Robert J. Danon*

# The PPT in Post-BEPS Tax Treaty Law: It Is a GAAR but Just a GAAR!

**In this article, the author discusses the principal purpose test (PPT) included in article 29 of the OECD and UN Models (2017), arguing in particular that while the PPT certainly permits a purposive interpretation, it may not be used to build into tax treaty law additional requirements that were never intended. Finally, the author concludes by looking at the other side of the coin and wonders whether a comparable "PPT" should not regulate the performance by States of their treaty obligations.**

## 1. Introduction

The principal purpose test (PPT), which has been incorporated into the OECD Model (2017)[1] and the UN Model (2017),[2] today represents the minimum multilateral standard to combat tax treaty abuse. While the PPT is not entirely new and to a large extent codifies the so-called "guiding principle" introduced in the Commentary on Article 1 of the OECD Model (2003),[3] it is, however, fair to say that it has caused a significant degree of anxiety among taxpayers. For tax administrations as well, the PPT may seem difficult to apply and further guidance would be welcome.[4]

Arguably, the problem lies first of all in the fact that the PPT is by essence vague. How should "one of the principal purposes of any arrangement or transaction" be understood? And when is the granting of treaty benefits "in accordance with the object and purpose of the relevant provisions of this Convention"? What is the difference between taking into account the "object and purpose of the relevant provisions" under article 29(9) of the OECD Model (2017) and a proper interpretation of treaty law in accordance with article 31 of the Vienna Convention on the Law of Treaties (the "Vienna Convention") (1969)?[5] But these questions alone do not explain the uncertainty surrounding the PPT. After all, general anti-avoidance rules (GAARs) drafted along the lines of the PPT are well-known both in domestic and tax treaty practice. In the author's opinion, the source of the confusion is also due to the fact that the PPT is part of a holistic project – the OECD/G20 Base Erosion and Profit Shifting (BEPS) initiative – founded on common pillars: coherence, substance and transparency. Naturally, therefore, the relevance of other BEPS Action items for purposes of interpreting the PPT arises. The commentaries on the PPT also fuel this controversy by referring, inter alia, to notions that seemed to be inspired from transfer pricing principles. These references have, therefore, prompted certain commentators to question whether a link should for instance be established between the PPT and BEPS Actions 8-10 relating to the alignment of transfer pricing outcomes with value creation.[6] One could even wonder if, more generally, the PPT should not serve to ensure an allocation of taxing rights between the Contracting States that is in line with an overriding concept of value creation governing the entire BEPS initiative.[7] From there, of course, very practical questions emerge: can a holding company, a special purpose vehicle (SPV), a financing or a royalty company still qualify for treaty benefits under the PPT standard? How relevant is the need to centralize functions in one single entity? And what if, for example, in the case of a royalty structure, a full centralization may

* **Professor of Law, Director of the Tax Policy Center of the University of Lausanne (Switzerland) and Chairman of the Permanent Scientific Committee of the International Fiscal Association (IFA), and Partner, Danon, Lausanne.** **The author would like to thank Mr Benjamin Malek and Mrs Ariene Reis, associates at the Tax Policy Center of the University of Lausanne, for their research and editorial help in preparing this contribution. A draft of this article was presented at the interdisciplinary conference "Tax Treaty Interpretation after BEPS" held in Lausanne from 19 to 20 December 2019 and organized by the Max Planck Institute for Tax Law and Public Finance and the Tax Policy Center of the University of Lausanne.** **The author can be contacted at robert.danon@danonlaw.ch.**

1. *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Treaties & Models IBFD.
2. *UN Model Double Taxation Convention between Developed and Developing Countries* (1 Jan. 2017), Treaties & Models IBFD.
3. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 9.5 ad art. 1 (28 Jan. 2003), Treaties & Models IBFD.
4. The relation between the PPT and tax certainty is mentioned in the International Monetary Fund (IMF)/OECD, *Report for the G20 Finance Ministers and Central Bank Governors: Update on Tax Certainty* para. 2.1.2., p. 12 (IMF/OECD July 2018), available at www.oecd.org/ctp/tax-policy/tax-certainty-update-oecd-imf-report-g20-finance-ministers-july-2018.pdf: "The implementation of PPT rules in bilateral treaties, while effective in reducing aggressive tax planning, is perceived as potentially increasing tax uncertainty. Various stakeholders have in fact expressed concerns on the implementation of the PPT. These concerns are expressed notwithstanding the extensive work already carried on by the OECD on tax conventions and related questions on the development on Commentary on the application of the PPT or on the work carried on the possible inadvertent effects of the PPT on the treaty entitlement of non-collective investment vehicles (CIVs) funds. To increase tax certainty in the application of the PPT, the OECD has formed an informal group of interested delegates that would explore various areas where more tax certainty could be provided in the PPT, including best practices in the area of the general anti-avoidance rules and would report back with recommendation." Presumably, much progress was not made on this front because of the ongoing full attention on the digital economy debate.
5. *UN Vienna Convention on the Law of Treaties* (23 May 1969), Treaties & Models IBFD [hereinafter the *Vienna Convention* (1969)].
6. OECD/G20, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Report* (OECD 2015), Primary Sources IBFD.
7. *See*, for example, A.J. Martín Jiménez, *Tax Avoidance and Aggressive Tax Planning as an International Standard – BEPS and the "New" Standards of (Legal and Illegal) Tax Avoidance*, in *Tax Avoidance Revisited in the EU BEPS Context* p. 25 et seq. (A.P. Dourado ed., IBFD 2017), Books IBFD.



© IBFD

not be fully accomplished due to the past acquisition of certain entities, or simply for regional considerations?

Significant scholarly attention has already been devoted to the PPT[8] and the author has also expressed his views in earlier publications.[9] Therefore, the present contribution does not aim at revisiting the topic exhaustively.[10] Rather, the author wishes simply to clear up at least some of the foregoing confusion. To that end, this article begins with general considerations on the problem of improper use of tax treaties. The problem is discussed from both a technical and policy perspective (*see* section 2.1.). Next, we turn to the main roots and traditional policy responses to the improper use of tax treaties (*see* section 2.2.). For purposes of our discussion, we shall, in particular, highlight that the BEPS initiative has not altered the fundamental architecture of treaty law. Specifically, source countries remain vulnerable to treaty shopping because the notion of treaty residence in article 4 of the OECD Model continues to incorporate a "weak" nexus test that makes it, as a matter of principle, possible for an entity to claim treaty benefits as soon as it is incorporated in a Contracting State and liable to tax therein on an unlimited basis. Whether this is a desirable policy is not the subject of the present contribution. However, this article will argue that the unchanged structure of the OECD Model and UN Model and the roots of treaty shopping associated thereto are important considerations to take into account when testing the limits of the PPT.

Having set the scene, we turn to the PPT and look at what it can accomplish and what it cannot do (*see* section 3.). In essence, this contribution will submit that once it is established that the subjective element of the PPT is satisfied, i.e. it is reasonable to conclude that one of the main purposes of the arrangement was to claim the relevant treaty benefit, the decision to grant or deny treaty benefits on the basis of the "object and purpose of the relevant provisions" certainly permits a purposive interpretation. Such purposive interpretation is different than the one ordinarily conducted under article 31 of the Vienna Convention (1969) in that the former does not find its limits in the clear wording of the treaty. However, even the purposive interpretation dictated by the PPT may not be used to build into treaty law requirements that were never intended, for example incorporating additional nexus requirements into article 4 of the OECD Model. On this point, the findings of the Canadian Federal Court of Appeal (CFCA) in the recently decided case of *Alta Energy* (2020)[11] must be approved and the references made, for example, by the Commentaries on the OECD Model (2017)[12] to economic substance cannot be understood as additional requirements to be met to access treaty benefits. From a policy perspective, one may argue that this outcome is not satisfying because it limits the impact of the PPT. However, it also serves as a reminder of the fact that addressing the roots of the problem of treaty shopping efficiently would probably require a more fundamental reform. In other words, the PPT is a GAAR, but just a GAAR.

Finally, the author concludes by looking at the other side of the coin and raises one question: would it be appropriate to develop a rule comparable to the PPT to regulate the performance by States of their treaty obligations? (*see* section 4.).

## 2. General Considerations on the Problem of Improper Use of Tax Treaties

### 2.1. Improper use of tax treaties versus treaty shopping

#### *2.1.1. Technical perspective*

The phenomenon of the improper use of tax treaties, which primarily affects the State of source, is well-known. A section thereupon was for the first time included in the Commentary on Article 1 of the OECD Model (1977).[13] As described in 1987 by the UN Ad Hoc Group of Experts:

> the term "abuse of tax treaties" may be defined loosely as the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits the treaties were not designed to give them.[14]

Another way of looking at the problem is to connect the improper use of tax treaties to their proper use. This connection became stronger as the Commentaries on the

8. *See*, among others, A. Baez Moreno, *GAARs and Treaties: From the guiding principle to the Principal Purpose Test. What Have We Gained from BEPS Action 6*, 45 Intertax 6/7, pp. 432-446 (2017); V. Chand, *The Principal Purpose Test in the Multilateral Convention: An In Depth Analysis*, 46 Intertax 1, pp. 18-44 (2018) and *The Interaction of the Principal Purpose Test (and the Guiding Principle) with Treaty and Domestic Anti-Avoidance Rules*, 46 Intertax 2, pp. 115-123 (2018); L. De Broe, *BEPS Action 6: Tax Treaty Abuse*, 43 Intertax, 2, pp. 122-146 (2015) and *Tax Treaty and EU Law aspects of the LOB and PPT provision proposed by BEPS action 6*, in *Base Erosion and Profit Shifting (BEPS) – Impact for European and international tax policy*, Tax Policy Series, p. 213 (R.J. Danon ed., Inst. Tax L. 2016); D.G. Duff, *Tax Treaty Abuse and the Principal Purpose Test – Part I and II*, 66 Can. Tax J. 3/4 (2018); C. Elliffe, *The Meaning of the Principal Purpose Test: One Ring to Bind Them All?*, 11 World Tax J. 1 (2019), Journal Articles & Papers IBFD; B. Kuźniacki, *The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application*, 10 World Tax J. 2 (2018), Journal Articles & Papers IBFD; M. Lang, *BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties*, 74 Tax Notes Intl. 7, p. 655 (19 May 2014); and S. van Weeghel, *A Deconstruction of the Principal Purposes Test*, 11 World Tax J. 1 (2019), Journal Articles & Papers IBFD.
9. *See*, among others, R.J. Danon, *Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups*, 72 Bull. Intl. Taxn. 1 (2018), Journal Articles & Papers IBFD and *Intellectual Property (IP) Income and Tax Treaty Abuse: Relevance of BEPS Actions 5 and 8-10 for the Principal Purpose Test*, in *Taxation of Intellectual Property under Domestic Law, EU Law and Tax Treaties* (G. Maisto ed., IBFD 2018), Books IBFD; and R.J. Danon & H. Salome, *The BEPS Multilateral Instrument: General overview and focus on treaty abuse, IFF Forum für Steuerrecht*, pp. 197-246 (2017).
10. In particular, in order to keep the discussion within manageable proportions, the relation between the PPT and EU law will not be discussed here. On this latter point, *see*, in particular on this issue, W. Schön, *Interpreting European Law in the Light of the BEPS Action Plan*, Working Paper of the Max Planck Institute for Tax Law and Public Finance No. 2020-01 (21 Jan. 2020), available at http://dx.doi.org/10.2139/ssrn.3522962.
11. CA: CFCA, 12 Feb. 2020, *Alta Energy Luxembourg S.A.R.L. v. Her Majesty the Queen*, 2020 FCA 43, Case Law IBFD.
12. *OECD Model Tax Convention on Income and on Capital: Commentaries* (21 Nov. 2017), Treaties & Models IBFD.
13. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* (11 Apr. 1977), Treaties & Models IBFD.
14. United Nations Ad Hoc Group of Experts, *Contributions to international co-operation in tax matters: Treaty shopping, Thin capitalization, Co-operation between tax authorities, Resolving international tax disputes*, para. 8 (1988).

OECD Model were updated over the years. The Commentary on Article 1 of the OECD Model (1977) stated that:

> The purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons; they should not, however, help tax avoidance or evasion.[15]

As a result of the Commentary on Article 1 of the OECD Model (2003), the prevention of treaty abuse was elevated to "a purpose" of tax treaties as compared to their "principal purpose".[16] With the new preamble to the OECD Model (2017), the need to prevent tax treaty abuse now expressly serves as a limit to the positive objective of tax treaties, the Contracting States:

> intending to conclude a Convention for the elimination of double taxation... without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States).[17]

The introduction to the OECD Model (2017) now states that the elimination of international double taxation as well as the prevention of tax evasion and avoidance are "the main purposes"[18] of the OECD Model.

While the section of the Commentaries on the OECD Model dedicated to the improper use of tax treaties was gradually enriched over the years – notably in the Commentaries on Article 1 of the OECD Model (1992),[19] the OECD Model (2003)[20] and, of course, in the OECD Model (2017)[21] – the OECD Commentaries have consistently illustrated the notion of treaty shopping in the same fashion, noting that the problem arises:

> ... for example, if a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly. Another case would be an individual who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, and who, essentially in order to sell the shares and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 5 of Article 13), transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax.[22]

This passage of the OECD Commentary on Article 1 (2017) illustrates the two main forms of treaty shopping, namely so-called conduit cases and abusive restructurings (*see* sections 2.2.2. and 2.2.3.). However, as the OECD Commentary on Article 1 (2017) indicates ("whether or not a resident of a Contracting State"),[23] treaty shopping may also concern residents of a Contracting State. This is, for instance, the case in so-called "round-tripping" structures in which income arising in one Contracting State is artificially shifted to an entity interposed in the other Contracting State and then transferred back to resident investors of the first Contracting State. An intermediary situation, which is the one mentioned in the foregoing passage of the OECD Commentary on Article 1 (2017), is the one in which the taxpayer and his investment originate from the same State, but the taxpayer transfers his residence in the other Contracting State to avoid taxation in his initial State of residence (now the State of source for tax treaty purposes).

15. Para. 7, ad art. 1 *OECD Model: Commentary on Article 1* (1977).
16. Para. 7, ad art. 1 *OECD Model: Commentary on Article 1* (2003): "The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion".
17. Preamble, *OECD Model* (2017).
18. Para. 3, Introduction *OECD Model* (2017). In passing, the author would note that the introduction to the *OECD Model* (2017) still erroneously suggests that the application of tax treaties is limited to international juridical double taxation: "International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods". As argued elsewhere, tax treaties merely allocate taxing jurisdictions between the Contracting States. For the purposes of their application, therefore, it is irrelevant whether a particular item of income is taxed in the hands of the same taxpayer or during an identical period. This is now expressly recognized by art. 1(2) *OECD Model* (2017), which, in line with OECD, *The Application of the OECD Model Tax Convention to Partnerships – Report: adopted on 20 January 1999* (OECD 1999), Primary Sources IBFD, permits the granting of treaty benefits where, for domestic tax purposes, income is allocated to different taxpayers in case of hybrid arrangements. Likewise, the *OECD Model: Commentary on Article 23A and B* (2017) confirms that relief must be given by the State of residence even where the income is not allocated to the same person under domestic law or taxed during the same period (timing mismatch, *see*, on this latter point, *OECD Model: Commentary on Article 23 A and B*, para. 32.8 (2017). For a critical discussion of the views discussed herein, *see* R.J. Danon & H. Salome, *De la double imposition internationale*, 73 Archives de droit fiscal suisse (ASA) 6/7, pp. 337-390. *See also* K. Vogel (2008), *Introduction*, in *Doppelbesteuerungsabkommen* [*Double Taxation Agreements*] p. 118, No. 5 (5th ed., K. Vogel & M. Lehner eds. DBA 2008): "*Für die Anwendung der Doppelbesteuerungsabkommen kommt es aber nur auf die Auslegung der jeweiligen Abkommensvorschriften an.... Was Doppelbesteuerung begrifflich ist, ist für die Abkommensanwendung nicht von Bedeutung*".
19. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* (1 Sept. 1992), Treaties & Models IBFD.
20. Para. 7 et seq. *OECD Model: Commentary on Article 1* (2003).
21. Para. 54 et seq. *OECD Model: Commentary on Article 1* (2017).
22. Para. 56, ad art. 1 *OECD Model: Commentary on Article 1* (2017). Up to *OECD Model: Commentary on Article 1* (2017), there was a close connection between the improper use of tax treaties and the use of "*artificial legal constructions*". *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 8, ad art. 1 (26 July 2014), Treaties & Models IBFD provided that: "It is also important to note that the extension of double taxation conventions increases the risk of abuse by facilitating the use of artificial legal constructions aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in double taxation conventions". Para. 55 ad art. 1 *OECD Model: Commentary on Article 1* (2017), no longer makes reference to this notion but simply states that: "The extension of the network of tax conventions increases the risk of abuse by facilitating the use of arrangements aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in these conventions". Certain scholars have, therefore, questioned whether this marks an intention to expand the notion of improper use of tax treaties (*see*, for example, Van Weeghel, *supra* n. 8, at sec. 2.). In the author's view, this change is of little relevance as in the pre-BEPS era the question may not be answered *in abstracto*, but depends, rather, on the standard being applied to combat what is perceived as improper treaty application.
23. Para. 56, ad art. 1 *OECD Model: Commentary on Article 1* (2017). *See also* the decision of the US District Court for the District of Columbia (USDC): [14 Aug. 2017], *Starr International Co Inc v. United States of America; United States of America v. Starr International Co Inc*, 20 ITLR 94, 116: "treaty shopping does frequently involve the participation of a third-country resident, but it needs not. Rather, its essential characteristic is treaty abuse—manipulating on-paper residency for the purpose of obtaining treaty benefits".



© IBFD

### 2.1.2. Policy perspective

This being said, there is also a strong policy dimension to the problem of treaty abuse. The Commentaries on the OECD Model have certainly consistently indicated that tax treaty abuse is considered inappropriate for two main reasons. First, tax treaty benefits negotiated between the Contracting States are extended to persons resident in a third country in a way unintended by these jurisdictions.[24] As a result, the principle of reciprocity is breached and the balance of the tax treaty disturbed. Second, the State of residence of the ultimate income beneficiary has little incentive to enter into a tax treaty with the source country because its residents can indirectly receive tax treaty benefits from the source State without the need for the country of residence to provide reciprocal benefits.[25]

However, an important question immediately emerges. Should any form of treaty shopping always be regarded as an improper of use of a tax treaty? Leaving aside technical questions, i.e. in particular whether the applicable tax treaty incorporates a limitation on benefits (LOB) provision, in policy terms the question is whether treaty shopping is always "bad"? The author would argue that the answer is certainly affirmative in classical round-tripping or circular cases. In *Vodafone* (2012), for example, the Indian Supreme Court (ISC) noted that: "if a structure is used for circular trading or round tripping then such transactions, though having a legal form, should be discarded by applying the test of fiscal nullity".[26] Similarly, in *Verdannet* (2017), the French *Conseil d'État* (Supreme Administrative Court, CE) considered that the:

> the primary function of these treaties, beyond this immediate purpose, is to facilitate international economic exchanges.... It is, therefore, part of their very logic that they be read as not intending to apply to taxpayers who artificially create the conditions of foreignness allowing them to claim, according to a literal interpretation, the benefit of their clauses.[27]

In these instances, it is easy to say that the objectives of tax treaties are defeated. The revenue losses borne by a Contracting State are not even compensated by a genuine increase in foreign direct investment. Probably, the same conclusion could be taken where, as mentioned by the Commentary on Article 1 of the OECD Model (2017), the taxpayer and his investment originate from the State of source, but the taxpayer transfers his residence in the other Contracting State to escape taxation in his initial State of residence.[28]

More delicate, by contrast, are situations in which an entity is interposed in an intermediary jurisdiction with a view to allow a foreign enterprise to genuinely make a new investment in the source country, but that the sole reason (or at least a principal purpose) for the interposition of such entity is to obtain treaty benefits that would otherwise not have been available (at least not to the same extent). *Azadi Bachao Andolan* (2003)[29] is a good illustration of this position. In this case, the ISC favoured a liberal approach to treaty shopping putting forward in particular that it may serve as a "tax incentive to attract scarce foreign capital or technology".[30] Of course, where two Contracting States model their tax treaty on the OECD Model, it is arguable that the expectations and policy objectives of these States should be consistent with the principles by its Commentaries on the OECD Model.[31] However, as the introduction to the OECD Model (2017) now expressly recognizes:

> the question of whether or not to enter into a tax treaty with another country is for each State to decide on the basis of different factors, which include both tax and non-tax considerations.

In the end, therefore, what constitutes an improper of a tax treaty will also strongly depend on the policy objectives pursued by the Contracting States and the context in which such agreement was concluded. In this context, Rosenbloom (1983) noted that treaty abuse:

24. OECD, *Double Taxation Conventions and the Use of Conduit Companies*, in OECD, *Model Tax Convention on Income and on Capital: Full Version*, R(6), Vol. I and II, para. 7 (OECD 2010) [hereinafter OECD, *Conduit Report*].
25. Id.
26. IN: ISC, 20 Jan. 2012, *Vodafone International Holdings BV v. Union of India*, Civil Appeal No. of 2012 (arising out of S.L.P. (C) No. 26529 of 2010), para. 68, 14 ITLR 431, 451, Case Law IBFD.
27. FR: CE, 25 Oct. 2017, Case No. 396954, *Verdannet*, 20 ITLR 832, 872, Case Law IBFD.
28. Para. 56, ad art. 1 *OECD Model: Commentary on Article 1* (2017).
29. IN: ISC, 7 Oct. 2003, *Union of India and another v. Azadi Bachao Andolan and another*, 2003-(263)-ITR-0706-SC, 6 ITLR 233, Case Law IBFD.
30. Id., at p. 279: 'Many developed countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to a significant loss of tax revenues. Moreover, several of them allow the use of their treaty network to attract foreign enterprises and offshore activities. Some of them favour treaty shopping for outbound investment to reduce the foreign taxes of their tax residents but dislike their own loss of tax revenues on inbound investment or trade of non-residents. In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology. They are able to grant tax concessions exclusively to foreign investors over and above the domestic tax law provisions. In this respect, it does not differ much from other similar tax incentives given by them, such as tax holidays, grants, etc. … Developing countries need foreign investments, and the treaty shopping opportunities can be an additional factor to attract them. The use of Cyprus as a treaty haven has helped capital inflows into eastern Europe. Madeira (Portugal) is attractive for investments into the European Union. Singapore is developing itself as a base for investments in South East Asia and China. Mauritius today provides a suitable treaty conduit for South Asia and South Africa. In recent years, India has been the beneficiary of significant foreign funds through the 'Mauritius conduit'. Although the Indian economic reforms since 1991 permitted such capital transfers, the amount would have been much lower without the India-Mauritius tax treaty … Overall, countries need to take, and do take, a holistic view. The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy. Many of them do not appear to be too concerned unless the revenue losses are significant compared to the other tax and non-tax benefits from the treaty, or the treaty shopping leads to other tax abuses. …. There are many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long-term development. Deficit financing, for example, is one; treaty shopping, in our view, is another. Despite the sound and fury of the respondents over the so-called 'abuse' of 'treaty shopping', perhaps, it may have been intended at the time when the Indo-Mauritius DTAC was entered into. Whether it should continue, and, if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations. This court cannot judge the legality of treaty shopping merely because one section of thought considers it improper. A holistic view has to be taken to adjudge what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy.'
31. S. van Weeghel, *The Improper Use of Tax Treaties*, p. 117 (Kluwer 1998).

> is a heavily loaded term. Not only is it derogatory; it implies that the proper use of tax treaties can be identified. Yet differences over precisely that point lie at the heart of the current discussion. Because the term suggests that what is being discussed is a point of common understanding and agreement, when plainly it is not, the usefulness of the term is questionable.[32]

From this perspective, one could say that a distinction should be drawn between, on the one hand, securing the proper application of the treaty bargain and policy agreed between two States and, on the other, revising this policy.[33]

In the author's opinion, this observation continues to be valid even after the BEPS initiative. While the BEPS initiative has certainly entailed a stronger shift to fiscal multilateralism, this shift is, however, incapable of and does in fact not seriously intend to "switch off" the policy nuances which may exist between the members of the Inclusive Framework on BEPS. In fact, the peer reviewing of BEPS Action 6 relating to the prevention of treaty abuse naturally focuses only on the implementation of the minimum standards (in particular the PPT) as opposed to setting a substantive detailed distinction between what constitutes a proper and an improper application of a tax treaty.[34] On the other hand, the Commentary on Article 29 of the OECD Model (2017) certainly provides for a multilateral framework for the interpretation of the PPT which, as we have recognized, will contribute to avoid an arbitrary application of the new treaty GAAR.[35] But by providing that a treaty benefit may be granted where it is "established that granting that benefit... would be in accordance with the object and purpose of the relevant provisions of this Convention",[36] the PPT cannot be disconnected from the particular circumstances and policy objectives pursued by two Contracting States. This implicitly transpires in the Commentaries on the OECD Model. Indeed, in order to assess whether this condition is satisfied, the focus of the OECD Commentaries is generally on "the general objective of tax conventions [...] to encourage cross-border investment".[37] However, what constitutes a "significant level of existing or projected cross-border trade and investment"[38] is by essence for the Contracting States to decide and, if these circumstances change, the parties should seek to modify, replace or even terminate the relevant tax treaty.[39] In some other instances, the policy of a Contracting State may even be in a transitioning phase. The issue arose for instance in the Canadian case of *Prévost* (2008 and 2009).[40] While the interposition of an entity in the Netherlands had in this case increased possible tax treaty benefits, Canadian tax treaty policy was at the time in a transitional phase with the Canada-Sweden Income Tax Treaty (1996)[41] and the Canada-United Kingdom Income Tax Treaty (1978)[42] being renegotiated.[43]

Therefore, whether, in a given case, treaty benefits ought to be denied based on a proper interpretation or on the PPT, is an issue that cannot simply be assessed against an abstract multilateral benchmark, but must also take into account the intentions of the Contracting States to the extent that such understanding, of course, is not contradicted by the wording of their agreement.[44]

## 2.2. Main roots and traditional policy responses

### *2.2.1. Opening comments*

We now return to a more technical discussion and find it appropriate to dwell on the main roots of treaty shopping and the traditional possible policy responses to address this problem. The author distinguishes, on the one hand, (i) the problem linked to the treaty residence notion (*see* section 2.2.2.); and, on the other, (ii) selected difficulties caused by the distributive rules (*see* section 2.2.3.).

### *2.2.2. The nexus problem and the limits of the treaty residence notion*

As is well known, the notion of treaty residence is a fundamental condition to access tax treaty benefits. It determines the personal scope of tax treaties, solves cases where double taxation arises in consequence of double residence and constitutes a prerequisite to the application of the distributive rules that are aiming at eliminating double taxation between the State of residence and the State of source.[45] As already mentioned in section 1., the notion of treaty residence has not been revisited by the BEPS ini-

32. H.D. Rosenbloom, *Tax Treaty Abuse: Problems and Issues*, 15 L. & Policy Intl. Bus., p. 766 (1983).
33. *See*, for example, *Alta Energy* (2020), *supra* n. 11, at p. 238, para. 85: "When the Treaty was negotiated, the Canadian treaty negotiators were aware of the fact that Luxembourg allowed its resident to avoid Luxembourg income tax on gains arising from the sale of shares of foreign corporations in broad circumstances. In this light, if Canada wished to curtail the benefits of the Treaty to potential situations of double taxation, Canada could have insisted that the exemption provided for under art 13(5) be made available only in the circumstance where the capital gain was otherwise taxable in Luxembourg. Canada and Luxembourg did not choose this option. It is certainly not the role of the Court to disturb their bargain in this regard."
34. OECD/G20, *Prevention of Treaty Abuse – Peer Review Report on Treaty Shopping: Inclusive Framework on BEPS: Action 6* (OECD 2019).
35. Danon, *Treaty Abuse in the Post-BEPS World*, *supra* n. 9, at sec. 4.3.2.
36. Art. 29(9) *OECD Model* (2017).
37. *See*, for example, para. 182, Example C *OECD Model: Commentary on Article 29* (2017).
38. Para. 15.2, Introduction *OECD Model* (2017).
39. Id., at para. 15.1
40. *See* the decision of the Tax Court of Canada (TCC) in CA: TCC, 22 Apr. 2008, *Prévost Car Inc. v. Her Majesty the Queen*, 2004-2006(IT)G and 2004-4226(IT)G, 10 ITLR 736, Case Law IBFD and CA: CFCA, 26 Feb. 2009, *Prévost Car Inc. v. Her Majesty the Queen*, A-252-08, 11 ITLR 757, Case Law IBFD.
41. *Convention between Sweden and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (27 Aug. 1996), Treaties & Models IBFD.
42. *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains* (8 Sept. 1978) (as amended through 2003), Treaties & Models IBFD.
43. An exchange of e-mails between senior officials of the Canada Revenue Agency (CRA) and Finance Canada (FC), reproduced by Ward in a research report prepared for the Advisory Panel on Canada's System of International Taxation, provides in this respect that: "Given that we were negotiating with Sweden and UK at this time and our apparent willingness to provide the 5 percent rate as a matter of policy in any new treaty, I think it will be difficult for a court to smell the nastiness of this scheme by two multinationals resident in treaty countries, to avail themselves of the policy rate." (*See* D.A. Ward, *Access to Tax Treaty Benefits*, Research Report Prepared for the Advisory Panel on Canada's System of International Taxation, p. 47 (2008)).
44. Pursuant to art. 31(1) *Vienna Convention* (1969).
45. Para. 1, ad art. 4 *OECD Model: Commentary on Article 4* (2017).



© IBFD

tiative. Article 4 of the OECD Model continues to provide that:

> the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof.[46]

Therefore, predominance of residence over source taxation for tax treaty purposes may be achieved by the incorporation of an entity in a Contracting State as long as such incorporation triggers unlimited tax liability in such a State. Moreover, under the predominant interpretation which continues to be favoured by the Commentary on Article 4 of the OECD Model (2017), such liability does not require effective taxation in the State of residence.[47]

Because under the traditional interpretation of article 4 of the OECD Model, an entity is not required to have a significant nexus with the State of residence (apart from its incorporation therein),[48] it is obvious that the architecture of the OECD Model – again unmodified by the BEPS initiative – places the State of source in a rather vulnerable position and naturally increases the occurrence of treaty shopping situations.

The traditional policy response to this problem,[49] which has been championed and developed over the years by the United States, is the adoption of LOB clauses. These clauses, which have been incorporated in article 29(1)-(7) of the OECD Model (2017),[50] but which are not regarded as minimum standards, 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, while recognizing that, in some cases, persons who are not residents of a Contracting State may establish an entity in that State for legitimate business reasons.[51] Article 29(1) to (7) of the OECD Model (2017) are structured pretty much like their counterparts in the US Model (2016)[52] and are, in essence, based on the premise that certain (i) "qualified residents",[53] (ii) residents engaged in the active conduct of a business in the State of residence from which the relevant income emanates (or is incidental to)[54] and (iii) those resident entities owned by persons entitled to equivalent treaty benefits should be automatically accorded tax treaty protection.[55] However, because taxpayers may fail these rigid mechanical tests,[56] LOB clauses provide that the competent authority may still grant treaty benefits on a discretionary basis where it is established that the structure did not have as one of its principal purposes the obtaining of benefits under the tax treaty.[57]

In treaty practice, LOB clauses are often perceived as simply imposing requirements in addition to the residence test embodied in article 4 of the OECD Model.[58] Perhaps one of the explanations for this lies in the fact that, within the framework of LOB clauses, the discretionary relief founded on the PPT is often only applied when the taxpayer nearly qualifies under one or more of the objectives clauses.[59] However, from a policy and tax treaty law point of view, LOB clauses may not simply be regarded as elevating the threshold of treaty residence by requiring, for instance, a substantial nexus in the State of residence. If that were the case, it would be unnecessary for these clauses to be complemented by a PPT. Rather, LOB clauses rely on the existence of such nexus as a proxy to exclude the subjective intention of the taxpayer to abuse the tax treaty, which is facilitated by a weak residence test. In other words, LOB clauses do not interfere with the notion of treaty residence.[60]

A different approach, which has been recently advocated by certain commentators in an attempt to treat the root of the problem of treaty shopping, would involve by contrast modifying article 4 of the OECD Model to include a substantial nexus test. Recently, Gooijer (2019) has, for example, argued in favour of a modified version of article 4 of the OECD Model incorporating the permanent estab-

46. For a recent discussion of the history of treaty residence of entities, *see*, for example, J. Gooijer, *Tax Treaty Residence of Entities*, Kluwer Law International, Series on International Taxation, vol. 74 (Wolters Kluwer 2019); and E. Escribano, *Jurisdiction to Tax Corporate Income Pursuant to the Presumptive Benefit Principle*, Kluwer Law International, Series on International Taxation, vol. 70 (Wolters Kluwer 2019) and *Alternative Approaches to Address the (Yet to Be Defined) Treaty Shopping Phenomenon*, 47 Intertax 1, p. 938 et seq. (2019).
47. Para. 8.11, ad art. 4 *OECD Model: Commentary on Article 4* (2017).
48. *See* Escribano, *Treaty Shopping*, *supra* n. 46, at p. 938 for an alternative interpretation of art. 4 *OECD Model* (2017) *de lege lata*.
49. J. Bates et al., *Limitation on Benefits Articles in Income Tax Treaties: The Current State of Play*, 41 Intertax 6/7, p. 395 (2013), noting that: "The fundamental problem addressed by LOB provisions is that eligibility for tax treaty benefits traditionally has been based on the residence of the party claiming benefits, alone, leaving treaties vulnerable to abuse".
50. Art. 29(1)-(7) *OECD Model* (2107).
51. Para. 5, ad art. 29 *OECD Model: Commentary on Article 1* (2017).
52. *US Model Tax Convention on Income* art. 22 (17 Feb. 2016), Treaties & Models IBFD.
53. Arts. 29(2) and 5(5) *OECD Model* (2107).
54. Id., at art. 29(3).
55. Id., at art. 29(4).
56. *Starr International Co Inc v. United States of America; United States of America v. Starr International Co Inc* (2017), *supra* n. 23, at p. 101.
57. Para. 5, ad art. 29 *OECD Model: Commentary on Article 1* (2017) and art. 29(6) *OECD Model* (2017). *See also United States Model Income Tax Convention of September 20, 1996 Technical Explanation* ad art. 22 (20 Sept. 1996), Treaties & Models IBFD.
58. Bates et al., *supra* n. 49.
59. Escribano, *Treaty Shopping*, *supra* n. 46, at pp. 940-941. This is the so-called "near-miss" argument, which was put forward by the taxpayer to argue that the discretionary relief standard had been misapplied. *See Starr International Co Inc v. United States of America; United States of America v. Starr International Co Inc* (2017), *supra* n. 23, at p. 123: "After concluding that one of Starr's principal purposes for relocating to Switzerland was obtaining treaty benefits, the Competent Authority went on to state: 'Moreover, in our view, art 22(6) of the US-Swiss Treaty was designed to provide relief to a taxpayer that can make a strong case that, while coming within the spirit of an available [Limitation on Benefits] provision, it narrowly misses the mechanical tests associated with that provision'. A.R. 274. Starr notes that 'the US-Swiss Technical Explanation and the US-Swiss Treaty do not mention or suggest a "near miss" requirement', and that even if such a requirement existed, '[Starr] would satisfy it'. Pl.'s Cross-MSJ 48. As the Government explains, however, the Competent Authority in making this statement was likely responding to arguments that Starr itself had made during the review process. See Def.'s Reply 36. More to the point, the statement was made as an aside, after the Competent Authority had applied the 'principal purpose' standard in order to reach its determination. Whether the 'near-miss' concept accurately describes the scope of art 22(6) is therefore beside the point."
60. *Starr International Co Inc v. United States of America; United States of America v. Starr International Co Inc* (2017), *supra* n. 23, at p. 112.

lishment (PE) concept of article 5 of the OECD Model as a threshold for treaty residence in a Contracting State.[61]

Whether such a change in article 4 of the OECD Model would be appropriate is not for the present contribution to investigate. For the purposes of this discussion, a conclusion already emerges. Only an amendment to article 4 of the OECD Model may effectively increase the threshold to access tax treaty benefits. By contrast, an additional objective substantial nexus requirement may not be built into current tax treaties via their interpretation or the PPT or even LOB clauses. Rather, as we shall see, the purpose of tax treaty interpretation and the PPT is only to determine whether the granting of treaty benefits in a given case is in accordance with the object and purpose of the tax treaty as a whole,[62] respectively with "the object and purpose of the relevant provisions of the Convention".[63]

In light of the foregoing, a relevant consideration to be taken into account when exploring the boundaries of the PPT will be to carefully distinguish on the one hand – in particular in the framework of its objective component – the need to take into account the "object and purpose of the relevant provisions of the Convention" and, on the other, the threshold of treaty residence which the PPT or the LOB clauses may not modify.

### 2.2.3. *Selected difficulties caused by the distributive rules*

#### 2.2.3.1. *Initial remarks*

Moving to the distributive rules and to keep the discussion within manageable proportions, we shall here concentrate on two classical cases of treaty shopping, namely (i) conduit cases (*see* section 2.2.3.2.); and (ii) so-called "last minute" restructurings (*see* section 2.2.3.3.).

#### 2.2.3.2. *Conduit cases*

A well-known incarnation of treaty shopping are cases involving the channelling of income by an entity interposed in the State of residence to other persons, whether or not resident in a Contracting State. The problem was for the first time extensively discussed in the 1986 OECD Conduit Report. The report draws a distinction between so-called "direct conduit" and "stepping-stone" structures.[64] A direct conduit situation occurs where, in essence, the income (typically dividends, interest or royalties) received by an entity interposed by a non-resident in the State of residence is immediately and (almost) entirely distributed in the form of dividends[65] to non-residents not entitled to similar tax treaty benefits.[66] By contrast, stepping stone structures refer to cases in which the entity interposed in the State of residence is under the obligation to pass on the treaty-favoured income it receives to a non-resident through deductible expenses[67] (management fees, interest, royalties, etc.), eroding its taxable basis and usually giving rise to no withholding tax.[68] A classic example of stepping stone strategies is a back-to-back arrangement involving two mirror loans and corresponding interest payments.[69]

In its recent decisions on directive shopping, the Court of Justice of the European Union (ECJ or CJEU) held, very much in line with the 1986 OECD Conduit Report, that an indicator of the existence of a direct conduit arrangement was the fact that the interposed entity receives dividends which "very soon after their receipt" are passed on to its shareholders.[70] A similar conclusion was drawn by the ECJ in relation to a stepping structure involving a classical back-to-back loan:

> The fact that a company acts as a conduit company may be established where its sole activity is the receipt of interest and its transmission to the beneficial owner or to other conduit companies.[71]

Technically, conduit cases do not involve an improper use of treaty residence under article 4 of the OECD Model.[72] For example, a large resident financial institution – even having a significant presence in the State of residence – may act as a conduit company and, conversely, this may not be the case of a holding company having a very limited organizational structure.[73] Indeed, the problems relates

61. Gooijer, *supra* n. 46, at p. 237 et seq., in particular pp. 253-257. *See also* generally on the need to reshape the residence test, Escribano, *Jurisdiction to tax Corporate Income*, *supra* n. 46, at p. 96 et seq.
62. Art. 31(1) *Vienna Convention* (1969).
63. With regard to the difference between the interpretation of the treaty in light of its object and purpose pursuant to art. 31(1) *Vienna Convention* (1969) and the object and purpose of the relevant provisions of the Convention, as per art. 29(9) *OECD Model* (2017), *see* sec. 3.2.3.
64. For a detailed discussion of these notions, *see*, in particular, Van Weeghel, *supra* n. 31, at p. 119 et seq. and L. De Broe, *International Tax Planning and Prevention of Abuse* p. 5 et seq. (IBFD 2008), Books IBFD.
65. These dividends would typically not be subject to a domestic withholding tax in the State of residence of the intermediary entity.
66. *See* OECD, *Conduit Report*, *supra* n. 24, at N 4, pp. 3-4. The main signs of a conduit arrangement include: (i) the interposition of an entity in a Contracting State by a resident of a third State; (ii) the transfer of assets and rights to such entity with a view to take advantage of the tax treaty concluded with the State of source; (iii) the immediate redistribution, in the form of dividends, of the treaty-protected income to a resident of a third State; and (iv) the absence of withholding tax on these distributions according to the laws of the Contracting State in which the conduit entity is a resident. *See* thereupon De Broe, *supra* n. 64, at sec. p. 14 et seq.
67. OECD, *Conduit Report*, *supra* n. 24, at N 6, p. 4: "The situation is the same … However, the company resident of State A is fully subject to tax in that country. It pays high interest, commissions, service fees and similar expenses to a second related 'conduit company' set up in State D. These payments are deductible in State A and tax-exempt in State D where the company enjoys a special tax regime".
68. OECD, *Conduit Report*, *supra* n. 24, at N 5 and R.J. Danon, *Le concept de bénéficiaire effectif dans le cadre du MC OCDE under the OECD Model Convention, IFF Forum für Steuerrecht*, p. 38 et seq. (2007).
69. OECD, *Conduit Report*, *supra* n. 24, at N 4.
70. DK: ECJ, 26 Feb. 2019, Case C-116/16, *Skatteministeriet v. T Danmark*, para. 101, Case Law IBFD.
71. DK: ECJ, 26 Feb. 2019, Case C-115/16, *N Luxembourg 1 v. Skatteministeriet*, para. 131, Case Law IBFD.
72. This distinction is however not always rigorously made by courts. For example, in its recent decisions in the Danish cases, the ECJ relies on criteria which could be interpreted as pointing to the degree of nexus that an intermediary entity has with a State, for example, the references to the availability of premises and equipment (*T Danmark* (C-116/16), para. 104), while others, by contrast, refer to the manner in which the entity derives its income and passes it on to related entities in the group, for example, the reference to the fact that the dividends are passed on very soon after their receipt and indications of an artificial arrangement may also be constituted by the various contracts existing between the companies involved in the financial transactions at issue, giving rise to intra-group flows of funds (*N Luxembourg 1* (C-115/16), para. 132.
73. *See* DE: ECJ, 20 Dec. 2017, Case C-504/16, *Deister Holding* para. 73, Case Law IBFD: "The fact that the economic activity of a non-resident

 © IBFD

exclusively to the distributive rules – specifically the dividends,[74] interest[75] and royalties[76] – and to a misuse of the requirement embodied in these rules that income be paid or derived by a recipient in the State of residence.

LOB clauses, which focus on the subjective attributes of the recipient of the income as opposed to the way this person derives the treaty-favoured income, do not deal with this problem. Leaving aside "sham", "simulation" or "economic substance" doctrines or other domestic anti-avoidance rules, it is fair to say that the problem of conduit companies has been primarily addressed by the beneficial ownership limitation introduced in the OECD Model (1977)[77] in the foregoing distributive rules. This has, in particular, been the case in numerous jurisdictions construing this limitation on the basis of a substance-over-form approach.[78] Another possible response is the so-called "conduit arrangement clause" incorporated for example in the United Kingdom-United States Income Tax Treaty (2001)[79] and applying to the dividends,[80] interest[81] and royalties[82] articles. In fact, this clause, which combines an anti-conduit rule and a main purpose test, has directly inspired the interpretation of the PPT which is now meant to also apply to conduit cases. As we shall see in section 3.2.3., this raises the question of the delineation between the beneficial ownership limitation, on the one hand, and the PPT, on the other.

*2.2.3.3. "Last-minute" restructurings*

Improper use of tax treaties stemming from so-called "last minute" restructurings equally concern the distributive rules. Here, a restructuring takes place in order to cause the application of the dividend article of a new tax treaty[83] or of a more favourable treaty provision within the same tax treaty, for example, transitioning from the portfolio[84] to the qualifying holding residual rate of the dividend article[85] (rule shopping).[86] With regard to capital gains, the Commentary on Article 13 of the OECD Model mentions an example concerning article 13(5) of the OECD Model. According to this provision, "gains from the alienation of any property... shall be taxable only in the Contracting State of which the alienator is a resident".[87] Under the Commentary on Article 1 of the OECD Model (2017), an individual resident of State A and holding a substantial shareholding in a company of that State, may, just prior to selling his shares, transfer his residence to State B, where such gains are subject to little or no tax[88] and claim that these gains are solely taxable in State B pursuant to article 13(5) of the State A-State B Tax Treaty. Another illustrative example is article 13(4) of the OECD Model, which reads:

> Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

Under this provision, which already pursues an anti-avoidance purpose, a sale of shares in a company situated in the State of source is, therefore, equated to a sale of an immovable property located therein where, in essence, the value of the shares predominantly stems from immovable property.[89] The application of article 13(4) of the OECD Model may, however, be avoided if, shortly before the sale of the shares, assets are contributed to the entity to dilute the proportion of the value of these shares stemming from immovable property located in the State of source.

The problem lies here in the fact that, in all of the foregoing examples, treaty benefits may not be denied on the basis

parent company consists in the management of its subsidiaries' assets or that the income of that company results only from such management cannot per se indicate the existence of a wholly artificial arrangement which does not reflect economic reality."

74. Art. 10 *OECD Model* (2017).
75. Id., at art. 11.
76. Id., at art. 12.
77. *OECD Model Tax Convention on Income and on Capital* (11 Apr. 1977), Treaties & Models IBFD.
78. For a recent discussion of the beneficial ownership limitation, *see* R.J. Danon, *The Beneficial Ownership Limitation in Articles 10, 11 And 12 OECD MC and Conduit Companies in Pre and Post BEPS Tax Treaty Policy – Do We (Still) Need It?*, in *Contemporary Tax Issues* (G. Maisto ed., IBFD 2020 (forthcoming)), Books IBFD.
79. *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains* art. 3(1)(n) (24 July 2001) (as amended through 2002), Treaties & Models IBFD [hereinafter *U.K.-U.S. Income Tax Treaty* (2001)].
80. Id., at art. 10(9).
81. Id., at art. 11(7).
82. Id., at art. 12(5).
83. A first example are cases in which a resident of a third country transfers its shareholding in a company in the State of source (State S) to an entity in the State of residence (State R) with a view to claim the benefits of the State S-State R Tax Treaty (i.e. a more favourable residual rate) on subsequent dividend distribution. The existence of a potential abuse typically arises if a dividend consisting in the retained earnings generated before the transfer is distributed shortly after the latter (or even more so in the case of a liquidating distribution). In Switzerland, for example, this fact pattern is tackled by the so-called "old reserves theory", which in a treaty context essentially leads to the application of the (treaty residual) withholding tax rate on the reserves generated before the share transfer. *See* thereupon, in particular, the decisions of the *Bundesverwaltungsgericht/Tribunal administratif fédéral* (Federal Administrative Court, BVGer/TAF) in CH: BVGer/TAF, 23 Mar. 2010, Case A-2744/2008, RF 2010, 652 et seq. and CH: BVGer/TAF, 31 Aug. 2016, Case A-5692/2015. *See also*, with further references on the Swiss administrative practice, R.J. Danon & T. Obrist, *La théorie des "anciennes reserves" en droit fiscal international: commentaire de l'arrêt du Tribunal administratif fédéral A-2744 du 23 mars 2010*, 65 *Revue fiscale*, p. 621 et seq. (2010); R.J. Danon, *Cession transfrontalière de droits de participations: distinction entre évasion fiscale, "treaty" et "rule shopping"*, in *Evasion fiscale: une approche théorique et pratique de l'évasion fiscal* p. 136 et seq. (P.-M. Glauser ed., Schulthess 2010); and S. Oesterhelt, *Altreservenpraxis, internationale Transponierung und stellvertretende Liquidation*, *IFF Forum für Steuerrecht* p. 99 et seq. (2017).
84. Art. 10(2)(b) *OECD Model* (2017).
85. Id., at art. 10(2)(a).
86. A variation of this example is the case in which a taxpayer (for instance, an individual) entitled to the 15% portfolio rate of art. 10(2)(b) State S-State R Tax Treaty contributes his shareholding to a company resident of State R in order to obtain the 5% (or even 0%) rate of art. 10(2)(a) of the same treaty on subsequent dividend (liquidating) distributions. This second variation is described as a "rule shopping" because the applicability of the State S-State R Tax Treaty is not at issue here. Rather, the question is whether the benefit of a more favourable distributive should be regarded as abusive. *See* thereupon Danon, *supra* n. 83, at p. 145.
87. Art. 13 (5) *OECD Model* (2017).
88. Para. 56, ad art. 1 *OECD Model: Commentary on Article 1* (2017).
89. *See* thereupon para. 28.3 et seq., ad art. 13 *OECD Model: Commentary on Article 13* (2017); E. Reimer, *Article 13 Capital Gains*, in *Klaus Vogel on Double Taxation Conventions* N 106 et seq., ad art. 13 (4th ed., E. Reimer & A. Rust eds., Kluwer L. Intl. 2015); and R.J. Danon & A. Faltin, *Article 13 MC OCDE* (*Article 13 OECD MC*), in *Modèle de Convention Fiscale OCDE Concernant le Revenu et la Fortune* para. 19 et seq., ad art. 13 (R.J. Danon et al. eds., (Helbing Lichtenhahn & Éditions Francis Lefebvre 2014).

© IBFD

of the literal wording of the relevant distributive. Under articles 10 (Dividends) and 13 (Capital gains) of the OECD Model, the situation prevailing at the time of payment of the dividends, respectively upon alienation of the shares is indeed solely decisive.[90] Hence, a so-called "compartmentalization" approach consisting in granting treaty benefits only with regard to earnings generated after the cross-border or domestic restructuring is not possible. As we shall see in section 3.3.1., a relevant consideration in the framework of the analysis of the impact of the PPT in these cases will, therefore, be whether the object and purpose of the relevant provisions at stake is defeated. For example, under article 10(2)(a) of the OECD Model, dividends paid by a subsidiary to a parent company are taxed less heavily to avoid recurrent taxation and, importantly also, to facilitate international investment.[91] However, suppose that, just prior to a large dividend distribution, a majority shareholding is transferred by an individual in the State of residence to a newly incorporated entity in the same State. The entity claims the benefit of article 10(2)(a) of the OECD Model, but such an entity is then liquidated shortly after the dividend distribution. Clearly, if the benefits of article 10(2)(a) of the OECD Model were to be granted, the purpose of this provision would be defeated.

## 3. The PPT as a Multilateral Response to Treaty Abuse: Contextualization and Substantive Analysis

### 3.1. Introductory remarks

Having set the scene, we now move to the core of this contribution and test the impact and limits of the PPT as the multilateral response to combat tax treaty abuse. For this purpose, we find it appropriate to begin the analysis by contextualizing the role of the PPT in the treaty application process (*see* section 3.2.). We then move to the substantive analysis, looking in particular at the impact of the subjective and objective components of the PPT (*see* section 3.3.)

### 3.2. Contextualization of the PPT

#### *3.2.1. Opening comments*

The PPT has been codified in article 29(2) of the OECD Model dealing with entitlement to treaty benefits. This systematic insertion, therefore, confirms that the application of the PPT only comes into play after: (i) a proper establishment of the facts relevant to the case at hand; and (ii) the interpretation of treaty law pursuant to article 31 et seq. of the Vienna Convention (1969). For example, it must first be established under a proper interpretation of treaty law whether a person qualifies as a resident[92] and whether the requirements imposed by the relevant distributive rule (for example, the beneficial ownership limitation in case of articles 10 to 12 of the OECD Model) are satisfied. While these distinctions seem clear as a matter of principle, some controversial issues may nevertheless arise. We, therefore, find it appropriate to delineate and look separately at these various steps. As we shall see in section 3.2.2., this will prove to be useful when assessing the true impact of the PPT.

#### *3.2.2. Delineation with the establishment of the facts*

The starting point of the treaty application process consists in establishing the facts. It is undisputed that tax treaties apply only to true facts. In other words, at this level of the analysis, the true legal substance of the arrangements and transactions presented by the taxpayer should be considered. This has two main implications. First of all, if their governing law so permits, not only written but also unwritten or implied legal obligations must be taken into account. Therefore, beneficial ownership could for instance be denied to a conduit company if the income it receives is subject to an implied contractual obligation (typically an agency agreement).[93] From the Commentary on Article 10 of the OECD Model (2014) onwards, this situation has been confirmed as follows:

> Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person.[94]

Second, it is quite clear that treaty benefits ought not to be granted on the basis of facts incorporating sham[95] or simulated[96] arrangements and transactions. Again, a conduit

90. With regard to the temporal scope of distributive rules in general, *see* J. Schuch, *Die Zeit im Recht der Doppelbesteuerungsabkommen (f. Österreich): Recent Trends* in particular p. 217 et seq. (Linde 2002).
91. Para. 10, ad art. 10 *OECD Model: Commentary on Article 1* (2017).
92. Art. 4 *OECD Model* (2017).
93. C.P. du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties*, sec. 6.3.2.10.2. (1999), IBFD.
94. Para. 12.4, ad art. 10 *OECD Model: Commentary on Article 10* (2014). As mentioned in sec. 3.2.2., however, the distinction between legal and economic substance under this passage of the commentaries is controversial.
95. On the notion of sham in common law, *see* the decision of the High Court, in UK: [QB], 1967, *Snook v. London West Riding Investments,* [1967] 2 QB 786: "it means acts done or documents executed by the parties to the sham which are intended by them to give third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual rights and obligations (if any) which the parties intended to create" and for a recent example in a tax treaty context in Canada, *see* CA: TCC, 18 Sept. 2009, *Paul Antle v. Her Majesty the Queen; Marquis-Antle Spousal Trust v. Her majesty the Queen; Antle and another v. Her Majesty the Queen*, 2009 TCC 465 and CA: CFCA, 21 Oct. 2010, *Paul Antle (appellant) v. Her Majesty the Queen (respondent) Renee Marquis-Antle Spousal Trust (appellant) v. Her Majesty the Queen*, (2010), 413 N.R. 128 (FCA);2010 FCA 280. The TCC in *Antle* (2009), *supra*, initially found that the arrangement under consideration (a trust) was not a sham (12 ITLR 359), but the CFCA in *Antle* (2010), *supra*, reversed the decision on this point and confirmed that the trust was a sham (13 ITLR 399).
96. The definition in *Snook v. London West Riding Investments* (1967), p. 2 QB 786 is not so far apart from the one given in certain civil law jurisdictions. For example, in Switzerland, the *Bundesgericht/Tribunal fédéral* (Federal Supreme Court, BGer/TF), relying on the notion of simulation ("*simulation*"; "*Scheingeschäft*") under CH: *Bundesgesetz betreffend die Ergänzung des Schweizerischen Zivilgesetzbuches (Fünfter Teil: Obligationenrecht); Loi fédérale complétant le Code civil suisse(Livre cinquième: Droit des obligations)* Code of Obligations, art. 18 held in CH: BGer/TF 1982, Case published in SJ 1982, 232, p. 234: "Un acte juridique est simulé lorsque les parties conviennent d'émettre des déclarations de volonté ne concordant pas avec leur volonté véritable. Il y a donc simulation lorsqu'il existe une contradiction entre la volonté réelle des parties et leur volonté déclarée, de sorte que l'effet juridique que les parties déclarent vouloir produire n'est pas conciliable avec le contenu

 © IBFD

company will not be regarded as the beneficial owner of the income it receives if the ownership over such income is purely a sham or simulated.[97] The Commentary on Article 1 of the OECD Model (2017) also illustrates the impact of a sham arrangement for tax treaty purposes by the following example. The domestic law of State A provides for the taxation of gains derived from the alienation of shares of a domestic company in which the alienator holds more than 25% of the capital if that alienator was a resident of State A for at least seven of the ten years preceding the alienation. In year two, an individual, who was a resident of State A for the previous ten years, becomes a resident of State B. Shortly after becoming a resident of State B, the individual sells the totality of the shares of a small company that he previously established in State A. The facts reveal, however, that all the elements of the sale were finalized in year one, that an interest-free "loan" corresponding to the sale price was made by the purchaser to the seller at that time, that the purchaser cancelled the loan when the shares were sold to the purchaser in year two and that the purchaser exercised de facto control of the company from year one. According to the OECD Commentary on Article 1 (2017), although the gain from the sale of the shares might otherwise fall under article 13(5) of the State A-State B Tax Treaty, the circumstances of the transfer of the shares are such that the alienation in year 2 constitutes a sham within the meaning given to that term by the courts of State A. The commentaries conclude that:

> In that case, to the extent that the sham transaction doctrine developed by the courts of State A does not conflict with the rules of interpretation of treaties, it will be possible to apply that doctrine when interpreting paragraph 5 of Article 13 of the State A-State B treaty, which will allow State A to tax the relevant gain under its domestic law rule.[98]

To the extent that it is confined to the strict identification of the true legal arrangements put in place by the parties, treaty law generally, and the PPT in particular, have no bearing at this level of the analysis. This being said, in several jurisdictions sham doctrines equate substance anti-abuse rules, which becomes a source of confusion. In fact, this confusion is echoed by the Commentary on Article 1 of the OECD Model (2017), which places on an equal footing substance over form, economic substance, sham, business purpose, step transaction, abuse of law and *fraus legis* doctrines.[99] In this latter case, the issue of compatibility of these rules with tax treaties arises. Following the position taken by the OECD since the Commentary on Article 1 of the OECD Model (2003),[100] the OECD Commentary on Article 1 (2017) take the position that these rules will comply with tax treaties to the extent that treaty benefits would have also been denied under the guiding principle.[101] In other words, this then no longer concerns the establishment of the facts but, rather, becomes a matter of interpretation of treaty law to which we now turn.

#### *3.2.3. Delineation with the interpretation of treaty law under article 31 of the Vienna Convention (1969)*

Once the facts have been properly established, treaty law must be interpreted in order to determine the consequences derived from its application to these facts, i.e. access or no access to treaty benefits. As is well known, this stage of the analysis is primarily governed by article 31 of the Vienna Convention (1969). The new question that has emerged with the BEPS outcome, however, is the relevance, and perhaps more importantly, the impact of the new preamble to the OECD Model in this framework

According to article 31 of the Vienna Convention (1969), a treaty: "shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose". It is settled that article 31 of the Vienna Convention (1969) expresses the primacy of the textual approach in the interpretative process.[102] This implies first of all that the principle of effectiveness must be observed.[103] Therefore, any interpretation that would render a treaty provision superfluous or diminish its practical effects is to be avoided.[104] For example, overlooking the beneficial ownership requirement in the interpretation of provisions modelled after articles 10 to 12 of the OECD Model would not be compatible with the principle of effectiveness. This being said, as is well-known, article 31 of the Vienna Convention (1969) does not favour a pure grammatical or microscopic interpretation of tax treaty law. Rather, the interpretation must be holistic and contextual.[105] For this reason, treaty terms should be construed "in their context".[106] In other words, "the reality of the methods of interpretation of tax conventions should be taken into account".[107] According to article 31(2) of the

de leur volonté véritable, soit qu'elles ne veuillent produire aucun effet juridique, soit qu'elles veuillent en produire un autre".

97. De Broe, *supra* n. 64, p. 723. A similar reasoning was for example followed by the Argentine *Tribunal Fiscal de la Nación* (National Tax Court, TFN) in the *Molinos* case, which involved an intermediary holding company simply redistributing all of its income. The TFN held that: "Although the present case is not in any manner a fiduciary one, the parties here behave in a similar way to actors in the [fiduciary context], leaving aside all type of fiduciary property or separated property, which is evident, since [this case] is not about the incorporation of a trust. Thus, once the dividends were received by the intermediary (Holding), this latter transferred the dividends to the parent [Molinos Argentina], which we assimilate to the 'settlor', and now we also must consider as 'beneficial owner' of such dividends." (*See* AR: TFN, 14 Aug. 2013, *Molinos Rio de la Plata SA v. Administración Federal de Ingresos Públicos*, 34.739-I to 35.783-I, 16 ITLR 616, 672, Case Law IBFD.)
98. Para. 75, ad art. 1 *OECD Model: Commentary on Article 1* (2017).
99. Id., at para. 78, ad art. 1.
100. Para. 9.5, ad art. 1 *OECD Model: Commentary on Article 1* (2003).
101. Para. 61, ad art. 1 and para. 79, ad art. 1 *OECD Model: Commentary on Article 1* (2017), in stating that "As a general rule and having regard to paragraph 61, therefore, the preceding analysis leads to the conclusion that there will be no conflict between tax conventions and judicial anti-abuse doctrines or general domestic anti-abuse rules".
102. F.A. Engelen, *Interpretation of Tax Treaties under International Law* p. 426 (IBFD 2004), Books IBFD and K. Vogel & A. Rust, *Introduction*, in *Klaus Vogel*, *supra* n. 89, at N 84.
103. O. Dörr, *Vienna Convention on the Law of Treaties, A commentary* para. 52 (Springer 2018), ad art. 31 of the *Vienna Convention*.
104. Id.
105. M.E. Villiger, *Commentary on the 1969 Vienna Convention on the Law of Treaties* para. 10 (Koninklijke Brill NV 2009), ad art. 31 of the *Vienna Convention*; J.F. Avery Jones, *Treaty Interpretation – Global Tax Treaty Commentaries*, sec. 3.4.10., Global Topics IBFD: and V. Lowe, *How domestic anti-avoidance rules affect double taxation conventions*, in International Fiscal Association (IFA), *Cahiers de droit fiscal international*, IFA Congress Seminar Series vol. 19c, p. 7 (Kluwer L. Intl. 1994).
106. Art. 31(1) *Vienna Convention* (1969).
107. *Verdannet* (2017), p. 862.

Vienna Convention (1969), the context includes the preamble of the treaty. The new preamble to the OECD Model (2017), which provides that Contracting States intend to eliminate:

> double taxation... without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)

is undoubtedly context according to article 31(2) of the Vienna Convention (1969).[108] At the same time, the Commentary on Article 1 of the OECD Model (2017) does not discuss how the preamble – on a standalone basis – could influence the interpretation of treaty provisions. Rather, the preamble is mainly mentioned in the framework of article 29 of the OECD Model, which is deemed to reflect: "... the intention of the Contracting States, incorporated in the preamble of the Convention".[109] Does this mean that the new preamble is only relevant for purposes of interpreting article 29 of the OECD Model? This begs two questions.

The first question is whether the new preamble has a sufficient level of normative density to really make a difference on its own in the interpretation exercise. In existing treaty practice, it is fair to say that preambles have had little impact, notably because the tax treaties reviewed by courts did not include reference to tax avoidance but only to tax evasion.[110] An exception is, perhaps, *Verdannet* in which the French CE referred to the broad objective of the France-Luxembourg Income and Capital Tax Treaty (1958)[111] and considered that:

> The States that are parties to the Franco-Luxembourg tax treaty cannot be regarded as admitting, in the distribution of the power of taxation, the application of its provisions to situations arising from artificial transactions devoid of any economic substance. It follows that in finding that the operation in question was contrary to the objectives pursued by the two signatory States, the Court did not commit any error of law in its judgment.[112]

As mentioned, however, *Verdannet* concerned a clear round-tripping case in which arguably the very essence of the tax treaty in question had been defeated. However, whether the new preamble to the OECD Model (2017) will on its own make a difference in treaty practice can be left open at this stage.

In the author's opinion, the real question lies in the limits to the contextual and purposive interpretation under article 31 of the Vienna Convention (1969). It is, indeed, settled that the contextual and purposive interpretation finds its limits in the text of the tax treaty and, therefore, may not lead to a result that undermines the actual terms of the agreement.[113] From this perspective, therefore, the position expressed by the French CE in *Verdannet* should not be read as an endorsement of an unlimited purposive interpretation beyond the actual terms of the tax treaty. Indeed, in *Re Société Schneider Electric*, the same Court held that, "[e]ven assuming that it had been established that the objective of combating tax avoidance and evasion had been assigned to the Franco-Swiss treaty, this objective may not, in the absence of express provisions to that effect, derogate from the rules stated in the treaty".[114]

At the same time, however, the answer depends on the interpretation of article 31 of the Vienna Convention (1969) that is favoured, on the one hand, and on the language of the relevant treaty rule, on the other.

Several scholars[115] and courts[116] around the globe have considered that a proper interpretation of treaty law under article 31 of the Vienna Convention (1969) allows, in certain instances, treaty benefits to be denied in cases of abuse. The predominant position, at least in scholarly writing, is however that the object and purpose of the treaty under article 31 of the Vienna Convention (1969)

108. *See* Introduction, para. 16 *OECD Model* (2017), which states the obvious "since the title and preamble form part of the context of the Convention and constitute a general statement of the object and purpose of the Convention, they should play an important role in the interpretation of the provisions of the Convention".
109. Para. 1, ad art. 29 *OECD Model: Commentary on Article 1* (2017).
110. *See*, for example, in Australia, the decision of the Full Federal Court of Australia (FFCA) in AU: FFCA, 20 Aug. 1997, *Lamesa Holding BV v. Commissioner of Taxation*, NG 225 of 1997, [1997] FCA 134; 35 ATR 239, Case Law IBFD: "The Agreement is an agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income. Although, therefore, the Agreement has this dual object, the Agreement substantially concerns allocation of taxing power" and "Save as to its operation to allocate taxing power, the Agreement is little concerned directly with fiscal evasion. However, Art 25 provides for an exchange of information between the competent authorities of each State, which exchange is vital to countering fiscal evasion." *See also* CA: TCC, 18 Aug. 2006, *Mil (Investments) S.A. v. Her Majesty the Queen*, 2004-3354(IT)G, 9 ITLR 29, Case Law IBFD and CA: CFCA, 13 June 2007, *Mil Investments S.A. v. Her Majesty the Queen*, A-416-06, 9 ITLR 1111, Case Law IBFD. Specifically, the TCC held that: "In particular, in light of the OECD commentary and the decision by Canada and Luxembourg not to include an explicit reference to anti-avoidance rules in their carefully negotiated treaty, I find there is no ambiguity in the treaty permitting it to be construed as containing an inherent anti-abuse rule. Simply put, the 'ordinary meaning' of the treaty allowing the appellant to claim the exemption must be respected." (*See Mil (Investments) S.A* (2006), p. 52.) *See* again *Alta Energy* (2020), para. 77: "A tax treaty is a multi-purpose legal instrument. The preamble of the Treaty states that the two governments desired "to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital." While indicative of the general purpose of the Treaty, this statement remains vague regarding the application of specific articles of the Treaty".
111. *Convention between France and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance with Respect to Taxes on Income and Capital* [unofficial translation] (1 Apr. 1958) (as amended through 1970), Treaties & Models IBFD.
112. *Verdannet* (2017), pp. 856-857.
113. Engelen, *supra* n. 102, p. 429.
114. Re Société Schneider Electric 4 ITLR 1077, 1108.
115. Vogel was one of the first scholars to express this view (*see* Vogel, *supra* n. 18, at N 121), which was then endorsed by several commentators (D.A. Ward, *Abuse of Tax Treaties*, 23 Intertax 4, p. 180 (1995); R.G. Prokisch, in *Doppelbesteuerungsabkommen* [*Double Taxation Agreements*] N 117, ad art. 1 (5th ed., K. Vogel & M. Lehner eds. DBA 2008); F. Engelen, *On Values and Norms: The Principle of Good Faith in the Law of Treaties and the Law of Tax Treaties in Particular* p. 36 (Kluwer L. Intl. 2006); De Broe, *supra* n. 64, at pp. 374-375; and Vogel & Rust, *supra* n. 102, at N 57, Annex C, ad art. 1, including the present author (R.J. Danon, in *Modèle de Convention Fiscale OCDE Concernant le Revenu et la Fortune* N 144, ad art. 1 (R.J. Danon et al. eds., Helbing Lichtenhahn & Éditions Francis Lefebvre 2014).
116. *See* the decision of the Israeli District Court (IDC) in IL: IDC, 30 Dec. 2007, *Yanko-Weiss Holdings (1996) Ltd. v. Assessing Officer of Holon*, 5663/07, 10 ITLR 524, Case Law IBFD and CH: BGer/TF, 28 Nov. 2005, Case No. 2A.239/2005, *X ApS v. Federal Tax Administration*, 8 ITLR 536, Case Law IBFD. This reasoning was by contrast not accepted by the TTC in *Mil (Investments) SA* (2006) and by the CFCA in *Mil (Investments) SA* (2007).


© IBFD

only supports this in extreme and blatant circumstances. This is because the argument is here made on the basis of article 31 of the Vienna Convention (1969) and not pursuant to a genuine treaty GAAR. Hence, commentators require the existence of a wholly artificial arrangement entered into for the sole (or at least predominant) purpose[117] of enjoying treaty benefits and which completely defeats the fundamental purposes of tax treaties, i.e. promoting the free movement of goods, persons, services and capital between the Contracting States by avoiding international double taxation is frustrated.[118] This would be the case, for example, if the interposition of an entity in the State of residence does not (or very marginally) contribute to any international activity.[119] It would appear to us that these extreme circumstances would typically be satisfied in the case of a circular artificial round tripping structure, which, by definition, involves no real international activity. From this perspective, the preamble to the OECD Model (2017) merely strengthens this predominant position, but does not add anything to it. Further, to the extent the applicable treaty provision is clear, giving a wider effect to the new preamble would not be compatible with article 31 of the Vienna Convention (1969). Since the updated Commentary on Article 1 of the OECD Model (2003), the OECD also supports the view that treaty benefits may be denied where this results:

> from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties (interpretative approach)).[120]

The OECD Commentary on Article 1 (2003) note that "it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions".[121] However, the Commentary on Article 1 of the OECD Model (2017) arrives at the conclusion that:

> a guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.[122]

As some commentators[123] have argued, the guiding principle prima facie lowers the threshold of abuse since it requires only "a main purpose" for entering into the transactions or arrangements. However, this is not sufficient. Tax authorities following this position must in addition establish that granting treaty benefits would be contrary to "the object and purpose of the relevant provisions". The position taken by the OECD however raises two awkward questions. The first question relates to the guiding principle itself: since the analysis here takes place in the framework of article 31 of the Vienna Convention (1969) – and not on the basis of a separate treaty GAAR such as the PPT – it is debatable whether a purposive interpretation, i.e. looking for "the object and purpose of the relevant provisions" per se and without being limited by the wording of the treaty, is really possible. In any event, the new preamble to the OECD Model (2017) could not justify this.

The second question relates to the relation between the guiding principle and the PPT. The Commentary on Article 1 of the OECD Model (2017) states that the PPT is aiming at expressly confirming the guiding principle into the treaty text,[124] but at the same time indicates that the guiding principle may also apply independently from the PPT.[125] From a substantive point of view, a question that arises is whether, as pointed out by commentators,[126] treaty benefits could be granted on the basis of the guiding principle at the level of the interpretation of treaty law pursuant to article 31 of the Vienna Convention (1969) and then, nevertheless, denied under article 29(9) of the OECD Model. The OECD Commentary on Article 1 (2017) does not really address these two points and a clarification thereupon would be welcome.

Returning to the new preamble to the OECD Model (2017), the conclusion may be drawn that the latter will in most instances not have any impact of its own at the level of interpretation of treaty law pursuant to article 31 of the Vienna Convention (1969). This is primarily because the contextual interpretation may not produce a result that is not supported by the actual wording of the agreement. As Gooijer (2019) correctly submits, this holds true in particular as regards treaty residence under article 4 of the OECD Model (2017), which sets the required nexus with the State of residence to access treaty benefits.[127] An exception could however be foreseen in cases in which the treaty terms are rather open-ended and could support an interpretation geared towards the preamble. It is not the purpose of the present contribution to deal with this issue exhaustively. One example may however be given: the beneficial ownership limitation in articles 10 to 12 of the OECD Model. The Commentary on Article 10 of the OECD Model (2003) onwards has stated the obvious and provides expressly that the term "beneficial owner" should also be interpreted "in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance".[128] It is, therefore, arguable that among various possible ordinary meanings of beneficial ownership under article 31(1) of the Vienna Convention (1969), the one which, within the meaning of the preamble, best prevents "treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement" should be preferred. Accordingly, the question arises as to whether this line of reasoning could strengthen the idea that beneficial ownership should be construed on

117. De Broe, *supra* n. 64, at p. 375.
118. Engelen, *supra* n. 115, at p. 36.
119. De Broe, *supra* n. 64, at p. 375.
120. Para. 59, ad art. 29 *OECD Model: Commentary on Article 1* (2017).
121. Para. 9.5, ad art. 1 *OECD Model: Commentary on Article 1* (2003).
122. Para. 60, ad art. 29 *OECD Model: Commentary on Article 1* (2017).
123. *See*, among others, De Broe, *supra* n. 64, at p. 319 et seq.
124. Para. 61, ad art. 29 *OECD Model: Commentary on Article 1* (2017).
125. Id.
126. Van Weeghel, *supra* n. 8, at sec. 2.
127. Gooijer, *supra* n. 46, at p. 77: "the purpose of the OECD MC to prevent tax avoidance cannot be of any help in the interpretation of the definition of resident in Article 4(1), if the provision itself does not contain any reference to the motives behind the establishment of residency in a particular case".
128. Para. 12.1 *OECD Model: Commentary on Article 10* (2017).

the basis of a substance-over-form interpretation, which is a position already taken by several jurisdictions.[129] This being said, if we now assume that the new preamble to the OECD Model (2017) would indeed have the effect of revitalizing the beneficial ownership limitation in the sense of a more substance-oriented limitation, an additional difficulty would come into play from a policy perspective: any ordinary meaning of beneficial ownership under article 31 of the Vienna Convention (1969) does not allow to build a PPT – if one prefers an intentional element – into this limitation.[130] Consequently, following this line of reasoning, there could be instances in which treaty benefits could first be denied on the basis of an objective and broad interpretation of beneficial ownership, whereas this would not have been the case under the PPT in the fulfilment of its subjective component.[131]

### 3.3. Substantive analysis of the PPT under article 29(9) of the OECD Model (2017)

#### *3.3.1. General considerations*

Turning to the substantive analysis of the PPT, we begin with general considerations. Article 29(9) of the OECD Model (2017) reads as follows:

> 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.

Like the guiding principle and some common law GAARs, in particular the Canadian GAAR, the PPT incorporates three elements.[132] First of all, a so-called "result test" in that the arrangement or the transaction must have resulted in the treaty benefit. Secondly, a subjective element – the purpose test – which is however objectified pursuant to a "reasonableness" test.[133] In the common law GAAR jargon, this is the so-called "avoidance transaction" test.[134] In contrast, the objective component part, also inspired from common law GAARs,[135] focuses on "the object and purpose of the relevant provisions of this Convention". The discussion will here focus on these two latter components.

The language of the PPT is very much identical to the guiding principle with, however, two differences. First of all, article 29(9) of the OECD Model (2017) refers to "one of the principal purposes", while the guiding principle makes reference to "a main purpose". Second, while both the guiding principle and the PPT incorporate an objective element, the latter uses this element as a carve-out to exclude the application of article 29(9) of the OECD Model (2017). In effect, the onus of the proof is controversially shifted to the taxpayer ("unless it is established").[136] From a policy perspective, it is questionable whether this approach is correct. As pointed out, for instance, in Canadian case law:

> The taxpayer, once he or she has shown compliance with the wording of a provision, should not be required to disprove that he or she has thereby violated the object, spirit or purpose of the provision. It is for the Minister who seeks to rely on the GAAR to identify the object, spirit or purpose of the provisions that are claimed to have been frustrated or defeated, when the provisions of the Act are interpreted in a textual, contextual and purposive manner. The Minister is in a better position than the taxpayer to

129. Two counter-arguments could however be put forward to challenge this interpretation. The first counter-argument relates to the language used by the *OECD Model: Commentaries* (2014), which states that in order for beneficial ownership to be denied, the recipient's right to use and enjoy must be "constrained by a contractual or legal obligation to pass on the payment received to another person". (*See* para. 12.4 *OECD Model: Commentary on Article 10* (2014).) Accordingly, "where the recipient of a dividend does have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the 'beneficial owner' of that dividend." (*See* para. 12.4 *OECD Model: Commentary on Article 10* (2014).) It is, therefore, arguable since beneficial ownership ought to be interpreted in a strict legal fashion that the limitation, even construed in light of the new preamble, would have a limited effect. The second counter-argument which adds weight to the first one concern the passages of the *OECD Model: Commentaries* (2017) suggesting that conduit cases are now to be dealt with by the PTT. For example, the *OECD Model: Commentary on Article 29* (2017) provides that the PPT covers: "limitations on the taxing rights of a Contracting State in respect of dividends, interest or royalties arising in that State, and paid to a resident of the other State (who is the beneficial owner) under Article 10, 11 or 12." (*See* para. 175 *OECD Model: Commentary on Article 29* (2017).) The *OECD Model: Commentaries on Articles 10, 11 and 12* (2017) also mirror this policy: "The provisions of article 29 and the principles put forward … will apply to prevent abuses, including treaty shopping situations where the recipient is the beneficial owner of the dividends." (*See* paragraph 12.5 of the *OECD Model: Commentary on Article 29* (2017).) However, with regard to the existence of an obligation to pass on the income which affects beneficial ownership the *OECD Model: Commentaries* (2014) state that such obligation: "may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person." (*See* para. 12.4 *OECD Model: Commentary on Article 10* (2014).) As shown in a recent judgement of the Swiss Federal Tribunal in which the 2014 commentaries were expressly mentioned, the distinction between legal substance and economic substance is rather a fine one. (*See* CH: Bg/Tf, 16 Dec. 2019, Case No. TF 2C_209/2017, Case Law IBFD). The ECJ in its decisions on directive shopping, although not expressly referring to the *OECD Model: Commentaries* (2014), also blurred this distinction. (*See N Luxembourg 1* (C-115/16) and *T Danmark* (C-116/16), para. 132.)
130. In the United Kingdom, HM Revenue & Customs (HMRC) took note of the substance-over-form interpretation of beneficial ownership favoured by the Court of Appeal of England and Wales (CAEW) in the *Indofood* decision (UK: CAEW, 2 Mar. 2006, *Indofood International Finance Ltd*, A3/2005/2497, 8 ITLR 653, Case Law IBFD), but, at the same time, took the position that this notion is only relevant when there is an abuse: "However, as indicated above in applying the beneficial ownership concept in the context of Double Taxation Conventions (DTCs), regard should be had to the objective of the DTC. Where there is no abuse of the DTC, there is no need, in practice, to apply the 'international fiscal meaning' of beneficial ownership." (*See* HMRC, International Manual, INTM332060, available at www.gov.uk/hmrc-internal-manuals/international-manual/intm332060 (accessed 23 Mar. 2020).) While this position makes sense from a policy perspective, it is, however, difficult to reconcile with the ordinary meaning of beneficial ownership under art. 31 *Vienna Convention* (1969). In Switzerland, by contrast, courts, have endorsed an undifferentiated (objective) application of beneficial ownership, irrespective of the underlying motives of the arrangement (*see* CH: Bg/Tf, 5 May 2015, Case No. 2C_364/2012, *Re Swiss Swaps Case I/A*, 18 ITLR 138, Case Law IBFD.)
131. *See* thereupon Danon, *supra* n. 78.
132. Duff, *Part II*, *supra* n. 8, at pp. 967-868.
133. Para. 178, ad art. 29 *OECD Model: Commentary on Article 1* (2017).
134. *See*, for example, CA: Income Tax Act (CITA), sec. 245 and *Alta Energy* (2020), p. 235.
135. *See*, for example, sec. 245(4) CITA.
136. *See* De Broe, *Tax Treaty and EU Law*, *supra* n. 8 and Baez Moreno, *supra* n. 8, at p. 435.



© IBFD

make submissions on legislative intent with a view to interpreting the provisions harmoniously within the broader statutory scheme that is relevant to the transaction at issue.[137]

For this reason, under the Canadian GAAR, it is, by contrast, the tax authorities that are to establish that a benefit that a taxpayer would otherwise obtain would contravene the object and purpose of the relevant provisions.[138]

The PPT may also be compared to the discretionary relief in the LOB clause of article 29(5)[139] and (6)[140] of the OECD Model (2017), which has been clearly imported from the US Model (2016) and treaty practice and which reads as follows:

> 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 [or 4 (simplified version)] [, 4 or 5 (detailed version)], 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.[141]

Prima facie, it is tempting to rely on this provision for purposes of interpreting the PPT because the US rule has been around for some time and has produced some treaty practice. A closer look at this provision, however, reveals some textual difference with the PPT. First of all, article 29(5) and (6) of the OECD Model (2017) refers to "the object and purpose of this Convention", while article 29(9) of the OECD Model refers to "the object and purpose of the relevant provisions of this Convention". Article 29(9) of the OECD Model, therefore, seems to focus primarily on the "relevant" provisions primarily concerned with the treaty benefits requested, i.e. most frequently article 4 and the distributive rules, while, in article 29(5) and (6), the focus seems to be on the object and purpose of the convention as a whole. More importantly however, while "the object and purpose of this Convention" is taken into account in article 29(5) and (6) of the OECD Model (2017), treaty benefits are only granted 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.

In other words, treaty benefits may be denied as soon as the subjective element is satisfied even if granting such benefits would be in accordance with the object and purpose of the convention. This focus on the subjective element of the test also appeared clearly in the reasoning of the US District Court in the case of *Starr* (2017).[142] In article 29(9) of the OECD Model, by contrast, even if the subjective element is satisfied, treaty benefits will have to be granted if it is established that this "would be in accordance with the object and purpose of the relevant provisions of this Convention".[143] This difference of policy is confirmed very clearly by the OECD Commentaries. With respect to article 29(5) and (6) of the OECD Model, the Commentary on Article 29 of the OECD Model state that: "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".[144] Full stop. As regards article 29(9) of the OECD Model, the Commentary on Article 29 of the OECD Model by contrast states that:

> The provisions of paragraph 9 have the effect of denying a benefit under a tax convention where one of the principal purposes of an arrangement or transaction that has been entered into is to obtain a benefit under the convention. Where this is the case, however, the last part of the paragraph allows the person to whom the benefit would otherwise be denied the possibility of establishing that obtaining the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.[145]

It is submitted that article 29(9) of the OECD Model (2017) incorporates the right policy and that a literal reading of article 29(5) and (6) leads to an absurd result as one fails to see why – even if the subjective element is satisfied – treaty benefits should not be granted if this is in accordance with the object and purpose of the convention and the relevant provisions.[146] While this inconsistency may stem from a lack of coordination when inserting the two provisions into the OECD Model (2017) and should be corrected,[147] it nevertheless for the time being strongly undermines the relevance of article 29(5) and (6) for purposes interpreting article 29(9).

### 3.3.2. *Interpretation of article 29(9) of the OECD Model (2017) under article 31 of the Vienna Convention (1969)*

It is beyond doubt that the interpretation of article 29(9) of the OECD Model (2017) is subject to the principles of article 31 of the Vienna Convention (1969) just like any other treaty provision. This has several consequences. First of all, in accordance with the principle of effectiveness, both the subjective and objective component of the PPT should be given weight and applied in this order.

137. *See* the decision of the Supreme Court of Canada (SCC) in CA: SCC, 19 Oct. 2005, *Her Majesty the Queen v. Canada Trustco Mortgage Company*, 2005 SCC 54, [2005] 2 S.C.R. 601, para. 39.
138. Duff, *Part II*, *supra* n. 8, at p. 986.
139. The simplified version of the LOB.
140. The detailed version of the LOB.
141. Para. 101 et seq., ad art. 29 *OECD Model: Commentary on Article 1* (2017).
142. *Starr International Co Inc v. United States of America; United States of America v. Starr International Co Inc* (2017).
143. In the same vein, *see also* Van Weeghel, *supra* n. 8, at sec. 7.
144. Para. 102, ad art. 29 *OECD Model: Commentary on Article 1* (2017).
145. Id., at para. 170 ad art. 29.
146. Art. 29(5) and (6) *OECD Model* (2017) could possibly be aligned with art. 29(9) by having recourse to supplementary means of interpretation (art. 32 *Vienna Convention* (1969)) on the ground that the meaning of the former under art. 31 *Vienna Convention* (1969) is "unclear" and/or "leads to a result that a result which is manifestly absurd or unreasonable" (art. 32 (1)(a) and (b) *Vienna Convention* (1969)). Given the language of the *OECD Model: Commentary on Article 29(5) and (6)* (2017), we doubt, however, that this would lead to a conclusive outcome.
147. In the same vein, *see* Van Weeghel, *supra* n. 8, at sec. 7.

© IBFD

Further, whether, for example, recourse to a subjective element is desirable or not,[148] is irrelevant when it comes to the interpretation of article 29(9) of the OECD Model (2017). Second, the terms contained in article 29(9) of the OECD Model (2017) should be interpreted in their context and in light of the object and purpose of the treaty. As confirmed by the Commentary on Article 1 of the OECD Model (2017), it is, therefore, quite clear that the new preamble is context for purposes of interpreting article 29(9) of the OECD Model (2017).[149] This being said, and again stating the obvious, such contextual and purposive interpretation is limited by the wording of this provision. This consideration applies to both components of the PPT, in particular to the interpretation of "the object and purpose of the relevant provisions of this Convention". As we shall see, while these terms require a purposive interpretation of the relevant treaty provisions, they may not by contrast be used to add an additional requirement to restrict the access to treaty benefits. Finally, the articulation of this objective component with the "object and purpose" of the treaty under article 31 of the Vienna Convention (1969) arises. In the author's opinion, this articulation may be summarized as follows. Article 31(1) of the Vienna Convention (1969) regulates the interpretation of all treaty provisions, including article 29(9) of the OECD Model (2017). Article 29(9) of the OECD Model (2017), in turn, allows a purposive interpretation of the relevant provisions to be performed to determine whether treaty benefits ought to be granted. Unlike under article 31 of the Vienna Convention (1969), such purposive interpretation is then no longer limited by the treaty text. Nevertheless, as we shall see in section 3.3.4., the object and purpose of the relevant treaty provisions must still be properly identified. The author recognizes, however, that the Commentaries on the OECD Model (2017) add confusion to this articulation by suggesting that the PPT merely confirms the guiding principle derived from article 31 of the Vienna Convention (1969).

Bearing the foregoing considerations in mind, let us now move to the analysis of the subjective and objective element of the PPT.

### *3.3.3. The subjective element of the PPT*

According to article 29(9) of the OECD Model (2017), a denial of tax treaty benefits by the source State may come into play where "one of the principal purposes" of the arrangement or transaction was to obtain these benefits. In accordance with the "reasonableness" test of the PPT, it is, therefore, not necessary to find conclusive proof of the intent of a person concerned with an arrangement or transaction.[150] The Commentary on Article 1 of the OECD Model (2017) state that the purpose of this requirement is:

> to ensure that tax conventions apply in accordance with the purpose for which they were entered into, i.e. to provide benefits in respect of bona fide exchanges of goods and services, and movements of capital and persons as opposed to arrangements whose principal objective is to secure a more favourable tax treatment.[151]

Where an arrangement can only be reasonably explained by a benefit that arises under a treaty, it may be concluded that one of the principal purposes of that arrangement was to obtain the benefit.[152] The reference to "one of the principal purposes" means that obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction.[153] The OECD Commentary on Article 1 (2017) illustrates this with the following example concerning article 13(5) of the OECD Model (2017):

> a person may sell a property for various reasons, but if before the sale, that person becomes a resident of one of the contracting States and one of the principal purposes for doing so is to obtain a benefit under a tax convention, art. 29(9) OECD MC [Model] could apply notwithstanding the fact that there may also be other principal purposes for changing residence, such as facilitating the sale of the property or the re-investment of the proceeds of the alienation.[154]

A similar fact pattern occurred in the Canadian case *Alta Energy*. As part of a restructuring, a company was formed in Luxembourg in 2012 and shares in a Canadian corporation were transferred to it. In 2013, the Luxembourg company sold its Canadian shareholding, realized an important capital gain and claimed that such gain was exclusively taxable in Luxembourg in accordance with article 13(5) of the Canada-Luxembourg Income and Capital Tax Treaty (1999).[155,156] The restructuring qualified as an avoidance transaction under the Canadian GAAR because the taxpayer had conceded that the use of the Luxembourg entity had not been "arranged primarily for a bona fide purpose other than to obtain a tax benefit".[157] However, the taxpayer won – both before the Tax Court of Canada (TCC)[158] and the CFCA[159] – because the Crown had failed to demonstrate that the object and purpose of the provisions at stake (articles 4 and 13 of the Canada-Luxembourg Income and Capital Tax Treaty (1999) had been frustrated. Therefore, the transaction was not regarded as abusive (*see* section 3.3.4.). In the same vein, in the foregoing example given by the OECD Commentaries on article 29 treaty benefits would still have to be granted if the taxpayer manages to demonstrate that the object and purpose of articles 4 and 13 of the OECD Model (2017) are not defeated. Unfortunately, the OECD Commentaries (2017) here focus only on the subjective

148. *See*, thereupon, Lang, *supra* n. 8, at pp. 655-664.
149. Para. 1, ad art. 29 *OECD Model: Commentary on Article 1* (2017).
150. Id., at para. 178, ad art. 29.
151. Id., at para. 174, ad art. 29.
152. Id., at para. 178, ad art. 29.
153. Id., at para. 180, ad art. 29.
154. Id.
155. *Convention between the Government of Canada and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* (10 Sept. 1999) (as amended through 2012), Treaties & Models IBFD.
156. CA: TCC, 22 Aug. 2018, *Alta Energy Luxembourg S.A.R.L. v. Her Majesty the Queen*, 2018 TCC 152, 21 ITLR 219, Case Law IBFD and *Alta Energy* (2020).
157. *Alta Energy* (2018), p. 235.
158. Id., p. 219.
159. *Alta Energy* (2020).


© IBFD

element of the PPT and fail to provide any indication on its second prong.

Another controversial point is whether the level of nexus or "substance" that the taxpayer has with the State of residence matters in the PPT analysis. For some commentators, this element is relevant to both the subjective and objective component of the PPT,[160] while other scholars[161] tend to connect it to the latter.[162] There are indeed numerous references in the Commentaries on the OECD Model (2017) suggesting that economic substance plays a role in the PPT analysis. For instance, in an example involving a regional company providing intra-group services, the Commentaries note that:

> Assuming that the intra-group services to be provided by RCO, including the making of decisions necessary for the conduct of its business, constitute a real business through which RCO exercises substantive economic functions, using real assets and assuming real risks, and that business is carried on by RCO through its own personnel located in State R, it would not be reasonable to deny the benefits of the treaties concluded between State R and the five States where the subsidiaries operate unless other facts would indicate that RCO has been established for other tax purposes or unless RCO enters into specific transactions to which paragraph 9 would otherwise apply....[163]

This has led scholarly writing to question whether the PPT incorporates a substance-oriented requirement or to what extent there would be a connection between the PPT and other BEPS actions items, such as BEPS Actions 8-10 relating to transfer pricing or BEPS Action 5 concerning intellectual property (IP) regimes and the modified nexus approach.[164] As the author has already argued elsewhere,[165] it follows from the OECD Commentaries (2017) that the presence of significant functions and substance in the State of residence are important elements to evidence that one of the principal purposes of an arrangement, i.e. particularly the creation and maintenance of an entity in the State of residence, respectively the transfer to such entity of rights giving rise to income, is not to obtain the benefits of the treaty concluded by the State of residence with the State of source. From this perspective, the author has submitted that in the area of IP income, the transfer pricing principles flowing from BEPS Actions 8-10 could for instance serve as guidance. The same holds true as regards IP income falling into the scope of the modified nexus approach applying to IP regimes. In such a case, and subject to a minor uplift of 30%, IP income is indeed deemed to be linked to substantial research and development (R&D) activities exercised in the State of residence. In fact, from the perspective of tax certainty and administrability, the notion of substance under the modified nexus approach and BEPS Action 5[166] is even easier to apply than a transfer pricing analysis under BEPS Actions 8-10, which remains more subjective. At the same time, however, it should be borne in mind that the PPT is not a specific anti-avoidance rule (SAAR) focusing mechanically and solely on the transfer pricing functions exercised in the State of residence to grant or deny treaty benefits. Such interpretation of article 29(9) of the OECD Model (2017) would clearly not be supported by its clear wording. Rather, all circumstances surrounding the arrangement or event must always be considered on a case-by-case basis.[167] Therefore, the level of substance in the State of residence should only be understood as a possible proxy to exclude the subjective element of the PPT. The Commentary on Article 1 of the OECD Model (2017) notes, indeed, that:

> A purpose will not be a principal purpose when it is reasonable to conclude... that obtaining the benefit was not a principal consideration and would not have justified entering into any arrangement or transaction that has, alone or together with other transactions, resulted in the benefit. In particular, where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit.[168]

However, the absence of significant transfer pricing functions in the State of residence should not automatically lead to the denial of treaty benefits if other compelling factual elements reveal that the subjective element of the PPT is not satisfied (for example, because the arrangement put in place is predominantly based on commercial and non-tax reasons). Example E of the OECD Commentary on Article (2017) to conduit cases illustrates this. In this example, a holding company only keeps a small spread in a licensing and sub-licensing structure, thereby exercising very little functions in the State of residence in respect of this income and presumably having little organizational substance due to its purpose as a holding company, but the subjective element is not satisfied because the entity is "conforming to the standard commercial organization and behaviour of the group".[169] From this perspec-

160. B. Kuźniacki, *The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application*, 10 World Tax J. 2 (2018), Journal Articles & Papers IBFD.
161. Van Weeghel, *supra* n. 8, at sec. 7.
162. Id., at sec. 9.
163. Para. 182, Example G, *OECD Model: Commentary on Article 29* (2017). *See also* para. 182, Example K *OECD Model: Commentary on Article 29* (2017) involving an institutional investor: "The decision to establish the regional investment platform in State R was mainly driven by the availability of directors with knowledge of regional business practices and regulations, the existence of a skilled multilingual workforce,... RCO employs an experienced local management team to review investment recommendations from Fund and performs various other functions which, depending on the case, may include approving and monitoring investments, carrying on treasury functions, maintaining RCO's books and records, and ensuring compliance with regulatory requirements in States where it invests."
164. Martín Jiménez, *supra* n. 7.
165. Danon, *Treaty Abuse in the Post-BEPS World*, *supra* n. 9 and *Intellectual Property (IP) Income and Tax Treaty Abuse*, *supra* n. 9.
166. The author would certainly agree with Van Weeghel, *supra* n. 8, at sec. 9. that the modified nexus approach could only serve as an indicator in the case of IP regimes. For this reason, this commentator has, in particular, argued in favour of relying on the "active business test" of LOB clauses. However, in the area of R&D functions, the modified nexus approach provides for a much more detailed framework (distinguishing in particular between acquired IP, outsourcing and in-house R&D) than the active business test, which is much more rudimentary and seems to assume that R&D functions are always performed in one State. (*See* para. 74 *OECD Model: Commentary on Article 29* (2017).)
167. Para. 178 *OECD Model: Commentary on Article 29* (2017).
168. Para. 181, ad art. 29 *OECD Model: Commentary on Article 1* (2017).
169. Para. 187, ad art. 29, Example E *OECD Model: Commentary on Article 1* (2017). *See also* art. 3(1)(n), Example 5 *U.K.-U.S. Income Tax Treaty* (2001), from which the Example in the *OECD Model: Commentary on Article 1* (2017) is derived: "even though the specific fact pattern, as presented, meets the first part of the definition of a 'conduit arrangement' ... on balance the conclusion would be that 'the main purpose or one of

tive, as the author has argued, the approach taken under the PPT rule is different from a broad substance oriented but objective (i.e. without taking into account the motives of the taxpayer) interpretation of beneficial ownership favoured by several jurisdictions. Therefore, coordination and policy problems could emerge if tax treaty benefits are denied at the level of the distributive rules, for lack of beneficial ownership, whereas this would not have been the case under the PPT.[170]

### *3.3.4. The objective element of the PPT*

As mentioned in section 3.3.1., the objective element of the PPT takes the form of an escape clause. Where it is established that "one of the principal purposes of any arrangement or transaction" was to claim a treaty benefit, the taxpayer may still claim such benefit if he establishes that granting such benefit would be "in accordance with the object and purpose of the relevant provisions of this Convention". Based on a proper interpretation of these terms in accordance with article 31 of the Vienna Convention (1969), the following observations may be formulated. First, the "relevant provisions" are those on which the requested treaty benefits are based. This will typically be the treaty residence article (article 4 of the OECD Model) in combination with the applicable distributive rule (articles 6 to 22) and, as the case may be, the relief provisions (article 23A or 23B). Second, within the framework of article 29(9) of the OECD Model, as already mentioned in section 3.2.3., the purposive interpretation is not limited by the wording of the applicable provisions. The Commentary on Article 29 of the OECD Model (2017) state that article 29(9) of the OECD Model (2017):

> ... must be read in the context of paragraphs 1 to 7 and of the rest of the Convention, including its preamble. This is particularly important for the purposes of determining the object and purpose of the relevant provisions of the Convention.[171]

However, because the interpretation of article 29(9) of the OECD Model (2017) itself is subject to the principles embodied in article 31 of the Vienna Convention (1969), the access to or denial of treaty benefits under the escape clause must be rooted in the object and purpose of the relevant provisions and not simply in the object and purpose of the convention in general.[172] Such latter reading of article 29(9) of the OECD Model (2017) would indeed be erroneous and conflict with the clear wording of this provision. This conclusion also makes sense from a policy perspective. While the general objective of the OECD Model (2017), as reflected in its preamble, is:

> the elimination of double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)[173]

and, of course, treaty provisions (in particular the treaty residence article and the distributives rules) put this objective into effect, access to tax treaty benefits is, however, not granted under the same conditions by all provisions. Some rules are subject to particular conditions (for example, a beneficial ownership limitation or a holding threshold and period in the case of dividends),[174] while others are not (for example, as regards the default exclusive allocation of the right to tax capital gains to the State of residence[175]). These differences reflect various policy considerations which have guided the drafters of the OECD Model and tax treaties patterned on the former. Therefore, merely considering the general object and purpose of the convention would not only contradict the wording of article 29(9) of the OECD Model (2017), but also be erroneously based on the premises that either treaty provisions have no specific object and purpose or that the latter is the same for all rules.

In some instances, the Commentaries on the OECD Model rightly and rigorously focuses on the object and purpose of the applicable provision. A good illustration is Example J relating to article 5(3) of the OECD Model which provides that "a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months". In this example, RCO, a company resident of State R, has successfully submitted a bid for the construction of a power plant for SCO, an independent company resident of State S. That construction project is expected to last 22 months. During the negotiation of the contract, however, the project is divided into two different contracts, each lasting 11 months. The first contract is concluded with RCO and the second contract is concluded with SUBCO, a recently incorporated wholly owned subsidiary of RCO resident of State R. At the request of SCO, which wanted to ensure that RCO would be contractually liable for the performance of the two contracts, the contractual arrangements are such that RCO is jointly and severally liable with SUBCO for the performance of SUBCO's contractual obligations under the SUBCO-SCO contract. The Commentary on Article 1 of the OECD Model (2017) correctly concludes that the subjective element of the PPT would here be satisfied and that granting:

> ... the benefit of that rule in these circumstances would be contrary to the object and purpose of that paragraph as the time limitation of that paragraph would otherwise be meaningless.[176]

A confirmation that the object and purpose of article 5(3) of the OECD Model would be defeated by arrangements of this kind also flows from the fact that the OECD Commentary on Article 1 (2017) recommends an optional SAAR to deal with this problem.[177] A second illustra-

the main purposes' of the transactions was not the obtaining of UK/US treaty benefits. So the structure would not constitute a conduit arrangement".

170. *See* Danon, *supra* n. 78.
171. Para. 173, ad art. 29, Example E *OECD Model: Commentary on Article 1* (2017).
172. Danon, *Treaty Abuse in the Post-BEPS World*, *supra* n. 9, at sec. 4.3.2.; Baez Moreno, *supra* n. 8, at p.437-440; and De Broe, *Tax Treaty and EU Law*, *supra* n. 8, at p. 213.
173. Preamble *OECD Model* (2017).
174. Id., at art. 10(2).
175. Id., at art. 13(5).
176. Para. 182, ad art. 29, Example J *OECD Model: Commentary on Article 1* (2017).
177. Paras. 51 and 52, *OECD Model: Commentary on Article 1* (2017).



© IBFD

tion is Example E relating to the ownership threshold of article 10(2)(a) of the OECD Model. In this case, RCO is a company resident of State R and, for the last five years, has held 24% of the shares of company SCO, a resident of State S. Following the entry-into-force of the State R-State S Tax Treaty, RCO decides to increase its ownership of the shares of SCO to 25%. The facts and circumstances reveal that the decision to acquire these additional shares has been made primarily in order to obtain the benefit of the lower rate of tax provided by article 10(2)a) of the State R-State S Tax Treaty. This example is well conceived because it perfectly illustrates the articulation of the subjective and objective component of the PPT. The OECD Commentary on Article 1 (2017) notes indeed that:

> although one of the principal purposes for the transaction through which the additional shares are acquired is clearly to obtain the benefit of Article 10(2) a), paragraph 9 would not apply because it may be established that granting that benefit in these circumstances would be in accordance with the object and purpose of Article 10(2) a). That subparagraph uses an arbitrary threshold of 25 per cent for the purposes of determining which shareholders are entitled to the benefit of the lower rate of tax on dividends and it is consistent with this approach to grant the benefits of the subparagraph to a taxpayer who genuinely increases its participation in a company in order to satisfy this requirement.[178]

However, the OECD Commentary on Article 1 (2017) insists on the genuiness of the increase of the participation. Accordingly, the author believes that the benefit of article 10(2)(a) of the OECD Model could still be denied if the increase of the participation is a sham or simulated operation (in which case this conclusion would be technically based on a proper establishment of the facts) or defeats the object and purpose of this provision, i.e. to provide a lower residual tax in the State of source to facilitate international investment in parent-subsidiary relationships,[179] because, for instance, the shareholding is immediately reduced below the threshold of article 10(2)(a) after a large dividend distribution.

This being said, in several other examples, the object and purpose of the applicable provisions are not seriously considered. Rather, "the object and purpose of the tax convention"[180] is referred to in order to determine whether treaty benefits should be granted. Accordingly, to deny treaty benefits, it is contended that "it would be contrary to the object and purpose of the tax convention to grant the benefit of that exemption under this treaty-shopping arrangement",[181] and in cases in which the PPT rule does not apply, the fact that "the general objective of tax conventions is to encourage cross-border investment"[182] is put forward. The problem with this approach is threefold. First, as already noted, it does not do justice to the clear wording of article 29(9) of the OECD Model. Second, from a policy perspective, what constitutes an encouragement of cross-border investment is highly subjective and, as mentioned in section 1., depends by essence on various national policy considerations. Probably, the only situation in which most countries would agree that there is no encouragement of cross-border investment is the one in which a tax treaty is used for a circular arrangement ("round-tripping") in which case, by essence, this cross-border dimension is completely artificial. Finally, in various situations and as correctly pointed out for example by the Full Federal Court of Australia (FFCA) in *Lamesa* (1997), the object and purpose of the tax treaty will not throw light on the interpretation to be adopted with respect to a particular treaty provision.[183]

It is, therefore, submitted that it must always be determined whether the relevant provisions have their own specific purpose.[184] In the author's opinion, the optional SAARs which have been included in the OECD Model (2017) play a useful role in this respect. The first situation is the case in which the applicable tax treaty includes the relevant SAAR. Assume for instance that the equivalent of articles 10(2)(a) and 13(4) of the OECD Model in the tax treaty in question include the "365 day" period test designed to prevent abusive dividend transfer transactions and the circumvention of the look-through principle applying to gains realized on the disposal of interests in real estate entities. Using the language of the Commentary on Article 10 of the OECD Model in relation to the 25% holding threshold of article 10(2)(a) of the OECD Model, it is submitted that, if the taxpayer "genuinely" satisfies this arbitrary 365-day test, granting tax treaty benefits is in accordance with these relevant provisions. This being said, the argument is often made that a SAAR does not exclude the application of a GAAR because a SAAR may by essence not cover all cases of abuse.[185] The language of article 29(9) of the OECD Model, "Notwithstanding the other provisions of this Convention", seems to go in that direction. However, as the author has already argued elsewhere, the PPT could only come into play to test an additional factual element that is not covered by the SAAR itself.[186] Therefore, where for example the taxpayer satisfies a 365 day holding period within the meaning of article

178. Id., at para. 182, ad art. 29, Example E.
179. Id., at para. 10, ad art. 10.
180. Para. 182, Examples A, B, C, D, *OECD Model: Commentary on Article 29* (2017).
181. Id., at para. 182, Example A (2017).
182. Para. 182, Example C (2017) *OECD Model: Commentary on Article 29* (2017).
183. *Lamesa* (1997), p. 608: "At this point one may have regard in considering Art 13(2)(a)(iii), both to the policy of double taxation treaties generally and to the specific policy revealed in Art 13. There will be cases, and Thiel was one, where resort to the purpose of the double tax treaty to be found in the words 'for the avoidance of double taxation with respect to taxes on income' may throw light on the interpretation to be adopted with respect to a particular Article. But it is difficult to see that that is the case here. If Art 13 applies, then profit from the alienation is authorised to be taxed in the place where the realty referred to in the Article is. If the alienation falls outside Art 13, then any profit falls to be taxed under Art 4, in this case in the Netherlands."
184. In the same vein, *see* De Broe, *supra* n. 64, at pp. 344 and 403 et seq., and E. Furuseth, *The Interpretation of Tax Treaties in Relation to Domestic GAARs* p. 147 (IBFD 2018), Books IBFD.
185. *See*, for example, IN: Government of India, Ministry of Finance, Department of Revenue Central Board of Direct Taxes (F.no. 500/43/2016-FT& TR-IV), Clarifications on implementation of GAAR provisions under the Income Tax Act, 1961, 27 Jan. 2017: "It is internationally accepted that specific anti avoidance provisions may not address ail situations of abuse and there is need for general anti-abuse provisions in the domestic legislation. The provisions of GAAR and SAAR can coexist and are applicable, as may be necessary, in the facts and circumstances of the case."
186. Danon, *Treaty Abuse in the Post-BEPS World*, *supra* n. 9, at sec. 4.8.2.

10(2)(a) of the OECD Model, treaty benefits may not be denied because the tax administration nevertheless finds a particular restructuring abusive. Rather, an additional factual element (unrelated to the holding period itself, for example, a conduit arrangement) would need to be present and, assuming the subjective element of the PPT is satisfied, it would then need to be demonstrated that this additional factual element defeats the object and purpose of article 10 of the OECD Model.

Assume now that the relevant tax treaty does not incorporate the 365-day period test in its equivalent of article 10(2)(a) and 13(4) of the OECD Model. In this situation, the author would argue that this 365-day test could still be used to identify the object and purpose of these provisions. The argument runs as follows. The fact that this optional SAAR has been included in the OECD Model (2017) and the Commentaries on the OECD Model (2017) evidences that the object and purpose of these provisions would be defeated if they could be manipulated by last-minute restructurings. As regards dividends, this interpretation is confirmed by the earlier Commentaries on the OECD Model.[187] Therefore, if such an abusive restructuring takes place, the PPT may then come into play to deny treaty benefits as the taxpayer could not successfully invoke the benefit of its escape clause in these circumstances. This is also confirmed by the Commentary on Article 1 of the OECD Model (2017) in a number of instances without, again, properly discussing the object and purpose of the provisions at stake.[188] Following this line of reasoning, the author would then further submit that even if the 365-day test is not incorporated in the applicable treaty provisions, this test may, nevertheless, serve as a safe harbour to determine whether the object and purpose of these provisions have been defeated with respect to issues concerning the timing of a restructuring. This would not only increase tax certainty, but also make sense from a policy perspective: given the fact that an arbitrary 365-day test has been identified and incorporated into the OECD Model and that the timing element is key in these types of restructurings, it would be absurd if, by relying on the PPT alone, countries having chosen not to incorporate these SAARs into their tax treaties, would look at the object and purpose of article 10(2)(a) and 13(4) using different timing tests.[189]

This being said, from a policy perspective, the PPT reaches its limits where the problem at stake concerns the issue of nexus in the State of residence. Indeed, the primary rule which then comes into play is the definition of treaty residence under article 4 of the OECD Model. Of course, various tests, for example the active business test of LOB clauses applied by analogy[190] or, as the author has suggested, the BEPS Action 5 modified nexus approach in the case of IP income), may be used as safe harbours, and if these tests are satisfied, it may be contended that the general objective of the tax treaty (fostering the exchanges of goods and services, and the movement of capital and persons while preventing tax avoidance)[191] is fulfilled and that granting treaty benefits would be in accordance with article 4 of the OECD Model as this provision does of course not contradict such objective but aims at putting the latter into effect. However, this does not mean that granting treaty benefits in circumstances in which such threshold is not satisfied would necessarily be in breach of the object and purpose of article 4 of the OECD Model, even contextually construed in light of the new preamble. That would indeed amount to an additional nexus requirement in article 4 of the OECD Model through the purposive interpretation. However, as shown by the recently decided case of *Alta Energy*, the purposive interpretation cannot by definition accomplish this. In this case, it was apparent that the entity claiming treaty benefits in Luxembourg did not have strong economic ties with this country. Accordingly, the Crown had submitted that granting treaty benefits in these circumstances would defeat the object and purpose of the provisions at stake:

> Articles 1, 4 and 13(4) of the Convention, together, are intended to grant a particular treaty benefit to Luxembourg investors whose investments in specific taxable Canadian property gives rise to gains for them, in Luxembourg. Those provisions are not intended to benefit entities who do not have the potential to realize income in Luxembourg, nor have any commercial or economic ties therewith. Such situations are wholly dissimilar to the relationships or transactions that are contemplated by those provisions of the Convention.[192]

The CFCA flatly dismissed this reasoning noting that:

> There is no distinction in the Luxembourg Convention between residents with strong economic or commercial ties and those with weak or no commercial or economic ties. If a person satisfies the definition of resident in Article 4, then that person is a resident for the purposes of Articles 13(4) and (5). The Crown did not provide any support for its contention that the object, spirit and purpose of Articles 13(4) and (5) was only to exclude from taxation in Canada gains arising from the disposition of shares held by Luxembourg residents with strong economic or commercial ties to Luxembourg.[193]

187. *See*, for example, para. 17 of the *OECD Model: Commentary on Article 10* (2014): "The reduction envisaged in subparagraph a) of paragraph 2 should not be granted in cases of abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction. To counteract such manoeuvres Contracting States may find it appropriate to add to subparagraph a) a provision along the following lines: provided that this holding was not acquired primarily for the purpose of taking advantage of this provision."
188. *See* para. 182, ad art. 29, Example A in *OECD Model: Commentary on Article 1* (2017) and in relation to a rule shopping situation, para. 186.
189. In the same vein, *see* Duff, *Part II*, *supra* n. 8, at pp. 964-965.
190. *See* Van Weeghel, *supra* n. 8, at sec. 9.
191. Para. 54, *OECD Model Commentary on Article 1* (2017).
192. *Alta Energy* (2020), para. 38, referring to para. 91 of the Crown's memorandum.
193. *Alta Energy* (2020), para. 65. *See also*, already in the same vein, CA: TCC, 10 Sept. 2009, *Garron and another v. R; Re Garron Family Trust and Garron v. R; St Michael Trust Corp v. R; Re Fundy Settlement; Dunin v. R; St Michael Trust Corp v. R; Re Summersby Settlement* 450, 12 ITLR 79, p. 132, Case Law IBFD: "The Minister also submits that the treaty exemption was not intended to apply to the trusts because they had very little connection with Barbados. It was noted that the assets, contributors and beneficiaries are all Canadian. To apply the treaty exemption in these circumstances would facilitate the avoidance of tax by Canadians" (para. 380) and "The problem that I have with this argument is that, if accepted, it would result in a selective application of the treaty to residents of Barbados, depending on criteria other than residence. It seems to me that this is contrary to the object and spirit of the treaty, which


© IBFD

In other words, according to the CFCA:

> [w]hile the GAAR can change the tax consequences from what they would otherwise be, the GAAR cannot be used, in this case, to justify adding a requirement for investment that is not present in the Luxembourg Convention.[194]

We subscribe to the reasoning of the CFCA on this point, which the author finds to also be relevant for the purposes of the objective component of the PPT. As discussed earlier in section 2.2.2., treaty residence according to article 4 of the OECD Model is exclusively based on the existence of an unlimited liability to tax under the laws of the relevant Contracting State and, therefore, may be satisfied by the mere incorporation of an entity in that State. This, of course, facilitates treaty shopping. However, the PPT cannot correct this policy by incorporating for example into article 4 of the OECD Model a significant nexus test that was never intended.

A similar conclusion applies to article 13(5) of the OECD Model, which states that:

> gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.

This provision equally does not incorporate such a requirement or, for example, a holding period. The fact that a 365-day period was included in article 10(2)(a) and in article 13(4) but not in article 13(5) of the OECD Model confirms this conclusion. As mentioned already in section 3.3.3., the Commentary on Article 1 of the OECD Model (2017) states, however, that:

> a person may sell a property for various reasons, but if before the sale, that person becomes a resident of one of the contracting States and one of the principal purposes for doing so is to obtain a benefit under a tax convention, art. 29(9) OECD MC [Model] could apply notwithstanding the fact that there may also be other principal purposes for changing residence, such as facilitating the sale of the property or the re-investment of the proceeds of the alienation.[195]

While it is here conceivable that the subjective element of the PPT be satisfied, for example, if the asset is sold shortly after the transfer of residence, the author fails to see why granting treaty benefits in these circumstances would defeat the object and purpose of article 13(5) of the OECD Model. Treaty benefits could however be denied if it were established that, as a matter of legal substance, the transaction had already been effected before the transfer of residence and that the subsequent sale was just a sham. The denial of treaty benefits would then not be based on the PPT but, rather, on a proper establishment of the facts.

As already correctly observed by a commentator at the time in relation to *Lamesa*,[196] the foregoing shows that the fact that a taxpayer sets up an arrangement with the aim to avoid tax is in itself not sufficient to deny him the treaty benefits. Rather, the taxpayer should also act contrary to the objectives of the provision of which he seeks advantage as such objectives are materialized in the terms of that provision.[197] In the author's opinion, this observation remains fully valid as regards the PPT.

## 4. The Other Side of the Coin: How about a PPT to Regulate the Conduct of States?

We wish to conclude this contribution with a final question. How about a PPT to regulate the conduct of States?

As it has been incorporated in article 29(9) of the OECD Model, the PPT applies, of course, only to deny treaty benefits to taxpayers. What about, however, the misuse of tax treaties by States? If one follows the position of the OECD that the guiding principle also derives "from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (*see* article 31 of the Vienna Convention (1969)),[198] it is hard to dispute the fact that article 31 (and article 26) of the Vienna Convention (1969) imposes a similar obligation on States. In fact, even commentators who are reluctant to accept the existence of an inherent prohibition of abuse applying to taxpayers recognize that the performance of treaty obligations by States is subject to such prohibition.[199] It is accepted that the principle of good faith enshrined in article 26 of the Vienna Convention (1969) incorporates a doctrine of abuse of rights, according to which parties shall abstain from acts calculated to frustrate the object and purpose and, thus, impede the proper execution of the treaty.[200]

Misuse of a tax treaty by a Contracting State in a way that breaches the principle of good faith may take various forms, and it is certainly beyond the scope of this contribution to exhaustively address this problem.

A first classical case, however, is a subsequent change made by a Contracting State to its domestic law with the effect that the application of such change, through article 3(2) of the OECD Model, affects the balance of allocation of taxing rights agreed with the other Contracting State in a way that breaches the principle of good faith.[201] Leaving aside good faith, such changes are at tension with the object and purpose of the treaty, which is also to maintain its balance of rights and obligations created.[202] Courts

is apparent in art I and art IV(1). Residents of Barbados, as defined for purposes of the treaty, are entitled to the benefits of art XIV(4) as long as they are not also residents of Canada" (para. 381).

194. *Alta Energy* (2020), para. 46.
195. Para. 180, ad art. 29 *OECD Model: Commentary on Article 1* (2017).
196. *Lamesa* (1997), p. 608.
197. De Broe, *supra* n. 64, at p. 373, N 140.
198. Para. 59, ad art. 29 *OECD Model: Commentary on Article 1* (2017).
199. *See* S. van Weeghel & A. Gunn, *General Anti-Abuse Principle of International Law: Can It Be Applied in Tax Cases*, in *Essays on Tax Treaties: A Tribute to David A. Ward* p. 323 (G. Maisto, A. Nikolakakis & J.M. Ulmer eds., Can. Tax Fond./IBFD 2012).
200. Villiger, *supra* n. 105, at N 8, ad art. 26. *See also* the decision of the International Court of Justice (ICJ) in ICJ, *Cahcfkovo-Nagymaros*, [1997] ICJ Rep 7, para. 142, which reads: "Article 26 combines two elements, which are of equal importance. It provides that 'Every treaty in force is binding upon the parties to it and must be performed by them in good faith.' This latter element, in the ICJ's view, implies that, in this case, it is the purpose of the treaty, and the intentions of the parties in concluding it, which should prevail over its literal application. The principle of good faith obliges the parties to apply it in a reasonable way and in such a manner that its purpose can be realized."
201. *See*, among others, K. Vogel, *Klaus Vogel on Double Taxation Conventions* p. 65, N 125 (3rd ed., Kluwer L. Intl 1997) who refers to such situation as "tax treaty dodging" which should be distinguished from a formal tax treaty override and Vogel & Rust, *supra* n. 102, at N 149; and De Broe, *supra* n. 64, at p. 272.
202. Villiger, *supra* n. 105, at N 11, ad art. 31.

have dealt with this problem, for example in Belgium[203] and in the Netherlands.[204] Moreover, the Commentary on Article 3(2) of the OECD Model recognizes that:

> a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention.[205]

A similar concern was expressed at the time by Switzerland in the context of conflicts of qualification and the obligation for the State of residence to accept the domestic law qualification of the State of source as regards the applicable distributive rule in the Commentary on Article 23 of the OECD Model (2000).[206] Switzerland, indeed, reserved:

> its right not to apply the rules laid down in paragraph 32.3 in cases where a conflict of qualification results from a modification to the internal law of the State of source subsequent to the conclusion of a Convention.[207]

A second case concerns the introduction by a Contracting State of new "taxes", allegedly outside the material scope of its treaties, to avoid their restricting effect on its domestic law. Here a tension with article 2 (Taxes covered) of the OECD Model arises. As is well known, the topic has captured significant attention in light of the challenges raised by digitalization and the shift back to a certain "fiscal unilateralism" in an effort to move quickly with the introduction of "equalization levies", "digital services taxes", etc.[208] With the objective of protecting the material scope of the treaty, the Commentary on Article 2 of the OECD Model mentions that the intention of article 2 of the OECD Model is to widen as much as possible the field of application of the Convention.[209] In that sense, article 2(4) of the OECD Model also provides that:

> The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.

Further, the Commentary on Article 2 of the OECD Model suggests that Contracting States extend this notification requirement to cover any significant changes in other laws that have an impact on their obligations under the Convention.[210] For this purpose, the last sentence of article 2(4) of the OECD Model could be replaced by the following:

> The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws or other laws affecting their obligations under the Convention.[211]

In light of the foregoing, it is, therefore, fair to say that the awareness that States may misuse or try to escape their treaty obligations in a way that is not compatible with the principle of good faith flows from different passages of the Commentaries on the OECD Model. With regard to equalization levies, for example, the author has observed that, at the time, these taxes were carefully drafted in order to remain outside the scope of tax treaties, but that it was unacceptable for States to design a tax with the intention of keeping it outside of the scope of tax treaties in order to accomplish what was de facto an expansion of source taxing rights.[212]

This being said, unlike for taxpayers with the PPT in article 29(9) of the OECD Model, there is to date no codified general rule in the OECD Model and UN Model that regulates the performance of treaty obligations by Contracting States in good faith. Building on article 29(9) of the OECD Model, we thus wonder whether or not it would not be appropriate to develop a clause that could be drafted along the following lines:

> Notwithstanding the other provisions of this Convention, in particular para. 2 of art. 3, an important change introduced by a Contracting State in its domestic law or practice after the signature of this convention shall, subject to an agreement between the competent authorities of the Contracting States, be disregarded, if is reasonable to conclude, having regard to all relevant facts and circumstances, that such change affects the obligations of the first-mentioned State or the balance of allocation of taxings rights under the Convention, unless it is established that the change introduced remains in accordance with the object and purpose of the relevant provisions of this Convention.

The proposed clause not only makes reference to an important change affecting the balance of allocation of taxing rights under the Convention, but also to treaty obligations imposed on the State introducing the change (for example, that arising out of the non-discrimination article). The reference to the "object and purpose of the

203. *See* the decision of the Belgian *Cour d'Appel Bruxelles* (Court of Appeal of Brussels, CA Bruxelles), in BE: CA Bruxelles, 15 Feb. 2002, FJF, 2002/109 affirmed by the Belgian *Hof van Cassatie/Cour de Cassation* (Supreme Court, HvC/CdC) in BE: HvC/CdC, 5 Dec. 2003, FJF, 2004/64.
204. *See* the decision of the Netherlands *Hoge Raad* (Supreme Court, HR) in NL: HR, 18 Nov. 2016, Case No. 15/04977, ECLI:NL:HR:2016:2497, BNB 2017/34, NTFR 2016/28/64 (*X v. State Secretary for Finance (Fictitious Wage 3)*), 20 ITLR 125; and F.P.G. Pötgens & T.M. Vergouwen, *Supreme Court Issues Third Ruling on Fictitious Wage and Tax Treaties: Decision of the Netherlands Supreme Court of 18 November 2016, BNB 2017/34*, 57 Eur. Taxn. 8 (2017), Journal Articles & Papers IBFD; and F.P.G. Pötgens, *The Relationship between Preservative Tax Assessments and Netherlands Tax Treaties: Not Always* Pacta Sunt Servanda?, 50 Eur. Taxn. 5 (2010), Journal Articles & Papers IBFD. In NL: HR: 14 July 2017, Case No. 7/01256, ECLI:NL:HR:2017:1324, BNB 2017/186, the HR held, in contrast, that the Dutch exit levies imposed on annuities and pensions complies with the good faith principle. For a critical analysis, *see* F.P.G. Pötgens & E.M.L. Kool, *The Relationship between Tax Treaties and Protective Tax Assessments Issued in Respect of Pensions and Annuities upon Emigration:* Pacta sunt servanda *and Compartmentalization*, 58 Eur. Taxn. 9 (2018), Journal Articles & Papers IBFD.
205. Para. 13, ad art. 3 *OECD Model: Commentary on Article 3* (2017).
206. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23*, para. 32.3 (29 Apr. 2000), Treaties & Models IBFD.
207. Id., at para. 81, ad art. 23. *See* thereupon, R.J Danon & H. Salomé, *The OECD Partnership Report – A Swiss View on Conflicts of Qualification*, 31 Intertax 5, pp. 190-196 (2002).
208. *See* thereupon, for example, R.J. Danon, *Can Tax Treaty Policy Save Us? The Case of the Digital Economy*, in *Tax Treaties After the BEPS Project – A Tribute to Jacques Sasseville* p. 75 (B.J. Arnold ed., Can. Tax Fond. 2018); A.J. Martín Jiménez, *Controversial Issues About the Concept of Tax in Income and Capital Tax Treaties in the Post-BEPS World*, in *Tax Treaties After the BEPS Project – A Tribute to Jacques Sasseville* p. 165 (B.J. Arnold ed., Can. Tax Fond. 2018); R. Ismer & C. Jescheck, *The Substantive Scope of Tax Treaties in a Post-BEPS World: Article 2 OECD MC (Taxes Covered) and the Rise of New Taxes*, 45 Intertax 5, p. 386 (2017); and, more broadly, A. Turina, *Which 'Source Taxation' for the Digital Economy?*, 46 Intertax 6/7, p. 495 (2018).
209. Para. 1, ad art. 2 *OECD Model: Commentary on Article 2* (2017).
210. Id., at para. 8, ad art. 2.
211. Id.
212. Danon, *supra* n. 208, at pp. 82-83.



© IBFD

relevant provisions of this Convention" entails that the compatibility of a domestic change with treaty obligations would be assessed in light of a purposive interpretation of the relevant provisions, much like with the escape clause in the PPT of article 29(9) of the OECD Model. This would also ensure that not every change affecting the balance of the allocation of taxing rights would be disregarded. Here is an example. Assume that article 13(5) of the State A-State B Tax Treaty includes a "subject-to-tax" requirement according to which a State has to forego its right to tax conferred on it by the domestic laws only if the other State on which the right to tax is conferred by the Convention makes use thereof.[213] Now assume that after the conclusion of the tax treaty, State A, which initially exempted capital gains, modifies its domestic tax law with a view to subject these items to regular taxation. Clearly, this would then imply a shift of allocation of taxing right, as article 13(5) of the tax treaty would then operate with the capital gain becoming exclusively taxable in the State of residence of the alienator. This consequence, which flows from the fact that the subject-to-tax clause of this provision would be satisfied, would remain, however, in accordance with its object and purpose. Therefore, the change would need to be accepted.

In the author's opinion, such a clause merely expresses what may already be derived from a proper performance of treaty obligations by States in good faith, in accordance with articles 26 and 31 of the Vienna Convention (1969). The existence of an express provision inspired from the PPT, but which would regulate the conduct of States, would, thus, merely confirm these principles. From a policy perspective, however, perhaps such a clause could encourage States to act within their treaty obligations and to properly renegotiate the latter when necessary rather than following the easy but dangerous path of trying to circumvent them. Whether or not States would accept to restrict themselves in this fashion is another question. However, if one truly believes in fiscal multilateralism (or even in bilateralism…), it seems difficult to disagree.

213. Para. 21, ad art. 13 *OECD Model: Commentary on Article 13* (2017), which states that Contracting States are free to supplement their bilateral convention in such a way.

IBFD, Your Portal to Cross-Border Tax Expertise **www.ibfd.org**

Covering over 60 countries, Global Transfer Pricing Explorer Plus is a practical guide that will assist you in making transfer pricing decisions.

- Includes practical examples, cases and diagrams.
- Chapters deal with comparability analyses, transfer pricing methods, compliance, transfer pricing audits, penalties, advance pricing agreements and litigation.
- Covers very specific issues such as intangibles, services, cost contribution arrangements, business restructuring, intra-group financing and the intricate role of transfer pricing in indirect taxes.
- Includes Transfer Pricing Tables, Transfer Pricing Documentation Tables and BEPS Country Monitor.
- Information on documentation requirements includes CbC, MF, LF and deadlines.

To see the full collection content and tools, to take a free 7-day trial or to order, please visit www.ibfd.org.

**Contact us**

**IBFD Head Office**
Rietlandpark 301
1019 DW Amsterdam

P.O. Box 20237
1000 HE Amsterdam,
The Netherlands

**Tel.:** +31-20-554 0100 (GMT+1)
**Customer Support:** info@ibfd.org
**Sales:** sales@ibfd.org

**Online:** www.ibfd.org
www.linkedin.com/company/ibfd
@IBFD_on_Tax

2020_1