

Tax e-Alert

4 APRIL 2019

BEPS Action 6 — Treaty Shopping And Principal Purpose Test

Malaysia has officially joined the OECD¹ Inclusive Framework (IF) on BEPS² as an associate member despite not being an OECD member. Malaysia signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (**MLI Convention**, also known as the Multilateral Instrument) on 24 January 2018, more than a year ago, but has only recently begun the ratification process.

The signing of the MLI Convention has been commended as a “major step towards updating the international tax rules through the swift implementation of the BEPS package”.³

MLI Convention And BEPS

The MLI Convention is an agreement negotiated to facilitate the fight against BEPS by implementing tax treaty related measures on existing Malaysian tax treaties without renegotiating them. The key question for Malaysian businesses and multinational corporations (**MNCs**) concerns the measures that are being implemented in Malaysia.

Essentially, BEPS involves tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low- or no-tax locations where there is little or no economic activity. Such tax planning strategies may be considered as tax mitigation, and not tax avoidance or tax evasion. It has been established by the Court of Appeal in *Sabah Berjaya Sdn Bhd v Ketua Pengarah Jabatan Hasil Dalam Negeri* (2000) MSTC 3771 that taxpayers are free to mitigate their tax liability and that it is not an offence.

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¹ Organisation for Economic Co-operation and Development

² Base Erosion and Profit Shifting

³ OECD, “Major step forward in international tax co-operation as additional countries sign landmark agreement to strengthen tax treaties” (OECD, 24 January 2018) <<http://www.oecd.org/countries/malaysia/major-step-forward-in-international-tax-cooperation-as-additional-countries-sign-landmark-agreement-to-strengthen-tax-treaties.htm>> (accessed 28 March 2019)

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The BEPS Project was commenced to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment. The result of the BEPS Project is the development of 15 measures to counter the issues, known as the 15 Actions. Under the IF that Malaysia is an associate member of, there are four minimum standards out of the 15 Actions that must be adhered to, which are:

- Action 5: Countering Harmful Tax Practices (The Impacts of BEPS 5 on MSC Companies in Malaysia has been discussed in an earlier Tax e-Alert dated 16.11.2018. Click [here](#).)
- Action 6: Preventing Treaty Abuse
- Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting
- Action 14: Making Dispute Resolution Mechanisms More Effective

BEPS Action 6

Business practices such as treaty shopping, splitting up of contracts, hiring out of labour and engaging in dividend transfer transactions are today regarded as treaty abuse practices and BEPS Action 6 largely deals with this. Treaty shopping, which is regarded as a popular tax avoidance manoeuvre, is the practice of structuring an MNC to take advantage of more favourable tax treaties available in other jurisdictions by establishing an operation in a source country which have a favourable tax treaty with the source country where it receives its income from. It essentially encompasses the practice of setting up “post box” or “shell corporations” in the other source country which has treaty benefits with the income deriving source country. Such practice is not illegal or considered as “tax evasion” *per se* as it is legal.⁴

Nevertheless, BEPS Action 6 is aimed at providing an additional level of protection against treaty shopping where another test must be met before the treaty benefit is granted. BEPS Action 6 provides the following:

“Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty

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⁴ United Nations, “Treaty Abuse and Treaty Shopping” (21-24 UN Doc E/C.18/2006/2, 2006)

benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids.”⁵

Reading the above, it is clear that tax treaties under the MLI must include an anti-abuse rule to prevent treaty benefits from being granted in situations when they are unintended to be granted.⁶ The approaches that may be implemented to curb such treaty abuses are by way of adopting:

- A Principal Purpose Test (**PPT**);
- A PPT and either a simplified or detailed limitation-on-benefits (**LOB**) provisions;
- A detailed LOB provision supplemented by an anti-conduit rule.

Principal Purpose Test

Of the three approaches, Malaysia has adopted the first. The test under the PPT is that treaty benefits are to be denied “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”.⁷

This test should be interpreted broadly as otherwise, many genuine arrangements or transactions may be captured under the PPT. The reference to “one of the principal purposes” also reinforces that the intention of taking advantage of the treaty benefits need not be the sole or dominant purpose, but one of

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⁵ OECD, “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report” (OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015) <<http://dx.doi.org/10.1787/9789264241695-en>> (accessed 28 March 2019)

⁶ Jasper Korving and Loes van Hulsten, “MLI: Testing the ‘principal purpose’” (2018) International Tax Review <<https://www.internationaltaxreview.com/Article/3848991/MLI-Testing-the-principal-purpose.html?ArticleId=3848991>> (accessed 28 March 2019)

⁷ *Supra* n 4

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many principal purposes is sufficient to satisfy the test. Hence, it is imperative to undertake an objective analysis of the aims and objectives of the company involved in that transaction or arrangement.

Despite the broad test, there is an exception, which is that if it were the intention of the provision of the Convention that such treaty benefits be provided under the arrangement or transactions, these should then be granted. It is worth noting that in respect of the treaty benefits that may be exploited or abused here, Malaysia is to introduce a statement of intent that the Double Taxation Avoidance Agreement is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.

Recent Developments

Malaysia began the ratification of the MLI Convention by implementing several enabling provisions containing the PPT approach under the Income Tax Act 1967 (**ITA**) and the Labuan Business Activity Tax Act 1990 (**LBATA**). The examples are:

- Section 132(1A) of the ITA⁸ on Double Taxation Arrangements:

“For the purposes of this section, arrangements made with a view to affording relief from double taxation include any arrangements which modify the effect of arrangements so made.”

- Section 132B(1A) of the ITA⁹ on Mutual Administrative Assistance Arrangement:

“Where any arrangements have effect by virtue of this section, section 138 shall not prevent the disclosure to a duly authorized servant or agent of the government with which the arrangements have been made of such information as is required to be disclosed under the arrangements.”

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⁸ Income Tax Act 1967, Section 132(1A)

⁹ *Ibid*, Section 132B(1A)

- Section 132C of the ITA¹⁰ on International Obligations:

“(1) Notwithstanding section 132, 132A or 132B, if the Minister by statutory order declares that

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- (a) arrangements specified in the order have been made by the Government to give effect to Malaysia's international obligations in relation to tax under this Act or other taxes of every kind under any written law; and
 - (b) it is expedient that those arrangements should have effect, then, so long as the order remains in force, notwithstanding anything in any written law, those arrangements shall have effect in relation to tax under this Act or other taxes of every kind under written law.
- (2) Where any arrangements have effect by virtue of this section, section 138 shall not prevent the disclosure to a duly authorized servant or agent of the government with which the arrangements have been made of such information as is required to be disclosed under the arrangements.
- (3) Any order made under this section shall be laid before the Dewan Rakyat.”

- Section 21(1)(b) of the LBATA¹¹ on the Power of Minister to Make Regulations:

“(1) The Minister may make regulations —

- (a) ...
- (b) for the purpose of implementing or facilitating the operation of an arrangement

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¹⁰

Ibid, Section 132C

¹¹

Labuan Business Activity Tax Act 1990, section 21(1)(b)

having effect under section 132, 132A, 132B or 132C of the Income Tax Act 1967.”

Conclusion

Malaysia appears committed to honouring its obligations under the MLI Convention as indicated by its introduction of the enabling provisions highlighted above. Accordingly, it is imperative that taxpayers, especially MNCs in Malaysia, take note of the jurisdictions that have ratified the MLI Convention and, consequently, amend their tax treaties with Malaysia. Taxpayers should consider a BEPS-compliant structure in developing new business models and ensure that their existing business structure, including the distribution of profits out of Malaysia, is consistent with the spirit of the MLI Convention.

If you have any queries in relation to the above or require assistance in matters pertaining to international taxation, please contact our tax partners **Datuk D P Naban** or **S Saravana Kumar** at tax@lh-ag.com

**Published by the Tax, SST & Customs Practice,
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