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OECD

Conflicts Seen Between Text, Commentary in OECD Super-Treaty

By Kevin A. Bell

The world of tax treaty interpretation—in complexity akin to nephrology—requires unraveling a critical question to determine whether multinational companies are entitled to benefits under the OECD's super-treaty: How does the treaty apply when a country signs up for only one type of substance test and the treaty commentary is written in terms of another type?

Article 7 of the Organization for Economic Cooperation and Development's ground-breaking multilateral instrument (MLI), designed to enable multiple changes to the global tax system to be adopted at once, generally would allow governments to deny treaty benefits to companies under two types of provisions. The principal purpose test (PPT) would deny benefits when the main purpose of a transaction is tax avoidance, and a limitation-on-benefits (LOB) provision would allow or deny them based on a list of qualifying factors, such as the entity's legal nature and ownership, and the general activities of residents in a jurisdiction.

Article 7(1) of the MLI defines the PPT, while the commentary to Article 7(1) refers to a definition in Article 7(8) through 7(13), where the simplified LOB provision is set forth, to explain which companies are entitled to treaty benefits. One aspect of the commentary is a reference to a "qualified person"—a concept that arises under LOB provisions but not a PPT.

Steve Towers of Deloitte LLP's Singapore office said most countries planning to sign on to the MLI are likely to adopt a PPT but not an LOB provision; he and others called for a clarification on how the commentary applies to treaties that don't contain an LOB article. However, a former OECD official told Bloomberg BNA that no change to the commentary is needed.

Snapshot

- Treaty allows countries to adopt either "principal purpose test" for substance or more quantitative "limitation on benefits" provision—or both
- Commentary refers to LOB, contemplating treaties with both provisions, when countries have option of adopting only PPT
- Countries to sign on to various treaty provisions June 7 in Paris

Four Options

The MLI adopts various recommendations from the OECD's sweeping project to rewrite the global tax rules, on which most of the work was completed in October 2015. The super-treaty incorporates findings from the report on Action 6, the action devoted to preventing treaty abuse, which recommends countries implement one of four options:

- a PPT only;
- a PPT and a simplified LOB;
- a PPT and a detailed LOB provision; or
- a detailed LOB provision, supplemented by a mechanism that would deal with conduit arrangements not already dealt with in tax treaties.

Marlies de Ruiter, the former head of the OECD's division on tax treaties, transfer pricing and financial transactions, told Bloomberg BNA May 23 that it isn't necessary to change the OECD's commentary to Article 7 to address a treaty that incorporates only the PPT.

The commentary should be read in the context of the reservations that countries will be making to the MLI, said de Ruiter, who led the organization's BEPS work on tax treaties, including the final report on Action 6. She is now a partner with Ernst & Young Belastingadviseurs LLP in Rotterdam, Netherlands.

Two other former OECD officials—Jesse Eggert and Michael Plowgian, now principals in the international tax group of the Washington National Tax practice of KPMG LLP—noted that the commentary was drafted in light of an earlier version of the Action 6 guidance that contemplated both a PPT and an LOB provision. Eggert led the OECD's negotiations among more than 100 jurisdictions to develop the MLI and Plowgian was a senior adviser on the BEPS project.

Interpretation Issue

Under the PPT as described in Article 7(1) of the MLI, a treaty benefit won't be granted to a company if it is reasonable to conclude, in light of 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."

The recommended commentary on the PPT appears in the final report under BEPS Action 6 released in October 2015.

Towers pointed out that paragraph 5 of the commentary on Article 7 states that the PPT shouldn't be applied in isolation but rather in the context of the LOB provision also contained in the final Action 6 report.

An example in the paragraph involves a public company, whose shares are regularly traded on a recognized stock exchange in the contracting state of which the company is a resident, that derives income from another other contracting state.

Speaking on a Dbriefs Bytes broadcast May 19, Towers said paragraph 5 provides that as long as the company is a "qualified person" as defined in paragraph 2 of the LOB article of the MLI, it is clear that the benefits of the treaty shouldn't be denied solely on the basis of the ownership structure of that company—for example, because a majority of the shareholders aren't residents of the same state.

According to paragraph 5, the object and purpose of subparagraph 2(c) of the LOB article is to establish a threshold for the treaty entitlement of public companies whose shares are held by residents of different contracting states.

"This viewpoint will need to be revised for the many treaties where the PPT only option is followed," Towers said. "If there is no LOB provision in the treaty then it can't provide context for the application of the PPT."

Commentary Structure

The final report on Action 6 includes a combination of an LOB rule and a PPT, de Ruiter noted. "However, it is also recognized that alternatively countries may make a different choice and then are still able to meet the minimum standard," she added.

According to de Ruiter:

- paragraphs 3 to 5 of the commentary on the PPT assume that countries will adopt both provisions;
- paragraph 3 indicates that the PPT supplements and doesn't restrict the LOB provision;
- paragraph 4 indicates that if a company satisfies the LOB provision, it can still be denied a treaty benefit for a specific transaction under the PPT; and
- paragraph 5 indicates that if the PPT is applied, the "object and purpose" of the other provisions in the treaty, including the LOB provision, should be taken into account, and this is illustrated through an example on the object and purpose of the LOB provision.

PPT Only

De Ruiter said that when a treaty doesn't include an LOB provision, "it means that you still need to test the PPT to take account of the object and purpose of the other provisions of the treaty. But of course this does not relate to the LOB provision because it is not part of that specific treaty."

Paragraph 5 remains relevant, but the illustration in relation to the LOB doesn't reflect the situation for that specific treaty, de Ruiter said. "However, other examples can be found for such situations," she said. "If it was clear during the treaty negotiations that a country has a participation exemption and the withholding tax on dividends is lowered under the treaty, such a treaty benefit cannot be denied solely on the basis that the income is not taxed based on the participation exemption." Therefore, paragraph 5 is relevant for the situation, the former official said.

"In my opinion it is not necessary to change the commentary or the conclusions of the Action 6 final report," de Ruiter said. "The best approach is to take the most extensive treaty option as a starting point and then allow

countries to reserve on certain parts, which would result in the commentary on these parts not being relevant to them."

'A Fine Line'

Plowgian said the commentary presumably was drafted in light of the original recommendation for treaties to include both a PPT and an LOB provision. "If a treaty includes only a PPT, the references to paragraphs 1 to 6 and 'qualified person' do not make much sense, although the concept of reading the PPT in the context of the entire treaty remains a crucial concept," he told Bloomberg BNA in an email May 23.

Eggert told Bloomberg BNA that "as far as I am aware, the plan is still that after the next update, both a PPT and an LOB will be included in the text" of the OECD Model Tax Convention. Because the model is expected to include both provisions side by side—even though countries have the option to include only one of the two if they prefer—it was necessary for the commentary language to address the interaction between the two, he said in a May 23 email to Bloomberg BNA.

The countries "had a bit of a fine line to walk" in developing the recommendations under Action 6, Eggert said. They said up front that the PPT didn't restrict in any way the scope of the LOB—and vice versa—but also said that the PPT had to be read in the context of the rest of the treaty including the simplified LOB.

"That tension would have made it challenging to then say explicitly that the interpretation of the PPT would differ depending on whether the treaty included the LOB," he said.

More Guidance?

Paragraph 5 of the commentary as laid out in the OECD final Action 6 report is fully relevant only where there is a detailed LOB provision in the operative treaty, said John P. Warner, a partner at Buchanan Ingersoll & Rooney PC in Washington. "The examples in the proposed commentary involve a company whose shares are publicly traded on an established securities market in one of the contracting states, so it is a 'qualified person' within the meaning of Article X, paragraph 2 c) of the treaty, that earns income in the other contracting state," he told Bloomberg BNA in a May 23 email.

Therefore, if the actual treaty doesn't have an LOB provision and therefore doesn't have the concept of a "qualified person," but merely has a general PPT provision, the examples would be irrelevant, Warner said. "Presumably, the commentary in that instance should provide an example of some other tax structuring that was undertaken with a principal purpose of ensuring literal treaty coverage for a given transaction or arrangement, which coverage in that circumstance is—or is not—within the object and purpose of providing such coverage."

Carol Doran Klein, vice president and international tax counsel at the United States Council for International Business said that if she were interpreting a tax treaty with only the PPT, "then I would simply ignore paragraph 5 because it is not relevant."

Most Countries Will Opt for PPT Only: Towers

Most of the countries signing on to the MLI June 7 in Paris are expected to agree to a PPT and the OECD expects at least 60 jurisdictions will sign the treaty. The U.S., which doesn't plan to sign the treaty, has adopted an LOB provision in its tax treaties.

"The word on the street is that the overwhelming majority of the signing jurisdictions will choose the 'PPT only' option to satisfy their Action 6 minimum standard obligation," Towers said.

De Ruiter said she assumes "PPT only" countries will reserve on the LOB. "Depending on these choices, the commentary needs to be read in this context," she said.

"Even though I do not expect many countries to combine the LOB with a PPT, there will definitely be some doing so," de Ruiter said. For those countries, the guidance in the final report is relevant, and "there would be a gap if this guidance was not included."

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