

The Principal Purpose Test as Introduced by the OECD MLI: Is It Time for a Compromise with EU Tax Law?

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The OECD Multilateral Instrument (MLI) introduced the principal purpose test (PPT) as a considerable step forward in counteracting treaty abuse. This article analyses the PPT rule in light of the possible restriction of EU freedoms. The first part analyses the wording, structure, rationale and effect of the PPT rule. Particular attention is paid to the reasonableness test and to the circumstance that the PPT rule introduced by the OECD MLI does not literally incorporate a reference to the genuine activity and the business purpose and, as such, seems to lower the threshold of abuse compared to the EU Court of Justice (ECJ) standard.

Subsequently, compatibility with EU law is explored via the three-step process as developed under settled case law of the ECJ. An interim conclusion is reached concerning the risk of incompatibility of the PPT rule with EU law. Next, an interpretative effort is made on the basis of a systematic interpretation (1) of the Commentary on the OECD Model (2017) and (2) of recent ECJ case law in order to show that PPT rule may be reconciled with the ECJ standard of abuse and a compromise may be achieved. Finally, the achieved compromise is briefly exemplified having regard to an 'equity wall' structure in order to illustrate a fact pattern (different from the clear-cut examples given by the OECD Commentary) that might fall within the scope of the PPT for tax treaty purposes.

I INTRODUCTION

Article 7 of the Multilateral Instrument of the OECD (OECD MLI)¹ introduced a principal purpose test (PPT) to counteract the abuse of income tax treaties (tax treaties). The PPT applies when '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'. Accordingly, the PPT contains two kinds of tests: first, a reasonableness test concerning the scope of the arrangement(s) or transaction(s) put in place by the taxpayer. Second, a 'one of the principal purposes' test under which the tax authorities would be allowed to deny the tax benefit if the latter were one (literally, not the only one!) of the purposes of the arrangement(s) or transaction(s).

Right from its introduction, doubts were raised about the compatibility of the PPT with the principles of EU law and the settled case law of the EU Court of Justice (ECJ). Literally, the PPT rule does not mention the non-artificiality (the genuineness) of the arrangement(s) or transaction(s) that is the parameter identified by the ECJ as appropriate to justify an anti-abuse measure. Consequently, it has been argued that the PPT rule introduced a lower threshold of abuse that is not in line with the ECJ position.²

Furthermore, the broader meaning of the reasonableness test ('if it is reasonable to conclude') was criticized in terms of compatibility with the EU principles of proportionality and legal certainty. According to authoritative scholars,³ in principle the application of the reasonableness test jointly with the 'one of the principal purposes' test would risk ending up with tax authorities having the power to disregard tax structures that – even if they incorporated a tax

Notes

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¹ OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (OECD Publishing 24 Nov. 2016). For an overview, see Y. Brauner, *McBEPS: The MLI – The First Multilateral Tax Treaty that Has Never Been*, 46 *Intertax* 6–17 (2018).

² For example, R. J. Danon, *Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups*, 72(1) *Bull. Int'l Tax'n* 31, 46 (2017); E. Pinetz, *Final Report on Action 6 of the OECD/G20 Base Erosion and Profit Shifting Initiative: Prevention of Treaty Abuse*, 70(1/2) *Bull. Int'l Tax'n* 113, 118 (2016); A. P. Dourado, *Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6*, 43(1) *Intertax* 42–57 (2015).

³ D. Weber, *The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) Versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law*, 10(1) *Erasmus L. Rev.* 48–59 (2017); P. Baker QC, *The BEPS Action Plan in the Light of EU Law: Treaty Abuse*, 3 *Brit. Tax Rev.* 408–16 (2015); L. De Broe & J. Luts, *BEPS Action 6: Tax Treaty Abuse*, 43(2) *Intertax* 122–46 (2015).