



**Papers on Selected Topics in Protecting the Tax Base
of Developing Countries**

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Preventing Tax Treaty Abuse

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Contents

1. Introduction.....	3
2. Theme 1: Inappropriately accessing treaty benefits	7
2.1 Examples of some structures for accessing treaties	10
2.2 Challenging inappropriate access using domestic law	14
2.3 Challenging inappropriate access under the terms of the treaty	16
2.3.1 A general limitation of benefit article	18
2.3.2 A general limitation of benefits article based on purpose and abuse	43
2.3.3 Changes to the Preamble	45
2.4 Targeted anti-abuse provisions in the treaty	45
2.5 Impact on existing treaties	46
3. Theme 2. Negating double non-taxation through treaties	47
4. Theme 3. Abuse of domestic law by treaties	49
5. Theme 4. Tax considerations in choosing treaty partners	51

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1. Introduction

Many developing countries have already negotiated a number of tax treaties with their neighbours and with capital exporting countries, while others are keen to expand their existing tax treaty network. An extensive treaty network is typically considered to be an important indicator that a developing country can use to demonstrate that it is keen to attract foreign direct investment and that it is willing to impose tax on foreign investors according to internationally-accepted taxation norms. Bilateral income tax treaties are one visible manifestation of a country's desire for economic development and greater integration in the global economy.

While income tax treaties are thus important signals to the international community, the experience of developing countries, like developed countries, is that treaties can be misused as part of sophisticated tax planning to frustrate the tax claims of developing countries. Tax treaty abuse is a matter which has caught the attention of the revenue authorities of some developing countries already. For example, in response to the questionnaire circulated in 2014 by the UN Subcommittee on Base Erosion and Profit Shifting Issues for Developing Countries, Mexico noted that, 'our priorities are Action 6 and the Actions related to Transfer Pricing (Actions 8, 9 and 13).'¹ Similarly, the OECD's *Report ... On the Impact of BEPS in Low Income Countries* lists treaty abuse as one of the high priority action items for developing countries, noting concerns from Zambia and Mongolia.² This chapter is about how developing countries can protect their domestic tax base against erosion arising from the abuse of the tax treaties they have negotiated or are pursuing.

¹ Government of Mexico, 'Mexico's Experiences Regarding Base Erosion and Profit Shifting Issues,' http://www.un.org/esa/ffd/tax/Beps/CommentsMexico_BEPS.pdf.

² OECD, *Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* (July 2014), <http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf>.

Item 6 in the OECD's Base Erosion and Profit Shifting ('**BEPS**') Action Plan refers to the ways in which taxpayers abuse a country's network of tax treaties and mechanisms to counter this behaviour. The Action Item requires the OECD to –

Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty 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 coordinated with the work on hybrids.³

This Item, as originally presented in 2013, involved three distinct themes:

1. developing recommendations to prevent inappropriate access by taxpayers to a country's tax treaty network. These recommendations will involve both changes to the text of the OECD's Model Treaty and changes to domestic tax rules;
2. clarification, perhaps within the text of the OECD's Model treaty, Commentary or elsewhere, that tax treaties are not intended to generate double non-taxation. It is presumably this theme which would be coordinated with the work on hybrids;⁴ and
3. recommendations about the considerations which should influence a country in deciding whether to enter a tax treaty with another country.

In March 2014, the OECD released a *Public Discussion Draft BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*⁵ elaborating the Action Item in

³ OECD, *Action Plan on Base Erosion and Profit Shifting* (2013) 19 <http://www.oecd.org/ctp/BEPSActionPlan.pdf>.

⁴ A separate Discussion Paper was issued by the OECD in March 2014 dealing with amendments to the OECD Model treaty and Commentary to address the problem of hybrid entities and instruments. See *Public Discussion Draft, BEPS Action 2: Neutralise the Effects Of Hybrid Mismatch Arrangements (Treaty Issues)* (March 2014) <http://www.oecd.org/ctp/treaties/hybrid-mismatch-arrangements-discussion-draft-treaty-issues-march-2014.pdf>.

⁵ OECD, *Public Discussion Draft BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (March 2014), <http://www.oecd.org/ctp/treaties/treaty-abuse-discussion-draft-march-2014.pdf>

more detail.⁶ It made recommendations for action about those items but it also added a further dimension to the issue. It referred to –

4. instances where a treaty is used as the pretext for an argument that a domestic anti-abuse rule is rendered ineffective.

This additional theme is important because it adds an additional theme to the notion of treaty abuse. The first theme focuses on ‘abuse’ consisting of **non-residents** inappropriately gaining access to a treaty in order to enjoy treaty benefits. It is abuse **of** a treaty. But in the fourth theme, the abuse consists of structures or transactions, especially those undertaken by **residents**, which are designed to enliven a treaty with the expectation that it will defeat a domestic anti-abuse rule; the abuse is not in inappropriately accessing a treaty network, but in employing a treaty to defeat a domestic anti-abuse outcome. It is abuse **by** a treaty.

The OECD’s agenda for countering tax treaty abuse is thus rather more expansive than typical discussions of ‘treaty shopping’ which focus just on the issue of inappropriately accessing treaty benefits. The potential for treaties to thwart anti-abuse rules, the exploitation of treaties to generate double non-taxation and the policy drivers for selecting appropriate treaty partners, which have all been incorporated into this Action Item, are examined far less often.

The proposals in the *Public Discussion Draft* do not attempt to catalogue current treaty practices – rather, the document proposes a combination of general approaches to treaty abuse (the changes to the Preamble, a structural limitation on benefits clause and a purpose-based limitation on benefits clause) and a number of specific measures directed at particular current problems. It is worth noting that many countries adopt particular anti-abuse measures in their Model such as specific limitation of benefit articles, especially in the dividend, interest and royalties articles and specific rules for conduit financing (back to back transaction rules). It may be that these existing practices will be viewed as superseded by the general changes proposed in the *Public Discussion Draft* but developing countries may

⁶ The OECD's BEPS Action Plan in 2013 had identified as the outputs from this Item both proposals for changes to the text of the OECD Model treaty and 'recommendations regarding the design of domestic rules.' OECD, above 3, at 31. The March 2014 document focuses principally on proposals for changes to the text of the OECD Model treaty and the Commentary to it. It is not clear whether future OECD work will propose drafts of domestic legislation designed to implement or buttress the treaty proposals.

wish to consider whether the general approaches will turn out to be sufficient – there is an ‘all-the-eggs-in-one-basket’ dimension to the recommendations. In other words, it may still be sound policy to employ a number of specific anti-abuse measures even if more general approaches are adopted.

Next, it is worth noting that if the OECD’s work on this portion of the BEPS agenda is fruitful, it is likely to be valuable to developing countries. One of the principal effects of a tax treaty is to limit the ability of source countries to retain tax claimed under domestic law. This can come about explicitly through the allocation rules in a treaty (for example, the requirement of a permanent establishment before the source country can tax business profits) and the rate limitation provisions (for dividends, interest and royalties) and less obviously through income classification rules.⁷

As developing countries are predominantly source countries, and less significant capital exporting countries, limits on the ability of source countries to insist on domestic law tax claims are particularly important for them. When developing countries negotiate a treaty, therefore, they are making a decision to surrender tax claimed under domestic law in exchange for the benefits that the treaty promises. Because this item in the BEPS Action Plan is directed at curtailing the circumstances where treaties can be invoked – and source country tax claims are reduced – it should be especially valuable for developing countries. The OECD notes that the impact of work on this action item should be to reinforce source country tax claims:

Tight treaty anti-abuse clauses coupled with the exercise of taxing rights under domestic laws will contribute to restore source taxation in a number of cases.⁸

Finally, it is worth thinking about the relationship between the work being undertaken at the OECD and this project, conducted under the auspices of the UN. The OECD’s BEPS project

⁷ Limits on the taxing rights claimed by source countries can come about through the income classification rules that treaties employ. For example, income which a source country might classify and tax under domestic law as a royalty (and thus amenable to tax at source under article 12 of the UN Model treaty) might, where the treaty supplants domestic law definitions, be classified for the purposes of a treaty as business profits (and thus taxable at source only if a permanent establishment exists). One obvious example of this kind of outcome arose from the re-classification in the OECD Model Treaty of income from the leasing of cargo containers in the mid 1990s.

⁸ OECD, above n. 2, 18.

will likely lead to changes to the text of the OECD Model treaty and Commentary⁹ and recommendations for changes to domestic tax laws. The UN's response to this work may lead to parallel changes to the UN Model treaty and Commentary,¹⁰ as well as recommended changes to domestic laws. But it is worth noting that the OECD's BEPS Action Items are not necessarily exhaustive of the range of issues that may concern developing countries, nor are the solutions proposed necessarily ideal for developing countries. The UN may wish to explore other options for protecting the tax base of developing countries. Some other possibilities not currently being considered are mentioned below.

2. Theme 1: Inappropriately accessing treaty benefits

Arrangements by which taxpayers from a third country can gain access to a State's treaty network may pose a serious threat to a State's tax system. Tax treaties are individually negotiated bargains between sovereign states and one significant effect for a source country from concluding a treaty is that the State's ability to retain tax claimed under domestic law will be constrained. Presumably source countries have taken this decision and entered into a treaty in the expectation that this reduction in tax will be enjoyed only by the residents of the other contracting state. Where resident of third states are able to enjoy those benefits, governments cannot be sure that they have appropriately quantified the amount of revenue loss that the treaty will produce. Similarly, source countries may find that other benefits they hoped to secure from the treaty – access to information held offshore, a formal system for resolving tax disputes, the promise of non-discrimination, assistance in collecting taxes, and so on – cannot be fully provided by the tax administration of the treaty partner because the taxpayer lacks any real presence in the other Contracting State.

A State might, nevertheless, be tempted by the argument that any new investment is to be welcomed, even if it comes as a result of shopping into the country's treaty network. After all, the point of the treaty was to encourage greater inward investment and this has been achieved, albeit from an investor resident in a third State. This position may be tempting but it is short-sighted.¹¹

⁹ OECD, Model Tax Convention on Income and on Capital (2010).

¹⁰ UN, Model Double Taxation Convention Between Developed and Developing Countries (2011) http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf.

¹¹ The considerations for capital exporting countries are slightly different. Their concern will likely be that third countries will see less need to negotiate a treaty if their residents can free-ride on

Just how serious the threat of improperly accessing a country's tax treaties is depends to some extent on who is gaining access to the treaty. It can be helpful to draw a distinction between two different forms of inappropriate access to a treaty:

- shopping into a tax treaty – a taxpayer resident in State C (a state which does not have a treaty with the source country, State A) puts in place a mechanism to get access to the treaty between State A and State B, and
- shopping between tax treaties – a taxpayer resident in State C (a state which has a treaty with the source country, State A) puts in place a mechanism to get access to the treaty between State A and State B, instead of being subject to the terms of the treaty between State A and State B.

The second situation may, but need not, be problematic for a country. And, as we will see, the difference can matter when tax officials try to decide what situation should be taxed in lieu of the offending situation – ie, if the benefits of the treaty are to be denied should other tax consequences follow instead?

The principal factors which encourage shopping into tax treaties and shopping between tax treaties are:

- the extent of the divergence of the tax treaty from the claims made under domestic tax law; and
- the extent of the divergences between treaties negotiated with different States.

Where the tax claims made by domestic law are not significantly reduced by the terms of a treaty and the terms of the individual treaties in a State's treaty network are not significantly different, the attractiveness of treaty shopping is much reduced. Thus there is a place for States to consider the settings in their domestic law as a means of controlling treaty abuse.

the treaty of another country. The capital exporting country's residents will not enjoy reduced source country taxation in those third countries. This will mean that the capital exporting country will reduce its revenue claims without the offsetting increase in revenue expected to arise from a corresponding reduction in the source country.

This point is worth emphasising as developing countries have traditionally expressed the view that the architecture of the international tax framework should provide greater scope for the taxation of income at source. While greater source taxation may seem appealing, given international competition for investment, it is likely to be sustainable only in cases where the source country has some specific advantage which is peculiar to the country, such as a particular resource. In the absence of some particular advantage, source countries may discover that insisting on high source country taxation produces reduced levels of foreign investment. Consequently, it may well be that in many cases – for example, withholding taxes on interest on debt borrowed from unrelated parties – low source country taxation is necessary in order to attract capital and has the added advantage of reducing the scope for treaty abuse.

The most difficult part of any discussion of ‘inappropriate’ access to treaties lies in defining what is, and is not, appropriate. The Commentary to article 1 of the UN Model contains a long description of various forms of abuse of treaties and some mechanisms that countries may employ to counter these practices.¹² It is not always easy to identify when non-residents claiming to be entitled to the benefits of a treaty should be denied those benefits. Many different definitions and different terms are used to denote the inappropriate enjoyment of treaty benefits, the most common being ‘treaty shopping.’ Most of the definitions of treaty shopping or treaty abuse involve some notion of purpose or intention – that is, the result of deliberate planning and conscious decision making, rather than a more objective set of facts and circumstances. Tests which rely upon notions of ‘purpose’ or ‘intention’ are notoriously difficult for tax administrations to administer and for taxpayers to comply with. It is not surprising, therefore, that other more mechanical tests are used to control the misuse of treaties. These tests, however, can create their own problems if they are triggered in inappropriate circumstances. It can, therefore, be important to have a further fall-back, allowing the competent authorities to deliver access to treaties or deny access that might otherwise be given. As will be seen below, the approach being advocated by the OECD combines all three elements – a test based on the taxpayer’s purpose, a test

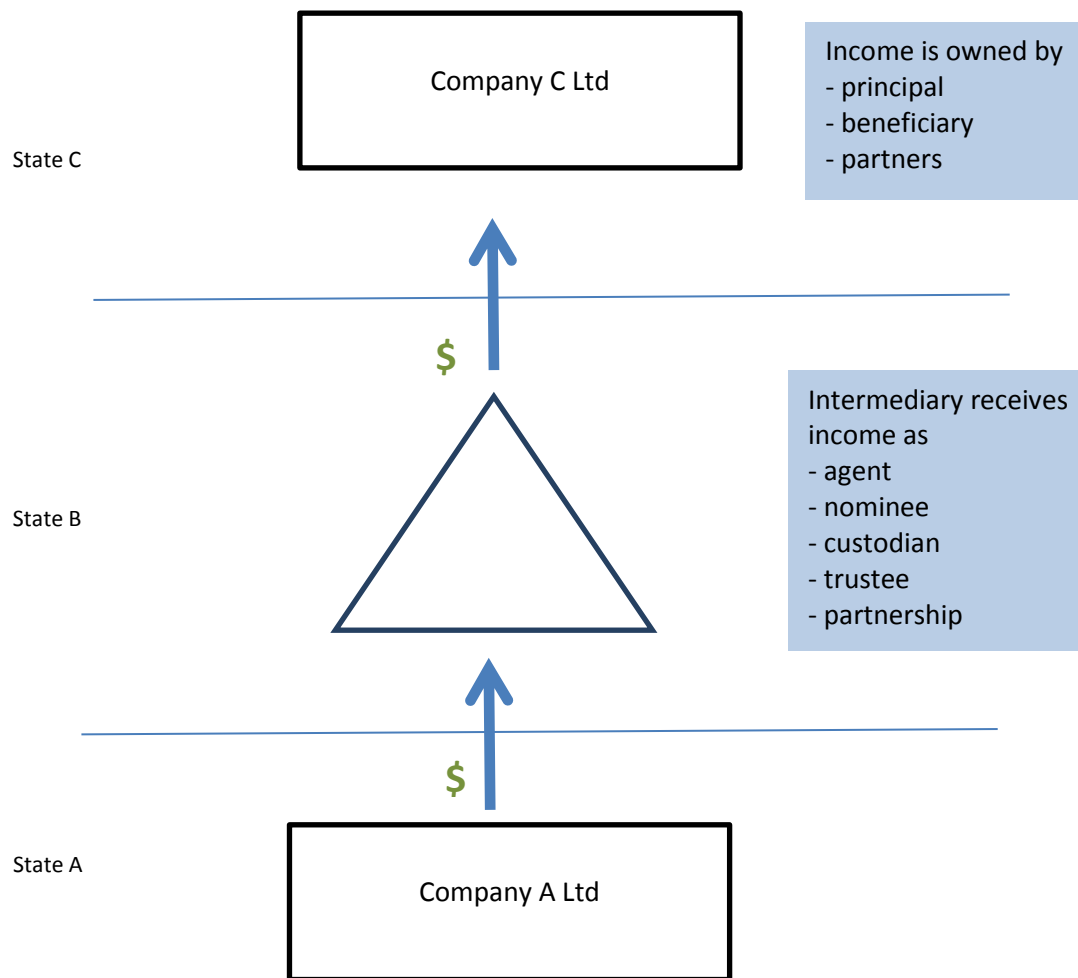
¹² See UN, above n. 10, Commentary to art 1, paras 8-103. See also P. Baker, 'Improper use of Tax Treaties, Tax Avoidance and Tax Evasion' in A. Trepelkov, H. Tonino and D. Halka (eds) *Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (2013) http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf

that is more mechanical and describes a state of affairs, and a safety-valve in the form of negotiations between the competent authorities.

2.1 Examples of some structures for accessing treaties

There are many mechanisms by which treaty benefits can be inappropriately enjoyed unless they are monitored and countered. The simplest arrangements involve the creation in the treaty partner of a contractual or legal arrangement that is transparent for tax purposes under the law of that state. For example, income may be paid to an entity in the treaty partner which receives the income:

- as an agent for a principal resident in the non-treaty state,
- as a nominee or custodian for a taxpayer resident in a third state,
- as trustee of a bare trust for a beneficiary resident in a third state,
- as trustee of an active trust for beneficiaries primarily resident in a third state, or
- as a partnership of entities primarily resident in a third state.



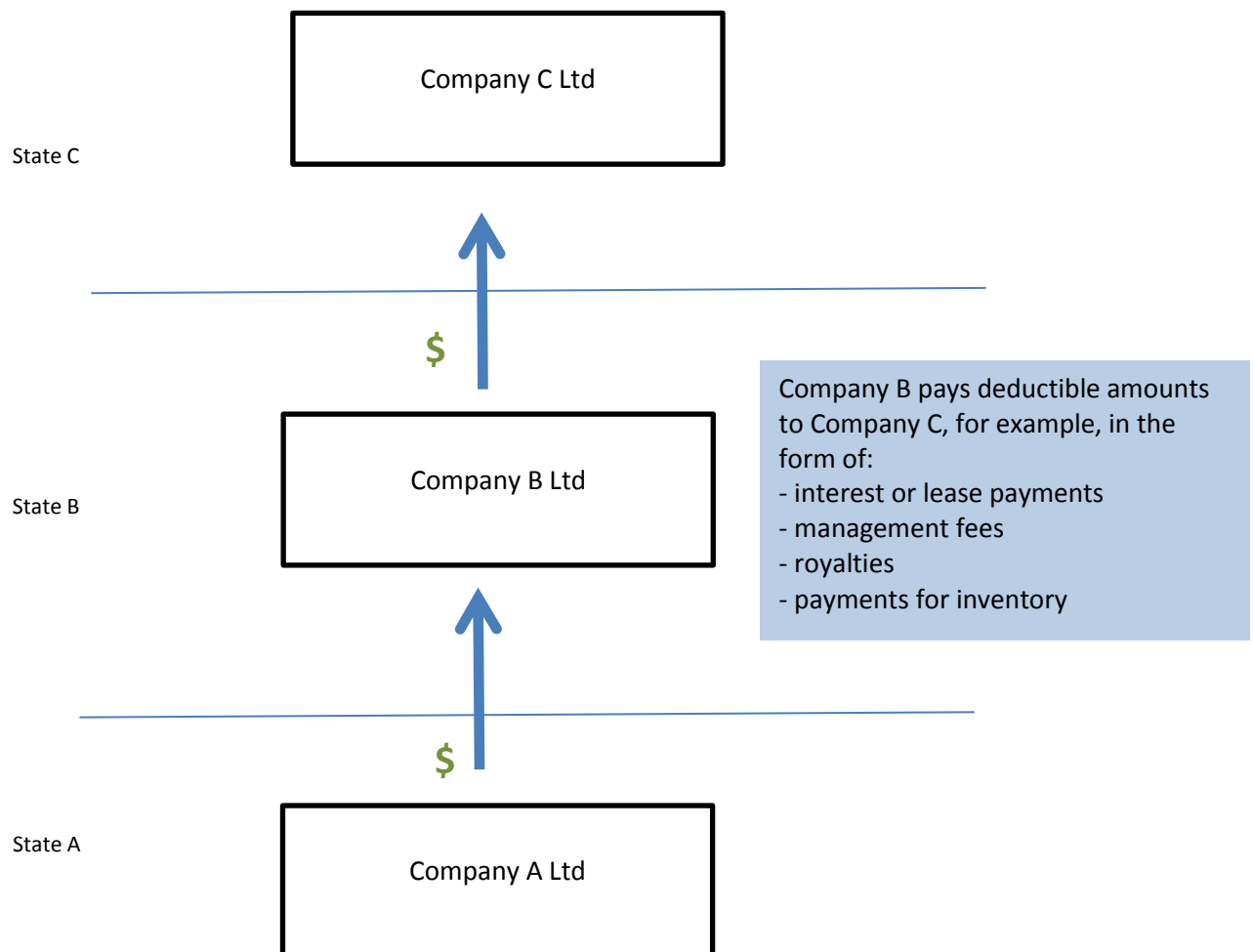
A tax treaty exists between State A and State B.
No treaty exists between State A and State C.

If, under the law of State B, these arrangements are fiscally transparent – that is, no tax is levied in State B on the income in the hands of the agent, nominee, custodian, trustee or partnership – the treaty between State A and State B should not be enlivened to limit State A's tax claims.

This may be appreciated already. Accepted interpretations of several explicit provisions in tax treaties would deny treaty benefits to the Intermediary in State B. For example, where the relevant arrangement is simply contractual (the resident of State C has organised for its income to be collected by an agent or custodian), the relevant 'person' for treaty purposes is the person with whom the resident is dealing and that is the resident of State C, not its agent.¹³ Secondly, the Intermediary may not satisfy the requirements to be a 'resident' of State B for the purposes of the treaty – if the tax liability falls on the principal, beneficiary or partners and not the Intermediary, the Intermediary is not a 'person who, under the laws of that State, is liable to tax therein ...' Similarly, if the income involved is a dividend, interest or royalty, the Intermediary ought not to be regarded as the 'beneficial owner' of the income.

However, there will often be less obvious arrangements by which taxpayers can gain access to a treaty network. For example, an entity may be established in the treaty partner which is a taxpayer in that State in its own right and a resident, but in effect it is an empty shell because it pays its entire income to a taxpayer resident in a third country – base erosion. While these payments might sometimes trigger withholding tax on the way out of State B, they may not bear tax at the full corporate rate levied in State B. Indeed, the withholding taxes levied by State B may themselves be reduced if a treaty exists between State B and State C.

¹³ This issue is discussed in J. Wheeler, 'Persons Qualifying for Treaty Benefits' in A. Trepelkov, H. Tonino and D. Halka (eds) *Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (2013) http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf



A tax treaty exists between State A and State B.
No treaty exists between State A and State C.

In this situation it is less obvious that the transaction will be easily amenable to challenge without provisions in the treaty or perhaps domestic law – provisions which the laws and treaties of a developing country might currently lack. Company B is clearly a ‘person’ for the purposes of the treaty, it is likely to meet the tests for being a ‘resident’ of State B, and it is harder to argue that Company B is not the ‘beneficial owner’ of the amounts it has received merely because it has undertaken obligations which will result in it having to spend that income or choosing to distribute it as a dividend.¹⁴

2.2 Challenging inappropriate access using domestic law

Most countries will have domestic rules which aim to prevent or minimise the scope for tax avoidance and these measures may be suitable to use as weapons against treaty abuse.

The first issue that arises is to ensure that a country has a complete set of domestic anti-avoidance rules. Developed countries will often have a very large suite of domestic anti-avoidance rules such as thin capitalization rules, controlled foreign company and foreign investment fund rules, indirect asset transfer rules, transfer pricing rules, specific anti-avoidance rules and statutory general anti-avoidance rules. Developing countries which lack comprehensive anti-abuse rules make the task of countering the most common forms of abuse more difficult.

Similarly, existing judicial doctrines (with labels such as ‘business purpose,’ ‘economic substance,’ ‘*fraus legis*,’ ‘*abus de droit*’ or ‘substance over form’) which were developed initially to control domestic tax abuse may also play a role in preventing tax treaty abuse.

The obvious issue is whether the suite of domestic legislative and judicial rules can be raised against practices which rely upon a treaty but are regarded as treaty abuse. It is sometimes argued that domestic anti-avoidance rules and existing judicial anti-avoidance doctrines cannot be applied if they would have the effect of denying the benefits which a treaty apparently offers. The Commentary to both the OECD Model and the UN Model accepts that specific legislative anti-abuse rules, general anti-abuse rules and general judicial doctrines

¹⁴ The meaning of ‘beneficial owner’ is examined at length in J. Wheeler, above n. 13, at 78. See also OECD, *OECD Model Tax Convention: Revised Proposals Concerning the Meaning of ‘Beneficial Owner’ in Articles 10, 11 and 12* (2012) <http://www.oecd.org/ctp/treaties/Beneficialownership.pdf>

that are part of domestic law do have the potential to generate conflicts between the treaty and domestic law, and that in cases where the other treaty partner considers the domestic rule results in a direct conflict, the treaty must be given priority.¹⁵

But the issue is not simple. It is worth noting that Canada, which is currently undertaking a review into mechanisms to curb treaty abuse, appears inclined to approach the problem through amendments to its domestic law.¹⁶ The position taken by the Government of Canada is that it can approach the problem through domestic provisions because, 'domestic law provisions to prevent tax treaty abuse are not considered by the OECD or the United Nations to be in conflict with tax treaty obligations and a number of other countries have enacted legislation to that effect.'¹⁷ Australia, has attempted to resolve any doubt by inserting a provision in its domestic law which asserts that its general anti-abuse rule will prevail over its treaties, and since that provision has been in place since 1981, it is assumed that all treaties entered since then were negotiated on the basis that this provision was acceptable to the treaty partner.

The Commentary to the UN Model proposes another way of dealing with any argument about inconsistency.¹⁸ It suggests mechanisms inside a treaty which are likely to mirror the intended scope and operation of domestic rules. But, being inside the text of the treaty, the possibility of a conflict is removed – the domestic law provisions need not be called upon to counter the abuse. The OECD's BEPS Action Plan suggests some similar approaches to be included in the text of the OECD Model and the Commentary. These recommendations are discussed further in sections 2.3.2 and 2.2.3 below.

¹⁵ See UN, above n. 10, Commentary to art 1, para 10.

¹⁶ The Government of Canada announced its 2013 Budget that it would initiate a project to address treaty abuse. The Ministry of Finance of Canada released consultation paper in August 2013. Canada, *Consultation Paper on Treaty Shopping – The Problem and Possible Solutions*, <http://www.fin.gc.ca/activty/consult/ts-cf-eng.asp>. In the February 2014 Budget, the Government of Canada canvassed a domestic provision to curb treaty shopping. Canada, *Budget 2014, Annex 2 – Tax Measures; Supplementary Information*, <http://www.budget.gc.ca/2014/docs/plan/anx2-1-eng.html>.

¹⁷ Canada, *Budget 2014, Annex 2 – Tax Measures; Supplementary Information*, <http://www.budget.gc.ca/2014/docs/plan/anx2-1-eng.html>.

¹⁸ See UN, above n. 10, Commentary to art 1, para 34 ff.

The administrative requirements necessary to enjoy treaty benefits may also play a part in detecting and countering treaty abuse.¹⁹ Clearly, some evidence must exist to establish the entitlement of a non-resident to treaty benefits and States should consider carefully the kind and the extent of the evidence that needs to be provided, the entity to whom this evidence should be provided and who is responsible for retaining this evidence. For income such as dividends, interest, royalties or gains, there may be a question whether treaty benefits are delivered at source or whether non-resident taxpayers must apply to have the relevant tax refunded to them. It may be appropriate for the revenue authority's audit programs to undertake *ex post* confirmation and verification that the facts which justified the granting of treaty benefits still exist. Part of this process may involve using the exchange of information provisions of a bilateral treaty or the Multilateral Convention to verify and detect instances of inappropriate access.

This role that administrative systems can play in controlling inappropriate access to tax treaties is not discussed in the OECD's BEPS Action Plan but States should carefully consider how their administrative regimes are established so that they both clearly deliver the benefits that the treaty requires and have in-built safeguards that can impede the inappropriate access of treaties. Clearly, excessive administrative obligations have the potential to undermine the benefits that the treaty was intended to secure, and so the issue becomes one of balancing the need for a quick and streamlined process against the possibility of ongoing undetected abuse.²⁰

In summary, domestic substantive and administrative rules can play a part as weapons against treaty abuse. The next stages in the BEPS Action Plan may well suggest some draft domestic legislation to buttress the proposals for changes inside the text of treaties.

2.3 Challenging inappropriate access under the terms of the treaty

¹⁹ See generally, UN Model, above 10, Commentary to art 1, para 100 ff ('many substantive provisions in tax treaties need to be supported by proper administrative procedures'). See also, P Harris, 'Taxation of Residents on Foreign Source Income' in A. Trepelkov, H. Tonino and D. Halka (eds) *Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (2013) http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf.

²⁰ See generally, UN Model, above n. 10, Commentary to art 1, paras 100 ff; OECD Model, above n. 9, Commentary to art 1, para 26.2.

The problem of inappropriate access to treaty benefits is not something that has taken the international community by surprise. The UN and the OECD have very detailed Commentary on the operation of their Model Treaties and each Commentary already outlines a number of strategies and approaches which might be invoked to counter treaty abuse.

The Commentary to the OECD Model (endorsed in the Commentary to the UN Model) examines the notion of the abuse of a treaty as a doctrine of international law which might allow the benefits of a treaty to be denied; that is, a notion which already underlies the operation and interpretation of tax treaties as international instruments:

a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the *Vienna Convention on the Law of Treaties*).²¹

The Commentary on individual articles in each Model also contains many passages which draw attention to possible interpretations of the text which can buttress the arguments of tax officials seeking to deny treaty benefits.

This OECD's *Public Discussion Draft* encourages some new approaches to the problem which will be incorporated in the OECD Model and Commentary. Some of these measures are in common use; others are not. Developing countries may wish to include provisions such as these in their treaties in order to enhance the integrity of future treaties. Four separate strategies are being proposed:

1. a general limitation of benefits article based on observable structural features,
2. a general limitation of benefits article based on a purpose or state of mind,
3. a change to the Preamble to the OECD Model to reiterate that the treaty is not intended to provide relief from tax to residents of third States, and
4. a shopping-list of particular changes to the Model and Commentary to address a number of particular issues that have been identified as abuses of treaties.

²¹ OECD Model, above note 9, Commentary to art 1, para 9.3.

2.3.1 A general limitation on benefits article

One of the measures likely to follow from the OECD's BEPS Project is the inclusion in the text of the OECD Model Treaty of a general 'limitation on benefits' ('**LOB**') article. A LOB article is already discussed in the Commentary to the OECD Model²² and the Commentary to the UN Model²³ but the clause will be given much greater prominence if it is moved to the body of the treaties. The clause proposed in the March *Public Discussion Draft* differs in some important respects from the texts in the OECD Model and UN Model, no doubt reflecting current thinking about how to design LOB clauses. Some other countries routinely employ LOB provisions (the clause being proposed resembles article 22 of the US Model) and making the article part of both Models will likely lead to more widespread adoption.

The proposed LOB clause adds a further requirement before treaty benefits will be conferred. It is not sufficient that the relevant taxpayer is a 'resident' of the other contracting State. In addition, the taxpayer will have to meet one of two (or perhaps three) other tests.

Qualified person. The first option will be if the taxpayer can demonstrate that it meets the definition of a 'qualified person.' The OECD's proposed clause says -

1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to the benefits of this Convention otherwise accorded to residents of a Contracting State unless such resident is a "qualified person" as defined in paragraph 2.

Where this test is met, the entity will enjoy all of the benefits of the treaty. Whether or not an entity is a 'qualified person' is re-assessed for each year -

2. A resident of a Contracting State shall be a qualified person for a taxable year if ...

²² A limitation on benefits article is already set out in the Commentary to article 1 of the OECD Model. See OECD, above n. 9, Commentary to art 1, para 20.

²³ UN, above n. 10, pp. 59-62.

The definition of 'qualified person' is drafted using a number of observable criteria. They are alternative means of satisfying the 'qualified person' test. The discussion below breaks down the OECD's proposed clause into a series of discrete clauses, and explains the kinds of entities and situations to which it is catering. The qualifications and limitations surrounding the rules are also examined.

One set of tests focuses on the status of the foreign entity. So, an *individual* who is a resident of one of the contracting states will always be a 'qualified person:'

2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:
 - (a) an individual;

In the same way, the **government** of the other contracting state and some government-owned agencies will also be a 'qualified person.'

2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is ...
 - (b) a Contracting State, or a political subdivision or local authority thereof, or a statutory body, agency or instrumentality of such State, political subdivision or local authority;

Thirdly, various types of **charities, benevolent and cultural institutions** will typically be a 'qualified person' if they are established for one of the specified purposes:

2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is ...
 - (d) a person, other than an individual, that -
 - (i) was constituted and is operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes,

In this formulation, it is not necessary that the entity is exempt from tax in the residence country, although this will often be the case for religious, charitable and similar organisations. Similarly, it is not sufficient that the entity is exempt from tax in the residence

country – for example, various sporting organisations or hospitals might be tax exempt in the residence country but they would not qualify under paragraph (d).

Presumably, an entity is being 'operated exclusively' for the appropriate purposes if it owns investments which generate income, even if some of that income might be retained rather than applied to current works. It may be more difficult to say that a company wholly-owned by a charity etc. is being 'operated exclusively' for the appropriate purposes when its function is to **fund** those activities rather than conduct them itself. Similar issues could arise if charities are permitted for tax and regulatory purposes to undertake commercial activities, provided the profits generated from those activities are applied to the charitable works in question -- for example, a charity which operates a second-hand bookshop selling donated books, where the proceeds are paid to the charity to further its work. The status of 'qualified person' can be lost if business activities occur within the entity: the person must be 'operated exclusively' for one of the listed purposes and it is not obvious that the book sales amount to charitable works even if they are undertaken to fund charitable works. There would be some doubt whether this problem could be solved by conducting the business activity through a wholly-owned subsidiary. Again, the issue would be whether the entity is 'operated exclusively' for one of the purposes if it is operated to fund the activity.

Fourthly, paragraph (d) also extends the status of 'qualified person' to private **pension funds** established to provide pension and similar benefits principally to persons who are residents of either of the contracting states:

2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is ...
 - (d) a person, other than an individual, that ...
 - (ii) was constituted and is operated exclusively to administer or provide pension or other similar benefits, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident in either Contracting State

The formulation used in this section appears to refer to the number of beneficial interests ('more than 50 per cent of the beneficial interests') rather than the value of the interests or the way the income is being applied in any year.

Paragraph (d) also extends to include **investment funds**, presumably investment funds that are not providing retirement income benefits:

2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is ...
 - (d) a person, other than an individual, that ...
 - (iii) was constituted and is operated to invest funds for the benefit of persons referred to in subdivision ii), provided that substantially all the income of that person is derived from investments made for the benefit of these persons;

The intended operation of this paragraph is unclear. It refers to an investment fund that was established to invest funds for the benefit of the 'persons referred to in subdivision ii)'. The difficulty is that subdivision ii) refers to two 'persons' – one is the 'person' that was constituted to provide pension benefits [ie, the pension fund] and the other is the 'person' who must hold the beneficial interests [ie, the member of the fund resident in one of the States].

If paragraph (d)(iii) is meant to be alluding to the pension fund, then this paragraph could confer the status of 'qualified person' on the various investment funds into which the pension fund invests contributions. In practice, there would likely be difficulties unless a separate class of investment fund emerges in the market which only accepted investments from pension funds. An investment fund which accepted investments from pension funds and, say, banks and life insurance companies, would probably not satisfy the requirement that 'substantially all the income of that person is derived from investments made for the benefit of' the pension funds.

A second part of the 'qualified person' test focuses on the ownership structure of the entity. This part of the test is intended for artificial legal entities such as companies, trusts and partnerships. For these kinds of entities, the tests focus on a number of different criteria – sometimes, the residence of the owners of the entity; sometimes, the place where it is managed; sometimes the place where its shares are traded, and so on.

First, a rule is created for a **publicly-traded company** -- that is, a company in which the principal class of shares is regularly traded on a recognised stock exchange in either State (or in a third state if the competent authorities agree). These companies can be a 'qualified person' in one of two ways based on where its shares are traded or where its executives work. The rule applies only to 'companies' – other entities which have interests that are listed on a stock exchange and regularly traded do not fall under this provision.

The first option for becoming a 'qualified person' is to demonstrate that the listed company's main class of shares is principally traded on the recognised stock exchanges of its state of residence -- that is, its shares are locally traded:

2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:
 - (c) a company, if:
 - (i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and
 - (A) its principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or

This test looks to the location of the stock exchange rather than to the location of the ultimate shareholders. It is quite possible, therefore, that a company will qualify under this test even though a substantial proportion of its ultimate shareholders will not be residents of the state where the stock exchange is located. This test looks no further than the location of the stock exchange.

The test also does not expressly disqualify a listed company based on the degree of concentration of ultimate share ownership. It is quite possible, therefore, that a company could qualify under this test even though a significant parcel of its shares is held by a single shareholder resident in a third country. There is no express indication how many of the principal class of shares must actually be actively traded or how frequently.²⁴

²⁴ The US Model includes a similar phrase and the Technical Explanation takes the view that shares would be 'regularly traded' if trades in the shares occurred on at least 60 days per year and the

The test is applied to the company's 'principal class of shares' and any 'disproportionate class of shares' and it is these shares which must be 'primarily traded' on one of the appropriate stock exchanges. Other classes of shares which are insignificant will not count for the purposes of this test; minor trading even in the 'principal class of shares' on other exchanges will not disqualify the company.

Notice also the inter-play between the place of the company's residence and the place where its shares are principally traded. A company which is a resident of a third State cannot become a 'qualified person' under this paragraph merely because its shares are traded on the stock exchange of one of the contracting states. And a company which is a resident of one state, would lose access to treaty benefits if its shares are traded primarily on the stock exchange of the other state or a third state.

For publicly-traded companies, the second possibility is that the company's principal place of management and control is located in its state of residence - that is, it is locally managed:

2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:
 - (c) a company, if:
 - (i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and ...
 - (B) the company's primary place of management and control is in the Contracting State of which it is a resident

The definition of 'primary place of management and control' in paragraph 5 says -

- (d) a company's "primary place of management and control" will be in the Contracting State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more

aggregate number of shares which turned over during the year was at least 10% of all the shares on issue. This interpretation follows from US law but it gives an indication of the kind and level of activity that might satisfy a 'regularly traded' test. US Model, *Technical Explanation Accompanying the US Model Income Tax Convention of November 15, 2006*, Commentary to article 22, <http://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf>.

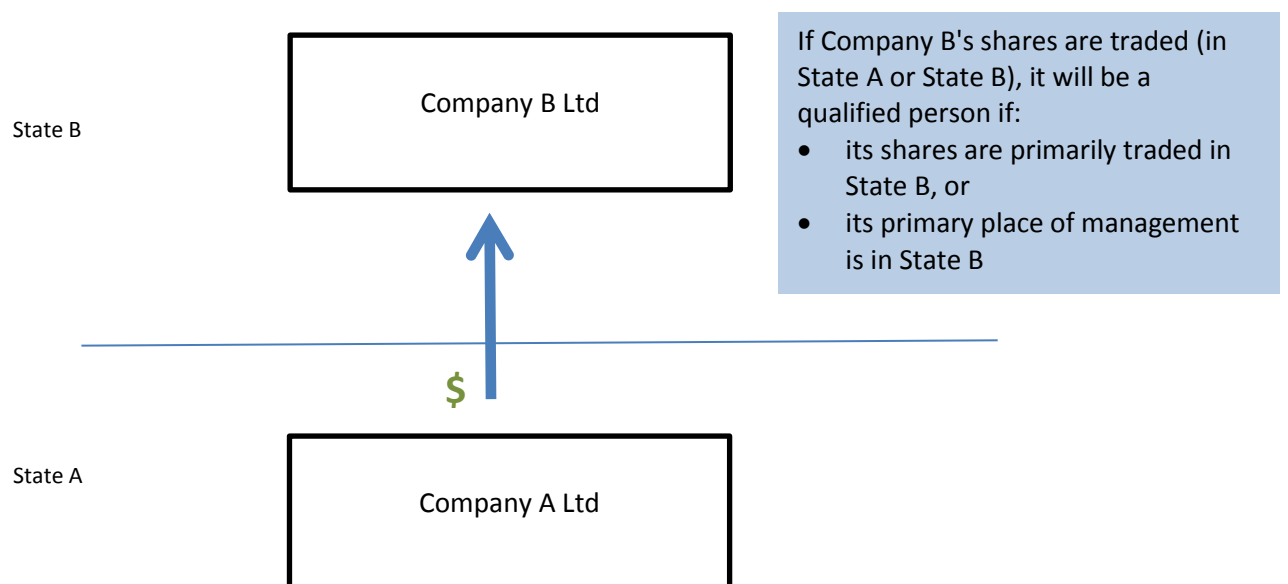
of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that Contracting State than in any other state and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions in that Contracting State than in any other state.

That is, the test focuses on the place where operating decisions are made, not for example where the company's directors meet nor where shareholder meetings occur. The test involves many components:

- first, it is applied by looking at only certain corporate executives: 'executive officers and senior management employees' and 'the staff of such persons.' It seems that the test will be failed if either group does not satisfy the test;
- secondly, within that group, the test examines just the ones involved in 'strategic, financial and operational policy decision making .' They must have and exercise day-to-day decision-making responsibilities;
- thirdly, the test recognises that management decisions can be spread throughout a corporate group and so the requirement is that more of the relevant preparation and ultimate decisions occur in the residence state than occur elsewhere
- the test appears to focus on the number of decisions rather than their importance;
- the test requires an examination of the decision-making for the company claiming to be entitled to treaty benefits and any 'direct and indirect subsidiaries.' Clearly, the listed company will not be a 'qualified person' under this option if it is effectively managed from offshore, but the drafting suggests that the listed company must assume responsibility for the decision-making of subsidiaries; relevant operational policy decisions cannot apparently be left to the executives of the operating subsidiaries.

Where either the 'locally traded' or 'locally managed' test is satisfied, the listed company will enjoy access to all treaty benefits, but the most important ones are likely to be treaty

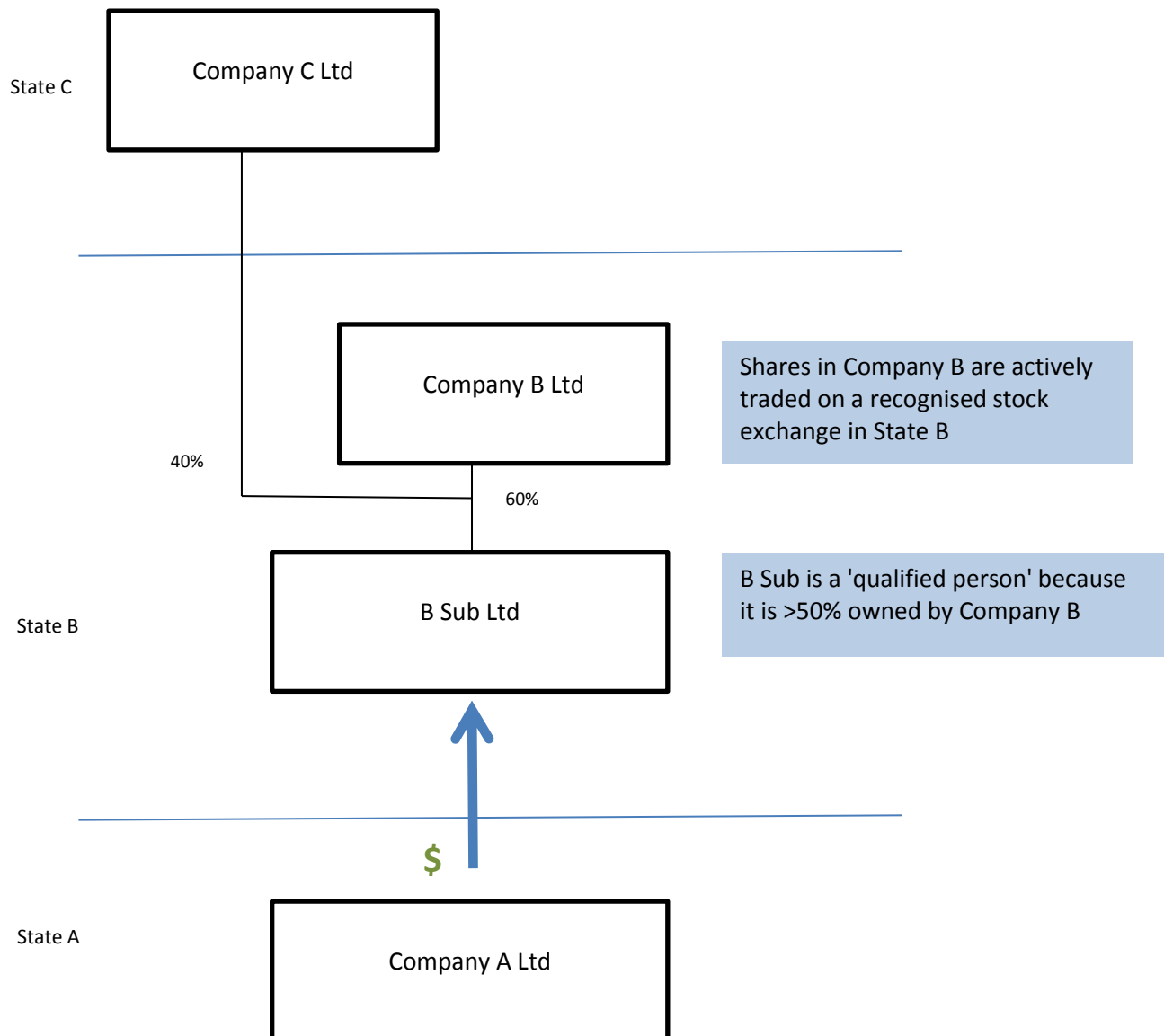
benefits for dividends, interest and royalties received from its subsidiary in the source country, and treaty benefits for income from business activities conducted in the source state without a permanent establishment.



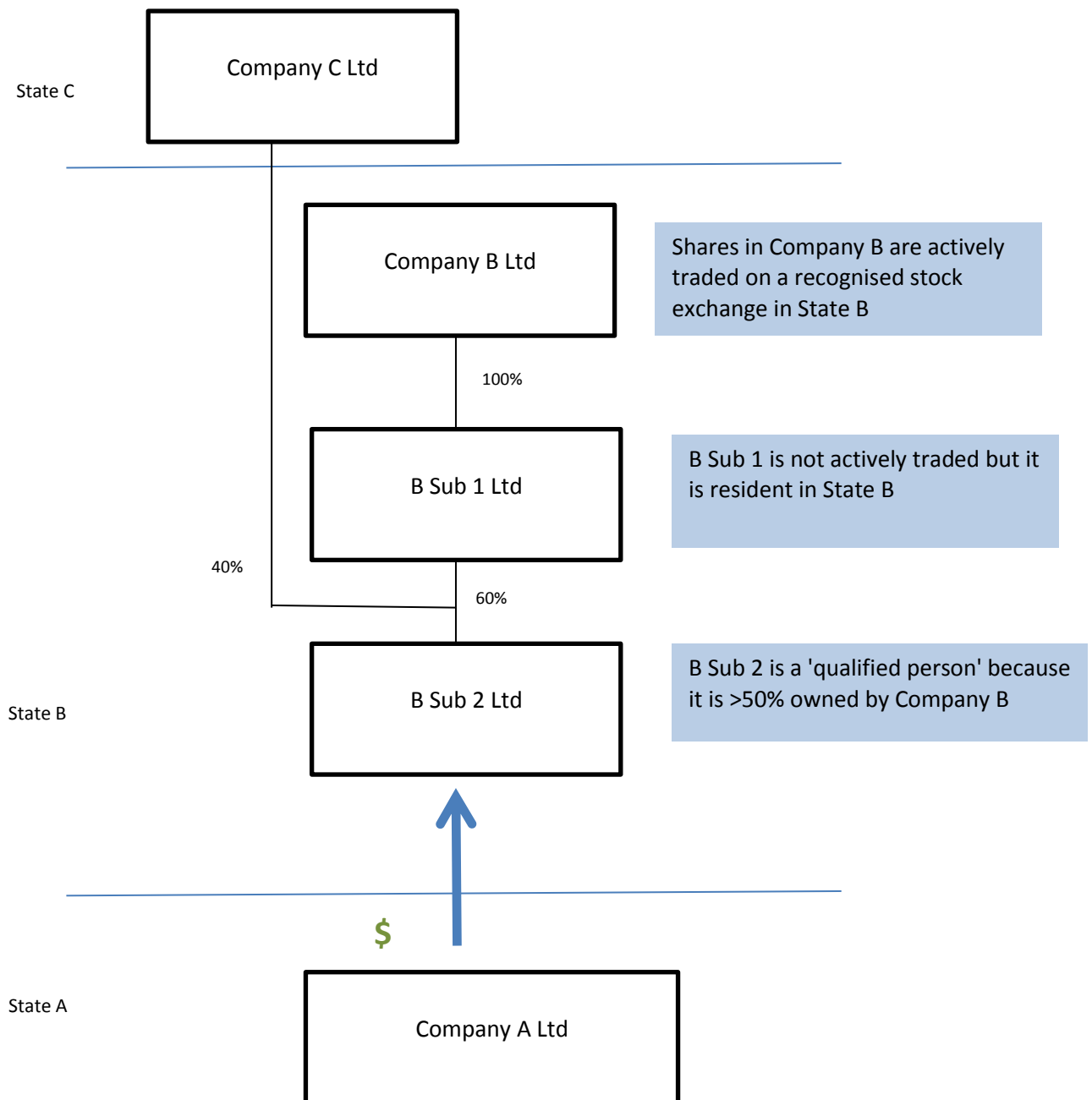
A second rule exists for companies that are **subsidiaries of publicly-traded companies** – that is, a company can be a 'qualified person' if it is at least 50% owned by a listed and publicly traded company that is resident in one of the States and itself a 'qualified person':

2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:
 - (c) a company, if ...
 - (ii) at least 50 percent of the aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subdivision i) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;

The test can extend to partly-owned subsidiaries and joint-venture companies: the test will be satisfied by tracing at least 50% of the shareholding in the relevant company to one or more publicly-traded companies resident in either state. And the test does allow for a significant portion of the company being examined to be owned by shareholders resident in a third state.



Paragraph (c)(ii) also allows a company to become a 'qualified person' by tracing through any intermediate companies to rely upon the status of the listed and actively traded parent company provided all the relevant companies (the parent, the intermediary and the company receiving the foreign source income) are all resident in either contracting State.



The final rule in paragraph (e) is a residual test that applies to any ‘person other than individual.’ So, for example, paragraph (e) could apply to:

- an entity that is not a company – for example, a trust or partnership. The test extends beyond companies and refers to entities which issue ‘shares’ and those which issue other types of ‘beneficial interest’. This may be relevant, for example, for investment funds and other collective investment vehicles if they are not structured as companies;
- an entity that is privately-held – ie, its shares are not listed on a stock exchange. Again, this may be relevant for investment funds where interests in the fund are issued and redeemed, rather than traded on a stock exchange;
- a listed company that is actively traded on a stock exchange but does not satisfy either the ‘locally traded’ or ‘locally managed’ elements of that test; and
- a subsidiary of a listed entity which, for example, is owned by the listed entity but through a third country intermediary.

In order for this type of entity to be a ‘qualified person,’ two tests must be satisfied:

- **an ownership test:** during at least half the year, more than 50% of the interests in it must be held by taxpayers which are (i) resident in the same contracting state and (ii) are themselves ‘qualified persons;’ and
- **a base erosion test:** less than 50% of its gross income can be paid in any year in the form of tax deductible payments either to non-residents or to persons who are not themselves ‘qualified persons’ (although this requirement is not enlivened for payments made to purchase goods, real estate or services at arm’s length prices in the ordinary course of business).

Paragraph (e) sets out the test in these terms:

- (e) a person other than an individual, if:
 - (i) on at least half the days of the taxable year, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph a), subparagraph b), subdivision i) of subparagraph c), or subparagraph d) of this paragraph own, directly or indirectly, shares or other beneficial interests representing at least 50 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) of the person, provided that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State, and
 - (ii) less than 50 percent of the person's gross income for the taxable year, as determined in the person's Contracting State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), subparagraph b), subdivision i) of subparagraph c), or subparagraph d) of this paragraph in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property).

There are several important aspects to the ownership test. First, given that the ownership of interests in the entity may change during the year, the test only needs to be satisfied for at least half the year. Secondly, the owners must be resident in the same state as the entity being tested. Thirdly, the owners must account for at least 50% of ownership which still permits a substantial portion of the ownership of the entity to be held offshore. Fourthly, ownership is measured by looking to the 'aggregate voting power' and to the 'value' of the interests being tested, and apparently both aspects must be satisfied. Finally, not all entities which are 'qualified persons' will suffice for this test: the list in paragraph (i) omits entities which are owned by listed entities. This means that a subsidiary of a listed entity is eligible to become a 'qualified person' by applying this section, but a subsidiary of that company

cannot rely upon the status of its immediate owner; it must trace through to the ultimate listed parent.

The base erosion test focuses on the proportion of gross income that is paid to residents of third countries or to persons who are residents but are not 'qualified persons.' Again, up to 50% of the gross income of the tested entity can leak to residents of third countries without offending this rule. The reference to amounts flowing 'directly or indirectly' to such persons may prove very problematic in practice where income flows are supplemented or dissipated as they move through successive taxpayers.

The exception for payments for 'services or tangible property' will need some explanation in the Commentary. The obvious intention of the provision is to require that payments for interest and payments for the use of intangibles (eg, royalty payments for the use of intellectual property) must be examined; payment of arm's length prices for inventory, equipment or real estate do not need to be examined. Developing countries may however be concerned that payments of management fees would not need to be tested provided they are at arm's length prices – they are presumably payments for 'services.'

The base erosion test focuses on one particular mechanism by which income might leak to a third country – an amount is 'paid or accrued ... in the form of payments that are deductible for purposes of the taxes covered by this Convention ...' The situation being described is one where the recipient of the income would be taxable but it reduces the tax payable by making tax deductible payments. The same result could, however, be achieved in other ways: the recipient might not be taxable at all if it distributes sufficient of its receipts – in other words, the recipient is or can become transparent for tax purposes. Alternatively, the relevant domestic rules might make the fund the proper taxpayer on retained income and the investor the proper taxpayer on distributed income. In this respect, it is worth returning to paragraph (d)(iii) which was mentioned above. It includes as a 'qualified person' –

- (d) a person, other than an individual, that ...
 - (iii) was constituted and is operated to invest funds for the benefit of persons referred to in subdivision ii), provided that substantially all the income of that person is derived from investments made for the benefit of these persons.

It was noted above that this clause seems directed at investment funds and that paragraph (e) is potentially also applicable to investment funds. There will be an interesting question whether the test in paragraph (e) is easier or harder to satisfy than that in paragraph (d) in any year: paragraph (e) might be easier to satisfy where the mechanism under domestic law which shifts the tax burden works through something other than a tax deduction; but paragraph (e) may be more difficult to satisfy since it requires ‘substantially all’ of the relevant income to belong to residents.

Active business income. A second way in which a taxpayer will be able to enjoy (some) treaty benefits is if the taxpayer satisfies an active business income test. Again, this test can be satisfied regardless of the legal form of the taxpayer.

While a ‘qualified person’ will enjoy all of the benefits of the treaty, satisfying the active business income test will only entitle the taxpayer to enjoy treaty benefits for ‘an item of income.’ Paragraph 3 provides:

A resident of a Contracting State will be entitled to benefits of this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person ...

In order for the entity to be a ‘qualified person’ for a particular item of income, the taxpayer must meet two and sometimes three tests. It must be:

engaged in the active conduct of a trade or business in [its State of residence] (other than the business of making or managing investments for the resident’s own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer respectively),

This test will clearly be satisfied for taxpayers that are exclusively engaged in manufacturing, assembly, extraction, production activities or the provision of professional services. It is not entirely clear how a company which is a holding company should be regarded but presumably holding shares in subsidiaries would not amount to the ‘active conduct of a trade or business’ and even if it did, this activity would fall into the exclusion for an entity

that exists for ‘making or managing investments.’ The same analysis might apply to a company that exists to just hold intellectual property assets and receive royalty payments, or which is an in-house finance company for the corporate group and exists just to receive interest payments. On the other hand, a company which holds and manages a portfolio of investments for external clients would likely be regarded as engaged in ‘the active conduct of a trade or business’ and this business is not one which is carried on ‘for the resident’s own account.’

A more complicated question arises for companies that do more than engage in ‘active trade or business’ – for example, a single company which is both a manufacturer and which licenses intellectual property to related entities. The drafting of the clause suggests that such a company would satisfy this part of the test as long as its manufacturing operations were more than merely cosmetic.

The second part of the active business income test requires that –

the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business.

In other words, a company which satisfies the active income test based on its status as a manufacturer cannot rely on that status to enjoy treaty benefits for all items of income it earns from the source country – merely for income which is earned in connection with its manufacturing operations. Where a single company is both a manufacturer and licenses intellectual property to related entities, it may be argued that the royalties derived from the intellectual property that it licenses is income that is ‘in connection with, or is incidental to, that [manufacturing] trade or business.’ On the other hand, royalties derived from unrelated intellectual property are presumably excluded from enjoying treaty benefits.

The third part of the active income test is an additional requirement which must be met if the resident is earning active business income through its offshore branch or from an associated enterprise in the source country. That is –

If a resident of a Contracting State derives an item of income from a trade or business activity conducted by that resident in the other Contracting State, or

derives an item of income arising in the other Contracting State from an associated enterprise ...

Where either situation exists, the added requirement is that the business operations of the recipient are regarded as 'substantial' when compared to the business operations conducted by the payer. In other words, income will not enjoy treaty benefits if it is being paid to an entity that is largely a wrapper around some modest business activities:

subparagraph (a) shall be considered to be satisfied with respect to such item only if the trade or business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the trade or business activity carried on by the resident or associated enterprise in the other Contracting State. Whether a trade or business activity is substantial for the purposes of this paragraph will be determined based on all the facts and circumstances.

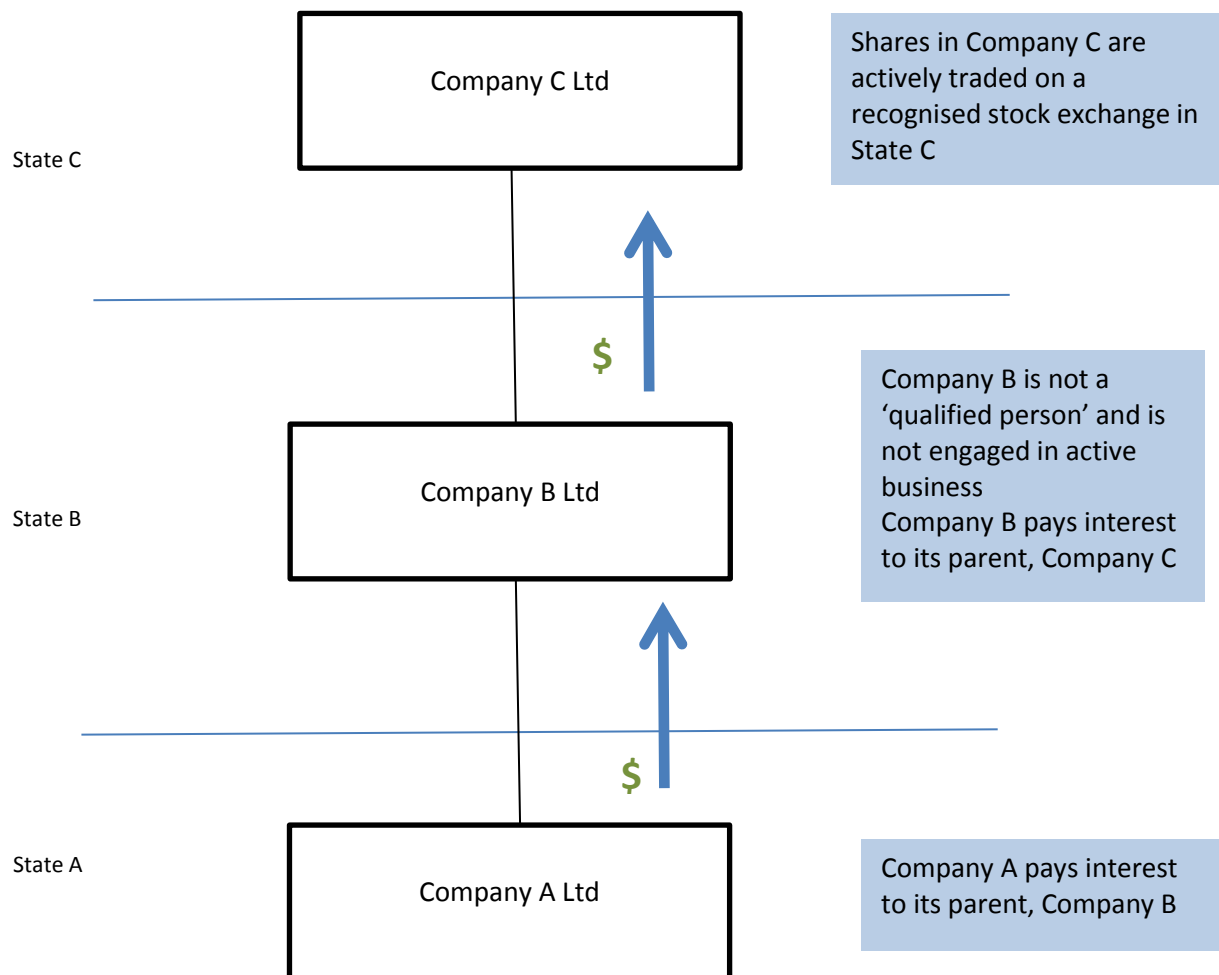
In applying this test, the payer and the recipient are allowed (and required) to aggregate any 'activities conducted by persons connected to a person ...' This aggregation occurs for any entity that shares 50% common ownership or more and may have significant effects in deciding whether activities conducted in the recipient state are substantial when compared to those conducted in the source state.

The active income test does not contain a restriction or qualification where base eroding payments are made. So, a company that conducts active business operations in the residence state faces no denial of treaty benefits even though most of its income leaks from the residence state to a third country. This creates a curious outcome. A privately-held company might not satisfy the tests to be a 'qualified person' under paragraph (2)(e) because a substantial portion of its income is eroded by deductible payments made to third countries. If however that same company conducts an active business, the ultimate destination of its income becomes irrelevant.

Equivalent benefits. The *Public Discussion Draft* also discusses the possibility of a third method for qualifying for treaty benefits. This option would deal with structures that appear to involve shopping **between** treaties (rather than **into** treaties). For example, a structure might exist which would not satisfy the objective LOB tests for a particular treaty, but the

participants in that structure would all be entitled to similar benefits under other treaties. The obvious question is, should the source country simply apply the original treaty anyway, given that it would afford similar benefits if it applied the other relevant treaties instead?

In the example below, Company B may not be entitled to treaty benefits under the A-B treaty where its shares are not traded on a local stock exchange, its only shareholder is resident in State C, and its only activity is to collect and remit interest from Company A. While the structure may seem abusive, it is not obvious that State A has suffered any loss of revenue from applying the A-B treaty when the ultimate owner of the income is an entity that would be entitled instead to the benefits of the identical A-C treaty.



A tax treaty exists between State A and State B. The rate in article 11(2) is 10%
A tax treaty exists between State A and State C. The rate in article 11(2) is 10%

This issue is alluded to in the *Public Discussion Draft* and a possible clause is examined. The clause would reinstate the original treaty [in the example, the A-B treaty] in its entirety where a company (and only a company) is (predominantly) owned by an 'equivalent beneficiary.' The original treaty will be reinstated if both an ownership test and a base erosion test are met. Full treaty benefits are given to:

A company that is a resident of a Contracting State ... if:

- (a) at least 95 percent of the aggregate voting power and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary, and
- (b) less than 50 percent of the company's gross income, as determined in the company's State of residence, for the taxable year is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm's length payments in the ordinary course of business for services or tangible property) that are deductible for the purposes of the taxes covered by this Convention in the company's State of residence.

Both the ownership test and the base erosion test are framed around the term 'equivalent beneficiary.' The notion of 'equivalent beneficiary' relies upon the 'qualified person' tests just discussed and also to the rates prescribed in the treaty with the third state.

The first option for being an 'equivalent beneficiary' is for entities that are resident in a third state and again consists of two elements. The first element is that the company resident in the third state must be entitled to full benefits under that treaty, including being a 'qualified person' under that treaty where it contains an LOB clause. If there is no comprehensive LOB clause, the entity must qualify as 'qualified person' under the current treaty:

- (e) the term 'equivalent beneficiary' means a resident of any other State, but only if that resident

- (i) (A) would be entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed under provisions analogous to subparagraph a), b), subdivision i) of subparagraph c), or subparagraph d) of paragraph 2 of this Article, provided that if such convention does not contain a comprehensive limitation on benefits article, the person would be entitled to the benefits of this Convention by reason of subparagraph a), b), subdivision i) of subparagraph c), or subparagraph d) of paragraph 2 of this Article if such person were a resident of one of the States under Article 4 of this Convention

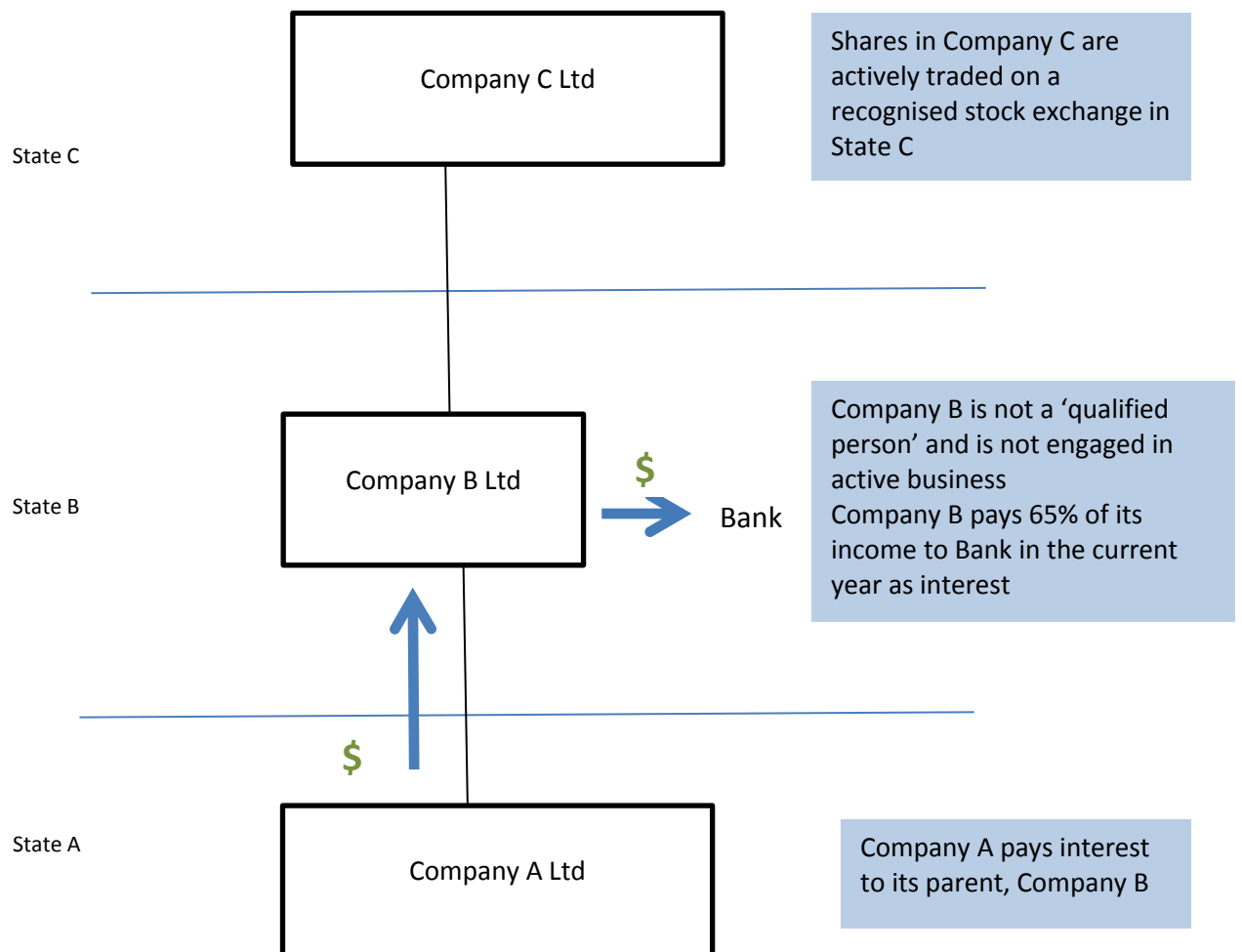
The second requirement is that, for dividends, interest and royalties, the rates stipulated in the treaty with the third state must be the same or lower than the rates in the current treaty:

- (B) with respect to income referred to in Articles 10, 11 and 12 of this Convention, would be entitled under such convention to a rate of tax with respect to the particular class of income for which benefits are being claimed under this Convention that is at least as low as the rate applicable under this Convention; or

A second option for becoming an 'equivalent beneficiary' is for entities that are resident in one of the Contracting States:

- (e) the term "equivalent beneficiary" means a resident of any other State, but only if that resident ...
 - (ii) is a resident of a Contracting State that is entitled to the benefits of this Convention by reason of subparagraph a), b), subdivision i) of subparagraph c) or subparagraph d) of paragraph 2 of this Article.

This part of the clause is significant principally for its impact on other taxpayers, rather than on the company being described; it will assist other tax payers to meet the base erosion tests and in indirect ownership situations. In the example below, Company B is 100% owned by Company C so that paragraph (a) is satisfied if Company C is an 'equivalent beneficiary.' Company C will be an 'equivalent beneficiary' if there is a A-B treaty and Company C is entitled to full benefits under that treaty. But since 60% of the gross income of Company B is paid to Bank, it will also be necessary for Bank to be an 'equivalent beneficiary' if Company B is to satisfy paragraph (b). If Bank is both a resident of State B and a 'qualified person' under the terms of the A-B treaty in its own right, this will have an effect on Company B: Company B can now enjoy the benefits of the A-B treaty.



The OECD's document is ambivalent about recommending that such a clause be adopted noting that in some cases the clause might not work appropriately. It may be that a better solution to this problem lies in the discretionary power proposed in the general LOB clause which would permit the competent authorities to treat a resident as a 'qualified person' in circumstances such as this.

Residual power to cure problems. Because the LOB rule will be drafted using objective observable criteria there is a residual power in the competent authorities to overcome any unintended exclusion from treaty benefits. The OECD's proposal expresses the residual power in the competent authority to permit other entities to be a 'qualified person' in this way:

4. If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 nor entitled to benefits with respect to an item of income under paragraph 3 of this Article, the competent authority of the other Contracting State shall nevertheless treat that resident as being entitled to the benefits of this Convention, or benefits with respect to a specific item of income, if such competent authority determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention.

2.3.2 A general limitation of benefits article based on purpose and abuse

A further recommendation contained in the *Public Discussion Draft* is to include a purpose-based general LOB clause. The clause is intended to operate as a further and independent ground for denying treaty benefits, even where a taxpayer was able to satisfy the objective observable LOB clause just discussed. The proposed clause says –

Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the main 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.

The clause thus contains two distinct elements – a rule which would deny access to treaty benefits based on the 'purposes of any arrangement or transaction,' and an exception which would reinstate access to treaty benefits where doing so 'would be in accordance with the object and purpose' of the treaty provision. The second aspect of the clause is clearly very important: many taxpayers will undoubtedly undertake investments and transactions in the knowledge of the effects of the treaty and intending to enjoy the benefits of the treaty. Indeed, treaties are negotiated in order to induce taxpayers to change their behaviour and so denying treaty benefits simply on the basis that taxpayers have responded to that inducement is inappropriate. Rather, the clause is meant to focus on whether the way in which taxpayers have responded to that inducement – the way they structured their investment or transaction – has produced an outcome that is not in accordance with the object and purpose of the treaty provision being relied upon.

According to the *Public Discussion Draft*, this article would simply express in the text of the Model notions that are currently contained in the Commentary. Consequently, the new provision is not seen as a major departure from existing principles:

Paragraph 6 mirrors the guidance in ... the Commentary to Article 1. According to that guidance, the benefits of a tax convention should not be available where one of the main purposes of certain transactions or arrangements is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax convention. Paragraph 6 incorporates the principles underlying these paragraphs into the Convention itself ...²⁵

The discussion in the *Public Discussion Draft* suggests that this is an objective enquiry to be undertaken based on the evidence of transactions which occurred. The subjective state of mind of the participants is not the focus of attention in this formulation. Instead, the investigation is meant to be about the purpose of 'the arrangement.' This formulation is intended to make the enquiry more objective and more focused on observable facts and

²⁵ OECD, above n. 5, para 20.

circumstances than would be the case if the enquiry was directed to finding the state of mind of some taxpayer or their advisers.

2.3.3 Changes to the Preamble

The *Public Discussion Draft* also proposes changes to the Preamble to the OECD Model to reinforce the notion that treaties are not meant to be exploited through inappropriate access to the treaty by residents of third countries. The preamble will now provide the two contracting states are entering the treaty –

Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)

The OECD suggests that the new Preamble will have affect in the interpretation of treaty provisions because the Title and Preamble, should play an important role in the interpretation of the provisions of the Convention 'according to the general rule of treaty interpretation contained in Article 31(1) of the *Vienna Convention on the Law of Treaties*.'²⁶

2.4 Targeted anti-abuse provisions in the treaty

The *Public Discussion Draft* proposes a shopping-list of individual changes (sometimes to the text of the OECD Model and sometimes to the text of the Commentary) to deal with a number of transactions that have been identified as currently causing problems:

- splitting the contracts for construction, exploration and similar projects into several short periods so that no permanent establishment arises;
- labour hire arrangements;
- re-characterising dividends to avoid source country taxation;
- share transfers occurring just prior to dividend payments to access lower withholding tax rates in the hands of the recipient;

²⁶ OECD, above n. 5, 28.

- transactions attempting to eliminate source country taxation from the sale of shares in land-rich companies;
- replacing the automatic tie-breaker rule for entities other than individuals with a case-by-case judgment by the competent authorities; and
- preventing abuse through the creation of a permanent establishment in a third State.

Some of these transactions are already examined in the Commentary to article 1 of the UN Model.

2.5 Impact on existing treaties

The recommendations in the *Public Discussion Draft* will likely lead to recommended changes to the text of the OECD Model, some of which may flow through to changes to the UN Model. Recommended changes to the Models will clearly be influential in the negotiation of future treaties between States, but there is an obvious question about what to do to the text of existing treaties in light of these recommendations?

At this time, there is no easy answer to this problem. It is obviously impractical for a country to renegotiate all of its existing treaties to include changes to the text recommended in the *Public Discussion Draft*. However, minor adjustments to the terms of the treaty might be effected through a protocol or exchange of notes between the competent authorities, where both States agree with the adjustment. Where one state was unwilling to adjust the existing text and was unwilling to accept changes based on these recommendations, a State might decide that it should simply unilaterally override or even terminate a treaty with the treaty partner, though either would be an extremely drastic action.

In the longer term, it may be that the proposed multilateral instrument being considered in BEPS Action Item 15 offers the best hope for simple and clear procedure for updating existing bilateral treaties to accommodate subsequent developments in treaty practice. Action Item 15 proposes exploring, ‘a multilateral instrument’ so that jurisdictions could ‘implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.’

There will also likely be changes to the Commentary to the OECD Model as a result of the BEPS Project, which again may flow through to changes to the Commentary to the UN Model. Here, there may be more flexibility about the impact of these changes on the interpretation of existing treaties. The OECD maintains the position that changes to the Commentary can have retrospective effect – that is, additions or revisions to the Commentary should be understood to apply to the interpretation of treaties already on foot –

other changes or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD member countries as to the proper interpretation of existing provisions and their application to specific situations.²⁷

This position may be somewhat ambitious. Some domestic courts have taken the view that, as commentaries form part of the background against which a treaty was negotiated, subsequent changes to the commentary cannot assist the Court to uncover the intention of the contracting states at the time they negotiated their treaty.

3. Theme 2. Negating double non-taxation through treaties

Another aspect of item 6 of the BEPS Action Plan is an examination of measures, ‘to clarify that tax treaties are not intended to be used to generate double non-taxation.’

The *Public Discussion Draft* proposes that this part of the Action Item be dealt with by changes to the Title and Preamble to the OECD Model treaty, and some changes to the Commentary explaining what the changes mean. The recommended Title to the Convention would become:

Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance

²⁷ OECD, above n. 9, Introduction, para 35.

and the Preamble would now specifically provide that the intention of the States in signing the treaty was ‘to further develop their economic relationship and to enhance their cooperation in tax matters’ through ‘a Convention for the elimination of double taxation with respect to taxes on income and on capital’ but to do so –

without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States).

While these changes do not directly change the text of the distributive articles in the treaty (articles 6-22), the OECD suggests that the new Title and Preamble will have affect in the interpretation of those provisions because the Title and Preamble should play an important role in the interpretation of the provisions of the Convention 'according to the general rule of treaty interpretation contained in Article 31(1) of the Vienna Convention on the Law of Treaties.'²⁸

It is important to note that this recommendation is quite limited. The proposal does not seek to overturn all instances of double non-taxation. It does not even seek to overturn double non-taxation due to some lack of clarity or uncertainty about how the rules are meant to operate. Rather it is directed to a much smaller class: ‘non-taxation or reduced taxation through tax evasion or avoidance ...’ That is a very important qualification – the changes are directed at situations where double non-taxation arises and it involves abuse.

Having said that, no doubt the Title and Preamble can and would be referred to when there is some question about the scope and operation of a particular provision. Article 31 of the Vienna Convention requires a State to interpret a treaty, ‘in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.’

But in many cases, there will be no doubt that double non-taxation will result from the operation of the treaty, and that result is both clear and unambiguous and is a result that a

²⁸

OECD, above n. 5, 28.

State ‘acting in good faith’ must reach. And because it does not involve ‘tax evasion or avoidance’ the result will be allowed to survive.

For example, assume Company A sells all the shares of Subsidiary, a company resident in State B, for a profit. It is quite conceivable that no tax will arise in either State – with a few exceptions, State B will be precluded from taxing Company A under the treaty, and State A may have a participation exemption so that it does not tax profits made on the sale of shares in offshore operating subsidiaries. The result is double non-taxation of Company A and it seems clear that, in the absence of some indication of tax evasion or avoidance, the changes to the Title or Preamble are not meant to overturn that result.

Thus the recommended changes may be helpful in cases where there is evidence of tax evasion or avoidance, and cases where there is some doubt about the way a particular provision should be understood and applied, but the recommended changes would not create a universal rule to negate the operation of a treaty just because double non-taxation will result.

It is worth noting that it would be possible for a developing country to be more ambitious than this proposal, and to insist that treaty provisions may only be invoked against a State where the same amount of income will be (or perhaps, has been) taxed in the hands of the same taxpayer in the other State. This would require specific drafting and goes beyond the current recommendation. But since one major objective of a treaty is to remove double tax as a barrier to closer economic integration, it is entirely consistent with that objective to insist that treaty benefits are conditional upon proving the imposition of tax by the other State.

4. Theme 3. Abuse of domestic law by treaties

One theme which emerged in the March 2014 *Public Discussion Draft*²⁹ was the need ‘to ensure that treaties do not prevent the application of specific domestic law [anti-abuse] provisions that would prevent [abusive] transactions.’³⁰ The *Public Discussion Draft* notes arguments have been made that various treaty provisions prevent the application of a wide

²⁹ OECD, above n. 5.

³⁰ Id. at 21.

variety of domestic anti-abuse rules: domestic thin capitalisation rules, CFC rules, exit taxes, rules restricting tax consolidation to resident entities, anti-dividend stripping rules, assignment of income rules and specific and general anti-avoidance rules. The *Public Discussion Draft* does not accept that these arguments have technical merit, pointing to various parts of the Commentary on the OECD Model where these arguments are considered and rejected,³¹ but the OECD does acknowledge the value of trying to express more clearly which domestic provisions will survive the application of a treaty. While the Commentary to the OECD Model and the UN Model currently try to protect domestic anti-abuse rule, the *Public Discussion Draft* notes the practical difficulty in trying to distinguish rules which are anti-abuse rules from those which are not. The document also notes the difficulty in trying to distinguish general anti-abuse rules (which are meant to be immune from challenge under a treaty) from specific or targeted anti-abuse rules which might be drafted around objectively observable facts and circumstances.

The approach put forward in the *Public Discussion Draft* does not seek to entrench or buttress a long list of domestic regimes which will be immune from challenge because of a treaty, although it notes that other parts of the BEPS project might lead to recommendations to this effect. Instead, the *Public Discussion Draft* comes at the problem in a much more ambitious way. It focuses on the fact that many of these regimes are directed at the tax position of residents and it proposes inserting a new clause which would preserve any regime (whether viewed as an anti-abuse measure or not) directed at the taxation of residents, with a few exceptions. The text notes that this approach is already seen in the 'savings clause' seen in US tax treaties.³² The new article would allow a State to tax its residents without any concern that treaty measures, which exist primarily for the benefit of non-residents, will also constrain the ability of a State to tax its residents. The new article would provide:

This Convention shall not affect the taxation, by a Contracting State, of its residents ...

³¹ The Commentary to the OECD Model treaty addresses challenges from a treaty to the operation of CFC rules (Commentary to art 1, para 23), thin capitalisation rules (Commentary to art 9, para 3) and specific and general anti-avoidance rules (Commentary to art 1, para 22).

³² See US Model Convention, above n. 24, art 1(4) and (5).

The proposed Commentary to this new article specifically alludes to the problem of dual residence and notes that a dual resident will not be affected by this clause, even if it is a resident of one State under the domestic laws of that State, if it is taken to be a resident only of the other State under the residence 'tie-breaker' rule in the treaty. Or to put this the other way, the domestic tax laws of the residence State can be applied to a dual resident without interference from the treaty if the entity is still a resident after the application of the 'tie-breaker' rule.

The blanket immunity for any rule being applied to residents is then made subject to specific exceptions. The residence State must still give effect to those parts of a treaty which –

- adjust the tax position of a resident consequent upon a transfer pricing analysis reallocating profits between the resident and an offshore branch or associated company,
- protect from tax income from services rendered by a resident to the government of the other State or as a member of a diplomatic or consular mission of the other State,
- protect from tax income earned by a resident student or apprentice in the form of a scholarship provided from another State,
- give tax relief in the residence country for income taxed in the other State, and
- ensure residents have unfettered rights to protection against discrimination and the ability to seek assistance from the competent authority.

The OECD also notes the possibility that the list could be expanded to deal with other possible situations where the parties might wish to afford treaty benefits to a resident, and gives the examples of pensions and social security benefits.

5. Theme 4. Tax considerations in choosing treaty partners

Action Item 6 in the BEPS Action Plan refers specifically to addressing, ‘the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.’³³ The OECD *Public Discussion Draft* recommends adding text to the Introduction to the Commentary articulating some of the relevant considerations explaining why countries should be very reluctant to negotiate tax treaties with low- or no-tax jurisdictions. This is an important discussion because it serves as a counter to the apparent assumption in many countries that a bigger income tax treaty network is always to be preferred, even if those treaties are with low- or no-tax jurisdictions. Clearly, there are significant non-tax considerations that bear on the decision whether to have a tax treaty with another country but in so far as tax considerations are important, developing countries should have a clear understanding of the tax costs and tax benefits for them from negotiating a treaty.

One of the main tax considerations that should bear on the issue is the recognition that source countries surrender tax claimed under domestic law in exchange for the economic benefits that the treaty promises. Thus the initial question for a country should be, ‘is there a real likelihood of significant and increased inward investment from negotiating a treaty with the treaty partner?’ Another way of thinking about this question would be to ask, ‘are there significant tax-driven impediments to greater cross-border trade and investment for which the best solution is a tax treaty?’ The proposed Commentary puts it this way:

the existence of risks of double taxation resulting from the interaction of the tax systems of the two States involved will be the primary tax policy concern.³⁴

It is important to appreciate why this is put with an inbound investment focus. A State might wish to pursue a treaty as a means for encouraging greater outbound investment and trade, but many instances of double taxation for outbound investment can be solved unilaterally without the need to negotiate a treaty. It may be that tax impediments to outbound trade and investment can be adequately addressed by domestic law.

In deciding whether and with whom to negotiate a treaty, source countries should thus consciously take into account whether amounts of income, which they will no longer be

³³ OECD, above n. 3, at 19.

³⁴ OECD, above n. 5, at 30.

taxing, will be taxed in the residence country. The *Public Discussion Draft* suggests that this is part of the bargain which underlies a treaty,

where a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State.³⁵

This is not simply a self-serving position, ‘if the treaty partner is not going to tax the income we might as well tax it.’ Rather, if the income is not taxed in the residence country, the possibility of double taxation and tax-driven impediments to greater trade and investment are less plausible. The source country tax is being curtailed but, in the absence of significant residence country tax, there is little scope for double taxation and any argument that unrelieved double taxation is frustrating trade and investment is unconvincing.

While the benefit usually sought from a treaty is eliminating tax as an impediment to greater levels of cross-border trade and investment, a State may wish to conclude a tax treaty with a low- or no-tax country in order to secure some of the other benefits that tax treaties promise, particularly assistance from abroad in the administration and collection of domestic taxes: access to information held offshore that is currently not available, a formal system for resolving tax disputes between States, promises of nondiscrimination, assistance in collecting domestic taxes, and so on. The OECD makes the judgment that these benefits –

would not, by themselves, provide a sufficient tax policy basis for the existence of a tax treaty because such administrative assistance could be secured through more targeted alternative agreements, such as the conclusion of a tax information exchange agreement or the participation in the multilateral Convention on Mutual Administrative Assistance in Tax Matters.³⁶

Moreover, there will undoubtedly be instances where the treaty partner will be unable to perform fully the administrative commitments they undertake in signing a treaty, whether through legal impediments, administrative capacity limitations or other reasons. A treaty

³⁵ Ibid.

³⁶ OECD, above n. 5, at 31.

signed in the hope of gaining just administrative benefits may ultimately produce little of lasting value, while at the same time curtailing the source country's tax base.

Finally, the discussion above has suggested an over-arching principle that tax treaties should not result in double non-taxation. Where the source country curtails its own tax claims knowing that the residence country imposes no significant taxation, the country is in effect assisting to produce a double non-taxation outcome.