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BEPS: Proposed General Anti-avoidance Rule Commentary for a New Article

SUMMARY

This note, drawn up as part of the work of the BEPS Subcommittee, proposes that a new general anti-abuse rule be added to the United Nations Model Convention as paragraph 9 of Article 29 The new Article is identical to the general anti-abuse rule to be added to the OECD Model Convention as paragraph 2 of Article 1. It would therefore read:

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.

For the most part, the proposed OECD Commentary on the Article is relevant for the United Nations Model Convention Commentary. However, the OECD Commentary would need to be modified appropriately for inclusion in the United Nations Model Convention. The draft Commentary for new Article 29, paragraph 9 is reproduced in this note.

The Commentary on Article 1 of the United Nations Model Convention needs to be revised to reflect the fact that new Article 29, paragraph 9 is now included in the Convention. The references in the Commentary on Article 1 to a general anti-abuse rule remain appropriate for those tax treaties that do not contain a general anti-abuse rule. The revised Commentary on Article 1 is contained in a separate note.

PROPOSED GENERAL ANTI-AVOIDANCE RULE – COMMENTARY FOR A NEW ARTICLE

Introduction

1. Until the 2017 update, the United Nations Model Convention did not include a general anti- abuse rule, but provided an optional text for inclusion in the Commentary to Article 1 in paragraph 36. As part of the 2017 Update, the Committee decided that a general anti-abuse rule should be included in the United Nations Model Convention as paragraph 9 of Article 29. Therefore, paragraphs 14 to 24 of the Commentary on Article 1 are relevant primarily for those bilateral tax treaties that do not contain a general anti-abuse rule similar to this paragraph.

2. Paragraph 9 of the Article corresponds to the general anti-abuse rule [recommended by the OECD/G20 in the Final Report on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) and] added to the OECD Model Convention as paragraph 2 of Article 1. Therefore, the Committee determined that paragraphs 168 to 186 of the Commentary on paragraph 9 of Article 29 of the OECD Model Convention are also relevant for the purposes of paragraph 9 of this Article. These paragraphs with appropriate modifications to reflect the inclusion of the general anti-abuse rule in paragraph 9 of this Article of the United Nations Model Convention are reproduced below.

> ***168. Paragraph 9 mirrors the guidance in paragraphs [20 to 23]~~9.5, 22, 22.1 and 22.2~~ of the Commentary on Article 1. According to that guidance, the benefits of a tax convention should not be available where one of the principal purposes of certain transactions or arrangements is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax convention. Paragraph 9 incorporates the principles underlying these paragraphs into the Convention itself in order to allow States to address cases of improper use of the Convention even if their domestic law does not allow them to do so in accordance with paragraph [20] ~~s 22 and 22.1~~ of the Commentary on Article 1; it also confirms the application of these principles for States whose domestic law already allows them to address such cases.***

169. The provisions of paragraph 9 have the effect of denying a benefit under a tax convention where one of the principal purposes of an arrangement or transaction that has been entered into is to obtain a benefit under the convention. Where this is the case, however, the last part of the paragraph allows the person to whom the benefit would otherwise be denied the possibility of establishing that obtaining the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

170. Paragraph 9 supplements and does not restrict in any way the scope or application of the provisions of paragraphs 1 to 7 (the limitation-on-benefits rule): a benefit that is denied in accordance with these paragraphs is not a "benefit under the Convention" that paragraph 7 would also deny. Moreover, the guidance provided in the Commentary on paragraph 7 should not be used to interpret paragraphs 1 to 6 and vice-versa.

171. Conversely, the fact that a person is entitled to benefits under paragraphs 1 to 6 does not mean that these benefits cannot be denied under paragraph 9. Paragraphs 1 to 6 are rules that focus primarily on the legal nature, ownership in, and general activities of, residents of a Contracting State. As illustrated by the example in the next paragraph, these rules do not imply that a transaction or arrangement entered into by such a resident cannot constitute an improper use of a treaty provision.

172. Paragraph 9 must be read in the context of paragraphs 1 to 6 and of the rest of the Convention, including its preamble. This is particularly important for the purposes of determining the object and purpose of the relevant provisions of the Convention. Assume, for instance, that a public company whose shares are regularly traded on a recognized stock exchange in the Contracting State of which the company is a resident derives income from the other Contracting State. As long as that company is a "qualified person" as defined in paragraph 2, it is clear that the benefits of the Convention should not be denied solely on the basis of the ownership structure of that company, e.g. because a majority of the shareholders in that company are not residents of the same State. The object and purpose of subparagraph 2 c) is to establish a threshold for the treaty entitlement of public companies whose shares are held by residents of different States. The fact that such a company is a qualified person does not mean, however, that benefits could not be denied under paragraph 9 for reasons that are unrelated to the ownership of the shares of that company. Assume, for instance, that such a public company is a bank that enters into a conduit financing arrangement intended to provide indirectly to a resident of a third State the benefit of lower source taxation under a tax treaty. In that case, paragraph 9 would apply to deny that benefit because subparagraph 2 c), when read in the context of the rest of the Convention and, in particular, its preamble, cannot be considered as having the purpose, shared by the two Contracting States, of authorizing treaty-shopping transactions entered into by public companies.

173. The provisions of paragraph 9 establish that a Contracting State may deny the benefits of a tax convention where it is reasonable to conclude, having considered all the relevant facts and circumstances, that one of the principal purposes of an arrangement or transaction was for a benefit under a tax treaty to be obtained. The provision is intended to ensure that tax conventions apply in accordance with the purpose for which they were entered into, i.e. to provide benefits in respect of bona fide exchanges of goods and services, and movements of capital and persons as opposed to arrangements whose principal objective is to secure a more favourable tax treatment.

174. The term "benefit" includes all limitations (e.g. a tax reduction, exemption, deferral or refund) on taxation imposed on the State of source under Articles 6 through 22 of the Convention, the relief from double taxation provided by Article 23, and the protection afforded to residents and nationals of a Contracting State under Article 24 or any other similar limitations. This includes, for example, limitations on the taxing rights of a Contracting State in respect of dividends, interest or royalties arising in that State, and paid to a resident of the other State (who is the beneficial owner) under Article 10, 11, 12 or 12 A]. ~~or 12.~~ It also includes limitations on the taxing rights of a Contracting State over a capital gain derived from the alienation of movable property located in that State by a resident of the other State under Article 13. When a tax convention includes other limitations (such as a tax sparing provision), the provisions of this Article also apply to that benefit.

175. The phrase "that resulted directly or indirectly in that benefit" is deliberately broad and is intended to include situations where the person who claims the application of the benefits under a tax treaty may do so with respect to a transaction that is not the one that was undertaken for one of the principal purposes of obtaining that treaty benefit. This is illustrated by the following example:

> ***TCo, a company resident of State T, has acquired all the shares and debts of SCo, a company resident of State S, that were previously held by SCo's parent company. These include a loan made to SCo at 4 per cent interest payable on demand. State T does not have a tax convention with State S and, therefore, any interest paid by SCo to TCo is subject to a withholding tax on interest at a rate of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, there is no withholding tax on interest paid by a company resident of a Contracting State and beneficially owned by a company resident of the other State; also, that treaty does not include provisions similar to paragraphs 1 to 6. TCo decides to transfer the loan to RCo, a subsidiary resident of State R, in exchange for three promissory notes payable on demand on which interest is payable at 3.9 per cent.***

In this example, whilst RCo is claiming the benefits of the State R-State S treaty with respect to a loan that was entered into for valid commercial reasons, if the facts of the case show that one of the principal purposes of TCo in transferring its loan to RCo was for RCo to obtain the benefit of the State R-State S treaty, then the provision would apply to deny that benefit as that benefit would result indirectly from the transfer of the loan.

176. The terms "arrangement or transaction" should be interpreted broadly and include any agreement, understanding, scheme, transaction or series of transactions, whether or not they are legally enforceable. In particular they include the creation, assignment, acquisition or transfer of the income itself, or of the property or right in respect of which the income accrues. These terms also encompass arrangements concerning the establishment, acquisition or maintenance of a person who derives the income, including the qualification of that person as a resident of one of the Contracting States, and include steps that persons may take themselves in order to establish residence. An example of an "arrangement" would be where steps are taken to ensure that meetings of the board of directors of a company are held in a different country in order to claim that the company has changed its residence. One transaction alone may result in a benefit, or it may operate in conjunction with a more elaborate series of transactions that together result in the benefit. In both cases the provisions of paragraph 9 may apply.

177. To determine whether or not one of the principal purposes of any person concerned with an arrangement or transaction is to obtain benefits under the Convention, it is important to undertake an objective analysis of the aims and objects of all persons involved in putting that arrangement or transaction in place or being a party to it. What are the purposes of an arrangement or transaction is a question of fact which can only be answered by considering all circumstances surrounding the arrangement or event on a case by case basis. It is not necessary to find conclusive proof of the intent of a person concerned with an arrangement or transaction, but it must be reasonable to conclude, after an objective analysis of the relevant facts and circumstances, that one of the principal purposes of the arrangement or transaction was to obtain the benefits of the tax convention. It should not be lightly assumed, however, that obtaining a benefit under a tax treaty was one of the principal purposes of an arrangement or transaction and merely reviewing the effects of an arrangement will not usually enable a conclusion to be drawn about its purposes. Where, however, an arrangement can only be reasonably explained by a benefit that arises under a treaty, it may be concluded that one of the principal purposes of that arrangement was to obtain the benefit.

178. A person cannot avoid the application of this paragraph by merely asserting that the arrangement or transaction was not undertaken or arranged to obtain the benefits of the Convention. All of the evidence must be weighed to determine whether it is reasonable to conclude that an arrangement or transaction was

undertaken or arranged for such purpose. The determination requires reasonableness, suggesting that the possibility of different interpretations of the events must be objectively considered.

179. The reference to "one of the principal purposes" in paragraph 9 means that obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the principal purposes was to obtain the benefit. For example, a person may sell a property for various reasons, but if before the sale, that person becomes a resident of one of the Contracting States and one of the principal purposes for doing so is to obtain a benefit under a tax convention, paragraph 9 could apply notwithstanding the fact that there may also be other principal purposes for changing the residence, such as facilitating the sale of the property or the re-investment of the proceeds of the alienation.

180. A purpose will not be a principal purpose when it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the benefit was not a principal consideration and would not have justified entering into any arrangement or transaction that has, alone or together with other transactions, resulted in the benefit. In particular, where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit. Where, however, an arrangement is entered into 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 obtaining one benefit under one treaty from being considered a principal purpose for that arrangement. Assume, for example, that a taxpayer resident of State A enters into a conduit arrangement with a financial institution resident of State B in order for that financial institution to invest, for the ultimate benefit of that taxpayer, in bonds issued in a large number of States with which State B, but not State A, has tax treaties. If the facts and circumstances reveal that the arrangement has been entered into for the principal purpose of obtaining the benefits of these tax treaties, it should not be considered that obtaining a benefit under one specific treaty was not one of the principal purposes for that arrangement. Similarly, purposes related to the avoidance of domestic law should not be used to argue that obtaining a treaty benefit was merely accessory to such purposes.

181. The following examples illustrate the application of the paragraph (the examples included in paragraph 186 below should also be considered when determining whether and when the paragraph would apply in the case of conduit arrangements):

- ***Example A: TCo, a company resident of State T, owns shares of SCo, a company listed on the stock exchange of State S. State T does not have a tax convention with State S and, therefore, any dividend paid by SCo to***

TCo is subject to a withholding tax on dividends of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, there is no withholding tax on dividends paid by a company resident of a Contracting State and beneficially owned by a company resident of the other State. TCo enters into an agreement with RCo, an independent financial institution resident of State R, pursuant to which TCo assigns to RCo the right to the payment of dividends that have been declared but have not yet been paid by SCo.

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the arrangement under which TCo assigned the right to the payment of dividends to RCo was for RCo to obtain the benefit of the exemption from source taxation of dividends provided for by the State R-State S tax convention and it would be contrary to the object and purpose of the tax convention to grant the benefit of that exemption under this treaty-shopping arrangement.

– ***Example B: SCo, a company resident of State S, is the subsidiary of TCo, a company resident of State T. State T does not have a tax convention with State S and, therefore, any dividend paid by SCo to TCo is subject to a withholding tax on dividends of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, the applicable rate of withholding tax on dividends paid by a company of State S to a resident of State R is 5 per cent. TCo therefore enters into an agreement with RCo, a financial institution resident of State R and a qualified person under subparagraph 3 a) of this Article, pursuant to which RCo acquires the usufruct of newly issued non-voting preferred shares of SCo for a period of three years. TCo is the bare owner of these shares. The usufruct gives RCo the right to receive the dividends attached to these preferred shares. The amount paid by RCo to acquire the usufruct corresponds to the present value of the dividends to be paid on the preferred shares over the period of three years (discounted at the rate at which TCo could borrow from RCo).***

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the arrangement under which RCo acquired the usufruct of the preferred shares issued by SCo was to obtain the benefit of the 5 per cent limitation applicable to the source taxation of dividends provided for by the State R-State S tax convention and it would be contrary to the object and purpose of the tax convention to grant the benefit of that limitation under this treaty-shopping arrangement.

– ***Example C: RCo, a company resident of State R, is in the business of producing electronic devices and its business is expanding rapidly. It is***

now considering establishing a manufacturing plant in a developing country in order to benefit from lower manufacturing costs. After a preliminary review, possible locations in three different countries are identified. All three countries provide similar economic and political environments. After considering the fact that State S is the only one of these countries with which State R has a tax convention, the decision is made to build the plant in that State.

In this example, whilst the decision to invest in State S is taken in the light of the benefits provided by the State R-State S tax convention, it is clear that the principal purposes for making that investment and building the plant are related to the expansion of RCo's business and the lower manufacturing costs of that country. In this example, it cannot reasonably be considered that one of the principal purposes for building the plant is to obtain treaty benefits. In addition, given that a general objective of tax conventions is to encourage cross-border investment, obtaining the benefits of the State R-State S convention for the investment in the plant built in State S is in accordance with the object and purpose of the provisions of that convention.

– ***Example D: RCo, a collective investment vehicle resident of State R, manages a diversified portfolio of investments in the international financial market. RCo currently holds 15 per cent of its portfolio in shares of companies resident of State S, in respect of which it receives annual dividends. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 30 per cent to 10 per cent.***

RCo's investment decisions take into account the existence of tax benefits provided under State R's extensive tax convention network. A majority of investors in RCo are residents of State R, but a number of investors (the minority investors) are residents of States with which State S does not have a tax convention. Investors' decisions to invest in RCo are not driven by any particular investment made by RCo, and RCo's investment strategy is not driven by the tax position of its investors. RCo annually distributes almost all of its income to its investors and pays taxes in State R on income not distributed during the year.

In making its decision to invest in shares of companies resident of State S, RCo considered the existence of a benefit under the State R-State S tax convention with respect to dividends, but this alone would not be sufficient to trigger the application of paragraph 9. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 9 applies to an investment, it is necessary to consider the context in which the investment was made. In this example, unless RCo's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the

benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax treaty to RCo.

– ***Example E: RCo is a company resident of State R and, for the last 5 years, has held 24 per cent of the shares of company SCo, a resident of State S. Following the entry-into-force of a tax treaty between States R and S (Article 10 of which is identical to Article 10 of this Model), RCo decides to increase to 25 per cent its ownership of the shares of SCo. The facts and circumstances reveal that the decision to acquire these additional shares has been made primarily in order to obtain the benefit of the lower rate of tax provided by Article 10(2)a) of the treaty.***

In that case, although one of the principal purposes for the transaction through which the additional shares are acquired is clearly to obtain the benefit of Article 10(2)a), paragraph 9 would not apply because it may be established that granting that benefit in these circumstances would be in accordance with the object and purpose of Article 10(2)a). That subparagraph uses an arbitrary threshold of 25 per cent for the purposes of determining which shareholders are entitled to the benefit of the lower rate of tax on dividends and it is consistent with this approach to grant the benefits of the subparagraph to a taxpayer who genuinely increases its participation in a company in order to satisfy this requirement.

– ***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 services such as accounting, legal advice and human resources; financing and treasury services such as managing currency risks and arranging hedging transactions, as well as 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 9 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 also undertakes the development of new manufacturing facilities in State S. For that purpose, it contributes equity capital and makes loans to SCO, a subsidiary resident of State S that RCO established for the purposes of owning these facilities. 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 9 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.

– ***Example J: RCO is a company resident of State R. It has successfully submitted a bid for the construction of a power plant for SCO, an independent company resident of State S. That construction project is expected to last 22 months. During the negotiation of the contract, the project is divided into two different contracts, each lasting 11 months. The first contract is concluded with RCO and the second contract is concluded with SUBCO, a recently incorporated wholly-owned subsidiary of RCO resident of State R. At the request of SCO, which wanted to ensure that RCO would be contractually liable for the performance of the two contracts, the contractual arrangements are such that RCO is jointly and severally liable with SUBCO for the performance of SUBCO's contractual obligations under the SUBCO-SCO contract.***

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the conclusion of the separate contract under which SUBCO agreed to perform part of the construction project was for RCO and SUBCO to each obtain the benefit of the rule in paragraph 3 of Article 5 of the State R-State S tax convention. Granting the benefit of that rule in these circumstances would be contrary to the object and purpose of that paragraph as the time limitation of that paragraph would otherwise be meaningless.

– ***Example K: RCO, a company resident of State R, is a wholly-owned subsidiary of Fund, an institutional investor that is a resident of State T and that was established and is subject to regulation in State T. RCO operates exclusively to generate an investment return as the regional investment platform for Fund through the acquisition and management of a diversified portfolio of private market investments located in countries in a regional grouping that includes State R. The decision to establish the regional investment platform in State R was mainly driven by the availability of directors with knowledge of regional business practices and regulations, the existence of a skilled multilingual workforce, State R's membership of a regional grouping and use of the regional grouping's common currency,***

and the extensive tax convention network of State R, including its tax convention with State S, which provides for low withholding tax rates. RCO employs an experienced local management team to review investment recommendations from Fund, approve and monitor investments, carry on treasury functions, maintain RCO's books and records, and ensure compliance with regulatory requirements in States where it invests. The board of directors of RCO is appointed by Fund and is composed of a majority of State R resident directors with expertise in investment management, as well as members of Fund's global management team. RCO pays tax and files tax returns in State R.

RCO is now contemplating an investment in SCO, a company resident of State S. The investment in SCO would constitute only part of RCO's overall investment portfolio, which includes investments in a number of countries in addition to State S which are also members of the same regional grouping. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 30 per cent to 5 per cent. Under the tax convention between State S and State T, the withholding tax rate on dividends is 10 per cent.

In making its decision whether or not to invest in SCO, RCO considers the existence of a benefit under the State R-State S tax convention with respect to dividends, but this alone would not be sufficient to trigger the application of paragraph 9. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 9 applies to an investment, it is necessary to consider the context in which the investment was made, including the reasons for establishing RCO in State R and the investment functions and other activities carried out in State R. In this example, in the absence of other facts or circumstances showing that RCO's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCO.

– ***Example L: RCO, a securitisation company resident of State R, was established by a bank which sold to RCO a portfolio of loans and other receivables owed by debtors located in a number of jurisdictions. RCO is fully debt-funded. RCO has issued a single share which is held on trust and has no economic value. RCO's debt finance was raised through the issuance of notes that are widely-held by third-party investors. The notes are listed on a recognised stock exchange, which allows for their trading on the secondary market, and are held through a clearing system. To comply with regulatory requirements, the bank also retained a small percentage of the listed, widely-held debt securities issued by RCO. RCO currently holds 60 per cent of its portfolio in receivables of small and medium sized enterprises***

resident in State S, in respect of which RCO receives regular interest payments. The bank is a resident of a State T which has a tax treaty with State S that provides benefits equivalent to those provided under the State R-State S tax treaty. Under the tax treaty between State R and State S, the withholding tax rate on interest is reduced from 30 per cent to 10 per cent.

In establishing RCO, the bank took into account a large number of issues, including State R's robust securitisation framework, its securitisation and other relevant legislation, the availability of skilled and experienced personnel and support services in State R and the existence of tax benefits provided under State R's extensive tax convention network. Investors' decisions to invest in RCO are not driven by any particular investment made by RCO and RCO's investment strategy is not driven by the tax position of the investors. RCO is taxed in State R on income earned and is entitled to a full deduction for interest payments made to investors.

In making its decision to sell receivables owed by enterprises resident in State S, the bank and RCO considered the existence of a benefit under the State R-State S tax convention with respect to interest, but this alone would not be sufficient to trigger the application of paragraph 9. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 9 applies to an investment, it is necessary to consider the context in which the investment was made. In this example, in the absence of other facts or circumstances showing that RCO's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCO.

– ***Example M: Real Estate Fund, a State C partnership treated as fiscally transparent under the domestic tax law of State C, is established to invest in a portfolio of real estate investments in a specific geographic area. Real Estate Fund is managed by a regulated fund manager and is marketed to institutional investors, such as pension schemes and sovereign wealth funds, on the basis of the fund's investment mandate. A range of investors resident in different jurisdictions commit funds to Real Estate Fund. The investment strategy of Real Estate Fund, which is set out in the marketing materials for the fund, is not driven by the tax positions of the investors, but is based on investing in certain real estate assets, maximising their value and realising appreciation through the disposal of the investments. Real Estate Fund's investments are made through a holding company, RCO, established in State R. RCO holds and manages all of Real Estate Fund's immovable property assets and provides debt and/or equity financing to the underlying investments. RCO is established for a number of commercial and legal reasons, such as to protect Real Estate Fund from the liabilities of and potential claims against the fund's immovable property assets, and to***

facilitate debt financing (including from third-party lenders) and the making, management and disposal of investments. It is also established for the purposes of administering the claims for relief of withholding tax under any applicable tax treaty. This is an important function of RCO as it is administratively simpler for one company to get treaty relief rather than have each institutional investor process its own claim for relief, especially if the treaty relief to which each investor would be entitled as regards a specific item of income is a small amount. After a review of possible locations, Real Estate Fund decided to establish RCO in State R. This decision was mainly driven by the political stability of State R, its regulatory and legal systems, lender and investor familiarity, access to appropriately qualified personnel and the extensive tax convention network of State R, including its treaties with other States within the specific geographic area targeted for investment. RCO, however, does not obtain treaty benefits that are better than the benefits to which its investors would have been entitled if they had made the same investments directly in these States and had obtained treaty benefits under the treaties concluded by their States of residence.

In this example, whilst the decision to locate RCO in State R is taken in light of the existence of benefits under the tax conventions between State R and the States within the specific geographic area targeted for investment, it is clear that RCO's immovable property investments are made for commercial purposes consistent with the investment mandate of the fund. Also RCO does not derive any treaty benefits that are better than those to which its investors would be entitled and each State where RCO's immovable property investments are made is allowed to tax the income derived directly from such investments. In the absence of other facts or circumstances showing that RCO's investments are part of an arrangement, or relate to another transaction, undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the tax treaties between RCO and the States in which RCO's immovable property investments are located.

3. The following examples also illustrate the application of paragraph 9:

Example M: TCo, a resident of State T, is a member of a multinational group of companies that provides various cleaning and waste management services to businesses in State T and also in other states. TCo enters into a contract with SCo, a company resident of State S to provide its services at three of SCo's business facilities in State S for a period of 180 working days. Subsequently, at a time when TCo has spent 150 working days in State S, TCo and SCo begin negotiations to extend the contract for an additional 90 days. As allowed by the amended contract, TCo assigns its rights and obligations under the contract to SUBCo, a wholly-owned

subsidiary of TCo and also a resident of State T. SUBCo performs the required services to SCo for 90 days under the amended contract with the assistance of personnel supplied by TCo. The tax convention between State T and State S contains a provision identical to subparagraph (3)(b) of Article 5. Both TCo and SUBCo claim the benefit of subparagraph (3)(b) of Article 5 on the basis that neither of them furnishes services in State S for more than 183 days in any 12-month period.

In this example, the facts and circumstances may reveal that a principal purpose of limiting the services provided by TCo in State S to 180 days was to avoid having a permanent establishment in State S and to obtain the benefit of the time threshold in subparagraph (3)(b) of Article 5. However, the general anti-abuse rule in paragraph 9 of the Article would not apply in this example if TCo's services in State S were limited to 180 days because granting the benefit of subparagraph (3)(b) of Article 5 in this situation is in accordance with its object and purpose. Subparagraph (3)(b) of Article 5 establishes a bright-line time threshold of more than 183 working days in any 12-month period for the existence of a permanent establishment and it is consistent with this object and purpose to grant the benefit of the subparagraph to a taxpayer who limits its activities of performing services in a country to less than the threshold. This result is consistent with the result in Example E above.

However, on the basis of the assignment of TCo's rights and obligations under the extension of the contract to SUBCo and in the absence of any other relevant facts and circumstances, it would be reasonable to conclude that one of the principal purposes for the assignment to SUBCo is to obtain the benefit of the time threshold for both TCo and SUBCo. If TCo had continued to provide services in State S under the extension of the contract, TCo would have exceeded the time threshold in subparagraph (3)(b) of Article 5 and would have been deemed to have a PE in State S. It would contrary to the object and purpose of the convention to grant the benefit of subparagraph (3)(b) of Article 5 to TCo and SUBCo under such an artificial contract-splitting arrangement.

Example N: RCo is a company incorporated and resident under the laws of State R with its place of effective management also in State R. RCo anticipates that it will incur large losses from some of its business activities in the next few years. RCo has a profitable subsidiary, SUBCo, a resident of

State S. Under the domestic law of State S, group companies are entitled to consolidate their profits and losses. RCo establishes its place of effective management in State S and is considered to be a resident of State S under its domestic law. Under the tie-breaker rule in paragraph (3) of Article 4 of the tax convention between State T and State S, RCo is considered to be a resident only of State S for purposes of the treaty. RCo claims the deduction of its losses in both State T and State S.

In this example, in the absence of other facts and circumstances, it would be reasonable to conclude that one of the principal purposes for RCo to shift its place of effective management from State R to State S was to obtain dual residence status in both State R and State T and the benefit of the tie-breaker rule in Article 4, paragraph (3). Also, it would be contrary to the object and purpose of the tie-breaker rule in Article 4, paragraph (3) to allow it to be misused to obtain deductions for RCo's losses in both State R and State S. The object and purpose of the tie-breaker rules in Article 4 is to avoid situations in which dual residents are denied treaty benefits by both states, not to allow losses to be claimed in multiple states. Therefore, the Article could be applied by State S to deny the deduction of RCo's losses. ***[Note for Committee: perhaps omit this example since the tie-breaker in Article 4(3) will be changed to resolution by the competent authorities?]***

4. The OECD Commentary continues as follows:

182. 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 acceleration 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 9 is only applied after approval at a senior level within the administration.

183. Also, some States consider that where a person is denied a treaty benefit in accordance with paragraph 9, the competent authority of the Contracting State that would otherwise have granted this benefit should have the possibility of treating that person as being entitled to this benefit, or to different benefits with respect to the relevant item of income or capital, if such benefits would have been granted to that person in the absence of the transaction or arrangement that triggered the application of paragraph 9. In order to allow that possibility, such

States are free to include the following additional paragraph in their bilateral treaties:

> ***10. Where a benefit under this Convention is denied to a person under paragraph 9, 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 9. 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.***

184. For the purpose of this alternative provision, the determination that benefits would have been granted in the absence of the transaction or arrangement referred to in paragraph 9 and the determination of the benefits that should be granted are left to the discretion of the competent authority to which the request is made. The alternative provision grants broad discretion to the competent authority for the purposes of these determinations. The provision 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.

185. The following example illustrates the application of this alternative provision. Assume 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 25 ~~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 9, the alternative provision would allow the competent authority of State S to grant the benefit of the reduced rate provided for in subparagraph b) of paragraph 2 of

Article 10 if that competent authority determined that such benefit would have been granted in the absence of the assignment to another company of the right to receive dividends.

[Note: paragraph 186 of the OECD Commentary on Article 1 dealing with conduit rules should be quoted here]

5. In paragraphs 117 and 118 of the Commentary on Article 1, the Committee recognizes the general importance of proper mechanisms for the administration and interpretation of tax treaties to minimize the risks of tax abuse. These mechanisms are especially important with respect to general anti-abuse rules in both domestic law and tax conventions. Inevitably, general anti-abuse rules involve an element of uncertainty, which may have a negative impact on legitimate cross-border trade and investment. Countries may wish to consider reducing the uncertainty for taxpayers in various ways, such as the application of the Article only after approval by senior officials of the tax administration as discussed in paragraph 18 above, an advance rulings procedure, or the provision of guidance by the tax administration to taxpayers as to how it intends to apply paragraph 9 of the Article. Similarly, as noted in paragraph 119 of the Commentary on Article 1, a strong independent judicial system will help to provide taxpayers with the assurance that the Article is applied objectively. Similarly, an effective application of the mutual agreement procedure will ensure that disputes concerning the application of paragraph 9 of the Article will be resolved according to internationally accepted principles so as to maintain the integrity of tax treaties.