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In this article, the author discusses the saving clause in the OECD's multilateral instrument and potential problems that may result from its application, and concludes that for a majority of OECD member states, adopting the clause may not be appropriate.

The saving clause, found in article 1(4) of the U.S. model tax convention,[1] provides that treaty partners can tax their own residents or citizens in accordance with their domestic laws irrespective of whether the treaty is in effect. The clause is a standard feature of U.S. treaty policy. From a U.S. perspective, it reinforces the U.S.'s ability to tax its residents and citizens on their worldwide income. However, article 1(5) of the U.S. model also contains exceptions to the saving clause.[2] These exceptions ensure that treaty benefits are available to residents or citizens. Again taking a U.S. perspective, this suggests that the U.S. is restricted from applying its domestic law and must apply treaty benefits when a situation falls within specific exceptions. While it is a U.S. creation, it is worth noting that the clause operates on the basis of reciprocity. This implies that the clause saves the right of *both* contracting states to tax their own residents (or citizens) in accordance with their internal laws unless and until an exception applies.

In October 2015[3] the OECD released its final deliverable on action 6 of the base erosion and profit-shifting project. Along with other measures, a saving clause like that in the U.S. model (customized to the OECD model) was proposed. Article 1(3) provides that:

> This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23, 24 and 25 and 28.

This provision is also reflected in article 11(1)(a)-(g) of the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI).[4] However, in order to ensure that the exceptions reflect existing treaty practice (likely, U.S. practice), the MLI added subparagraphs (h)[5] and (i)[6] to address instances when the taxpayer is exclusively taxed in the state of source. The MLI further broadens the exceptions by adding subparagraph (j), which is intended to "cover provisions that expressly limit taxation rights of the residence jurisdiction or

[1] U.S. Model Tax Income Tax Convention of February 17, 2016, article 1(4). The first sentence of the paragraph provides that "Except to the extent provided in paragraph 5 of this Article, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens."

[2] *Id*. at article 1(5). The exceptions include, among other provisions, article 9(2) (associated enterprises), article 7(3) (business profits), article 23 (relief from double taxations), article 24 (non-discrimination), and several provisions dealing with pensions, alimony, and social security.

[3] OECD, "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report" (Oct. 5, 2015).

[4] OECD, "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (Nov. 24, 2016).

[5] This exception provides that pensions or other payments made under social security legislation of the source state are taxable only in that state.

[6] This exception provides that pensions and similar payments, annuities, alimony payments, or other maintenance payments arising in the state of source are taxable only in that state.

expressly allow taxation rights exclusively to the source jurisdiction." [7]

Notably, the saving clause is optional; states may choose whether to opt for its inclusion[8] because it is not a minimum standard. The key question addressed in this article is whether states that have no experience with this clause should opt for the saving clause and notify the depository of the MLI accordingly. This article is not intended to serve as a detailed analysis of the clause.[9]

The Reasons for the OECD's Saving Clause

The OECD's final report on action 6 introduced the saving clause as part of its discussion about the interaction between specific domestic antiavoidance rules and tax treaties.[10] The report argues that the majority of tax treaty provisions operate to restrict the taxing rights of the source state, as opposed to the taxing rights of the state of the taxpayer's residence. However, in limited cases, tax treaties have been interpreted as limiting the state of residence's right to tax its own resident taxpayer. The report[11] states that this latter position should be rejected, referring to portions of the OECD commentary on partnerships (specifically, paragraph 6.1 of the commentary on article 1) and controlled foreign company rules (specifically, paragraph 23 of the commentary on article 1, and paragraph 14 of the commentary on article 7). Nevertheless, the report proposes the introduction of the saving clause[12] to explicitly state that treaty provisions should not limit a state's right to tax its own residents, particularly when that state applies "domestic anti-abuse rules (as illustrated by the example of controlled foreign companies rules)" to its own residents.

[7] *See* OECD, "Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (Nov. 24, 2016), para. 150.

[8] *See id.*, para. 153.

[9] For a detailed analysis, see Georg Kofler, "Some Reflections on the 'Saving Clause,'" 44(8/9) *Intertax* 574-589 (2016).

[10] OECD action 6 report, *supra* note 3, at para. 60.

[11] *Id*. at para. 61.

[12] *Id*. at para. 62.

Is a Saving Clause Useful and Appropriate?

In the context of CFC-type rules, the question arises whether the provisions of a tax treaty (based on the 2014 OECD model) restrict a state (State R) from imputing to its own resident taxpayer (a controlling corporation or controlling individual, X) the income derived by a controlled foreign entity (P) established in another state (State P). International organizations,[13] namely the U.N. and OECD, believe that these domestic antiavoidance rules do not conflict with tax treaties. Several courts[14] and the tax administrations of several OECD member states[15] agree. However, a few courts[16] and a handful of tax administrations argue otherwise.[17] Moreover, in the context of hybrid entities (which may or may not be set up with a tax avoidance purpose), a question arises whether the provisions of a tax treaty restrict a state (State R) from imputing to its own resident taxpayer (partner X) the income derived by a foreign opaque partnership (P) established in another state (State P). Again, a majority[18] of OECD member states are of the opinion that the domestic rules do not conflict with tax treaties. However, the minority argue otherwise.[19] Since the majority of states perceive no conflict between such domestic income

[13] OECD, "Commentaries on the Articles of the Model Tax Convention" (July 15, 2014), article 1, para. 23; article 7, para. 14; article 10, paras. 37-39. *See also* U.N., "Commentaries on the Articles of the Model Double Tax Convention Between Developed and Developing Countries" (2011), article 1, para. 74; article 7, para. 8; and article 10, para. 16.

[14] For example, see *Bricom Holdings Limited v. Inland Revenue Commissioners*, STC 1179 (CA), Court of Appeal (July 25, 1997) (U.K. court interpreting treaty with the Netherlands); *Re A Oyj Abp*, KHO:2002.26, 4 ITLR 1009 (Mar. 20, 2002), pp. 1009-1076 (Finnish court interpreting treaty with Belgium); and *Glaxo Kabushiki Kaisha v. Director of Kojimachi Tax Office*, Case No. 2008 (Gyou Hi), 12 ITLR 644 (Oct. 29, 2009) (Japanese court interpreting treaty with Singapore).

[15] See the view of the majority expressed in the OECD, "Double Taxation Conventions and the Use of Base Companies," para. 39 (Nov. 26, 1986).

[16] For example, see *Re Société Schneider Electric*, CE No. 232276 (June 28, 2002) (French court interpreting treaty with Switzerland); *Eagle Distribuidora de Bebidas SA v. Second group of the Revenue Department in Brasilia*, Ac. 101-97-070 (Dec. 17, 2008) (Brazilian court interpreting treaty with Spain).

[17] For instance, see the observations to the OECD commentary, *supra* note 13, by Belgium, Ireland, Luxembourg, the Netherlands, and Switzerland on article 1, article 7, and article 10(5).

[18] OECD, "The Application of the OECD Model Tax Convention to Partnerships," para. 127 (discussion in Example 16) and para. 131 (discussion in Example 17) (Aug. 26, 1999).

[19] *Id*. at para. 126 (discussion in Example 16) and para. 132 (discussion in Example 17).

imputation rules and treaty law, there simply is nothing that needs saving. Accordingly, adopting the saving clause would not make sense for those majority states.

Nevertheless, to avoid specific recurring controversies, it may be wise for both the majority and the minority to adopt a treaty provision clarifying that treaties do not prevent the application of CFC-type rules and do not prevent the application of residence state income attribution rules. The saving clause does achieve this purpose. However, its impact also goes beyond its stated purpose, which raises several concerns.

The Saving Clause and the BEPS Project

First, as a fundamental starting point, I do not believe that the saving clause is a treaty antiabuse clause akin to the principal purpose test or the limitation on benefits clause. The clause preserves a state's right to tax its resident in both "genuine" as well as "tax avoidance" situations. Since the main objective of action 6 is to ensure that tax treaties do not facilitate tax avoidance, one might question whether the saving clause belongs in the BEPS project, since the clause also preserves the right of a state to tax its residents in genuine circumstances.

The Saving Clause and the Arm's-Length Standard

Second, and most important, the arm's-length provision found in article 9(1) of the OECD model tax convention is not listed as an exception to the saving clause. This could affect those states that consider article 9(1) to be a "restrictive" as opposed to an "illustrative" provision.[20]

For example, suppose a company in State R (Corp A) sells goods to its associated enterprise (Corp B) in State S for $100. However, the arm's-length price for this transaction, as determined by applying one of the authorized OECD transfer pricing methods, is determined to be $120. Nevertheless, under its domestic rules for pricing transactions with associated enterprises, State R considers the sale price for the transaction to be $150 (for example, by using a formulary apportionment mechanism).[21] If article 9(1) is read as restrictive, it would permit State R to rewrite the accounts of Corp A only up to the arm's-length standard price of $120. However, because article 9(1) is not excepted from the saving clause, State R may not need to apply the arm's-length standard when making primary adjustments, since State R can tax its residents in accordance with its internal laws. Consequently, the accounts of Corp A could be rewritten to $150. The question then becomes whether State S should provide a corresponding adjustment under article 9(2), which *is* listed as an exception to the saving clause. Article 9(2) requires State S to provide an adjustment only when State R makes profit adjustments on an arm's-length basis. Since the adjustment is not on an arm's-length basis, State S would not be obliged to provide a corresponding adjustment (for the non-arm's-length amount). Ultimately the discrepancy means the issue would have to be resolved by the mutual agreement procedure in article 25.

Further, by not excepting article 9(1), the saving clause can also affect the application of thin capitalization rules. For example, consider the following situation: A company in State R (Corp A) funds its associated enterprise (Corp B) in State S with an interest-bearing loan. To counteract base erosion, State S applies its domestic arbitrary fixed debt-equity ratio (for instance, 4 to 1), which applies only to associated enterprises, and limits the interest deduction for Corp B.[22] The domestic rule applies even though the funding and interest rate are at arm's length. The OECD commentary suggests that some thin capitalization rules (such as arbitrary fixed debt-equity ratio rules) could conflict with article 9(1).[23]

[20] *See* OECD, "Thin Capitalization," para. 50 (Nov. 26, 1986). It is debated whether article 9(1) is restrictive or illustrative in its scope. A restrictive interpretation of article 9(1) would lead to the conclusion that it prohibits the adjustment of profits to an amount exceeding the arm's-length amount whereas an illustrative interpretation would lead to the conclusion that article 9(1) does not prohibit a country from adjusting the profits to an amount exceeding the arm's-length profit.

[21] For instance, the European Commission believes that the common consolidated corporate tax base is an "effective tool for attributing income to where the value is created, through a formula based on three equally weighted factors (i.e. assets, labor, and sales). Since these factors are attached to where a company earns its profits, they are more resilient to aggressive tax planning practices than the widespread transfer pricing methods for allocating profit." *See* European Commission, Proposal for a Common Corporate Tax Base (2016), at 2.

[22] *See, e.g.*, OECD, "Thin Capitalization," *supra* note 20, at para. 79.

[23] OECD commentary, *supra* note 13, at article 9, para. 3. *See also* 2011 U.N. commentary, *supra* note 13, at article 1, paras. 69-70.

Since article 9(1) is not listed as an exception to the saving clause, it could be argued that the tax treaty should not affect State S's taxation of its own resident (Corp B). Therefore, the saving clause opens the door for states to apply non-arm's-length thin capitalization rules to associated enterprises. But, if the treaty contains the deduction nondiscrimination clause (article 24, paragraph 4) or the ownership nondiscrimination clause (article 24, paragraph 5), and that rule applies to nonresidents (or nonresidents that have ownership interests in a payer), then the saving clause cannot protect the arbitrary fixed ratio rule, because article 24 is an exception.[24] Notably, some OECD member states do not include some provisions of the nondiscrimination articles in their tax treaties[25] or have carved out exceptions for interest limitation rules.[26] These states, if they adopt the saving clause, could deviate from the limitations imposed by the arm's-length standard in these circumstances.

The Saving Clause and Hybrid Entities

The saving clause also raises treaty interpretation issues for hybrid entities.

Suppose Partner X, a resident of State R, owns an interest in a foreign opaque partnership (P) established in State P. P derives royalty income (taxable only in the state of residence under article 12 of the P-R tax treaty) from State R. State R considers the partnership transparent and allocates the royalty income to X while State P treats it as a resident entity and allocates the income to P. The first question that arises is whether P should be entitled to treaty benefits. The final report on BEPS action 2 provides an answer by suggesting an anti-hybrid treaty provision.[27] The provision provides that:

> For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

This provision is mirrored in the (optional[28]) article 3(1) of the MLI.[29] Accordingly, P is entitled to treaty benefits only to the extent State P treats it as a resident taxpayer to whom income is allocated for tax purposes. Consequently, the royalty income is taxable only in State P.

Next, the question arises whether State R can tax X on the royalty income, even if exclusive taxation of royalties vests with State P under article 12 of the tax treaty. As discussed previously, most OECD member states follow the opinion that nothing in the treaty prevents State R from taxing X, its own resident. However, the OECD proposed the saving clause in the MLI to bring clarity to the situation. Nevertheless, if states reserve their right and do not opt for the saving clause, the MLI provides that states who opt to apply article 3(1) should add the following sentence at the end of the anti-hybrid provision: "In no case shall the provisions of this paragraph be construed to affect a Contracting Jurisdiction's right to tax the residents of that Contracting Jurisdiction."[30] By inserting this limited version of the saving clause, the OECD wishes to ensure that the tax treaty cannot prevent State R from taxing its own resident, Partner X, even if the treaty allocates taxing rights on the royalty income to State P.

This prompts another question: Should State R should provide relief to partner X (via a credit or exemption) for the taxes paid by an opaque partnership in State P? In the partnership report, the OECD states that relief should be provided.[31] However, in the action 6 report, after discussing

[24] OECD commentary, *supra* note 13, at article 24, paras. 74 and 79. *See also* 2011 U.N. commentary, *supra* note 13, article 1, para. 68.

[25] For example, see the reservations made to the nondiscrimination article of the OECD model by Canada and New Zealand. OECD commentary, *supra* note 13, at article 24, para. 85.

[26] For example, see the reservations made to the nondiscrimination article of the OECD model by France. *Id*. at article 24, para. 91.

[27] OECD, "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 — 2015 Final Report," Chapter 14 (Oct. 5, 2015). *See also* Dhruv Sanghavi, "BEPS Hybrid Entities Proposal: A Slippery Slope, Especially for Developing Countries," *Tax Notes Int'l*, Jan. 23, 2017, p. 357 (arguing that the anti-hybrid clause fails to achieve the goals of the BEPS project and thus is an undesirable provision).

[28] MLI, *supra* note 4, at article 3(5)(a).

[29] *Id*. at article 3(1).

[30] MLI, *supra* note 4, at article 3(3).

[31] OECD partnership report, *supra* note 18, at para. 129 (discussion in Example 16) and para. 139 (discussion in Example 18).

the saving clause, the OECD argues otherwise and proposes amending article 23 to clarify that "both States are not reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer."[32] The amended article 23 is also reflected in article 3(2) of the MLI.[33] However, even if states apply article 3(1) and article 3(3), states may reserve their right to apply article 3(2).[34] What happens in this situation? Can arguments still be made that the partnership report principles apply and hence State R should provide relief for the taxes paid by the partnership? In my opinion, this creates confusion and could raise relief-related issues when dealing with hybrid entities.

If states adopt both the anti-hybrid clause and the saving clause, another issue arises with CFC-type rules that follow a transparency approach (versus a deemed dividend approach). The question is whether the CFC rules fall within the scope of article 3(1), thus restricting the source state from applying its domestic taxing provisions. For example, suppose X, a controlling shareholder resident in State R, has an interest in P, a CFC established in State P. P derives dividend income from State S. From the perspective of State S and State P, P is a taxable entity. However, State R applies its CFC rule and, following a transparency approach, treats P as fiscally transparent, imputing the dividend income to X. All three states incorporate the anti-hybrid provision and the saving clause suggested by the MLI. Let's assume that the R-S treaty provides that dividends are taxed at a zero rate in the state of source while the P-S treaty provides for a tax rate at source of 15 percent. There is no doubt that State R can tax X on the income; the saving clause crystalizes this position. The key question from a State S perspective is whether it should be restricted to a zero rate or if it can apply the 15 percent rate. Applying article 3(1), State S should be restricted because the income is "derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law" of State R since State R considers the dividend to be "the income of a resident of that State," that is, X. The position is strengthened by example 9 of the OECD partnership report,[35] which also suggests that State S should be restricted to a zero rate because this is a case of double treaty entitlement. However, the OECD has analyzed the same issue in the context of CFC rules that follow a transparency approach and has concluded otherwise.[36] Why does the OECD have two different positions for similar situations? From a policy perspective, different treatment of similar situations is not desirable.

The Scope of the Saving Clause

Finally, the scope of the exceptions in the MLI might be broader than the scope of the exceptions provided by article 1(5) of the U.S. model. Suppose X, an individual tax resident of State R, owns a building in State S from which he derives rental income. Assume that article 6, the provision regarding immovable property, in the R-S tax treaty grants exclusive taxing rights on rental income to State S (versus a shared taxing right). If the saving clause in the R-S treaty resembles the U.S. saving clause, State R would be able to tax X (its own resident) because the article dealing with immovable property (article 6) is not listed as an exception to the clause. However, if the R-S treaty uses a clause similar to that in the MLI, then State R would not be able to tax its own resident, X. This is because subparagraph (j) excepts provisions that provide "expressly that the Contracting Jurisdiction in which an item of income arises has the exclusive right to tax that item of income."[37] Although this exception makes perfect sense, I think it is worth noting that subparagraph (j) to article 11 enlarges the scope of the exceptions to the saving clause in the MLI beyond that provided by the U.S. model.

Conclusion

As demonstrated, a majority of OECD member states are of the opinion that tax treaties

[32] OECD action 6 report, *supra* note 3, at para. 64.

[33] MLI, *supra* note 3, at article 3(2).

[34] *Id*. at article 3(5)(f).

[35] OECD partnership report, *supra* note 18, at para. 74 (discussion in Example 9); OECD commentary, *supra* note 13, at article 1, para. 6.5.

[36] OECD base companies report, *supra* note 15, at para. 59.

[37] MLI, *supra* note 4, at article 11(1)(j).

do not restrict a state from applying CFC-type rules or residence state income attribution rules (specifically, regarding partnerships).[38] Accordingly, these states have no need for the saving clause.

If the OECD's key intention with the saving clause was to clarify that tax treaties do not prevent the application of residence state domestic antiavoidance rules such as CFC-type rules, I believe that simpler solutions could have been proposed instead of a complex saving clause. For instance, a treaty provision could provide that "Nothing in this Convention shall be construed as preventing a Contracting State from including in the income of a resident of that Contracting State amounts under controlled foreign entity type legislation or general anti-avoidance rules." A reference to general antiavoidance rules (judicial or statutory) is made as those rules may also impute the income of nonresident entities to resident taxpayers.

If the OECD's intention was to clarify that treaties do not prevent a residence state from applying its attribution rules to hybrid entities, the aforementioned provision could be supplemented by a second sentence stating that "This provision also applies to entities in which a resident of a Contracting State has an interest such as a partnership, trust, or a similar entity."

Of course, these provisions could lead to double taxation. Accordingly, suitable treaty provisions would need to be designed to ensure that relief from double taxation is provided to taxpayers, especially, in cases of residence-residence conflicts.[39] ■

[38]In my opinion, the provisions of a tax treaty do not restrict a state from applying CFC-type rules to its own residents.

[39]For a discussion on these conflicts, see Robert Danon, "Qualification of Taxable Entities and Treaty Protection," *Bulletin for International Taxation* 192-201 (Apr./May 2014).