TAX EXECUTIVES INSTITUTE, INC.

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Tax Treaties, Transfer Pricing and Financial
Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
Paris, France

Via Email: taxtreaties@oecd.org

RE: Discussion Draft on BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

To Whom It May Concern:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Action Plan or the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries' tax bases are being eroded or profits shifted improperly. Pursuant to Action 6 of the Plan, "Prevent treaty abuse," the OECD issued a public discussion draft on 14 March 2014 on *BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (hereinafter the Discussion Draft or Draft). The Discussion Draft sets forth several recommendations to modify the provisions of the OECD's Model Tax Convention on Income and Capital (Model Treaty) to address whether treaty benefits were granted in inappropriate cases.

The OECD requested comments on the Discussion Draft no later than 9 April 2014. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for comments.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 55 chapters in Europe, North America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 members represent over 3,000 of the largest companies in Europe, the United States, Canada, and Asia.

TEI Comments

BEPS Action 6 was envisioned to address perceived tax treaty abuse. Thus, it is perhaps unsurprising that the Discussion Draft seems imbued with the perspective that accessing treaty benefits is abusive, or, at a minimum, fraught with a great risk of inappropriate tax avoidance. This view is reflected in the proposed changes to the title of the Model Treaty and its preamble to include a reference to the prevention of "tax avoidance" and avoiding "creating opportunities for non-taxation or reduced taxation."[1]

TEI believes that a more balanced approach would be conveyed in the Draft if the OECD were to acknowledge explicitly that the vast majority of taxpayer claims to treaty benefits are *bona fide*, rather than treating any claim to treaty benefits as automatically suspect. This approach would be in accord with the general (and original) purposes of bilateral treaties to promote cross-border trade and investments by eliminating double-taxation and to prevent illegal fiscal evasion. Combatting legal (but disfavored) tax avoidance or eliminating double non-taxation are objectives that seem to be outside these primary purposes. Treaties accomplish these purposes by, in part, allocating taxing jurisdiction between the Contracting Parties. The perspective evidenced by the Draft, however, would move treaties from a general position of granting taxpayers certain rights to curbing such rights and potentially subjecting income to tax under a treaty where it may have been untaxed in the absence of the treaty. TEI appreciates the statement that tax treaties are not intended to give rise to double non-taxation. However, if tax treaties lead, or contribute, to double non-taxation, the provisions of the treaties themselves should be changed without resorting to the potential paradigm shift in the focus of the Model Treaty that the Discussion Draft portends.

<u>Specific Provisions of the Discussion Draft</u>

"Treaty Provisions and/or Domestic Rules to Prevent the Granting of Treaty Benefits in Inappropriate Circumstances"[2]

TEI commends the OECD for recommending changes to the language of its Model Treaty to address concerns with respect to tax treaty abuse under BEPS Action 6. Too often changes to the official OECD commentary to the Model Treaty (Official Commentary) have been made that could be interpreted in a manner that effectively amends the language of the Model, and thus greatly influence the interpretation of the various bilateral treaties that use the

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1 Discussion Draft at p.27-28.

2 *Id*. at p.3-26.

Model as their base. By recommending changes to language of the Model Treaty itself, countries that use the Model as a base will need to renegotiate their treaties and come to an agreement with the other contracting state (or states if the mechanism developed under BEPS Action 15 is utilised) on the meaning and interpretation of the new language. This will provide the certainty for taxpayers and tax authorities that is lacking when the OECD changes only the Official Commentary, which is more likely to lead to differing interpretations between taxpayers and tax authorities and between the competent authorities of the parties to a bilateral treaty.

With respect to the recommended changes to prevent granting treaty benefits inappropriately, the Discussion Draft distinguishes two sets of circumstances: (i) cases where a person tries to circumvent limitations provided by the treaty itself, and (ii) cases where a person tries to circumvent the provisions of domestic law using treaty benefits. With respect to the former, the OECD further categorises the issues as either "treaty shopping" or "other situations where a person seeks to circumvent treaty limitations." To address treaty shopping, the OECD recommends a three-pronged approach. First, the Discussion Draft recommends that the Model Treaty include a clear statement in the preamble and title that the contracting states wish to prevent tax avoidance and avoid creating opportunities for treaty shopping. Second, the Draft recommends including a specific anti-abuse rule in the Model Treaty based on the limitations-on-benefits provisions of treaties concluded by the United States and a few other countries (LOB provision). Third, the Draft recommends the inclusion of a more general anti-abuse rule, which will, in part, incorporate the principles of the Official Commentary to Article 1 of the Model Treaty, "according to which the benefits of a tax treaty should not be available where one of the main purposes of the arrangements or transactions is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the objective and purpose of the relevant provisions of the tax treaty . . . ." (hereinafter referred to as the treaty anti-abuse rule).[3]

The LOB Provision

The Discussion Draft sets forth a highly detailed LOB Provision as paragraphs 1-5 of a new "Article 'X,' Entitlement to Benefits." The Discussion Draft notes that a "detailed Commentary will explain the main features of this rule" and discusses some alternatives to, and additional issues that may be presented by, an LOB Provision (including the inclusion of a "derivative benefits" provision).[4]

In TEI's view, the inclusion of an LOB Provision similar to that set forth in the Draft is preferable to the inclusion of a treaty anti-abuse rule, as also recommended by the Draft. The LOB Provision, while complicated and detailed, is at least an objective standard that can be

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3 *Id*. at p.5.

4 *Id*. at p.5-9.

measured and verified. This approach provides the certainty that multi-national enterprises (MNEs) need to plan and conduct their international business operations. An LOB Provision permits an MNE to confidently take into account the application of a treaty and its associated benefits when making its business decisions. In contrast, the treaty anti-abuse rule is inherently subjective and would present MNEs with great uncertainty with respect to the cross-border tax consequences of their operations. Thus, TEI strongly recommends that any additions to the Model Treaty that would erect additional barriers to accessing the benefits of a treaty be in the form of an objective LOB Provision similar to the one set forth in the Discussion Draft.

With respect to the Draft's recommended version of the LOB Provision, TEI has the following comments. First, as the Discussion Draft notes, the LOB Provision is modeled on a similar provision included in the United States' model income tax treaty. The provision therefore inherently reflects U.S. domestic policy concerns, which may not be applicable on a global basis. If a U.S.-style LOB Provision is to be incorporated into the Model Treaty, the question arises whether the Official Commentary to the Treaty should also include the additional U.S. guidance interpreting the U.S. limitation-on-benefits provision (*e.g.*, the technical explanation of the U.S. model treaty released by the U.S. Treasury Department). TEI recommends that, if the OECD substantially adopts the U.S. LOB approach, the OECD should also substantially adopt the additional U.S. guidance in the Official Commentary. This would permit taxpayers to draw upon a generally well developed, known, and accessible body of regulatory and other guidance when applying the new LOB Provision of the Model Treaty.

Second, the LOB Provision includes various tests that, if satisfied, will entitle a person to treaty benefits if that person is entitled to benefits under the remaining provisions of the Model Treaty, including meeting the provisions of any treaty anti-abuse rule. These tests include a public company subsidiary test[5] and a base erosion test.[6] As drafted, these tests would deny treaty benefits if there is an intermediate entity in the chain of ownership that is not a resident of the same Contracting State as the public company or the persons otherwise entitled to treaty benefits that directly or indirectly own the person being tested.

This limitation does not recognise the global nature of MNE operations, which in many cases may have subsidiary ownership chains that cross back and forth between borders. Thus, the LOB Provision would deny treaty benefits to many subsidiaries where there does not appear to be a principled reason for the denial. TEI recommends that the OECD remove the requirement that intermediate entities be resident in the same Contracting State in the publicly traded subsidiary and base erosion tests. The other provisions of these tests (*i.e.*, the required direct and indirect ownership percentages and/or base erosion limitations) should be sufficient to ensure that treaty benefits are appropriate for such entities.

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[5] *See* Discussion Draft, Section 2.(c) of proposed Article "X" (pages 5-6).

[6] *See id*. at Section 2.(e), (page 6).

Third, TEI commends the inclusion of paragraph 4 of proposed Article "X," which permits a resident of a Contracting State not otherwise entitled to the benefits of the treaty to nevertheless obtain the relevant treaty benefit if the Competent Authority of the other Contracting State determines that establishment and conduct of the resident "did not have as one of its principal purposes the obtaining of benefits" under the treaty (hereinafter the Discretionary Benefits Provision).[7] This provision provides an "escape hatch" and needed flexibility for MNEs that conduct *bona fide* business operations in a Contracting State, but nevertheless fail the specific tests of the LOB Provision. On the other hand, an MNE availing itself of the Discretionary Benefits Provision is likely to face a time-consuming and unpredictable process with an overburdened competent authority. Therefore, it would be preferable to relax the tests in the LOB Provision to permit more residents to qualify for the treaty under those tests. In the absence of a relaxed test, the efficacy of the Discretionary Benefits Provision would be improved by including a list of factors and several examples that the relevant competent authority should consider when deciding whether to grant discretionary benefits. In addition, competent authorities should be obligated to complete a request for discretionary benefits within a set period of time.

Finally, TEI recommends the inclusion of a derivative benefits provision in the Model Treaty. The Discussion Draft does not specifically include such a provision in the LOB Provision set forth in proposed Article "X." Instead, the Draft provides language for a derivative benefits provision, but then sets forth an example where such a provision "could result in the granting of treaty benefits in the case of base eroding payments in situations that have given rise to BEPS concerns."[8] It appears that the objectionable portion of the example is that one Contracting State provides a preferential tax rate on certain income (royalties in the example), causing the company in the example to shift its operations from a relatively high tax country to the country with the preferential rate, even though treaty benefits are the same in both countries. If the OECD believes the low country tax rate is the objectionable feature, the situation in the example should be addressed by BEPS Action 5 on harmful tax practices, rather than in the revised Model Treaty. Doing so would permit the OECD to adopt the derivative benefits provision in the LOB Provision of a new Model Treaty. As important, in TEI's view, if two countries agree that their bilateral income tax treaty should have a derivative benefits provision (or not), then that should be the end of the matter. A derivative benefits provision should not be considered objectionable, or subject to attack, because it is to the detriment of a third country that is not a party to a treaty with such a provision.

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[7] *Id*. at p.7.

[8] *Id*. at p.9.

The treaty anti-abuse rule

In addition to the LOB Provision, the Draft provides a separate treaty anti-abuse rule that would deny treaty benefits in cases where "it is reasonable to conclude . . . [that] one of the main purposes" of an arrangement or transaction was to obtain the treaty benefit "directly or indirectly," unless "it is established that granting that benefit . . . would be in accordance with the object and purposes of the relevant provisions" of the treaty.[9] If applicable, this rule would deny treaty benefits to a person even if the person was a "qualified person" within the meaning of the LOB Provision. Similarly, the Draft provides that the LOB Provision can apply to deny benefits in cases where the treaty anti-abuse rule would not. In other words, both provisions must be satisfied for a taxpayer to claim the benefits of a treaty.

TEI opposes the inclusion of the treaty anti-abuse rule in the Model Treaty. In contrast to the objective LOB Provision, the treaty anti-abuse rule is highly subjective and susceptible to inconsistent and unpredictable interpretations by tax authorities. Further, paragraphs 24-32 of the Discussion Draft make clear that the treaty anti-abuse rule should be read broadly to include any type of benefit under a treaty and any type of arrangement if "one of" the main purposes (*i.e.*, not the sole or dominant purpose) will result, directly or indirectly, in a treaty benefit[10] – subject only to the exception for granting benefits "in accordance with the object and purpose" of the relevant treaty provisions.

For these reasons, a treaty anti-abuse rule would inject a high degree of uncertainty into the determination of whether a taxpayer is entitled to treaty benefits. This would increase the difficulty of making informed business decisions and arranging an MNE's operations because the resulting tax burden cannot be predicted with certainty.

Further, if taxpayers are not put on notice of what actions may be objectionable, even if not abusive, then it is difficult to see how a "main purpose" test can be applied. The examples set forth in the Discussion Draft are unhelpful in delineating what kinds of actions are subject to the main purpose test from those that are not, as the examples are based on extreme circumstances and are difficult to generalise from. In fact, it appears from the Discussion Draft

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9 *Id*. at p.10.

10 For example, paragraph 28 of the Draft states that changing the location of the meetings of the board of directors of a company to a different jurisdiction to claim that the company has changed its residence is an example of an "arrangement" that may be subject to the treaty anti-abuse rule. Historically, the location of the board of directors meeting has long been held by courts to be where the management of the company resides. The example thus runs counter to these decisions and will cause confusion and uncertainty for businesses when determining the location of a company's management. This example also fails to take into account that it is now common for a company's Board to have individual directors who reside in different jurisdictions and therefore at least some directors must necessarily travel to different jurisdiction to attend Board meetings.

that the "abuse" being policed is access to treaty benefits, which calls into question the reason for entering into tax treaties in the first place. Indeed, under the broad reach of the proposed treaty anti-abuse rule as described in the Draft, the operational structures of many MNEs that have been accepted by tax authorities under the current rules would be considered inappropriate and taxpayers would be denied the benefits of a treaty.

While TEI is strongly opposed to the inclusion of a treaty anti-abuse rule, if the OECD is determined to include one then TEI recommends that the LOB Provision be excluded from the Model Treaty (bearing in mind that our primary preference with respect to particular anti-treaty shopping provisions is to include an LOB Provision and exclude a treaty anti-abuse rule). Taxpayers should not have to go through the complicated and difficult process of determining whether they satisfy a treaty's LOB Provision only to have treaty benefits denied under a treaty anti-abuse rule.

Similarly, if a treaty anti-abuse rule is included in the Model Treaty, the Treaty should also include an effective process through which a taxpayer could receive a timely administrative decision on whether the rule applies if asserted by a government. The uncertain rule should not be exacerbated by an unwieldy and lengthy process to determine the rule's proper application, including drawn out mutual agreement procedures in cases where competent authorities disagree on the rule's application. In addition, the wording of the test should be changed from "a" main purpose to "the" main purpose to provide taxpayers with additional certainty and require evidence that the dominant purpose of the transaction is to obtain treaty benefits. Finally, the examples to be included in the detailed Official Commentary regarding the application of this provision, as promised by the Discussion Draft, should be clear and universally applicable.

Exclusion of third country permanent establishments

The Discussion Draft proposes a new paragraph 4 to Article 1 "Persons Covered" of the Model Treaty to address the use of permanent establishments (PE) in third countries to obtain preferential treatment of certain income. In particular, the Draft refers to the potential abuse that may result from the transfer of assets to a third country PE set up solely for the purpose of the transfer to obtain a low rate of tax on the assets' income. "Where the state of residence exempts, or taxes at low rates, profits of such [PEs] situated in third States, the State of source should not be expected to grant treaty benefits with respect to that income."[11] The Draft proposes a targeted anti-abuse rule to address this situation if the tax rate on the relevant income is less than 60 percent of the general rate of company tax applicable in the residence state. The rule is subject to certain exceptions, including for income derived from the active conduct of a trade or business of the third country PE.

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11 Discussion Draft at p.19.

TEI is not opposed to a targeted anti-abuse rule in this circumstance. The suggested rule is objective and clear, and as long as it is consistently applied, it should not present the type of uncertainties presented by the treaty anti-abuse rule.

"Saving clause" provision

The Discussion Draft also proposes a "saving clause" in new paragraph 3 of Article 1, which would provide that "This Convention shall not affect the taxation, by a Contracting State, of its residents" except with respect to certain treaty benefits enumerated in the new paragraph. This addition to the Model Treaty is "to prevent interpretations intended to circumvent the application of a Contracting State's domestic anti-abuse rules (as illustrated by the example of controlled foreign company rules)."[12] The Draft states that this provision corresponds to the practice in the United States with respect to its treaties.

TEI is not generally opposed to savings clauses in treaties, as long as they are objective and it is clear how they apply. TEI would oppose a savings clause that introduces an element of subjectivity to the determination of whether a resident of a Contracting State can avail itself of the benefits of a treaty.

Corporate residence tie-breaker

The current corporate residence tie-breaker rule in paragraph 3 of Article 4 "Residence" of the Model Treaty determines the residence of a dual-resident company by reference to the company's "place of effective management." The Discussion Draft would replace the current rule with a case-by-case determination of residence through mutual agreement of the Contracting States' competent authorities. Factors to consider in this determination are the place of effective management of the company, the place where it is organised, and any other relevant factors. If the competent authorities cannot come to an agreement, then the company would not be entitled to the benefits of the relevant treaty unless the competent authorities otherwise agree. The Draft notes that the reason for this change is that "the view of many countries was that cases where a company is a dual-resident often involve tax avoidance arrangements."[13]

In TEI's view, the issue of companies with dual residencies should be addressed by domestic law. If the domestic law of a Contracting State permits a corporation to, *e.g.*, change the place where it is organised to become resident in more than one country for tax avoidance purposes, then the State should change its law to either not permit such a reincorporation or look to the company's place of effective management for determining residence. That is, if a country objects to dual-resident companies, then that country's law should not allow them.

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12 *Id*. at 24.

13 *Id*. at 17.

Proposed new Article 4(3) of the Draft further pushes tax treaties toward a new paradigm of combatting tax avoidance by creating taxation where there would otherwise be none.

Dividends: source country intermediary company

The Draft recommends that an anti-abuse rule (or rules) should be included in Article 10 "Dividends" to address "cases where certain intermediary entities established in the State of source are used to take advantage of the treaty provisions that lower the source taxation of dividends."[14] The Draft notes that "a specific anti-abuse rule might be drafted to address situations where a non-resident company makes indirect portfolio investments into domestic companies through a domestic investment company that is not taxed on dividends it receives from such other domestic companies."[15]

TEI opposes the inclusion of vague and subjective anti-abuse rules that look to the "purpose" of a transaction, *e.g.*, "to take advantage of" lower source taxation of dividends, because of the resulting uncertainty. Anti-abuse rules should be objective, narrow, and targeted. In the particular case cited of indirect portfolio investments via investment companies, a simpler solution that would not require modifications to the Model Treaty would be to change the law of the Source state so that the dividends received by the investment company would be taxable in that company's hands.

Effective Date, Transition Rules & Grandfathering, and Interpretation

As noted, the changes proposed by the Discussion Draft will cause many currently acceptable MNE business structures to fail to qualify for treaty benefits, causing significant disruption to MNEs that planned their operations based on the availability of such benefits. TEI therefore recommends that the OECD provide an effective date for the recommended changes in the Draft (*e.g.*, two years from when a treaty enters into force). In addition to an effective date, the OECD should provide transition or grandfathering rules to give taxpayers time to change their existing operations to comply with the new rules, or to provide certainty that their current structures can remain in place. Finally, these rules should be accompanied by a directive that a "main purpose" or similar test should only be applied by tax authorities prospectively to arrangements and transactions that arise after the effective date. Otherwise, tax authorities may be tempted to use the test to invalidate structures put in place before the existence of the test.

Conclusion

TEI appreciates the opportunity to comment on the OECD's Discussion Draft on *BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*. These

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[14] *Id*. at 16.

[15] *Id*.

comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +352 26 20 77 46, nickha@herbalife.com, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.

Terilea J. Wielenga
International President