E/C.18/2017/CRP.8

Distr.: General
31 March 2017

Original: English

Committee of Experts on International Cooperation in Tax Matters
Fourteenth session
New York, 3-6 April 2017
Agenda item 3(a)(ii): BEPS

NEW ARTICLE 29 (ENTITLEMENT TO BENEFITS) OF THE UN MODEL AND ITS COMMENTARY

INTRODUCTION

At the December 2016 meeting of the Committee, Henry Louie gave a detailed presentation of the 2016 U.S. Model limitation on benefits (LOB) article. After a lengthy discussion, the Committee decided that the UN Model in its next update should be amended to include an LOB provision following the U.S. Model. In addition, the Committee decided that the UN Model should reflect on an equal footing the four options for combatting treaty shopping that had been endorsed by the OECD G20 BEPS initiative: 1) an LOB alone (if conduit arrangements are dealt with under domestic law; 2) a "principal purpose test (PPT)"; 3) an LOB plus a PPT; or 4) an LOB with a treaty provision dealing with conduit arrangements.

Mr. Louie was asked to consult with a small group of Committee members comprising Carmel Peters, Ignatius Mvula and Armando Lara to develop a proposal for presenting these provisions in the UN Model. While acknowledging the wish of the Committee to present the four options above in a neutral fashion, Mr. Louie proposed to the small group a practical approach under which a new Article that contained both the LOB and the PPT (following option 3) above) would be incorporated into the UN Model, but that the Commentary would recognize that countries could, in their bilateral negotiations, amend the new Article follow either of the other three options above. The small group concurred with this practical approach.

The text of proposed new Article 29 follows the final result of the treaty abuse revisions to the OECD Model with one notable exception: whereas the new Article 29 in the OECD Model contains "simplified" and "detailed" versions of the LOB provisions, as explained above, the Committee concluded in the December meeting that the UN Model should adopt just the detailed LOB, which is broadly equivalent to the U.S. Model LOB. The changes to the OECD wording are shown in redline.

It should also be noted that paragraph 8 of the proposed new Article 29 is the rule denying benefits on certain payments to permanent establishments in third states that are subject to little or no tax. This provision had, in prior meetings of the Committee, been presented by Carmel Peters as part of her BEPS review of miscellaneous items for inclusion into the UN Model, although the placement of the provision in the Model had been heretofore undecided.

The commentary for the PPT in paragraph 9 of the new Article will be presented separately by Mr. Brian Arnold.

At its April meeting, the Committee is invited to approve new Article 29 and its Commentary for inclusion into the 2017 update of the UN Model.

Proposed new Article 29 (Entitlement to Benefits):

ARTICLE 29

ENTITLEMENT TO BENEFITS[1]

1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25) unless such resident is a "qualified person", as defined in paragraph 2, at the time that the benefit would be accorded.

2. A resident of a Contracting State shall be a qualified person at a time when a benefit would otherwise be accorded by the Convention if, at that time, the resident is:

a) an individual;

b) that Contracting State, or a political subdivision or local authority thereof, or an agency or instrumentality of that State, political subdivision or local authority;

c) a company or other entity, if, throughout the taxable period that includes that time, the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:

(i) its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or

(ii) the company's or entity's primary place of management and control is in the Contracting State of which it is a resident;

d) a company, if:

(i) throughout the taxable period that includes that time, at least 50 per cent of the aggregate vote and value of the shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subparagraph c) of this paragraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of the Contracting State from which a benefit under this Convention is being sought or is a qualifying intermediate owner; and

(ii) with respect to benefits under this Convention other than under Article 10, less than 50 per cent of the company's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible in that taxable period for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e);

e) a person, other than an individual, that

(i) is a [agreed description of the relevant non-profit organisations found in each Contracting State],

(ii) is a recognised pension fund to which subdivision (i) of the definition of recognised pension fund in paragraph 1 of Article 3 applies, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident of either Contracting State, or more than [__ per cent] of the beneficial interests in that person are owned by individuals resident of either Contracting State or of any other State with respect to which the following conditions are met

A) individuals who are residents of that other State are entitled to the benefits of a comprehensive convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed, and

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

(iii) is a recognised pension fund to which subdivision (ii) of the definition of recognised pension fund in paragraph 1 of Article 3 applies, provided that it is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in the preceding subdivision; [or]

f) a person other than an individual, if

(i) at that time and on at least half the days of a twelve-month period that includes that time, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph a), b), c) or e) own, directly or indirectly, shares representing at least 50 per cent of the aggregate vote and value (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) of the shares in the person, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and

(ii) less than 50 per cent of the person's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions), to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e) of this paragraph; [or]

g) [*possible provision on collective investment vehicles*];

Note from Henry Louie: The Committee will need to decide if a rule for collective investment vehicles should be included in the UN

Model LOB. It has not yet been discussed.

3. a) A resident of a Contracting State shall be entitled to benefits under this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a business in the first-mentioned State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank or [list financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer respectively), and the income derived from the other State emanates from, or is incidental to, that business. For purposes of this Article, the term "active conduct of a business" shall not include the following activities or any combination thereof:

i) operating as a holding company;

ii) providing overall supervision or administration of a group of companies;

iii) providing group financing (including cash pooling); or

iv) making or managing investments, unless these activities are carried on by a bank [list financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer in the ordinary course of its business as such.

b) If a resident of a Contracting State derives an item of income from a business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other State from a connected person, the conditions described in subparagraph a) shall be considered to be satisfied with respect to such item only if the business activity carried on by the resident in the first-mentioned State to which the item is related is substantial in relation to the same or complementary business activity carried on by the resident or such connected person in the other Contracting State. Whether a business activity is substantial for the purposes of this paragraph shall be determined based on all the facts and circumstances.

c) For purposes of applying this paragraph, activities conducted by connected persons with respect to a resident of a Contracting State shall be deemed to be conducted by such resident.

4. [*A rule providing so-called derivative benefits. The question of how the derivative benefits paragraph should be drafted in a convention that follows the detailed version is discussed in the Commentary.*]

5. A company that is a resident of a Contracting State that functions as a headquarters company for a multinational corporate group consisting of such company and its direct and indirect subsidiaries shall be entitled to benefits under this Convention with respect to dividends and interest paid by members of its multinational corporate group, regardless of whether the resident is a qualified person. A company shall be considered a headquarters company for this purpose only if:

a) such company's primary place of management and control is in the Contracting State of which it is a resident;

b) the multinational corporate group consists of companies resident of, and engaged in the active conduct of a business in, at least four States, and the businesses carried on in each of the four States (or four groupings of States) generate at least 10 per cent of the gross income of the group;

c) the businesses of the multinational corporate group that are carried on in any one State other than the Contracting State of residence of such company generate less than 50 per cent of the gross income of the group;

d) no more than 25 per cent of such company's gross income is derived from the other Contracting State;

e) such company is subject to the same income taxation rules in its Contracting State of residence as persons described in paragraph 3 of this Article; and

f) less than 50 per cent of such company's gross income, and less than 50 per cent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property or payments in respect of financial obligations to a bank that is not a connected person with respect to such company, and in the case of a tested group, not including intra-group transactions) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e) of paragraph 2.

If the requirements of subparagraph b), c) or d) of this paragraph are not fulfilled for the relevant taxable period, they shall be deemed to be fulfilled if the required ratios are met when averaging the gross income of the preceding four taxable periods.

6. If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 of this Article, nor entitled to benefits under paragraph 3, 4 or 5, the competent authority of the Contracting State in which benefits are denied under the previous provisions of this Article may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income

or capital, taking into account the object and purpose of this Convention, but only if such resident demonstrates to the satisfaction of such competent authority that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the Contracting State to which a request has been made, under this paragraph, by a resident of the other State, shall consult with the competent authority of that other State before either granting or denying the request.

7. For the purposes of this and the previous paragraphs of this Article:

a) the term “recognised stock exchange” means:

(i) [list of stock exchanges agreed to at the time of signature]; and

(ii) any other stock exchange agreed upon by the competent authorities of the Contracting States;

b) with respect to entities that are not companies, the term “shares” means interests that are comparable to shares;

c) the term “principal class of shares” means the ordinary or common shares of the company or entity, provided that such class of shares represents the majority of the aggregate vote and value of the company or entity. If no single class of ordinary or common shares represents the majority of the aggregate vote and value of the company or entity, the “principal class of shares” are those classes that in the aggregate represent a majority of the aggregate vote and value;

d) two persons shall be “connected persons” if one owns, directly or indirectly, at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) or another person owns, directly or indirectly, at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) in each person. In any case, a person shall 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.

e) the term “equivalent beneficiary” means:

(i) a resident of any State, provided that:

A) the resident is entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that State and the Contracting State from which the benefits of this Convention are sought, under provisions substantially similar to subparagraph a), b), c) or e) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under provisions substantially similar to paragraph 5 of this Article in such convention, provided that, if such convention does not contain a detailed limitation on benefits article, such convention shall be applied as if the provisions of subparagraphs a), b), c) and e) of paragraph 2 (including the definitions relevant to the application of the tests in such subparagraphs) were contained in such convention; and

B) 1) with respect to income referred to in Article 10, 11 or 12, if the resident had received such income directly, the resident would be entitled under such convention, a provision of domestic law or any international agreement, to a rate of tax with respect to such income for which benefits are being sought under this Convention that is less than or equal to the rate applicable under this Convention. Regarding a company seeking, under paragraph 4, the benefits of Article 10 with respect to dividends, for purposes of this subclause:

I) if the resident is an individual, and the company is engaged in the active conduct of a business in its Contracting State of residence that is substantial in relation, and similar or complementary, to the business that generated the earnings from which the dividend is paid, such individual shall be treated as if he or she were a company. Activities conducted by a person that is a connected person with respect to the company seeking benefits shall be deemed to be conducted by such company. Whether a business activity is substantial shall be determined based on all the facts and circumstances; and

II) if the resident is a company (including an individual treated as a company), to determine whether the resident is entitled to a rate of tax that is less than or equal to the rate applicable under this Convention, the resident's indirect holding of the capital of the company paying the dividends shall be treated as a direct holding; or

2) with respect to an item of income referred to in Article 7, 13 or 21 of this Convention, the resident is entitled to benefits under such convention that are at least as favourable as the benefits that are being sought under this Convention; and

C) notwithstanding that a resident may satisfy the requirements of clauses A) and B) of this subdivision, where the item of income has been derived through an entity that is treated as fiscally transparent under the laws of the Contracting State of residence of the company seeking benefits, if the item of income would not be treated as the income of the resident under a provision analogous to paragraph 2 of Article 1 had the resident, and not the company seeking benefits under paragraph 4 of this Article, itself owned the entity through which the income was derived by the company, such resident shall not be considered an equivalent beneficiary with respect to the item of income;

(ii) a resident of the same Contracting State as the company seeking benefits under paragraph 4 of this Article that is entitled to all the benefits of this Convention by reason of subparagraph a), b), c) or e) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under paragraph 5, provided that, in the case of a resident described in paragraph 5, if the resident had received such interest or dividends directly, the resident would be entitled to a rate of tax with respect to such income that is less than or equal to the rate applicable under this Convention to the company seeking benefits under paragraph 4; or

(iii) a resident of the Contracting State from which the benefits of this Convention are sought that is entitled to all the benefits of this Convention by reason of subparagraph a), b), c) or e) of paragraph 2, provided that all such residents' ownership of the aggregate vote and value of the shares (and any disproportionate class of shares) of the company seeking benefits under paragraph 4 does not exceed 25 per cent of the total vote and value of the shares (and any disproportionate class of shares) of the company;

f) the term "disproportionate class of shares" means any class of shares of a company or entity resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other Contracting State by particular assets or activities of the company;

g) a company's or entity's "primary place of management and control" is in the Contracting State of which it is a resident only if:

(i) the executive officers and senior management employees of the company or entity exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company or entity and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions, in that Contracting State than in any other State; and

(ii) such executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company or entity and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions, than the officers or employees of any other company or entity;

h) the term “qualifying intermediate owner” means an intermediate owner that is either:

i) a resident of a State that has in effect with the Contracting State from which a benefit under this Convention is being sought a comprehensive convention for the avoidance of double taxation; or

ii) a resident of the same Contracting State as the company applying the test under subparagraph d) or f) of paragraph 2 or paragraph 4 to determine whether it is eligible for benefits under the Convention;

i) the term “tested group” means the resident of a Contracting State that is applying the test under subparagraph d) or f) of paragraph 2 or under paragraph 4 or 5 to determine whether it is eligible for benefits under the Convention (the “tested resident”), and any company or permanent establishment that:

i) participates as a member with the tested resident in a tax consolidation, fiscal unity or similar regime that requires members of the group to share profits or losses; or

ii) shares losses with the tested resident pursuant to a group relief or other loss sharing regime in the relevant taxable period; [and]

j) the term “gross income” means gross receipts as determined in the person’s Contracting State of residence for the taxable period that includes the time when the benefit would be accorded, except that where a person is engaged in a business that includes the manufacture, production or sale of goods, “gross income” means such gross receipts reduced by the cost of goods sold, and where a person is engaged in a business of providing non-financial services, “gross income” means such gross receipts reduced by the direct costs of generating such receipts, provided that:

i) except when relevant for determining benefits under Article 10 of this Convention, gross income shall not include the portion of any dividends that are effectively exempt from tax in the person’s Contracting State of residence, whether through deductions or otherwise; and

ii) except with respect to the portion of any dividend that is taxable, a tested group's gross income shall not take into account transactions between companies within the tested group [./; and]

k) [possible definition of "collective investment vehicle"].[1]

Note from Henry Louie: The Committee will need to decide if a rule for collective investment vehicles should be included in the UN Model LOB. It has not yet been discussed.

8. a) Where

i) an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats such income as attributable to a permanent establishment of the enterprise situated in a third jurisdiction, and

ii) the profits attributable to that permanent establishment are exempt from tax in the first-mentioned State,

the benefits of this Convention shall not apply to any item of income on which the tax in the third jurisdiction is less than the lower of [*rate to be determined bilaterally*] of the amount of that item of income and 60 per cent of the tax that would be imposed in the first-mentioned State on that item of income if that permanent establishment were situated in the first-mentioned State. In such a case any income to which the provisions of this paragraph apply shall remain taxable according to the domestic law of the other State, notwithstanding any other provisions of the Convention.

b) The preceding provisions of this paragraph shall not apply if the income derived from the other State emanates from, or is incidental to, the active conduct of a business carried on through the permanent establishment (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are

1 A definition of the term "collective investment vehicle" should be added if a provision on collective investment vehicles is included in paragraph 2 (see subparagraph *g*) of paragraph 2).

banking, insurance or securities activities carried on by a bank, insurance enterprise or registered securities dealer, respectively).

c) If benefits under this Convention are denied pursuant to the preceding provisions of this paragraph with respect to an item of income derived by a resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by such resident, such competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph *(such as the existence of losses)*. The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request.

9. 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.

____

1. The drafting of this Article will depend on how the Contracting States decide to implement their common intention, reflected in the preamble of the Convention and incorporated in the minimum standard agreed to as part of the OECD-G20 Base Erosion and Profit Shifting project by particular countries, to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. This may be done either through the adoption of paragraph 9 only, through the adoption of the detailed version of paragraphs 1 to 7 that is described in the Commentary on Article 29 together with the implementation of an anti-conduit mechanism as described in paragraph 186 of that Commentary, or through the adoption of paragraph 9 together with any variation of paragraphs 1 to 7 described in the Commentary on Article 29.

The following proposed Commentary is based on the Commentary to the detailed version of Article 29 of the OECD Model. The changes to that Commentary are shown in redline:

COMMENTARY ON ARTICLE 29 CONCERNING THE ENTITLEMENT TO TREATY BENEFITS

Preliminary remarks

1. As explained in the footnote to the Article, Article 29 reflects the intention of the Contracting States, incorporated in the preamble of the Convention, to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements. This intention and the wording of the Article correspond to the minimum standard that was agreed to by participating States as part of the OECD-G20 Base Erosion and Profit Shifting Project and that is described in paragraph 22 of the report Preventing the Granting of Treaty Benefits in Inappropriate Circumstances - Action 6: 2015 Final Report. As indicated in that report, the drafting of the Article will depend on how ~~the~~ Contracting States that are seeking consistency with that minimum standard decide to implement it.~~that minimum standard~~. Depending on their own circumstances, States may wish to adopt only the general anti-abuse rule of paragraph 9 of the Article, may prefer instead to adopt ~~the detailed version of~~ paragraphs 1 to 7 of the Article ~~that is described below~~, which they would supplement by a mechanism that would address conduit arrangements not otherwise dealt with by the provisions of the Convention, or may prefer to include in their treaty the entirety of the Article~~general anti-abuse rule of paragraph 9 together with any variation of paragraphs 1 to 7 described below~~.

2. A State may prefer the last approach described above because it combines the flexibility of a general rule that can prevent a large number of abusive transactions with the certainty of a more "automatic" rule that prevents transactions that are known to cause treaty shopping concerns and that can be easily described by reference to certain features (such as the foreign ownership of an entity). ~~That last approach is reflected in the "simplified version" of paragraphs 1 to 7 reproduced below, which should only be used in combination with the general rule of paragraph 9.~~ Such a combination should not be construed in any way as restricting the scope of the general anti-abuse rule of paragraph 9~~-~~: a transaction or arrangement should not be considered to be outside the scope of paragraph 9 simply because the specific anti-abuse rules of paragraphs 1 to 7~~-~~, which only deal with certain cases of treaty shopping that can be easily identified by certain of their features, are not applicable.

3. A State may, however, prefer to deal with treaty ~~-~~shopping without the general anti-abuse rule of paragraph 9~~-~~, relying instead on the specific anti-abuse rules of paragraphs 1 to 7~~-~~,

together with a mechanism that will address conduit arrangements that would escape the application of these paragraphs. This may be the case of a State ~~whose~~ the domestic law of which includes strong anti-abuse rules that are sufficient to deal with other forms of treaty abuses. ~~States that adopt that approach will need to ensure that the version of paragraph 1 to 7 that they include in their bilateral conventions is sufficiently robust to prevent most forms of treaty shopping. For this reason, the paragraphs below provide different versions of the provisions of paragraphs 1 to 7 , the more robust version of these paragraphs mentioned above being referred to as the "detailed version". States that do not wish to include paragraph 9 for the reasons explained in this paragraph should adopt the detailed version, as opposed to the "simplified" version, subject to any adaptations referred to in the Commentary below.~~

4. Whereas the version of Article 29 that was incorporated into the OECD Model in 2017 contains a "simplified" as well as a "detailed" version of the Article, the Committee decided that Article 29 of the UN Model would adopt just the detailed version, concluding that the detailed version would provide the tax conventions concluded by developing countries with more robust protections against treaty shopping abuses.

5. Paragraphs 4 through 6 of the Commentary describing the detailed version of Article 29 of the OECD Model provide:

> "4. This Article contains provisions that prevent various forms of treaty shopping through which persons who are not residents of a Contracting State might establish an entity that would be a resident of that State in order to reduce or eliminate taxation in the other Contracting State through the benefits of the tax treaty concluded between these two States. Allowing persons who are not directly entitled to treaty benefits (such as the reduction or elimination of withholding taxes on dividends, interest or royalties) to obtain these benefits indirectly through treaty shopping would frustrate the bilateral and reciprocal nature of tax treaties. If, for instance, a State knows that its residents can indirectly access the benefits of treaties concluded by another State, it may have little interest in granting reciprocal benefits to residents of that other State through the conclusion of a tax treaty. Also, in such a case, the benefits that would be indirectly obtained may not be appropriate given the nature of the tax system of the former State; if, for instance, that State does not levy an income tax on a certain type of income, it would be inappropriate for its residents to benefit from the provisions of a tax treaty concluded between two other States that grant a reduction or elimination of source taxation for that type of income and that were designed on the assumption that the two Contracting States would tax such income.

5. The provisions of paragraphs 1 to 7 seek to deny treaty benefits in the case of structures that typically result in the indirect granting of treaty benefits to persons that are not directly entitled to these benefits whilst recognising that in some cases, persons who are not residents of a Contracting State may establish an entity in that State for legitimate business reasons. Although these provisions apply regardless of whether or not a particular structure was adopted for treaty-shopping purposes, the Article allows the competent authority of a Contracting State to grant treaty benefits where the other provisions of the Article would otherwise deny these benefits but the competent authority determines that the structure did not have as one of its principal purposes the obtaining of benefits under the Convention.

6. The Article restricts the general scope of the other provisions of the Convention, including those of Article 1 according to which the Convention applies to persons who are residents of a Contracting State. Paragraph 1 of the Article provides that a resident of a Contracting State shall not be entitled to the benefits of the Convention unless it constitutes a "qualified person" under paragraph 2 or unless benefits are granted under the provisions of paragraphs 3, 4, 5 or 6. Paragraph 2 determines who constitutes a "qualified person" by reference to the nature or attributes of various categories of persons; any person to which that paragraph applies is entitled to all the benefits of the Convention. Under paragraph 3, a person is entitled to the benefits of the Convention with respect to an item of income even if it does not constitute a "qualified person" under paragraph 2 as long as that item of income emanates from, or is incidental to, the active conduct of a business in that person's State of residence (subject to certain exceptions). Paragraph 4 is a "derivative benefits" provision that allows certain entities owned by residents of third States to obtain treaty benefits provided that these residents would have been entitled to equivalent benefits if they had invested directly. Paragraph 5 is a "headquarters company" provision under which a company that is not eligible for benefits under paragraph 2 may nevertheless qualify for benefits with respect to particular items of income. Paragraph 6 includes the provisions that allow the competent authority of a Contracting State to grant treaty benefits where the other provisions of the Article would otherwise deny these benefits. Paragraph 7 includes a number of definitions that apply for the purposes of the Article."

Paragraph 1: provision denying treaty benefits to a resident of a Contracting State who is not a "qualified person"

~~7~~6. Paragraph 1 ~~of both the simplified and detailed versions~~ provides that a resident of a Contracting State, as defined under Article 4, will be entitled to the benefits otherwise accorded to residents of a Contracting State under the Convention only if it constitutes a "qualified person" under paragraph 2 or unless benefits are otherwise granted under paragraphs 3, 4, 5 or 6. The benefits otherwise accorded to a resident of a Contracting State under the Convention include all limitations to the Contracting States' taxing rights under Articles 6 through 22, the elimination of double taxation provided by Article 23 and the protection afforded to residents of a Contracting State under Article 24. The Article does not, however, restrict the availability of treaty benefits under ~~paragraph 3 of Article 4,~~ paragraph 2 of Article 9, ~~or~~ Article 25 or under the few provisions of the Convention that do not require that a person be a resident of Contracting State in order to enjoy the benefits of those provisions (*e.g.* the provisions of paragraph 1 of Article 24, to the extent that they apply to nationals who are not residents of either Contracting State). ~~Whilst the provisions of paragraph 3 of Article 7 share the main features of paragraph 2 of Article 9, the availability of the benefits of paragraph 3 of Article 7 is restricted by paragraph 1 of Article 29 because relief of double taxation under Article 7 depends largely on the provisions of paragraph 2 of that Article (see paragraphs 40 to 57 of the Commentary on Article 7) and it would be inconsistent to be more generous with respect to the relief provided under paragraph 3 of Article 7 than with respect to the relief provided under paragraph 2 of that Article.~~

7. Paragraphs 8 through 10 of the Commentary describing the detailed version of Article 29 of the OECD Model provide:

> "8. Paragraph 1 does not extend in any way the scope of the benefits granted by the other provisions of the Convention. Thus, a resident of a Contracting State who constitutes a "qualified person" under paragraph 2 must still meet the conditions of the other provisions of the Convention in order to obtain these benefits (*e.g.* that resident must be the beneficial owner of dividends in order to benefit from the provisions of paragraph 2 of Article 10) and these benefits may be denied or restricted under applicable anti-abuse rules such as the rules in paragraphs 8 and 9.
>
> 9. Paragraph 1 applies at any time when the Convention would otherwise provide a benefit to a resident of a Contracting State. Thus, for example, it applies at the time when income to which Article 6 applies is derived by a resident of a Contracting State, at the time that dividends to which Article 10 applies are paid to a resident of a Contracting State or at any time when profits to which Article 7 applies are made. The paragraph requires that, in order to be entitled to the benefit provided by the relevant provision of the Convention, the resident of the Contracting State must be a "qualified person", within the meaning of paragraph 2, at the relevant time. In some cases, however, the definition of "qualified person" requires that a resident of a Contracting

State must satisfy certain conditions over a period of time in order to constitute a "qualified person" at a given time.

10. Since the definition of "equivalent beneficiary" that would be used for the purpose of paragraph 4 of the detailed version dealing with derivative benefits would exclude persons who, under another convention, are entitled to relief from taxation by the State of source that is not as favourable as the relief provided under the Convention, that definition would have the so-called "cliff" effect of denying all treaty benefits even if the difference in the relief provided by the two conventions is relatively minor. In that case, some States consider that it is appropriate to provide relief from taxation by the State of source that is similar to the relief that would be provided under the other convention. This treatment may be achieved through the alternative provisions included in paragraph [??] below that relate to the taxation of dividends, interest and royalties, which are provisions that alleviate the so-called "cliff effect" when a potential equivalent beneficiary is, under another convention, entitled to restrictions on taxation by the State of source that are not as favourable as those provided by the Convention. Instead of denying all treaty benefits with respect to such income, these provisions grant limited benefits that broadly correspond to those that would have been available under the other convention. In order to ensure that paragraph 1 does not deny the benefits granted under these alternative provisions, which would be contrary to the purpose of these provisions, these States should adopt a different version of paragraph 1 that would be drafted as follows:

> Except as otherwise provided in this Article and in paragraph *[reference to the paragraph that provides limited benefits to dividends]*~~6~~ of Article 10, paragraph *[reference to the paragraph that provides limited benefits to interest]*~~3~~ of Article 11 and paragraph *[reference to the paragraph that provides limited benefits to royalties]*~~3~~ of Article 12, a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25), unless such resident is a "qualified person", as defined in paragraph 2, at the time that the benefit would be accorded."

Paragraph 2: situations where a resident is a "qualified person"

8. Paragraphs 11 and 12 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"11. Each of the subparagraphs of paragraph 2 of the simplified and detailed versions describes a category of residents that are qualified persons at the time when the relevant treaty benefits are claimed.

12. It is intended that the provisions of paragraph 2 will be self-executing. Unlike the provisions of paragraph 6, discussed below, claiming benefits under paragraph 2 does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed."

Subparagraph a): individuals

9. Paragraph 13 of the Commentary to the detailed version of Article 29 of the OECD Model provides:

"13. Subparagraph *a*) of both the simplified and detailed versions provides that any individual who is a resident of a Contracting State will be a qualified person. [As explained in paragraph XXX below, under some treaty provisions, a collective investment vehicle must be treated as an individual for the purposes of applying the relevant treaty; where that is the case, such a collective investment vehicle will therefore constitute a qualified person by virtue of subparagraph *a*).]"

Subparagraph b): Contracting States, political subdivisions and their agencies and instrumentalities

10. Paragraph 14 of the Commentary to the detailed version of Article 29 of the OECD Model provides:

"14. Subparagraph *b*) of both the simplified and detailed versions provides that the Contracting States and any political subdivision or local authority thereof constitute qualified persons. These words apply to any part of a State, such as a separate fund established by the State that does not constitute, and is not owned by, a separate person. Under the last part of the subparagraph, a separate legal person which is a resident of a Contracting State and is an agency or instrumentality of a Contracting State, or a political subdivision or local authority thereof, will also be a qualified person and, therefore, will be entitled to all the benefits of the Convention whilst it qualifies as such. The concept of "agency or instrumentality" is restricted to entities set up by a State (or a political subdivision or local authority thereof) to perform exclusively functions of a governmental nature; it does not apply, for example, to a company that acts as an agent of the State for certain purposes but that was not set up by the State to perform functions of a governmental nature. The wording of the subparagraph may need to be adapted to reflect the different legal nature that State-owned entities, such as sovereign wealth funds, may have in the Contracting States as well as the different views that these States may have concerning the application of Article 4 to these entities (see paragraphs 6.35 to 6.39 of the Commentary on Article 1 and paragraphs 8.5 and 8.11 of the Commentary on Article 4)."

Subparagraph c): publicly-traded companies and entities

11. Paragraphs 16 through 23 of the Commentary to the detailed version of Article 29 of the OECD Model provides:

"16. Subparagraph *c*) recognises that, as a general rule, because the shares of publicly-traded companies and of some entities are generally widely-held, these companies and entities are unlikely to be established for treaty shopping.

17. Subparagraph *c*) provides that a company or entity resident in a Contracting State constitutes a qualified person at a time when a benefit is provided by the Convention if, throughout the taxable period that includes that time, the principal class of its shares, and any disproportionate class of shares, is regularly traded on one or more recognised stock exchanges, provided that the company or entity also satisfies at least one of the following additional requirements: first, the company's or entity's principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident or, second, the company's or entity's primary place of management and control is in its State of residence. These additional requirements take account of the fact that whilst a publicly-traded company or entity may be technically resident in a given State, it may not have a sufficient relationship with that State to justify allowing such a company or entity to obtain the benefits of treaties concluded by that State. Such a sufficient relationship may be established by the fact that the shares of the publicly-traded company or entity are primarily traded in recognised stock exchanges situated in the State of residence of the company or entity; given the fact that the globalisation of financial markets means that shares of publicly-listed companies that are residents of some States are often traded on foreign stock exchanges, the alternative test provides that this sufficient relationship may also be established by the fact that the company or entity is primarily managed and controlled in its State of residence.

18. A company or entity whose principal class of shares is regularly traded on a recognised stock exchange will nevertheless not qualify for benefits under subparagraph *c*) of paragraph 2 if it has a disproportionate class of shares that is not regularly traded on a recognised stock exchange.

19. The terms “recognised stock exchange”, “shares”, “principal class of shares” and “disproportionate class of shares” are defined in paragraph 7. As indicated in these definitions, the term “shares” covers comparable interests in entities, other than companies, to which the subparagraph applies; this includes, for example, publicly-traded units of a trust.

20. The regular trading requirement can be met by the trading of issued shares on any recognised exchange or exchanges located in either State. Trading on one or more recognised stock exchanges may be aggregated for purposes of this requirement; a company or entity could therefore satisfy this requirement if its shares are regularly traded, in whole or in part, on a recognised stock exchange located in the other Contracting State.

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

22. Subdivision (*ii*) provides the alternative requirement applicable to a company or entity whose principal class of shares is regularly traded on recognised stock exchanges but not primarily traded on recognised stock exchanges situated in the State of residence of the company or entity. Such a company or entity may claim treaty benefits if its

"primary place of management and control" (as defined in paragraph 7) is in its State of residence.

23. The conditions of subparagraph *c*) must be satisfied throughout the taxable period of the company or entity. This does not require that the shares of the company or entity be traded on the relevant stock exchanges each day of the relevant period. For shares to be considered as regularly traded on one or more stock exchanges throughout the taxable period, it is necessary that more than a very small percentage of the shares be actively traded during a sufficiently large number of days included in that period. The test would be met, for example, if 10 per cent of the average number of outstanding shares of a given class of shares of a company were traded during 60 days of trading taking place in the taxable period of the company. The phrase "taxable period" in subparagraphs *c*) and *e*) refers to the period for which an annual tax return must be filed in the State of residence of the company or entity. If the Contracting States have a concept corresponding to "taxable period" in their domestic law, such as "taxable year", they are free to replace the reference to taxable period by that other concept."

Subparagraph d): affiliates of publicly-traded companies and entities

12. Paragraphs 24 through 35 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"24. Subparagraph *d*) extends the principle underlying subparagraph *c*) (*i.e.* that publicly-traded companies and entities are unlikely to be established for treaty shopping purposes) to some companies in which five or fewer publicly-traded companies and entities own a majority interest, subject to additional conditions.

25. In order for a company resident of a Contracting State to be entitled to all the benefits of the Convention under subparagraph *d*) at a given time, that company must satisfy two conditions applicable to the taxable period that includes that time.

26. First, under subdivision (*i*), the company must satisfy an ownership test. Under that test, five or fewer publicly-traded companies or entities described in subparagraph *c*) must be, throughout that taxable period, the direct or indirect owners of at least 50 per cent of the aggregate vote and value of the company's shares (and at least 50 per cent of any disproportionate class of shares). If the publicly-traded companies or entities are indirect owners, however, each of the intermediate companies or entities must either be a resident of the Contracting State from which a benefit under this Convention is being sought or be a "qualifying intermediate owner". The term "qualifying intermediate

owner" is defined in paragraph 7; under that definition, a qualifying intermediate owner also includes a resident of the same Contracting State as the company claiming benefits under subparagraph *d*).

27. Thus, for example, a company resident of a Contracting State satisfies the requirements of subdivision (*i*) if it is wholly owned by a company that is a resident of the same State and that satisfies the requirements of subparagraph *c*). Furthermore, if a publicly-traded parent company in the other Contracting State indirectly owns the company through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of the Contracting State from which a benefit under this Convention is being sought or a qualifying intermediate owner in order for the company to meet the ownership test in subdivision (*i*).

28. The phrase "50 per cent of the aggregate vote and value of the shares", which is used in subparagraphs *d*) and *f*) and in other parts of paragraphs 1 to 7, refers to a participation that represents both at least 50 per cent of all the voting rights in the relevant company or entity and at least 50 per cent of the value of all the shares in that company or entity. That test would therefore not be satisfied in the case of a participation that would satisfy the vote condition without satisfying the value condition (or vice versa).

29. Under the second condition, included in subdivision (*ii*), the company must also satisfy a base erosion test with respect to any treaty benefits that it claims (other than a benefit with respect to dividends under Article 10). That base erosion test is satisfied if

- less than 50 per cent of the company's gross income (and less than 50 per cent of the tested group's gross income if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the company's tax in its State of residence, and
- less than 50 per cent of the tested group's gross income (if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the tax of any member of the tested group in the State of residence of the company claiming the treaty benefits.

30. The term "ineligible persons" used in the previous paragraph refers to any persons other than the residents of each Contracting State who are entitled to the

benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*) of paragraph 2. Entities that are residents of the Contracting States and that are entitled to the benefits of this Convention under this subparagraph or under subparagraph *f*) of paragraph 2 are, therefore, ineligible persons; this ensures that these entities are not used in arrangements that could allow third country investors to accumulate indirectly a significant amount of the base eroding payments made by a company seeking benefits under this subparagraph. Paragraph 7 includes the definition of the terms “tested group” and “gross income” which are used in subdivision (*ii*).

31. For the purpose of the base erosion test, deductible payments do not include arm’s-length amounts paid or accrued in the ordinary course of business for services or tangible property. To the extent they are deductible from the taxable base, trust distributions are deductible payments. Depreciation and amortisation deductions, which do not represent payments or accruals to other persons, are disregarded for this purpose. Furthermore, in the case of a tested group, deductible payments do not include intra-group payments. Finally, payments of interest are not arm’s-length amounts paid or accrued in the ordinary course of business for services or tangible property, and would therefore be taken into account if made to an ineligible person.

32. The following examples illustrate the application of the base erosion test of subdivision (*ii*) of subparagraph *d*) by a Contracting State (referred to in the examples as the “first-mentioned State”), taking into account the definitions of “tested group” and “gross income” in paragraph 7:

- *Example A:* Assume that at all relevant times, R3 is a company wholly owned by another company, R2, which in turn is wholly owned by R1, a publicly-traded company that satisfies the requirements of subparagraph *c*). R3, R2 and R1 are all residents of the other Contracting State under Article 4 and are all members of the same tax consolidation group. The ownership test in subdivision (*i*) of subparagraph *d*) is satisfied because R1, a company satisfying the requirements of subparagraph *c*), indirectly owns at least 50 per cent of the aggregate vote and value of R3 (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares of R3), and R2, which is an intermediate owner, is a resident of the other Contracting State and is therefore a qualifying intermediate owner.

  During the taxable period that includes the time when the benefit would otherwise be accorded by the first-mentioned State, R3 derives: first, 200 of dividends from a company resident in a third State that are excluded from gross income of R3 in the other Contracting State; and, second, 100 of interest arising in the first-mentioned State, for which R3 is seeking the benefits of Article 11 of the Convention. R3 makes a base eroding payment of 49 to an ineligible person and pays a dividend of 51 to R2. In addition to the 51 dividend that it receives from R3, R2 receives additional gross receipts of 100 from persons outside the tested group. R2 makes a base eroding payment of 51 to an ineligible person.

In this example, the tested group, as defined in paragraph 7, consists of R3, R2 and R1, because the three companies participate in a tax consolidation regime. In order to be eligible for benefits with respect to the interest arising in the first-mentioned State, R3 and the tested group must each meet the base erosion test of subparagraph (*ii*).

R3's gross income, as defined in paragraph 7, is 100 (the interest arising in the first-mentioned State), since the 200 dividend paid to R3 from a third-State company is excluded. Thus, for the taxable period for which R3 seeks benefits, less than 50 of R3's gross income is in the form of base eroding payments to ineligible persons. R3 has made only 49 in base eroding payments and would therefore satisfy the part of the base erosion test that applies to it.

The tested group's gross income computed under the tax law of the other Contracting State excludes the 200 dividend paid to R3 from a third-State company as well as intragroup transactions (*i.e.*, the 51 dividend from R3 to R2). The tested group's gross income is, therefore, 200 (the 100 interest arising in the first-mentioned State plus the 100 R2 received from persons outside the tested group). Thus, during the taxable period in question, the tested group must make less than 100 in base eroding payments to ineligible persons in order to satisfy the base erosion test of subdivision (*ii*).

In this example, R3 does not satisfy the requirements of subparagraph *d*). Although R3's 49 of base eroding payments to ineligible persons does not exceed the allowable limit of less than 50, the tested group's total base eroding payments to ineligible persons of 100 (49 + 51), exceeds the tested group's allowable limit of base eroding payments to ineligible persons, which was less than 100.

– *Example B:* Assume the same facts as in Example A, except that R3 derives 100 of dividends paid by a company resident of the first-mentioned State rather than interest arising in that State, and has no other gross income in the taxable year. Since the only treaty benefit that R3 is seeking is under Article 10 with respect to the dividends, R3 is not required to apply the base erosion test under subdivision (*ii*). Accordingly, R3 will be a qualified person with respect to the dividend under subparagraph *d*) because it satisfies the ownership requirement of subdivision (*i*).

– *Example C:* Assume that at all relevant times, P2 (the relevant company) is a company that is wholly owned by P1, a publicly-traded company that satisfies the requirements of subparagraph *c*). P2 and P1 are residents of the other Contracting State.

  During the taxable year in question, P2's only items of income are interest of 100 arising in the first-mentioned State for which P2 seeks to claim the benefits of Article 11. P2 makes a deductible interest payment of 100 to P1, a person that satisfies subparagraph *c*). P1 makes a deductible payment during the same taxable period of 100 to ThirdCo, a company resident in State Y. P2, through P1, has indirectly made a base eroding payment of 100 to an ineligible person. In this example, the base erosion test under subdivision (*ii*) is not satisfied and P2 will not be a qualified person."

33. As indicated in the Commentary on Article 1, some States consider that provisions should be included in their tax treaties in order to deny the application of specific treaty provisions with respect to income that is paid to connected persons (as defined in paragraph 7) that benefit from regimes that constitute "special tax regimes" (see paragraphs 26.12 to 26.27 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity (see paragraph 26.34 of the Commentary on Article 1). These States may want to modify the base-erosion test of subdivision (*ii*) in order to include in the category of "ineligible persons" persons who, although they are residents of one of the Contracting States, benefit from such special tax regimes or notional deductions with respect to deductible payments made or accruing to them. This could be done by amending subdivision (*ii*) as follows:

> (*ii*) with respect to benefits under this Convention other than under Article 10, less than 50 per cent of the company's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible in that taxable period for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)

A) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*);

B) to persons that are connected to the person described in this subparagraph and that benefit from a special tax regime, as defined in *[reference to the paragraph of the convention that includes the definition of "special tax regime"]* of this Convention, with respect to the deductible payment; or

C) with respect to a payment of interest, to persons that are connected to the person described in this subparagraph and that benefit from notional deductions described in *[reference to the paragraph of Article 11 that relates to notional deductions for equity]*.

34. The following example illustrates the application of the alternative formulation of the base erosion test included in the previous paragraph:

- *Example:* Assume the same facts as in Example B in paragraph 32 above, except that R3's only items of income are 100 of royalties arising in the State from which the treaty benefits are sought, for which R3 seeks to claim the benefits of Article 12. R3 makes a deductible royalty payment of 100 to R1. At all relevant times, R1 benefits from a special tax regime (as defined in that Convention) with respect to royalties.

  The ownership condition of subdivision (*i*) of subparagraph *d*) is satisfied because R1, a company satisfying the requirements of subparagraph *c*), indirectly owns at least 50 per cent of the aggregate vote and value of R3 and R2 is a qualifying intermediate owner. However, even though R1 is a person that satisfies subparagraph *c*), the deductible royalty payment made to R1 by R3 is a base eroding payment because R1 is an ineligible person. R1 is a connected person with respect to R3 and benefits from a special tax regime with respect to the royalty income. In this example, R3 does not satisfy the base erosion test under subdivision (*ii*) because R3 has made 100 of base eroding payments to a person who benefits from a special tax regime and the amount, 100, exceeds R3's allowable limit of base eroding payments to ineligible persons (that limit being exceeded if the total of these payments is not lower than 50).

35. Some other States, however, may consider that there is no need to impose the base-erosion condition of subdivision (*ii*) in the case of companies that are primarily owned by publicly-traded companies or entities. These States may therefore wish to omit

subparagraph *d*) and use the following version of subparagraph *c*) which would deal both with publicly-traded companies or entities and with companies in which five or fewer publicly-traded companies and entities own a majority interest:

c) a company or other entity, if, throughout the taxable period that includes that time

(*i*) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:

A) its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or

B) the company's or entity's primary place of management and control is in the Contracting State of which it is a resident;

(*ii*) at least 50 per cent of the aggregate vote and value of the shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) in the company or entity is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subdivision (*i*) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of the Contracting State from which a benefit under this Convention is being sought or is a qualifying intermediate owner; or".

Subparagraph e): non-profit organisations and recognised pension funds

13. Paragraphs 39 and 40 of the detailed version of Article 29 of the detailed version of the OECD Model provide:

"39. Subparagraph *e*) of the detailed version provides rules under which certain non-profit organisations (to the extent that they qualify as residents of a Contracting State, as explained in paragraph 8.11 of the Commentary on Article 4) and certain recognised pension funds will be entitled to all the benefits of the Convention.

40. Entities that would be described in subdivision (*i*) automatically qualify for treaty benefits without regard to the residence of their beneficiaries or members. These entities would generally correspond to those that do not pay tax in their State of residence and that are constituted and operated exclusively to fulfil certain social functions (*e.g.* charitable, scientific, artistic, cultural, or educational). The description of such entities that will be included in subdivision (*i*) with respect to each State will typically refer to the

provisions of the domestic law of that State that describe these entities or to the domestic law factors that allow the identification of these entities. Depending on the wording used, States may also want to amend subdivision (*i*) in order to allow their competent authorities to agree subsequently to amend or supplement the description provided."

14. States wishing to clarify the application of a tax convention to pension funds may wish to define the term "recognised pension fund" in Article 3. Such definition could be drafted along the following lines and included as a subparagraph to paragraph 1 of that Article:

> "the term "recognized pension fund" of a State means an entity or arrangement established in that State that is treated as a separate person under the taxation laws of that State and:
>
> (i) that is established an operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that State or one of its political subdivisions or local authorities; or
>
> (ii) that is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in subdivision (i)."

15. Paragraphs 41 and 42 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

> "41. Under subdivision (*ii*), a recognised pension fund that falls within subdivision (*i*) of the definition of that term in paragraph 1 of Article 3 (which is the part of the definition that applies to an entity that administers or provides retirement benefits and ancillary or incidental benefits to individuals) will qualify for treaty benefits if more than 50 per cent of the beneficial interests in that person are owned by individuals resident of either Contracting State or if more than a certain percentage of these beneficial interests, to be determined during bilateral negotiations, are owned by such residents or by individuals who are residents of third States provided that, in the latter case, two additional conditions are met: first, these individuals are entitled to the benefits of a comprehensive tax convention concluded between that third State and the State of source and, second, that convention provides for a similar or greater reduction of source taxes on interest and dividends derived by pension funds of that third State. For purposes of this provision, the term "beneficial interests in that person" should be understood to refer to the interests held by persons entitled to receive pension benefits from the fund. Some States, however, consider that the risk of treaty shopping by recognised pension funds does not

warrant the costs of compliance inherent in requiring funds to identify the treaty residence and entitlement of the individuals entitled to receive pension benefits. States that share that view may modify subdivisions (*ii*) and (*iii*) accordingly and may, for instance, simply replace these two subdivisions by one subdivision that would read "is a recognised pension fund", which, like the provision found in the simplified version, would ensure that any recognised pension fund covered by the definition found in paragraph 1 of Article 3 would automatically constitute a "qualified person".

42. Subdivision (*iii*) applies to the so-called "funds of funds" that are referred to in subdivision (*ii*) of the definition of "recognised pension fund" in paragraph 1 of Article 3. These are funds which do not directly provide retirement benefits to individuals but are constituted and operated to invest funds of recognised pension funds that are themselves covered by subdivision (*i*) of the definition of "recognised pension fund". Subdivision (*iii*) only applies, however, if substantially all the income of such a "fund of funds" is derived from investments made for the benefit of recognised pension funds qualifying for benefits under subdivision (*ii*)."

Subparagraph f): ownership / base erosion

16. Paragraphs 46 through 54 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"46. Subparagraph *f*) of the detailed version provides an additional method to qualify for treaty benefits that applies to any form of legal entity that is a resident of a Contracting State. The test provided in subparagraph *f*), the so-called ownership and base erosion test, is a two-part test; both parts must be satisfied for the resident to be entitled to treaty benefits under subparagraph *f*).

47. Under subdivision (*i*), which is the ownership part of the test, 50 per cent or more of the aggregate vote and value of the outstanding shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) in the person must be owned, directly or indirectly, at the time when the relevant treaty benefit otherwise would be accorded and on at least half the days of a twelve-month period that includes that time, by persons who are residents of the Contracting State of which that person is a resident and that are themselves entitled to treaty benefits under subparagraphs *a*), *b*), *c*) or *e*). In the case of indirect owners, however, each of the intermediate owners must be a qualifying intermediate owner. The term "qualifying intermediate owner" is defined in paragraph 7; under that definition, a qualifying intermediate owner also includes a

resident of the same Contracting State as the company claiming benefits under subparagraph *f*).

48. Whilst subparagraph *f*) will typically be relevant in the case of private companies, it may also apply to an entity such as a trust that is a resident of a Contracting State and that otherwise satisfies the requirements of the subparagraph. According to the definition of shares in paragraph 7, the reference to "shares", in the case of entities that are not companies, means interests that are comparable to shares; this would generally be the case of the beneficial interests in a trust. For the purposes of subdivision (*i*), the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust. The interest of a beneficiary entitled to the remaining part of a trust will be equal to 100 per cent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust will not be considered to be owned by a person entitled to benefits under subparagraphs *a*), *b*), *c*) or *e*) if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of the beneficiaries in a trust, the ownership test under subdivision (*i*) cannot be satisfied, unless all possible beneficiaries are persons entitled to benefits under subparagraphs *a*), *b*), *c*) or *e*).

49. Subdivision (*ii*) constitutes the base erosion part of the test, which is broadly similar to the base erosion test in subdivision (*ii*) of subparagraph *d*) except for the fact that, unlike that other test, it also applies to a person that is seeking benefits under Article 10. That base erosion test is satisfied if

- less than 50 per cent of the company's gross income (and less than 50 per cent of the tested group's gross income if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the company's tax in its State of residence, and
- less than 50 per cent of the tested group's gross income (if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the tax of any member of the tested group in the State of residence of the company claiming the treaty benefits.

50. The term "ineligible persons" used in the previous paragraph refers to any persons other than the residents of each Contracting State who are entitled to the benefits of this

Convention under subparagraph *a*), *b*), *c*) or *e*) of paragraph 2. Also, paragraph 7 includes the definition of the terms “tested group” and “gross income” which are used in subdivision (*ii*).

51. The base erosion test of subdivision (*ii*), unlike that of subparagraph *d*), applies if a person wishes to obtain the benefits of Article 10. Such a person shall, for the purpose of subdivision (*ii*), include in its gross income any dividends received even if the dividends are effectively exempt from tax in that person’s State of residence. This is provided for in subdivision (*i*) of the definition of “gross income” in paragraph 7.

52. As in the case of the base erosion test in subparagraph *d*), for the purpose of applying the test in subdivision (ii), deductible (*i.e.* base-eroding) payments do not include arm’s-length amounts paid or accrued in the ordinary course of business for services or tangible property. To the extent they are deductible from the taxable base under the tax law of the person’s State of residence, trust distributions constitute such base-eroding payments. Depreciation and amortisation deductions, which do not represent payments or accruals to other persons, are not taken into account for the purposes of subdivision (*ii*). Furthermore, in the case of a tested group, deductible payments do not include intra-group payments. Finally, payments of interest are not arm’s-length amounts paid or accrued in the ordinary course of business for services or tangible property, and would therefore be taken into account if made to an ineligible person.

53. As explained in paragraph 33 above, which is applicable to the base erosion test of subparagraph *d*), States that want to deny the application of specific treaty provisions with respect to income that is paid to connected persons that benefit from regimes that constitute “special tax regimes” and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity, may also want to modify the base erosion test of subdivision (*ii*) in order to include in the category of “ineligible persons” persons who, although they are residents of one of the Contracting States, benefit from such special tax regimes or notional deductions with respect to deductible payments made or accruing to them. This could be done by amending subdivision (*ii*) as follows:

> (*ii*) less than 50 per cent of the company’s gross income, and less than 50 per cent of the tested group’s gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible in that taxable period for purposes of the

taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)

A) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*);

B) to persons that are connected to the person described in this subparagraph and that benefit from a special tax regime, as defined in *[reference to the paragraph of the convention that includes the definition of "special tax regime"]* of this Convention, with respect to the deductible payment; or

C) with respect to a payment of interest, to persons that are that are connected to the person described in this subparagraph and that benefit from notional deductions described in *[reference to the paragraph of Article 11 that relates to notional deductions for equity];*

54. The following examples illustrate the application of the base erosion test of subdivision (*ii*) of subparagraph *f*) by a Contracting State (referred to in the examples as the "first-mentioned State"), taking into account the definitions of "tested group" and "gross income" in paragraph 7:

– *Example A:* Assume that at all relevant times, R2 (the entity seeking treaty benefits under subparagraph *f*)) is a wholly owned subsidiary of R1, which in turn is wholly owned by Z, an individual. R1, R2 and Z are all residents of the other Contracting State under Article 4. R2 and R1 are both members of the same tax consolidation group. The ownership test in subdivision (*i*) of subparagraph *f*) is satisfied because Z, a qualified person under subparagraph *a*), owns indirectly at least 50 per cent of the aggregate vote and value of R2, and R1 is a qualifying intermediate owner.

  During the relevant taxable period, R2 has 50 of exempt dividends paid by a company resident of a third State and 50 of interest arising in the first-mentioned State. R2 makes a deductible interest payment of 24 to an ineligible person and pays a 51 dividend to R1. In addition to the 51 dividend that it receives from R2, R1 receives additional income of 100 from persons outside the tested group. R1 makes a deductible interest payment of 51 to an ineligible person. R2 is seeking to claim the benefits of Article 11 of the Convention, but not of Article 10.

For purposes of applying the tested group base erosion test, the tested group consists of R1 and R2. The tested group's gross income for this purpose is 150 (50 of interest arising in the first-mentioned State plus 100 of additional income from persons outside of the tested group). R2 has made a base eroding payment of 24 and R1 has made a base eroding payment of 51 to ineligible persons. The base eroding payments of the tested group total 75 (24 + 51), which is not less than 50 per cent of the tested group's gross income of 150. Therefore, the base erosion test is not satisfied and R2 is not a qualified person under subparagraph *f*).

– *Example B:* Assume the same facts as Example A above, except that the income with respect to which R2 seeks to be a qualified person is 50 of dividends paid by a company resident of the first-mentioned State instead of 50 of interest arising in that State. For this purpose, R2's gross income is 100 (the 50 of dividends paid by a company resident of a third State and the 50 of dividends paid by a company of the first-mentioned State). The gross income of the tested group is 200 (R2's gross income of 100 plus R1's income of 100 from persons outside the tested group). R2 has made a base eroding payment of 24 and R1 has made a base eroding payment of 51. The base eroding payments of R2 equal 24, which is less than 50 per cent of R2's gross income of 100. In addition, the base eroding payments of the tested group total 75 (24 + 51), which is less than 50 per cent of the tested group's gross income of 200. Therefore, under this example, the base erosion test of subdivision (*ii*) is satisfied and R2 shall be a qualified person under subparagraph *f*) for purposes of obtaining a lower rate of taxation on the dividend paid by the company resident of the first-mentioned State."

Subparagraph g): – Collective investment vehicles

17./18.

Note from Henry Louie: The Committee will need to decide if a rule for collective investment vehicles should be included in the UN Model LOB. It has not yet been discussed.

55. As indicated in the footnote to subparagraph *g*), whether a specific rule concerning collective investment vehicles (CIVs) should be included in paragraph 2, and, if so, how that rule should be drafted, will depend on how the Convention applies to CIVs and on the treatment and use of CIVs in each Contracting State. Such a specific rule will frequently be needed since a CIV

may not be a qualified person under either the other provisions of paragraph 2 or of paragraphs 3, 4 or 5 because, in many cases

- the interests in the CIV are not publicly-traded (even though these interests are widely distributed);
- these interests are held by residents of third States;
- the distributions made by the CIV are deductible payments;
- the CIV is used for investment purposes rather than for the "active conduct of a business" within the meaning of paragraph 3;
- the CIV does not meet the ownership test of paragraph 4, and
- the CIV does not qualify as a headquarters company under paragraph 5.

56. Paragraphs 6.8 to 6.34 of the Commentary on Article 1 discuss various factors that should be considered for the purpose of determining the treaty entitlement of CIVs and these paragraphs are therefore relevant when determining whether a provision on CIVs should be included in paragraph 2 and how it should be drafted. These paragraphs include alternative provisions that may be used to deal adequately with the CIVs that are found in each Contracting State. As explained below, the use of these provisions may make it unnecessary to include a specific rule on CIVs in paragraph 2, although it will be important to make sure that, in such a case, the definition of "equivalent beneficiary", if the term is used for the purposes of one of these alternative provisions, is adapted to reflect the definition included in paragraph 7.

57. If it is included, subparagraph *g*) will address cases where a Contracting State agrees that CIVs established in the other Contracting State constitute residents of that other State under the analysis in paragraphs 6.9 to 6.12 of the Commentary on Article 1 (such agreement may be evidenced by a mutual agreement as envisaged in paragraph 6.16 of the Commentary on Article 1 or may result from judicial or administrative pronouncements). The provisions of the Article, including subparagraph *g*), are not relevant with respect to a CIV that does not qualify as a resident of a Contracting State under the analysis in paragraphs 6.9 to 6.12 of the Commentary on Article 1. Also, the provisions of subparagraph *g*) are not relevant where the treaty entitlement of a CIV is dealt with under a treaty provision similar to one of the alternative provisions in paragraphs 6.17, 6.21, 6.26, 6.27 and 6.32 of the Commentary on Article 1.

58. As explained in paragraphs 6.19 and 6.20 of the Commentary on Article 1, Contracting States wishing to address the issue of CIVs' entitlement to treaty benefits may want to consider the economic characteristics, including the potential for treaty shopping, of the different types of CIVs that are used in each Contracting State.

59. As a result of that analysis, they may conclude that the tax treatment of CIVs established in the two States does not give rise to treaty-shopping concerns and decide to include in their bilateral treaty the alternative provision in paragraph 6.17 of the Commentary on Article 1, which would expressly provide for the treaty entitlement of CIVs established in each State and, at the same time, would ensure that they constitute qualified persons under subparagraph *a*) of paragraph 2 of the Article (because a CIV to which that alternative provision would apply would be treated as an individual). In such a case, subparagraph *g*) should be omitted. States that share the view that CIVs established in the two States do not give rise to treaty shopping concerns but that do not include in their treaty the alternative provision in paragraph 6.17 of the Commentary on Article 1 should ensure that any CIV that is a resident of a Contracting State should constitute a qualified person. In that case, subparagraph *g*) should be drafted as follows:

> *g*) a collective investment vehicle *[a definition of "collective investment vehicle" would then be included in paragraph 7]*;

60. The Contracting States could, however, conclude that CIVs present the opportunity for residents of third States to receive treaty benefits that would not have been available if these residents had invested directly and, for that reason, might prefer to draft subparagraph *g*) in a way that will ensure that a CIV that is a resident of a Contracting State will constitute a qualified person but only to the extent that the beneficial interests in the CIV are owned by equivalent beneficiaries. In that case, subparagraph *g*) should be drafted as follows:

> *g*) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established or by equivalent beneficiaries.

61. That treatment corresponds to the treatment that would result from the inclusion in a tax treaty of a provision similar to the alternative provision in paragraph 6.21 of the Commentary on Article 1. As explained in paragraphs 6.18 to 6.24 of the Commentary on Article 1, the inclusion of such an alternative provision would provide a more comprehensive solution to treaty issues arising in connection with CIVs because it would address treaty-shopping concerns whilst, at the same time, clarifying the tax treaty treatment of CIVs in both Contracting States. If that alternative provision is included in a tax treaty, subparagraph *g*) would not be necessary as regards the CIVs to which that alternative provision would apply: since that alternative provision provides that a CIV to which it applies shall be treated as an individual (to the extent that the beneficial interests in that CIV are owned by equivalent beneficiaries), that CIV will constitute a qualified person under subparagraph *a*) of paragraph 2 of the Article.

62. The approach described in the preceding two paragraphs, like the approach in paragraphs 6.21, 6.26 and 6.28 of the Commentary on Article 1, makes it necessary for the CIV to make a determination, when a benefit is claimed as regards a specific item of income, regarding the proportion of holders of interests who would have been entitled to benefits had they invested directly. As indicated in paragraph 6.29 of the Commentary on Article 1, however, the ownership of interests in CIVs changes regularly, and such interests frequently are held through intermediaries. For that reason, the CIV and its managers often do not themselves know the names and treaty status of the beneficial owners of interests. It would therefore be impractical for the CIV to collect such information from the relevant intermediaries each time the CIV receives income. Accordingly, Contracting States should be willing to accept practical and reliable approaches that do not require such daily tracing. As indicated in paragraph 6.31 of the Commentary on Article 1, the proportion of investors in the CIV is likely to change relatively slowly even though the identity of individual investors will change daily. For that reason, the determination of the extent to which the beneficial interests in a CIV are owned by equivalent beneficiaries should be made at regular intervals, the determination made at a given time being applicable to payments received until the following determination. This corresponds to the approach described in paragraph 6.31 of the Commentary on Article 1, according to which:

> … it would be a reasonable approach to require the CIV to collect from other intermediaries, on specified dates, information enabling the CIV to determine the proportion of investors that are treaty-entitled. This information could be required at the end of a calendar or fiscal year or, if market conditions suggest that turnover in ownership is high, it could be required more frequently, although no more often than the end of each calendar quarter. The CIV could then make a claim on the basis of an average of those amounts over an agreed-upon time period. In adopting such procedures, care would have to be taken in choosing the measurement dates to ensure that the CIV would have enough time to update the information that it provides to other payers so that the correct amount is withheld at the beginning of each relevant period.

63. Another view that Contracting States may adopt regarding CIVs is that expressed in paragraph 6.26 of the Commentary on Article 1. Contracting States that adopt that view may wish to draft subparagraph *g*) so that a CIV that is a resident of a Contracting State would only constitute a qualified person to the extent that the beneficial interests in that CIV are owned by residents of the Contracting State in which the CIV is established. In that case, subparagraph *g*) should be drafted as follows:

> *g*) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established.

Since the inclusion of the alternative provision in paragraph 6.26 of the Commentary on Article 1 would achieve the same result with respect to the CIVs to which it would apply, subparagraph *g*) would not be necessary, if that alternative provision is included in a treaty, as regards the CIVs to which that provision would apply.

64. A variation on the preceding approach would be to consider that a CIV that is a resident of a Contracting State should constitute a qualified person if the majority of the beneficial interests in that CIV are owned by individuals who are residents of the Contracting State in which the CIV is established. This result could be achieved by omitting subparagraph *g*) and simply relying on the application of subparagraph *f*) (the ownership and base erosion test).

65. Another possible view that the Contracting States could adopt would be to conclude that the fact that a substantial proportion of the CIV's investors are treaty-eligible is adequate protection against treaty shopping, and thus that it is appropriate to provide an ownership threshold above which benefits would be provided with respect to all income received by a CIV. An alternative provision that would ensure that result is included in paragraph 6.27 of the Commentary on Article 1 and subparagraph *g*) would not be necessary, if the Contracting States include that provision in their bilateral treaty, with respect to the CIVs to which the provision would apply. If that provision is not included in the treaty, the scope of subparagraph *g*) could be broadened in order to achieve a similar result by referring to "a collective investment vehicle, but only if [*percentage to be determined bilaterally*] per cent of the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established and by equivalent beneficiaries".

66. Similarly, the Contracting States may use the alternative provision in paragraph 6.32 of the Commentary on Article 1 where they consider "that a publicly-traded collective investment vehicle cannot be used effectively for treaty shopping because the shareholders or unit holders of such a collective investment vehicle cannot individually exercise control over it". In such case, subparagraph *g*) would not be necessary with respect to the CIVs to which the alternative provision would apply. States that share that view but that have not included the alternative provision in their treaty could draft subparagraph *g*) to read:

> *g*) a collective investment vehicle if the principal class of shares in the collective investment vehicle is listed and regularly traded on a recognised stock exchange.

67. Finally, as explained in paragraph 6.25 of the Commentary on Article 1, States that share the concern described in that paragraph about the potential deferral of taxation that could arise with respect to a CIV that is subject to no or low taxation and that may accumulate its income rather than distributing it on a current basis may wish to negotiate provisions that extend

benefits only to those CIVs that are required to distribute earnings currently. Depending on their drafting, such provisions may render subparagraph *g*) unnecessary.

Paragraph 3: active conduct of a business

18./19. Paragraph 68 through 77 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

> "68. Paragraph 3 of both the simplified and detailed versions sets forth an alternative test under which a resident of a Contracting State may receive treaty benefits with respect to certain items of income that are connected to an active business conducted in its State of residence. This paragraph recognises that where an entity resident of a Contracting State actively carries on business activities in that State, including activities conducted by connected persons, and derives income from the other Contracting State that emanates from, or is incidental to, such business activities, granting treaty benefits with respect to such income does not give rise to treaty-shopping concerns regardless of the nature and ownership of the entity. The paragraph will provide treaty benefits in a large number of situations where benefits would otherwise be denied under paragraph 1 because the entity is not a "qualified person" under paragraph 2.
>
> 69. A resident of a Contracting State may qualify for benefits under paragraph 3 regardless of the fact that it is not a qualified person under paragraph 2. Under the active-conduct test of paragraph 3, a person (typically a company) will be eligible for treaty benefits if it satisfies two conditions: first, it is engaged in the active conduct of a business in its State of residence and second, the payment for which benefits are sought is related to the business. In certain cases, an additional requirement that the business be substantial in size relative to the activity in the State of source generating the income must be met.
>
> 70. Subparagraph *a*) sets forth the general rule that a resident of a Contracting State engaged in the active conduct of a business in that State may obtain the benefits of the Convention with respect to an item of income derived from the other Contracting State. The item of income, however, must emanate from, or be incidental to, that business.
>
> 71. The term "business" is not defined and, under the general rule of paragraph 2 of Article 3, must therefore be given the meaning that it has under domestic law. An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting (such as officers or employees of a company) conduct substantial managerial and operational activities.

72. Under subparagraph *a*), the business of making or managing investments for the resident's own account is not considered to be a business unless the relevant activities are part of banking, insurance or securities activities conducted by a bank, or a financial institution that the Contracting States would consider to be similar to a bank (such as a credit union or building society), an insurance enterprise or a registered securities dealer respectively. Such activities conducted by a person other than a bank (or financial institution agreed to by the Contracting States), insurance enterprise or registered securities dealer will not be considered to be the active conduct of a business, nor would they be considered to be the active conduct of a business if conducted by a bank (or financial institution agreed to by the Contracting States), insurance enterprise or registered securities dealer but not as part of the enterprise's banking, insurance or dealer business.

73. In addition, subdivisions (*i*) through (*iv*) of subparagraph *a*) identify specific functions that, either on their own or in combination, will be considered, for purposes of paragraph 3, not to constitute the active conduct of a business in a Contracting State, even when all such functions are conducted in the same State. These are: (*i*) operating as a holding company; (*ii*) providing overall supervision or administration of a group of companies; (*iii*) providing group financing (including cash pooling); and (*iv*) making or managing investments, unless these activities are carried on by a regulated bank (or financial institution agreed to by the Contracting States), insurance company or registered securities dealer in the ordinary course of its business as such. This list of activities is intended to clarify that the administrative support functions of multinationals, as well as the activities of operating as a holding company, do not constitute the active conduct of a business and, therefore, income that emanates from, or is incidental to, such activities cannot be entitled to treaty benefits under paragraph 3. Some States consider, however, that some or all of the activities listed in subdivisions (*i*) through (*iv*) should be included in what constitutes the active conduct of a business and these States may therefore wish to adopt a different formulation of subparagraph *a*).

74. Whether an item of income emanates from the company's active conduct of a business in the State of residence must be determined based on facts and circumstances. In general, an item of income emanates from the active conduct of a business in the State of residence if there is a factual connection between the actively conducted business and the item of income for which benefits are sought. For example, if a company conducts research and development in its State of residence and develops a patent for a new process, royalties from licensing the patent would be factually connected to the actively conducted business in the State of residence. In the case of dividends or interest paid to a

parent company, the activities of the paying company will be relevant in determining whether the dividend or interest emanates from the parent's actively conducted business in its State of residence.

75. For the purposes of determining whether the activities of the paying company in the State of source have the required factual connection with the actively conducted business in the State of residence, it will be important to compare the lines of business in each State. The line of business in the State of source may be upstream or downstream to the activity conducted in the State of residence. Thus, the line of business in the State of source may provide inputs for a manufacturing process that occurs in the State of residence, or the line of business in the State of source may sell the output of the manufacturing process conducted by a resident. The following examples illustrate these principles:

- *Example A:* ACO is a company resident of State A and is engaged in the active conduct of a business in that State consisting in manufacturing product X. ACO owns 100 per cent of the shares of BCO, a company resident of State B. BCO acquires product X from ACO and distributes it to customers in State B. Since the distribution activity by BCO of product X is factually connected to ACO's manufacturing of that product, dividends paid by BCO to ACO will be treated as emanating from ACO's business.
- *Example B:* ACO is a company resident of State A that operates a large research and development facility in State A that develops intellectual property that it licenses to affiliates worldwide, including BCO. ACO owns 100 per cent of the shares of BCO, a company resident of State B. BCO manufactures and markets the ACO-designed products in State B. Since the activities conducted by BCO are factually connected to ACO's actively conducted business in State A, royalties paid by BCO to ACO for the use of its intellectual property will be treated as emanating from ACO's business.
- *Example C:* ACO is a company resident of State A and is engaged in State A in the active conduct of a manufacturing business that requires the use of commodity X. ACO owns 100 per cent of the shares of BCO, a company resident of State B, which contains a large supply of commodity X. BCO extracts commodity X and sells it to ACO, which uses the commodity to manufacture goods that it sells in the open market. Since the business activity conducted by BCO provides upstream inputs to ACO for use in manufacturing its goods, BCO's business is factually connected to ACO's manufacturing activities in State A. Dividends paid by BCO to ACO will be treated as emanating from ACO's business.

76. An item of income derived from the State of source is "incidental to" the business carried on in the State of residence if production of the item facilitates the conduct of the business in the State of residence. An example of incidental income is income derived from the temporary investment of working capital of a person in the State of residence in securities issued by persons in the State of source.

77. Subparagraph *b*) of paragraph 3 states a further condition to the general rule in subparagraph *a*) in cases where the business generating the item of income in question is carried on either by the person deriving the income or by a connected person in the State of source. Subparagraph *b*) states that the business carried on in the State of residence, under these circumstances, must be substantial in relation to the activity in the State of source. The determination of substantiality is based upon all the facts and circumstances and takes into account the comparative sizes of the businesses in each Contracting State, the relative sizes of the economies and markets in the two States, the nature of the activities performed in each State, and the relative contributions made to that business in each State."

19./20. One/Some Member/s of the Committee is/are of the view that for purposes of determining if the business in the residence State is substantial in relation to the activity in the State of source, the relative sizes of the economies and markets in the two States is irrelevant. Accordingly, that/those Member/s does/do not agree with that part of the guidance provided in paragraph 77 of the OECD Model Commentary quoted above.

20./21. Paragraphs 78 through 81of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"78. The determination of whether subparagraph *b*) applies is made separately for each item of income derived from the State of source, with reference to the business in the State of residence from which the item of income in question emanates. It is therefore possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another. If a resident of a Contracting State is entitled to treaty benefits with respect to a particular item of income under paragraph 3, the resident is entitled to all the benefits of the Convention insofar as they affect the taxation of that item of income in the State of source.

79. The substantiality requirement under subparagraph *b*) will not apply, however, if the business generating the item of income in question is not carried on in the State of source by the resident seeking benefits or by a connected person in the State of source. For example, if a small research firm in one State develops a process that it licenses to a

very large pharmaceutical manufacturer in another State that is not a connected person with respect to the small research firm, the size of the business activity of the research firm in the first State would not have to be tested against the size of the business activity of the manufacturer. Similarly, a small bank of one State that makes a loan to a very large company that is not a connected person and that is operating a business in the other State would not have to pass a substantiality test to be eligible for treaty benefits under paragraph 3.

80. Subparagraph *c*) provides attribution rules in the case of activities conducted by connected persons for purposes of applying the substantive rules of subparagraphs *a*) and *b*). Thus, these rules apply for purposes of determining whether a person meets the requirement in subparagraph *a*) that it be engaged in the active conduct of a business and that the item of income emanates from that active business, and for making the comparison required by the "substantiality" requirement in subparagraph *b*). The term "connected person" is defined in paragraph 7.

81. The following examples illustrate the application of paragraph 3 in relation to activities conducted by connected persons:

- *Example A:* PARENTCO is a resident of a third State and is the parent of HOLDCO, which itself is the parent of OPCO1 and OPCO2. OPCO1 and HOLDCO are residents of State A. OPCO2 is a resident of State B. OPCO1 and OPCO2 are engaged in the business of manufacturing the same product in their respective States of residence. HOLDCO manages the investments of the group and is considered not to be engaged in the active conduct of a business. HOLDCO receives dividends from OPCO2. Under subparagraph *c*), HOLDCO is deemed to be engaged in the active conduct of a business because it is deemed to conduct the activities of OPCO 1, which is engaged in the active conduct of a business. Therefore, HOLDCO is treated as engaged in the active conduct of a business in State A. Nevertheless, the fact that HOLDCO's deemed business is the same as the business of OPCO2 is not sufficient to demonstrate that the dividends paid by OPCO 2 are factually connected to HOLDCO's actively conducted business. Accordingly, such dividends will not enjoy the reduced rates of withholding of Article 10 of the convention between States A and B by virtue of paragraph 3.
- *Example B:* ACO is a company resident of State A and is engaged in State A in the active conduct of a manufacturing business that requires the use of commodity X. All the shares of ACO are owned by HOLDCO, also a resident of State A, which also owns 100 per cent of the shares of BCO, a company resident of State B

where there is a large supply of commodity X. BCO extracts commodity X and sells it to ACO, which uses the commodity to manufacture goods that it sells in the open market. HOLDCO is considered to be engaged in the active conduct of a business because it is deemed under subparagraph *c*) to conduct the activities of ACO. Since the business activity conducted by BCO provides upstream inputs for use in HOLDCO's deemed active conduct of a business, BCO's business is considered to form part of HOLDCO's deemed manufacturing business, Dividends paid by BCO to HOLDCO will therefore emanate from HOLDCO's deemed active conduct of a business."

Paragraph 4: derivative benefits

21./22. Paragraphs 83 through 91 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"83. The drafting of the derivative benefits paragraph in a convention that follows the detailed version depends on the views of the Contracting States concerning treaty-shopping opportunities that might arise from such a paragraph with respect to residents of States whose tax system includes certain preferential features.

84. As indicated in the Commentary on Article 1, some States consider that provisions should be included in their tax treaties in order to deny the application of specific treaty provisions with respect to income that is paid to connected persons (as defined in paragraph 7) that benefit from regimes that constitute "special tax regimes" (see paragraphs 26.12 to 26.27 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity (see paragraph 26.34 of the Commentary on Article 1). These States may want to ensure that any derivative benefits provisions included in their conventions do not allow base eroding payments to be made to such connected persons even if they qualify as equivalent beneficiaries. States that share these views are likely to want to adopt a derivative benefits paragraph drafted as follows:

4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention if:

a) at the time when the benefit otherwise would be accorded and on at least half of the days of any twelve-month period that includes that time, at least 95 per cent of the aggregate vote and value of its shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and

b) less than 50 per cent of the person's gross income, and less than 50 per cent of the tested group's gross income for the taxable period that includes that time, as determined in the person's Contracting State of residence, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)

(*i*) to persons that are not equivalent beneficiaries;

(*ii*) to persons that are equivalent beneficiaries only by reason of paragraph 5 of this Article or of a substantially similar provision in the relevant comprehensive convention for the avoidance of double taxation;

(*iii*) to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that benefit from a special tax regime, as defined in *[reference to the paragraph of the convention that includes the definition of "special tax regime"]* of this Convention, with respect to the deductible payment, provided that if the relevant comprehensive convention for the avoidance of double taxation does not contain a definition of a special tax regime analogous to the definition of that term included in this Convention, the principles of that definition shall apply, but without regard to the requirement in subdivision *v*) of that definition; or

(*iv*) with respect to a payment of interest, to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that benefit from notional deductions of the type described in *[reference to the paragraph of Article 11 that relates to notional deductions for equity]*.

85. States that do not consider that provisions on special tax regimes and notional deductions with respect to equity should be included in their tax treaties, however, may prefer to use the following version of the derivative benefits paragraph:

4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention if:

a) at the time when the benefit otherwise would be accorded and on at least half of the days of any twelve-month period that includes that time, at least 95 per cent of the aggregate vote and value of its shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and

b) less than 50 per cent of the person's gross income, and less than 50 per cent of the tested group's gross income for the taxable period that includes that time, as determined in the person's Contracting State of residence, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)

(*i*) to persons that are not equivalent beneficiaries; or

(*ii*) to persons that are equivalent beneficiaries only by reason of paragraph 5 of this Article or of a substantially similar provision in the relevant comprehensive convention for the avoidance of double taxation;

86. Some States, however, may consider that the provisions of a derivative benefits paragraph drafted along the lines of the provision included in the previous paragraph create unacceptable risks of treaty shopping with respect to payments that are deductible in the State of source. Instead of not providing any derivative benefits, these States might prefer to restrict the scope of that provision to dividends, which are typically not deductible. States that share that view are free to amend the first part of the alternative provision so that it reads as follows:

4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded under Article 10:

87. Whether drafted as suggested in paragraph 84 or in paragraph 85 above, paragraph 4 on derivative benefits sets forth an alternative test under which a resident of a Contracting State that is not a qualified person under paragraph 2 may receive treaty benefits with respect to certain items of income. In general, this derivative benefits test entitles a company that is a resident of a Contracting State to treaty benefits if 95 per cent of the vote and value of its shares are owned, directly or indirectly, by seven or fewer equivalent beneficiaries and the company satisfies a base erosion test. The requirement that at least 95 per cent of the vote and value of the company seeking treaty benefits under paragraph 4 be owned, directly or indirectly, by seven or fewer equivalent beneficiaries is intended to avoid the administrative burden of having to determine whether a large number of shareholders are equivalent beneficiaries; it is also consistent with the objective of the derivative benefits test to provide benefits for holding companies of a multinational group in the situations contemplated by the provision.

88. Subparagraph *a*) sets forth the ownership test. Under this test, seven or fewer equivalent beneficiaries must own, directly or indirectly, shares representing at least 95 per cent of the aggregate vote and value of the company and at least 50 per cent of any disproportionate class of shares on at least half of the days of any twelve-month period that includes the date when benefits would otherwise be accorded. In the case of indirect ownership, each intermediate owner must be a qualifying intermediate owner. The term "qualifying intermediate owner" is defined in paragraph 7 (see paragraphs 151 to 154 below); the following example illustrates the application of that definition in the context of paragraph 4:

– *Example:* HOLDCO, a company resident of State A, is a wholly owned direct subsidiary of ZCO, a company resident of State Z, which itself is a wholly owned direct subsidiary of XCO, a resident of State X. XCO's principal class of shares is primarily and regularly traded on the stock exchange in State X. HOLDCO is not entitled to benefits under paragraph 2 of the treaty between States A and B because it is a subsidiary of a company resident and publicly traded in a third state. HOLDCO is not engaged in the conduct of an active business in State A, and therefore it is not entitled to any benefits under paragraph 3. HOLDCO derives and beneficially owns interest arising in State B that would otherwise be entitled to the benefits of Article 11 of the treaty between States A and B. Assume that by virtue of the provisions of the income tax convention between State B and State

X, XCO qualifies as an equivalent beneficiary under the definition of that term included in the treaty between States A and B.

Although XCO indirectly owns all the shares of HOLDCO, ZCO, as an intermediate owner, must satisfy the definition of “qualifying intermediate owner” in paragraph 7 of the treaty between States A and B in order for HOLDCO to be eligible for the benefits of Article 11 of the treaty between States A and B with respect to the interest that it received from State B. If State Z does not have in effect a comprehensive convention for the avoidance of double taxation (or, if the definition of qualifying intermediate owner is drafted as suggested in paragraph 153 below, such a convention is in effect but it does not include provisions addressing special tax regimes and notional deductions), ZCO will not be a qualifying intermediate owner and the requirements of subparagraph *a*) will not be satisfied with the result that HOLDCO will not be eligible, under paragraph 4, for the benefits of the convention.

89. Subparagraph *b*) sets forth the base erosion test applicable for purposes of paragraph 4. That test is broadly similar to the base erosion test in subdivision *ii*) of subparagraph *f*) of paragraph 2 except that the list of ineligible persons is different (see below). The base erosion test of subparagraph *b*) is satisfied if

- less than 50 per cent of the company’s gross income (and less than 50 per cent of the tested group’s gross income if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the company’s tax in its State of residence, and
- less than 50 per cent of the tested group’s gross income (if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the tax of any member of the tested group in the State of residence of the company claiming the treaty benefits.

90. Paragraph 7 includes the definition of the terms “tested group” and “gross income” which are used in subparagraph *b*). Also, the term “ineligible persons” used in the previous paragraph refers to:

- if paragraph 4 is drafted as indicated in paragraph 84 above, persons who are not equivalent beneficiaries under the definition of that term in paragraph 7 as well as persons who are equivalent beneficiaries under that definition but fall within one of the three following categories:

1. they are equivalent beneficiaries solely by reason of being a headquarters company under paragraph 5 of this Convention or of the relevant convention;
2. they are connected persons (as defined in paragraph 7) with the company seeking treaty benefits under paragraph 4 and benefit from a special tax regime with respect to the payment, or
3. with respect to a payment of interest, they are connected persons (as defined in paragraph 7) with the company seeking treaty benefits under paragraph 4 and benefit from notional deductions for equity.

– if paragraph 4 is drafted as indicated in paragraph 85 above, persons who are not equivalent beneficiaries under the definition of that term in paragraph 7 as well as persons who are equivalent beneficiaries under that definition solely by reason of being a headquarters company under paragraph 5 of this Convention or of the relevant convention.

91. The following illustrates the base erosion test of paragraph 4:

– *Example:* Company X, a resident of State X, owns Company Y, a resident of State Y. Company Y owns Company B, a resident of State B that seeks benefits of the treaty between States A and B under paragraph 4. Company X is an equivalent beneficiary and Company Y is a qualifying intermediate owner under the definitions of these terms in paragraph 7 of the treaty between States A and B. Accordingly, Company B would satisfy the ownership requirement of subparagraph *a*) because, first, Company X, an equivalent beneficiary, indirectly owns shares representing at least 95 per cent of the aggregate vote and value of Company B and at least 50 per cent of any disproportionate class of shares (as defined in paragraph 7), and, second, each intermediate owner (*i.e.* Company Y) is a qualifying intermediate owner.

  Company B's gross income for the taxable period in question consists of 100 of interest arising in State A and 200 of dividends from a third State which is exempt from tax under the law of State B. Company B seeks treaty benefits with respect to the 100 of interest. Under the law of State B, Company B, Company Y and Company X are not allowed to participate in a common tax consolidation or other regime that would allow the ~~two~~ three companies to share profits or losses nor is there any loss sharing regime available. Accordingly, in this example, there is no tested group. Company B's gross income is 100 (the interest arising in State A). Company B will fail the base erosion test of subparagraph *b*) if Company B makes base eroding payments of at least 50 to ineligible persons described in the previous paragraph."

Paragraph 5: headquarters company

22./23. Paragraphs 92 through 100 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"92. Paragraph 5 sets forth an alternative test under which a resident of a Contracting State that is a headquarters company and that is not a qualified person under paragraph 2 may receive treaty benefits with respect to dividends and interest paid by members of the company's multinational corporate group. A headquarters company's multinational corporate group means the company and its direct and indirect subsidiaries (and does not include upper-tier companies).

93. A company seeking to qualify for benefits as a headquarters company must satisfy six conditions. First, under subparagraph *a*), the headquarters company's primary place of management and control, as defined in paragraph 7, must be in the Contracting State of which it is a resident. The same test is applied for publicly-traded companies. Subdivision (*ii*) of the definition of "primary place of management and control" allows the possibility that, in certain limited cases, the management of a subgroup (such as a subgroup responsible for a regional area) may be exercised more by a company that is not the top-tier company for the entire group of connected companies, and in certain narrow cases a lower-tier company may satisfy the headquarters company test.

94. Second, under subparagraph *b*), the multinational corporate group must consist of companies resident of, and engaged in the active conduct of a business (as defined in paragraph 3) in, at least four States (including either Contracting State), and the businesses carried on in each of the four States (or four groupings of States) must generate at least 10 per cent of the gross income of the group. The application of this requirement is illustrated by the following example:

- *Example:* Company X is resident of State X and is a member of a multinational corporate group consisting of itself and its direct and indirect subsidiaries resident in States X, A, B, C, D, E and F. The gross income generated by each of these companies for year 01 and year 02 is as follows:

State	Year 01	Year 02
X	45	60
A	25	12
B	10	20
C	10	12
D	7	10
E	10	9
F	5	7
Total	112	130

For year 01, 10 per cent of the gross income of this group is equal to 11,20. Only the companies in States X and A satisfy the requirement of subparagraph *b*) for that year. The other States may be aggregated into groupings to meet this requirement. Since States B and C have a total gross income of 20, and States D, E and F have a total gross income of 22, these two groupings of countries may be treated as the third and fourth members of the group for purposes of subparagraph *b*).

For year 02, 10 per cent of the gross income is 13. Only the companies in States X and B satisfy this requirement. Since States A and C have a total gross income of 24, and States D, E and F have a total gross income of 26, these two groupings of countries may be treated as the third and fourth members of the group for purposes of subparagraph *b*). The fact that State A replaced State B in a group is not relevant for this purpose. The composition of the grouping may change annually.

95. Third, under subparagraph *c*), the businesses of the multinational corporate group that are carried on in any one State other than the Contracting State of residence of such company must generate less than 50 per cent of the gross income (as defined in paragraph 7) of the group. A company whose multinational corporate group generates 50 per cent or more of the group's gross income in the Contracting State of source does not meet this condition.

96. Fourth, under subparagraph *d*), no more than 25 per cent of the company's gross income can be derived from the other Contracting State. Unlike the third condition described in the previous paragraph, this condition looks only at the gross income earned by the company seeking status as a headquarters company rather than the gross income earned by members of its multinational corporate group.

97. Fifth, under subparagraph *e*), such company must be subject to the same income taxation rules in its Contracting State of residence as persons described in paragraph 3. Therefore, such company must be subject to the general corporate taxation rules for companies that are engaged in the active conduct of a business in the Contracting State of residence, and not to a regime for headquarters companies.

98. Sixth, under subparagraph *f*), such company must satisfy a base erosion test that is broadly similar to the base erosion test in subdivision (*ii*) of subparagraph *f*) of paragraph 2 except that base eroding payments do not include payments in respect of financial obligations to a bank that is not a connected person with respect to the company. For example, unlike the base erosion test in subparagraph *f*) of paragraph 2, interest payments made by a company to a bank that is not a connected person to the company will not be treated as a base eroding payment for purposes of applying the base erosion test under paragraph 5. Paragraph 7 includes the definition of the terms “tested group” and “gross income” which are used for the purposes of this base erosion test.

99. As explained in paragraph 33 above which is applicable to the base erosion test of subparagraph *d*) of paragraph 2, States that want to deny the application of specific treaty provisions with respect to income that is paid to connected persons that benefit from regimes that constitute “special tax regimes” and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity, may also want to modify the base erosion test of subparagraph *f*) in order to include in the category of “ineligible persons” persons who, although they are residents of one of the Contracting States, benefit from such special tax regimes or notional deductions with respect to deductible payments made or accruing to them. This could be done by amending subparagraph *f*) as follows:

f) less than 50 per cent of such company’s gross income, and less than 50 per cent of the tested group’s gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company’s Contracting State of residence (but not including arm’s length payments in the ordinary course of business for services or tangible property or payments in respect of financial obligations to a bank that is not a connected person with respect to such company, and in the case of a tested group, not including intra-group transactions):

(*i*) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*) of paragraph 2;

(*ii*) to persons that are connected persons with respect to such company and that benefit from a special tax regime as defined in *[reference to the paragraph of the convention that includes the definition of "special tax regime"]* with respect to the deductible payment; or

(*iii*) with respect to a payment of interest, to persons that are connected persons with respect to the company referred to in this paragraph and that benefit from notional deductions of the type described in [*reference to the paragraph of Article 11 that relates to notional deductions for equity]*.

100. The six conditions of paragraph 5 must be tested with respect to the taxable year in which the company received the dividends or interest for which it is seeking benefits under the Convention. A company that does not satisfy the second, third or fourth conditions described above for the relevant taxable year may still be treated as a headquarters company if it satisfies such conditions by averaging the required ratios for the preceding four taxable periods (which does not include the taxable period that includes the payment for which a treaty benefit is being sought)."

Paragraph 6: discretionary relief

23./24. Paragraphs 101through 112 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"101.Paragraph 5 of the simplified version and paragraph 6 of the detailed versions both provide that where, under the previous paragraphs of the Article, a resident of a Contracting State is not entitled to benefits of the Convention, that resident may request that the competent authority of the State in which benefits are denied under these paragraphs grant these benefits. The only difference between the simplified and the detailed versions relates to the cross-reference to the paragraphs of the Article under which benefits of the Convention are otherwise granted.

102. Where a request is made under paragraph 5 (simplified version) or paragraph 6 (detailed version), the competent authority to which that request is made may grant the benefits of this Convention, or benefits with respect to a specific item of income or capital, taking into account the object and purpose of this Convention, but only if the person who made the request demonstrates to the satisfaction of the competent

authority that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under this Convention. Thus, persons that establish operations in one of the Contracting States with a principal purpose of obtaining the benefits of the Convention will not be granted benefits of the Convention under the paragraph.

103. In order to be granted benefits under the paragraph, a person must establish, to the satisfaction of the competent authority of the State from which benefits are being sought, that, first, there were clear non-tax business reasons for its formation, acquisition, or maintenance and for the conduct of its operations and, second, that the allowance of benefits would not otherwise be contrary to the object and purpose of the Convention. For the purposes of determining that neither the establishment, acquisition or maintenance, nor the conduct of the operations, of a resident of a Contracting State had as one of its principal purposes the obtaining of benefits under the Convention, one of the factors that the competent authority will typically take into account is whether or not the resident has a substantial non-tax nexus to its State of residence. For example, in the case of a resident subsidiary company with a parent in a third State, the fact that the relevant withholding rate provided in the Convention is at least as low as the corresponding withholding rate in the income tax convention between the State of source and the third State is not by itself evidence of a nexus or relationship to the other Contracting State. Similarly, a relationship or nexus to the treaty State cannot be established by a desire to take advantage of favourable domestic laws of the treaty State, including the existence of a network of tax treaties.

104. Also, discretionary benefits typically will not be granted if the benefit requested would result in no or minimal tax imposed on the item of income in both the State of residence of the applicant and the State of source, taking into account the domestic law of both Contracting States as well as the provisions and the object and purpose of the Convention. For example, double non-taxation may occur through the use of a hybrid instrument that generates a deduction in the State of source where the income from that instrument is treated as exempt in the State of residence. On the other hand, the fact that there is no or minimal tax in both States may not be inconsistent with the object and purpose of the Convention in the case of dividends paid by a company resident of one State to a company resident of the other State that owns a substantial part of the shares of the paying company where the provisions of the Convention reveal that the Contracting States intended these dividends to be subject to low or no taxation in both States.

105. Whilst it is impossible to provide a detailed list of all the facts and circumstances that would be relevant to the application of the paragraph, examples of such facts and circumstances include the history, structure, ownership and operations of the resident that makes the request, whether that resident is a long-standing entity that was recently acquired by non-residents for non-tax reasons, whether the resident carries on substantial business activities, whether the resident's income for which the benefits are requested is subject to double taxation and whether the establishment or use of the resident gives rise to non-taxation or reduced taxation of the income.

106. The reference to "one of the principal purposes" in the paragraph means that obtaining benefits under a tax treaty needs not be the sole or dominant purpose for the establishment, acquisition or maintenance of the person and the conduct of its operations. It is sufficient that at least one of the principal purposes was to obtain treaty benefits. Where the competent authority determines, having regard to all relevant facts and circumstances, that obtaining benefits under the Convention was not a principal consideration and would not have justified the establishment, acquisition or maintenance of the person and the conduct of its operations, it may grant that person these benefits, or benefits with respect to a specific item of income or capital. Where, however, the establishment, acquisition or maintenance of the person and the conduct of its operations is carried on for the purpose of obtaining similar benefits under a number of treaties, it should not be considered that obtaining benefits under other treaties will prevent the obtaining of benefits under one treaty from being considered a principal purpose for these operations.

107. Although a request under the paragraph will usually be made by a resident of a Contracting State to the competent authority of the other Contracting State, there may be cases in which a resident of a Contracting State may request the competent authority of its own State of residence to grant relief under the paragraph. This would be the case if the treaty benefits that are requested are provided by the State of residence, such as the benefits of the provisions of Articles 23 A and 23 B concerning the elimination of double taxation.

108. The paragraph grants broad discretion to the competent authority and, as long as the competent authority has exercised that discretion in accordance with the requirements of the paragraph, it cannot be considered that the decision of the competent authority is an action that results in taxation not in accordance with the provisions of the Convention (see paragraph 1 of Article 25). The paragraph does require, however, that the competent authority must consider the relevant facts and

circumstances before reaching a decision and must consult the competent authority of the other Contracting State before granting or denying a request to grant benefits 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 should ensure that Contracting States treat similar cases in a consistent manner and can justify their decision on the basis of the facts and circumstances of the particular case. This consultation process does not, however, require that the competent authority to which the request has been presented obtain the agreement of the competent authority that is consulted.

109. The competent authority to which a request is made under the paragraph may grant benefits but it may then grant all of the benefits of the Convention to the taxpayer making the request, or it may grant only certain benefits. For instance, it may grant benefits only with respect to a particular item of income in a manner similar to paragraph 3. Further, the competent authority may establish conditions, such as setting time limits on the duration of any relief granted.

110. The request for a determination under the paragraph may be presented before (*e.g.* through a ruling request) or after the establishment, acquisition or maintenance of the person for whom the request is made. The request must be presented, however, before benefits may be claimed. If the competent authority determines that benefits are to be allowed, it is expected that benefits will be allowed retroactively to the later of the time of entry into force of the relevant treaty provision or to the time of the establishment or acquisition of the person for whom the request is made, assuming that all relevant facts and circumstances justify granting the retroactive application of benefits.

111. The competent authority that receives a request for relief under the paragraph should process that request expeditiously.

112. To reduce the resource implications of having to consider requests for discretionary relief, and to discourage vexatious requests, a Contracting State may find it useful to publish guidelines on the types of cases that it considers will and will not qualify for discretionary relief. However, any administrative conditions that a Contracting State imposes on applicants should not deter persons from making requests where they consider that they have a reasonable prospect of satisfying a competent authority that benefits should be granted.”

Paragraph 7: Definitions

23./24. Paragraph 113 of Commentary to the detailed version of Article 29 of the OECD Model provides:

> "113. Paragraph 6 of the simplified version and paragraph 7 of the detailed version include a number of definitions that apply for the purposes of these paragraphs themselves as well as the previous paragraphs of the Article. These definitions supplement the definitions included in Articles 3, 4 and 5 of the Convention, which apply throughout the Convention."

Commentary on the definition of "recognised stock exchange"

24./25. Paragraphs 116 through 120 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

> "116. The definition of "recognised stock exchange" in the detailed version includes, in subdivision (*i*), stock exchanges that both Contracting States agree to identify at the time of the signature of the Convention. Although this would typically include stock exchanges established in the Contracting States on which shares of publicly listed companies and entities that are residents of these States are actively traded, the stock exchanges to be identified in the definition need not be established in one of the Contracting States. This recognises that the globalisation of financial markets and the prominence of some large financial centres have resulted in the shares of many public companies being actively traded on more than one stock exchange and on stock exchanges situated outside the State of residence of these companies.
>
> 117. The list to be included in subdivision (*i*) may include the names of specific stock exchanges. It may also include a generic description of a number of stock exchanges that would each constitute a "recognised stock exchange". For example, in the case of the United States, such a generic description could read "any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934". If the Contracting States wish to cover European Union stock exchanges that are officially recognised as such, such a generic description could read "any stock exchange established in States that are members of the European Union or are party to the Agreement on the European Economic Area and that are regulated by the European Union Markets in Financial Instruments Directive (Directive 2004/39/EC as amended) or by any successor Directive".

118. Subdivision (*ii*) of the definition allows the competent authorities of the Contracting States to supplement, through a subsequent agreement, the list of stock exchanges identified in the definition at the time of signature of the Convention.

119. The stock exchanges to be included in the definition should impose listing requirements that ensure that shares of entities listed on that stock exchange are genuinely publicly traded. The following factors should be considered when determining whether a stock exchange should be listed in the definition or subsequently added to that list through the competent authority agreement referred to in the preceding paragraph:

- What are the requirements/standards with respect to listing a company on the stock exchange?
- What are the requirements/standards in order to continue to be listed on the stock exchange, including minimum financial standards?
- What are the annual/interim disclosure and/or filing requirements for companies whose shares are traded on the stock exchange?
- What is the volume of shares traded on the stock exchange in a calendar year?
- Do the rules governing the stock exchange ensure active trading of listed stocks? If so, how?
- Are the companies listed on the stock exchange required to disclose on an ongoing basis financial information and information on events that may have a material impact on their financial situations?
- Is information on the trading volume and overall shareholding of the companies listed on the stock exchange publicly available?
- Does the stock exchange impose any minimum size requirements, such as minimum capitalisation or number of employees, for companies whose shares are traded on the exchange?
- Does the stock exchange impose a required minimum percentage of public ownership? If so, what is the minimum amount?
- For a company to be listed on the stock exchange, are the shares of companies required to be freely negotiable and fully paid for?
- Is the stock exchange required to disclose the share prices of its listed companies within a certain timeframe?

- Is the stock exchange regulated or supervised by a government authority of the State in which it is located?
- *[In the case of a new stock exchange to be added to an existing list:]* Why would a company prefer to list on the new exchange rather than on another exchange, including those exchanges that are already "recognised stock exchanges" in the tax treaty? For example, are there lesser corporate governance and financial disclosure requirements?
- *[In the case of a new stock exchange to be added to an existing list:]* Does the new stock exchange provide a more efficient vehicle for raising capital and, if so, why?"

The term "shares"

Commentary on the definition of "shares" in the simplified and detailed versions

25./26. Paragraph 120 of the Commentary to the detailed version of Article 29 of the OECD Model provides:

> "120. Neither the simplified nor the detailed version contains an exhaustive definition of the term "shares", which, under paragraph 2 of Article 3, should generally have the meaning which it has under the domestic law of the State that applies the Article. Subparagraph *b*), however, provides that the term "shares", when used with respect to entities that do not issue shares (*e.g.* trusts), refers to interests that are comparable to shares. These will typically be beneficial interests that entitle their holders to a share of the income or assets of the entity."

The term "principal class of shares"

Commentary on the definition of "principal class of shares" in the detailed version

26./27. Paragraphs 122 through 125 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

> "122.The detailed version's definition of the term "principal class of shares" refers to the ordinary or common shares of a company or entity but only if these shares represent the majority of the voting rights as well as of the value of the company or entity. If a company or entity has only one class of shares, that class of shares will naturally constitute its "principal class of shares". If a company or entity has more than one class of shares, it is

necessary to determine which class or classes constitute the "principal class of shares", which will be the class of shares, or any combination of classes of shares, that represent, in the aggregate, a majority of the aggregate vote and value of the company or entity. If a company or entity does not have a class of ordinary or common shares representing the majority of its aggregate vote and value, then the "principal class of shares" shall be any combination of classes of shares that represent, in the aggregate, a majority of the vote and value of the company or entity. Although in a particular case involving a company with several classes of shares it is conceivable that more than one group of classes could be identified that would represent the majority of the aggregate vote and value of the company, it is only necessary to identify one such group that meets the conditions of subparagraph *c*) of paragraph 2 in order for the company to be entitled to treaty benefits under that provision (benefits will not be denied to the company or entity even if a second group of shares representing the majority of the aggregate vote and value of the company or entity, but not satisfying the conditions of subparagraph *c*) of paragraph 2, could be identified).

123. In a few States, certain publicly-listed traded companies are governed by a dual listed company arrangement and these States may wish to address expressly the situation of these companies in order to ensure that they are not inadvertently denied the benefits of conventions because of the definition of "principal class of shares".

The term "dual listed company arrangement" refers to an arrangement, adopted by certain publicly-listed companies, that reflects a commonality of management, operations, shareholders' rights, purpose and mission through a series of agreements between two parent companies, each with its own stock exchange listing, together with special provisions in their respective articles of association including in some cases, for example, the creation of special voting shares. Under these structures, the position of the parent company's shareholders is, as far as possible, the same as if they held shares in a single company, with the same dividend entitlement and same rights to participate in the assets of the dual listed companies in the event of a winding up. States wishing to address the situation of such companies may therefore wish to add the following sentence to the definition of "principal class of shares":

> In the case of a company participating in a dual listed company arrangement, the principal class of shares will be determined after excluding the special voting shares which were issued as a means of establishing that dual listed company arrangement.

124. This additional sentence would be supplemented by the addition of the following definition of "dual listed company arrangement":

the term "dual listed company arrangement" means an arrangement pursuant to which two publicly listed companies, while maintaining their separate legal entity status, shareholdings and listings, align their strategic directions and the economic interests of their respective shareholders through:

(*i*) the appointment of common (or almost identical) boards of directors, except where relevant regulatory requirements prevent this;

(*ii*) management of the operations of the two companies on a unified basis;

(*iii*) equalised distributions to shareholders in accordance with an equalisation ratio applying between the two companies, including in the event of a winding up of one or both of the companies;

(*iv*) the shareholders of both companies voting in effect as a single decision-making body on substantial issues affecting their combined interests; and

(*v*) cross-guarantees as to, or similar financial support for, each other's material obligations or operations except where the effect of the relevant regulatory requirements prevents such guarantees or financial support.

125. Other States, however, may prefer not to include any specific reference to dual listed company arrangements in the Article because of possible concerns about the use of similar arrangements for avoidance purposes and may therefore prefer to address legitimate dual listed arrangements on a case-by-case basis through the other provisions of the Article, including the discretionary relief provision of paragraph 6."

The term "connected person"

27./28. Paragraphs 126 and 127 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"126. The term "connected person" is used in paragraph 3 of the simplified version and in various parts of the detailed version. Although the definition is somewhat similar to the definition of "closely related" in Article 5, a main difference is that a direct or indirect ownership of exactly 50 per cent of the beneficial interests could result in a person being "connected" to another person whilst the definition of "closely related" requires a direct or indirect ownership of more than 50 per cent of the beneficial interests.

127. As indicated in paragraph 33 above, some States consider that provisions should be included in their tax treaties in order to deny the application of specific treaty provisions with respect to income that is paid to connected persons that benefit from

regimes that constitute "special tax regimes" (see paragraphs 26.12 to 26.27 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity (see paragraphs 26.34 of the Commentary on Article 1). If such provisions are included in the Convention, the Contracting States may consider it more appropriate to include the definition of "connected person" in Article 3, which includes definitions that apply throughout the Convention."

The term "equivalent beneficiary"

28./29. Paragraphs 131 through 147 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"131.The definition of "equivalent beneficiary" in the detailed version is relevant for the purposes of the derivative benefits test in paragraph 4 but may also be relevant for the purposes of subparagraph *g*) of paragraph 2 dealing with collective investment vehicles, depending on how that subparagraph is drafted (see paragraph 56 above).

132. The definition recognises three different categories of persons who qualify as "equivalent beneficiary".

133. The first category (subdivision (*i*) of the definition) covers residents of third States that would be entitled to all of the benefits of a comprehensive income tax convention between that person's State of residence and the State from which benefits are sought (referred to below as the "tested convention") under provisions that are substantially similar to the rules in subparagraph *a*), *b*), *c*) or *e*) of paragraph 2. A company may also be an equivalent beneficiary under subdivision (*i*) if it is entitled to benefits under a convention pursuant to a headquarters company test under the tested convention that is substantially similar to paragraph 5, but only if the benefits being sought by the company are with respect to interest or dividends paid by a member of the equivalent beneficiary's multinational corporate group. If the tested convention does not have a comprehensive limitation on benefits article the requirements of clause *A*) of subdivision (*i*) are also met if the resident of the third state applies the tested convention as if such convention included the provisions of subparagraphs *a*), *b*), *c*) and *e*) of paragraph 2 (including the relevant definitions for purposes of applying the provisions of such subparagraphs), and would have satisfied one of the limitation on benefits provision by reason of one of the incorporated subparagraphs.

134. The following examples illustrate the application of subdivision (*i*) of the definition:

- *Example A:* HOLDCO, a resident of State R, is a wholly owned direct subsidiary of XCO, a resident of State X. XCO's principal class of shares is primarily and regularly traded on the X Stock Exchange, a stock exchange located in State X. HOLDCO is not entitled to benefits under paragraph 2 of the convention between States S and R because it is a subsidiary of a company resident of, and publicly traded in, a third state. HOLDCO is not engaged in the conduct of an active business in State R, and therefore it is not entitled to any benefits under paragraph 3. HOLDCO derives and beneficially owns interest arising in State S that would otherwise be subject to the 10 per cent rate of Article 11 of the convention between States S and R. In order to determine if HOLDCO is entitled to benefits under the derivative benefits test of paragraph 4 of that convention, it is necessary to determine whether XCO satisfies the definition of equivalent beneficiary in paragraph 7. The income tax convention between States S and X contains a comprehensive limitation on benefits provision, including a rule for companies whose principal class of shares is primarily and regularly traded on the X Stock Exchange that is substantially similar to subparagraph *c*) of paragraph 2. Therefore, XCO satisfies the requirement of clause *A*) of subdivision (*i*) of the definition of equivalent beneficiary. The convention between States S and X would also subject interest arising in either State to the 10 per cent rate of Article 11, so XCO satisfies the requirement of clause *B*) of subdivision (*i*) of the definition of equivalent beneficiary. Accordingly, XCO is an equivalent beneficiary.

- *Example B*: Assume the same facts as in Example A, except that the income tax convention between States S and X does not include a comprehensive limitation on benefits provision. Accordingly, for the purpose of determining whether XCO is an equivalent beneficiary, that convention shall be applied as if it contained the provisions of subparagraphs *a*), *b*), *c*) and *e*) of paragraph 2 (including the relevant definitions for purposes of applying these subparagraphs) of this Convention. If this Convention defines a recognised stock exchange to include the X Stock Exchange, the principal class of XCO's shares would be primarily traded on a recognised stock exchange located in XCO's State of residence. Therefore XCO would satisfy subparagraph *c*) of paragraph 2 and would be an equivalent beneficiary. If however, the X Stock Exchange is not included in this Convention as a recognised stock exchange, XCO would not be an equivalent beneficiary.

135. A third-State resident cannot be an equivalent beneficiary if the person only satisfies:

– a test for subsidiaries of publicly traded companies substantially similar to subparagraph *d*) of paragraph 2;

– an ownership / base erosion test substantially similar to subparagraph *f*) of paragraph 2;

– [a test for collective investment vehicles substantially similar to what may be included in subparagraph *g*) of paragraph 2;]

– an active business test substantially similar to paragraph 3;

– a derivative benefits test substantially similar to paragraph 4;

– a discretionary relief provision substantially similar to paragraph 6, or

– any other limitation on benefits provision of the tested convention that is not a test under this Convention,

because such resident would not be a qualified person under provisions substantially similar to subparagraph *a*), *b*), *c*) or *e*) of this Article.

136. Some States may wish to restrict and in some cases deny treaty benefits to individuals who are liable to tax on a remittance basis or taxed on a fixed-fee / forfait basis. If the Convention between the Contracting States does so, these States may also wish to prevent such individuals resident of third States from qualifying as an "equivalent beneficiary". This could be done by amending clause *A*) of subdivision (*i*) as follows:

A) the resident is entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that State and the Contracting State from which the benefits of this Convention are sought, under provisions substantially similar to subparagraph *a*), *b*), *c*) or *e*) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under provisions substantially similar to paragraph 5 of this Article in such convention, provided that, if such convention does not contain a detailed limitation on benefits article, the resident would be entitled to the benefits of this Convention by reason of subparagraph *a*), *b*), *c*) or *e*) of paragraph 2 if such resident were a resident of one of the Contracting States under Article 4. Notwithstanding the preceding sentence, an individual who is

1) liable to tax in that individual's State of residence with respect to foreign source income or gains only on a remittance or similar basis, or

2) whose tax is determined in that State, in whole or in part, on a fixed-fee, "forfait" or similar basis,

shall not be considered an equivalent beneficiary; and

137. Subclause *B*) *1*) of subdivision (*i*) requires an equivalent beneficiary to be entitled to a rate of tax on the type of income derived by the company seeking benefits under paragraph 4 under either the tested convention, domestic law or any international agreement that is less than or equal to the rate of tax applicable under this Convention to the company seeking benefits under paragraph 4. Thus, the rates to be compared are: first, the rate of tax that the State of source could impose under the Convention on income paid to that company if it qualified for the benefits; and, second, the rate of tax that the State of source could have imposed if the potential equivalent beneficiary had derived the income directly from the State of source.

138. As described above, subclause *B*) *1*) provides that any reduced rates of taxation that are available under domestic law or any international agreement will be taken into account. This rule recognises that withholding taxes on many inter-company dividends, interest and royalties may be eliminated, for example, pursuant to provisions such as those of the Parent-Subsidiary and Interest and Royalties Directives[1] of the European Union, rather than by an income tax convention. This is illustrated by the following example:

– *Example:* EUCO1, a company resident of State EU1, wholly owns ACO, a resident of State A. ACO wholly owns EUCO2, a resident of State EU2, and derives interest arising in State EU2. The income tax convention between States A and EU2 contains the detailed version's definition of equivalent beneficiary and exempts interest from source taxation. EU1 and EU2 are both members of the European Union. Under the Interest and Royalties Directive, interest paid by EUCO2 to

1 Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, as amended; Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

EUCO1 may not be taxed by EUCO2. Therefore, EUCO1 satisfies subclause *B*) *1*) of subdivision (*i*) of the definition of equivalent beneficiary in the income tax convention between States A and EU2 even if the income tax convention between States EU1 and EU2 allows the source taxation of interest.

139. Subclause *B*) *1*) (*I*) of subdivision (*i*) provides a rule, applicable with respect to dividends, that allows an individual to be treated as a company for purposes of the rate comparison test of subclause *B*) *1*). Since dividends beneficially owned by individuals are not entitled to the lower rate provided for by subparagraph *a*) of paragraph 2 of Article 10, whereas a company may be entitled to that lower rate if certain conditions are met, absent this provision, individual shareholders of a company seeking derivative benefits under paragraph 4 generally would not qualify as equivalent beneficiaries in the case of dividends derived from substantial participations in other companies. By treating individuals as companies for purposes of the rate comparison test, this rule allows a company seeking derivative benefits under paragraph 4 to take into account the shares owned, directly or indirectly, by the individual as if such shares were owned by a company described in subparagraph *c*) of paragraph 2 for purposes of determining whether the company seeking derivative benefits under paragraph 4 is 95 percent owned by equivalent beneficiaries.

140. To be eligible to apply the rule in subclause *B*) *1*) *I*), the company seeking derivative benefits under paragraph 4 must be engaged in the active conduct of a business in its State of residence. The rule treats an individual shareholder who otherwise meets the requirements of subclause *A*) of subparagraph (*i*) as if it were a company described in subparagraph *c*) of paragraph 2 but only if the company seeking derivative benefits under paragraph 4 is engaged in the active conduct of a business in its State of residence that is both substantial in relation to, and similar or complementary, to the business that generated the earnings from which the dividend is paid. The test in subclause *B*) *1*) *I*) is similar to the active conduct of a business test under paragraph 3, but is not exactly the same because it does not require that the income from the State of source “emanate” from the business actively conducted by the company seeking derivative benefits under paragraph 4. The phrase “active conduct of a business” has the same meaning as in subparagraph *a*) of paragraph 3, and therefore does not include the activities described in subdivisions (*i*) through (*iv*) of that subparagraph. For purposes of determining if the company seeking derivative benefits under paragraph 4 is engaged in the active conduct of a business in a Contracting State, activities conducted by a person connected to that company shall be deemed to be conducted by the company. The phrase “substantial in relation to” has the same meaning as in subparagraph *c*) of

paragraph 3. That substantiality requirement, however, must be applied regardless of whether the dividend is derived from a connected person. On the other hand, the dividend derived from the other Contracting State does not have to emanate from the active business of the company seeking derivative benefits under paragraph 4, as is required under subparagraph *a*) of paragraph 3, in order to obtain benefits, because the active business conducted in the Contracting State of residence for purposes of subclause *B*) *1*) *I*) needs only be "similar or complementary" to the active business conducted in the State of source, and not "the same or complementary" to that active business conducted in the State of source.

141. The following example illustrates the application of subclause *B*) *1*) *I*):

- *Example:* RCO is a company resident of State R. RCO is engaged in the active conduct of a business in State R that is similar to the business of SCO, a company resident of State S. RCO has been a resident of State R for 13 months and has also held 25 per cent of the capital of SCO for 13 months. Individual Y is the sole shareholder of RCO and is a resident of State Y. Paragraph 2 of Article 10 of the income tax conventions between States S and Y and between States S and R is identical to the corresponding provision of the OECD Model Tax Convention. RCO, therefore, satisfies the requirements set forth in subparagraph *a*) of paragraph 2 of Article 10 for purposes of the lower rate applicable to dividends. Absent subclause *B*) *1*) *I*), however, RCO would not be entitled to that lower rate because individual Y would only have been entitled to the 15 per cent rate (under subparagraph *a*) of paragraph 2 of Article 10) if he had received the dividends directly from SCO. By virtue of subclause *B*) *1*) *I*), however, Y shall be treated as a company within the meaning of paragraph *c*) of paragraph 2 of the income tax convention between States S and R for the purposes of the rate comparison test, which means that RCO will satisfy the rate comparison requirement. Therefore, assuming all other requirements (such as the base erosion test and the beneficial ownership requirement of Article 10) are satisfied, RCO will be entitled to the lower rate in Article 10 of the income tax convention between States S and R with respect to the dividends paid by SCO.

142. Subclause *B*) *1*) *II*) provides the rule for determining the percentage of the capital of a company paying a dividend that a potential equivalent beneficiary will be deemed to hold for purposes of the rate comparison test, which, like subclause *B*) *1*) *I*), will affect the entitlement to the lower rate of tax, under subparagraph *a*) of paragraph 2 of Article 10, of the equivalent beneficiary, had it derived the dividend directly. For these purposes, when applying the rate comparison test described in subclause *B*) *1*), the potential

equivalent beneficiary's indirect holding of the capital of the company paying the dividends shall be treated as a direct holding. The following example illustrates the application of subclause *B*) *1*) *II*):

- *Example:* XCO and YCO each own directly 50 per cent of RCO, a company resident of State R. For 13 months, RCO has held 25 percent of the capital of SCO and been a resident of State R. State S has income tax conventions with States R, X and Y; paragraph 2 of Article 10 of these income tax conventions is identical to the corresponding provision of the OECD Model Tax Convention. XCO is a resident of State X and would have qualified person status under subparagraph *c*) of paragraph 2 of the income tax convention between States S and R. YCO is a resident of State Y and would also have qualified person status under subparagraph *c*) of paragraph 2 of the income tax convention between States S and R. Both XCO and YCO, therefore, would satisfy subclause *A*) of the definition of equivalent beneficiary. For purposes of determining the rate of tax on dividends paid by SCO that XCO and YCO would have been entitled to under their respective tax treaties with State S, however, XCO and YCO are each treated, under subclause *B*) *1*) *II*), as holding directly 12.5 per cent of the capital of SCO (50 per cent of the 25 per cent shareholding in SCO is equal to 12.5 per cent, the amount of XCO and YCO respective indirect holdings in the capital of SCO that is treated as a direct holding). XCO and YCO, therefore, would not be entitled to the lower rate of tax of subparagraph *a*) of paragraph 2 of Article 10 and would not, therefore, be considered equivalent beneficiaries because they fail to meet the rate comparison test under subclause *B*) *1*) (see, however, paragraph [147] below concerning alternative provisions that would allow RCO to benefit from the 15 per cent rate of subparagraph *b*) of paragraph 2 of Article 10 of the income tax convention between States S and R).

143. Subclause *B*) *2*) of subdivision (*i*) provides derivative benefits rules for items of income that fall within Articles 7, 13 or 21. The potential equivalent beneficiary must be entitled to a benefit under the tested convention that is at least as favourable as that which would apply under the Convention to such business profits, gains or other income. Thus, the benefits to be compared are: first, the benefits that the State of source would grant to the company seeking derivative benefits under paragraph 4 if it qualified for benefits with respect to the relevant item of income and, second, the benefits that the State of source would grant to the potential equivalent beneficiary if it derived the income directly. The following example illustrates the application of subclause *B*) *2*):

- *Example:* RCO is a company resident in State R, which is wholly owned by XCO, a publicly traded company resident in State X. RCO has a contract to construct a major office complex in State S. Under the terms of the income tax convention between States S and R, a construction site constitutes a permanent establishment only of it lasts for more than twelve months. Under the terms of the income tax convention between States S and X, however, a construction site constitutes a permanent establishment only of it lasts more than six months. If the construction site lasts more than six months but less than 12 months, XCO would not be an equivalent beneficiary because it would not be entitled to the same protection, under Article 7 of the income tax convention between States S and X, that RCO would be entitled to under Article 7 of the income tax convention between States S and R.

144. Subclause *C*) of subdivision (*ii*) provides an additional limitation where the item of income has been derived through an entity that is treated as fiscally transparent under the laws of the Contracting State of residence of the company seeking derivative benefits under paragraph 4. In such case, notwithstanding that the resident may satisfy the requirements of subclauses *A*) or *B*) based on a comparison of the terms of the tested convention with the terms of the convention under which the company is seeking derivative benefits, the resident will not meet the requirements of this subclause if the relevant item of income would not be treated as the income of that resident under a provision analogous to paragraph 2 of Article 1 had it, rather than the company seeking derivative benefits under paragraph 4, been paid the item of income for which that company is claiming benefits. The following example illustrates the application of subclause *C*):

- *Example:* RCO, a publicly traded company resident of State R, owns shares of SCO, a company resident of State S, through P, a partnership organised in State S. P is fiscally transparent under the domestic tax law of State S and is treated as a company under the domestic tax law of State R. Accordingly, under the provisions of paragraph 2 of Article 1, dividends paid by SCO through P would not be considered derived by RCO, and thus would not be eligible for a reduction from source taxation in State S under Article 10. RCO interposes XCO, a resident of State X, between itself and P. Under the domestic tax law of State X, P is fiscally transparent, and therefore, XCO is considered to derive dividends paid by SCO to P.

  The income tax convention between States S and X contains the detailed version of paragraphs 1 to 7 of Article 29. In order to enjoy the dividend withholding tax reductions provided in that convention, XCO must satisfy the derivative benefits test. Although the dividend rates under paragraph 2 of Article 10 of the convention between States S and X are the same as those under Article 10 of the convention between States S and R, and subclause *A*) of subparagraph (*ii*) would be satisfied, dividends would not be considered derived by RCO if RCO, and not XCO, had owned SCO through the partnership P. Accordingly, by virtue of subclause *C*), RCO is not an equivalent beneficiary, and for that reason, XCO is not entitled to derivative benefits under paragraph 4 with respect to the dividends paid by SCO through P.

145. The second category of persons who qualify as "equivalent beneficiary" (subdivision (*ii*) of the definition) applies to persons who are residents of the same Contracting State as the company seeking derivative benefits under paragraph 4. Such persons will be equivalent beneficiaries if they are eligible for benefits by reason of subparagraph *a*), *b*), *c*) or *e*) of paragraph 2, or under paragraph 5 as a headquarters company. A headquarters company, however, will solely be an equivalent beneficiary of the company seeking derivative benefits under paragraph 4 if it receives interest or dividends from a member of the headquarters company's multinational corporate group. A rate comparison test applies, however, for any resident satisfying the headquarters company test in paragraph 5 that derives dividends or interest from the other Contracting State. That requirement is intended to ensure that the headquarters company is entitled to at least the same treaty benefits with respect to dividends or interest as the company seeking derivative benefits under paragraph 4 so that if, for instance, Article 11 of the Convention generally exempts interest from source taxation but does not do so with respect to interest paid to a headquarters company by a member of that company's multinational group, the headquarters company will not be an equivalent beneficiary of a company that would otherwise be entitled to the treaty exemption from source taxation applicable to a similar interest payment.

146. The third category of persons who qualify as "equivalent beneficiary" (subdivision (*iii*) of the definition), applies to persons who are residents of the Contracting State of source. Such persons will be equivalent beneficiaries if they are eligible for benefits by reason of subparagraph *a*), *b*), *c*) or *e*) of paragraph 2, provided that such residents' ownership of the aggregate vote and value of the shares (and any disproportionate class of shares as defined in paragraph 7) of the company that requests the derivative benefits does not exceed 25 per cent. Under the ownership requirement in subparagraph *a*) of paragraph 4, ownership may be direct or indirect, but in the case of indirect ownership,

each intermediate owner must be a “qualifying intermediate owner” under the definition of that term in paragraph 7 (see below).

147. As explained in paragraph 10 above, where paragraph 4 on derivative benefits applies, the definition of equivalent beneficiary will exclude persons who, under another convention, are entitled to relief from taxation by the State of source that is not as favourable as the relief provided under the Convention. Some States may want to address the resulting so-called “cliff” effect of denying all treaty benefits even if the difference in the relief provided by the two conventions is relatively minor by providing relief from taxation by the State of source that is similar to the relief that would have been provided under the other convention. This treatment could be achieved through the alternative provisions below that relate to the taxation of dividends, interest and royalties and that grant limited benefits that broadly correspond to those that would have been available under the other convention:

Provision on dividends to be added to Article 10

Notwithstanding the provisions of paragraphs 1 and 2 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 29 of this Convention regarding a dividend, if such company fails to satisfy the criteria of that paragraph solely by reason of:

a) the requirement in clause *B*) of subdivision (*i*) of the definition of the term “equivalent beneficiary” in subparagraph *e*) of paragraph 7 of Article 29; or

b) the requirement, in subdivision (*ii*) of the definition of the term “equivalent beneficiary” in subparagraph *e*) of paragraph 7 of Article 29, that a person entitled to benefits under paragraph 5 of Article 29 would be entitled to a rate of tax with respect to the dividend that is less than or equal to the rate applicable under paragraph 2 of this Article;

such company may be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that Contracting State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in the definition of the term “equivalent beneficiary” in subparagraph *e*) of paragraph 7 of Article 29 (notwithstanding the requirements referred to in subparagraphs *a*) and *b*) of this paragraph) would have been entitled if such persons had received the dividend directly. For purposes of this paragraph:

c) such persons' indirect ownership of the voting stock of the company paying the dividends shall be treated as direct ownership, and

d) a person described in subdivision (*iii*) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the dividends.

Provision on interest to be added to Article 11

Notwithstanding the provisions of paragraph 1 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 29 regarding a payment of interest, if such company fails to satisfy the criteria of that paragraph solely by reason of:

a) the requirement in clause *B*) of subdivision (*i*) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29; or

b) the requirement in subdivision (*ii*) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 that a person entitled to benefits under paragraph 5 of Article 22 would be entitled to a rate of tax with respect to the interest that is less than or equal to the rate applicable under paragraph 2 of this Article;

such company may be taxed by the Contracting State in which the interest arises according to the laws of that State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 (notwithstanding the requirements referred to in subparagraphs *a*) and *b*) of this paragraph) would have been entitled if such persons had received the interest directly. For purposes of this paragraph, a person described in subdivision (*iii*) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the interest.

Provision on royalties to be added to Article 12

Notwithstanding the provisions of paragraph 1 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 29 regarding royalties, if such company fails to satisfy the criteria of that paragraph solely by reason of the requirement in clause *B*) of subdivision (*i*) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29, such company may be taxed in the Contracting State of which the royalty arises and according to the laws of that State, except that the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 (notwithstanding the requirement of clause *B*) of subdivision (*i*) of that definition) would have been entitled if such persons had received the royalty directly. For purposes of this paragraph, a person described in subdivision (*iii*) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the royalties."

The term "disproportionate class of shares"

29./30. Paragraph 148 of the Commentary to the detailed version of Article 29 of the OECD Model provides:

"148.Under the definition of the term "disproportionate class of shares", which is used in the ownership test in various parts the Article, a company or entity has a disproportionate class of shares if it has outstanding shares that are subject to terms or other arrangements that entitle the holder of these shares to a larger portion of the company's or entity's income derived from the other Contracting State than that to which the holder would be entitled in the absence of such terms or arrangements. Thus, for example, a company resident in one Contracting State has a "disproportionate class of shares" if some of the outstanding shares of that company are "tracking shares" that pay dividends based upon a formula that approximates the company's return on its assets employed in the other Contracting State. This is illustrated by the following example:

- *Example:* ACO is a company resident of State A. ACO has issued common shares and preferred shares. The common shares are listed and regularly traded on the principal stock exchange of State A. The preferred shares have no voting rights and only entitle their holders to receive dividends equal in amount to interest payments that ACO receives from unrelated borrowers in State B. The preferred shares are owned entirely by a single shareholder who is a resident of a third State with which State B does not have a tax treaty. The common shares account for more than 50 per cent of the value of ACO and for 100 per cent of the votes. Since the owner of the preferred shares is entitled to receive payments corresponding to ACO's interest income arising in State B, the preferred shares constitute a "disproportionate class of shares" and because these shares are not regularly traded on a recognised stock exchange, ACO will not qualify for benefits under subparagraph *c*) of paragraph 2."

The term "primary place of management and control"

30./31. Paragraphs 149 and 150 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"149.The term "primary place of management and control" is relevant for the purposes of subparagraph *c*) of paragraph 2 and of paragraph 5 of the detailed version. This term must be distinguished from the concept of "place of effective management", which was used before 2017 in paragraph 3 of Article 4 and in various provisions, including Article 8, applicable to the operation of ships and aircraft. The concept of "place of effective management" was interpreted by some States as being ordinarily the place where the most senior person or group of persons (for example a board of directors) made the key management and commercial decisions necessary for the conduct of the company's business. The concept of the primary place of management and control, by contrast, refers to the place where the day-to-day responsibility for the management of the company or entity (and its direct and indirect subsidiaries) is exercised.

150. A company's or entity's primary place of management and control will be situated in the State of residence of that company or entity only if the following two conditions are satisfied:

- First, under subdivision (*i*), the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company or entity and for its direct and indirect subsidiaries, and the staff that support such management in preparing for and making those decisions conduct more of their necessary day-to-day activities, in that State than in the other State or any third State. Thus, the test looks to the overall activities of the relevant persons to see where those activities are conducted. In most cases, it will be a necessary, but not a sufficient, condition that the chief executive officer and other top executives normally are in the Contracting State of which the company is a resident.

– Second, the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company and its direct and indirect subsidiaries, and the staff that support such management in making those decisions conduct more of their necessary day-to-day activities, than the officers or employees of any other company or entity."

The term "qualifying intermediate owner"

31./32. Paragraphs 151 through 154 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"151. The definition of "qualifying intermediate owner" in the detailed version is relevant for the purposes of the ownership tests found in subparagraphs *d*) and *f*) of paragraph 2 as well as the derivative benefits rule of paragraph 4.

152. Under subdivision (*i*) of that definition, a qualifying intermediate owner is an entity resident of a third State that has in effect a comprehensive income tax convention with the Contracting State from which a treaty benefit is sought.

153. As indicated in the Commentary on Article 1, some States consider that provisions should be included in their tax treaties in order to deny the application of specific treaty provisions with respect to income benefiting from regimes that constitute "special tax regimes" (see paragraphs 26.12 to 26.27 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity (see paragraph 26.34 of the Commentary on Article 1). These States may want to restrict the scope of subdivision (*i*) so that it would only apply to residents of third States with which the State from which treaty benefits are sought has concluded comprehensive income tax conventions, and that do not benefit from a special tax regime or from notional interest deductions. This could be done by amending subdivision (*i*) as follows:

(*i*) a resident of a State that has in effect with the Contracting State from which a benefit under this Convention is being sought a comprehensive convention for the avoidance of double taxation and that does not benefit from either (A) a special tax regime, provided that if the relevant comprehensive convention for the avoidance of double taxation does not contain a definition of special tax regime analogous to the provisions included in *[reference to the paragraph of the convention that includes the definition of "special tax regime"],* the principles of the definition provided in this Convention shall apply, but without regard to the requirement in clause (v) of that definition; or (B) notional interest deductions of the type described in *[reference to the paragraph of Article 11 that relates to notional deductions for equity]*; or

154. Under subdivision (*ii*) of the definition, a qualifying intermediate owner also includes a resident of the same Contracting State as the company to which the relevant ownership test is applied under subparagraphs *d*) or *f*) of paragraph 2 or under the derivative benefits rule of paragraph 4."

The term "tested group"

32./33. Paragraph 155 of the Commentary to the detailed version of Article 29 of the OECD Model provides:

"155. This subparagraph defines the term "tested group" for purposes of the base erosion rules in subdivision (*ii*) of subparagraphs *d*) and *f*) of paragraph 2 and in paragraphs 4 and 5. The tested group shall consist of the tested company to which the relevant base erosion rule is applied (which is referred to as the "tested resident") and any company that either participates as a member with that tested resident in a tax consolidation regime, fiscal unity or similar regime that allows members of the group to share profits or losses, or any company that, during the relevant taxable period, shares losses with the tested resident pursuant to a group relief or other loss sharing regime. If there is no tested group, then the relevant base erosion test applicable to a tested group does not apply."

The term "gross income"

33./34. Paragraphs 156 and 157 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

"156. This subparagraph defines the term "gross income" for purposes of the base erosion rules in subdivision (*ii*) of subparagraphs *d*) and *f*) of paragraph 2 and in paragraphs 4 and 5. The starting point for calculating gross income is gross receipts as determined in the relevant entity's Contracting State of residence for the taxable period that includes the time when the benefit would be accorded. If the entity is engaged in a business that includes the manufacture, production or sale of goods, "gross income" means gross receipts reduced by the cost of goods sold. If the tested subsidiary is engaged in a business of providing non-financial services, “gross income” means such gross receipts reduced by the direct costs of generating such receipts.

157. Subdivision (*i*) of the definition further provides that except for determining benefits with respect to dividends under Article 10, gross income shall not include the portion of any dividends that are effectively exempt from tax in the person’s Contracting State of residence, whether through deductions or otherwise, regardless of the State of residence of the company paying these dividends. Subdivision (*ii*) provides that, except with respect to the portion of any dividend that is taxable, a tested group’s gross income will not take into account any transactions between companies within the tested group.”

The term “collective investment vehicle”

Note from Henry Louie: The Committee will need to decide if a rule for collective investment vehicles should be included in the UN Model LOB. It has not yet been discussed.

34./35.

158. As indicated in the footnote to the subparagraph, a definition of “collective investment vehicle” should be included if a provision dealing with collective investment vehicles is included in subparagraph *g*) of paragraph 2. That definition should identify the collective investment vehicles of each Contracting State to which that provision is applicable and could be drafted as follows:

> the term “collective investment vehicle” means, in the case of [State A], a [ ] and, in the case of [State B], a [ ], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this paragraph;

159. As explained in paragraph 6.22 of the Commentary on Article 1, it is intended that the open parts of that definition would include cross-references to relevant tax or securities law provisions of each State that would identify the CIVs to which subparagraph *g*) of paragraph 2 should apply.

Paragraph 8

35.36 Paragraphs 161 through 168 of the Commentary to the detailed version of Article 29 of the OECD Model provide:

“161.As mentioned in paragraph 32 of the Commentary on Article 10, paragraph 25 of the Commentary on Article 11 and paragraph 21 of the Commentary on Article 12, potential abuses may result from the transfer of shares, debt-claims, rights or property to permanent establishments set up solely for that purpose in countries that do not tax, or offer preferential tax treatment to*,* the income from such assets. Where the State of residence exempts the profits attributable to such permanent establishments situated in third jurisdictions, the State of source should not be expected to grant treaty benefits with respect to such income. The proposed paragraph, which applies where a Contracting State exempts the income of enterprises of that State that are attributable to permanent establishments situated in third jurisdictions, provides that treaty benefits will not be granted in such cases. That rule, however, does not apply if

– the income bears a significant level of tax in the State in which the permanent establishment is situated, or
– the income emanates from, or is incidental to, the active conduct of a business through the permanent establishment, excluding an investment business that is not carried on by a bank, insurance enterprise or registered securities dealer.

162. Under subparagraph c), in any case where benefits are denied under this paragraph, the resident of a Contracting State who derives the relevant income may request that the competent authority of the other Contracting State ~~to~~ grant these benefits. The competent authority who receives such a request may, at its discretion, grant these benefits if it determines that doing so would be justified; it shall, however, consult with the competent authority of the other Contracting State before granting or denying the request.

163. The following example illustrates the type of situation in which the paragraph is intended to apply. An enterprise of a Contracting State sets up a permanent establishment in a third jurisdiction that imposes no or low tax on the profits of the permanent establishment. The profits attributable to the permanent establishment are exempt from tax by the first-mentioned State either pursuant to a provision similar to Article 23 A included in a tax convention between that State and the jurisdiction where the permanent establishment is located or pursuant to the first-mentioned State’s domestic law. The enterprise derives interest arising in the other Contracting State which is included in the profits attributable to the permanent establishment. Assuming that the conditions for the application of Article 11 are met, the State in which the interest arises would, in the absence of paragraph 8, be obliged to grant the benefits of the limitation of tax provided for in paragraph 2 of Article 11 despite the fact that the interest is exempt

from tax in the first-mentioned State and is subject to little or no tax in the third jurisdiction in which the permanent establishment is situated. In that situation, the benefits of the Convention will be denied with respect to that income unless the exception of subparagraph b) applicable to income that emanates from, or is incidental to, the active conduct of a business applies to the relevant income or unless these benefits are granted, under the discretionary relief provision of subparagraph c), by the competent authority of the State in which the interest arises.

164. The reference to the word “income” in subdivision (i) means that the provision applies regardless of whether the relevant income constitutes business profits. The rule therefore applies where an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats the right or property in respect of which the income is paid as effectively connected with a permanent establishment situated in a third jurisdiction (including under a provision such as paragraph 2 of Article 21 in a treaty between the first-mentioned State and the third jurisdiction).

165. Where the conditions of subdivisions (i) and (ii) are met, subparagraph a) denies the benefits that otherwise would apply under the other provisions of the Convention if the relevant item of income is treated as being part of the profits of the permanent establishment situated in the third jurisdiction and the amount of tax levied on that item of income in that third jurisdiction is less than the lower of the following two amounts: a) the amount of that item of income multiplied by the minimum rate that the Contracting States have determined bilaterally for the purposes of the paragraph, and b) 60 per cent of the amount of tax that would be imposed on that item of income in the State of the enterprise if that permanent establishment were situated in that State.

166. The phrase “the amount of that item of income” refers to the amount of the relevant income after the deduction of all expenses relevant to that item of income that are deductible under the law of the relevant jurisdiction. Thus, for the purposes of determining the tax in the third jurisdiction that relates to that item of income, the overall tax applicable to the profits of the permanent establishment situated in that jurisdiction will first be computed after deducting all expenses that are deductible, in accordance with the law of that jurisdiction, in determining the taxable profits attributable to the permanent establishment. The tax that applies to the relevant amount of item of income would then be determined by multiplying that overall tax applicable to the profits of the permanent establishment by the ratio of the net amount of the item of income (i.e. the gross amount of the item of income less the deduction of the expenses

deducted in computing the taxable profits of the permanent establishment that relate specifically or proportionally to that item of income) to the taxable profits of the permanent establishment. A similar computation will be made for the purposes of determining the tax that would be imposed on that item of income in the Contracting State of the enterprise if the permanent establishment were situated in that State; in that case, the expenses that will be deducted are those that are deductible in accordance with the law of that State.

167. For the purposes of the exception included in subparagraph b), the reference to income that “emanates from, or is incidental to, the active conduct of a business” should be interpreted as indicated in paragraphs 74 to 76 above.

168. Instead of adopting the wording of paragraph 8**,** some States may prefer a more comprehensive solution that would not be restricted to situations where an enterprise of a Contracting State is exempt from tax, in that State, on the profits attributable to a permanent establishment situated in a third jurisdiction, that would not include the exception applicable to income that emanates from, or is incidental to, the active conduct of a business and that would not require an evaluation of the tax that would have been paid in the State of the enterprise if the permanent establishment had been situated in that State. In such a case, the rule would be applicable in any case where income derived from one Contracting State that is attributable to a permanent establishment situated in a third jurisdiction~~s~~ is subject to combined taxation, in the State of the enterprise and the jurisdiction of the permanent establishment, at an effective rate that is less than the lower of a rate to be determined bilaterally and 60 per cent of the general rate of corporate tax in the State of the enterprise. The following is an example of a rule that could be used for that purpose:

> Where an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats that income as profits attributable to a permanent establishment situated in a third jurisdiction, the benefits of this Convention shall not apply to that income if that income is subject to a combined aggregate effective rate of tax in the first-mentioned State and the jurisdiction in which the permanent establishment is situated that is less than the lesser of [*rate to be determined bilaterally*] or 60 per cent of the general statutory rate of company tax applicable in the first-mentioned State. If benefits under this Convention are denied pursuant to the preceding sentence with respect to an item of income derived by a resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by

such resident, such competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request."

PROPOSED CHANGE TO PARAGRAPH 71 OF THE OECD COMMENTARY TO ARTICLE 24, WHICH IS QUOTED IN THE UN COMMENTARY TO THAT ARTICLE:

Background: Paragraph 71 of the OECD Commentary to Article 24 contemplates the abusive situation that paragraph 8 of the new Article 29 expressly deals with. The change below coordinates the non-discrimination Commentary with the relevant part of new Article 29:

71. Where a permanent establishment situated in a Contracting State of an enterprise resident of another Contracting State (the State of residence) receives dividends, interest or royalties from a third State (the State of source) and, according to the procedure agreed to between the State of residence and the State of source, a certificate of domicile is requested by the State of source for the application of the withholding tax at the rate provided for in the convention between the State of source and the State of residence, this certificate must be issued by the latter State. While this procedure may be useful where the State of residence employs the credit method, it seems to serve no purposes where that State uses the exemption method as the income from the third State is not liable to tax in the State of residence of the enterprise. On the other hand, the State in which the permanent establishment is located could benefit from being involved in the certification procedure as this procedure would provide useful information for audit purposes. Another question that arises with triangular cases is that of abuses. ***For example, if a Contracting State applies the exemption method of Article 23 A to the profits attributable to a permanent establishment situated in a third State which does not tax passive income that arises in the other Contracting State but that is attributable to such permanent establishment, there is risk that such income might not be taxed in any of the three States. Paragraph 8 of Article 29 addresses this issue.*** ~~If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be~~

~~included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment.~~