PwC's comments on Action 6

PwC welcomes the opportunity to comment on the OECD Public Discussion Draft regarding BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. As a global professional services business with a network of firms throughout the world, we work with a full variety of business enterprises both as advisers and auditors and are continuously involved in dialogues with tax administrators throughout the world. This experience makes us keenly aware of the challenges faced by both taxpayers and tax administrators in the interpretation and application of income tax treaties.

We welcome the Discussion Draft as a starting point in the OECD's development of Action 6 for preventing the granting of treaty benefits in inappropriate circumstances. The OECD has played a leading role in setting the standards that have led to a robust network of income tax treaties that are vital in the promotion of international trade and investment by removing tax barriers to cross-border transactions. We submit, however, that many of the proposals in the Discussion Draft have the potential to erode this accomplishment by creating uncertainty for both taxpayers and governments and by narrowing which business enterprises would have access to income tax treaties to mitigate excessive taxation and double taxation.

Below, we offer our specific comments and suggestions in the context of the proposals set out in the Discussion Draft. To put our comments in perspective, they are guided by the following fundamental principles:

- Bilateral income tax treaties exist, first and foremost, because they promote cross-border trade and investment between residents of the treaty partners by eliminating tax barriers.

- The intended beneficiaries of tax treaties are the individuals, organisations, and enterprises that are subject to residency-based taxation in their home country and have sufficient nexus in that country.

- If a tax treaty lends itself to inappropriate use by residents of third countries or facilitates double non-taxation, the above vital roles are compromised.

- In order to not undermine the fundamental role of tax treaties, rules developed to combat their inappropriate use should:

    - Be designed to ensure that they do not impede access to treaty benefits for *bona fide* residents that are not motivated by treaty shopping or abusing the rules to achieve unintended benefits;
    - Adhere to the standards set out in the OECD's Action Plan to establish "agreed international rules that are clear and predictable, giving certainty to both governments and businesses"; and
    - Be administrable so that they do not strain the resources of tax administrators.

We submit that the current draft falls short of meeting these basic goals and we offer our suggestions as to how to bring the proposals into conformity with these goals.

1. Comments on Part A

Executive Summary

In summary we:

1. Recommend specific modifications to the proposed Entitlement to Benefits article to eliminate overly restrictive standards and to add clarity and predictability;

2. Recommend that the final paper clarify that the Working Party has not addressed the application of income tax treaties to collective investment vehicles and pooled funds, which is being addressed independently of the BEPS project;

3. Urge that the main purpose test be eliminated from the article as it would undermine a basic benefit of the article of providing objectivity and predictability and the concerns it is aimed at addressing should be dealt with in other ways as we explain below ; and

4. Offer comments on the dual residency test and additional anti-abuse rules considered in the Discussion Draft.

1.1. Entitlement to Benefits article: eliminate overly restrictive standards to add clarity and predictability

We welcome the inclusion of an article providing objective criteria for establishing a person's entitlement to treaty benefits. Such provisions, if appropriately drafted, will serve to provide a yardstick for situations where granting treating benefits is justified and where it is not. This increases the investment certainty for business. This would also reduce tax controversy by providing tax authorities and courts objective criteria to assess whether entitlement to treaty benefits is appropriate. However, the Entitlement to Benefits article as proposed in the Discussion Draft seems unduly and unnecessarily complex, adding new areas of uncertainty and controversy and has the potential to deprive *bona fide* business enterprises of access to treaty benefits.

In the next section, we identify and explain specific changes we would recommend to achieve an acceptable model that addresses treaty shopping without impeding access to the treaty for those not engaged in treaty shopping. This reduces new and unnecessary areas of controversy. In doing so, we draw on the experience in the US, where a limitation on benefits (LOB) article has been included in income tax treaties since the 1980s. We note that, in recent years, the US has added further restrictions, many of which are repeated in the Discussion Draft's model, that we believe are inappropriate (as detailed below). Only a handful of US tax treaties have these additional restrictions.

1.2. Suggested revisions to the Entitlement to Benefits article

In the following comments, we suggest modifications to specific sections of the article.

1.2.1. Publicly traded company test

c) a company if:

i) A) the principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges

This modification eliminates the additional criteria in the current draft that would require a publicly traded company to also establish that it has a substantial presence in its residence country based on where its shares are primarily traded or where its primary place of management control takes place. This is based on the position in recent US tax treaties, added at a time when US policy makers were focused on formerly US parented groups that had "inverted" so that the parent was no longer a US corporation. It was added to limit the ability of inverted companies to access US tax treaty benefits. This is an addition that was made to address a domestic tax policy concern. The more appropriate place to address that concern is in domestic law (and, in fact, it is addressed in US domestic law by the addition of a provision that treats a former US company meeting the provision's criteria as continuing to be treated as a domestic corporation for tax purposes).

However, since the substantial presence test has nothing to do with residents of third countries accessing the benefits of the treaty, it has no place in an LOB article. Most importantly, it would deprive many publicly traded companies of access to the treaty because: (1) they choose to list their shares on an exchange outside their country of residence to access an exchange with broader access to investors and (2) the corporation is a multinational enterprise that has decentralised management. In summary, the publicly traded test we have proposed is a test that has been accepted as the appropriate standard for decades and was altered in the US, not because of any perceived shortcomings to the test but rather to further a domestic policy objective. It would add a significant layer of complexity, particularly in the context of the imprecise principal place of management and control test, which would harm both taxpayers and tax administrators.

Likewise, the proposed paragraph 2c)i)A) requirement for shares to be traded on a local stock exchange would in our view breach EU/EEA law for treaties between EU or EEA countries and should, to be EU/EEA law compliant, be expanded to shares traded on a stock exchange anywhere in the EU/EEA (see in particular the ECJ RBS case C-311/97).

1.2.2. Subsidiary of a publicly traded company

> ***ii) at least 50 percent of the aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subdivision i) of this subparagraph***

This is the same language as in the Discussion Draft except that it eliminates the restriction that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State. The Discussion Draft offers no explanation of why this restriction is needed and we question the foundation for such a restriction (which is repeated in the ownership/base erosion test and in the derivative benefits test, as discussed below).

Such a restriction on intermediate companies would in our view again be contrary to EU/EEA law (see in particular the Papillon case re tracing French tax grouping via an intermediate Dutch company C-418/07).

In most countries, a dividend from a subsidiary to its parent company is exempt from taxation in the hands of the parent company. So, income earned in the subsidiary could readily be distributed to the parent and then reinvested by the parent in an affiliate in a third country.

We do not see why there should be any policy reason justifying why having the income pass through a third country intermediate holding company is unacceptable whereas having the income move horizontally is perfectly acceptable. Most multinational enterprises (MNEs) involve hundreds, if not thousands, of affiliates each based in a specific country for business reasons dictated by the function the company performs. It is very common for an MNE to have regional holding companies established in jurisdictions whose laws and infrastructure are most compatible with a holding company function. We submit that, before a restriction that would constrain a typical MNE by precluding an efficient regional holding company structure is adopted, the reason why this is considered necessary should be aired to give stakeholders an opportunity to provide input.

1.2.3. Ownership/base erosion

e) A person other than an individual, if:

i) on at least half the days of the taxable year, persons who are residents of a Contracting State and who are entitled to the benefits of this Convention under subparagraph a), subparagraph b), subdivision i) of subparagraph c), or subparagraph d) of this paragraph own, directly or indirectly, shares or other beneficial interests representing at least 50 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) of the person, and

ii) less than 50 percent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention in the form of payments that are deductible[1] for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property).

This proposed language departs from the Discussion Draft in three important respects.

First, for the same reasons as discussed immediately above, it eliminates the requirement that any intermediate owner be a resident of the same country as the tested company, a requirement even more questionable in a test that also includes a base erosion criterion.

Secondly, it treats residents of either country as acceptable owners of at least fifty percent of the shares. This is the test that has historically applied under US tax treaties and was changed to the more restrictive version treating only residents of the same country as the residency of the tested company as "good" owners around the same time the substantial presence test was added to the publicly traded test, presumably for the same domestic policy considerations aimed at inverted companies. Again, the Discussion Draft has no direct discussion of why a joint venture company owned or controlled by residents of the two Contracting States should be denied access to the benefits of the treaty. However, footnote 3 in the Discussion Draft suggests that where a resident of a Contracting State seeks treaty benefits through use of an entity resident in the other Contracting State, this *could be considered* a form of treaty shopping. This would be a novel departure from the traditional view of treaty shopping – that is, a resident of a third jurisdiction attempting to achieve the benefits of the treaty. Most countries have anti-deferral rules, such as CFC legislation and, in the case of the US, its passive foreign investment company (PFIC) rules, that would currently tax its residents on income earned by a CFC or a PFIC if the income were passive in nature. In other words, the policy issue perceived in footnote 3 is best addressed by domestic legislation and, in fact, already is in the domestic law of many countries, rather than artificially disrupting the formation of a business joint venture.

Thirdly, we have revised the base erosion test to provide that deductible payments made to residents of either of the Contracting States will not be considered base eroding payments. Under the Discussion Draft, payments that are not for services or tangible property, such as interest or royalties, made to corporate recipients can only escape base eroding categorisation if the recipient is a publicly traded company. Hence, a totally local enterprise that, in the ordinary course of business, makes payments on a loan from a bank that is a subsidiary of a publicly traded bank holding company, or makes payments to a local business for a license of software may find itself disqualified from the ownership/base erosion test.

[1] If the OECD adopts something along the lines suggested in the recently issued Discussion Draft on Tax Challenges in the Digital Economy which would limit interest expense to interest paid on external debt, then interest should not be considered a base eroding payment for purposes of the LoB because the ability to erode a particular jurisdiction's tax base would be eliminated.

1.2.4. Active trade or business test

f)

i) The resident is engaged in the active conduct of a trade or business in the Contracting State of which it is resident (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),
ii) Substantially all of its income is derived in connection with, or is incidental to, that trade or business, and
iii) If a resident of a Contracting State derives an item of income from a trade or business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from an associated enterprise, the trade or business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the trade or business activity carried on by the resident or associated enterprise in the other Contracting State. Whether a trade or business activity is substantial for the purposes of this paragraph will be determined based on all the facts and circumstances.
iv) For the purposes of applying the above paragraphs, activities conducted by persons connected to a person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent 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 percent of the beneficial interest (or, in the case of a company, at least 50 percent of the aggregate 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.

We have altered this test to provide that the test is met if substantially all of the resident's income is derived from the active conduct of its trade or business (rather than limiting its application to income that is connected to the trade or business) to simplify the test, with the added requirement that business connected income must be *substantially* all of the income of the tested entity and, for that reason, have added this to the category of qualified persons. To provide greater certainty in applying this, we recommend that substantially all the income of the tested entity be defined as at least 75% of the entity's gross income. Guidance on this provision should make clear that a look-through approach would apply for dividends and interest received from connected persons.

It may be difficult for source states within the EU/EEA to agree on the proposed clause as it currently stands in their treaties with other EU/EEA states. Under the proposed wording, the relevant business needs to be conducted in the residence state only, but business conducted in other EU/EEA states is disregarded. The freedom of establishment in the EC Treaty (Article 49 TFEU) requires all EU (and similarly EEA) member states to refrain from imposing restrictions or obstacles on the right to establish in other member states. If the contracting state (source state) is an EU/EEA state it is bound thereby (similarly to the situation in the "Open Skies" cases (see EC IP/02/1609 5 November 2002) with regard to the requirements imposed on shareholders). This suggests that it will be necessary to make it sufficient that the taxpayer be engaged in suitable business in *any* EU/EEA member state outside the other contracting state (source state) to qualify for treaty benefits.

1.2.5. Derivative benefits

The Discussion Draft leaves open whether the model Entitlement to Benefits article will include a derivative benefits test, providing an example of the concern that has been raised and then continuing with what the model derivative benefits test would provide if included. The reason for inclusion of a derivative benefits test is clear: if the owner of a tested company could have obtained the same or better benefits had it received the benefitted income directly, the use of the subsidiary/tested company cannot have had a motive of shopping for a treaty benefit. Since it is common for MNEs to have one or more holding companies within the group, qualification for treaty benefits under a derivative benefits test accommodates common corporate structures and does not accommodate treaty shopping.

In addition to this, we note in this regard the ECJ "Open Skies" cases in which the ECJ held that the "nationality clauses" in 8 EU countries' bilateral international air transport agreements with the US were held to breach EU law, namely, the EC treaty (now TFEU) fundamental freedoms. In particular, the requirement in most of those bilateral agreements for more than 50% of the shares in their national airline to be held by nationals of that airline's home country breached the freedom of establishment of the EC treaty. Similarly, in our view, EU/EEA law (in particular, the ECJ Papillon case: C-418/07) requires EU/EEA countries to be able to trace bilateral treaty entitlement via any EU/EEA country entity, and not just via the relevant EU/EEA country and its treaty partner entities. Accordingly, we urge the OECD to take this into account, as otherwise, in our view, the OECD will be proposing a limitation on benefits article which 23 of the 42 BEPS countries will be unable to adopt, as it would be in breach of EU/EEA law.

Based on our view that a derivative benefits test should be an integral part of the article, we suggest the following formulation:

3. A company that is a resident of a Contracting State shall also be entitled to the benefits of this Convention if:

a) at least 95 percent of the aggregate voting power and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, and

b) less than 50 percent of the company's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm's length payments in the ordinary course of business for services or tangible property) that are deductible for the purposes of the taxes covered by this Convention in the company's State of residence.

5 e) the term "equivalent beneficiary" means a resident of any other State, but only if that resident

i)A) would be 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, provided that if such convention does not contain a comprehensive limitation on benefits article, the person would be entitled to the benefits of this Convention if such person were a resident of one of the States under Article 4 of this Convention; and

B) with respect to income referred to in Articles 10, 11 and 12 of this Convention, the rate of tax that would be available under such convention to a company resident in such other State and eligible for benefits under such convention (and otherwise comparable to the company claiming benefits under this Convention) with respect to the particular class of income for which benefits are being claimed under this Convention is at least as low as the rate being claimed under this Convention; or

ii) is a resident of a Contracting State that is entitled to the benefits of this Convention by reason of paragraph 2 of this Article.

The above formulation departs from the version in the Discussion Draft as follows:

First, as in the case of the subsidiary of a publicly traded company and the ownership/base erosion tests, and for the same reasons, we have eliminated the restrictions on intermediate owners.

Secondly, we have included as an equivalent beneficiary any company that qualifies for treaty benefits under the income tax treaty between that company's country of residence and the source country, in contrast to the Discussion Draft that would limit the corporate category to publicly traded companies. We believe our formulation is more in keeping with the spirit of the test and also addresses the criticism of the base erosion test that we noted in our discussion of the ownership/base erosion test; without this change, that test would not treat certain ordinary course of business payments to a non-public company as acceptable for the test.

Thirdly, we have clarified the rate comparison test to make clear it is comparing the rates generally available under the two treaties.

1.2.6. Discretionary grant of treaty benefits

Paragraph 4 of the proposed article would provide an important safety net for companies that do not qualify under any of the objective tests and we endorse its inclusion. However, we would note from the US experience that the discretionary grant of treaty benefits based on this standard is a lengthy and cumbersome process in which a company will not know whether it is eligible for treaty benefits until the end of the process. It also requires tax administrators to devote additional resources to the process. In other words, it would not be a realistic response to the restrictive nature of the article proposed in the Discussion Draft. In fact, if the restrictions we have identified as troublesome are not eliminated, tax administrators are likely to be overwhelmed with requests for the discretionary grant of benefits.

To make Paragraph 4 more practical, we suggest (i) that the relevant Competent Authority be compelled to complete the process within a reasonable time frame, say six months, with the automatic grant of the requested benefits if the time requirements are not met and (ii) the OECD provide guidelines for the factors to be considered by the Competent Authority, including examples. The examples could include: (i) a company that is acquired by private equity interests that met the EBT criteria prior to the acquisition, (ii) the privatisation of a former governmental entity, (iii) a family owned company that met the 7 or fewer requirement of the derivative benefits standard but now has more than 7 owners due to the expansion of the family ownership, and (iv) a company that is created by the legislative body of its country of residence.

1.2.7. Example in paragraph 15

The Discussion Draft considers the possible inclusion of a derivative benefits standard for eligibility for treaty benefits but raises concerns about "base eroding" payments that give rise to BEPS concerns. It illustrates this by an example in which a State S company (the tested company) is wholly owned by a parent company in State T that meets the equivalent beneficiary standard and the State S company makes a royalty payment to a sister company in State R and the State R company also qualifies as an equivalent beneficiary. The BEPS concern identified in the example is that State R provides a preferential rate of tax on royalties. We question whether this is a concern that should preclude the inclusion of the test for treaty eligibility frequently relied on in US tax treaties.

The OECD has repeatedly stated in the context of the BEPS project that BEPS is not about tax rate competition, yet the Discussion Draft cites a preferential tax rate as the reason for omitting a derivative benefits test. We note that all three companies in the example would be entitled to the same source country tax reduction under the relevant treaties, so the establishment of the tested company in State S does not provide any treaty benefit

that would not otherwise be available. We further note that the Parent in State T could also pay a royalty to the affiliate in State R and that apparently does not raise BEPS concerns. Similarly, any resident of State S qualifying under any of the tests in the article could pay a royalty to an affiliate in State R without raising BEPS concerns. If the preferential tax regime for royalties in State R is considered a BEPS concern, then the proper avenue for addressing it is in the Harmful Tax Practices Action item. If the preferential rate is considered to constitute a harmful tax practice, then the appropriate response is for State S to take this into account in its treaty with State R. If the preferential regime is not harmful and State S has considered it in the context of the treaty with State R, then there is no reason to consider that preferential regime in determining whether derivative benefits are appropriate

1.3. Main purpose rule

1.3.1. General comment

The inclusion of a main purpose rule in the treaty in addition to and as a part of the Entitlement to Benefits article would eliminate the principal benefit of the Entitlement to Benefits article of providing certainty and predictability and would seriously erode the role of tax treaties in promoting bilateral trade and investment. The uncertainty and subjectivity of the main purpose test is underscored by the Discussion Draft's explanation of the test in paragraphs 24 through 31 which makes clear its broad and uncertain scope. A large part of the concern about treaty shopping can be mitigated in the standards a country applies in deciding to enter into a treaty relationship. Decisions on which countries are appropriate treaty partners and restraints built into individual treaties to address areas of concern based on the domestic laws of the potential treaty partner can go a long way towards alleviating concern about treaty shopping. This is a far better way to address the concern than adopting a broad, subjective test of taxpayer intent.

A main purpose rule relies largely on subjective criteria – as opposed to measurable and, thus, objective criteria. This poses a significant risk as in many countries general anti-abuse rules were introduced just recently or have not yet been introduced – and, hence, the domestic tax authorities or courts have no or limited experience in applying such a rule. In countries that have had a similar rule, the results in the courts have been mixed, adding to the uncertainty. The potential is clear for growing controversy taking up valuable time of tax administrators and taxpayers.

1.3.2. The US experience with a main purpose test

The main purpose test has been proposed in US tax treaties and soundly rejected by the US Senate, the legislative body whose approval is required for US ratification of a tax treaty. The Senate's 1998 rejection was explained, in part, as follows:

> "The new main purpose tests in the proposed treaty are subjective, vague and add uncertainty to the treaty. It is unclear how the provisions are to be applied. In addition, the provisions lack conformity with other U.S. tax treaties. This uncertainty could create difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty."

1.3.3. The role of examples and Commentary

The Discussion Draft states that the main purpose test is to be supplemented by detailed Commentary that would explain its main features and provide examples. Perhaps this is to suggest that the subjectivity of the test could be mitigated by the detailed Commentary. If it is really possible to provide greater objectivity and certainty of results by standards expressed in the Commentary, we suggest those standards, after public consultation, should be the rule, rather than an explanation of an otherwise vague rule.

The examples set out in the Discussion Draft are examples at either end of the spectrum and, as a result, do not add clarity but rather raise more questions regarding its scope. The examples illustrating where the main purpose would apply involve facts that could be addressed by more targeted anti-abuse rules which we believe is the right avenue for addressing treaty abuse. The examples illustrating where it does not apply may imply its application in similar circumstances that are not within the scope of the example. For example, Example C involves a decision by a company regarding where to locate manufacturing facilities to take advantage of lower labour costs and concludes that including in its considerations the availability of treaty benefits does not violate the main purpose test. This example raises the question of whether the same result should apply if the activity, rather than manufacturing, is the common practice of MNEs to concentrate holding company and financing centre operations in separate companies for reasons unrelated to taxation. If an MNE chooses to locate its treasury centre in a jurisdiction that has a favourable network of tax treaties, is that a violation of the main purpose test?

We submit it should not be, but absent an example confirming this analysis, an MNE would, in effect, be penalised for placing its holding company or treasury centre in a jurisdiction with a broad network of tax treaties. Countries could adopt appropriate rules dealing with the assignment of income, which would deal with many of the abusive cases identified in the Discussion Draft.

1.3.4. Impact on mergers and acquisitions

The main purpose test could have a chilling effect on cross-border mergers and acquisitions and would appear particularly relevant for private equity which will normally fail the publicly traded LOB test and may have to rely on the competent authority route. When one MNE group purchases another, the group structures may not be compatible. Structures that might have incurred little or no withholding tax prior to the acquisition may become subject to substantial withholding tax. Will it be possible to reorganise following such an acquisition or will such a reorganisation be considered to fail the main purpose test?

1.3.5. Impact on the investment community

The Discussion Draft's discussion of the main purpose test fails to take into account that treaties are not used solely by multinationals. Treaties are equally important in allocating taxing jurisdiction with respect to investment income. The best known example involves a resident of Country X investing in an investment fund organised under the laws of Country Y which may earn dividends or other income from an investment in a company resident in Country Z. For any number of reasons, a main purpose test does not work well in this fact pattern. All countries agree that the goal in such cases should be to tax the ultimate investors/beneficial owners only once. The unfortunate reality is that sometimes treaties have to be used to attain that goal. In such cases, the fund might literally be said to have as its main purpose claiming treaty benefits, but nothing about that is abusive.

1.3.6. The importance of procedural safeguards

If it is ultimately concluded to recommend a main purpose test, the OECD needs to recommend effective procedures so that the uncertainty of such a test is not magnified by a lengthy period of uncertainty regarding the propriety of its application. A taxpayer should have the right to know what its tax responsibilities are without having a lengthy process for resolving whether the application of the main purpose test is appropriate. If this uncertainty cannot be resolved by an effective advance ruling process or an expedited process for dispute resolution after a government claim that it applies, the cost to the business and investment community will be excessive.

We further recommend that if an enterprise meets any of the other criteria in an LOB article for eligibility for treaty benefits, the burden be placed on the tax authority challenging the access to treaty benefits to clearly demonstrate that the main purpose test applies. In addition, to ensure that a single Competent Authority does not violate the spirit of the main purpose test by aggressive interpretation of the standards, a decision by a

Competent Authority to apply the main purpose test should require acceptance of that decision by the Competent Authority of the treaty partner with mandatory binding arbitration to resolve disputes. Finally, to mitigate the unpredictability of reliance on the judgment of each tax authority as to taxpayer intent, changing a main purpose to the main purpose would provide taxpayers a measure of protection against over-zealous use of this tool by tax authorities.

1.4. Collective Investment Vehicles

Significant work has been done by the OECD to date, notably in publishing the April 2010 Report *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles* (the 2010 CIV Report). The report seeks to address the specific issues of collective investment vehicles (CIVs) within the overall framework of tax treaties. A key principle is that "the goal is to achieve neutrality between a direct investment and an investment through a CIV in the international context" (see inter alia paragraph 6.18 of the draft paragraphs proposed as additions to the Commentary on Article 1, set out at paragraph 62 of the 2010 CIV Report).

The 2010 CIV Report recognises the wide variety of legal characteristics and tax attributes that it is possible for the CIV type of entity to possess. However, it proposes two main alternative avenues for integrating CIVs into the treaty framework.

- CIVs are to be treated as *individuals* who are "residents of the Contracting State" in which they are established and as the beneficial owner of the income they receive; or
- CIVs are not treated as "residents of the Contracting State" in which they are established, but they may make claims to treaty benefits on behalf of their investors.

As a general matter, we strongly urge that further and prompt action by the OECD, to bring CIVs into the Model Treaty framework in the ways proposed in the 2010 CIV Report, is now essential. As CIVs clearly are not within the scope of Action 6 and could inadvertently be deprived of treaty benefits due to the lack of focus on CIV and other pooled funds in the proposed Entitlement to Benefits article, we urge that the final version of Action 6 make clear that further work needs to progress on the application of treaties to CIVs and similar pooled investments at an accelerated pace to assure they are appropriately addressed in any final version of an LOB article.

1.4.1. Private equity and hedge funds

In addition, to date the term "CIV" has been applied to funds that are widely held, hold a diversified portfolio of securities and are subject to investor protection regulation in the country in which they are established. This definition excludes an extremely important group of collective investment arrangements that may be categorised as pooled private capital investment funds. It has been acknowledged previously that the issues and principles faced by CIVs could also be applied to them.

We strongly urge that such arrangements are also included in the Model Treaty framework in ways that follow the recommendations noted above, for the same rationale. Systems and solutions may need to be developed to ensure tax administrations are able to ensure proper compliance with tax obligations, from the perspective of both source and residence countries. However, this practical challenge should not deprive appropriate investors from the benefit of tax treaties to avoid effective double or greater levels of taxation.

1.5. Tie-breaker rule

We do not consider that the long-standing effective management tie-breaker for dual residence should be replaced by a competent authority process because of the uncertainty both regarding outcome and timing this involves. Although competent authority is used by one BEPS country in particular, the vast majority of tax

treaties still use place of effective management for which there is experience and some case law. The competent authority process by comparison is not transparent and can take considerable time. Two years or more is not unusual.

Hence, an amendment of the tie-breaker rule would add considerable uncertainty to multinational companies. This is increased by the fact that – as mentioned – today's reality is marked by diaspora ie a scattering of management across a number of countries and very often criteria for unlimited taxation are given to two or even more countries without the companies recognising this. If the tie-breaker rule were to move away from the criterion of place of effective management which has worked for years as a fair principle for allocating residency for treaty purposes, numerous companies would be affected without any treaty abuse whatsoever as trigger.

If a change were nevertheless made to adopt the competent authority process, there should be a mandate for expeditious resolution of the status of the taxpayer, say within 3 to 6 months. If no mutual agreement can be achieved within a reasonable period of time, mandatory binding arbitration should be required.

1.6. PEs in third country states (triangular branch situations)

Under paragraph 56 of the Discussion Draft, it is proposed to adopt an approach under which treaty benefits are to be denied where income is attributable to a permanent establishment (PE), and the result is that the aggregate tax burden on that income represents an effective rate less than 60% of the general rate of company tax in the State where the enterprise is resident. This "triangular branch provision" would constitute a major change from existing practice.

We submit that treaties are the wrong vehicle for addressing this concern. The concern is founded on the fact that the residency jurisdiction has agreed to deduct or substantially lower its taxation of profits attributable to a PE and the PE jurisdiction taxes lightly or not at all. If that is truly a concern, it should be addressed in the context of Harmful Tax Practices. It has always been a basic principle of treaty policy that when treaty benefits are tied to taxability in the residence jurisdiction, the standard is whether the item of income is subject to tax in that jurisdiction, not on whether a tax is actually paid. It is also commonly accepted that rate competition is not considered harmful competition. Hence, whether a rate reduction in the residence jurisdiction combined with low or no tax in a PE jurisdiction justifies denying or limiting source country tax relief is not at all clear and is a matter that should be addressed outside the abuse of treaties work.

1.7. Domestic law anti-abuse provisions

In endorsing the use of domestic anti-abuse rules, the OECD should make clear that it is not acceptable for a State to override its treaty obligations in the guise of an anti-abuse rule. A clear distinction should be drawn between domestic laws that address treaty abuse and domestic laws that reflect a change in policy that is in conflict with its treaty obligations.

2. Comments on Part B

We note that, on the 4 April 2014, the United States Council for International Business (USCIB) submitted comments on Action 6. One of those comments addressed the proposed changes to the Preamble to treaties to stress that one of the goals of tax treaties is to avoid creating opportunities for inappropriate use of tax treaties. The Discussion Draft explained that the motivation for the proposed change to the Preamble was that Article 31(1) of the *Vienna Convention on the Law of Treaties* includes the principle that treaties should be interpreted "in their context and in light of its object and purpose."

The USCIB suggested additional clarifying language which we agree would be in order to present a balanced presentation of the object and purpose of the treaty and avoid having courts give undue weight to the clarification that treaties are not to be interpreted to create opportunities for inappropriate use. Accordingly, we endorse the USCIB proposed language which we repeat here (with the USCIB additions underscored);

> ***Desiring to further develop their economic relationship <u>and the promotion of bilateral trade and investment by removing artificial barriers and promoting greater certainty and predictability of tax results to residents</u> and to enhance their cooperation in tax matters,***
>
> ***Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping arrangements aimed at obtaining reliefs provided in this Convention <u>principally</u> for the indirect benefit of residents of third States)…***

3. Concluding remarks

For the goals of Action 6 to be effectively achieved, the appropriate tools for combatting inappropriate use of tax treaties must be developed with sensitivity so as not to undermine the basic purpose of tax treaties – that is, to remove tax barriers to cross-border trade and investment. If the final formulation of the rules disrupts the normal course of international business or establishes barriers to access to tax treaties for the majority of residents of treaty countries that are not making inappropriate use of the treaty, the solution will be far worse than the problem. We hope you will find our comments helpful in reaching that balance between effectively policing abuse and furthering the cross-border trade and investment that is so vital to maintaining a vibrant global economy.