The International Application and Development Prospect of the Principle Purpose Test Clause

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Abstract. Abuse of tax treaties by taxpayers through various means has become increasingly rampant, infringing on the tax base of each country. The OECD has formulated the PPT rule in order to protect global tax order. The main content of the rule is: a tax benefit shall not be granted if obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit. The PPT rule is favored by countries for its simplicity, and it gradually developed into one of the most important rules in the anti-abuse system. However, there are many problems in the current application of the rule. This paper begins with a description of the concept of the PPT rule and three points of contention, followed by an analysis of the application of the PPT rule in the domestic laws of four countries and the problems that exist globally. Finally, this paper puts forward three recommendations that are relevant to the future development of the PPT rule.

Keywords: Principle purpose test; Abuse of tax treaties; MLI.

1. Introduction

The globalization of commercial exchanges and capital movements reveal new ways of obtaining value in economic activities [1]. In response to the phenomenon of double taxation in international trade, many tax treaties have been established between countries. The original intention of tax treaties is to reduce double taxation by allocating tax jurisdictions, imposing only one tax on the same income. However, the various tax treaties have instead opened up the possibility of tax treaty abuse, which means that taxpayers enjoy tax benefits to which they are not entitled. They circumvent the restrictions in tax treaties, and reap huge economic benefits while eroding the tax base of signing countries. According to the statistics of the Organization for Economic Cooperation and Development (OECD), the total amount of global tax evasion or avoidance is about 100 to 400 billion dollars per year, greatly damaging the economic balance and tax order. In order to avoid the increasingly rampant tax base erosion problem, the Principal Purpose Test clause (PPT) have been created. In 2013, the OECD released the Base Erosion and Profit Shifting (BEPS) Action Plan, which consists of 15 action plan reports designed to address the issue of tax treaty abuse in a comprehensive and integrated manner, which included principle purpose test. The Multilateral Convention on the Implementation of Measures Related to Tax Agreements to Prevent Base Erosion and Profit Shifting (MLI), agreed in June 2017, proposes three options to discourage abuse of tax treaties, and principle purpose test is involved in each of them. As of April 2023, there are more than 2,000 bilateral tax treaties in which the principle purpose test is applied. It is also foreseeable that the test will be the dominant tool for regulating tax treaty abuses for a long time. In practice, however, the ambiguity of the description of the test have made the principle purpose test controversial. Therefore, it is necessary to analyze the constitutive elements and the existing problems of the PPT rule, in order to put forward suggestions for improving the application of PPT rule, so as to provide a reference basis for the relevant legislative work.

2. Overview on Principle Purpose Test Clause

2.1. Definition of PPT Clause in MLI

The MLI provides 3 types of measures for regulating abuse of treaties: the PPT Rule, the PPT Rule and a simplified version of the Limitation of Benefits Clause (LOB Rule), and an exhaustive version of the LOB Rule and measures to regulate specific conduit arrangements. Most signatories have opted for a separate PPT Rule. It can be seen that the PPT rule is universally applicable in the international context.

The PPT rule can be found in Article 7 of MLI: Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement 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 the Covered Tax Agreement [2].

Specifically, the article proposes a three-test rule to argue the legitimacy of the tax benefit. The logical sequence can be organized as follows: The first step is the result test: if a transaction an arrangement directly or indirectly produce a benefit under a tax treaty, it can be supervised by the PPT rule. The second step is the subjective test: if a tax benefit is one of the purposes of the transaction or arrangement, it will not be legitimate. The third step is the objective test, If a tax benefit failed on the subjective test, but it is consistent with the object and purpose of the treaty, then its legitimacy should be granted. Although the logic is clear, the application of this article is controversial due to its vague expression. The following paragraph will discuss the controversial points in each of the three steps.

2.2. Applicable Criteria for Application of the Principle Purpose Test

2.2.1. “Directly or indirectly”

In the result test, “directly or indirectly” describes whether the transaction is closely linked to the result of obtaining a tax benefit. If a taxpayer makes transactions and arrangements directly result in an abuse of a tax treaty, then this situation can certainly fall within the scope of the PPT rule. In practice, however, it is difficult to establish a direct link between a transaction and a tax benefit. Generally speaking, an indirect link in this context means that the transaction or arrangement does not directly result in a tax benefit, but it is a prerequisite for the tax benefit to arise. For example, if a tax treaty provides for a tax deduction for the repayment of a loan between certain businesses, the transfer of the loan to obtain this tax benefit is an indirect link between the means and the result. This indirect relationship often cannot be adjusted by the conventional anti-abuse rules, so the "indirect" in the PPT rule is particularly important. In addition, due to the strict tax regulation, taxable entities often do not take too obvious and direct means, which makes indirect tax treaty abuse a more common way of tax avoidance in practice and relatively difficult to regulate. Therefore, Article 8 of Action Plan 6 of BEPS stipulates that "directly or indirectly generating the benefit" should be broadly understood to include the case where the applicant applies for a tax treaty benefit based on a trade (but not for a transaction which main purpose is to obtain the treaty benefit).

2.2.2. “One of the principle purposes”

According to the MLI, the subjective test requires that obtaining the tax benefit is "one of the principle purposes" of the transaction or arrangement, and the main controversy of the PPT rule lies in the phrase "one of". Many scholars believe that the "one of" here is redundant, that is, obtaining tax benefits must be the main purpose of the taxpayer's transaction or arrangement. The former expression means that the transaction or arrangement which has two or more equally important purposes would fail the subjective test. The latter requires the tax benefit to be the predominant consideration, otherwise it would pass the test. For example, a taxpayer sells its real estate. Before

the sale, he became a resident of a tax treaty country, and one of the principle purposes of the act was to benefit from the the tax treaty. In such a case, the change of his domicile has other purposes, such as to facilitate the sale of the property. Such conduct can only be regulated by the PPT rule if the provision is understood to be "one of the principal purposes" [3].

There are advantages and disadvantages to both views. Those who support the deletion of "one of" from the PPT rule argue that taxation is a crucial part of the business activities of various taxpayers, such as multinational corporations, and that it is impossible to require individual taxpayers to completely disregard the impact of taxation in their transactions, while "one of the main purposes" requires the taxpayer to consider only the business interest itself and exclude tax considerations altogether. This may lead to taxpayers abandoning transactions for fear of failing the subjective test, indirectly affecting market dynamics. This defeats the original purpose of establishing the PPT rule to improve the market environment.

However, there are reasons why the MLI clearly includes the phrase "one of" in the treaty. First, the PPT rule is a general anti-abuse provision that applies to cases where special anti-abuse provisions cannot be applied. In other words, most of the cases with distinctive features can be solved by special provisions, and the PPT rule plays a bottoming role. The phrase "one of" can make the PPT rule more universal and can more effectively regulate the increasing abuse of tax agreements. In addition, to address the problem of overbreadth, Article 7 also introduces the objective rule, leaving open the possibility of excluding the application of the subjective test in most cases.

2.2.3. "In accordance with the object and purpose"

The objective test is the taxpayer's remedy in the PPT rule, which means a case that does not pass the subjective test could still pass the PPT test if it is consistent with the object and purpose of the treaty. In practice, there is a lot of controversy about how to determine whether the act of obtaining tax benefits is consistent with the treaty. Article VI of the MLI includes that: "The purpose is to eliminate double taxation with respect to the taxes to which this Agreement applies, while preventing non-taxation or under-taxation resulting from tax evasion [2]." However, this article is vague and covers an overly broad scope, which in turn makes the first two tests meaningless in many cases. Therefore, its interpretation should be carefully analyzed in terms of the context and the individual clauses used to illustrate the purpose of the agreement, in order to achieve a balance between the objective test and the first two tests.

2.3. Comparison between PPT Clause and Special Anti-abuse Regulations

The MLI stipulates more than just the PPT rule. Other relatively important provisions are the LOB provision and the beneficial owner system. These concepts overlap to some extent and the following paragraphs describe the differences between the PPT rule and these important concepts.

2.3.1. Comparison with LOB

The LOB test is short for limitation on Benefits test. It consists of a series of tests aimed at identifying whether the taxpayer has a genuine and close relationship with the contracting state, otherwise the relevant tax benefit is deemed to be an abuse of the tax treaty. Specifically, the LOB rules create certain conditions for the taxpayer to meet in order to qualify as a legitimate taxpayer [4]. As for the relationship between LOB rule and PPT rule, LOB rule is a special provision and PPT rule is a general rule. The PPT rule represent the minimum standard of the MLI, and it can solve any cases that can or cannot be solved by the LOB rules. Its scope of application is much broader than that of the LOB rule.

2.3.2. Comparison with the beneficial owner system

The concept of beneficial owner system is that if a beneficiary of interest and dividends has a contractual or legal obligation to transfer this money to a third party, then this beneficiary cannot be recognized as a beneficial owner and cannot enjoy the tax benefits. Generally speaking, the beneficial owner system is also a special provision, which is related to the PPT rule in a special and general way.

However, different countries have different regulations on the beneficial owner system, and in practice, it is common to apply the PPT rule directly without applying the beneficial owner rules. For example, most countries adopt the PPT rule to solve the cases of conduit arrangement [5].

3. Current Situation and Problems in Applications of PPT Rule

3.1. China

3.1.1. Domestic legislation on the principle purpose test

Currently, there are no specific legislative provisions for PPT rule in China. However, many existing legal documents contain legal provisions that are similar to the purpose of the PPT rule, such as the "substance over form" standard in the Individual Income Tax Law of the People's Republic of China. The closest provision to the PPT rule is the principle of “reasonable business purpose” as stipulated in the Enterprise Income Tax Law of the People's Republic of China. It is stipulated that if a taxpayer's business arrangement is "for the purpose of reducing, exempting or delaying the payment of tax", then it is not a business purpose recognized by laws and regulations, but belongs to the category of tax avoidance. In 2010, the Implementation Measures of Special Tax Adjustment were issued, which stipulate that if an enterprise obtains tax benefits by implementing business transactions without reasonable commercial purposes other than specific anti-avoidance acts, the tax authorities shall review and assess the act. It responds to the specific problems of enterprises and residents in applying the reasonable commercial purpose rule in a more detailed manner. However, the legislative provisions are vague and the judicial interpretations are unclear, resulting in a lack of theoretical support for the application of the reasonable business purpose. It also leads to confusion from administrative subjects in interpreting the boundaries of this principle. However, the purpose of the PPT rule is more or less reflected in the relevant laws, which provides some theoretical basis for the localization of PPT rule in the future.

At present, Chinese laws and regulations related to PPT are also general anti-abuse provisions, which may conflict with PPT rule in international trade. According to the international practice, this situation should be regulated by applying the PPT rule as a priority. In addition, because the PPT rule is too simple, more specific domestic laws can be applied in many cases, which makes the PPT rule the bottom rule of China's anti-abuse rules. In addition, the interpretation and implementation of the PPT rule are more perfect at the international level, and the relevant provisions in China can also use these practices as reference, so that the two can be consistent in dealing with specific cases.

3.1.2. Application of the principle purpose test in China’s tax treaties

As of April 2023, China has signed bilateral agreements for the avoidance of double taxation with 107 countries or regions around the world, and 100 of them are in force. 24 bilateral tax treaties contain anti-abuse provisions, and there are six treaties that explicitly address the PPT rule, namely those signed by China with Argentina, Chile, Congo, Kenya, France and the Czech Republic.

The specific elaboration of the PPT rule also differs among these treaties, such as the treaty signed by China and France in which the objective test is a constitutive element rather than an exclusion element, and the treaty signed by China and Czech Republic in which there is no objective test but only the subjective will of the taxpayer is judged. The other treaties are basically in line with what is stipulated in the MLI.

3.2. Other Countries

3.2.1. The U.S.

The U.S. does not specifically stipulate PPT rule in its domestic law, but rather uses the LOB rules as the primary means of anti-abuse. This is because the LOB rules were first born and developed in the United States and its domestic anti-avoidance system is more mature and complex compared to the provisions in the MLI. Specifically, the U.S. legislator concealed the PPT rule in the discretionary provisions of the LOB rules in the 2006 US model tax treaty: “If a resident of a contracting state fails

any objective test under the terms of the LOB, but is satisfied that the taxpayer's relevant transaction or arrangement was not entered into primarily for the purpose of obtaining an agreement benefit, the taxpayer may also be granted an agreement benefit [6].”

3.2.2. European union

Almost all countries in the EU apply the PPT rile and their legislation has made some modifications. Since the EU is a large free trade area among countries, emphasizing the mobility of cross-border trade and low tax rates, the needs of economic trade among members are much higher than those of ordinary countries and regions [7]. However, the PPT rule under OCED is too broad in its application and is likely to undermine free trade to a certain extent. Therefore, the EU amended the original rule from "one of the main purposes" to "the main purpose or one of the main purposes", so that the judiciary can choose how to apply it in specific cases. In addition, the EU also introduced the economic materiality test, which emphasizes the authenticity of commercial activities. These changes enhance the flexibility of the rules and facilitate the free movement of capital in the EU.

3.2.3. Australia

Australia has one of the most comprehensive domestic anti-avoidance legislation in the world, and many of its domestic laws relating to personal and corporate income taxation have similar standards of judgment to the PPT rule, and its legal system have developed many specific anti-abuse rules [8]. Even so, Australia was one of the first parties to the MLI and has actively adopted the PPT rule under the OECD in its bilateral tax treaties, which reflects the superiority of this rule. In addition, the Australian legislator also considers the standard of "one of the principle purposes" to be more stringent and often uses “principle purpose" in judicial practice.

3.3. Current Problems in Implementing PPT Clause

3.3.1. Inconsistent application of the PPT rule

Although a total of 100 countries or territories are currently signatories to the MLI, bilateral tax treaties using the PPT rule still represent only a small percentage of all treaties. Moreover, most of these agreements have either abridged or modified the PPT rule or made it applicable only to certain circumstances [9]. For example, the bilateral tax treaty between Russia and China explicitly stipulates that the PPT rules can only apply to treaties on dividends and interest, and the treaty does not include a subjective test in the PPT rule. Such cases abound. While most countries can agree on the broad rules of the PPT, they often disagree on many of the controversial points in the rules. This may lead countries to be more cautious in applying the PPT rule, thus resulting in the PPT rule losing its meaning as a general rule.

3.3.2. Imperfection in the standard of proof

The standard of proof under the PPT rule is the minimum standard by which tax authorities should measure whether a tax benefit is an abuse before the subjective test is applied. The PPT does not specify its standard of proof, so countries have established different standards in their domestic law, which leads to the possibility of reaching completely different conclusions in the same case. Only the word "reasonable" is used to describe how the tax authorities determine whether a tax benefit is likely to abuse a tax treaty. This description is so vague that the extremely low threshold of proof may render the tax authority's burden of proof meaningless.

In addition, if the tax authorities readily presume an abuse of the agreement, the taxpayer will then bear the burden of proof of the objective test, proving that he or she acted in accordance with the object and purpose of the treaty. However, there is no authoritative standard of proof for the objective test, and the taxpayers' knowledge on taxation is quite uneven. It is much more difficult for the taxpayers to meet the burden of proof for the "object and purpose" test than for the tax authorities. Most of the countries have not issued targeted guidance documents on this issue. In practice, they can only use the vague PPT rule and domestic jurisprudence as reference, which has greatly reduced the fairness of the PPT rule.

3.3.3. Absence of normative documents in domestic law

Most countries in the world have not established a complete system of anti-abuse rules in the area of domestic law, or do not have specific anti-abuse provisions, but only provide some general anti-abuse rules in the relevant commercial regulations.

For domestic jurisdictions, the absence of a relevant supporting system can make it difficult for countries to actually apply the PPT rule in practice. The MLI only provides for the conditions of application, exclusions, burden of proof of the PPT clause, but does not include specific provisions on how to implement it. As for the judgment criteria, relevant consequences, procedural deadlines and operational steps of the PPT clause, there are massive gaps in the legislation of each country [10]. As a result, the judicial authorities of each country rarely actually use the clause to protect the tax base of each country. Even if the PPT rule is used, the lack of normative documents will lead to different standards and different judgments in the same case.

For bilateral treaties, the general anti-abuse rules in domestic law should be closely related to the PPT rule in tax treaties, and the contracting parties should use their respective domestic laws as the basis of interpretation for the parts that are not specified in the tax treaties, so as to help protect their own interests. However, the current legislative measures of domestic laws around the world are far from perfect, and the general anti-abuse rules are not close to the actual situation. The provisions are rather abstract. This leads to both contracting parties being prone to tax disputes arising from the imbalance of domestic laws and having no appropriate legal basis to defend their own national rights and interests.

3.3.4. Lack of coordination between LOB clause and PPT clause

In many cases, as another anti-abuse tool, the LOB rule is more flexible and precise than the PPT rule. Therefore, many countries would choose to use the LOB rule in combination with the PPT rule when signing tax treaties. However, how to solve the coordination problem between the PPT rule and the LOB rule needs further clarification. The U.S. practice of integrating the PPT rule in the LOB rule can be a possible way to deal with the issue for countries to learn from. In addition, the attitude of countries facing the LOB rule varies greatly. Some countries such as China think that the LOB rule is difficult to operate. It has small scope of application and is not general. However, countries such as the U.S. believe that the LOB rule is objective and has a strong certainty, and their domestic laws and bilateral tax treaties contain a large number of provisions on the LOB rule. This may lead to increasing confusion in resolving the coordination problem between two rules.

4. Suggestions on Improving PPT Clauses

4.1. Expand the Global Application of the PPT Test

It is advised that countries should expand the application of the PPT rule when signing future treaties. Although, with the signing of MLI, some bilateral agreements will be updated to PPT provision, there are still many non-signatory countries whose international trade is not regulated by the PPT rule. It is recommended that countries make the PPT rule default when entering into tax treaties to reduce the lack of control over abuses. In addition to this, countries around the world should still continue to adhere to the PPT rule on the basis of present treaties. If they all choose to give priority to the application of domestic anti-abuse provisions, conflicts will arise due to the difference in specific provisions between domestic laws and the PPT rule, resulting in confusion in the global anti-abuse system. The PPT is an authoritative rule worldwide and it is the easiest way for countries to align with international anti-abuse [11].

4.2. Improve the Allocation of the Burden of Proof

In order to solve the problem of unclear allocation of the burden of proof under the PPT rule, the tax authorities should bear the entire burden of proof and give taxpayers the right to disprove. When the tax authorities believe that the taxpayer is suspected of abusing the tax agreement, they should

adhere to the principle of "the one who claims should prove". Also, it is suggested to strengthen the difficulty of the tax authorities in proving the cause of abuse. If the taxpayer disagrees, he/she should be allowed to testify against the evidence presented by the tax authorities. If it is determined that there is no abuse by the taxpayer after the evidence is presented by both parties, the tax benefit should be considered as legal [12]. In addition, countries should stipulate the taxpayer's duty to assist in the investigation, in order to reduce the cost of the investigation and improve the efficiency of the litigation. Most importantly, countries should explicitly provide an authoritative standard of proof in domestic law, which should not exist only within the tax authorities, but should be made public and transparent. This will facilitate the balance between taxpayers and tax authorities and help the application of PPT rule.

4.3. Issue of Domestic Normative Documents to Clarify the Application of the PPT

For concepts that are not clear in tax treaties, countries can interpret them with the help domestic law, in order to protect their own benefits. So it is essential to establish a domestic anti-abuse system. In addition, since countries have different situations and different legal systems, they need their own domestic legislation to interpret the PPT rule and solve specific problems,such as whether the PPT rule should be interpreted as "principle purpose" or "one of the principle purposes", and how to adjust the relationship between PPT rule and other anti-abuse rules and other issues [13]. In addition, it is recommended to establish a case guidance system since the same type of tax abuse may have different manifestations due to the variability of tax cases, which makes it difficult for government departments to distinguish. Therefore, the establishment of the relevant guidance case system can provide the theoretical basis for the legislation.

5. Summary

The main controversial points of the PPT rule are "directly and indirectly", "one of the principle purposes" and "object and purpose". This paper compares different views and proposes and gives explanation that is more appropriate for the implementation of the PPT rule. As for the relationship between the PPT rule and other anti-abuse rules, the PPT rule is an underlying clause. Since countries have different ways in implementing the PPT rule, this paper compares its specific rules and advantages and disadvantages, and identifies some problems of the PPT rule worldwide. These problems mainly include inconsistent application of PPT rule, imperfection in the standard of proof, absence of normative documents in domestic law and lack of coordination between the LOB rule and the PPT clause. It is suggested that these problems could be solved by expanding the global application of the PPT rule and improve the allocation of the burden of proof. On top of this, issuance of domestic normative documents could also help address the problem, making the anti-abuse of global tax treaties more certain and scientific.

In conclusion, the PPT rule, as an important rule against abuse of tax treaties, has been accepted and adopted by more and more countries. It is hoped that countries can reach further cooperation on the basis of the PPT rule in the future to protect their tax bases and promote economic prosperity.

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