

Public Discussion Draft

# **BEPS ACTION 6: PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES**

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## PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES

### BEPS Action 6

#### INTRODUCTION

1. At the request of the G20, the OECD published its Action Plan on Base Erosion and Profit Shifting (Action Plan)<sup>1</sup> in July 2013. The BEPS Action Plan includes 15 actions to address BEPS in a comprehensive manner and sets deadlines to implement these actions.

2. The Action Plan identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns. Action 6 (Prevent Treaty Abuse) describes the work to be undertaken in this area. The relevant part of the Action Plan reads as follows:

**Existing domestic and international tax rules should be modified in order to more closely align the allocation of income with the economic activity that generates that income:**

*Treaty abuse is one of the most important sources of BEPS concerns.* The Commentary on Article 1 of the OECD Model Tax Convention already includes a number of examples of provisions that could be used to address treaty-shopping situations as well as other cases of treaty abuse, which may give rise to double non-taxation. Tight treaty anti-abuse clauses coupled with the exercise of taxing rights under domestic laws will contribute to restore source taxation in a number of cases.

#### *Action 6*

#### **Prevent treaty abuse**

*Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids.*

3. This report is the result of the work carried on in the three different areas identified by Action 6:
- A. Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.
  - B. Clarify that tax treaties are not intended to be used to generate double non-taxation.
  - C. Identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.

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1. Available at <http://www.oecd.org/ctp/BEPSActionPlan.pdf>.

4. The conclusions of the work in these three different areas of work correspond respectively to Sections A, B and C of this report. All changes that are proposed to the existing text of the Model Tax Convention appear in *bold italics* for additions and ~~strikethrough~~ for deletions.

#### **A. TREATY PROVISIONS AND/OR DOMESTIC RULES TO PREVENT THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES**

5. In order to determine the best way of preventing the granting of treaty benefits in inappropriate circumstances, it was found useful to distinguish two types of cases:<sup>2</sup>

1. Cases where a person tries to circumvent limitations provided by the treaty itself.
2. Cases where a person tries to circumvent the provisions of domestic tax law using treaty benefits.

6. Since the first category of cases involve situations where a person seeks to circumvent rules that are specific to tax treaties, it is unlikely that these cases will be addressed by specific anti-abuse rules found in domestic law. Although a domestic general anti-abuse rule could prevent the granting of treaty benefits in these cases, a more direct approach involves the drafting of anti-abuse rules to be included in treaties. The situation is different in the second category of cases: since these cases involve the avoidance of domestic law, they cannot be addressed exclusively through treaty provisions and require domestic anti-abuse rules, which raises the issue of the interaction between tax treaties and these domestic rules.

##### *1. Cases where a person tries to circumvent limitations provided by the treaty itself*

###### *a) Treaty shopping*

7. The first requirement that must be met by a person who seeks to obtain benefits under a tax treaty is that the person must be “a resident of a Contracting State”, as defined in Art. 4 of the OECD Model Tax Convention. There are a number of arrangements through which a person who is not a resident of a Contracting State may attempt to obtain benefits that a tax treaty grants to a resident of that State. These arrangements are generally referred to as “treaty shopping”. Treaty shopping cases typically involve persons who are residents of third States attempting to access indirectly the benefits of a treaty between two Contracting States.<sup>3</sup>

8. The OECD has previously examined the issue of treaty shopping in different contexts:

- The concept of “beneficial owner” was introduced in the Model in 1977 in order to deal with simple treaty shopping situations where income is paid to an intermediary resident of a treaty country who is not treated as the owner of that income for tax purposes (such as an agent or nominee). At the same time, a short new section on “Improper Use of the Convention” (which included two examples of treaty shopping) was added to the Commentary on Art. 1 and the Committee indicated that it intended “to make an in-depth study of such problems and of other ways of dealing with them”.

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2. This note does not deal with situations where countries make a conscious decision not to exercise taxing rights allocated to them by a tax treaty. Such situations are more appropriately dealt with under Action 5 (Counter harmful tax practices more effectively, taking into account transparency and substance).

3. Cases where a resident of the Contracting State in which income originates seeks to obtain treaty benefits (e.g. through a transfer of residence to the other Contracting State or through the use of an entity established in that other State) could also be considered to constitute a form of treaty shopping and are addressed by the recommendations included in this note.

- That in-depth study resulted in the 1986 reports on *Double Taxation and the Use of Base companies* and *Double Taxation and the Use of Conduit Companies*,<sup>4</sup> the issue of treaty shopping being primarily dealt with in the latter.
- In 1992, as a result of the report on *Double Taxation and the Use of Conduit Companies*, various examples of provisions dealing with different aspects of treaty shopping were added to the section on “Improper Use of the Convention” in the Commentary on Art. 1. These included the alternative provisions currently found in paragraphs 13-19 of the Commentary on Article 1 under the heading “Conduit company cases”.
- In 2003, as a result of the report *Restricting the Entitlement to Treaty Benefits*<sup>5</sup> (which was prepared as a follow-up to the 1998 Report *Harmful Tax Competition: an Emerging Global Issue*)<sup>6</sup>, new paragraphs intended to clarify the meaning of “beneficial owner” in some conduit situations were added to the Commentary on Art. 10, 11 and 12 and the section on “Improper Use of the Convention” was substantially extended to include additional examples of anti-abuse rules, including a comprehensive limitation-on-benefits provision based on the provision found in the 1996 US Model<sup>7</sup> as well as a purpose-based anti-abuse provision based on UK practice and applicable to Art. 10, 11, 12 and 21.<sup>8</sup>
- Finally, the on-going work on the clarification of the “beneficial owner” concept has allowed the OECD to examine the limits of using that concept as a tool to address various treaty-shopping situations. As indicated in proposed paragraph 12.5 of the Commentary on Art. 10, which was included in the latest discussion draft on the meaning of “beneficial owner”:<sup>9</sup> “[w]hilst the concept of ‘beneficial owner’ deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.”

9. A review of the treaty practices of OECD and non-OECD countries shows that countries use different approaches to try to address treaty shopping cases not already dealt with by the provisions of the Model Tax Convention. Based on the advantages and limitations of these approaches, it is recommended that the following three-pronged approach be used to address treaty shopping situations:

- First, it is recommended to include in the title and preamble of tax treaties a clear statement that the Contracting States, when entering into a treaty, wish to prevent tax avoidance and, in particular, intend to avoid creating opportunities for treaty shopping (this recommendation is included in Section B of this note).

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4. Reproduced at page R(5)-1 and R(6)-1 of the full version of the Model.

5. Reproduced at page R(17)-1 of the full version of the Model.

6. See, in particular, Recommendation 9 of the Report:

“that countries consider including in their tax conventions provisions aimed at restricting the entitlement to treaty benefits for entities and income covered by measures constituting harmful tax practices and consider how the existing provisions of their tax conventions can be applied for the same purpose; that the Model Tax Convention be modified to include such provisions or clarifications as are needed in that respect.”

7. Paragraph 20 of the Commentary on Art. 1.

8. Paragraph 21.4 of the Commentary on Art. 1.

9. Released on 12 October 2012; see <http://www.oecd.org/ctp/taxtreaties/Beneficialownership.pdf>.

- Second, it is recommended to include in tax treaties a specific anti-abuse rule based on the limitation-on-benefits provisions included in treaties concluded by the United States and a few other countries. Such a specific rule will address a large number of treaty shopping situations based on the legal nature, ownership in, and general activities of, residents of a Contracting State (this recommendation is included in subsection *i*) below).
- Third, in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the specific anti-abuse rule described in the preceding paragraph (such as certain conduit financing arrangements), it is recommended to add to tax treaties a more general anti-abuse rule. That rule will incorporate into tax treaties the principles already reflected in paragraphs 9.5, 22, 22.1 and 22.2 of the Commentary to Article 1, according to which the benefits of a tax treaty should not be available where one of the main purposes of arrangements or transactions is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax treaty (this recommendation is included in subsection *ii*) below).

10. Other recommendations included in this note will also assist in preventing treaty shopping. For instance, the proposals for specific treaty anti-abuse rules included in Section A.1.b) will deal with some specific forms of treaty shopping, such as strategies aimed at using a permanent establishment located in a low-tax jurisdiction in order to take advantage of the exemption method applicable by a Contracting State. Section C, which includes tax policy considerations that, in general, States should consider before deciding to enter into a tax treaty with another country, may also contribute to reducing treaty shopping opportunities. Conversely, the approach recommended in paragraph 9 is not restricted to treaty shopping cases and will also contribute to preventing the granting of treaty benefits in other inappropriate circumstances, this being particularly the case of the general anti-abuse provision referred to at the end of that paragraph.

*i) Limitation-on-benefits provision*

11. The following specific anti-abuse rule aimed at treaty shopping is based on provisions already found in a number of tax treaties, including treaties concluded by the United States but also in some treaties concluded by Japan and India:

**ARTICLE X**

**ENTITLEMENT TO BENEFITS**

- 1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to the benefits of this Convention otherwise accorded to residents of a Contracting State unless such resident is a “qualified person” as defined in paragraph 2.**
- 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:**
  - a) an individual;**
  - b) a Contracting State, or a political subdivision or local authority thereof, or a statutory body, agency or instrumentality of such State, political subdivision or local authority;**
  - c) a company, if:**
    - i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and either:**

- A) *its principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or*
- B) *the company's primary place of management and control is in the Contracting State of which it is a resident; or*
- ii) *at least 50 percent of the aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subdivision i) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;*
- d) *a person, other than an individual, that*
  - i) *was constituted and is operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes,*
  - ii) *was constituted and is operated exclusively to administer or provide pension or other similar benefits, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident in either Contracting State, or*
  - iii) *was constituted and is operated to invest funds for the benefit of persons referred to in subdivision ii), provided that substantially all the income of that person is derived from investments made for the benefit of these persons.*
- e) *a person other than an individual, if:*
  - i) *on at least half the days of the taxable year, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph a), subparagraph b), subdivision i) of subparagraph c), or subparagraph d) of this paragraph own, directly or indirectly, shares or other beneficial interests representing at least 50 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) of the person, provided that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State, and*
  - ii) *less than 50 percent of the person's gross income for the taxable year, as determined in the person's Contracting State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), subparagraph b), subdivision i) of subparagraph c), or subparagraph d) of this paragraph in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property).*
- 3. a) *A resident of a Contracting State will be entitled to benefits of this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a trade or business in the first-mentioned Contracting State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer respectively), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business.*
- b) *If a resident of a Contracting State derives an item of income from a trade or business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from an associated enterprise, the conditions described in subparagraph a) shall be considered to be satisfied with respect to*

*such item only if the trade or business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the trade or business activity carried on by the resident or associated enterprise in the other Contracting State. Whether a trade or business activity is substantial for the purposes of this paragraph will be determined based on all the facts and circumstances.*

- c) *For purposes of applying this paragraph, activities conducted by persons connected to a person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or another person possesses at least 50 percent of the beneficial interest (or, in the case of a company, at least 50 percent of the aggregate voting power and value of the company's shares or of the beneficial equity interest in the company) in each person. In any case, a person shall be considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.*

4. *If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 nor entitled to benefits with respect to an item of income under paragraph 3 of this Article, the competent authority of the other Contracting State shall nevertheless treat that resident as being entitled to the benefits of this Convention, or benefits with respect to a specific item of income, if such competent authority determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention.*

5. *For purposes of the preceding provision of this Article:*

- a) *the term "recognized stock exchange" means:*
- i) *the \_\_\_\_\_ Stock Exchange (of Contracting State A);*
  - ii) *the \_\_\_\_\_ Stock Exchange (of Contracting State B); and*
  - iii) *any other stock exchange agreed upon by the competent authorities of the Contracting States;*
- b) *the term "principal class of shares" means the ordinary or common shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. If no single class of ordinary or common shares represents the majority of the aggregate voting power and value of the company, the "principal class of shares" are those classes that in the aggregate represent a majority of the aggregate voting power and value of the company;*
- c) *the term "disproportionate class of shares" means any class of shares of a company resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other Contracting State by particular assets or activities of the company; and*
- d) *a company's "primary place of management and control" will be in the Contracting State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that Contracting State than in any other state and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions in that Contracting State than in any other state.*

12. A detailed Commentary will explain the main features of this rule. For example, that Commentary will explain that the phrase “shall nevertheless treat that resident as being entitled to the benefits of this Convention”, which is found in paragraph 4, means that a resident that would otherwise be denied treaty benefits will have access to these benefits but only to the extent that the conditions applicable to the relevant benefits are satisfied (*e.g.* that person will also need to be the beneficial owner, as opposed to a mere nominee or agent, of dividends, interest or royalties received from the other State).

13. One of the issues that was discussed by the Focus Group when examining the above rule was whether the rule should include a so-called “derivative benefits” provision. One version of such a provision that was considered by the Group read as follows:

*[to be added after paragraph 3]*

A company that is a resident of a Contracting State shall also be entitled to the benefits of this Convention if:

- a) at least 95 percent of the aggregate voting power and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary and
- b) less than 50 percent of the company’s gross income, as determined in the company’s State of residence, for the taxable year is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm’s length payments in the ordinary course of business for services or tangible property) that are deductible for the purposes of the taxes covered by this Convention in the company’s State of residence.

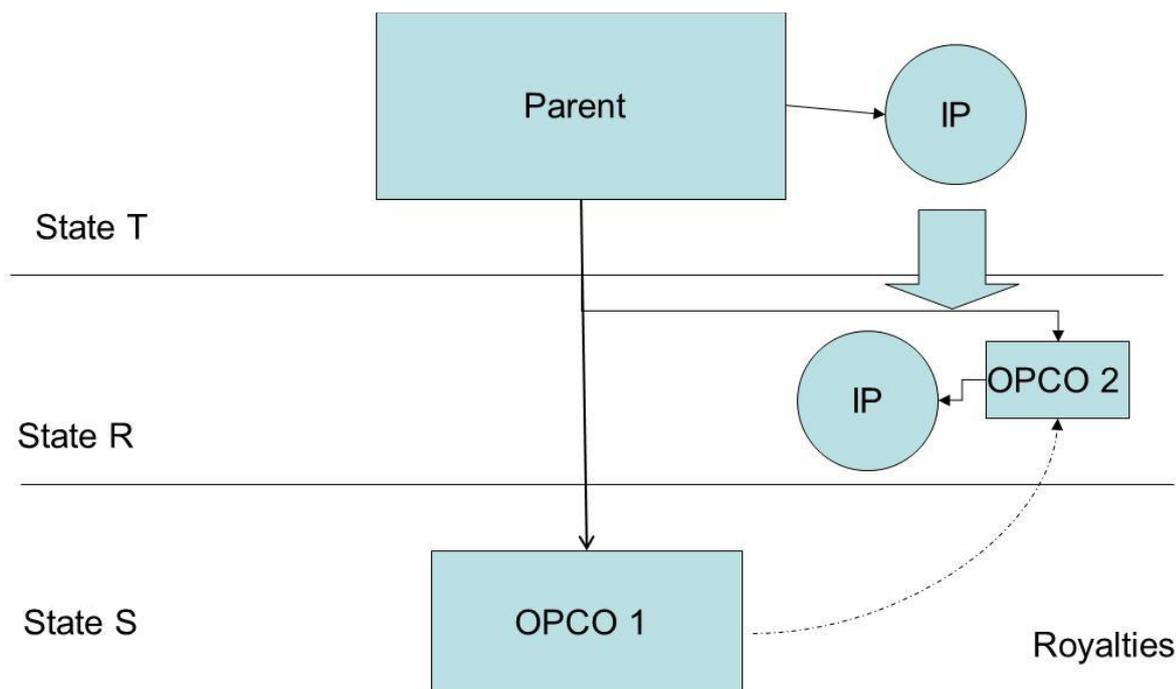
*[to be added to the definitions in paragraph 5]*

- e) the term “equivalent beneficiary” means a resident of any other State, but only if that resident
  - i) A) would be entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed under provisions analogous to subparagraph *a)*, *b)*, subdivision *i)* of subparagraph *c)*, or subparagraph *d)* of paragraph 2 of this Article, provided that if such convention does not contain a comprehensive limitation on benefits article, the person would be entitled to the benefits of this Convention by reason of subparagraph *a)*, *b)*, subdivision *i)* of subparagraph *c)*, or subparagraph *d)* of paragraph 2 of this Article if such person were a resident of one of the States under Article 4 of this Convention; and
    - B) with respect to income referred to in Articles 10, 11 and 12 of this Convention, would be entitled under such convention to a rate of tax with respect to the particular class of income for which benefits are being claimed under this Convention that is at least as low as the rate applicable under this Convention; or
  - ii) is a resident of a Contracting State that is entitled to the benefits of this Convention by reason of subparagraph *a)*, *b)*, subdivision *i)* of subparagraph *c)* or subparagraph *d)* of paragraph 2 of this Article.

14. The Group recognised that the inclusion of such a provision would be an appropriate way of dealing with cases where taxation of an item of income in the two Contracting States is comparable to the

taxation of the same item of income if it had been received directly by the shareholders of the company that received that item of income. Since many States do not effectively tax dividends received by a resident parent from its foreign subsidiaries, that situation will often arise in the case of dividends, where the tax levied by the State of source will be the only tax levied by the two Contracting States.

15. The Group also noted, however, that such a provision could result in the granting of treaty benefits in the case of base eroding payments in situations that have given rise to BEPS concerns. The following illustrates one such case:



16. In that example, State S has treaties with States R and T and both treaties provide that royalties may only be taxed by the State of residence. Under State R tax system, however, royalties are taxed at a preferential rate whereas State T taxes royalties at the normal corporate rate. Under a “derivative benefits” provision similar to the one reproduced above, State S would seem to be required to grant treaty benefits to a subsidiary (OPCO 2) set up by a company resident of State R (Parent) and to which Parent would have transferred intangible property for the purpose of taking advantage of the low taxation regime of State R.

17. The Group invites comments on that situation and on possible ways of addressing such cases if a “derivative benefits” provision were included in the limitation-on-benefits rule. It also invites examples of situations which should be covered by a “derivative benefits” provision.

ii) *Rules aimed at arrangements one of the main purposes of which is to obtain treaty benefits*

18. As previously indicated, the following rule, which incorporates principles already recognised in the Commentary on Article 1 of the Model Tax Convention, would provide a more general way to address treaty avoidance cases, including treaty shopping situations that would not be covered by the specific anti-abuse rule in subsection *i*) above (such as certain conduit financing arrangements):

**ARTICLE X**  
**ENTITLEMENT TO BENEFITS**

*[Paragraphs 1 to 5: see subsection i) above]*

***6. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the main 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.***

19. It is intended to supplement this rule with a detailed Commentary that would explain its main features and that would include a number of examples. Comments are invited on what the Commentary should cover. The following are some explanations that could be included in the Commentary.

20. Paragraph 6 mirrors the guidance in paragraphs 9.5, 22, 22.1 and 22.2 of the Commentary to Article 1. According to that guidance, the benefits of a tax convention should not be available where one of the main purposes of certain transactions or arrangements is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax convention. Paragraph 6 incorporates the principles underlying these paragraphs into the Convention itself in order to allow States to address cases of improper use of the Convention even if their domestic law does not allow them to do so in accordance with paragraphs 22 and 22.1 of the Commentary; it also confirms the application of the principles for States whose domestic law already allows them to address such cases.

21. The provisions of paragraph 6 have the effect of denying a benefit under a tax convention where one of the main purposes of an arrangement or transaction that has been entered into is to obtain a more favourable tax treatment. 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.

22. Paragraph 6 supplements and does not restrict in any way the scope or application of the provisions of paragraphs 1 to 5 of the limitation-on benefits rule put forward in subsection *i*): a benefit that is denied in accordance with these paragraphs is not a “benefit under the Convention” that paragraph 6 would also deny.

23. Conversely, the fact that a person is entitled to benefits under paragraphs 1 to 5 does not mean that these benefits cannot be denied under paragraph 6. Paragraphs 1 to 5 are rules that focus primarily on the legal nature, ownership in, and general activities of, residents of a Contracting State. As illustrated by the example in the next paragraph, these rules do not imply that a transaction or arrangement entered into by such a resident cannot constitute an improper use of a treaty provision.

24. Paragraph 6 must be read in the context of paragraphs 1 to 5 and of the rest of the Convention, including its preamble. This is particularly important for the purposes of determining the object and purpose of the relevant provisions of the Convention. Assume, for instance, that a public company whose shares are regularly traded on a recognized stock exchange in the Contracting State of which the company is a resident derives income from the other Contracting State. As long as that company is a “qualified person” for the purpose of paragraph 2, it is clear that the benefit of the Convention should not be denied solely on the basis of the ownership structure of that company, *e.g.* because a majority of the shareholders in that company are not residents of the same State. The object and purpose of subparagraph 2c) is to establish a threshold for the treaty entitlement of public companies whose shares are held by residents of different States. The fact that such a company is a qualified person does not mean, however, that benefits could not be denied under paragraph 6 for reasons that are unrelated to the ownership of the shares of that company. Assume, for instance, that such a public company is a bank that enters into a conduit financing arrangement intended to provide indirectly to a resident of a third State the benefit of lower source taxation under a tax treaty. In that case, paragraph 6 would apply to deny that benefit because subparagraph 2 c), when read in the context of the rest of the Convention and, in particular, its preamble, cannot be considered as having the purpose, shared by the two Contracting States, of authorizing treaty shopping transactions entered into by public companies.

25. The provisions of paragraph 6 establish that a Contracting State may deny the benefits of a tax convention where it is reasonable to conclude, having considered all the relevant facts and circumstances, that one of the main purposes of an arrangement or event was for a benefit under a tax treaty to be obtained. The provision is intended to ensure that tax conventions apply in accordance with the purpose for which they were entered into, *i.e.* to provide benefits in respect of bona fide exchanges of goods and services, and movements of capital and persons as opposed to arrangements whose main objective is to secure a more favourable tax treatment.

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

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

TCo, a company resident of State T, has acquired all the shares and debts of SCo, a company resident of State S, that were previously held by SCo’s parent company. These include a loan made to SCo at 4% interest payable on demand. State T does not have a tax convention with State S and, therefore, any interest paid by SCo to TCo is subject to a withholding tax on interest at a rate of 25% in accordance with the domestic law of State S. Under the State R-State S tax convention, however, there is no withholding tax on interest paid by a company resident of a Contracting State and beneficially owned by a company resident of the other State; also, that treaty does not include provisions similar to paragraphs 1 to 5 of Article [ ]. TCo decides to transfer the loan to RCo, a subsidiary resident of State R, in exchange for three promissory notes payable on demand on which interest is payable at 3.9%.

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

28. The terms “arrangement or transaction” should be interpreted broadly and include any agreement, understanding, scheme, transaction or series of transactions, whether or not they are legally enforceable. In particular they include the creation, assignment, acquisition or transfer of the income itself, or of the property or right in respect of which the income accrues. These terms also encompass arrangements concerning the establishment, acquisition or maintenance of a person who derives the income, including the qualification of that person as a resident of one of the Contracting States, and include steps that persons may take themselves in order to establish residence. An example of an “arrangement” would be where steps are taken to ensure that meetings of the board of directors of a company are held in a different country in order to claim that the company has changed its residence. One transaction alone may result in a benefit, or it may operate in conjunction with a more elaborate series of transactions that together result in the benefit. In both cases the provisions of paragraph 6 may apply.

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

30. A person cannot avoid the application of this paragraph by merely asserting that the arrangement or transaction was not undertaken or arranged to obtain the benefits of the Convention. All of the evidence must be weighted to determine whether it is reasonable to conclude that an arrangement or transaction was undertaken or arranged for such purpose. The determination requires reasonableness, suggesting that the possibility of different interpretations of the events must be objectively considered.

31. The reference to “one of the main purposes” in paragraph 1 means that obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the main purposes was to obtain the benefit. For example, a person may sell a property for various reasons, but if before the sale, that person becomes a resident of one of the Contracting States and one of the main purposes for doing so is to obtain a benefit under a tax convention, paragraph 6 could apply notwithstanding the fact that there may also be other main purposes for changing the residence, such as facilitating the sale of the property or the re-investment of the proceeds of the alienation.

32. A purpose will not be a main purpose when it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the benefit was not a main 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 main purpose will be considered to be the obtaining of that benefit.

33. Comments are invited on examples that could be included in the Commentary in order to illustrate cases in which paragraph 6 would apply as well as cases where it would not apply. During the drafting of paragraph 6, the following were put forward as examples that could be used for that purpose and comments are also invited on these examples:

<i>Possible examples of situations in which paragraph 6 would apply</i>	<i>Possible examples of situations in which paragraph 6 would not apply</i>
<p><i>Example A:</i> TCo, a company resident of State T, owns shares of SCo, a company listed on the stock exchange of State S. State T does not have a tax convention with State S and, therefore, any dividend paid by SCo to TCo is subject to a withholding tax rate on dividends of 25% in accordance with the domestic law of State S. Under the State R-State S tax convention, however, there is no withholding tax on dividends paid by a company resident of a Contracting State and beneficially owned by a company resident of the other State. TCo enters into an agreement with RCo, an independent financial institution resident of State R, pursuant to which TCo assigns to RCo the right to the payment of dividends that have been declared but have not yet been paid by SCo.</p> <p>In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the main purposes for the arrangement under which TCo assigned the right to receive the payment of dividends to RCo was for RCo to obtain the benefit of the exemption from source taxation of dividends provided for by the State R-State S tax convention and it would be contrary to the object and purpose of the tax convention to grant the benefit of that exemption under this treaty shopping arrangement.</p>	<p><i>Example C:</i> RCo, a company resident of State R, is in the business of producing electronic devices and its business is expanding rapidly. It is now considering establishing a manufacturing plant in a developing country in order to benefit from lower manufacturing costs. After a preliminary review, possible locations in three different countries are identified. After considering the fact that State S is the only one of these countries with which State R has a tax convention, the decision is made to build the plant in that State.</p> <p>In this example, whilst the decision to invest in State S is taken in the light of the benefits provided by the State R-State S tax convention, it is clear that the main purposes for making that investment and building the plant are related to the expansion of RCo's business and the lower manufacturing costs of that country. In this example, it cannot reasonably be considered that one of the main purposes for building the plant is to obtain treaty benefits. In addition, given that a general objective of tax conventions is to encourage cross-border investment, obtaining the benefits of the State R-State S convention for the investment in the plant built in State S is in accordance with the object and purpose of the provisions of that convention.</p>
<p><i>Example B:</i> SCo, a company resident of State S, is the subsidiary of TCo, a company resident of State T. State T does not have a tax convention with State S and, therefore, any dividend paid by SCo to TCo is subject to a withholding tax on dividends of 25% in accordance with the domestic law of State S. Under the State R-State S tax convention, however, the applicable rate of withholding tax on dividends paid by a company of State S to a resident of State R is 5%. TCo therefore enters into an agreement with RCo, a financial institution resident of State R and a qualified person under subparagraph (3)(a) of this Article, pursuant to which RCo acquires the usufruct of newly issued non-voting preferred shares of SCo for a period of three years. TCo is the bare owner of these shares. The usufruct gives RCo the right to receive the dividends attached to these preferred shares. The amount paid by RCo to acquire the usufruct corresponds to the present value of the dividends to be paid on the preferred shares over the period of three years</p>	<p><i>Example D:</i> RCo is a publicly traded corporation that is a resident of State R and manages a diversified portfolio of investments in the international financial market. RCo currently holds 15% of its portfolio in shares of corporations in State S, in respect of which it receives annual dividends. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 30% to 10%.</p> <p>RCo's investment decisions take into account the existence of tax benefits provided under State R's extensive tax convention network. A majority of investors in RCo are residents of State R, but a number of investors (the minority investors) are residents of states with which State S does not have a tax convention. Investors' decisions to invest in RCo are not driven by any particular investment made by RCo, and RCo's investment strategy is not driven by the tax position of its investors. RCo annually distributes almost all of its</p>

<p>(discounted at the rate at which TCo could borrow from RCo).</p> <p>In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the main purposes for the arrangement under which RCo acquired the usufruct of the preferred shares issued by SCo was to obtain the benefit of the 5% limitation applicable to the source taxation of dividends provided for by the State R-State S tax convention and it would be contrary to the object and purpose of the tax convention to grant the benefit of that limitation under this treaty shopping arrangement.</p>	<p>profits to its investors and pays taxes in State R on income not distributed during the year.</p> <p>In making its decision to invest in shares of corporations in State S, RCo considered the existence of a benefit under State R-State S tax convention on dividends, but this alone would not be sufficient to trigger the application of paragraph 6. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 6 applies to an investment, it is necessary to consider the context in which the investment was made. In this example, unless RCo's investment is part of an arrangement or relates to another transaction undertaken for a main purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax treaty to RCo.</p>
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*b) Other situations where a person seeks to circumvent treaty limitations*

34. Apart from the requirement that a person be a resident of a Contracting State, other conditions must be satisfied in order to obtain the benefit of certain provisions of tax treaties. In certain cases, it may be possible to enter into transactions for the purposes of satisfying these conditions in circumstances where it would be inappropriate to grant the relevant treaty benefits. Although the general anti-abuse rule in subsection *ii*) above will be useful in addressing such situations, targeted specific treaty anti-abuse rules generally provide greater certainty for both taxpayers and tax administrations. Such rules are already found in some Articles of the Model Tax Convention (see, for example, Art. 13(4) and 17(2)). In addition, the Commentary suggests the inclusion of other anti-abuse provisions in certain circumstances (see, for example, paragraphs 16 and 17 of the Commentary on Art. 10). Other anti-abuse provisions are found in bilateral treaties concluded by OECD and non-OECD countries.

35. The following are examples of situations with respect to which specific treaty anti-abuse rules may be helpful and proposals for changes intended to address some of these situations.

*i) Splitting-up of contracts*

36. Paragraph 18 of the Commentary on Article 5 indicates that “[t]he twelve-month threshold [*of Art. 5(3)*] has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group.”

37. The paragraph provides that although such abuses may be addressed by legislative or judicial anti-avoidance rules, countries may deal with them through bilateral solutions. Whilst it was suggested that an alternative provision could be added to paragraph 18 for that purpose,<sup>10</sup> it was concluded that

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10. See, for example, the alternative provision suggested in paragraph 42.45 of the Commentary on Article 5 which deals with the splitting-up of contracts in order to circumvent the alternative provision found in paragraph 42.23.

transactions aimed at circumventing the permanent establishment threshold should be examined as part of the work on Action 7 (Prevent the artificial avoidance of PE status).

*ii) Hiring-out of labour cases*

38. Hiring-out of labour cases, where the taxpayer attempts to obtain inappropriately the benefits of the exemption from source taxation provided for in Art. 15(2), are dealt with in paragraphs 8.1 to 8.28 of the Commentary on Article 15. It was concluded that the guidance already found in these paragraphs, and in particular the alternative provision found in paragraph 8.3 of that Commentary, dealt adequately with this type of treaty abuse.

*iii) Transactions intended to avoid dividend characterisation*

39. In some cases, transactions may be entered into for the purpose of avoiding domestic law rules that characterise a certain item of income as dividend and to benefit from a treaty characterisation of that income (e.g. as capital gain) that prevents source taxation.

40. As part of its work on hybrid mismatch arrangements, Working Party 1 has examined whether the treaty definitions of dividends and interest could be amended, as is done in some treaties, in order to permit the application of domestic law rules that characterise an item of income as such. As this proposal is closely related to the issue of hybrid mismatch arrangements, it was concluded that it should be examined as part of the work on the treaty aspects of Action 2 (Hybrid Mismatches) of the BEPS Action Plan.

*iv) Dividend transfer transactions*

41. In these transactions, a taxpayer entitled to the 15% portfolio rate of Art. 10(2)*b*) seeks to obtain the 5% direct dividend rate of Art. 10(2)*a*) or the 0% rate that some bilateral conventions provide for dividends paid to pension funds (see paragraph 69 of the Commentary on Article 18).

42. Paragraphs 16 and 17 of the Commentary on Article 10 deal with transactions through which a taxpayer tries to access the lower rate of 5% applicable to dividends:

16. Subparagraph *a*) of paragraph 2 does not require that the company receiving the dividends must have owned at least 25 per cent of the capital for a relatively long time before the date of the distribution. This means that all that counts regarding the holding is the situation prevailing at the time material for the coming into existence of the liability to the tax to which paragraph 2 applies, *i.e.* in most cases the situation existing at the time when the dividends become legally available to the shareholders. The primary reason for this resides in the desire to have a provision which is applicable as broadly as possible. To require the parent company to have possessed the minimum holding for a certain time before the distribution of the profits could involve extensive inquiries. Internal laws of certain OECD member countries provide for a minimum period during which the recipient company must have held the shares to qualify for exemption or relief in respect of dividends received. In view of this, Contracting States may include a similar condition in their conventions.

17. 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 abovementioned 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.

43. It was concluded that in order to deal with such transactions, a minimum shareholding period should be included in subparagraph *a*) of Art. 10(2), which should therefore be amended to read as follows:

- a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which held directly at least 25 per cent of the capital of the company paying the dividends throughout a [ ] month period that included the time of the payment of the dividend;***

Comments are invited as to the length of the period of time that should be included in the above provision.

44. It was also concluded that additional anti-abuse rules should be included in Article 10 to deal with cases where certain intermediary entities established in the State of source are used to take advantage of the treaty provisions that lower the source taxation of dividends.

45. For example, paragraph 67.4 of the Commentary on Article 10 includes an alternative provision that may be included to prevent access to

- the 5% rate in the case of dividends paid by a domestic REIT to a non-resident portfolio investor, and
- both the 5% and the 15% rates in the case of dividends paid by a domestic REIT to a non-resident investor who holds directly or indirectly more than 10% of the REIT's capital.

46. Another example, found in U.S. treaty practice, is a provision that denies the 5% rate in the case of dividends paid to a non-resident company by a U.S. Regulated Investment Company (RIC) even if that non-resident company holds more than 10% of the shares of the RIC. As shown by that example, a specific anti-abuse rule might be drafted to address situations where a non-resident company makes indirect portfolio investments into domestic companies through a domestic investment company that is not taxed on dividends it receives from such other domestic companies. Comments are invited as to the potential issues that such a rule could create.

*v) Transactions that circumvent the application of Art. 13(4)*

47. Art. 13(4) allows the Contracting State in which immovable property is situated to tax capital gains realised by a resident of the other State on shares of companies that derive more than 50% of their value from such immovable property.

48. Paragraph 28.5 of the Commentary on Article 13 already provides that States may want to consider extending the provision to cover not only gains from shares but also gains from the alienation of interests in other entities, such as partnerships or trusts, which would address one form of abuse. It was agreed that Art. 13(4) should be amended to include such wording.

49. There might also be cases, however, where assets are contributed to an entity shortly before the sale of the shares or other interests in that entity in order to dilute the proportion of the value of these shares or interests that is derived from immovable property situated in one Contracting State. In order to address such cases, it was agreed that Art. 13(4) should be amended to refer to situations where shares or similar interests derive their value primarily from immovable property at any time during a certain period as opposed to at the time of the alienation only.

vi) *Tie-breaker rule for determining the treaty residence of dual-resident persons other than individuals*

50. One of the key limitations on the granting of treaty benefits is the requirement that a person be a resident of a Contracting State for the purposes of the relevant tax treaty. Under Art. 4(1) of the OECD Model Tax Convention, the treaty residence of a person is dependent on the domestic tax laws of each Contracting State, which may result in a person being resident of each State. In such cases, Art. 4(2) determines a single treaty residence in the case of individuals. Art. 4(3), which does the same for persons other than individuals, provides that the dual-resident person “shall be deemed to be a resident only of the State in which its place of effective management is situated”.

51. When this rule was originally included in the 1963 Draft Convention, the OECD Fiscal Committee expressed the view that “it may be rare in practice for a company, etc. to be subject to tax as a resident in more than one State”<sup>11</sup> but because that was possible, “special rules as to the preference” were needed.

52. The 2008 Update to the OECD Model Tax Convention introduced an alternative version of Art. 4(3) (see paragraphs 24 and 24.1 of the Commentary on Article 4) according to which the competent authorities of the Contracting States shall, having regard to a number of relevant factors, endeavour to determine by mutual agreement the State of which the person is a resident for the purpose of the Convention. When that alternative was discussed, the view of many countries was that cases where a company is a dual-resident often involve tax avoidance arrangements. For that reason, it is proposed that the current rule found in Art. 4(3) be replaced by the alternative found in the Commentary, which allows a case-by-case solution of these cases.

53. The following are the changes that are proposed for that purpose:

*Replace paragraph 3 of Article 4 of the Model Tax Convention by the following:*

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, ~~then it shall be deemed to be a resident only of the State in which its place of effective management is situated.~~ ***the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.***

*Replace paragraphs 21 to 24.1 of the Commentary on Article 4 by the following:*

21. This paragraph concerns companies and other bodies of persons, irrespective of whether they are or not legal persons. Cases where a company, etc. is subject to tax as a resident in more than one State may occur if, for instance, one State attaches importance to the registration and the other State to the place of effective management. So, in the case of companies, etc., also, special rules as to the preference must be established.

22. ***When paragraph 3 was first drafted, it was considered that it would not be an adequate solution to attach importance to a purely formal criterion like registration- and preference was given to***

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11. Paragraph 23 of the Commentary on Article 4 of the 1963 Draft Convention.

*a rule based on the place of effective management, which was intended to be based on* Therefore paragraph 3 attaches importance to the place where the company, etc. *was* is actually managed.

23. ~~The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the “place of management” of the enterprise is situated; other conventions attach importance to its “place of effective management”, others again to the “fiscal domicile of the operator”. In [2014], however, the Committee on Fiscal Affairs recognised that although situations of double residence of entities other than individuals were relatively rare, there had been a number of tax avoidance cases involving dual resident companies. It therefore concluded that a better solution to the issue of dual residence of entities other than individuals was to deal with such situations on a case-by-case basis.~~

24. As a result of these considerations, *the current version of paragraph 3 provides that the competent authorities of the Contracting States shall endeavour to resolve by mutual agreement cases of dual residence of a person other than an individual.* ~~the “place of effective management” has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.~~

24.1 ~~Some countries, however, consider that cases of dual residence of persons who are not individuals are relatively rare and should be dealt with on a case by case basis. Some countries also consider that such a case by case approach is the best way to deal with the difficulties in determining the place of effective management of a legal person that may arise from the use of new communication technologies. These countries are free to leave the question of the residence of these persons to be settled by the competent authorities, which can be done by replacing the paragraph by the following provision:~~

~~3. — Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting State.~~

Competent authorities having to apply *paragraph 3* ~~such a provision to determine the residence of a legal person for purposes of the Convention~~ would be expected to take account of various factors, such as where the meetings of *the person’s* ~~its~~ board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person’s headquarters are located, which country’s laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc. Countries that consider that the competent authorities should not be given the discretion to solve such cases of dual residence without an indication of the factors to be used for that purpose may want to supplement the provision to refer to these or other factors that they consider relevant. Also, since the application of the provision would normally be requested by the person

concerned through the mechanism provided for under paragraph 1 of Article 25, the request should be made within three years from the first notification to that person that its taxation is not in accordance with the Convention since it is considered to be a resident of both Contracting States. Since the facts on which a decision will be based may change over time, the competent authorities that reach a decision under that provision should clarify which period of time is covered by that decision.

vii) *Anti-abuse rule for permanent establishments situated in third States*

54. Paragraph 32 of the Commentary on Article 10, paragraph 25 of the Commentary on Article 11 and paragraph 21 of the Commentary on Article 12 refer to potential abuses that may result from the transfer of shares, debt-claims, rights or property to permanent establishments set up solely for that purpose in countries that offer preferential treatment to the income from such assets. Where the State of residence exempts, or taxes at low rates, profits of such permanent establishments situated in third States, the State of source should not be expected to grant treaty benefits with respect to that income.

55. The last part of paragraph 71 of the Commentary on Article 24 deals with that situation and suggests that an anti-abuse provision could be included in bilateral conventions to protect the State of source from having to grant treaty benefits where income obtained by a permanent establishment situated in a third State is not taxed normally in that State:

71. ... Another question that arises with triangular cases is that of abuses. If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment.

56. It was concluded that a specific anti-abuse provision should be included in the Model Tax Convention to deal with that and similar triangular cases where income attributable to the permanent establishment in a third State is subject to low taxation. Whilst the Group examined the following rule based on U.S. treaty practice, it concluded that other options should also be considered. Comments are therefore invited on the proposed rule below as well as other options that could address the issue.

*Add the following paragraph 4 to Article 1 of the Model Tax Convention:*

***4. Notwithstanding the other provisions of this Convention, where an enterprise of a Contracting State derives income from the other Contracting State and that income is attributable to a permanent establishment of that enterprise that is situated in a third State, the tax benefits that would otherwise apply under the other provisions of this Convention will not apply to that income if the profits of that permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and third State that is less than 60 percent of the general rate of company tax applicable in the first-mentioned Contracting State. Any dividends, interest or royalties to which the provisions of this paragraph apply shall remain taxable in the other Contracting State at a rate that shall not exceed 15 percent of the gross amount thereof. Any other income to which the provisions of this paragraph apply shall remain taxable according to the laws of the other Contracting State notwithstanding any other provision of this Convention. The provisions of this paragraph shall not apply if:***

- a) *in the case of royalties, the royalties are received as compensation for the use of, or the right to use, intangible property produced or developed by the enterprise through the permanent establishment; or*
- b) *in the case of any other income, the income derived from the other Contracting State is derived in connection with, or is incidental to, the active conduct of a trade or business carried on in the third State through the permanent establishment (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are banking or securities activities carried on by a bank or registered securities dealer).*

## 2. *Cases where a person tries to abuse the provisions of domestic tax law using treaty benefits*

57. Many tax avoidance risks that threaten the tax base are not caused by tax treaties but may be facilitated by treaties. In these cases, it is not sufficient to address the treaty issues: changes to domestic law are also required. Avoidance strategies that fall into this category include:

- Thin capitalisation and other financing transactions that use tax deductions to lower borrowing costs;
- Dual residence strategies (*e.g.* a company is resident for domestic tax purposes but non-resident for treaty purposes);
- Transfer mispricing;
- Arbitrage transactions that take advantage of mismatches found in the domestic law of one State and that are
  - related to the characterization of income (*e.g.* by transforming business profits into capital gain) or payments (*e.g.* by transforming dividends into interest);
  - related to the treatment of taxpayers (*e.g.* by transferring income to tax-exempt entities or entities that have accumulated tax losses; by transferring income from non-residents to residents);
  - related to timing differences (*e.g.* by delaying taxation or advancing deductions).
- Arbitrage transactions that take advantage of mismatches between the domestic laws of two States and that are
  - related to the characterization of income;
  - related to the characterization of entities;
  - related to timing differences.
- Transactions that abuse relief of double taxation mechanisms (by producing income that is not taxable in the State of source but must be exempted by the State of residence or by abusing foreign tax credit mechanisms).

58. Many of these transactions will be addressed through the work on other aspects of the Action Plan, in particular Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 4 (Limit base erosion via interest deductions and other financial payments) and Actions 8, 9 and 10 dealing with Transfer Pricing.

59. The main objective of the work aimed at preventing the granting of treaty benefits with respect to these transactions is to ensure that treaties do not prevent the application of specific domestic law provisions that would prevent these transactions.<sup>12</sup> Granting the benefits of these treaty provisions in such cases would be inappropriate to the extent that the result would be the avoidance of domestic tax. Such cases include situations where it is argued that

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12. Under the principles of public international law, as codified in Articles 26 and 27 of the *Vienna Convention on the Law of Treaties* (VCLT), if the application of a domestic anti-abuse rule has the effect of allowing a State that is party to a tax treaty to tax an item of income that that State is not allowed to tax under the provisions of the treaty, the application of the domestic anti-abuse rule would conflict with the provisions of the treaty and these treaty provisions should prevail.

- Provisions of a tax treaty prevent the application of a domestic GAAR;
- Art. 24(4) and Art. 24(5) prevent the application of domestic thin-capitalisation rules;
- Art. 7 and/or Art. 10(5) prevent the application of CFC rules;
- Art. 13(5) prevents the application of exit or departure taxes;
- Art. 24(5) prevents the application of domestic rules that restrict tax consolidation to resident entities;
- Art. 13(5) prevents the application of dividend stripping rules targeted at transactions designed to transform dividends into treaty-exempt capital gains;
- Art. 13(5) prevents the application of domestic assignment of income rules (such as grantor trust rules).

60. The Commentary already addresses a number of these issues. For instance, it deals expressly with CFC rules (paragraph 23 of the Commentary on Art. 1 provides that treaties do not prevent the application of such rules). It also refers to thin capitalisation rules (paragraph 3 of the Commentary on Art. 9 suggests that treaties do not prevent the application of such rules “insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm’s length situation”). It does not, however, address a number of other specific domestic anti-abuse rules.

61. Paragraphs 22 and 22.1 of the Commentary on Art. 1 of the OECD Model Tax Convention provide a more general discussion of the interaction between tax treaties and domestic anti-abuse rules. These paragraphs conclude that a conflict would not occur in the case of the application of certain domestic anti-abuse rules to a transaction that constitutes an abuse of the tax treaty:

22. Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including “substance-over-form”, “economic substance” and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties [...]

22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict. [...]

62. Paragraph 9.5 of the Commentary on Art. 1 offers the following guidance as to what constitutes an abuse of the provisions of a tax treaty:

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.”

63. As indicated in Section A.1, it is recommended to incorporate the principles underlying these paragraphs into a treaty anti-abuse provision of general application.

64. It is, however, usually easier to conclude that the guiding principle of paragraph 9.5 is met in the case of general anti-abuse rules or legislative doctrines that refer expressly to the purpose of entering into certain transactions than in the case of specific anti-abuse rules that apply regardless of whether or not transactions are tax-motivated.

65. The interaction between tax treaties and specific domestic anti-abuse rules is expressly addressed in the Commentary on Art. 1 of the UN Model:

16. ... such conflicts will often be avoided and each case must be analysed based on its own circumstances.

17. First, a treaty may specifically allow the application of certain types of specific domestic anti-abuse rules. For example, Article 9 of the Convention specifically authorizes the application of domestic transfer pricing rules in the circumstances defined by that Article. Also, many treaties include specific provisions clarifying that there is no conflict (or, even if there is a conflict, allowing the application of the domestic rules) in the case, for example, of thin capitalization rules, CFC rules or departure tax rules or, more generally, domestic rules aimed at preventing the avoidance of tax.

18. Second, many tax treaty provisions depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person, the determination of what is immovable property and of when income from corporate rights might be treated as a dividend. More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the treaty. In many cases, therefore, the application of domestic anti-abuse rules will impact how the treaty provisions are applied rather than produce conflicting results.

19. Third, the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied on a proper interpretation of the treaty. In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both the interpretation of the treaty and the domestic specific anti-abuse rules. Domestic specific anti-abuse rules, however, are often drafted by reference to objective facts, such as the existence of a certain level of shareholding or a certain debt equity ratio. While this greatly facilitates their application, it will sometimes result in the application of these rules to transactions that do not constitute abuses. In such cases, of course, a proper interpretation of the treaty provisions that would disregard abusive transactions only will not allow the application of the domestic rules if they conflict with provisions of the treaty.

66. It was agreed that the distinction between specific and general domestic anti-abuse measures that is put forward in these paragraphs should be clarified in the Commentary on the OECD Model Tax Convention. It was also agreed that specific treaty issues that may arise from the drafting of new domestic anti-abuse measures as a result of the work on other parts of the Action Plan should be dealt with in the context of the work on these other action items.

67. One issue that can already be clarified, however, is that of the interaction between treaty rules and domestic anti-abuse rules found in the domestic law of one State that are aimed at preventing avoidance arrangements entered into by residents of that State.

68. The majority of the provisions included in tax treaties are intended to restrict the right of a Contracting State to tax the residents of the other Contracting State. In some limited cases, however, it has been argued that some provisions that are aimed at the taxation of non-residents could be interpreted as limiting a Contracting State's right to tax its own residents. Such interpretations have been rejected in paragraph 6.1 of the Commentary on Article 1, which deals with a Contracting State's right to tax partners who are its own residents on their share of the income of a partnership that is resident of the other Contracting State, as well as in paragraph 23 of the same Commentary, which addresses the case of

controlled foreign companies rules (see also paragraph 14 of the Commentary on Article 7, which deals with the same issue).

69. It was concluded that the principle reflected in paragraph 6.1 of the Commentary on Article 1 should be applicable to the vast majority of the provisions of the Model Tax Convention in order to prevent interpretations intended to circumvent the application of a Contracting State's domestic anti-abuse rules (as illustrated by the example of controlled foreign companies rules). This corresponds to the practice long followed by the United States in its tax treaties, where a so-called "saving clause"<sup>13</sup> confirms the Contracting States' right to tax their residents (and citizens, in the case, of the United States) notwithstanding the provisions of the treaty except those, such as the rules on relief of double taxation, that are clearly intended to apply to residents.

70. The following are the changes to the Model Tax Convention that are proposed for that purpose:

*Add the following paragraph 3 to Article 1 of the Model Tax Convention:*

**3. 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.**

*Add the following paragraphs 26.17 to 26.21 to the Commentary on Article 1 (other consequential changes to the Commentary would be required):*

**26.17 Whilst some provisions of the Convention (e.g. Articles 23 A and 23 B) are clearly intended to affect how a Contracting State taxes its own residents, the object of the majority of the provisions of the Convention is to restrict the right of a Contracting State to tax the residents of the other Contracting State. In some limited cases, however, it has been argued that some provisions could be interpreted as limiting a Contracting State's right to tax its own residents in cases where this was not intended (see, for example, paragraph 23 above, which addresses the case of controlled foreign companies provisions).**

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13. The saving clause and its exceptions read as follows in the US Model:

4. Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may be taxed in accordance with the laws of that Contracting State.

5. The provisions of paragraph 4 shall not affect:

- a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), paragraph 7 of Article 13 (Gains), subparagraph b) of paragraph 1, paragraphs 2, 3 and 6 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support), paragraph 3 of Article 18 (Pension Funds), and Articles 23 (Relief From Double Taxation), 24 (Non-Discrimination), and 25 (Mutual Agreement Procedure); and
- b) the benefits conferred by a Contracting State under paragraph 1 of Article 18 (Pension Funds), Articles 19 (Government Service), 20 (Students and Trainees), and 27 (Members of Diplomatic Missions and Consular Posts), upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that State.

*26.18 Paragraph 3 confirms the general principle that the Convention does not restrict a Contracting State's right to tax its own residents except where this is intended and lists the provisions with respect to which that principle is not applicable.*

*26.19 The exceptions so listed are intended to cover all cases where it is envisaged in the Convention that a Contracting State may have to provide treaty benefits to its own residents (whether or not these or similar benefits are provided under the domestic law of that State). These provisions are:*

- Paragraph 3 of Article 7, which requires a Contracting State to grant to an enterprise of that State a correlative adjustment following an initial adjustment made by the other Contracting State, in accordance with paragraph 2 of Article 7, to the amount of tax charged on the profits of a permanent establishment of the enterprise.*
- Paragraph 2 of Article 9, which requires a Contracting State to grant to an enterprise of that State a corresponding adjustment following an initial adjustment made by the other Contracting State, in accordance with paragraph 1 of Article 9, to the amount of tax charged on the profits of an associated enterprise.*
- Article 19, which may affect how a Contracting State taxes an individual who is resident of that State if that individual derives income in respect of services rendered to the other Contracting State or a political subdivision or local authority thereof.*
- Article 20, which may affect how a Contracting State taxes an individual who is resident of that State if that individual is also a student who meets the conditions of that Article.*
- Article 23, which requires a Contracting State to provide relief of double taxation to its residents with respect to the income that the other State may tax in accordance with the Convention (including profits that are attributable to a permanent establishment situated in the other Contracting State in accordance with Art. 7(2)).*
- Article 24, which protects residents of a Contracting State against certain discriminatory taxation practices by that State (such as rules that discriminate between two persons based on their nationality).*
- Article 25, which allows residents of a Contracting State to request the competent authority of that State to consider cases of taxation not in accordance with the Convention.*
- Article 28, which may affect how a Contracting State taxes an individual who is resident of that State when that individual is a member of the diplomatic mission or consular post of the other Contracting State.*

*26.20 The list of exceptions included in paragraph 3 should include any other provision that the Contracting States may agree to include in their bilateral convention where it is intended that this provision should affect the taxation, by a Contracting State, of its own residents. For instance, if the Contracting States agree, in accordance with paragraph 27 of the Commentary on Article 18, to include in their bilateral convention a provision according to which pensions and other payments made under the social security legislation of a Contracting State shall be taxable only in that State, they should include a reference to that provision in the list of exceptions included in paragraph 3.*

*26.21 The term "resident", as used in paragraph 3 and throughout the Convention, is defined in Article 4. Where, under paragraph 1 of Article 4, a person is considered to be a resident of both Contracting States based on the domestic laws of these States, paragraphs 2 and 3 of that Article*

*determine a single State of residence for the purposes of the Convention. Thus, paragraph 3 does not apply to an individual or legal person who is a resident of one of the Contracting States under the laws of that State but who, for the purposes of the Convention, is deemed to be a resident only of the other Contracting State.*

## **B. CLARIFICATION THAT TAX TREATIES ARE NOT INTENDED TO BE USED TO GENERATE DOUBLE NON-TAXATION**

71. The second part of the work mandated by Action 6 was to “clarify that tax treaties are not intended to be used to generate double non-taxation”.

72. The existing provisions of tax treaties were developed with the prime objective of preventing double-taxation. This was reflected in the title proposed in both the *1963 Draft Double Taxation Convention on Income and Capital* and the *1977 Model Double Taxation Convention on Income and Capital*, which was:

Convention between (State A) and (State B) for the avoidance of double taxation with respect to taxes on income and on capital

73. In 1977, however, the Commentary on Article 1 was modified to provide expressly that tax treaties were no intended to encourage tax avoidance or evasion. The relevant part of paragraph 7 of the Commentary read as follows:

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.

74. In 2003, that paragraph was amended to clarify that the prevention of tax avoidance was also a purpose of tax treaties. Paragraph 7 now reads as follows:

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.

75. In order to provide the clarification required by Action 6, it has been decided to state clearly, in the title recommended by the OECD Model, that the prevention of tax evasion and avoidance is a purpose of tax treaties. It also been decided that the OECD Model should recommend a preamble that provides expressly that States that enter into a tax treaty intend to eliminate double taxation without creating opportunities for tax evasion and avoidance. Given the particular concerns arising from treaty shopping arrangements, it has also been decided to refer expressly to such arrangements as one example of tax avoidance that should not result from tax treaties. The following are the changes that are proposed to the OECD Model Tax Convention as a result of the work on this aspect of Action 6:

*Replace the Title of the Convention (including its footnote) by the following:*

***Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance***—~~Convention between (State A) and (State B) with respect to taxes on income and on capital~~<sup>1</sup>

- ~~1. States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.~~

*Replace the heading “Preamble to the Convention” (including its footnote) by the following:*

**PREAMBLE TO THE CONVENTION**<sup>1</sup>

- ~~1. The Preamble of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.~~

## **PREAMBLE TO THE CONVENTION**

*(State A) and (State B),*

*Desiring to further develop their economic relationship and to enhance their cooperation in tax matters,*

*Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital 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)*

*Have agreed as follows:*

76. The clear statement of the intention of the signatories to a tax treaty that appears in the above preamble will be relevant to the interpretation and application of the provisions of that treaty. According to the basic rule of interpretation of treaties in Art. 31(1) of the *Vienna Convention on the Law of Treaties* (VCLT), “[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**” [emphasis added]. Art. 31(2)<sup>14</sup> VCLT confirms that, for the purpose of this basic rule, the context of the treaty includes its preamble.<sup>15</sup>

77. The above changes to the Title and Preamble should be supplemented by the following changes to the Introduction to the Model Tax Convention:

*Replace paragraphs 2 and 3 of the Introduction by the following:*

2. It has long been recognized among the Member countries of the Organisation for Economic Co-operation and Development that it is desirable to clarify, standardize, and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial, or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation. ***These countries have also long recognized the need to improve administrative co-operation in tax matters, notably through exchange of information and assistance in collection of taxes, for the purpose of preventing tax evasion and avoidance.***

3. ***These are*** ~~this is~~ the main purposes of the OECD Model Tax Convention on Income and on Capital, which provides a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation. As recommended by the Council of the OECD,<sup>1</sup> Member countries, when concluding or revising bilateral conventions,

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14. “2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

(a) Any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;

(b) Any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.”

15. The Commentary on the 1966 Draft of the *Vienna Convention on the Law of Treaties* notes that the International Court of Justice “has more than once had recourse to the statement of the object and purpose of the treaty in the preamble in order to interpret a particular provision” (*Draft Articles on the Law of Treaties with commentaries*, Report of the International Law Commission to the General Assembly, Yearbook of the International Law Commission, 1966, vol. II, p. 221).

should conform to this Model Convention as interpreted by the Commentaries thereon and having regard to the reservations contained therein and their tax authorities should follow these Commentaries, as modified from time to time and subject to their observations thereon, when applying and interpreting the provisions of their bilateral tax conventions that are based on the Model Convention.

[Footnote to paragraph 3] 1. See Annex.

Replace paragraph 16 of the Introduction by the following:

16. In both the 1963 Draft Convention and the 1977 Model Convention, the title of the Model Convention included a reference to the elimination of double taxation. In recognition of the fact that the Model Convention does not deal exclusively with the elimination of double taxation but also addresses other issues, such as the prevention of tax evasion and *avoidance as well as non-discrimination*, it was ~~subsequently~~ decided, **in 1992**, to use a shorter title which did not include this reference. This change ~~has been~~ ~~was~~ made both on the cover page of this publication and in the Model Convention itself. However, it ~~is~~ ~~was~~ understood that the practice of many Member countries ~~is~~ ~~was~~ still to include in the title a reference to either the elimination of double taxation or to both the elimination of double taxation and the prevention of fiscal evasion *since both approaches emphasized these important purposes of the Convention*.

***16.1 As a result of work undertaken as part of the OECD Action Plan on Base Erosion and Profit Shifting, in [year] the Committee decided to amend the title of the Convention and to include a preamble. The changes made expressly recognise that the purposes of the Convention are not limited to the elimination of double taxation and that the Contracting States do not intend the provisions of the Convention to create opportunities for non-taxation or reduced taxation through tax evasion and avoidance. Given the particular base erosion and profit shifting concerns arising from treaty shopping arrangements, it was also decided to refer expressly to such arrangements as one example of tax avoidance that should not result from tax treaties, it being understood that this was only one example of tax avoidance that the Contracting States intend to prevent.***

***16.2 Since the title and preamble form part of the context of the Convention<sup>16</sup> 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. According to the general rule of treaty interpretation contained in Article 31(1) of the Vienna Convention on the Law of Treaties (VCLT), “[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.”***

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16. See Art. 31(2) VCLT.

## **C. TAX POLICY CONSIDERATIONS THAT, IN GENERAL, COUNTRIES SHOULD CONSIDER BEFORE DECIDING TO ENTER INTO A TAX TREATY WITH ANOTHER COUNTRY**

78. The third part of the work mandated by Action 6 was “to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country”.

79. It was agreed that having a clearer articulation of the policy considerations that, in general, countries should consider before deciding to enter into a tax treaty could make it easier for countries to justify their decisions not to enter into tax treaties with certain low or no-tax jurisdictions. It was also recognized, however, that there are also many non-tax factors that can lead to the conclusion of a tax treaty and that each country has a sovereign right to decide to enter into tax treaties with any jurisdiction with which it decides to do so.

80. In the course of the work on this aspect of Action 6, it was decided that the results of that work should reflect the fact that many of the tax policy considerations relevant to the conclusion of a tax treaty are also relevant to the question of whether to modify (or, ultimately, terminate) a treaty previously concluded in the event that a change of circumstances (such as changes to the domestic law of a treaty partner) raises BEPS concerns related to that treaty.

81. The following are the changes that are proposed to the Introduction of the OECD Model Tax Convention as a result of the work on this aspect of Action 6:

*Insert the following paragraphs and new heading immediately after paragraph 15 in the Introduction to the OECD Model Convention (existing section C of the Introduction would become section D):*

### ***C. Tax policy considerations that are relevant to the decision of whether to enter into a tax treaty or amend an existing treaty***

***15.1 In 1997, the OECD Council adopted a recommendation that the Governments of member countries pursue their efforts to conclude bilateral tax treaties with those member countries, and where appropriate with non-member countries, with which they have not yet entered into such conventions. Whilst 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, tax policy considerations will generally play a key role in that decision. The following paragraphs describe some of these tax policy considerations, which are relevant not only to the question of whether a treaty should be concluded with a State but also to the question of whether a State should seek to modify or replace an existing treaty or even, as a last resort, terminate a treaty (taking into account the fact that termination of a treaty often has a negative impact on large number of taxpayers who are not concerned by the situations that result in the termination of the treaty).***

***15.2 Since a main objective of tax treaties is the avoidance of double taxation in order to reduce tax obstacles to cross-border services, trade and investment, the existence of risks of double taxation resulting from the interaction of the tax systems of the two States involved will be the primary tax policy concern. Such risks of double taxation will generally be more important where there is a significant level of existing or projected cross-border trade and investment between two States. Most of the provisions of tax treaties seek to alleviate double taxation by allocating taxing rights between the two States and it is assumed that where a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State. Where a State levies no or low income taxes,***

*other States should consider whether there are risks of double taxation that would justify, by themselves, a tax treaty. States should also consider whether there are elements of another State's tax system that could increase the risk of non-taxation, which may include tax advantages that are ring-fenced from the domestic economy.*

*15.3 Accordingly, two States that consider entering into a tax treaty should evaluate the extent to which the risk of double taxation actually exists in cross-border situations involving their residents. A large number of cases of residence-source juridical double taxation can be eliminated through domestic provisions for the relief of double taxation (ordinarily in the form of either the exemption or credit method) which operate without the need for tax treaties. Whilst these domestic provisions will likely address most forms of residence-source juridical double taxation, they will not cover all cases of double taxation, especially if there are significant differences in the source rules of the two States or if the domestic law of these States does not allow for unilateral relief of economic double taxation (e.g. in the case of a transfer pricing adjustment made in another State).*

*15.4 Another tax policy consideration that is relevant to the conclusion of a tax treaty is the risk of excessive taxation that may result from high withholding taxes in the source State. Whilst mechanisms for the relief of double taxation will normally ensure that such high withholding taxes do not result in double taxation, to the extent that such taxes levied in the State of source exceed the amount of tax normally levied on profits in the State of residence, they may have a detrimental effect on cross-border trade and investment.*

*15.5 Further tax considerations that should be taken into account when considering entering into a tax treaty include the various features of tax treaties that encourage and foster economic ties between countries, such as the protection from discriminatory tax treatment of foreign investment that is offered by the non-discrimination rules of Article 24, the greater certainty of tax treatment for taxpayers who are entitled to benefit from the treaty and the fact that tax treaties provide, through the mutual agreement procedure, together with the possibility for Contracting States of moving to arbitration, a mechanism for the resolution of cross-border tax disputes.*

*15.6 An important objective of tax treaties being the prevention of tax avoidance and evasion, States should also consider whether their prospective treaty partners are willing and able to implement effectively the provisions of tax treaties concerning administrative assistance, such as the ability to exchange tax information, this being a key aspect that should be taken into account when deciding whether or not to enter into a tax treaty. The ability and willingness of a State to provide assistance in the collection of taxes would also be a relevant factor to take into account. It should be noted, however, that in the absence of any actual risk of double taxation, these administrative provisions would not, by themselves, provide a sufficient tax policy basis for the existence of a tax treaty because such administrative assistance could be secured through more targeted alternative agreements, such as the conclusion of a tax information exchange agreement or the participation in the multilateral Convention on Mutual Administrative Assistance in Tax Matters.<sup>17</sup>*

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17. Available at <http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf>.