

Revised discussion draft

# BEPS ACTION 6: PREVENT TREATY ABUSE

22 May 2015 – 17 June 2015





22 May 2015

**NEW DISCUSSION DRAFT ON ACTION 6 OF THE BEPS ACTION PLAN  
(PREVENT TREATY ABUSE)**

*New discussion draft*

Paragraph 5 of the Report on the work on Action 6 (“Prevent the granting of treaty benefits in inappropriate circumstances”) of the BEPS Action Plan (the “Report”) indicates that follow-up work will be done on certain aspects of the Report:

... it is recognised that further work will be needed with respect to the precise contents of the model provisions and related Commentary included in Section A of this report, in particular the LOB rule. Further work is also needed with respect to the implementation of the minimum standard and with respect to the policy considerations relevant to treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds. The model provisions and related Commentary included in Section A of this report should therefore be considered as drafts that are subject to improvement before their final version is released in September 2015...

On 21 November 2014, the OECD released a discussion draft that identified 20 different issues to be addressed as part of the follow-up work on Action 6. That draft included, in shaded boxes, specific questions on which comments were invited. Over 750 pages of public comments were received and a public consultation meeting was held on 22 January 2015. At its meetings of 5-6 and 11-13 March 2015, Working Party 1 on Tax Conventions and Related Questions continued its work on these issues in the light of the comments received, agreed on how to address the majority of these issues and discussed new proposals related to some issues.

This new discussion draft reflects the conclusions and proposals that resulted from that meeting and on which the Committee on Fiscal Affairs is now inviting comments. The discussion draft and the comments received on it will be discussed at the Working Party 1 meeting of 22-26 June 2015, when the Working Party will be asked to produce a final version of the Report on Action 6 that will take into account the conclusions of the follow-up work done on the issues identified in the November 2014 discussion draft.

As part of the transparent and inclusive consultation process mandated by the Action Plan, the Committee on Fiscal Affairs (CFA) invites interested parties to send comments on this discussion draft.

Comments should be sent by **17 June 2015** at the latest (no extension will be granted) and should be sent by email to [taxtreaties@oecd.org](mailto:taxtreaties@oecd.org) in Word format (in order to facilitate their distribution to government officials). They should be addressed to Marlies de Ruiter, Head, Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.

**Comments should be kept as short as possible:** this is the third discussion draft related to Action 6 and extensive comments have already been sent on the different proposals resulting from the work on that part of the BEPS Action Plan. For the same reason, no public consultation meeting will be held on the proposals included in this new discussion draft.

Please note that all comments received regarding this consultation draft will be made publicly available. Comments submitted in the name of a collective “grouping” or “coalition”, or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

*The proposals included in this discussion draft do not, at this stage, represent the consensus views of the CFA or its subsidiary bodies but are intended to provide stakeholders with substantive proposals on how to address the issues for analysis and comment.*

## TABLE OF CONTENTS

Introduction.....	4
PART 1 – Alternative “simplified” LOB rule and presentation of the LOB rule in the OECD Model.....	4
PART 2 – Issues identified in the November 2014 discussion draft .....	7
A. Issues related to the LOB rule .....	7
1. Collective investment vehicles: application of the LOB and treaty entitlement .....	7
2. Non-CIV funds: application of the LOB and treaty entitlement .....	8
3. Commentary on the discretionary relief provision of the LOB rule.....	10
4. Alternative LOB provisions for EU countries .....	12
5. Requirement that each intermediate owner be a resident of either Contracting State.....	14
6. Issues related to the derivative benefits provision.....	16
7. Provisions dealing with “dual-listed company arrangements” .....	19
8. Timing issues related to the various provisions of the LOB rule .....	20
9. Conditions for the application of the provision on publicly-listed entities .....	21
10. Clarification of the “active business” provision .....	22
B. Issues related to the PPT rule.....	24
11. Application of the PPT rule where benefits are obtained under different treaties.....	24
12. Inclusion in the Commentary of the suggestion that countries consider some form of administrative process ensuring that the PPT is only applied after senior approval .....	25
13. Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable.....	25
14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test .....	26
15. Whether some form of discretionary relief should be provided under the PPT rule .....	28
16. Drafting of the alternative “conduit-PPT rule”.....	30
17. List of examples in the Commentary on the PPT rule.....	34
C. Other issues.....	36
18. Application of the new treaty tie-breaker rule.....	36
19. The design and drafting of the rule applicable to PEs located in third States .....	39
20. Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules...40	
ANNEX - Presentation of the LOB in the OECD Model Tax Convention.....	42

## **PROPOSALS ON HOW TO DEAL WITH THE ISSUES FOR FOLLOW-UP WORK ON THE REPORT ON ACTION 6**

### **INTRODUCTION**

1. On 21 November 2014, the OECD released a discussion draft that identified 20 different issues to be addressed as part of the follow-up work on Action 6. That draft included, in shaded boxes, specific questions on which comments were invited. Over 750 pages of public comments were received and a public consultation meeting was held on 22 January 2015. At its meetings of 5-6 and 11-13 March 2015, Working Party 1 on Tax Conventions and Related Questions continued its work on these issues in the light of the comments received, agreed on proposals on how to address the majority of these issues and discussed new proposals related to some issues.

2. This new discussion draft reflects the conclusions and proposals that resulted from that meeting and on which the Committee on Fiscal Affairs is now inviting comments. Part 1 reflects the outcome of the discussion of a new proposal for an alternative “simplified” limitation-on-benefits (LOB) rule and on how the LOB rule should be presented in the OECD Model Tax Convention. Part 2 presents the outcome of the discussion of each of the 20 issues for follow-up work that were identified in the discussion draft of 21 November 2014, including new proposals for treaty rules intended to address concerns related to special tax regimes and to changes to domestic law made after the conclusion of a treaty (these proposals are included in Section 6 of Part 2).

### **PART 1 - ALTERNATIVE “SIMPLIFIED” LOB RULE AND PRESENTATION OF THE LOB RULE IN THE OECD MODEL**

3. At its March 2015 meetings, Working Party 1 discussed extensively how the LOB rule should be structured and presented in the OECD Model Tax Convention. That discussion was triggered by the presentation of the following alternative version of the LOB rule which is intended to be used in combination with the PPT rule; it also took into account the suggestions by a few commentators that the Report on Action 6 should not focus on developing a model LOB provision but should focus instead on the elaboration of guidance on underlying principles and the general elements that an LOB provision should contain:

#### *ARTICLE X*

#### *ENTITLEMENT TO BENEFITS*

1. Except as otherwise provided in this Article, a resident of a Contracting State shall be entitled to the benefits that would otherwise be accorded by this Convention only if such resident is a qualified person.
2. For the purposes of this Article, a resident of a Contracting State shall be a qualified person if the resident is either:

- a) an individual;
- b) that Contracting State, any political subdivision or local authority thereof, the central bank thereof or a person that is wholly owned, directly or indirectly, by that State or any political subdivision or local authority thereof;
- c) a company, if the principal class of its shares is regularly traded on one or more recognised stock exchanges;
- d) a person other than a company, if its beneficial interests are regularly traded on one or more recognised stock exchanges;
- e) a person other than an individual, if residents of that Contracting State that are qualified persons own, directly or indirectly, more than 50 per cent of the beneficial interests of the person.

3. A resident of a Contracting State that is not a qualified person shall nevertheless be entitled to a benefit that would otherwise be accorded by this Convention with respect to an item of income if persons that are equivalent beneficiaries own, directly or indirectly, more than 75 per cent of the beneficial interests of the resident.

4. a) A resident of a Contracting State that is neither a qualified person nor entitled under paragraph 3 to a benefit that would otherwise be accorded by this Convention with respect to an item of income shall nevertheless be entitled to such benefit if the resident is carrying on a business in the first-mentioned Contracting State (other than the business of making or managing investments for the resident's own account, unless the business is carried on by a bank, an insurance company, a registered securities dealer or any other institution agreed upon by the Contracting States) and that item of income is derived in connection with, or is incidental to, that business.
- b) If a resident of a Contracting State derives an item of income from a business carried on by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from a related enterprise of the resident, the conditions described in subparagraph a) shall be considered to be satisfied with respect to such item of income only if the business carried on by the resident in the first-mentioned Contracting State is substantial in relation to the business carried on by the resident or related enterprise in the other Contracting State. Whether a business is substantial for the purpose of this subparagraph shall be determined on the basis of all the facts and circumstances.
- c) For the purposes of this paragraph, the business carried on by a partnership in which a person is a partner and the business carried on by related enterprises of a person shall be deemed to be carried on by such person.

5. A resident of a Contracting State that is neither a qualified person nor entitled under paragraph 3 or 4 to a benefit that would otherwise be accorded by this Convention with respect to an item of income shall nevertheless be entitled to such benefit if the competent authority of the Contracting State from which the benefit is being claimed, upon request from that resident, determines, in accordance with its domestic law or administrative practice, that the establishment, acquisition or maintenance of the resident and the conduct of its operations are considered as not having as one of its principal purposes the obtaining of such benefit. The competent authority of the Contracting State to which such request has been made by a resident of the other Contracting State shall consult with the competent authority of that other State before rejecting the request.

6. For the purposes of this Article:

- a) the term “principal class of shares” means the class or classes of shares of a company which represents in the aggregate a majority of the voting power of the company;
- b) the term “recognised stock exchange” means:
  - i) any stock exchange established and regulated as such under the laws of either Contracting State; and
  - ii) any other stock exchange agreed upon by the competent authorities of the Contracting States;
- c) the term “equivalent beneficiary” means any person who would be entitled to an equivalent or more favourable benefit with respect to an item of income accorded by a Contracting State under the domestic law of that Contracting State, this Convention or any other international instrument as the benefit to be accorded to that item of income under this Convention, provided that, if that person is a resident of neither of the Contracting States, the first-mentioned Contracting State has a convention for the effective and comprehensive exchange of information relating to tax matters in effect with the state of which that person is a resident. For the purposes of determining whether a person is an equivalent beneficiary with respect to dividends, the person shall be deemed to hold the same capital, shares or voting powers, as the case may be, of the company paying the dividends as the company claiming the benefit with respect to the dividends holds those of the company paying the dividends.
- d) A person shall be a related enterprise of another if, on the basis of all the facts and circumstances, one has control of the other or both are under the control of the same person or persons.

7. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.

4. The Working Party discussed the various features of that rule, which was referred to as a “simplified LOB”, as well as issues and concerns that the proposal may raise.

5. A number of delegates considered that this alternative version of the LOB rule would address different concerns raised by the LOB rule included in the Report on Action 6 and would provide a simpler way to address the most obvious cases of treaty-shopping, other cases being dealt with under the PPT. It was agreed that this approach was consistent with the minimum standard described in paragraph 14 of the Report on Action 6, which may be satisfied by the inclusion of any form of LOB combined with the PPT, whereas the LOB rule that was included in the Report was considered more appropriate for countries that would prefer to meet the minimum standard through the combination of an LOB rule and a mechanism dealing with conduit arrangements. It was agreed, however, that it would be important to ensure that the non-application of the simplified LOB in a given case should not be interpreted in any way as suggesting that the PPT would not be applicable to that case.

6. This led the Working Party to discuss how the simplified LOB could be incorporated into the Model Tax Convention. It was proposed that this could be done by describing the main features of the LOB in the Articles of the Model and presenting the alternative formulations of each paragraph in the Commentary. The Annex includes an example illustrating how that approach would work in the case of the publicly-listed entity provision that is part of the LOB rule.



## **PART 2 – ISSUES IDENTIFIED IN THE NOVEMBER 2014 DISCUSSION DRAFT**

### **A. ISSUES RELATED TO THE LOB PROVISION**

#### **1. Collective investment vehicles: application of the LOB and treaty entitlement**

##### *Issue*

7. Paragraph 6 of the Report on Action 6 indicated that further work was needed “with respect to the policy considerations relevant to the treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds.”

8. Subparagraph 2 *f*) of the LOB rule (paragraph 16 of the Report) provides for the inclusion, in the list of “qualified persons”, of a provision dealing with collective investment vehicles (CIVs). A footnote indicates that the subparagraph should be drafted, or omitted, based on how CIVs are treated in the Convention and are used and treated in each Contracting State; that footnote also refers to paragraphs 6.4 to 6.38 of the Commentary on Article 1. The Commentary on the LOB rule includes a discussion of how CIVs could be dealt with as well as a number of alternative provisions that correspond to the various approaches included in the 2010 OECD Report “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles”.

9. As part of the follow-up work on the Report on Action 6, it was intended to review these alternative approaches and to examine whether it would be possible to suggest a single preferred approach, not only with respect to the application of the LOB to CIVs but also with respect to the more general question of the treaty entitlement of CIVs, taking into account developments since 2010 and, in particular, the results of the work on the Treaty Relief and Compliance Enhancement (TRACE) project.

10. Comments were therefore invited as to whether the recommendations of the 2010 CIV Report continued to be adequate for widely-held CIVs and whether any improvements should be made to the conclusions included in that Report. Comments were invited, in particular, on whether it would be advisable to adopt a preferred approach with respect to issues related to the tax treaty entitlement of the income of CIVs and the application of the LOB to CIVs, and if yes, on what that approach should be.

##### *Comments received*

11. The comments received on the November 2014 discussion draft uniformly supported the recommendations of the 2010 CIV Report, noting that a flexible approach was necessary with respect to the availability of treaty benefits for CIVs (in light of their varied structures, investor bases and investment policies). The general conclusion was therefore that a single approach to the treaty entitlement of CIVs was not feasible or advisable.

12. Commentators observed, however, that practical experience had demonstrated that some countries had not followed the recommendations of the 2010 Report. Commentators also noted the need to implement the TRACE implementation package and expressed concern that procedures for CIVs to obtain the treaty benefits to which they were entitled had become onerous and unreasonable; some commentators considered the widespread international implementation of TRACE to be a necessary precursor to the application of the LOB rule to CIVs.

13. A number of commentators argued that the LOB rule should not apply to CIVs – that CIVs should *per se* be “qualified persons” for purposes of the LOB rule. Other commentators stated that the widely held criterion was the most relevant factor to determine whether a CIV should be entitled to treaty

benefits and advocated an approach such as the United Kingdom “Genuine Diversity of Ownership” test. This last suggestion was repeated a few times during the public consultation meeting of 22 January.

### ***Proposed approach on how to address the issue***

14. When this issue and the comments received on it were discussed at the March 2015 meetings of Working Party 1, it was concluded that since there was general support for the conclusions of the 2010 CIV Report concerning the treaty entitlement of CIVs and since subparagraph 2 f) of the LOB rule dealt with the application of the LOB to CIVs in a way that reflected the conclusions of the 2010 CIV Report, there was no need for additional changes to the Report on Action 6 in order to address these issues. It was also agreed, however, that the implementation of the recommendations of the TRACE project was important for the practical application of these conclusions.

## **2. Non-CIV funds: application of the LOB and treaty entitlement**

### ***Issue***

15. Paragraph 5 of the Report on Action 6 indicated that further work was needed with respect to the policy considerations relevant to the treaty entitlement of non-CIV funds. Whilst changes were made in the final version of the Report in order to deal with collective investment vehicles, no such changes were made to address comments that were received on the March 2014 discussion draft in relation to Real Estate Investment Trusts (REITs), sovereign wealth funds (SWFs), pension funds and alternative funds (including private equity funds).

16. Although most of the issues that have been identified relate to the LOB rule, it has also been suggested that the PPT rule could affect negatively these investment funds. Some issues go beyond the work on Action 6 and relate to the treaty entitlement of investment funds. The November 2014 discussion draft included a description of the main issues.

### ***Comments received***

17. A number of commentators who responded to the November 2014 discussion draft argued that many of the same issues and policy considerations that apply to CIVs apply to non-CIVs and called for the expansion of the treatment provided for CIVs to non-CIVs, noting, for example, that non-CIVs (such as alternative and private equity funds) are often widely held and may hold investments in a wide range of markets, securities and/or activities. A number of commentators called for the Action 6 work on non-CIVs also to address expressly the treaty entitlement of REITs, corporate debt funds and securitisation vehicles. They argued that work on CIVs should not prejudice the availability of treaty benefits for non-CIVs.

18. Some commentators expressed concerns that a few countries had begun to introduce procedural requirements for pension funds to obtain treaty relief to which they were entitled, which made such relief “unattainable or prohibitively expensive”; these commentators considered that the LOB rule posed an additional threat to the treaty entitlement of pension funds and urged that attention also be focused on the practical manner in which pension funds would establish that they had satisfied the LOB rule. Some commentators suggested a carve-out from the LOB rule (and from the PPT rule) for pension funds that meet applicable requirements in the country in which they are established. – e.g. that pension funds be expressly included in the definition of “qualified persons” in paragraph 2 of the LOB rule – in light of their particular role and purpose and the low risk they presented of treaty-shopping risks. Some commentators recommended the elimination of the “more than 50 per cent of the beneficial interests” test for pensions in subparagraph 2 d), which some considered to contravene EU law or to fail to reflect the commercial and operational reality of MNEs. Some commentators suggested that a pension fund should be considered a resident of the country in which it is constituted regardless of whether it benefits from a limited or

complete exemption from taxation in that country. Commentators also supported the alternative provision in paragraph 69 of the Commentary on Article 18 providing for a reciprocal exemption for pension income and suggested that it not be limited to circumstances in which the two Contracting States follow the same approach in exempting pension funds' investment income.

***Proposed approach on how to address the issue***

19. The Working Party discussed these various comments and suggestions at its March 2015 meetings.

20. It first noted the concerns from the REIT industry that whilst the OECD has confirmed the conclusions of the 2010 CIV Report, it has not done so for the 2008 REIT Report. The Working Party agreed to further discuss, at its June meeting, the following proposal intended to add a specific reference to the conclusions of the REIT Report:

*Add the following footnote to the first part of paragraph 31 of the Commentary on subparagraph 2 f) of the LOB rule included in paragraph 16 of the Report on Action 6 (the additional footnote appears in bold italics):*

31. As indicated in the footnote to subparagraph f), whether a specific rule concerning collective investment vehicles (CIVs) should be included in paragraph 2, and, if so, how that rule should be drafted, will depend on how the Convention applies to CIVs and on the treatment and use of CIVs in each Contracting State.<sup>1</sup> ***Whilst no such rule will be needed with respect to an entity that would otherwise constitute a “qualified person” under other parts of paragraph 2, Such a specific rule will frequently be needed since a CIV may not be a qualified person entitled to treaty benefits under either the other provisions of paragraph 2 or under paragraph 3, because, in many cases ...***

*[Footnote 1] See also paragraphs 67.1 to 67.7 of the Commentary on Article 10 and the report “Tax Treaty Issues Related to REITs” which deal with the treaty entitlement of Real Estate Investment Trusts (REITs). With respect to the application of the definition of “resident of a Contracting State” to REITs, see paragraphs 8-9 of the report “Tax Treaty Issues Related to REITs”.*

21. The Working Party also agreed that a pension fund should be considered to be a resident of the State in which it is constituted regardless of whether it benefits from a limited or complete exemption from taxation in that State. It therefore agreed to consider, at its June meeting, a proposal for changes to the OECD Model Tax Convention that would ensure that outcome.

22. As regards the broader question of the treaty entitlement of non-CIV funds, the Working Party recognised the economic importance of these funds and the need to ensure that treaty benefits be granted where appropriate. It also noted, however, that most suggestions included in the comments received did not sufficiently take account of treaty-shopping concerns.

23. During the discussion, it was observed that the new treaty provision on transparent entities that is included in Part 2 of the Report on Action 2 (Neutralising the effects of hybrid mismatch arrangements) will be beneficial for non-CIV funds that use entities that one or the two Contracting States treat as fiscally transparent since income derived through such entities that will be taxed in the hands of the investors in these entities will generally receive treaty entitlement at the level of these investors even if these investors are residents of third States. It was also observed that the possible inclusion of a derivative benefits provision in the LOB rule (see Section 6 below) could also address some of the concerns regarding the treaty entitlement of non-CIV funds in which there are non-resident investors.

24. The Working Party agreed that it should continue to explore solutions to issues related to the treaty entitlement of non-CIV funds that would address two general concerns that governments have about granting treaty benefits with respect to non-CIVs: that non-CIVs may be used to provide treaty benefits to investors that are not themselves entitled to treaty benefits and that investors may defer recognition of income on which treaty benefits have been granted. Possible options that the Working Party intends to further discuss at its June meeting include adding a specific provision on non-CIVs in the LOB rule and adding one or more examples on non-CIVs to the Commentary on the PPT rule. The Working Party also agreed that work on these and other options might continue after the September 2015 adoption of the final report on Action 6 but should in any event be completed before the December 2016 deadline for the negotiation of the multilateral instrument that will implement the conclusions of the work on Action 6.

### **3. Commentary on the discretionary relief provision of the LOB rule**

#### *Issue*

25. Paragraph 5 of the LOB rule included in paragraph 16 of the Report on Action 6 is a provision that grants to the competent authority of a Contracting State the discretion to grant treaty benefits in some situations where a resident of a Contracting State would otherwise be denied treaty benefits under the LOB rule (the “discretionary relief” provision).

26. Paragraph 63 of the Commentary on the LOB rule explains that the person who makes a request for discretionary relief must establish to the satisfaction of the competent authority “that there were clear reasons, unrelated to the obtaining of treaty benefits, for its formation, acquisition, or maintenance...”. The November 2014 discussion draft suggested that paragraph 63 should clarify that, in the case of a resident subsidiary company with a parent in a third State, whilst the fact that the relevant withholding rate provided in the Convention is not lower than the corresponding withholding rate in the tax treaty between the State of source and the third State would be a relevant factor, that fact would not, in itself, be sufficient to establish that the conditions for granting the discretionary relief are met. In addition, other relevant factors and examples could be added to the Commentary in order to clarify circumstances where the discretionary relief provision is intended to apply.

27. The November 2014 discussion draft also suggested that the Commentary on the discretionary relief provision should encourage the competent authority that receives a request for relief under that provision to process that request expeditiously. Finally, it was suggested that, in order to remove any doubt, the Commentary should clarify that if a competent authority has properly exercised the discretion granted by the discretionary relief provision of paragraph 5, that provision has been complied with and it cannot, therefore, be argued that taxation is not in accordance with the provisions of the Convention.

#### *Comments received*

28. Commentators made a number of suggestions as to when discretionary relief should be available under paragraph 5 of the LOB rule, which included the following:

- A rebuttable presumption of non-abuse (*i.e.* discretionary relief should be provided) where the treaty with the jurisdiction of the ultimate parent provides for a rate of withholding tax not higher than the rate provided in the treaty with the jurisdiction of the immediate recipient of the income;
- Discretionary partial relief should be available where a benefit would be denied to the immediate recipient of the income and a treaty benefit would have been available had the ultimate owner invested directly (*e.g.* a pension fund investing through a third-country entity).

29. Commentators also suggested reference to the business (*i.e.* non-tax) rationale for residence in a particular jurisdiction, the commercial/operational development of MNE groups and acquisition histories; one commentator referred to the factors listed in the memorandum of understanding regarding the discretionary benefits provision in the LOB article of the 1992 Netherlands-United States treaty. Commentators called for the standard for discretionary relief under the LOB rule to be expressly aligned with the standard applied for purposes of the PPT rule (this separate issue is dealt with under Section 14 below). Some commentators called for special attention to situations in which a non-tax motivated change of circumstances causes a taxpayer which formerly satisfied the LOB rule to no longer satisfy it. Commentators also submitted a number of examples which they viewed as justifying the application of the discretionary relief provision.

30. A number of commentators questioned whether revenue authorities would be able to apply the discretionary relief provision in a timely and consistent manner and expressed concern that the discretionary relief provision provided little certainty. A number of commentators thus called for a transparent, time-bound process for requests for discretionary relief under the LOB rule, which would include, for example, published guidance on the standards to be applied and the anonymised publication of the decisions reached. Some commentators also urged that no requests for discretionary relief should be denied without prior bilateral competent authority consultation.

#### ***Proposed approach on how to address the issue***

31. At its March 2015 meetings, Working Party 1 agreed that the clarification mentioned in paragraph 26 above should be made. It also agreed that more guidance should be provided concerning the factors that should be taken into account by a competent authority considering a request for discretionary relief and that such guidance should be drafted for consideration at the June meeting of the Working Party. It finally agreed to change the Commentary on the discretionary relief provision as suggested in paragraph 27 above.

32. It is therefore proposed to make the following changes to the Commentary on paragraph 5 of the LOB rule (the discretionary relief provision) which appears in paragraph 16 of the Report on Action 6:

*Replace existing paragraphs 63 to 65 of the proposed changes to the Commentary on paragraph 5 of the LOB rule which appears in paragraph 16 of the Report on Action 6 (changes to the proposed Commentary included in the Report on Action 6 are underlined):*

***63. In order to be granted benefits under paragraph 5, the person must establish, to the satisfaction of the competent authority of the State from which benefits are being sought, that there were clear non-tax business reasons unrelated to the obtaining of treaty benefits, for its formation, acquisition, or maintenance and that any reasons related to the obtaining of treaty benefits were clearly secondary to those unrelated reasons, and for the conduct of its operations in the other Contracting State. Through this paragraph, a resident that is not entitled to the benefits of the Convention under paragraphs 1 through 4 but who has a substantial sufficient relationship to its State of residence, taking into account considerations in addition to other than those addressed through the objective tests in paragraphs 1 through 4, may be able to obtain treaty benefits where the allowance of benefits would not otherwise be contrary to the purposes of the Convention. In the case of a resident subsidiary company with a parent in a third State, whilst the fact that the relevant withholding rate provided in the Convention is not lower than the corresponding withholding rate in the tax treaty between the State of source and the third State would be a relevant factor, that fact would not, in itself, be sufficient to establish that the conditions for granting the discretionary relief are met. Similarly, ~~w~~Where a foreign company is engaged in a mobile business such as financing, or where the domestic law of a Contracting***

*State provides a special tax treatment for certain activities conducted in special zones or offshore (e.g. licensing intangibles) those factors will not be evidence of a non-tax business reason for locating in that State. In such cases, additional favourable business factors must be present to establish a ~~substantial~~<sup>sufficient</sup> relationship to that State. Paragraph 5 also provides that the competent authority of the State to which the request is made will consult with the competent authority of the other State before refusing to exercise its discretion to grant benefits to a resident of that other State.*

**64. The competent authority that receives a request for relief under paragraph 5 should process that request expeditiously.**

**64.1** *Although ~~such a request under paragraph 5~~ will usually be made by a resident of a Contracting State to the competent authority of the other Contracting State, there may be cases in which a resident of a Contracting State may request the competent authority of its own State of residence to grant relief under paragraph 5. This would be the case if the treaty benefits that are requested are provided by the State of residence, such as the benefits of the provisions of Articles 23 A and 23 B concerning the elimination of double taxation. In such cases, the paragraph does not require the competent authority to consult the competent authority of the other State before denying the request.*

**65.** *The paragraph grants broad discretion to the competent authority and, as long as the competent authority has exercised that discretion in accordance with the requirements of the paragraph, it cannot be considered that the decision of the competent authority is an action that results in taxation not in accordance with the provisions of the Convention (see paragraph 1 of Article 25). The paragraph does require, however, that the competent authority must consider the relevant facts and circumstances before reaching a decision and must consult the competent authority of the other Contracting State before rejecting a request to grant benefits. The first requirement seeks to ensure that the competent authority will consider each request on its own merits whilst the requirement that the competent authority of the other Contracting State be consulted should ensure that Contracting States treat similar cases in a consistent manner and can justify their decision on the basis of the facts and circumstances of the particular case. This consultation process does not, however, require that the competent authority to which the request has been presented obtain the agreement of the competent authority that is consulted. The determination that neither the establishment, acquisition or maintenance of the resident making the request, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under the Convention is a matter that is left to the discretion of the competent authority to which the request is made. Once it has determined that this is the case, the competent authority is required to grant benefits but it may then grant all of the benefits of the Convention to the taxpayer making the request, or it may grant only certain benefits. For instance, it may grant benefits only with respect to a particular item of income in a manner similar to paragraph 3. Further, the competent authority may establish conditions, such as setting time limits on the duration of any relief granted.*

#### **4. Alternative LOB provisions for EU countries**

##### **Issue**

33. Paragraph 13 of the Report on Action 6 acknowledged that the LOB rule (paragraph 16 of the Report on Action 6) may need to be adapted to reflect certain EU law requirements. The November 2014 discussion draft therefore suggested that there was a need to draft alternative provisions that would accommodate the concerns of EU Member States.

### *Comments received*

34. Most comments that were received on this issue following the release of the November 2014 discussion draft suggested that alternative provisions were needed for EU/EEA countries to avoid potential conflicts with EU law (although one commentator argued that a derivative benefits provision was not strictly required under EU law). Other comments noted that a derivative benefits provision should not discriminate in favour of EU residents as compared to residents of other States (*e.g.* States that are members of other regional groupings).

### *Proposed approach on how to address the issue*

35. EU law issues related to the Report on Action 6 were discussed at an *ad hoc* meeting of the Working Party that was held on 19-20 January 2015. The general conclusion of that meeting was that although no changes should be made to the model provisions included in the Report in order to address specific EU law issues, this would not preclude the inclusion of alternatives in the Commentary or changes to the model provisions that would deal with EU law issues whilst addressing other concerns (*e.g.* changes to the pension fund provisions of the LOB rule that would address other concerns related to the treaty entitlement of non-CIV funds; changes to address concerns of smaller States). It was also agreed, however, that as far as possible, alternatives to be included in the Commentary should not be restricted to EU/EEA States but should address issues more generically in order to avoid giving preferential treatment to EU/EEA residents compared to residents of other States. These general conclusions were confirmed at the March 2015 meetings of the Working Party.

36. On the basis of these conclusions, the Working Party addressed specific EU issues related to the publicly-listed entity and pension fund exceptions of the LOB rule.

37. In the case of the publicly-listed entity exception, the Working Party first agreed that there was no need to include a specific reference to EU/EEA stock-exchanges in the definition of “recognised stock exchange” in paragraph 6 of the LOB rule because that definition was open-ended and EU/EEA States would be able to require the listing of the relevant stock exchanges during bilateral negotiations. The Working Party also noted that paragraph 16 of the Commentary of the LOB rule already authorised alternative versions of the publicly-listed entity exception to accommodate concerns of States that are part of a regional grouping. It agreed, however, that the relevant sentence of paragraph 16 should be modified so as to also cover small States that are not members of a regional grouping.

38. It is therefore proposed to make the following changes to paragraph 16 of the Commentary on the LOB rule as it appears in paragraph 16 of the Report on Action 6 (changes proposed to the paragraph appear in ***bold italics*** in the case of additions and ~~strikethrough~~ in the case of deletions):

16. Subdivision (i)A) includes the additional requirement that the shares of the company or entity be primarily traded in one or more recognised stock exchanges located in the State of residence of the company or entity. In general, the principal class of shares of a company or entity are “primarily traded” on one or more recognised stock exchanges located in the State of residence of that company or entity if, during the relevant taxation year, the number of shares in the company’s or entity’s principal class of shares that are traded on these stock exchanges exceeds the number of shares in the company’s or entity’s principal class of shares that are traded on established securities markets in any other State. Some States, however, consider that the fact that shares of a company or entity resident in a Contracting State are primarily traded on recognised stock exchanges situated in ***other States that are part of regional grouping*** (*e.g.* in a State that is part of the European Economic Area within which rules relating to stock exchanges and securities create a single market for securities trading) constitutes a sufficient safeguard against the use of

that company or entity for treaty-shopping purposes; States that share that view may modify subdivision (i)A) accordingly.

39. As regards the pension fund exception, the Working Party concluded that removing all restrictions on the residence of the beneficiaries of a pension fund would raise treaty-shopping concerns, especially since the requirement that only 50 per cent of the beneficial interests in the pension fund be owned by individuals resident in either Contracting State already allowed a substantial foreign participation in a pension fund.

40. The Working Party agreed, however, to further consider at its June 2015 meeting the following proposal for a different drafting of the pension fund exception found in the LOB rule, which could address the concerns of many States, including EU/EEA States, whilst allowing greater foreign participation in a pension fund that constitutes a “qualified person”.

*Replace subparagraph to 2d)ii) of the LOB rule included in paragraph 16 of the Report on Action 6 by the following (changes proposed to the paragraph appear in **bold italics**):*

2. d) a person, other than an individual, that
  - i) ...
  - ii) was constituted and is operated exclusively to administer or provide pension or other similar benefits, provided that either more than 50 per cent of the beneficial interests in that person are owned by individuals resident in either Contracting State, ***or more than [90 per cent] of the beneficial interests in that person are owned by individuals resident of either Contracting State or of any other State with respect to which the following conditions are met***
    - A) ***individuals who are residents of that other State are entitled to 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, and***
    - B) ***with respect to income referred to in Articles 10 and 11 of this Convention, if the person were a resident of that other State entitled to all the benefits of that other convention, the person 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;***

## **5. Requirement that each intermediate owner be a resident of either Contracting State**

### ***Issue***

41. Subdivision 2 c)(ii) of the LOB rule (paragraph 16 of the Report on Action 6) includes a rule dealing with indirect ownership which requires that each intermediate owner be a resident of either Contracting State. A similar condition found at the end of subdivision 2 e)(i) requires that each intermediate owner be a resident of the same Contracting State as the company seeking qualified person status. In both cases, the condition has been put between brackets and the Commentary indicates that some States consider that the requirement is unduly restrictive and prefer to omit it.



42. The November 2014 discussion draft indicated that further work was required in order to determine whether and how the requirement could be relaxed without creating opportunities for treaty-shopping. It also indicated that this work would be carried on together with the work on issues related to the derivative benefits provision and the definition of equivalent beneficiary (see Section 6 below).

### *Comments received*

43. Most commentators who dealt with this issue expressed the view that the intermediate ownership requirements in the publicly-traded test (subdivision *c)(ii)* of paragraph 2 the LOB rule) and the ownership/base erosion test (subdivision *e)(i)* of paragraph 2) were unduly restrictive and disproportionate (e.g. they considered that concerns about abuse should be specifically identified and addressed through targeted measures such as CFC rules). A number of commentators argued that these requirements should be removed – i.e. intermediate owners should not be tested – because of the potential impact on MNE group holding structures and that the focus should be on the ultimate beneficial owner. Commentators also expressed concerns that intermediate owner requirements were in violation of EU law and proposed, for example, that the provisions should be modified to allow for intermediate ownership in any EU/EEA State. A number of comments referred to particular difficulties that may be faced by collective investment funds that pool funds in “offshore jurisdictions that have limited access to tax treaties” for “commercial reasons” and the challenges to CIVs posed by financial intermediation.

### *Proposed approach on how to address the issue*

44. When the Working Party discussed this issue at its March 2015 meeting, it was explained that the “intermediate owner” requirement was necessary to prevent the interposition of a company in a tax haven to which income derived from the State of source could be paid through a base-eroding payment.

45. During the discussion, it was observed that the intermediate owner provision was primarily relevant in the context of the requirement that each intermediate owner be an equivalent beneficiary for the purposes of the derivative benefits provision (see subparagraph 4 *a)* of the LOB rule in the Report on Action 6). The Working Party concluded that this issue was directly related to the scope of the derivative benefits provision and could possibly be addressed through changes that would deal with special tax regimes (see Section 6 below). It was argued, however, that such changes would not remove the need for the intermediate owner provisions that appear in square brackets in subparagraphs 2 *c)(ii)* and 2 *e)(i)* of the LOB rule. The Working Party then discussed whether this meant that these square brackets would be removed if the proposal for new rules concerning special tax regimes would be adopted. It was agreed to address this question at the June 2015 meeting, when a decision will be reached concerning the proposal for new rules concerning special tax regimes and when the wording of the derivative benefits and equivalent beneficiary provisions will be discussed in light of that decision.

46. During that discussion, the Working Party also examined how the simplified LOB rule in paragraph 3 above would deal with intermediate entities. It was explained that subparagraph 2 *e)* of the simplified LOB, which deals with intermediate entities through the concept of indirect ownership, would not address the above situation but would rely on the PPT to address the situation of an interposed entity located in a tax haven. Whilst discussing that issue, it was noted that subparagraph 2 *e)* of the simplified LOB rule seemed to allow a company resident of a Contracting State to be owned by a majority of non-residents by interposing holdings in that State. In order to address both issues, it was subsequently suggested to modify the wording of subparagraph 2 *e)* as follows:

- e) a person other than an individual, ~~if~~ ***provided that persons who are*** residents of that Contracting State ~~that~~ ***and are qualified persons by reason of subparagraphs a) to d)*** own, directly or indirectly, more than 50 per cent of the beneficial interests of the person.

## **6. Issues related to the derivative benefits provision**

### ***Issue***

47. As indicated in paragraph 5 of the Report on Action 6:

... one assumption in the drafting of the limitation-on-benefits rule found in Section A.1 below is that Action 5 (Counter harmful tax practices more effectively, taking into account transparency and substance) and Action 8 (Intangibles) will address BEPS concerns that may arise from a derivative benefits provision; that provision, or alternative means of addressing those BEPS concerns, may therefore need to be reviewed based on the outcome of the work on these Action items.

48. The November 2014 discussion draft indicated that there were still unresolved issues that needed to be addressed before a decision could be reached on the way that a derivative benefits provision would be reflected in the final version of the LOB rule and the Commentary thereon. It therefore indicated that:

... the provision in paragraph 4 of the LOB rule will therefore be reviewed in the light of progress on other parts of the Action Plan and, in particular, on Actions 5 and 8. In doing so, it is intended to examine whether other possible changes to the Model Tax Convention could ensure that the inclusion of a derivative benefit provisions would not raise BEPS concerns and contribute to the work on other parts of the Action Plan. It is also intended to examine whether changes could be made that would broaden the scope of the derivative benefit provision without creating opportunities for treaty shopping. One such change deals with the requirement, in subparagraph 4 *a*) of the LOB rule, that in the case of indirect ownership, each intermediate owner be an equivalent beneficiary.

### ***Comments received***

49. Many commentators who responded to the November 2014 discussion draft considered the intermediate ownership requirement in subparagraph 4 *a*) of the derivative benefits provision to be unduly restrictive and argued that it should be eliminated; these commentators considered, for example, that the intermediate ownership requirement was unnecessary in light of the base erosion test in subparagraph 4 *b*) or that concerns about intermediate owners were more appropriately addressed through other parts of the work on BEPS such as the work on hybrids (Action 2), the work on CFCs (Action 3) and the work on other anti-abuse rules such as the conduit-PPT rule. Commentators also questioned the policy rationale for restricting the application of the derivative benefits provision to entities owned by seven or fewer equivalent beneficiaries and for the 95 per cent ownership threshold (suggesting, for example, a 75 per cent threshold). Some commentators considered that privately-held companies should be included in the definition of “equivalent beneficiary”. In addition, a number of commentators argued against the “cliff effect” of the definition of “equivalent beneficiary” – *i.e.* commentators favoured the provision of partial relief, rather than the complete denial of treaty relief, where the treaty between the source State and the equivalent beneficiary’s State of residence provides for a reduction in source State withholding that is not as great as that provided by the treaty between the source State and the State of residence of the company that receives the payment. Some commentators noted potential issues for EU/EEA States that could arise as a consequence of EU law (*e.g.* freedom of establishment). One commentator observed that the 2010 CIV Report had recognised that a derivative benefits approach was potentially relevant to determining a CIV’s entitlement to treaty benefits and argued that the same concept should also be applied to other collective funds, including pension funds.

### ***Proposed approach on how to address the issue***

50. During the discussion of issues raised by the derivative benefits provision, the Working Party was invited to discuss two proposals by the Delegate for the United States concerning possible changes to

the OECD Model that would deal with special tax regimes and that would make a tax treaty responsive to certain future changes in a country's domestic tax laws. It was argued that these proposals could address some of the objections to the addition of a derivative benefits provision in the LOB rule.

51. The Working Party agreed that these proposals were consistent with the statement, included in the November 2014 discussion draft, that "it is intended to examine whether other possible changes to the Model Tax Convention could ensure that the inclusion of a derivative benefits provisions would not raise BEPS concerns and contribute to the work on other parts of the Action Plan" (see paragraph 48 above).

52. However, a number of technical issues and concerns were raised during the discussion of the proposals and a few changes were made as a result of that discussion. The Working Party concluded that a decision on these proposals would need to be reached at its June 2015 meeting in light of the comments that will be received on these proposals.

53. The following is the latest version of these proposals, which were not included in the Report on Action 6 or in previous discussion drafts related to the work on Action 6 and on which comments are therefore invited.

### **Proposal 1 – New treaty provisions on “special tax regimes”**

#### ***New definition of “special tax regime” to be included in Article 3 (General Definitions)***

- X) ... the term “special tax regime” with respect to an item of income or profit means any legislation, regulation or administrative practice that provides a preferential effective rate of taxation to such income or profit, including through reductions in the tax rate or the tax base. With regard to financing income, the term special tax regime includes notional interest deductions that are allowed without regard to liabilities for such interest. However, the term shall not include any legislation, regulation or administrative practice:
- i) the application of which does not disproportionately benefit interest, royalties or other income, or any combination thereof;
  - ii) except with regard to financing income, that satisfies a substantial activity requirement;
  - iii) that is designed to prevent double taxation;
  - iv) that implements the principles of Article 7 (Business Profits) or Article 9 (Associated Enterprises);
  - v) that applies to persons which exclusively promote religious, charitable, scientific, artistic, cultural or educational activities;
  - vi) that applies to persons substantially all of the activity of which is to provide or administer pension or retirement benefits;
  - vii) that facilitates investment in widely-held entities that hold real property (immovable property), a diversified portfolio of securities, or any combination thereof, and that are subject to investor-protection regulation in the Contracting State in which the investment entity is established; or
  - viii) that the Contracting States have agreed shall not constitute a special tax regime because it does not result in a low effective rate of taxation;”

#### ***Protocol provisions***

With reference to subparagraph X) of paragraph 1 of Article 3 (General Definitions):

The term “special tax regime” shall include:

- a) in the case of \_\_\_\_\_:
  - i) *[list relevant specific legislation, regulations and/or administrative practices in the Contracting State];*
- b) in the case of \_\_\_\_\_:
  - i) *[list relevant specific legislation, regulations and/or administrative practices in the Contracting State].*

With reference to subdivision *viii*) of subparagraph (X) of paragraph 1 of Article 3 (General Definitions):

The term “special tax regime” shall not include:

- a) in the case of \_\_\_\_\_:
  - i) *[list relevant specific legislation, regulations and/or administrative practices in the Contracting State];*
- b) in the case of \_\_\_\_\_:
  - i) *[list relevant specific legislation, regulations and/or administrative practices in the Contracting State].*

#### ***New Provisions for Articles 11, 12 and 21***

##### *New provision for Article 11 (Interest)*

Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident is subject to a special tax regime with respect to interest in its Contracting State of residence at any time during the taxable period in which the interest is paid.

##### *New provision for Article 12 (Royalties)*

Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident is subject to a special tax regime with respect to royalties in its Contracting State of residence at any time during the taxable period in which the royalties are paid.

##### *New provision for Article 21 (Other income )*

Other income arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident is subject to a special tax regime with respect to other income in its Contracting State of residence at any time during the taxable period in which the other income is paid.

#### **Proposal 2 – New general treaty rule intended to make a tax treaty responsive to certain future changes in a country’s domestic tax laws**

1. If at any time after the signing of this Convention, either Contracting State provides an exemption from taxation to resident companies for substantially all foreign source income (including interest and royalties), the provisions of Articles 10 (Dividends), 11 (Interest), 12

(Royalties) and 21 (Other Income) may cease to have effect pursuant to paragraph 3 of this Article for payments to companies resident of either Contracting State.

2. If at any time after the signing of this Convention, either Contracting State provides an exemption from taxation to resident individuals for substantially all foreign source income (including interest and royalties), the provisions of Articles 10, 11, 12 and 21 may cease to have effect pursuant to paragraph 3 of this Article for payments to individuals resident of either Contracting State.

3. If the provisions of either paragraph 1 or paragraph 2 of this Article are satisfied, a Contracting State may notify the other Contracting State through diplomatic channels that it will cease to apply the provisions of Articles 10, 11, 12 and 21. In such case, the provisions of such Articles shall cease to have effect in both Contracting States with respect to payments to resident individuals or companies, as appropriate, six months after the date of such written notification, and the Contracting States shall consult with a view to concluding amendments to this Convention to restore the balance of benefits provided.

## **7. Provisions dealing with “dual-listed company arrangements”**

### *Issue*

54. As a result of the public consultation on the March 2014 discussion draft, provisions were added to the definitions in paragraph 6 of the LOB rule (paragraph 16 of the Report on Action 6) in order to address the situation of “dual-listed company arrangements”. The November 2014 discussion draft indicated that these provisions would be examined in more detail, in particular to ensure that they are drafted in a way that appropriately addresses the situations for which they were designed and do not create treaty-shopping opportunities.

### *Comments received*

55. There were only a few comments on this issue and these comments supported the proposed exception for dual-listed company arrangements, although one commentator suggested that it should be made clear that the exception would be applied only in very limited circumstances.

### *Proposed approach on how to address the issue*

56. When that issue was discussed at the March 2015 meetings of Working Party 1, the Delegates for Australia and the United Kingdom provided more details on “dual-listed company arrangements” which are found in these countries. Whilst some delegates reserved the right to further examine the issue in light of the explanations provided, most delegates agreed with the principle of including an exception for such arrangements even though they were relatively rare.

57. During the discussion, it was noted that the phrase “excluding the special voting-shares which were issued as a means of establishing that dual-listed company arrangement”, which is found in the definition of “principal class of shares” in subparagraph *b)* of paragraph 6 of the LOB rule, was too restrictive because other instruments, such as dividend equalisation shares, could be used in place of, or in addition, to special voting shares in order to give effect to a dual-listed company arrangement and because the means by which such an arrangement is put in place may be modified after it is established. It was agreed to modify that definition accordingly.

58. Whilst the decision to include an exception for dual-listed company arrangements will need to be confirmed at the June meeting of Working Party 1, it is therefore proposed to make the following changes

to the definition of the term “principal class of shares” in subparagraph *b*) of paragraph 6 of the LOB rule which appears in paragraph 16 of the Report on Action 6 (changes proposed to the paragraph appear in ***bold italics*** in the case of additions and ~~striketrough~~ in the case of deletions):

6. For purposes of the preceding provisions of this Article:

...

- b) the term “principal class of shares” means the ordinary or common shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. If no single class of ordinary or common shares represents the majority of the aggregate voting power and value of the company, the “principal class of shares” are those classes that in the aggregate represent a majority of the aggregate voting power and value of the company. In the case of a company participating in a dual listed company arrangement, the principal class of shares will be determined after excluding the ~~special voting shares which were issued as a means of establishing~~ ***to give effect to*** that dual listed company arrangement;

## **8. Timing issues related to the various provisions of the LOB rule**

### *Issue*

59. Timing issues are dealt with differently under the various provisions of the LOB rule in paragraph 16 of the Report on Action 6. For instance, the definition of “qualified person” in paragraph 2 of the rule applies “at a time when a benefit would otherwise be accorded by the Convention if, at that time” the conditions of the relevant subparagraph are met. In the case of subparagraph *c*) (the “publicly-listed entity” provision), the conditions must also be met “throughout the taxable period that includes that time”, which means that a company that would become publicly-listed in the middle of a taxation year would fail that test. The November 2014 discussion draft indicated that further work was needed to ensure that the rules governing the temporal aspects of the various provisions of the LOB rule were appropriate.

### *Comments received*

60. With respect to the timing requirement in subparagraph 2 *c*) of the LOB rule (the publicly-listed test), commentators clarified that becoming or ceasing to be listed would not trigger a new taxable period in many jurisdictions, including the United Kingdom and Ireland. Commentators considered that it was unlikely that a company or other entity would become publicly-listed for treaty shopping purposes and that the “throughout the taxable period that includes that time” requirement should either be removed or modified (*e.g.* to require solely that the entity be publicly listed on the date on which the payment was received, in the prior tax year, or throughout a 365-day period that includes the date on which the payment was received). One commentator also argued that the ownership/base erosion test in subparagraph 2 *e*) and the base erosion prong of the derivative benefits test in paragraph 4 should be applied based on the facts of the prior taxable year, given that the taxpayer would otherwise not know whether it had met those tests before the end of the current taxable year.

### *Proposed approach on how to address the issue*

61. When that issue was discussed at the March 2015 meetings of Working Party 1, it was noted that the publicly-listed test was only one way of satisfying the conditions for treaty entitlement under the LOB rule and that applying this condition for only part of a taxable period could create difficulties in relation to the application of the “regularly traded condition”. For this reason, it was proposed to keep the phrase

“throughout the taxable period that includes that time” even though it was acknowledged that a company or other entity could become, or cease to be, publicly-listed during a taxable period.

62. During the discussion, it was observed that whilst the simplified LOB rule in paragraph 3 above did not expressly address timing issues, these issues could be dealt with by the competent authorities under paragraph 7 of the simplified LOB rule which allowed the competent authorities to settle the mode of application of that rule.

## **9. Conditions for the application of the provision on publicly-listed entities**

### *Issue*

63. It has been suggested that the alternative conditions in 2 c)i)A) and B) (the “publicly-listed entity” provision) of the LOB rule (paragraph 16 of the Report on Action 6) could be too restrictive for small countries that do not have important stock exchanges and whose companies are therefore listed on foreign stock exchanges. There is a risk that the alternative conditions would not be satisfied if the shares of such a company were traded on a foreign stock exchange and the subsidiaries of the company were managed from abroad. As was noted in the November 2014 discussion draft, however, it is not clear how the relevant provision could address these concerns whilst ensuring that a publicly-listed entity has a sufficient nexus with a State to warrant the application of the provision.

### *Comments received*

64. Comments on the November 2014 discussion draft that related to that issue emphasised the difficulties that would be faced by companies in smaller economies in meeting the publicly traded test. Commentators’ suggested modifications to subparagraph 2 c) of the LOB rule (which generally did not address how to ensure that a publicly-listed entity has a sufficient nexus with its country of residence) included allowing trading on any mutually-agreed “recognised stock exchange” (e.g. any EU/EEA exchange) and eliminating the primary place of management and control test.

### *Proposed approach on how to address the issue*

65. This issue was discussed as part of the discussion of Issue 4 (Alternative LOB provisions for EU countries) which resulted in a proposal for amending paragraph 16 of the Commentary on the LOB rule (see paragraph 38 above).

66. When discussing that issue, the Working Party also considered a proposal to include in the Commentary on the definition of “recognised stock exchange” a list of factors that should be considered when determining whether a stock exchange should be listed in that definition (or subsequently added to that list through a competent authority agreement). It agreed that the proposed list of factors could be added to the Commentary on the LOB rule subject to a final review of these factors at the June meeting of the Working Party.

67. It is therefore proposed to add the following new paragraph to the Commentary on the LOB rule that appears in paragraph 16 of the Report on Action 6:

*Add the following new paragraph 71.1 in the Commentary on the LOB rule that appears in paragraph 16 of the Report on Action 6:*

71.1 The stock exchanges to be included in the definition should impose listing requirements that ensure that shares of entities listed on that stock exchange are genuinely publicly traded. The following factors should be considered when determining whether a stock exchange should be

listed in the definition or subsequently added to that list through the competent authority agreement referred to in the preceding paragraph:

- What are the requirements/standards with respect to listing a company on the stock exchange?
- What are the requirements/standards in order to continue to be listed on the stock exchange, including minimum financial standards?
- What are the annual/interim disclosure and/or filing requirements for companies whose shares are traded on the stock exchange?
- What is the volume of shares traded on the stock exchange in a calendar year?
- Do the rules governing the stock exchange ensure active trading of listed stocks? If so, how?
- Are the companies listed on the stock exchange required to disclose information on an ongoing basis in a manner similar to companies listed on *[name of other recognised stock exchange that has information disclosure requirements that are considered to be adequate]*?
- Are the companies listed on the stock exchange required to disclose their shareholders and trading volume?
- Does the stock exchange impose any minimum size requirements, such as minimum capitalisation or number of employees, for companies whose shares are traded on the exchange?
- Does the stock exchange impose a required minimum percentage of public ownership? If so, what is the minimum amount?
- For a company to trade on the stock exchange, are the shares of companies required to be freely negotiable and fully paid for?
- Is the stock exchange required to disclose the share prices of its listed companies within a certain timeframe?
- Is the stock exchange regulated or supervised by a government authority of the country in which it is located?
- *[In the case of a new stock exchange to be added to an existing list:]* Why would a company prefer to list on the new exchange rather than on another exchange, including those exchanges that are already “recognised stock exchanges” in the tax treaty? For example, are there lesser corporate governance and financial disclosure requirements?
- *[In the case of a new stock exchange to be added to an existing list:]* Does the new stock exchange provide a more efficient vehicle for raising capital and, if so, why?

## 10. Clarification of the “active business” provision

### *Issue*

68. The November 2014 discussion draft noted the suggestion that various interpretative issues raised by paragraph 3 of the LOB rule (the “active business” provision) should be addressed through changes to the provision and/or its Commentary (*e.g.* what is the exact scope of the last sentence of paragraph 48 of the Commentary, which refers to headquarters operations, and what is the effect of the deeming rule in subparagraph *c*) in cases where subsidiaries situated in the same country carry on different activities such as manufacturing and investment activities).



### *Comments received*

69. A number of comments received on the November 2014 discussion draft requested clarification of the “active business” provision in paragraph 3 of the LOB rule as it would apply to headquarters companies, holding companies and companies formed to own and manage real estate. Commentators also suggested an expansion of the list of types of entities for which investment activities would constitute an active trade or business. Some commentators expressed concern that the substantiality test in subparagraph 3 *b*) would discriminate against companies resident in smaller economies. A few commentators also proposed that guidance on the definition of “active conduct of business” could be provided, for example, through express reference to equivalent tests in a jurisdiction’s domestic law or through the provision of safe harbours.

### *Proposed approach on how to address the issue*

70. When that issue was discussed at the March 2015 meetings of Working Party 1, some delegates referred to the concerns that they had previously expressed concerning the definition and interpretation of the “active business income” provision and, in particular, the exclusion of activities related to the management of investments for a resident’s own account. Other delegates, however, objected to changes that would substantially broaden the definition of what constitutes the active conduct of a business.

71. The Working Party agreed that the Commentary on the “active business” provision should clarify the concept of “business” in order to deal with situations where, for example, the same company would carry on both investment and manufacturing operations.

72. The Working Party also discussed the following proposal for changes to paragraph 3 of the LOB rule that was presented by the Delegate for the United States in order to prevent a resident from aggregating activities of a connected person enjoying a special tax regime and in order to provide that the resident and any connected persons must be in the same or a similar line of business before their activities may be aggregated. Since this proposal is partly related to the proposal on “special tax regimes” described in Section 6 above, it was concluded that a decision on that proposal should be reached at the Working Party’s June meeting in light of the comments that will be received on both proposals.

*Replace paragraph 3 of the LOB rule included in paragraph 16 of the Report on Action 6 by the following (proposed changes are indicated by **bold italics** for additions and ~~strikethrough~~ for deletions):*

3. *a)* A resident of a Contracting State shall 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, if the resident is engaged in the active conduct of a trade or business in the first-mentioned Contracting State (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), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business.
- b)* 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 a related person, the conditions described in subparagraph *a)* of this paragraph 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 *a* related person in the other Contracting State. Whether a

trade or business activity is substantial for the purposes of this paragraph shall be determined based on all the facts and circumstances.

- c) For purposes of applying this paragraph, activities conducted by persons connected to a ~~person~~ **resident of a Contracting State** shall be deemed to be conducted by such ~~person~~ **resident, but only if such resident is not subject to a special tax regime in its Contracting State of residence and such other persons are engaged in the same or a similar line of business.** A person shall be connected to another if one possesses at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or another person possesses at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate ~~vote~~ ~~voting power~~ and value of the company's shares or of the beneficial equity interest in the company) in each person. In any case, a person shall be considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

## **B. ISSUES RELATED TO THE PPT RULE**

### **11. Application of the PPT rule where benefits are obtained under different treaties**

#### *Issue*

73. Paragraph 13 of the Commentary on the PPT rule (paragraph 17 of the Report on Action 6) provides that where an arrangement is entered into for the purpose of obtaining benefits under a number of treaties or under both a treaty and domestic law, this should not lead to the conclusion that obtaining one benefit under one treaty was not a principal purpose for that arrangement. The November 2014 discussion draft referred to a previous suggestion that, in order to avoid any doubt, the wording of the PPT rule could be clarified in this respect.

#### *Comments received*

74. Whilst the commentators who dealt with this issue generally agreed that clarity was important with respect to the application of the PPT rule to arrangements entered into to obtain similar benefits under a number of treaties, some were concerned about the negative implications of singling out a taxpayer's consideration of treaty benefits under multiple treaties in choosing a jurisdiction, notably with respect to well-established models for holding structures. One commentator signalled the potential for a disproportionate impact on smaller economies with extensive tax treaty networks. Commentators also noted the need to ensure consistency with Examples C and D in paragraph 14 of the Commentary on the PPT rule.

#### *Proposed approach on how to address the issue*

75. When that issue was discussed at the March 2015 meetings of Working Party 1, it was agreed that the last four sentences of paragraph 13 of the Commentary on the PPT rule (in paragraph 17 of the Report on Action 6) already addressed the issue in very clear terms and that no changes were therefore needed.

**12. Inclusion in the Commentary of the suggestion that countries consider establishing some form of administrative process ensuring that the PPT is only applied after approval at a senior level**

*Issue*

76. In a number of countries, the application of the general anti-abuse rule found in domestic law is subject to approval by a committee composed of senior officials. In some cases, that committee includes academics and/or tax experts from the private sector. The November 2014 discussion draft included the suggestion that the Commentary on the PPT could encourage countries to consider establishing a similar form of administrative process that would ensure that the PPT is only applied after approval at a senior level.

*Comments received*

77. Commentators broadly supported the introduction of a procedural mechanism (a high-level administrative process) to provide certainty to cross-border investors with respect to the application of the PPT rule. Such a process was considered important to ensure that the PPT rule was applied consistently and only in exceptional cases. Some commentators also argued that time-bound administrative processes should be put in place through which taxpayers could obtain certainty regarding transactions/activities and that any denial of treaty benefits pursuant to the PPT rule should be subject to bilateral consultation/review.

*Proposed approach on how to address the issue*

78. When that issue was discussed at the March 2015 meetings of Working Party 1, it was agreed that despite the fact that most of the comments received on this issue advocated the implementation of a formal administrative process, differences in the audit and assessment procedures of each country would prevent the adoption of a single approach. This was consistent with a review of the different approaches that are currently applied by countries that have domestic general anti-abuse rules.

79. It is therefore proposed to add the following new paragraph to the Commentary on the PPT rule that appears in paragraph 17 of the Report on Action 6:

*Add the following new paragraph 14.1 in the Commentary on the PPT rule that appears in paragraph 17 of the Report on Action 6:*

14.1 In a number of States, the application of the general anti-abuse rule found in domestic law is subject to some form of approval process. In some cases, the process provides for an internal elevation of disputes on such provisions to senior officials in the administration. In other cases, the process allows for advisory panels to provide their views to the administration on the application of the rule. These types of approval processes reflect the serious nature of disputes in this area and promote overall consistency in the application of the rule. States may wish to establish a similar form of administrative process that would ensure that paragraph 7 is only applied after approval at a senior level within the administration.

**13. Whether the application of the PPT rule should be excluded from the issues with respect to which the arbitration provision of paragraph 5 of Article 25 is applicable**

*Issue*

80. The November 2014 discussion draft noted that some countries had expressed the view that the application of the PPT rule was not an issue suitable for the arbitration mechanism of paragraph 5 of Article 25 but that a majority of countries disagreed with that view. The discussion draft indicated that it

was therefore necessary to determine whether and how the views of the minority should be reflected when the final version of the PPT rule and its Commentary are included in the Model Tax Convention.

#### *Comments received*

81. Commentators considered it essential that the application of the PPT rule be subject to MAP arbitration. Arguments that were used to support that conclusion referred to the uncertainty created by the PPT, the need to ensure the timely resolution of disputes and the need to guarantee the co-ordinated and consensual interpretation and application of the PPT rule.

#### *Proposed approach on how to address the issue*

82. When that issue was discussed at the March 2015 meetings of Working Party, the majority of delegates supported the view expressed in the comments received and concluded that the OECD Model should not endorse the minority view according to which the application of the PPT rule should be excluded from the arbitration mechanism of paragraph 5 of Article 25. It was therefore decided that no changes should be made to the Report on Action 6 with respect to this issue but that the issue should also be discussed as part of the work on Action 14 (Make dispute resolution mechanisms more effective).

#### **14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test**

##### *Issue*

83. Both the PPT rule and the discretionary relief provision of the LOB rule include a test based on whether one of the principal purposes is the obtaining of benefits under a tax treaty. The November 2014 discussion draft observed that the Commentaries on these two provisions were developed separately and suggested that these Commentaries should provide consistent explanations as to how the principal purposes test applies for the purposes of the two provisions.

#### *Comments received*

84. Commentators generally agreed that the Commentary on the PPT rule and the Commentary on the discretionary relief provision of the LOB rule should be aligned to eliminate inconsistencies. Commentators recommended that the factors considered in requests for discretionary relief under the LOB rule should also be used for PPT determinations and that the examples included in the Commentary on the discretionary relief provision of the LOB rule to illustrate circumstances in which discretionary relief should be provided should also be used to provide examples of cases in which the PPT rule would not apply.

#### *Proposed approach on how to address the issue*

85. When that issue was discussed by the Working Party at its March 2015 meetings, a number of delegates considered that the alignment of the Commentaries on the PPT rule and the discretionary relief provision of the LOB rule would be useful but should focus on the general explanations provided as to the meaning of the phrase “one of the principal purposes” rather than on the examples included in the Commentary on the PPT rule because, unlike the PPT rule, the discretionary relief provision depends on the exercise of discretion based on the appreciation of relevant facts by the competent authority and has a narrower focus than the PPT rule since it focusses exclusively on what the competent authority may determine as being one of the principal purposes for the establishment, acquisition or maintenance of a person and the conduct of its operations. Some delegates, however, do not agree that there should be any alignment or equation between the PPT rule and the discretionary relief provision. These delegates do not

support the inclusion of a PPT provision and note that the two concepts were developed separately with no intention to equate the two. Therefore, these delegates will not find any PPT guidance relevant for purposes of the determination of discretionary relief under an LOB provision.

86. It is therefore proposed to make the following changes to paragraph 63 of the Commentary on the discretionary relief provision of the LOB rule as it appears in paragraph 16 of the Report on Action 6:

~~63. In order to be granted benefits under paragraph 5, the person must establish, to the satisfaction of the competent authority of the State from which benefits are being claimed, that there were clear reasons, unrelated to the obtaining of treaty benefits, for its formation, acquisition, or maintenance and that any reasons related to the obtaining of treaty benefits were clearly secondary to those unrelated reasons. [the preceding sentence has been moved to new paragraph 63.1]~~ Through this paragraph, a resident that is not entitled to the benefits of the Convention under paragraphs 1 through 4 but who has a **substantial**~~sufficient~~ relationship to its State of residence, taking into account considerations **in addition** ~~together than~~ those addressed through the objective tests in paragraphs 1 through 4, may be able to obtain treaty benefits **where the allowance of benefits would not otherwise be contrary to the purposes of the Convention. In the case of a resident subsidiary company with a parent in a third State, whilst the fact that the relevant withholding rate provided in the Convention is not lower than the corresponding withholding rate in the tax treaty between the State of source and the third State would be a relevant factor, that fact would not, in itself, be sufficient to establish that the conditions for granting the discretionary relief are met. Similarly, w**Where a foreign company is engaged in a mobile business such as financing, or where the domestic law of a Contracting State provides a special tax treatment for certain activities conducted in special zones or offshore (e.g. licensing intangibles) those factors will not be evidence of a non-tax business reason for locating in that State. In such cases, additional favourable business factors must be present to establish a **substantial**~~sufficient~~ relationship to that State. Paragraph 5 also provides that the competent authority of the State to which the request is made will consult with the competent authority of the other State before refusing to exercise its discretion to grant benefits to a resident of that other State.

**63.1 In order to be granted benefits under paragraph 5, the person must establish, to the satisfaction of the competent authority of the State from which benefits are being sought, that there were clear non-tax business reasons for its formation, acquisition, or maintenance and for the conduct of its operations in the other Contracting State. [the preceding sentence was previously found in paragraph 63; the changes made to it are explained in paragraphs 31 and 32 above] What the purposes are for the establishment, acquisition or maintenance of a person and the conduct of its operations are questions of fact which can only be answered by considering all relevant circumstances on a case by case basis. It is not necessary to find conclusive proof of intent, but the competent authority must be able to conclude, after an objective analysis of the relevant facts and circumstances, that none of the principal purposes for the establishment, acquisition or maintenance of the person and the conduct of its operations was to obtain benefits under the Convention. Whilst it should not be lightly assumed that obtaining benefits under a convention was one of these principal purposes, a person should not expect to obtain relief under paragraph 5 by merely asserting that its establishment, acquisition or maintenance and the conduct of its operations were not undertaken to obtain the benefits of the Convention. All of the evidence must be provided to the competent authority in order to enable it to determine whether this is the case.**

**63.2 The reference to “one of the principal purposes” in paragraph 5 means that obtaining benefits under a tax treaty need not be the sole or dominant purpose for the establishment, acquisition or maintenance of the person and the conduct of its operations. It is sufficient that at**

*least one of the principal purposes was to obtain treaty benefits. Where the competent authority determines, having regard to all relevant facts and circumstances, that obtaining benefits under the Convention was not a principal consideration and would not have justified the establishment, acquisition or maintenance of the person and the conduct of its operations, it shall treat that person as being entitled to these benefits, or benefits with respect to a specific item of income or capital. Where, however, the establishment, acquisition or maintenance of the person and the conduct of its operations is carried on for the purpose of obtaining similar benefits under a number of treaties, it should not be considered that obtaining benefits under other treaties will prevent the obtaining of benefits under one treaty from being considered a principal purpose for these activities.*

## 15. Whether some form of discretionary relief should be provided under the PPT rule

### *Issue*

87. The application of the PPT rule results in the denial of the application of treaty provisions, which means that the relevant income then becomes taxable under the provisions of domestic law. The November 2014 discussion draft observed that in some cases, however, it would seem more appropriate to provide some form of treaty relief. Assume, for instance, that a taxpayer engages in an avoidance transaction for the purposes of transforming what would normally be cross-border dividends (taxable at source under the provisions of Art. 10(2)) into a capital gain on shares (exempt from source taxation under Art. 13(5) of the Model Tax Convention). In such a case, the application of the PPT rule would result in the denial of the benefits under Art. 13(5) but a tax administration may consider it appropriate to apply the relief provided under Art. 10(2), which could be done in a manner similar to the discretionary relief provision of the LOB rule.

### *Comments received*

88. Commentators generally supported providing for some form of discretionary relief under the PPT rule, notably the application of the treaty to an item of income as re-characterised pursuant to the provisions of domestic law. Some commentators, however, also suggested that the PPT rule be more targeted (to avoid over-inclusiveness) or that certain transactions (e.g. share buy-back transactions used to repatriate funds to shareholders) be excluded from its scope. One civil society commentator argued that discretionary relief, if provided, should only be available in rare circumstances and subject to clearly delineated parameters, including a requirement of transparency.

### *Proposed approach on how to address the issue*

89. When the Working Party discussed this issue at its March 2015 meetings, a number of delegates endorsed the general thrust of the comments received. Some delegates observed, however, that under their country's legal system, a competent authority could not be given the type of discretion envisaged in paragraph 87 above.

90. It is therefore proposed to make the following changes to the PPT rule and its Commentary as they appear in paragraph 17 of the Report on Action 6:

*Add the following new paragraph to Article [X] (Entitlement to treaty benefits) immediately after paragraph 7 (the PPT rule) which appears in paragraph 17 of the Report on Action 6:*

**8. Where a benefit under this Convention is denied to a person under paragraph 7, the competent authority of the Contracting State that would otherwise have granted this benefit shall nevertheless treat that person as being entitled to this benefit, or to different benefits with respect**

*to a specific item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, determines that such benefits would have been granted to that person in the absence of the transaction or arrangement referred to in paragraph 7. The competent authority of the Contracting State to which the request has been made will consult with the competent authority of the other State before rejecting a request made under this paragraph by a resident of that other State.*

Add the following new heading and paragraphs 16 to 24 to the Commentary on the PPT rule that appears in paragraph 17 of the Report on Action 6:

**Paragraph 8**

*16. Paragraph 8 provides that where a person is denied a treaty benefit in accordance with paragraph 7, the competent authority of the Contracting State that would otherwise have granted this benefit shall nevertheless treat that person as being entitled to this benefit, or to different benefits with respect to the relevant item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, determines that such benefits would have been granted to that person in the absence of the transaction or arrangement referred to in paragraph 7.*

*17. The determination that benefits would have been granted in the absence of the transaction or arrangement referred to in paragraph 7 and the determination of the benefits that should be granted are matters that are left to the discretion of the competent authority to which the request is made. The paragraph grants broad discretion to the competent authority for the purposes of these determinations. The paragraph does require, however, that the competent authority must consider the relevant facts and circumstances before reaching a decision and must consult the competent authority of the other Contracting State before rejecting a request to grant benefits if that request was made by a resident of that other State. The first requirement seeks to ensure that the competent authority will consider each request on its own merits whilst the requirement that the competent authority of the other Contracting State be consulted if the request is made by a resident of that other State should ensure that Contracting States treat similar cases in a consistent manner and can justify their decision on the basis of the facts and circumstances of the particular case. This consultation process does not, however, require that the competent authority to which the request was presented obtain the agreement of the competent authority that is consulted.*

*18. The following example illustrates the application of the paragraph. Assume, for example, that an individual who is a resident of State R and who owns shares in a company resident of State S assigns the right to receive dividends declared by that company to another company resident of State R which owns more than 10 per cent of the capital of the paying company for the principal purpose of obtaining the reduced rate of source taxation provided for in subparagraph a) of paragraph 2 of Article 10. In such a case, if it is determined that the benefit of that subparagraph should be denied pursuant to paragraph 7, the competent authority of State S shall, under paragraph 8, grant the benefit of the reduced rate provided for in subparagraph b) of paragraph 2 of Article 10 if it determines that such benefit would have been granted in the absence of the assignment to another company of the right to receive dividends.*

*19. The domestic law of some States, however, may not allow the competent authority of such a State to exercise the type of discretion envisaged by the paragraph. These States are therefore free to omit the paragraph from their bilateral treaties.*

## 16. Drafting of the alternative “conduit-PPT rule”

### *Issue*

91. Paragraph 15 of the Commentary on the PPT rule includes an alternative to the PPT rule that States may use in order to address treaty-shopping strategies commonly referred to as “conduit arrangements” that would not be caught by the LOB rule. Questions have been expressed about some features of that rule (*e.g.* whether the “all or substantially all” threshold might be too high and whether the reference to a payment made “directly or indirectly” and “at any time” might be too broad). It has also been suggested that examples should be added to illustrate the application of the alternative rule, in particular to explain that the rule is not intended to apply to a company merely because that company’s policy is to distribute most of its profits in the form of dividends (some of the examples found in the Annex to the exchange of notes between the United States and the United Kingdom concerning the application of the “conduit arrangements” rules of the 2001 treaty between these two States could be used for that purpose).

### *Comments received*

92. A number of commentators viewed the definition of “conduit arrangement” that was proposed in the Action 6 Report for the purposes of an alternative “conduit-PPT rule” (see page 74 of the Action 6 Report) as inherently subjective and arbitrary; these commentators felt that such a rule would have to be appropriately circumscribed to avoid the inappropriate denial of treaty benefits and extensive disputes. Commentators called, for example, for clarification/guidance on when a taxpayer would be considered to “indirectly” pay income to another person and on the “all or substantially all” threshold (*e.g.* to illustrate that the rule was not intended to apply to a company with a policy to distribute most of its profits in the form of dividends or to a CIV which has as its object the distribution of all of its returns to investors). Commentators supported the use of the examples found in the exchange of letters between the United States and the United Kingdom regarding the interpretation of the “conduit arrangement” provision in the 2001 US-UK treaty.

### *Proposed approach on how to address the issue*

93. When the Working Party discussed that issue at its March 2015 meetings, it was argued that the alternative definition of “conduit arrangements” suggested in paragraph 15 of the proposed Commentary raised some technical difficulties and, in particular, that the “all or substantially all” threshold was problematic. It was therefore decided that the relevant part of the Commentary should simply focus on general principles and include examples of transactions that an anti-conduit rule should address. Delegates also agreed with the commentators who suggested that the examples found in the exchange of letters between the United States and the United Kingdom were useful and should be included in the Commentary.

94. It is therefore proposed to replace paragraph 15 of the Commentary that appears in paragraph 17 of the Report on Action 6 by the following (changes to the paragraph as it appeared in the Report appear in ~~strike through~~ in the case of deletions and ***bold italics*** in the case of additions):

15. For various reasons, some States may be unable to accept the rule included in paragraph 7. ***In order to effectively address treaty-shopping, however, these States, however, may wish will need*** to supplement the limitation-on-benefits rule of paragraphs 1 to 6 ~~by a narrower version of paragraph 7 in order to~~ ***by rules that will*** address treaty-shopping strategies commonly referred to as “conduit arrangements” that would not be caught by ***these paragraphs*** ~~the limitation-on-benefits rule. States wishing to do so could provide that. These~~



*rules would deal with such conduit arrangements by denying the benefits of the provisions of the Convention, or of some of them (e.g. those of Articles 7, 10, 11, 12 and 21) will not be accorded in respect of any income obtained under, or as part of, a conduit arrangement. They could also take the form of domestic anti-abuse rules or judicial doctrines that would achieve a similar result.* The following ~~is an~~ *are* examples of a definition of “conduit arrangements” *that would need to be addressed by such rules as well as examples of transactions that should not be considered to be conduit arrangements for that purpose* could be used for the purposes of such a rule:

The term “conduit arrangement” means a transaction or series of transactions:

- a) ~~which is structured in such a way that a resident of a Contracting State entitled to the benefits of this Convention receives an item of income arising in the other Contracting State but that resident pays, directly or indirectly, all or substantially all of that income (at any time or in any form) to one or more persons who are not resident of either Contracting State and who, if they received that item of income direct from the other Contracting State, would not be entitled under a convention for the avoidance of double taxation between the State of which those persons are resident and the Contracting State in which the income arises, or otherwise, to benefits with respect to that item of income which are equivalent to, or more favourable than, those available under this Convention to a resident of a Contracting State; and~~
- b) ~~which has as one of its principal purposes obtaining such increased benefits as are available under this Convention.~~

- *Example A: RCO a publicly-traded company resident of State R, owns all of the shares of SCO, a company resident of State S. TCO, a company resident of State T, which does not have a tax treaty with State S, would like to purchase a minority interest in SCO but believes that the domestic withholding tax on dividends levied by State S would make the investment uneconomic. RCO proposes that SCO instead issue to RCO preferred shares paying a fixed return of 4 per cent plus a contingent return of 20 per cent of SCO's net profits. The maturity of the preferred shares is 20 years. TCO will enter into a separate contract with RCO pursuant to which it will pay to RCO an amount equal to the issue price of the preferred shares and will receive from RCO after 20 years the redemption price of the shares. During the 20 years, RCO will pay to TCO an amount equal to 3.75 per cent of the issue price plus 20 per cent of SCO's net profits.*

*This arrangement constitutes a conduit arrangement that should be addressed by the rules referred to above because one of the principal purposes for RCO participating in the transaction was to achieve a reduction of the withholding tax for TCO.*

- *Example B: SCO, a company resident of State S, has issued only one class of shares that is 100 per cent owned by RCO, a company resident of State R. RCO also has only one class of shares outstanding, all of which is owned by TCO, a company resident of State T, which does not have a tax treaty with State S. RCO is engaged in the manufacture of electronics products, and SCO serves as RCO's exclusive distributor in State S. Under paragraph 3 of the limitation-of-benefits rule, RCO will be entitled to benefits with respect to dividends received from SCO, even though the shares of RCO are owned by a resident of a third country.*

*This example refers to a normal commercial structure where RCO and SCO carry on real economic activities in States R and S. The payment of dividends by subsidiaries*

*such as SCO is a normal business transaction. In the absence of evidence showing that one of the principal purposes for setting up that structure was to flow-through dividends from SCO to TCO, this structure would not constitute a conduit arrangement.*

- *Example C: TCO, a company resident of State T, which does not have a tax treaty with State S, loans 1 000 000 to SCO, a company resident of State S that is a wholly-owned subsidiary of TCO, in exchange for a note issued by SCO. TCO later realises that it can avoid the withholding tax on interest levied by State S by assigning the note to its wholly-owned subsidiary RCO, a resident of State R (the treaty between States R and S does not allow source taxation of interest in certain circumstances). TCO therefore assigns the note to RCO in exchange for a note issued by RCO to TCO. The note issued by SCO pays interest at 7 per cent and the note issued by RCO pays interest at 6 per cent.*

*The transaction through which RCO acquired the note issued by SCO constitutes a conduit arrangement because it was structured to eliminate the withholding tax that TCO would otherwise have paid to State S.*

- *Example D: TCO, a company resident of State T, which does not have a tax treaty with State S, owns all of the shares of SCO, a company resident of State S. TCO has for a long time done all of its banking with RCO, a bank resident of State R which is unrelated to TCO and SCO, because the banking system in State T is relatively unsophisticated. As a result, TCO tends to maintain a large deposit with RCO. When SCO needs a loan to fund an acquisition, TCO suggests that SCO deal with RCO, which is already familiar with the business conducted by TCO and SCO. SCO discusses the loan with several different banks, all on terms similar to those offered by RCO, but eventually enters into the loan with RCO, in part because interest paid to RCO would not be subject to withholding tax in State S pursuant to the treaty between States S and R, whilst interest paid to banks resident of State T would be subject to tax in State S.*

*The fact that benefits of the treaty between State R and S are available if SCO borrows from RCO, and that similar benefits might not be available if it borrowed elsewhere, is clearly a factor in SCO's decision (which may be influenced by advice given to it by TCO, its 100 per cent shareholder). It may even be a decisive factor, in the sense that, all else being equal, the availability of treaty benefits may swing the balance in favour of borrowing from RCO rather than from another lender. However, whether the obtaining of treaty benefits was one of the principal purposes of the transaction would have to be determined by reference to the particular facts and circumstances. In the facts presented above, RCO is unrelated to TCO and SCO and there is no indication that the interest paid by SCO flows through to TCO one way or another. The fact that TCO has historically maintained large deposits with RCO is also a factor that indicates that the loan to SCO is not matched by a specific deposit from TCO. On the specific facts as presented, the transaction would therefore likely not constitute a conduit arrangement.*

*If, however, RCO's decision to lend to SCO was dependent on TCO providing a matching collateral deposit to secure the loan so that RCO would not have entered into the transaction on substantially the same terms in the absence of that deposit, the facts would indicate that TCO was indirectly lending to SCO by routing the loan through a bank of State R and, in that case, the transaction would constitute a conduit arrangement.*

- *Example E: RCO, a publicly-traded company resident of State R, is the holding company for a manufacturing group in a highly competitive technological field. The manufacturing group conducts research in subsidiaries located around the world. Any patents developed in a subsidiary are licensed by the subsidiary to RCO, which then licenses the technology to its subsidiaries that need it. RCO keeps only a small spread with respect to the royalties it receives, so that most of the profit goes to the subsidiary that incurred the risk with respect to developing the technology. TCO, a company located in a State with which State S does not have a tax treaty, has developed a process that will substantially increase the profitability of all of RCO's subsidiaries, including SCO, a company resident of State S. According to its usual practice, RCO licenses the technology and sub-licenses the technology to its subsidiaries. SCO pays a royalty to RCO, substantially all of which is paid to TCO.*

*In this example, there is no indication that RCO established its licensing business in order to reduce the withholding tax payable in State S. Because RCO is conforming to the standard commercial organisation and behaviour of the group in the way that it structures its licensing and sub-licensing activities and assuming the same structure is employed with respect to other subsidiaries carrying out similar activities in countries which have treaties which offer similar or more favourable benefits, the arrangement between SCO, RCO and TCO does not constitute a conduit arrangement.*

- *Example F: TCO is a publicly-traded company resident of State T, which does not have a tax treaty with State S. TCO is the parent of a worldwide group of companies, including RCO, a company resident of State R, and SCO, a company resident of State S. SCO is engaged in the active conduct of a trade or business in State S. RCO is responsible for coordinating the financing of all of the subsidiaries of TCO. RCO maintains a centralised cash management accounting system for TCO and its subsidiaries in which it records all intercompany payables and receivables. RCO is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. RCO enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of RCO are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. RCO has 50 employees, including clerical and other back office personnel, located in State R. TCO lends to RCO 15 million in currency A (worth 10 million in currency B) in exchange for a 10-year note that pays 5 per cent interest annually. On the same day, RCO lends 10 million in currency B to SCO in exchange for a 10-year note that pays 5 per cent interest annually. RCO does not enter into a long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.*

*In this example, RCO appears to be carrying on a real business performing substantive economic functions, using real assets and assuming real risks; it is also performing significant activities with respect to the transactions with TCO and SCO, which appear to be typical of RCO's normal treasury business. RCO also appears to be bearing the interest rate and currency risk. Based on these facts and in the absence of other facts that would indicate that one of the principal purposes for these loans was the avoidance of withholding tax in State S, the loan from TCO to RCO and the loan from RCO to SCO do not constitute a conduit arrangement.*

## 17. List of examples in the Commentary on the PPT rule

### *Issue*

95. Paragraph 14 of the Commentary on the PPT rule illustrates how the PPT rule would apply through five examples. The November 2014 discussion draft suggested that the justification for the result in some of these examples could be better articulated and that additional examples could be added to the Commentary in order to provide more certainty to taxpayers and tax administrations.

### *Comments received*

96. Commentators submitted a large number of additional examples which could be included in paragraph 14 of the Commentary on the PPT rule.

### *Proposed approach on how to address the issue*

97. At its March 2015 meetings, the Working Party discussed extensively possible examples involving holding and regional companies. As a result of that discussion and based on the examples submitted in the comments, the Working Party decided to include four new examples in paragraph 14 of the Commentary on the PPT. Also, since the examples of conduit arrangements included in paragraph 94 above are relevant for the purpose of the application of the PPT, a cross-reference to these examples will also be added to the Commentary.

98. It is therefore proposed to make the following changes to paragraph 14 of the Commentary on the PPT rule that appears in paragraph 17 of the Report on Action 6 (the additions to the paragraph included in the Report appear in ***bold italics***):

*Replace the preamble of paragraph 14 of the proposed Commentary on the PPT rule included in paragraph 17 of the Report on Action 6 by the following:*

14. The following examples illustrate the application of the paragraph (***the examples included in paragraph 15 below should also be considered when determining whether and when the PPT rule would apply in the case of conduit arrangements***): [...]

*Add the following examples to paragraph 14 of the proposed Commentary on the PPT rule included in paragraph 17 of the Report on Action 6:*

- ***Example F: TCO is a publicly-traded company resident of State T. TCO's information technology business, which was developed in State T, has grown considerably over the last few years as a result of an aggressive merger and acquisition policy pursued by TCO's management. RCO, a company resident of State R (a State that has concluded many tax treaties providing for no or low source taxation of dividends and royalties), is the family-owned holding company of a group that is also active in the information technology sector. Almost all the shares of RCO are owned by residents of State R who are relatives of the entrepreneur who launched and developed the business of the RCO group. RCO's main assets are shares of subsidiaries located in neighbouring countries, including SCO, a company resident of State S, as well as patents developed in State R and licensed to these subsidiaries. TCO, which has long been interested in acquiring the business of the RCO group and its portfolio of patents, has made an offer to acquire all the shares of RCO.***

*In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that the principal purposes for the acquisition of RCO are related to the expansion of the business of the TCO group and do not include the obtaining of benefits under the treaty between States R and S. The fact that RCO acts primarily as a holding company does not change that result. It might well be that, after the acquisition of the shares of RCO, TCO's management will consider the benefits of the tax treaty concluded between State R and State S before deciding to keep in RCO the shares of SCO and the patents licensed to SCO. This, however, would not be a purpose related to the relevant transaction, which is the acquisition of the shares of RCO.*

- *Example G: TCO, a company resident of State T, is a publicly-traded company resident of State T. It owns directly or indirectly a number of subsidiaries in different countries. Most of these companies carry on the business activities of the TCO group in local markets. In one region, TCO owns the shares of five such companies, each located in different neighbouring States. TCO is considering establishing a regional company for the purpose of providing group services to these companies, including management, financing, treasury and some other non-financing related services. After a review of possible locations, TCO decides to establish the regional company, RCO, in State R. This decision is mainly driven by the skilled labour force, reliable legal system, business friendly environment, political stability, membership of a regional grouping, sophisticated banking industry and the comprehensive double taxation treaty network of State R, including its tax treaties with the five States in which TCO owns subsidiaries, which all provide low withholding tax rates.*

*In this example, merely reviewing the effects of the treaties on future payments by the subsidiaries to the regional company would not enable a conclusion to be drawn about the purposes for the establishment of RCO by TCO. Assuming that the intra-group services to be provided by RCO, including the making of decisions necessary for the conduct of its business, constitute a real business through which RCO exercises substantive economic functions, using real assets and assuming real risks, and that business is carried on by RCO through its own personnel located in State R, it would not be reasonable to deny the benefits of the treaties concluded between State R and the five States where the subsidiaries operate unless other facts would indicate that RCO has been established for other tax purposes or unless RCO enters into specific transactions to which paragraph 7 would otherwise apply (see also example F in paragraph 15 below with respect to the interest and other remuneration that RCO might derive from its group financing activities).*

- *Example H: TCO is a company resident of State T that is listed on the stock exchange of State T. It is the parent company of a multinational enterprise that conducts a variety of business activities globally (wholesaling, retailing, manufacturing, investment, finance, etc.). Issues related to transportation, time differences, limited availability of personnel fluent in foreign languages and the foreign location of business partners make it difficult for TCO to manage its foreign activities from State T. TCO therefore establishes RCO, a subsidiary resident of State R (a country where there are developed international trade and financial markets as well as an abundance of highly-qualified human resources), as a base for developing its foreign business activities. RCO carries on diverse business activities such as wholesaling, retailing, manufacturing, financing and domestic and international investment. RCO possesses the human and financial resources (in various areas such as legal, financial, accounting, taxation, risk management, auditing and internal control) that*

*are necessary to perform these activities. It is clear that RCO's activities constitute the active conduct of a business in State R.*

*As part of its activities, RCO undertakes the development of new business activities in State S. For that purpose, it contributes equity capital and makes loans to SCO, a subsidiary resident of State S that RCO has established. RCO will receive dividends and interest from SCO.*

*In this example, RCO has been established for business efficiency reasons and its financing of SCO through equity and loans is part of RCO's active conduct of a business in State R. Based on these facts and in the absence of other facts that would indicate that one of the principal purposes for the establishment of RCO or the financing of SCO was the obtaining of the benefits of the treaty between States R and S, paragraph 7 would not apply to these transactions.*

- *Example I: RCO, a company resident of State R, is one of a number of collective management organisations that grant licenses on behalf of neighbouring right and copyright holders for playing music in public or for broadcasting that music on radio, television or the internet. SCO, a company resident of State S, carries on similar activities in State S. Performers and copyright holders from various countries appoint RCO or SCO as their agent to grant licenses and to receive royalties with respect to the copyrights and neighbouring rights that they hold; RCO and SCO distribute to each right holder the amount of royalties that they receive on behalf of that holder minus a commission (in most cases, the amount distributed to each holder is relatively small). RCO has an agreement with SCO through which SCO grants licenses to users in State S and distributes royalties to RCO with respect to the rights that RCO manages; RCO does the same in State R with respect to the rights that SCO manages. SCO has agreed with the tax administration of State S that it will process the royalty withholding tax on the payments that it makes to RCO based on the applicable treaties between State S and the State of residence of each right holder represented by RCO based on information provided by RCO since these right holders are the beneficial owners of the royalties paid by SCO to RCO.*

*In this example, it is clear that the arrangements between the right holders and RCO and SCO, and between SCO and RCO, have been put in place for the efficient management of the granting of licenses and collection of royalties with respect to a large number of small transactions. Whilst one of the purposes for entering into these arrangements may well be to ensure that withholding tax is collected at the correct treaty rate without the need for each individual right holder to apply for a refund on small payments, which would be cumbersome and expensive, it is clear that such purpose, which serves to promote the correct and efficient application of tax treaties, would be in accordance with the object and purpose of the relevant provisions of the applicable treaties.*

## C. Other issues

### 18. Application of the new treaty tie-breaker rule

#### *Issue*

99. The new tie-breaker rule proposed in paragraph 39 of the Report on Action 6 provides that in the absence of an agreement between the competent authorities, a legal person that is a resident of each

Contracting State under Art. 4(1) “shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States”. The November 2014 discussion draft proposed to clarify that the fact that the person would not be entitled to relief and exemptions under the Convention would not prevent the person from being considered a resident of each Contracting State for the purposes of the provisions of the Convention that do not provide reliefs and exemptions to that person (e.g. Art. 15(2)b)). It also suggested that it would be useful to encourage competent authorities to address as quickly as possible requests that will be made under the new rule.

### *Comments received*

100. The majority of the comments received on this issue did not address the technical questions described above. These comments mostly focussed on the alleged uncertainty, unpredictability and risks of double taxation that would be created by a move away from the longstanding place of effective management criterion in Article 4(3). One commentator observed that the proposed change could also lead to significant issues for employees. Almost all commentators felt that the tie-breaker rule for determining the treaty residence of dual-resident persons other than individuals should not be changed. A number of Commentators also considered that the competent authorities should be obliged to determine a State of residence for treaty purposes (“shall determine by mutual agreement”). Commentators suggested that the provision should provide a fixed deadline for the determination of treaty residence (suggestions ranged between one and six months, with one commentator proposing MAP arbitration for unresolved cases).

### *Proposed approach on how to address the issue*

101. When this issue was discussed at the March 2015 meetings of Working Party 1, delegates agreed that the Commentary on the new tie-breaker provision should clarify that the fact that a dual-resident entity would not be entitled to treaty reliefs under the new provision will not prevent the person from being considered a resident of each Contracting State for the purposes of the provisions of the Convention (e.g. Art. 15(2)b)) that do not provide reliefs to that entity. It was also agreed that the competent authorities should be encouraged to address as quickly as possible requests that will be made under the new provision.

102. It is therefore proposed to make the following changes to the Commentary on the new version of Art. 4(3) that appears in paragraph 39 of the Report on Action 6:

*Replace existing paragraphs 24.1 and 24.2 of the proposed changes to the Commentary on Article 4 included in paragraph 39 of the Report on Action 6 by the following (changes to the proposed Commentary included in the Report on Action 6 are underlined):*

~~24.1 Some countries, however, consider that cases of dual residence of persons who are not individuals are relatively rare and should be dealt with on a case by case basis. Some countries also consider that such a case by case approach is the best way to deal with the difficulties in determining the place of effective management of a legal person that may arise from the use of new communication technologies. These countries are free to leave the question of the residence of these persons to be settled by the competent authorities, which can be done by replacing the paragraph by the following provision:~~

~~3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such~~

~~agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting State.~~

Competent authorities having to apply *paragraph 3* ~~such a provision to determine the residence of a legal person for purposes of the Convention~~ would be expected to take account of various factors, such as where the meetings of *the person's* ~~its~~ board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc. Countries that consider that the competent authorities should not be given the discretion to solve such cases of dual residence without an indication of the factors to be used for that purpose may want to supplement the provision to refer to these or other factors that they consider relevant. *[the next sentence has been moved to new paragraph 24.2; the last sentence of the paragraph has been moved to new paragraph 24.3 ]*

~~24.2 Also, since the~~ *A determination under paragraph 3* ~~application of the provision would~~ *will* normally be requested by the person concerned through the mechanism provided for under paragraph 1 of Article 25, ~~the~~ *Such a request may be made as soon as it is probable that the person will be considered a resident of each Contracting State under paragraph 1. Due to the notification requirement in paragraph 1 of Article 25, it should in any event be made within three years from the first notification to that person of taxation measures taken by one or both States that indicate that reliefs or exemptions have been denied to that person because of its dual-residence status without the competent authorities having previously endeavoured to determine a single State of residence under paragraph 3. The competent authorities to which a request for determination of residence is made under paragraph 3 should deal with it expeditiously and should communicate their response to the taxpayer as soon as possible.*

*24.3* Since the facts on which a decision will be based may change over time, the competent authorities that reach a decision under that provision should clarify which period of time is covered by that decision.

*24.4* *The last sentence of paragraph 3 provides that in the absence of a determination by the competent authorities, the dual-resident person shall not be entitled to any relief or exemption under the Convention except to the extent and in such manner as may be agreed upon by the competent authorities. This will not, however, prevent the taxpayer from being considered a resident of each Contracting State for purposes other than granting treaty reliefs or exemptions to that person. This will mean, for example, that the condition in subparagraph b) of paragraph 2 of Article 15 will not be met with respect to an employee of that person who is a resident of either Contracting State exercising employment activities in the other State. Similarly, if the person is a company, it will be considered to be a resident of each State for the purposes of the application of Article 10 to dividends that it will pay.*

*24.52* *Some States, however, consider that it is preferable to deal with cases of dual residence of entities through the rule based on the "place of effective management" that was included in the Convention before [next update]. These States also consider that this rule can be interpreted in a way that prevents it from being abused. States that share that view and that agree on how the concept of "place of effective management"*



*should be interpreted are free to include in their bilateral treaty the following version of paragraph 3:*

*Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.*

**19. The design and drafting of the rule applicable to permanent establishments located in third States**

*Issue*

103. Subsection A.1(b)(vii) of the Report on Action 6 (at paragraph 42) includes a new anti-abuse rule dealing with permanent establishments located in third States. The November 2014 discussion draft observed that, as drafted, the rule could be over or under-inclusive in some cases and therefore indicated that the drafting of the rule would be reviewed to address such cases.

*Comments received*

104. The comments that were received on the proposed rule applicable to permanent establishments in third States generally considered that the focus should be on substance – *i.e.* whether the structure artificially segregates taxable income from the activities that generate it – rather than the existence of a low tax rate *per se*. Some commentators considered that there was a significant scope for potential disputes regarding the determination of the level of taxation and/or whether income was derived “in connection with, or ... incidental to, the active conduct of a business carried on in the third State”.

*Proposed approach on how to address the issue*

105. When this issue was discussed at the March 2015 meetings of Working Party 1, it was proposed to make a number of changes to the provision. First, it was suggested to make technical changes to the drafting of the part of the provision that requires a comparison of the tax payable in the third State with that payable in the State of residence of the enterprise. Concerns were also expressed about the inclusion of insurance in the “active conduct of a business” exemption in subparagraph *e*) and it was decided to review that exception at the June 2015 meeting of the Working Party. It was also decided to delete the specific exemption for royalties provided in subparagraph *f*) after concerns were expressed about the potential for abuse of that rule (subparagraph *e*) would deal with many situations that would otherwise have been covered by subparagraph *f*)).

106. During the discussion, it was also suggested that the rule should not apply to PEs located in a country with which the State of source had a treaty if the effective rate of tax on the PE was not lower than 60 per cent of the rate of tax in that country. Another suggestion was that the application of the rule should be subject to some form of discretionary relief similar to that found in paragraph 5 of the LOB rule. Yet another suggestion was that the rule should not focus on the existence of a low tax rate as such but should focus on situations envisaged under paragraph 32 of the Commentary on Article 10, paragraph 25 of the Commentary on Article 11 and paragraph 21 of the Commentary on Article 12 where shares, loans or intangible rights or property are artificially transferred to a permanent establishment. No decision was reached on these suggestions and it was agreed to further examine them at the June 2015 meeting of the Working Party.

107. It is therefore proposed to make the following changes to the provision that appears in paragraph 42 of the Report on Action 6 (and to further discuss the suggestions described in the preceding paragraph as well as the inclusion of “insurance” in the last part of the provision):

[Proposed changes to the provision included in the paragraph 42 of the Report on Action 6 are indicated by **bold italics** for additions and ~~strikethrough~~ for deletions:]

Where

- a) an enterprise of a Contracting State derives income from the other Contracting State and such income is attributable to a permanent establishment of the enterprise situated in a third jurisdiction, and
- b) the profits attributable to that permanent establishment are exempt from tax in the first-mentioned State

the tax benefits that would otherwise apply under the other provisions of the Convention will not apply to any item of income on which the **effective rate of tax on the profits of the permanent establishment** in the third jurisdiction is less than [60] per cent of the **general rate of company tax** ~~that would be imposed in the first-mentioned State if the income were earned or received in that State by the enterprise and were not attributable to the permanent establishment in the third jurisdiction.~~ In such case

- c) any dividends, interest or royalties to which the provisions of this paragraph apply shall remain taxable according to the domestic law of the other State but the tax charged in that State shall not exceed [*rate to be determined*] per cent of the gross amount thereof, and
- d) any other income to which the provisions of this paragraph apply shall remain taxable according to the domestic law of the other State, notwithstanding any other provisions of the Convention.

The preceding provisions of this paragraph shall not apply if the income derived from the other State is

- ~~e) derived in connection with or is incidental to the active conduct of a business carried on through the permanent establishment (other than the business of making, managing or simply holding investments for the enterprise’s own account, unless these activities are banking or securities activities carried on by a bank or registered securities dealer, respectively)., or~~
- ~~f) royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the enterprise through the permanent establishment.~~

## 20. Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules

### *Issue*

108. Subsection A.2 of the Report on Action 6 (at paragraph 49) includes changes to the Commentary on Article 1 intended to clarify that the inclusion of the PPT rule in tax treaties will not affect the conclusions already reflected in the Commentary on Article 1 concerning the interaction between treaties and domestic anti-abuse rules. These conclusions will remain applicable, in particular with respect to treaties that do not incorporate the PPT rule, and it is intended to review the changes included in paragraph 49 in order to make this clearer and to address more generally the issue of potential conflicts between treaties and domestic law. Also, as mentioned in paragraph 5 of the Report, the changes to the Commentary proposed in paragraph 49 of the Report will need to be reviewed in order “to take account of recommendations for the design of new domestic rules that may result from the work on various Action

items, in particular Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing.” Additional changes to the Commentary on Article 1 and to the Commentary on other Articles will also be required in order to reflect the inclusion of the different anti-abuse rules found in the Report (*e.g.* the example of an LOB article currently found in paragraph 20 of the Commentary on Article 1 will be deleted as a result of the inclusion of the LOB rule in subsection A.1.(a)(i) of the Report).

### ***Comments received***

109. Some commentators expressed concerns about the potential for domestic law anti-abuse provisions to override tax treaties, with some questioning the statement in paragraph 12 of the proposed Commentary included in the Report on Action 6 that “in the vast majority of cases” there would be no conflict between domestic law general anti-abuse rules and the provisions of treaties. These commentators considered it important to provide greater clarity with respect to the interaction between treaties and such domestic law provisions, in particular to emphasise that tax treaty provisions take precedence over domestic law. One commentator also noted, in connection with the discussion in paragraph 8 of the proposed Commentary, that the Commentary should clarify that Article 3(2) only makes domestic rules relevant for purposes of determining the meaning of terms that are not defined in the treaty “unless the context otherwise requires”, that the PPT rule should pre-empt domestic law anti-abuse rules that are targeted at treaty benefits and that apply a different standard than the PPT rule and that the reference to thin capitalisation in paragraph 4 of the proposed Commentary should be cross-referenced to paragraph 3 of the Commentary on Article 9.

### ***Proposed approach on how to address the issue***

110. When this issue was discussed at the March 2015 meetings of the Working Party, it was concluded that the changes to the Commentary proposed in paragraph 49 of the Report on Action 6 would need to be reviewed at the June 2015 meeting of the Working Party in the light of progress on the work on other Action items in order to decide whether any recommendations resulting from the work on Actions 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing raised treaty issues not already addressed in the OECD Model Tax Convention.

111. As regards the section on the “Improper use of the Convention” in the existing Commentary on Article 1, it was suggested that most, if not all, of the alternative provisions currently found in paragraphs 13 to 21.5 of the Commentary on Article 1 could be deleted as a result of the new provisions included in the Report on Action 6. It was also noted that paragraphs 7 to 12 and 20 to 22.2 of the Commentary on Article 1 would need to be amended in order to avoid any overlap with the changes to the Commentary proposed in paragraph 49 of the Report whilst clarifying that the conclusions already reflected in these paragraphs concerning the interaction between treaties and domestic anti-abuse rules remain valid.

112. The changes that will be made to the Commentary in order to reflect these conclusions will be decided at the June 2015 meeting of the Working Party.

## ANNEX

### PRESENTATION OF THE LOB IN THE OECD MODEL TAX CONVENTION

*Add the following new Article [X] to the Articles of the Model Tax Convention:*

#### ARTICLE X

##### ENTITLEMENT TO BENEFITS<sup>1</sup>

1. [Provision that would deny treaty benefits to a resident of a Contracting State who is not a “qualified person” as defined in paragraph 2]
2. [Definition of situations where a resident would be a qualified person, which would cover
  - a) an individual;
  - b) a Contracting State, its political subdivisions and entities that it wholly owns;
  - c) certain publicly-listed entities and their affiliates
  - d) certain charities and pension funds
  - e) other entities that meet certain ownership requirements
  - f) certain collective investment vehicles]
3. [Provision that would provide treaty benefits to certain income derived by a person that is not a qualified person if the person is engaged in the active conduct of a business in its State of residence and the income is derived in connection with, or is incidental to, that business]

---

1. The drafting of this Article will depend on how the Contracting States decide to implement their common intention to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. This could be done either through the adoption of paragraph 7 only, through the adoption of the detailed version of paragraphs 1 to 6 that is described in the Commentary on Article [X] together with the implementation of an anti-conduit mechanism as described in paragraph [x] of that Commentary, or through the adoption of paragraph 7 together with any variation of paragraphs 1 to 6 described in the Commentary on Article [X].

4. [Provision that would provide treaty benefits to a person that is not a qualified person if at least more than an agreed proportion of that entity is owned by certain persons entitled to equivalent benefits]
5. [Provision that would allow the competent authority of a Contracting State to grant certain treaty benefits to a person where benefits would otherwise be denied under paragraphs 1 to 4]
6. [Definitions applicable for the purposes of paragraphs 1 to 5]
7. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

*Add the following new Commentary on Article [X] to the Commentary of the OECD Model Tax Convention:*

**COMMENTARY ON ARTICLE [X]  
CONCERNING THE ENTITLEMENT TO TREATY BENEFITS**

*Preliminary remarks*

1. As explained in the footnote to the Article, Article [X] reflects the intention of the Contracting States to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. The drafting of this Article will depend on how the Contracting States decide to do so. Depending on their own circumstances, States may wish to adopt only the general anti-abuse rule of paragraph 7 of the Article, may prefer instead to adopt the detailed version of paragraphs 1 to 6 that is described below, which they would supplement by a mechanism that would address specific conduit arrangements, or may prefer to include in their treaty the general anti-abuse rule of paragraph 7 together with any variation of paragraphs 1 to 6 described below.
2. A State may prefer the last approach described above because it combines the flexibility of a general rule that can prevent a large number of abusive transactions with the certainty of a more “automatic” rule that prevent transactions that are known to cause treaty shopping concerns and that can be easily described by reference to certain features (such as the foreign ownership of an entity). Such a combination should not be construed in any way as restricting the scope of the general anti-abuse rule of paragraph 7: a transaction or arrangement should not be considered to be outside the scope of paragraph 7 simply because the specific anti-abuse rules of paragraphs 1 to 6, which only deal with certain cases of treaty shopping that can be easily identified by certain of their features, are not applicable.
3. A State may, however, prefer to deal with treaty-shopping without the general anti-abuse rule of paragraph 7, relying instead on the specific anti-abuse rules of paragraphs 1 to 6, together with a mechanism that will address conduit arrangements that would escape the application of these paragraphs. This may be the case of a State whose domestic law includes strong anti-abuse rules that are sufficient to deal with other forms of treaty abuses. States that adopt that approach

will need to ensure that the version of paragraph 1 to 6 that they include in their bilateral conventions is sufficiently robust to prevent most forms of treaty shopping. For this reason, the paragraphs below provide different versions of the provisions of paragraphs 1 to 6.

[...]

***Provision under which certain publicly-listed entities and their affiliates are qualified persons***

X. As a general rule, because the shares of publicly-traded companies and entities are typically widely-held, these companies and entities are unlikely to be established for treaty shopping even though it is acknowledged that, in certain cases, they may enter into abusive transactions (*e.g.* treaty shopping arrangements where they act as conduits). States that adopt the approach described in paragraph 2 above may therefore recognize the treaty entitlement of companies and entities that are publicly-listed on recognized stock exchanges for the purposes of paragraphs 1 to 6 and rely on the general anti-abuse rule in paragraph 7 in order to deal with situations where these companies and entities enter into abusive transactions. This could be done by adopting the following simplified version of an exception for publicly-listed companies and entities:

[For the purposes of this Article, a resident of a Contracting State shall be a qualified person if the resident is either: ...]

- c) a company, if the principal class of its shares is regularly traded on one or more recognised stock exchanges;

X. As indicated in paragraph 3 above, however, States that do not include the general anti-abuse rule of paragraph 7 should adopt the following more detailed version of the provision:

[For the purposes of this Article, a resident of a Contracting State shall be a qualified person if the resident is either: ...]

- c) a company or other entity, if, throughout the taxable period that includes that time
  - i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:
    - A) its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or
    - B) the company's or entity's primary place of management and control is in the Contracting State of which it is a resident; or
  - ii) at least 50 per cent of the aggregate voting power and value of the shares (and at least 50 per cent of any disproportionate class of shares) in the company or entity is owned directly or indirectly by five or fewer companies or entities 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 preceding is provided solely for illustration purposes. The final version of the Commentary on the LOB rule will include the contents of the Commentary that appears in paragraph 16 of the Report on Action 6, subject to any changes required by the decisions reached on the LOB issues that were identified for follow-up work]*