Kluwer International Tax Blog

LoB Clauses, PPT Standard, and the Latin American Treaty Network Choices

Guillermo O. Teijeiro (Bomchil) · Friday, June 5th, 2015

Action 6 of the BEPS Action plan is aimed at (i) developing Model Treaty provisions and recommendations on the design of domestic tax rules to prevent the granting of treaty benefit in inappropriate circumstances, (ii) clarifying that tax treaties are not intended to be utilized to generate double non-taxation, and (iii) identifying tax policy considerations that countries should consider before deciding to sign a tax treaty with another country.

As a first response, the September 2014 Deliverable (Instrument) recommended that double tax conventions (DTCs) include in the Title and the Preamble a clear statement that DTCs are not aimed at creating opportunities for non-taxation or reduced taxation, including treaty shopping. It also recommended to include a general treaty anti-abuse rule (UK-style) to prevent arrangements one of the principal purposes is to obtain treaty benefits (principal purpose test or PPT), and a specific LoB provision patterned after the LoB provision contained in Article 22 of the US Model convention.

On November 21, 2014, the OECD released a Discussion Draft identifying 20 different issues to be addressed as part of the follow-up work on this Action, including specific questions and comments to the public; as a result of this invitation for comments, over 750 pages of public comments were received and a public consultation meeting was held on January 22, 2015. Later on, on meetings that took place on March 5-6, and March 11-13, 2015, the Working party 1 (WP1) addressed the great majority of the still open issues and discussed additional proposals related to some issues.

A Revised Discussion Draft (RDD) released on May 22, 2015, reflected the conclusions and proposal arrived at the WP1 March meetings, on which the CFA is now inviting comments; these will be discussed at WP1 meetings scheduled for June 22-26, 2015, at which time WP1 will be asked to produce a final version of the Report on Action 6.

Part 1 of The RDD presents the Alternative Simplified LoB rule and the Annex to the RDD the wording of the Entitlement to Benefits proposed clause, together with accompanying Commentaries to be included in the OECD MC.

It is worth mentioning that the footnote to the proposed article (as drafted in the Annex) gives signatories of a DTC the alternative to adopt (i) the detailed version of paragraphs 1 to 6 (LoB clause) together with the implementation of the anti-conduit mechanism described in the proposed Commentaries, (ii) paragraph 7, only (PPT), or (iii) PPT together with any variation of the LoB

clause (paragraph 1 to 6).

I do not envision that the options presented nor the text of the corresponding paragraphs may change significantly in the final document. In light of the foregoing, one may already speculate on the preferable alternative to the LATAM countries. What should they do? Should they be inclined to a LoB clause, or a PPT, or both? Should they dispense with any innovation and stay behind the BEPS trends in this area? Of course, these responses should be predicated on the basis of each country's past experiences and tax policy design concerning new treaties and treaty shopping.

Therefore, before responding these queries it is important to identify what countries in the region have been doing in this area thus far.

At glance, it is worth noting that some LATAM jurisdictions have relied heavily on the application of domestic general anti-abuse rules (GAAR) in treaty settings, particularly after the Copernican change in the Commentaries' approach towards their application to CDIs as from 2003 onwards.

GAAR are either applied to re-characterize income or redefine the beneficiary under a treaty umbrella, in both inbound and/or outbound (round trip) situations, i.e., when the jurisdiction is the source or the residence country. This group of countries lacks treaties with LoB provisions unless demanded by the treaty-partner country (e.g., the case of the treaties of Colombia, Panama, Brazil and Peru signed with Mexico, which with its widespread LoB policy is the notable exception to this rule in LATAM).

Mexico's extended treaty network include treaties with comprehensive LoB provisions (namely the treaties with Barbados, Colombia, china, UAE, USA, India, Israel, Kuwait, Panama, South Africa and Ukraine); treaties with more limited anti-abuse provisions (Austria, Bahrain, Brazil, Canada, Hungary, Lithuania, The Netherlands, Peru, Qatar, UK, Check Republic, Slovenia, Russia and Singapore); and treaties with an anti-abuse provision solely applicable to the interest and royalty clauses. Mexico's treaty policy concerning the inclusion of LoB clauses has been consistently applied long before the BEPS Action Plan was launched, and the September 2014 Deliverable on Action 6 delivered.

Among countries using or allowing the use of GAAR in a treaty setting are Argentina and Colombia, although in the latter case there are no cases decided yet (GAAR were introduced in 2012). Brazil, Chile, and Peru contemplated domestic GAAR but their application in a treaty setting is not expressly contemplated. GAAR in Peru and Chile are also quite new (2012 and 2014, respectively), while the business purpose test and substance over form criteria under the National Tax Code in Brazil is a rather recent development.

In recent years Argentina has resorted aggressively to GAAR, particularly in the case of round trip investments, regardless of an express treaty authorization. (1)

In the same sense, the Memorandum of Understanding (MOU) annexed to the new Tax Treaty with Spain, approved by Law 26,918, published on December 28, 2013, set forth two interrelated principles of application: (i) the DTC does not prevent applying domestic GAAR, and (ii) treaty benefits shall not be granted to a person who is not the beneficial owner of the income originated in the other contracting State or the items of wealth situated therein.

At first sight it would be sound for LATAM countries to prevent treaty shopping onward in accordance with its own legal tradition and, thus, countries applying so far domestic GAAR should

be inclined to apply the PPT which is precisely the corresponding treaty equivalent standard, while countries like Mexico should refine its treaty LoB in accordance with the texts finally approved under BEPS Action 6. A third group of countries, basically territorial jurisdictions with a very narrow treaty network could analyze, as a matter of tax policy, whether it is in their best interest including anti-treaty shopping rules of any type.

Notwithstanding the foregoing, and perhaps influenced by the BEPS mood and the Action Plan whose outcomes are being taken unconditionally and without reservation by individual countries in this region, as if they were the new and sole reveled truth in international taxation, it should be expected that, at least for the time being, new DTCs in the region adopt the most strictest version available of all possible choices. And as an illustration, article 24 of the new treaty between Chile and Argentina, signed in Santiago on May 15, last, contains the most detailed LoB provision available, combined with a PPT standard in its paragraph 6.

A final comment as regards inbound investments is concerned. So far, it has been usual for the global company to invest in the region through a holding company organized in an extra-zone country having treaties with the LATAM jurisdiction where operating subsidiaries are going to be established. These schemes have been allowed under GAAR as long as the holding company evidences economic as well as legal substance. Under the alternative LoB scrutiny the sole objective fact that the controlling shareholder be a resident of a third country would prevent the entity to benefit from the DTC, unless the shares are listed in a recognized stock exchange in the same country, which might not be the case. In my view, major efforts in LATAM should be concentrated in preventing the country’s own residents to abuse the treaty under round trip schemes, but at the same time avoiding to jeopardize genuine inbound FDI channeled through DTC regional holdings by adding unwarranted shackles coming from strict LoB provisions.

(1) Inbound investment: Ruling AFIP 57/94, re-characterization of insurance premium paid to foreign insurers under loan agreement as additional interest (higher borrowing cost), DTC with Spain and Italy; and DNI Memorandum 3/06, reallocation of income from DEG to participants under a participated loan agreement ruled by the DTC with Germany. Outbound investment: DNI Memorandum 64/09, use of an Austrian intermediary (shell) holding company without any economic substance; DNI Memorandum 799/10, double non-taxation obtained by using an interposed Chilean holding company (Chilean Platform regime) under a no longer in force Andean Pack-type treaty. Similarly, Tax Court, in re Molinos Rio de la Plata, August 14th, 2013, decision appealed and pending before the Federal Court of Claims.

---

intuitive research platform for Tax Professionals leveraging Wolters Kluwer's top international content and practical tools to provide answers. You can easily access the tool from every preferred location. Are you, as a Tax professional, ready for the future?

Learn how **Kluwer International Tax Law** can support you.

This entry was posted on Friday, June 5th, 2015 at 6:52 pm and is filed under BEPS, OECD, Tax Avoidance, Tax Planning, Tax Policy, Tax Treaties
You can follow any responses to this entry through the Comments (RSS) feed. You can skip to the end and leave a response. Pinging is currently not allowed.