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How LATAM's Principal Purpose Tests Impact Holding Companies

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The adoption of anti-treaty shopping measures like the PPT in Latin American jurisdictions complicates the analysis of whether treaty benefits will continue to be available for holding companies, and the scope of protection for a grandfathered holding structure remains unclear, say KPMG practitioners.

As the implementation of the BEPS 2.0 GloBE provisions continues to progress this year, many Inclusive Framework members are also continuing to advance the minimum standards from BEPS 1.0. Among these standards is the adoption of anti-treaty shopping measures, such as the principal purpose test (PPT) or limitation on benefits (LOB) provisions in bilateral income tax treaties (OECD (2019), *Model Tax Convention on Income and on Capital 2017 (Full Version)*, Article 29, OECD Publishing, Paris). With the increasing adoption and enforcement of these tax treaty-related measures, testing the availability of

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treaty benefits for holding companies will become more complex. In particular, the PPT allows a Contracting State to deny treaty benefits if one of the main purposes of an arrangement or transaction is to obtain those benefits in a manner inconsistent with the treaty's objectives. This article examines the implications for taxpayers operating through holding companies in certain Latin American jurisdictions considering the PPT provisions.

The Principal Purpose Test and Its Implications

The PPT is a general anti-abuse rule that applies to all tax treaties covered by the OECD's Multilateral Instrument (MLI), unless a specific reservation or exception is made by a contracting state (OECD (2015), *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). The PPT is intended to prevent treaty shopping, which is the practice of using a third country entity to access the benefits of a tax treaty that would otherwise be unavailable. Each arrangement or transaction requires a case-by-case analysis, considering relevant treaty provisions, applicable domestic laws, and the economic and legal consequences. The PPT does not have a de minimis threshold, meaning any purpose of obtaining a treaty benefit, no matter how small, could trigger its application if it is one of the principal purposes for the arrangement.

The PPT could have significant impact for holding companies that have investments in Latin America, as many as eight out of the 18 countries in the region have adopted the PPT (The following jurisdictions have adopted a PPT provision: Argentina, Brazil, Chile, Costa Rica, Mexico, Panama, Peru and Uruguay).Holding companies that rely on tax treaties to reduce or eliminate withholding taxes on investment income or capital gains from their Latin American subsidiaries could face challenges from source country tax authorities. These tax administrations could deny the treaty benefits if they consider that one of the principal purposes of the holding company structure is to obtain the treaty benefits, which may be interpreted by administrations as an analysis of whether the company or structure lacks sufficient economic substance or business purpose in its country of residence. The holding company would have to demonstrate that its presence and activities in its country of residence are not merely incidental to the treaty benefit, and that there are other valid commercial or financial reasons for the holding structure.

Further, while the United States has not adopted a general PPT provision in its treaties to prevent treaty shopping, US multinationals may still be impacted indirectly through their non-US Holding Company structures.US multinationals should consider the potential impact of the MLI if they are relying (or plan to rely) on the benefits of an indirect network of treaties, where benefits were previously granted but could now come under more scrutiny by source country tax administrations.The denial of benefits could lead to an increase of the US multinational's worldwide tax liabilities, increasing its effective tax rate.

The following country-specific surveys provide background information about the introduction of the PPT provisions in select Latin American jurisdictions:

Brazil

Has the jurisdiction adopted the PPT?

Yes, Brazil has a PPT provision in six of its in-force treaties.

Does the jurisdiction intend to apply the PPT consistent with OECD Commentary on the PPT provision?
Yes, for the specific treaties contemplating the PPT rule.

Will the PPT be applied retroactively or only prospectively?
Only prospectively.

Is the application of the PPT limited by any domestic statute of limitations for the tax administration to raise a challenge?
Yes, the general statute of limitations under Brazil law is five years and would apply to PPT application.

Is the application of the PPT or domestic general anti-avoidance rule (GAAR) subject to Mutual Agreement Procedure (MAP) in your country?
Yes, there is the possibility of MAP depending on specific treaty provisions which contain the PPT.

Is there any information reporting required by domestic or foreign entities that would allow your tax administration to identify transactions/entities potentially at risk for the PPT?
Taxpayers in Brazil must file several returns with the tax authorities throughout the calendar year, which contain details on the operations, accounting records, tax incentives, and tax payments, among other information. Hence, tax authorities may identify such arrangements from the local tax returns. Nonetheless, there is no specific return relating to treaty benefits or arrangements.

<u>Chile</u>
Has the jurisdiction adopted the PPT?
Yes, Chile has a PPT provision in 29 of its 37 in-force treaties.

Does the jurisdiction intend to apply the PPT consistent with OECD Commentary on the PPT provision?
Yes.

Will the PPT be applied retroactively or only prospectively?
Only prospectively.

Is the application of the PPT limited by any domestic statute of limitations for the tax administration to raise a challenge?
Yes. General rules apply. The statute of limitations for a tax audit is three years from the date of expiration of the legal deadline within which the payment of the tax should have been made. However, it can be extended to six years if no tax return was filed or if the tax return was maliciously false.

Is the application of the PPT or domestic GAAR subject to MAP in your country?
Yes, there is the possibility of MAP, as was recognized by the Chilean Tax Authority on MAP Regulations.

Is there any information reporting required by domestic or foreign entities that would allow your tax administration to identify transactions/entities potentially at risk for the PPT?
Yes. Affidavit No. 1946 must be submitted yearly by Chilean residents who carry out transactions with non-residents. Business profits not subject to taxation in Chile by the application of a treaty shall be declared separately.

Costa Rica

Has the jurisdiction adopted the PPT?
Yes, Costa Rica has a PPT provision in two of its in-force treaties.

Does the jurisdiction intend to apply the PPT consistent with OECD Commentary on the PPT provision?
Yes, Costa Rica intends to apply the PPT in a manner consistent with OECD Commentary.

Will the PPT be applied retroactively or only prospectively?
Unclear. Costa Rica has limited experience with the application of international taxation, and there are no judicial precedents regarding the PPT or MLI-modified double tax treaties (DTTs). According to the Political Constitution of Costa Rica, laws are generally not applied retroactively unless they are favorable to acquired rights. Since international treaties are ratified by Parliament and have superior legal status, it is likely that the PPT and any modifications to DTTs through the MLI or future bilateral agreements would be applied prospectively. However, local GAAR may still be invoked to challenge treaty benefits in cases of abuse.

Costa Rica introduced a GAAR in Article 12 bis of the Tax Code in 2019. The GAAR closely resembles the Centro Interamericano de Administraciones Tributarias (CIAT) Model Tax Code and addresses transactions that are artificial or improper to achieve tax benefits. The Tax Authorities must demonstrate that the taxpayer's actions were artificial or improper to apply the GAAR.
Although both the GAAR and the PPT are designed to counter tax avoidance, the PPT's broader scope and subjective nature may result in a more extensive application compared to the GAAR. The PPT operates on the premise that if obtaining a tax benefit is one of the principal purposes of a transaction, the Tax Authorities can challenge or deny treaty benefits. This is a broader test than the GAAR, which requires proof of artificial or improper acts by the taxpayer.

Is the application of the PPT or domestic GAAR subject to MAP in your country?
Yes, due to the potential application of these rules, it could generate double taxation not in accordance with double taxation agreements.

Is the application of the PPT limited by any domestic statute of limitations for the tax administration to raise a challenge?
Yes, the statute of limitations for tax challenges is generally four years. This period can be extended to 10 years for taxpayers not registered with the tax administration, or for those who have submitted fraudulent tax returns or failed to file.

Is there any information reporting required by domestic or foreign entities that would allow your tax administration to identify transactions/entities potentially at risk for the PPT?
Yes, Costa Rica requires all corporations to file an annual ultimate beneficial ownership tax form with the central bank. Local regulations provide mechanisms for the Tax Authorities to access this information. Additionally, there has been recent exchange of information with other tax administrations to scrutinize and challenge treaty benefits. These procedures are still administrative, and the outcomes of such audits are not yet public.

Dominican Republic

Has the jurisdiction adopted the PPT?
Not in any in-force treaties, although there is a protocol with Spain to implement the measure.

However, under domestic law there is already a provision of law that the legal form adopted by taxpayers is not binding on the tax administration, which will assess the tax consequence based on facts.As such, transactions should be grounded in economic reality to avoid challenge.

Does the jurisdiction intend to apply the PPT consistent with OECD Commentary on the PPT provision?
N/A.

Will the PPT be applied retroactively or only prospectively?
Only prospectively.

Is the application of the PPT limited by any domestic statute of limitations for the tax administration to raise a challenge?
Yes, there is a general domestic statute of limitations of three years for initiating tax actions.

Is the application of the PPT or domestic GAAR subject to MAP in your country?
Yes.

Is there any information reporting required by domestic or foreign entities that would allow your tax administration to identify transactions/entities potentially at risk for the PPT?
No.

Mexico
Has the jurisdiction adopted the PPT?
Yes, Mexico has 38 tax treaties with PPT in-force, and that number will be increased when other Countries ratify the MLI or start bilateral negotiations.

Does the jurisdiction intend to apply its PPT provision consistent with OECD Commentary on the PPT provision?
Yes.

Will the PPT be applied retroactively or only prospectively?
The application is unclear.However, a recent decision of the tax court points out that the domestic GAAR has a substantive nature and therefore, does not apply retroactively (Armando Lara Yaffar, Michel Sánchez O'Sullivan, Douglas Poms, Quyen Huynh, *Mexican GAAR: Recent Ruling Leads to More Questions than Answers*, Tax Mngmt. Int'l J. (June 13, 2024)).Since the legal construction of Mexico's GAAR has similarities with the PPT, applying similar criteria could serve as a basis to reaching a similar conclusion on only prospective application of the PPT. Mexico implemented its GAAR in 2020, which provides that legal acts that lack a business reason and that generate a direct or indirect tax benefit, will have the corresponding effects if they had been carried out to obtain a reasonably expected benefit.

Is the application of the PPT limited by any domestic statute of limitations for the tax administration to raise a challenge?
Yes, generally five years from the date on which the tax was paid or should have been paid, as tax examinations cannot start after this date. This period can be extended for 10 years but in very limited cases.

Is the application of the PPT or domestic GAAR subject to MAP in your country?
Yes, due to the potential application of these rules, it could generate double taxation not in accordance with double taxation agreements.

Is there any information reporting required by domestic or foreign entities that would allow your tax administration to identify transactions/entities potentially at risk for the PPT?
Yes, Mexico has implemented Mandatory Disclosure Rules and there are sections focusing on international reorganizations; U-Turn Payments; application of withholding rates provided for in tax treaties on dividends and application of tax treaties when the recipient and beneficial owner is not subject to tax. There are also obligations to report relevant transactions that include transactions with foreign residents and the reporting of interest and royalty payments made to foreign residents.

Panama

Has the jurisdiction adopted the PPT?
Yes, Panama has included a PPT provision in 15 of its 17 in-force treaties.

Will the PPT be applied retroactively or only prospectively?
Only prospectively.

Is the application of the PPT limited by any domestic statute of limitations for the tax administration to raise a challenge?
Yes, the application of the PPT is limited by the domestic statute of limitations applicable to income tax, which is five years**.**

Is the application of the PPT or domestic GAAR subject to MAP in your country?
Yes.

Is there any information reporting required by domestic or foreign entities that would allow your tax administration to identify transactions/entities potentially at risk for the PPT?
No.

Uruguay

Has the jurisdiction adopted the PPT?
Yes, Uruguay has included a PPT provision in 19 of its in-force treaties.

Does the jurisdiction intend to apply the PPT consistent with OECD Commentary on the PPT provision?
Yes.

Will the PPT be applied retroactively or only prospectively?
Only prospectively, in line with principles of certainty and equality.

Is the application of the PPT limited by any domestic statute of limitations for the tax administration to raise a challenge?
Yes, the general statute of limitations under Uruguayan law is five years, which can be extended to 10 years in certain scenarios, such as tax fraud, failure to register, or failure to file tax returns.

Is the application of the PPT or domestic GAAR subject to MAP in your country?
Yes, there is the possibility of MAP.

Is there any information reporting required by domestic or foreign entities that would allow your tax administration to identify transactions/entities potentially at risk for the PPT?
Yes, Uruguay requires companies that are part of multinational groups to notify the Central Bank of Uruguay about the chain of ownership leading to their final owners. Additionally, Uruguay has implemented Transfer Pricing (TP) documentation rules, including Country-by-Country reporting obligations for certain taxpayers that are part of large multinational groups (those exceeding annual revenues of EUR 750 million).

Application of the PPT to Holding Company Structures

The use of holding companies by multinational enterprises to manage investments offers numerous benefits, including legal and commercial certainty and protection over investments. These entities are often located in jurisdictions that provide tax-neutral outcomes, partly through access to a comprehensive network of tax treaties, which can mitigate taxes on investment income and capital gains. Given the limited US tax treaty network with Latin America, it may be common for investments in the region to be made through holding company jurisdictions like Spain or the Netherlands. However, evolving international tax policies targeting base erosion and profit shifting, along with more aggressive measures by jurisdictions to address COVID-19 deficits, may jeopardize the access of such companies to treaty benefits (As an example of a tax policy that combats base erosion profit shifting outcomes, within the EU there is an anti-tax avoidance directive (commonly referred to as ATAD3) that introduces rules to prevent the misuse of so-called shell entities and which require minimum levels of substance for operations within the EU).

Before the introduction of the PPT, many tax treaties only required that a holding company be resident in a treaty jurisdiction and the beneficial owner of the income be eligible for benefits. The PPT's entry into force increases pressure on holding companies to ensure that their operations align with the treaty's object and purpose—concepts that remain somewhat vague even in OECD commentary. In Latin American jurisdictions, where treaties have traditionally not limited the benefits of holding companies, aside from some treaties that may have narrow carve-outs for certain entities benefiting from a special tax regime, the PPT's application could challenge long-standing practices (For example, the treaty between Mexico and Luxembourg has historically limited benefits to Lux companies that benefit from Luxembourg's 1929 holding company regime).

The need for holding companies to have substance is becoming more and more evident. In jurisdictions like Mexico and Costa Rica, for example, there are no minimum substance rules, but auditing trends emphasize the need for a business reason, materiality, and substance. In Costa Rica, while the PPT is not a substance test per se, recent audits involving payments to companies with tax residence in a treaty jurisdiction often assess the right to treaty access based on the foreign entity's level of substance. Similarly, in Uruguay, tax authorities are increasingly concerned about substance, raising questions during audits, although no court precedents exist yet regarding the PPT's application in litigation.

As these provisions are relatively new, both taxpayers and tax administrations have limited experience in applying them to determine whether a holding company will or will not be eligible for treaty benefits. By contrast, in jurisdictions where a GAAR has also been introduced, there may be some experience in applying a broad-based anti-abuse rule to deny either domestic or treaty-based tax benefits. Tax

authorities are likely to focus on confirming the valid economic motive for structuring shareholding through a jurisdiction with which they have double tax agreements, considering factors such as personnel, facilities, decision-making capacity and authority, and costs and risks incurred, and the relevance of factors not related to tax in the decision to establish the holding company (to be analyzed and justified on a case-by-case basis). Mandatory disclosure rules in some Latin American jurisdictions could aid tax administrations to target specific transactions and holding companies where they may want to take action.Further, increasing levels of exchange of information and cooperation among treaty partners, may make holding company structures more susceptible to examination by tax authorities.

Taxpayers may also be concerned that the introduction of the PPT into tax treaties will increase the complexity of tax audits, may lead to disclosure of detailed information from foreign structures and transactions, and may demand more cooperation between the different tax administrations to prevent situations of double taxation. It is therefore a positive sign that where PPTs are being introduced that the jurisdictions appear willing to accept the application of the provision into MAP programs.That said, based on the OECD MAP statistics, there does not appear to be robust and active MAP cases (aside from attribution/allocation cases) in most Latin American jurisdictions (OECD (2023), *Making Dispute Resolution Mechanisms More Effective – Consolidated Information on Mutual Agreement Procedures 2023* , OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris).This may be due to inexperience with MAP or small competent authority staff which can lead to a longer time period for a potential resolution, even up to several years. In jurisdictions where withholding agents are held strictly or jointly liable for underwithheld amounts to ineligible treaty residents, there may be concerns about whether these agents should continue to accept only residence certificates or request additional documentation upfront.

Another consideration is the potential scope of application of the PPT provision. While some Latin American jurisdictions believe the PPT would only apply prospectively, the scope of protection for a grandfathered holding structure remains unclear. If the holding company structure was set up in line within the treaty's scope and objectives at the time in which it was put in place, an eventual denial of treaty benefits based on the application of the PPT clause to previous taxable events related to that structure would not be an acceptable outcome.This is because, among other considerations, such an application of the PPT would affect and go against general views that the entity was historically benefiting from the treaty in a manner consistent with its object and purpose (e.g., to facilitate cross-border trade and investment), and as a result, the PPT provision should only be prospectively applied or otherwise this would create much uncertainty.However, whether the PPT could apply to the same holding company regarding prospective payments of investment income or capital gains is not clear and a reason for why taxpayers should evaluate their existing structures into the Latin America region.

Additionally, the fact that for the application of the PPT tax, authorities are only required to "reasonably" conclude that one of the main purposes of a certain structure was to obtain treaty benefits, while the taxpayer has to objectively demonstrate that the grant of the benefits is in conformity with the purpose of the treaty might also be seen as questionable in relation to the reasonable balance that should exist between the position of the tax authorities and the taxpayers. In some jurisdictions, such as Brazil, the PPT may provide a basis for further shifts in tax treaty policy. Historically, the Brazilian government has attempted to establish rules for analyzing, controlling, and disregarding abusive tax planning. However, these proposals were often rejected, citing the federal constitution's protection of taxpayers' rights to structure their businesses and the principle of "strict legality," which limits tax authorities' interference. With the introduction of the PPT, tax authorities may now begin scrutinizing international tax planning using these clauses to deny benefits previously granted

under tax treaties. This shift could have ripple effects, initially impacting a few tax treaties but potentially tainting the broader tax treaty network and more general tax policies in the future.

US Impact of Changes

As previously mentioned, the United States has only three income tax treaties (Chile, Mexico, and Venezuela) in the region, and therefore the use of holding companies to invest in Latin America may be common for a US MNE group.The continued use of these structures is likely to face increasing pressure due to the PPT and evolving tax policy considerations that focus on operating functions.Under US income tax treaties with a standard LOB article to prevent treaty shopping, while holding companies may not meet the active trade or business test on their own (i.e., without aggregation of activities by related affiliates typically located in other jurisdictions), the company may still be able to qualify under certain ownership tests that do not require substantial activity or substance in terms of personnel, management, assets or risks managed by the company. As the PPT and detailed LOB are intended to be comparable under the OECD’s minimum standard, it is unclear if jurisdictions adopting a PPT will view the structure more favorably if the holding company could have otherwise satisfied one of the objective LOB provisions or if it will insist that taxpayers provide a more detailed explanation for the use of the holding company. Increasing functions associated with holding companies will help protect it from a potential challenge, including explaining the context for choosing the jurisdiction in which to locate the company (such as well-established legal protections, efficient and effective tax administration, and availability of qualified personnel in the jurisdiction).

How to Mitigate the Risks of the PPT

There are some steps that holding companies can take to mitigate the risks of the PPT and to strengthen their position in case of a tax audit or dispute. These include:

- Reviewing their existing holding structures and assessing the potential impact of the MLI and the PPT on their tax treaty benefits.
- Ensuring that their holding companies have a sufficient level of economic substance and business purpose in their country of residence, such as having adequate personnel, assets, functions, and risks, and engaging in real and substantial activities that are not merely passive or incidental to the treaty benefit.
- Documenting the commercial or financial reasons for their holding structures and the benefits that they bring to the group, such as facilitating the management and control of the subsidiaries, providing access to financing or capital markets, or enhancing the group’s reputation or market presence.
- Monitoring the developments and guidance on the MLI and the PPT in the countries where they have investments and being prepared to respond to any inquiries or challenges from the tax authorities.

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