EDITORIAL

Action 6. Hitting the Wrong Target

Among the few points of consensus reached within the Inclusive Framework on Base Erosion and Profit Shifting, Action 6 critically focuses on what is known as treaty abuse. Section A of its Final Report refers to a 'number of arrangements through which a person who is not a resident of a Contracting State, may attempt to obtain benefits that a tax treaty grants to a resident of that State'. It is a significant concern as it would allegedly undermine 'tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted'.[1] The main goal of Action 6 is to develop model provisions and anti-abuse measures to prevent what is considered to be the inappropriate granting of treaty benefits.[2]

Key recommendations include clarifying that 'tax treaties are not intended to be used to generate double non-taxation'[3] and implementing the limitation-on-benefits (LOB) and the principal purpose test (PPT) rules. The primary objective of the LOB rules and mainly of the PPT rules is to prevent residents of third states from establishing entities in one of the contracting states if one of their principal purposes is to benefit from the tax treaty between them as such practices would constitute treaty abuse. However, while treaty shopping is often associated with treaty abuse, the two concepts are not synonymous.[4] The former refers to tax planning strategies whereby taxpayers who are ineligible for specific treaty benefits restructure their business operations through interposed entities to access those benefits.[5] As Action 6 lacks a clear definition of abuse, it is necessary to examine the circumstances under which this purpose has been achieved if the concept of abuse entails exploiting treaty provisions beyond their intended purpose.

Consider a hypothetical scenario involving a US investor who has a direct investment in Brazil and notices that Brazil does not have a tax treaty with the United States. Under such circumstances, the investor transfers their shares in the Brazilian company to another entity of the group established in the Netherlands, which consequently allows using the tax treaty between the Netherlands and Brazil. When the countries signed a treaty in the early 1990s, both contracting states had clear purposes that did not include treaty shopping concerns. As a matter of fact, the Netherlands could already boast having one of the most expanded tax treaty networks that qualified it to be the ideal situs for MNEs to establish their headquarters. In this sense, a treaty with Brazil would be fully in accordance with the policy of attracting international investors to profit from that network. Brazil, on the other hand, was clearly a capital importing country aiming to benefit from international investments. In this sense, Brazil would be more than happy if an international investor would consider Brazil as a target for its investments. In summary, the Netherlands would invite international investors to establish themselves in that country and, from there, invest in third countries, including Brazil.

This being the case, it can hardly be stated that the hypothetical US investor would be engaging in abuse when it would accept the Dutch-Brazilian invitation to transfer its shares of the Brazilian company to its operation in the Netherlands and to invest in Brazil from that country. This is by no means abuse. This is a regular use of the treaty according to the intention of the contracting states.

In this context, the OECD recommending the inclusion of LOB and PPT clauses in the Brazil-Netherlands treaty could create a dangerous situation of confusion between legitimate treaty shopping and illegitimate tax treaty abuse under the pretense that both practices equally undermine the treaty's purpose. An interesting perspective is to consider the wording of the PPT, especially its final part:

Notes

1. OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, Action 6 – 2015 Final Report 13, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing 2015), http://dx.doi.org/10.1787/9789264241695-en (accessed 30 Oct. 2024), hereafter *Action 6 – 2015 Final Report.*
2. *Action 6 – 2015 Final Report*, at 9.
3. *Action 6 – 2015 Final Report*, at 9.
4. *See* L. E. Schoueri, *Planejamento Fiscal através de Acordos de Bitributação: Treaty Shopping,* at 22–24 (Revista dos Tribunais 1995); H. D. Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15(3) L. & Pol'y Int'l Bus. 766 (1983).
5. *See* L. E. Schoueri, *Planejamento fiscal através dos acordos de bitributação: Treaty Shopping*, at 2 (Revista dos Tribunais 1995).

> 7. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, *unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention*.

It could reasonably be argued that, given the circumstances under which Brazil and the Netherlands signed the treaty, attracting international investors would not contravene the treaty's object and purpose. This would certainly not be accepted by those who believe that the object of the treaty is to avoid double taxation suffered by residents of both contracting states. However, in spite of the OECD's efforts and some literature, there does not seem to be consensus on this; on the contrary, improving the flow of investments *by means* of the avoidance of double taxation is a better approach to a treaties' object and purpose. As already mentioned, this is especially true in the case of Brazil and the Netherlands.

Of course, the structure described above could be criticized for favouring tax planning. However, the Brazil-Netherlands treaty is not at fault. The whole problem is that the US investor can profit from the treaty between the United States and the Netherlands that makes the tax planning possible provided some substance is present (as would be the case if the investor already had operations in the Netherlands). If treaty shopping was to be restricted, an LOB or PPT clause in the treaty between Brazil and the Netherlands should not be included. It would be much more efficient if the United States would modify its treaty with the Netherlands and provide a restriction in treaty benefits in the event that the Netherlands is not the final destination of US investments irrespective of the presence of substance.

In summary, if it is believed that treaty shopping should be avoided, the first step should be to ask where the abuse is. The treaty between the residence state and the state of the intermediary person should be considered rather than the one between the latter and the source state.

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