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### A Deconstruction of the Principal Purposes Test

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# WTTJ World Tax Journal

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# World Tax Journal

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## *A Deconstruction of the Principal Purposes Test*

This article provides for a critical examination of the principal purposes test (PPT) of article 29(9) of the 2017 OECD Model Income Tax Convention on Income and on Capital. The focus is on the second part of the PPT, which allows for the granting of treaty benefits in the presence of a tax avoidance motive if that would be in accordance with the object and purpose of the relevant provisions of the OECD Model. Questions are raised as to how exactly the object and purpose are determined, the consistency of the relevant parts of the Commentary on the 2017 OECD Model is discussed, and the Examples that purport to clarify the application of the PPT are critically reviewed. Finally, an effort is made to come to a sensible and workable synthesis of the various aspects of the PPT, including the “nexus” part and the “abusive transactions” part thereof, which will be addressed in some detail, and a concept is explored to extend the multilateral approach taken with respect to the minimum standard of the BEPS Action 6 Final Report to the nexus part of the PPT.

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### 1. Introduction

The object and purpose of this article is to deconstruct article 29(9) of the 2017 OECD Model Tax Convention on Income and on Capital<sup>1</sup> (2017 OECD Model) on the principal purposes test (PPT). That deconstruction will mostly explore the second part of the PPT, which is now commonly referred to as the “objective test”: “unless it is established that granting that benefit in these circumstances would be in accordance with the object and

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1. *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Models IBFD [hereinafter *OECD Model* (2017)]. All references to the *OECD Model* have been specified with a date, unless a general reference was intended.

purpose of the relevant provisions of this Convention”.<sup>2</sup> This article will also touch upon the coherence of article 29 of the 2017 OECD Model as a whole, including the limitation-on-benefits (LOB) clause of article 29(1)-(7) and the triangular-case provision of article 29(8), but that will mostly be in the context of the exploration of the PPT. While the PPT’s operation is broad and not limited to treaty shopping, this article will, for the largest part, focus on treaty shopping. Before the focus is put on the objective test of article 29(9) of the OECD Model, some historical OECD context will be provided. This historical context is important because it facilitates the understanding of the evolution that led to the adoption of the PPT. Following that context, the role of the principal purpose, its usefulness and its relationship with the object and purpose of the relevant provisions of the relevant convention are explored, and it is briefly noted how the PPT, through its design, is likely to shift the onus from the tax authorities to the taxpayer to establish the lack of a tax avoidance result, as well as how the OECD had to walk a tightrope between preserving the “guiding principle” for existing tax treaties and introducing a more powerful instrument in the new article 29(9) going forward. This article then explores the different dynamics of, on the one hand, interpreting the treaty in accordance with the interpretation principles of the Vienna Convention on the Law of Treaties (VCLT), and on the other hand, determining whether granting treaty benefits would be “in accordance with the object and purpose of the relevant provisions of the Convention”. It is subsequently shown how the application of the PPT, in respect of the fact pattern of three well-known treaty shopping cases, would potentially lead to a result different from the outcome in two – or perhaps even in all – of those cases. In the context of those cases and the hypothetical application of the PPT, the question is raised as to how exactly the object and purpose of the relevant provisions of the convention are determined and whether there is one multilateral common denominator – as the preamble to the 2017 OECD Model seems to suggest – or perhaps not. Subsequently, the Commentary on Article 29(9) of the 2017 OECD Model is further examined, and its examples are scrutinized. Finally, an effort is made to come to a sensible and workable synthesis of the various aspects of the PPT, including the “nexus” part and the “abusive transactions” part thereof, as these will be addressed in some detail, and a concept is explored to extend the multilateral approach taken with respect to the minimum standard of BEPS Action 6<sup>3</sup> to the nexus part of the PPT. The potentially difficult relationship between the PPT and the concept of “wholly artificial arrangements” as per EU primary law and secondary law will not be explored in this article.<sup>4</sup> The reconciliation and treaty interpretation issues caused by the fact that the narrative and examples of (i) the Final Report on Action 6; (ii) the Commentary on Article 7(1) of the OECD Multilateral Convention to Implement Tax

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2. For the subjective part of the principal purposes test (PPT), *see*, inter alia, D. Weber, *The Reasonableness Test of the Principal Purpose Test in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law*, 10 Erasmus Law Review 1 (2017); P. Piantavigna, *The Role of the Subjective Element in Tax Abuse and Aggressive Tax Planning*, 10 World Tax J. 2, p. 193 et seq. (2018), Journals IBFD; and B. Kuźniacki, *The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application*, 10 World Tax J. 2, p. 255 et seq. (2018), Journals IBFD.
  3. OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2015 Final Report* (OECD 2015), International Organizations’ Documentation IBFD [hereinafter *Action 6 Final Report*].
  4. *See*, inter alia, R.J. Danon, *Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups*, 72 Bull. Intl. Taxn. 1, para. 4.4. (2018), Journals IBFD; and O. Koriak, *The Principal Purpose Test under BEPS Action 6: Is the OECD Proposal Compliant with EU Law?*, 56 Eur. Taxn. 12, pp. 552-559 (2016), Journals IBFD.

Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI);<sup>5</sup> and (iii) the Commentary on Article 29(9) of the 2017 OECD Model are not identical will also not be addressed in this article.<sup>6</sup>

## 2. Historical Context

The 1963 OECD Model<sup>7</sup> was silent on the improper use of tax treaties. It may be difficult to believe today, but the Commentary on Article 1 of the 1963 OECD Model consisted of one paragraph only, which explained the personal scope of the Convention. The 1977 OECD Model did address improper use of the Convention. Paragraphs 8 and 9 of the Commentary on Article 1 of the 1977 OECD Model<sup>8</sup> introduced the notion of “treaty shopping”, although neither paragraph used the term. In fact, paragraphs 55 and 56 of the Commentary on Article 1 of the 2017 OECD Model are almost literal incarnations of these paragraphs 8 and 9. It is worth noting that paragraph 8 of the 1977 OECD Model referred to “the creation of usually artificial legal constructions”, a phrase that bears resemblance to the “wholly artificial arrangements” appearing in the progressive development of primary and secondary EU law, but remarkably, this phrase was deleted in the Commentary on Article 1 of the 2017 OECD Model.<sup>9</sup>

5. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (7 June 2017), Treaties IBFD [hereinafter MLI].

6. Neither the Commentaries on the *OECD Model* (2017) nor the Explanatory Statement to the MLI provide for a watertight interpretative connection between the various sources of explanation to the PPT. Para. 12 of the Explanatory Statement to the MLI provides as follows:

The development of the BEPS measures that are implemented by the Convention also included development of commentary which was intended to be used in the interpretation of those provisions. While this Explanatory Statement is intended to clarify the operation of the Convention to modify Covered Tax Agreements, it is not intended to address the interpretation of the underlying BEPS measures (except with respect to the mandatory binding arbitration provision contained in Articles 18 through 26, as noted below in paragraphs 19 and 20). Accordingly, the provisions contained in Articles 3 through 17 should be interpreted in accordance with the ordinary principle of treaty interpretation, which is that 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 light of its object and purpose. In this regard, the object and purpose of the Convention is to implement the tax treaty-related BEPS measures. The commentary that was developed during the course of the BEPS Project and reflected in the Final BEPS Package has particular relevance in this regard. It should be noted that while in some cases, as noted below, the provisions of the Convention differ in form from the model provisions that were produced through the BEPS Project, unless noted otherwise, these modifications are not intended to make substantive changes to those provisions. Instead, they are intended to implement the agreed BEPS measures in the context of a multilateral instrument that applies to a widely varied network of existing treaties.

It seems that with this approach, in particular with examples having been added to the *OECD Model Tax Convention on Income and on Capital: Commentary on Article 29(9)* (21 Nov. 2017), Models IBFD after the *Action 6 Final Report*, the question as to the relevance of posterior commentaries in respect of existing tax treaties – also those covered by the MLI – remains relevant.

7. *OECD Model Tax Convention on Income and on Capital* (30 July 1963), Models IBFD [hereinafter *OECD Model* (1963)].

8. *OECD Model Tax Convention on Income and on Capital* (11 Apr. 1977), Models IBFD.

9. None of the publicly available OECD materials clarify why the reference to “usually artificial legal constructions” was deleted. One conceivable explanation is that the drafters of the *OECD Model: Commentary* (2017) were concerned that a similarity with the EU law concept of “wholly artificial arrangement” could lead to an interpretation of the PPT in a fashion perceived as too narrow. It is also conceivable that de facto control over the interpretation of the term by the Court of Justice of the European Union (ECJ) was thought of as not desirable. See, inter alia, UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, ECJ Case Law IBFD; and FR: ECJ, Case C-6/16, *Eqiom SAS, formerly Holcim France SAS, Enka SA v. Ministre des Finances et des Comptes*

The Commentary on Article 1 of the 1977 OECD Model touches only very lightly on the theme of improper use of the Convention. Paragraph 7 deals with the exploitation by taxpayers of differences in tax levels between countries without using tax treaties and suggests that countries might then wish to preserve the application of anti-avoidance provisions contained in their domestic tax laws in their bilateral tax treaties. This paragraph does not deal with treaty shopping, but rather with the preservation of the application of domestic anti-avoidance rules, such as controlled foreign corporation (CFC) and thin cap rules.

The two key sentences relating to treaty shopping can be found in paragraphs 8 and 9:

8. Moreover, the extension of the network of double taxation conventions still reinforces the impact of such manoeuvres as they make it possible, through the creation of usually artificial legal constructions, to benefit from both the tax advantages available under certain domestic laws and the reliefs from tax provided for in double taxation conventions.

9. This would be the case, for example, if a person (whether or not a resident of a Contracting State), acted through a legal entity created in a State essentially to obtain treaty benefits which would not be available directly to such person.

Paragraph 9, second sentence adds:

Another case would be one of an individual having in a Contracting State both his permanent home and all his economic interests, including a substantial participation in a company of that State, and who, essentially in order to sell the participation and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 4 of Article 13), transferred his permanent home to the other Contracting State, where such gains were subject to little or no tax.

Apart from identifying treaty shopping, the Commentary is remarkably silent on the nature of the problem and remedies. It does mention, in paragraph 10, the introduction of the concept of the “beneficial owner” in articles 10, 11 and 12 and refers to the Commentaries on these articles. It also refers to so-called “artiste companies”, and furthermore states that “[i]t may be appropriate for Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention”, thus implying that, in the absence of such preservation clauses, treaty relief would be available, even in the case of tax avoidance.

Ten years after the publication of the 1977 OECD Model, the OECD published the well-known Four Related Studies on International Tax Avoidance and Evasion.<sup>10</sup> In particular, the Conduit Companies Report<sup>11</sup> addressed the theme of treaty shopping. It refers to the above-mentioned paragraph 9 of the Commentary on Article 1 of the 1977 OECD Model and then states the following:

2. This report deals with the most important situation of this kind, where a company situated in a treaty country is acting as a conduit for channelling income economically accruing to a person in another State who is thereby able to take advantage “improperly” of the benefits provided by a tax treaty. This situation is often referred to as “treaty shopping”. [...] The tax advantages

.....  
*publics*, ECJ Case Law IBFD. Then there is the possibility that no such thinking was behind the deletion and that it was only the result of “streamlining” the text.

10. OECD, *International Tax Avoidance and Evasion: Four related studies*, Issues in International Taxation Series No. 1 (OECD 1987).

11. OECD, *Report on Double Taxation Conventions and the Use of Conduit Companies* (OECD 1987) [hereinafter Conduit Companies Report].

with which this report is primarily concerned occur to the detriment of the country of source of income.

Paragraph 7 of the Conduit Companies Report is worth reciting in its entirety:

[Treaty shopping] is unsatisfactory in several ways:

- a) Treaty benefits negotiated between two States are economically extended to persons resident in a third State in a way unintended by the contracting States; thus the principle of reciprocity is breached and the balance of sacrifices incurred in tax treaties by the contracting party altered;
- b) Income flowing internationally may be exempted from taxation altogether or be subject to inadequate taxation in a way unintended by the Contracting States. This situation is unacceptable because the granting by a country of treaty benefits is based, except in specific circumstances, on the fact that the respective income is taxed in the other State or at least falls under the normal tax regime of that State;
- c) The State of residence of the ultimate income beneficiary has little incentive to enter into a treaty with the State of source, because the residents of the State of residence can indirectly receive treaty benefits from the State of source without the need for the State of residence to provide reciprocal benefits.

Also interesting is paragraph 10:

10. The foregoing discussion is based on the assumption that improper use was made by a person resident in a State which had no treaty with the State of source. Similar problems may arise where there is a treaty between the State of residence and the State of source, but:

- a) This treaty offers less protection than the treaty between the State of source and the State of conduit;
- b) The use of a conduit company can avoid the disclosure of information to the State of residence;
- c) Both treaties offer equal protection but use is made of the conduit company in order to avoid taxation in the State of residence [e.g. because, by using the conduit company, income such as royalties is transformed into dividends to be exempted by a participation exemption (see example 2 [argument against “derivative benefit”] of paragraph 5)].

The principles set forth in this report are applicable to such cases.

The above-mentioned reasons why treaty shopping is unsatisfactory will be revisited below in the deconstruction of the PPT.

The Conduit Companies Report continues with a description of the provisions incorporated into the 1977 OECD Model that preclude treaty benefits in certain conduit company cases. In fact, this was the introduction of the term “beneficial owner” only. Interestingly, in paragraph 15, the Report states – somewhat imprecisely – that the new provisions of the 1977 OECD Model “deal with the conduit situations in a rudimentary way” (i.e. with the introduction of beneficial ownership), “expressing only a general concern that improper use of treaties should be avoided” (referring to paragraphs 8 and 9 of the Commentary on Article 1, paragraphs 17 and 22 of the Commentary on Article 10, paragraph 12 of the Commentary on Article 11 and paragraph 7 of the Commentary on Article 12). Again, the Report implies that, in the absence of specific treaty provisions, improper use of the tax treaty cannot be prevented: “[A]lthough it is clear that all necessary information should be exchanged between the two contracting States for the application of these clauses, this is not sufficient to preclude a person from acting through a legal entity created in a State in order

to obtain treaty benefits which would not be available directly to them, and from obtaining unjustifiable tax advantages (paragraphs 8 and 9 of the Commentary on Article 1).”

Part III of the Report addresses issues for treaty negotiations and gives various examples of possible treaty provisions. Interesting in particular is paragraph 42:

42. The solutions described above are of a general nature. In connection with them, it will be necessary to provide specific provisions to ensure that treaty benefits will be granted in bona fide cases. Such provisions could have the following wording:

*i) General bona fide provision*

The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and thus do not have as primary purpose the obtaining of any such benefits.

In part IV, which deals with the application of existing treaties, the Report again implies that treaty shopping cannot be prevented in the absence of treaty provisions to that effect:

43. Existing conventions may have clauses with safeguards against the improper use of their provisions. Where no such provisions exist, treaty benefits will have to be granted under the principle of “pacta sunt servanda” even if considered to be improper. *The Contracting States should, however, be prepared to grant all possible help by exchange of information (cf. paragraph 19 above) and to remedy the situation by adequately revising the treaty (cf. Part III above).* [Emphasis added]

The Report then goes on to address possibilities for dealing with “artificial tax avoidance” and refers to domestic anti-abuse and substance-over-form rules. The Report raises the question “as to whether the denial of treaty benefits in such cases [based on domestic law] is compatible with treaty obligations. This relates to the issue of the priority accorded to international law in relation to domestic law, a matter on which opinions differ among States, some taking the view that where the beneficiary of the income fulfils the conditions set in the convention (beneficial ownership, residence), the provision of the convention should apply, notwithstanding the domestic provisions of the State of source [...] [and] others taking the contrary view.”<sup>12</sup>

Following the recommendation in the Conduit Companies Report, much of the content of that report was reproduced in the Commentary on Article 1 of the 1992 OECD Model.<sup>13</sup> That Commentary provides examples of treaty provisions, including LOB provisions addressing the “direct conduit” and the “stepping stone conduit”.<sup>14</sup> Evidenced by paragraphs 22-26

.....  
12. Id., at para. 44.

13. OECD Model Tax Convention on Income and on Capital (1 Sept. 1992), Models IBFD.

14. See OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 para. 13 (1 Sept. 1992), Models IBFD:

A solution to the problem of conduit companies would be to disallow treaty benefits to a company insofar as the company is not owned, directly or indirectly, by residents of the State of which the company is a resident. For example, such a “look-through” provision might have the following wording:

A company which is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits unless it is neither owned nor controlled directly or through one or more companies, wherever resident, by persons who are not residents of the first-mentioned State.

See also para. 19:

It has been suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision which would single out cases of improper use with reference to the conduit arrangements themselves (the channel approach). Such a provision might have the following wording:

of the Commentary on Article 1 of the 1992 OECD Model, the OECD member countries struggled with the application of domestic anti-abuse rules – including substance-over-form rules – in the application of existing tax treaties, but their thinking had clearly evolved since the Conduit Companies Report. The clearest indication is in paragraph 24: “However, it is the view of the wide majority that such rules [including general principles, such as substance over form], and the underlying principles, do not have to be confirmed in the text of the convention to be applicable.” Nevertheless, the wording of these paragraphs and the evolution since 1977 leave the reader confused.<sup>15</sup>

The 1998 Report on Harmful Tax Competition contains recommendations concerning the entitlement to treaty benefits, including one concerning the clarification of the status of domestic anti-abuse rules and doctrines in tax treaties, but the language continues to be somewhat fuzzy and lacks a sharp distinction between the preservation of the application of domestic anti-avoidance rules for tax treaty purposes and rules pertaining to the improper use of the tax treaty itself. Some further work was done in the 2002 Report Restricting the Entitlement to Treaty Benefits, but the language that was proposed for changes in the Commentary on Article 1 of the OECD Model did not entirely foreshadow what was to come with the release of the Commentary on Article 1 of the 2003 OECD Model.<sup>16</sup>

According to some authors, the 2003 changes to the Commentary on Article 1 provide for a fundamentally different approach to tax avoidance and tax treaties in that from that moment one of the purposes of a tax treaty is to prevent tax avoidance, and it was made clear that tax treaties do not prevent the application of domestic anti-avoidance rules.<sup>17</sup> Other authors see the changes as mostly clarifying in nature.<sup>18</sup>

In the context of this article, the two most relevant additions to the Commentary on Article 1 in 2003 can be found in paragraphs 7 and 9.5 thereof. Paragraph 7, as is well known, makes clear that “it is also a purpose of tax conventions to prevent tax avoidance and evasion”. Paragraph 9.5 introduces the guiding principle that is now incorporated into the PPT:

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.

Where income arising in a Contracting State is received by a company which is a resident of the other Contracting State and one or more persons who are not residents of that other Contracting State

- a) Have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and
- b) exercise directly or indirectly, alone or together, the management or control of such company

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, depreciation of any kind of business assets including those on immaterial goods, processes, etc.).

15. See B. Arnold, *Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model*, 58 Bull. Intl. Fiscal Docn. 6, p. 246 (2004), Journals IBFD.
16. *OECD Model Tax Convention on Income and on Capital* (28 Jan. 2003), Models IBFD. See also A. Martín Jiménez, *The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries?*, 58 Bull. Intl. Fiscal Docn. 1, p. 18 (2004), Journals IBFD.
17. See, inter alia, Arnold, *supra* n. 15, at p. 245; and Martín Jiménez, *id.*, at p. 18. Martín Jiménez even speaks of a “u turn” in respect of the addition of the purpose of prevention of avoidance and evasion.
18. C. Elliffe, *Cross Border Tax Avoidance: Applying the 2003 OECD Commentary to Pre-2003 Treaties*, British Tax Review 3, p. 331 (2012).

One may wonder why, at the time (in 2003), the changes that have now found their way into the 2017 OECD Model – in particular, the preamble and the PPT – were not included in the 2003 OECD Model. Perhaps there was no consensus or there was a fear that incorporating these into the OECD Model would erode the position that domestic anti-avoidance principles, including substance over form, could be applied in respect of existing tax treaties in the absence of explicit clauses in those treaties. It is clear that in various places in the Commentary on Article 1 of the 2003 OECD Model, the drafters reiterate that, regardless of whether a country takes a factual approach or an interpretive approach to tax treaty interpretation, tax treaty benefits can be denied in cases of abuse.<sup>19</sup> To change the OECD Model by inclusion of the PPT would have required renegotiating existing treaties and would have undermined that position for treaties that were not renegotiated. Changing the Commentary, together with the assumption of a dynamic approach to the Commentary was done in order to achieve more effect, although, of course, subject to the argument that the guiding principle was not a clarification, but a change.

Following the 2013 OECD report on Addressing Base Erosion and Profit Shifting, the 2015 Final Report on Action 6 gave birth to the PPT as it has first been incorporated into the MLI. Article 7(1) of the MLI contains the PPT as it appears in the 2017 OECD Model.<sup>20</sup>

Finally, the 2017 OECD Model incorporated the PPT, rearranged and amended the Commentary on Article 1 somewhat and added the following to the Introduction:

16.1 As a result of work undertaken as part of the OECD/G20 Base Erosion and Profit Shifting Project, in 2014 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 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, “[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.”

The preamble reads as follows:

.....

19. See Arnold, *supra* n. 15, at p. 249 et seq.  
20. Worth noting is the optional art. 7(4), which does not appear in the *OECD Model (2017)*, but does appear, in essence, in para. 184 of the *OECD Model: Commentary on Article 29 (2017)*:

Where a benefit under a Covered Tax Agreement is denied to a person under provisions of the Covered Tax Agreement (as it may be modified by this Convention) that deny all or part of the benefits that would otherwise be provided under the Covered Tax Agreement where the principal purpose or one of the principal purposes of any arrangement or transaction, or of any person concerned with an arrangement or transaction, was to obtain those benefits, the competent authority of the Contracting Jurisdiction that would otherwise have granted this benefit shall nevertheless treat that person as being entitled to this benefit, or to different benefits with respect to a specific item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, determines that such benefits would have been granted to that person in the absence of the transaction or arrangement.

(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: [...]

### 3. One of the Principal Purposes: Relationship with the Object and Purpose and the Burden of Proof

This section will explore the relationship between “one of the principal purposes” and the “object and purpose” and will also briefly address the difference in operation of the “guiding principle” in the Commentary on Article 1, on the one hand, and in article 29(9) of the 2017 OECD Model, on the other hand.

As will be highlighted in section 8., the Commentary on Article 29(9) of the 2017 OECD Model and, in particular, the examples therein do not always make clear which prong of the test is addressed, i.e. the “principal purposes” part or the “object and purpose” part. A clear distinction would be useful because of the prominent role of the principal purposes part, but because the subjective and objective tests are so intertwined, a clear distinction is also difficult. One could even raise the question of whether having a subjective test is useful.<sup>21</sup> Would the application of tax treaty provisions in accordance with their object and purpose not be enough to accomplish proper application? One could see the subjective test in the context of legal certainty as protecting the taxpayer acting in good faith, but also as a proxy for testing violation of object and purpose. The reasoning would then be that if a particular structure is motivated by tax avoidance, that structure would be at odds with reality and, accordingly, would violate the object and purpose of the tax treaty (or of the relevant provisions thereof), unless the taxpayer could meet the burden of proof regarding the object and purpose. Some authors prefer to apply the subjective and objective tests in a holistic manner without distinguishing sharply between the principal purpose part and the reasonableness test, on the one hand, and the object and purposes part, on the other hand.<sup>22</sup>

The cited language from the *Azadi Bachao Andolan* case (mentioned in section 6.) and the first paragraph of the Introduction to the 2017 OECD Model indeed raise a question as to the relationship between the first and second prongs of the PPT. As Lang did, one could question why motive “one of the principal purposes” in article 29 should matter.<sup>23</sup> Is the interpretation of the tax treaty not all about the object and purpose? Further, when would not levying a tax in the presence of a principal purpose to obtain a benefit – or, more in general, avoiding tax – not be in accordance with the object and purpose of any rule of taxation? If one looks at this question in a one-dimensional way and with respect to income tax, the approach could be simple: the object and purpose of the provision are to levy tax, and every act conducted to avoid that tax is contrary to the object and purpose of the rule. However,

21. See R.L.H. IJzerman, *Het leerstuk van de wetsontduiking in het belastingrecht* p. 92 et seq. (Kluwer 1990), and the literature discussed therein.

22. M. Lang, *BEPS Action 6: Introducing an Anti-abuse Rule in Tax Treaties*, 7 Tax Notes International 74, p. 661 (2014).

23. Id.

sometimes a tax rule is merely, or also an instrument to achieve a non-tax policy goal. Certain “sin taxes”, e.g. an excise tax on tobacco, may aim to discourage the consumption of certain products. If an individual then refrains from using the relevant product in order to avoid the tax, the tax is avoided, and the object and purpose of the rule are fully met. In other words, object and purpose, as expressed in the relevant provisions of the law, induced the principal purpose to avoid the tax. If an individual would refrain from working and earning income in order to escape income tax, one could say that the object and purpose of the system, i.e. raising tax, were not achieved, but that the avoidance of tax is nevertheless in accordance with the object and purpose of the relevant provision of the law, i.e. taxing income only. When there is no income, taxation is not justified. If a government exempts interest in order to encourage savings and a taxpayer invests in bonds, the object and purpose of the rule, i.e. encouraging savings, are met. The problem arises when a taxpayer tries to “have his cake and eat it too”. If a taxpayer devises an arrangement that is outside the relevant provision of the law but economically falls within its ambit, the question arises as to whether the object and purpose of the relevant provision have been violated, and it seems that the motive of the taxpayer, i.e. the principal purpose, serves as an agent (perhaps even a proxy) to determine the violation of the object and purpose. In that sense, one could criticize the separation of the principal purpose prong of the PPT and the object-and-purpose prong, as that separation could operate against the taxpayer when the first prong is met but accordance with the object and purpose of the relevant provisions cannot be determined with sufficient certainty. This is particularly the case if one looks at international case law and the lack of consistency in the Commentary on the OECD Model.<sup>24</sup>

The instrumental nature of a rule of law, other than the object and purpose of raising tax, is particularly present in tax treaties following the OECD Model. While the preamble to the 2017 OECD Model and the Commentaries on Articles 1 and 29 express the three purposes recited in section 4. of this article, the overriding object and purpose of the OECD Model is found in paragraph 1 of the Introduction: “[...] removing the obstacles that double taxation presents to the development of economic relations between countries” because “[i]ts harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known”.

The first prong of article 29(9) of the 2017 OECD Model could perhaps, to a significant extent, be explained by the reciprocity element mentioned in section 2. of this article. If obtaining a benefit was one of the principal purposes of any arrangement, it is likely that that arrangement resulted in a benefit that was not otherwise available and was not negotiated by the state of residence of the ultimate income beneficiary (in the language of the Conduit Companies Report).

Then, there is the question of the burden of proof. Article 29(9) of the 2017 OECD Model reads as follows:

Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that

24. E.g. with respect to collective investment vehicles, as discussed in secs. 8 and 9 in the context of the examples, the Commentary on Article 1 of the *OECD Model: Commentary* (2017) states that states may require different levels of nexus for the granting of tax treaty benefits, but no conclusive recommendations are made.

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.

The Commentary on Article 29(9) of the 2017 OECD Model, in paragraph 169, states the following:

169. Paragraph 9 mirrors the guidance in paragraphs 61 and 76 to 80 of the Commentary on Article 1. According to that guidance, the benefits of a tax convention should not be available where one of the principal 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 9 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 76 to 80 of the Commentary on Article 1; it also confirms the application of these principles for States whose domestic law already allows them to address such cases.

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

The section on improper use of the Convention in the Commentary on Article 1 of the OECD Model was somewhat rearranged in 2017 but was not removed or moved to the Commentary on Article 29(9), for obvious reasons: if the entire section were removed or moved to article 29(9), the inference could be that, for existing tax treaties that do not contain a PPT and would also not be covered by the PPT incorporated in article 7(1) of the MLI, the guiding principle would not apply.<sup>25</sup> Paragraph 61 of the Commentary on Article 1 of the 2017 OECD Model reiterates the guiding principle and states that it “applies independently from the provisions of paragraph 9 of Article 29, which merely confirm it”. This is slightly curious, as one would normally expect that when a principle of a treaty is elevated from a commentary to its text, the relevant text would thereafter govern the application of the principle.<sup>26</sup> It is clear that the Commentary on Article 29(9) had to walk a fine line between the goal of having article 29(9) included in tax treaties and the preservation of the guiding principle for treaties without a PPT and in respect of situations covered by existing tax treaties prior to their inclusion as a covered tax agreement in the MLI.

As Arnold predicted in June 2004, the application of the guiding principle in respect of existing tax treaties is “an extremely difficult one that will play out in the courts of many countries over many years”.<sup>27</sup> While the OECD member countries all use the Commentary

25. One could wonder whether art. 1 is the logical place for the commentary with respect to improper use of the convention. The Introduction seems to be a better place, as that Introduction covers the entire *OECD Model* (2017).

26. Of course, there is the lingering discussion about the status of the *OECD Model: Commentaries* (2017); see, for example, H. Ault, *The Role of the OECD Commentary in the Interpretation of Tax Treaties*, 22 *Intertax* 4, p. 144 (1994); F. Engelen, *Some Observations on the Legal Status of the Commentaries on the OECD Model*, 60 *Bull. Intl. Taxn.* 3, p. 106 (2006), *Journals IBFD*; and S. Douma & F. Engelen (eds.), *The Legal Status of the OECD Commentaries* (IBFD 2008), but for the point made here, that discussion is not relevant.

27. See Arnold, *supra* n. 15, at p. 260. See, for a recent example of a court that struggled with the guiding principle without even mentioning it, CA: Tax Court, 22 Aug. 2018, 2018 TCC 152, *Alta Energy Luxembourg S.A.R.L. v. The Queen*, para. 71, *Tax Treaty Case Law IBFD*.

on the OECD Model as their guide (albeit with different weight given to it depending on, inter alia, whether the Commentary was contemporaneous or posterior), treaty shopping cases in OECD countries and beyond show a remarkable divergence in outcome regardless of whether reference is made to the Commentary on the 2003 OECD Model.<sup>28</sup> From some of the cases, it becomes clear that the difference between the guiding principle as formulated in the Commentary in 2003, on the one hand, and in article 29(9) of the 2017 OECD Model, on the other hand, may be significant. The Commentary on Article 1 of the 2003 OECD Model puts the onus on the tax authorities, while Article 29(9) of the 2017 OECD Model puts the onus on the taxpayer.<sup>29</sup> In a number of treaty cases under existing tax treaties, the tax avoidance motive was established, but treaty benefits were nevertheless granted because the court could not find a violation of the object and purpose when looking at the treaty text or relevant legislative history.<sup>30</sup> Clearly, under article 29(9), the tax authorities only have to pass the “reasonableness” test with respect to the motive (“one of the principal purposes”), and then the onus is on the taxpayer. However, the difficulty that tax authorities had in the past with demonstrating that granting the tax treaty benefits would be contrary to the object and purpose of the tax treaty now becomes the difficulty of the taxpayer to demonstrate that granting a benefit would be in accordance with the object and purpose of “the relevant provisions of this Convention”. With respect to the guiding principle of the 2003 Commentary, it was observed that its second requirement (contrary to the object and purpose of the treaty) is rather vague.<sup>31</sup> However, while this vagueness operated against the tax authorities in the past, it will operate against the taxpayers in the future. Of course, how this will play out is uncertain. Courts ought to be guided by the object and purpose of the relevant rule, and it is conceivable that the onus will effectively be on the party that fails to convincingly establish that granting treaty benefits will be in accordance with or against the object and purpose of the relevant provisions of the tax treaty.

#### 4. Object and Purpose of a Treaty versus Object and Purpose of the Relevant Provisions of this Convention

This section will briefly address the role of the object and purpose of the treaty as prescribed in article 31 of the VCLT in the interpretation of tax treaties following the introduction of the guiding principle in the Commentary on Article 1 of the OECD Model in 2003, as well as the role of the object and purpose of the relevant provisions of the tax treaty as per the text of article 29(9) of the 2017 OECD Model and other relevant provisions of the tax treaty. The reach of the object and purpose in the context of the different wording of each provision is quite different.

Article 31 of the VCLT’s general rule of interpretation is as follows:

28. See S. van Weeghel, *General Report*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions* p. 19 (IFA Cahiers vol. 95a, IBFD 2010), Online Books IBFD.

29. See, however, Lang, *supra* n. 22, p. 661.

30. See, inter alia, in a slightly different context, NL: Hoge Raad, 29 June 1994, Case 28 734, BNB 1994/294, with a case note by P.J. Wattel: “The position advocated by the Underminister of Finance before the Hoge Raad, that in case of non-taxability of the income in the Netherlands object and purpose of the treaty would be ignored is not supported in the text of the treaty or by the explanations of the contracting states.”

31. See Arnold, *supra* n. 15, at p. 247. See also the *Alta Energy* case (2018), at para. 77, last sentence (also mentioned in sec. 6. of this article).

1. 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]

The Commentary on Article 1 of the OECD Model since 2003, in its relevant part, states the following:

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*. [Emphasis added]

Article 29(9) of the 2017 OECD Model, in its relevant part, states the following:

[...] 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*. [Emphasis added]

Presumably, in the structure of the 2017 OECD Model, article 29 operates to the effect of denying treaty benefits that would otherwise be accorded by the Convention. This is made explicit in article 29(1) (“Except as otherwise provided in this Article, a resident of a contracting state shall not be entitled to a benefit that would otherwise be accorded by this Convention”) and is implied in article 29(9) (“Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted”). As was recited in section 3., according to paragraph 61 of the Commentary on Article 1 of the 2017 OECD Model, the guiding principle applies independently from the provisions of article 29(9), which merely confirm it. The curiosity of this relationship presents a different question: if a treaty structure passes the test of the guiding principle in the interpretation of the relevant treaty provisions without taking into account article 29(9), could the benefits nevertheless be denied when that article is applied, or will the two avenues effectively converge, as considered above?<sup>32</sup> That possibility would be at odds with the notion that the PPT “is a lowering of the abuse threshold”.<sup>33</sup>

The words “object and purpose” as used in paragraph 61 of the Commentary on and in article 29(9) of the 2017 OECD Model nudge one in the direction of article 31(1) of the VCLT. It is unlikely that article 29(9) and its reference to the object and purpose of the relevant provisions of the Convention was merely included in the OECD Model to confirm the guiding principle and the general rule of interpretation of article 31 of the VCLT. If that were the case, the inclusion of the new preamble, perhaps in combination with the expression of the guiding principle in the Commentary on Article 1 of the 2017 OECD Model, would have been enough to accomplish the desired result.<sup>34</sup>

If article 29(9) is disregarded for the moment, the tension between article 26 of the VCLT (*pacta sunt servanda*) and article 31 of the VCLT (general rule of interpretation) is apparent, at least if one sees a contradiction between the two provisions rather than their complemen-

.....  
32. The implication of the latter possibility would be that the inclusion of art. 29(9) has no effect. That is an implication at odds with the rule of effectiveness in treaty interpretation, i.e. “that treaty provisions are to be interpreted so as to give them their fullest weight and effect in such a way that a reason and a meaning can be attributed to every part of the text”. See O. Dörr & K. Schmalenbach (eds.), *Vienna Convention on the Law of Treaties* p. 539, para. 35 (Springer 2012).

33. Cf. L. De Broe, *Fighting Treaty Shopping after the Multilateral Instrument*, in *Tax Treaties after the BEPS Project, A Tribute to Jacques Sasseville* p. 99 (B. Arnold ed., Canadian Tax Foundation 2018).

34. Cf. Kuźniacki, *supra* n. 2, at p. 240.

tary nature.<sup>35</sup> One could indeed see the “good faith” part of article 26 of the VCLT as the foundation of the argument that the granting of tax treaty benefits is always subject to an “anti-abuse” proviso.<sup>36</sup> However, one could also question the presence or applicability of a general anti-abuse principle in the interpretation of tax treaties.<sup>37</sup> Of course, the text of a treaty provision remains the starting point, in particular the ordinary meaning of the terms in their context and in light of the object and purpose of the treaty.

Accordingly, before one applies article 29(9) of the 2017 OECD Model, the relevant provisions of the Convention should be interpreted in accordance with the interpretation rules of the VCLT. Does that imply that if the text, context and object and purpose of the tax treaty are clear, there is no role to play for article 29(9)? That is certainly not the case. Although article 31(1) of the VCLT prescribes that the terms of the treaty should be construed in their context and in light of the object and purpose of the treaty, as stated above, the ordinary meaning of the terms of the treaty is the starting point.<sup>38</sup> Put differently, teleological interpretation may find its boundaries if the ordinary meaning is determined.

As Villiger put it:

Interpretation in the light of a treaty’s object and purpose finds its limits in the treaty text itself. One of the (originally many possible) ordinary meanings will eventually prevail. In other words, Article 31 avoids an extreme functional interpretation which may, in fact, lead to “legislation” or the revision of a treaty.<sup>39</sup>

In addition, even though the object and purpose are referred to in the singular in the VCLT, a treaty may have more than one object and purpose, and these may conflict.<sup>40</sup> There may be a hierarchy in the objects and purposes of the treaty. If there is tension or an outright conflict, the interpreter needs to reconcile them, and obviously when objects and purposes go in different directions, the ordinary meaning of the terms of the treaty becomes even more important.

Within the boundaries of OECD membership or perhaps even the inclusive framework, the overarching purpose of tax treaties is fully captured in the first paragraph of the Introduction to the 2017 OECD Model:

.....

35. Conduit Companies Report, part IV, para. 43.

36. D.A. Ward, *Abuse of Tax Treaties*, in *Essays in International Taxation in Honor of Sydney I. Roberts* p. 403 (H.H. Alpert & K. van Raad eds., Kluwer Law and Taxation 1993).

37. See S. van Weeghel & A. Gunn, *A General Anti-Abuse Principle of International Law: Can It Be Applied in Tax Cases?*, in *Essays on Tax Treaties, A Tribute to David A. Ward* p. 305 et seq. (G. Maisto, A. Nikolakakis & J. Ulmer eds., Canadian Tax Foundation 2013). See also L. De Broe, *International Tax Planning and Prevention of Abuse* p. 307 et seq. (IBFD 2007), Online Books IBFD.

38. See, inter alia, L. De Broe & J. Luts, *BEPS Action 6: Tax Treaty Abuse*, 43 *Intertax* 2, p. 144 (2015).

39. M.E. Villiger, *Commentary on the 1969 Vienna Convention on the Law of Treaties* p. 428, para. 14 (Martinus Nijhoff Publishers 2009); and U. Linderfalk, *On the Interpretation of Treaties* p. 203 (Springer 2011). See also Dörr & Schmalenbach, *supra* n. 32, at p. 547, para. 58: “The consideration of object and purpose finds its limits in the ordinary meaning of the text of the treaty. It may only be used to bring one of the possible ordinary meanings of the terms to prevail and cannot establish a reading that clearly cannot be expressed with the words used in the text.” See also the same work, citing the Iran-US Claims Tribunal: “It follows that, under Article 31 of the Vienna Convention, a treaty’s object and purpose is to be used only to clarify the text, not to provide independent sources of meaning that contradicts the clear text (Iran-United States Claims Tribunal Federal Reserve Bank of New York v Bank Markazi (n 19) para 58).” See also F. Engelen, *Interpretation of Tax Treaties under International Law* pp. 172-174 (IBFD 2005), Online Books IBFD; and De Broe, *supra* n. 33, at p. 95.

40. See De Broe, *supra* n. 37, at pp. 328-329.

International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) states on the same tax payer in respect of the same subject matter and for identical periods. Its harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.

The 2017 OECD Model, by the terms of the preamble and the Commentary, has three stated purposes: (i) the elimination of double taxation; (ii) the prevention of tax evasion; and (iii) the prevention of tax avoidance. There is a textual difference between the preamble and paragraph 54 of the Commentary on Article 1 of the 2017 OECD Model. The preamble seems to express one purpose, i.e. “the elimination of double taxation ... without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance”, thus suggesting that there is only one purpose that should be accomplished within the prescribed limits (no tax evasion, no tax avoidance). On the other hand, paragraph 54 of the Commentary on Article 1 maintained the existing language, i.e. there is (i) a principal purpose, i.e. to promote, by eliminating international double taxation, exchanges of goods and services and the movement of capital and persons; and (ii) two ancillary purposes, i.e. to prevent tax avoidance and to prevent tax evasion.<sup>41</sup> The only slight change in the Commentary on Article 1 in the 2017 OECD Model when compared with the 2014 OECD Model is the added reference to the preamble.<sup>42</sup>

A simple example involving article 10 of the 2017 OECD Model may illustrate this tension:

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
  - a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 25 per cent of the capital of the company paying the divi-

41. Id., at p. 326, where De Broe mentions yet other purposes.

42. Then, of course, there is the Introduction to the *OECD Model* (2017), which provides – in particular, in para. 1 – a broader purpose:

1. International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Its harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.

2. It has long been recognised among the member countries of the Organisation for Economic Co-operation and Development that it is desirable to clarify, standardise, 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 recognised 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 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, member countries, when concluding or revising bilateral conventions, 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.

dends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);

- b) 15 per cent of the gross amount of the dividends in all other cases.

TCO, a company resident in 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 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 in a contracting state and beneficially owned by a company resident in the other state. In order to avoid State S taxation in respect of SCO dividends, TCO decides to incorporate a holding company in State R (RCO) and transfers the shares in SCO to RCO. RCO has unrestricted ownership of the SCO shares and is under no obligation to pass on dividends received by it from SCO. RCO's ownership of TCO shares is not merely temporary, but long-term.

In the application of article 10 of the 2017 OECD Model to this simple fact pattern, its terms must be interpreted. Some of these are defined in the treaty (dividends, company, resident, etc.), and others (e.g. paid by, paid to, beneficial owner) are not. If it is assumed that RCO is indeed a treaty resident, the beneficial owner of the SCO dividend, etc., a textual interpretation of article 10 would lead to the conclusion that RCO is entitled to the reduced treaty rate. If one would test this result against the object and purpose of article 10 in a narrow sense, i.e. the avoidance of double taxation in respect of dividends paid by residents of State S to residents of State R, textual and teleological interpretation would align. If one would then test the result against the object and purpose of the treaty as a whole, one may conclude that the conclusion is in line with the principal purpose of the treaty, i.e. the elimination of double taxation, but possibly not with one of the ancillary purposes, i.e. the prevention of tax avoidance, in particular in light of the guiding principle as introduced in the Commentary on Article 1 of the 2003 OECD Model. Regardless of whether the transfer of the SCO shares indeed resulted in tax avoidance, it appears that the application of article 31 of the VCLT results in an interpretation of article 10 to the effect that treaty benefits are granted to RCO in accordance with the terms of article 10. In Villiger's words, one of the treaty's objects and purposes may have found its limits in the treaty text itself.

However, if article 29(9) of the 2017 OECD Model is applied in respect of this simple example, it is clear that the first prong of the test, i.e. the subjective part, is met: the principal purpose of the interposition of RCO is obtaining the benefit of the reduced taxation of dividends. The question then becomes whether nevertheless granting treaty benefits would be in accordance with the object and purpose of the relevant provisions of the State S-State R tax treaty. If the tension between the various purposes of the treaty cannot be resolved, treaty benefits will be denied, at least in the system presented by article 29(9). In this example, it becomes clear that article 29(9) does not merely confirm the guiding principle, but adds a dimension to it, and one could argue that article 29(9) reduces the weight of the principal purpose of the tax treaty (the avoidance of double taxation) in favour of an ancillary purpose (the prevention of tax avoidance).

In practice, the facts and the application of a tax treaty provision in respect of the facts are rarely as straightforward as suggested in this example. There may be reasons to question (i)

the residence of RCO (if, in fact, its shareholder, TCO, manages the entity and State R would be the loser state pursuant to article 4(3) of the tax treaty between State T and State R); (ii) the reality of the involvement of RCO (perhaps it has no employees, it has no involvement with the ownership of the shares, dividends are paid directly to TCO or it does not record any dividend income in its accounts); or (iii) the beneficial ownership of the dividends (if there is an arrangement between TCO and RCO that effectively renders RCO a nominee for TCO). It would not be inconsistent with the textual interpretation of article 10 of the 2017 OECD Model to deny treaty benefits in the case of any of these circumstances. While that is quite clear with respect to residence and beneficial ownership, it may be less clear when the reality of the involvement of RCO is the issue, but also in that case, if it would be determined that the interposition of RCO amounts to a sham, the denial of treaty benefits seems almost universally accepted if one looks at international case law.<sup>43</sup>

## 5. Case Law

Case law dealing with article 10 of tax treaties based on the OECD Model in the context of the example in section 4. is relatively scarce and has diverse results. A few cases are addressed in some detail in this section.

In *Prévost*, a Dutch intermediate holding company of which the shares were owned by companies resident in the United Kingdom and Sweden received dividends from its Canadian wholly owned subsidiary (Prévost). The Canadian Revenue Authority (CRA) did not invoke the Canadian general anti-avoidance rule (GAAR), but rather argued that the Dutch holding company could not be regarded as the beneficial owner of the dividends. The Tax Court of Canada, based on the evidence presented, concluded that the Dutch intermediate holding was the beneficial owner of the dividends received.<sup>44</sup>

It would have been interesting if the CRA would have invoked the Canadian GAAR. From the facts of the case, as recited in the decision, it seems reasonable to conclude that obtaining the benefits of article 10 of the income tax treaty between the Netherlands and Canada by the use of a Dutch holding company as the vehicle to own the shares in Prévost (the Canadian company), was one of the principal purposes of the arrangement. In addition, it is known that the directors of the Canadian subsidiary were also directors of the Dutch holding company. Further, it is known that (i) the Dutch holding company did not have its own office, but had its registered office in the offices of a service provider; (ii) this service provider had very limited authority to act on behalf of the Dutch holding company; and (iii) the Dutch holding company did not have employees or any investments other than the shares in Prévost. A few citations from the case serve to illustrate the position:

[9] The reason for choosing a Dutch holding company was very simple, according to Mr. [...]. Tax was a consideration, but not an overriding consideration. He explained that [the UK shareholder] did not want a Swedish company and [the Swedish shareholder] did not want an English company. Both wanted a company resident in Europe where they have “a set-up” for that type of activity that is not too expensive and where business could be conducted in English. The choices were Switzerland, Luxembourg, Belgium and Holland, the latter being “very neutral”.

[10] However, the office of Arthur Anderson & Co. in Rotterdam had recommended that in order to avoid tax claims from the United Kingdom or Sweden, and other international tax

43. See van Weeghel, *supra* n. 28, at p. 19.

44. CA: Tax Court, 22 Apr. 2008, 2008 TCC 231, *The Queen v. Prévost Car Inc.*

issues, the effective management and control of [the Dutch holding company] be located in the Netherlands.

[13] The directors of Prévost were directors of [the Dutch holding company]. Directors of Prévost frequently discussed [the Dutch holding company's] affairs as well, including future declarations and payments of dividends.

[24] At all relevant times [the Dutch holding company's] registered office was in the offices of Trent International Management [...] ("TIM"), originally in Rotterdam and later in Amsterdam. TIM was affiliated with [the Dutch holding company's] banker, Citco Bank. In March 1996 the directors of [the Dutch holding company]. Executed a Power of Attorney in favour of TIM to allow it to transact business on a limited scale on behalf of [the Dutch holding company]. There is no evidence what this "limited" business included. Later, on December 1996, [the Dutch holding company]. Executed another Power of Attorney in favour of TIM to allow it to arrange for the execution of payment orders in respect of interim dividend payments to be made to [the Dutch holding company's] shareholders.

[25] During the years in appeal, [the Dutch holding company] had no employees in the Netherlands nor does it appear it had any investments other than the shares in Prévost.

The above-cited facts will be revisited below when the fact patterns of the various cases considered here will be tested against article 29(9) of the 2017 OECD Model.

In *X Holding ApS*, a Danish intermediate holding company, wholly owned by a company in Guernsey, which, in turn, was owned by a company in Bermuda, received dividends from its Swiss subsidiary.<sup>45</sup>

Swiss withholding tax of 35% was withheld from the dividends. When the Danish company requested a refund of the Swiss withholding tax pursuant to article 10 of the Denmark-Switzerland Income and Capital Tax Treaty (1973),<sup>46</sup> the Swiss Federal Tax Administration refused the refund, in essence because the Danish company did not conduct any business in Denmark and the only purpose for its interposition was the reduction of Swiss withholding tax. The Federal Supreme Court applied a textual interpretation of article 10, concluding that, pursuant to the text of article 10, it would indeed result in a reduction of the Swiss withholding tax. However, the Court subsequently turned to the question of whether the object and purpose of the treaty would stand in the way of this refund. The Court then looked at the Commentary on Article 1 of the 2003 OECD Model, in particular paragraph 9.4, and, consequently, also with reference to article 31 of the VCLT, denied the Danish company the benefits of the tax treaty.

Interestingly, the Swiss Court, in relying on the Commentary, referred to paragraphs 14 and 21 of the Commentary on Article 1 of the 1995 OECD Model (the look-through approach) and then also referred to the "general bona fide provision" of paragraph 19 of the Commentary. The facts, recited below, do not meet the conditions of the bona fide exception:<sup>47</sup>

.....

45. SE: Federal Tribunal, 28 Nov. 2005, 2003-159, *X Holding ApS v. Eidgenössische Steuerverwaltung*, available at [https://www.bger.ch/ext/eurospider/live/de/php/aza/http/index.php?highlight\\_docid=aza%3A%2F%2F28-11-2005-2A-239-2005&lang=de&type=show\\_document&zoom=YES&](https://www.bger.ch/ext/eurospider/live/de/php/aza/http/index.php?highlight_docid=aza%3A%2F%2F28-11-2005-2A-239-2005&lang=de&type=show_document&zoom=YES&). See for an informal translation of the case: 8 International Tax Law Reports 4, p. 551 (2006).

46. *Convention between the Swiss Confederation and the Kingdom of Denmark for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (23 Nov. 1973), Treaties IBFD.

47. It is remarkable that the Swiss court not only relied on posterior commentary (i.e. the *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* (1 Sept. 1996), Models IBFD and the *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* (28 Jan. 2003), Models IBFD) in respect of the 1973 income tax treaty between Denmark and Switzerland (a tax treaty based on

3.6.4 Die Beschwerdeführerin erfüllt keine der soeben genannten Bedingungen. Wie die Vorinstanz für das Bundesgericht verbindlich festgestellt hat (vgl. Art. 105 Abs. 2 OG), verfügt sie in Dänemark weder über eigene Büroräumlichkeiten noch über eigenes Personal. Dementsprechend verbuchte sie kein Anlagevermögen sowie keinen Miet- oder Personalaufwand. Der als „director“ der Beschwerdeführerin bezeichnete E.\_\_\_\_\_, der den gesamten Konzern offenbar beherrscht und auf den Bermudas ansässig ist, nimmt nach ihrer eigenen Sachdarstellung alle Geschäftsführungsfunktionen wahr und bezieht dafür keine Entschädigung. Damit übt die Beschwerdeführerin in Dänemark selbst keine effektive Geschäftstätigkeit aus; Verwaltung, Leitung der laufenden Geschäfte sowie Unternehmensführung werden dort nicht besorgt. Sie verfügt über einen bloss formellen Sitz in Dänemark. Bezeichnenderweise leitete die Beschwerdeführerin die Dividenden auch umgehend an ihre Muttergesellschaft weiter. Die Vorbringen der Beschwerdeführerin, sie beabsichtige, auch weitere europäische Beteiligungen des Gesamtkonzerns bei sich zu halten, sind unbehelflich. Entscheidend ist, dass sich die Beschwerdeführerin nach dem Gesagten letztlich als Briefkastenfirma erweist und ausser den steuerlichen Überlegungen keine wirtschaftlich beachtlichen Gründe für ihr Auftreten in Dänemark ersichtlich sind. Zu keinem anderen Schluss führt auch der Einwand der Beschwerdeführerin, es sei angesichts ihrer detaillierten Ausführungen im vorinstanzlichen Verfahren unhaltbar, wenn die Rekurskommission behaupte, sie [die Beschwerdeführerin] habe „unbestrittenermassen“ überhaupt keine Einrichtungen und Aktivitäten. Die fraglichen Ausführungen vor der Rekurskommission stehen den obigen Feststellungen nämlich nicht entgegen. Die Beschwerdeführerin hat es versäumt darzutun, welche beachtlichen Tätigkeiten sie in Dänemark selbst entfaltet. Wenn einerseits feststeht, dass der auf den Bermudas wohnhafte E.\_\_\_\_\_ sämtliche Geschäftsführertätigkeiten für die Holdinggesellschaft wahrnimmt und sonst kein anderes Personal vorhanden ist, genügt es nicht, wenn die Beschwerdeführerin in unsubstanziierter Weise nur behauptet, es werde soweit nötig mit auswärtigen Ressourcen gearbeitet und die dänische Firma H.\_\_\_\_\_ (als Revisionsstelle der Beschwerdeführerin) übe dabei in professioneller Weise derartige ausgelagerte Funktionen aus.

The Swiss Court approached the matter from a treaty abuse perspective. The Denmark-Switzerland Income and Capital Tax Treaty (1973) did not contain a beneficial ownership requirement. The Court left the question unanswered as to whether the Danish company could be regarded as the beneficial owner of the Swiss dividends because it effectively denied the benefits of the treaty based on the fact that there was abuse of the treaty. The Court pushed the boundaries of treaty interpretation, not only by relying so heavily on a treaty-posterior commentary, but even by taking “look-through” provisions from a posterior commentary as an example and applying them as if they had been present in the Denmark-Switzerland tax treaty.

Finally, a case decided by the Dutch Supreme Court is briefly summarized below.<sup>48</sup> In this Dutch case,<sup>49</sup> decided in 1994, a Netherlands Antilles limited company (*naamloze vennootschap*, NV) was interposed between its shareholders and a Dutch private company (*besloten vennootschap*, BV). Subsequent to the interposition of the NV, the BV distributed a dividend to the NV, in respect of which it withheld 25% dividend tax. Based on article 11(3) of the Tax Arrangement for the Kingdom,<sup>50</sup> the NV requested the tax inspector to refund the full amount of dividend tax withheld in respect of the dividend. The tax inspec-

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 the *OECD Model* (1963)), in respect of which the contemporaneous commentary does not contain a single word on treaty shopping or improper use of the Convention.

48. It should be noted that this case did not deal with the interpretation of an income tax treaty, but with the interpretation of specific legislation for the avoidance of double taxation between different parts of the Kingdom of the Netherlands (the Tax Arrangement for the Kingdom). However, the operation of this tax arrangement is very similar to that of an income tax treaty.

49. NL: Hoge Raad, 18 May 1994, Case No. 28 296, BNB 1994/253, with a case note by P.J. Wattel.

50. NL: Tax Arrangement for the Kingdom (*Belastingregeling voor het Koninkrijk*), 1964, available at <https://wetten.overheid.nl/BWBR0002464/2010-10-10> (accessed 12 Jan. 2018).

tor denied the NV the refund, arguing that it was merely a “paper company” that had been incorporated with the purpose of accomplishing a reduction in the withholding tax on dividends distributed by Dutch companies and, accordingly, that a legal situation was created almost solely with the purpose of unjustified avoidance of taxation, resulting in the object and purpose of the Dividend Tax Act 1965 and the Tax Arrangement for the Kingdom being ignored. The Court of Appeals reiterated the fact that the sale of the shares in the BV was solely motivated by the desire to avoid taxation and confirmed the decision of the tax inspector. Upon appeal, however, the Supreme Court rescinded the decision of the lower court. The Supreme Court considered the following:

The mere circumstance that the shares in E BV have been contributed and sold, as the case may be, to [D NV] solely for tax reasons, does not lead to the conclusion that there is a dealing in contravention of the object and purpose of the [Tax Arrangement for the Kingdom] and the [Dividend Tax Act].

The circumstances ... that D NV is a company incorporated in a country with a low tax burden, [that D NV] does not perform economic activity ... and [that D NV] is, solely based on incorporation in the country with the low tax burden, by fiction of law, a resident there, form insufficient grounds for a different conclusion.

Thus, the Dutch Supreme Court is very clear that a taxpayer is at liberty to use a structure involving an intermediate company to own shares in a Dutch BV with the sole purpose of avoiding Dutch dividend withholding tax. Therefore, in *Prévost, X Holding ApS* and the Dutch case, there are very similar fact patterns with different results. In *Prévost*, the Canadian GAAR was not invoked and thus not tested, and there was, in addition to the purpose to reduce tax, also a business purpose, i.e. the desire to have a neutral holding location for the joint ownership of shares. In *X Holding ApS*, a textual interpretation of article 10 of the Denmark-Switzerland Income and Capital Tax Treaty (1973) gave way to an interpretation in which the court referred to articles 26, 31 and 32 of the VCLT and relied heavily on the treaty-posterior Commentary on Article 1 of the 1995 OECD Model and on the Commentary on Article 1 of the 2003 OECD Model. In the Dutch case, albeit not dealing with treaty interpretation, the Dutch Supreme Court did recognize that the only reason for the interposition of a company was tax avoidance and also recognized that the interposed entity did not conduct any business activity, but nevertheless decided that the interposed company was entitled to the benefits of the Tax Arrangement for the Kingdom. While the latter case did not deal with a real tax treaty, subsequent case law dealing with tax treaties justifies the conclusion that the Dutch Supreme Court would not easily deny treaty benefits if the text of the treaty provision, applied in its ordinary meaning, would result in those benefits.<sup>51</sup>

If one would apply article 29(9) of the 2017 OECD Model to the cases described above, in each case, the first prong of that provision would easily be met: it would be reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the benefit of application of a provision equivalent to article 10 of the 2017 OECD Model was one of the principal purposes of the interposition of the holding company. The benefit of that provision would then not be granted unless it was “established that granting that benefit [...] would be in accordance with the object and purpose of the relevant provisions of [the] Convention”.

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51. See, inter alia, NL: Hoge Raad, 14 July 2006, Case No. 42 522 BNB 2007/42, with a case note by S. van Weeghel.

As discussed above in section 4, as opposed to the application of article 31(1) of the VCLT, in which the object and purpose of the treaty support textual interpretation, allowing treaty benefits pursuant to article 29(9) of the 2017 OECD Model turns on the object and purpose of the relevant provisions only. In the *X Holding ApS* case and in the Dutch case, any attempt to establish that granting the benefit would be in accordance with the object and purpose of the relevant provisions of the Convention would be bound to fail. There is a question as to what the relevant provisions would be in this context: would they be those equivalent to article 1, article 4, article 10 of the 2017 OECD Model, or all three?<sup>52</sup> Have the object and purpose changed as a result of the inclusion of the preamble, or is it just the preamble one has to consider? It seems that the thrust of the provision is clear: one has to look at the operative treaty provisions and the related Commentaries, the preamble and the Commentaries on Articles 1 and 29, of the tax treaty based on the 2017 OECD Model in determining the object and purpose. At first sight, it appears clear that it is not in accordance with the object and purpose of articles 1, 4 and 10 of the treaty, interpreted in the context of the preamble and the Commentaries on Articles 1 and 29, to grant benefits if a company would have been interposed in order to obtain the benefits of the treaty without any meaningful presence in the state of residence of that company and in the absence of any indication that “equivalent benefits” would have been available directly.<sup>53</sup> With respect to the *Prévost* case, the situation is somewhat more complicated because of the presence of a significant business purpose (i.e. the choice of a neutral jurisdiction for the joint venture entity), and because of the fact that there were income tax treaties between the United Kingdom and Canada and between Sweden and Canada that provided for higher source-state taxation on dividends than was the case in the Canada-Netherlands income tax treaty. However, both treaties were bound to be renegotiated pursuant to which lower source-state dividend tax rates would apply, equivalent to the rate in the Canada-Netherlands income tax treaty (in fact, the negotiations between Canada and Sweden had concluded and resulted in the signing of a new income tax treaty, with the lower rate, in the year to which the litigation pertained). There is also the interesting question of weighing the purposes for the interposition of the Dutch holding company for the purpose of applying the second prong of article 29(9). If there are two principal purposes, i.e. a tax avoidance purpose and a business purpose, the subjective test is met, but the business motive may be strong enough to conclude that it would still be in accordance with the object and purpose of the tax treaty to grant the benefits. That result is not very likely, however, in cases in which the nexus with the state of residence is negligible.

## 6. Object and Purpose: A Common Denominator?

Why would benefits be denied in *X Holding ApS* and the Dutch case? If one reviews the Commentaries on Articles 1 and 29(9), the answer seems clear: the source-state dividend tax was avoided in a way not intended by the contracting states. Of course, there is a textual paradox resulting from two of the three purposes of the 2017 OECD Model. The elimination of double taxation is accomplished through tax avoidance. In fact, the 1963 OECD Model was a “Convention between (State A) and (State B) for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital”. One could argue that it is not easy to

52. See, inter alia, A. Baéz Moreno, *GAARs and Treaties: From the Guiding Principle to the Principal Purpose Test – What Have We Gained from BEPS Action 6?*, 45 *Intertax* 6/7, pp. 437-438 (2017).

53. Even if equivalent benefits would have been available directly, one could argue that this fact could affect the testing of the motive, but not of the object and purpose.

determine which form of tax avoidance is intended by the contracting states to avoid double taxation and which is unintended. Furthermore, certainly prior to the adoption of the minimum standard of Action 6 of the BEPS Project, certain avoidance of taxation may have been intended by one of the contracting states but not by the other contracting state. Determining the intended use of a tax treaty was considerably more difficult than it will be going forward for treaties based on the 2017 OECD Model or modified as a result of the MLI. In 1983, Rosenbloom addressed the difficulty:

Treaty “abuse,” ... is a heavily loaded term. Not only is it derogatory; it implies that the proper use of tax treaties can be identified. Yet differences over precisely that point lie at the heart of the current discussion. Because the term suggests that what is being discussed is a point of common understanding and agreement, when it is clearly not, the usefulness of the term is questionable.<sup>54</sup>

In 1998, a definition of “improper use” was proffered that focused on fundamental and enduring expectations and policy objectives shared by both contracting states:

[Improper use] must have the sole intention to avoid the tax of either or both of the contracting states and must defeat fundamental and enduring expectations and policy objectives shared by both states and therewith the purpose of the treaty in a broad sense. Furthermore, if the contracting states modelled their tax treaty after the OECD Model Convention, the expectations and policy objectives of the states should be consistent with principles adopted by the OECD as evidenced by the Commentary on the OECD Model Convention, to the extent not reserved upon by the contracting states.<sup>55</sup>

There are court cases that suggest that sometimes both the residence country and the source country involved do not merely condone treaty shopping, but in fact stimulate it, and then reverse their position. The bluntness with which this is addressed by the Supreme Court of India in the well-known *Azadi Bachao Andolan* decision, dealing with the interpretation of the 1983 tax treaty between India and Mauritius, is revealing:

There are many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long-term development. Deficit financing, for example, is one; treaty shopping, in our view, is another. Despite the sound and fury of the respondents over the so-called “abuse” of “treaty shopping”, perhaps, it may have been intended at the time when the Indo-Mauritius DTAC was entered into. Whether it should continue, and, if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations. This court cannot judge the legality of treaty shopping merely because one section of thought considers it improper. A holistic view has to be taken to adjudge what is perhaps regarded in contemporary thinking as a necessary evil in a developing economy.<sup>56</sup>

The Court relied on Roy Rohatgi’s *Basic International Taxation*:<sup>57</sup>

Many developed countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to a significant loss of tax revenues. Moreover, several of them allow the use of their treaty network to attract foreign enterprises and offshore activities. Some of them favour treaty shopping for outbound investment to reduce the foreign taxes of their tax residents but dislike their own loss of tax revenues on inbound investment or trade of non-residents. In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology. They are able to grant

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54. H.D. Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15 Law and Policy in International Business 3, p. 766 (1983).  
55. S. van Weeghel, *The Improper Use of Tax Treaties* p. 258 (Kluwer 1998).  
56. IN: Supreme Court, 7 Oct. 2003, Case 8161-8162, *Union of India v. Azadi Bachao Andolan*, available at <https://indiankanoon.org/doc/1960330/>.  
57. R. Rohatgi, *Basic International Taxation* pp. 373-374 (Kluwer Law International 2005).

tax concessions exclusively to foreign investors over and above the domestic tax law provisions. In this respect, it does not differ much from other similar tax incentives given by them, such as tax holidays, grants, etc. [...]

Developing countries need foreign investments, and the treaty shopping opportunities can be an additional factor to attract them. The use of Cyprus as a treaty haven has helped capital inflows into eastern Europe. Madeira (Portugal) is attractive for investments into the European Union. Singapore is developing itself as a base for investments in South East Asia and China. Mauritius today provides a suitable treaty conduit for South Asia and South Africa. In recent years, India has been the beneficiary of significant foreign funds through the “Mauritius conduit”. Although the Indian economic reforms since 1991 permitted such capital transfers, the amount would have been much lower without the India-Mauritius tax treaty (Roy Rohatgi, *Basic International Taxation*, pages 373-374 (Kluwer Law International)).<sup>58</sup>

In the recent Canadian *Alta Energy* case, dealing with a treaty shopping structure through Luxembourg in which the Court acknowledged the existence of the Commentary on the OECD Model but did not refer to the Commentary on Article 1, considerations were devoted to the object and purpose of the relevant provisions of the Canada-Luxembourg Income and Capital Tax Treaty (1999).<sup>59</sup> However, these considerations were surprisingly narrow and raised the question of clarity of the object and purpose.<sup>60</sup> The Court considered the Canadian GAAR as follows:

[71] The first step involves identifying the object, spirit and purpose of the relevant rule. Statutory interpretation under GAAR differs from traditional word-based interpretation. Whereas, under the modern rule of statutory interpretation, the analysis seeks to determine what the meaning of a provision is, under the GAAR, statutory interpretation is used to determine the object, spirit or purpose of the provision. The object, spirit or purpose is the rationale underlying the provision. Transactions may be found abusive of a provision’s underlying rationale, even though they comply with the literal, contextual and purposive meaning of the words of the statute.

[77] A tax treaty is a multi-purpose legal instrument. The preamble of the Treaty states that the two governments desired “to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital.” While indicative of the general purpose of the Treaty, this statement remains vague regarding the application of specific articles of the Treaty. Under the GAAR analysis, the Court must identify the rationale underlying Article 1, 4 and 13, not a vague policy supporting a general approach to the interpretation of the Treaty as a whole.

Regarding treaty shopping, the Court considered the following:

[91] There is nothing in the Treaty that suggests that a single purpose holding corporation, resident in Luxembourg, cannot avail itself of the benefits of the Treaty. There is also nothing in the Treaty that suggests that a holding corporation, resident in Luxembourg, should be denied the benefit of the Treaty because its shareholders are not themselves residents of Luxembourg.

[100] The Minister argues that the Restructuration constitutes an abuse of Articles 1, 4 and 13, because, absent the Restructuration, the gain would have been taxable in Canada. I do not find this result contrary to the rationale underlying Articles 1, 4 and 13. The rationale underlying the carve-out is to exempt residents of Luxembourg from Canadian taxation where there is an investment in immovable property used in a business.

58. *Azadi Bachao Andolan* (2003).

59. *Convention between the Government of Canada and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* (10 Sept. 1999) (as amended through 2012), Treaties IBFD.

60. See also *supra* n. 31.

While the overriding object and purpose of tax treaties following the OECD Model are clear, when these are narrowed down to the three aspects expressed in the preamble and the Commentaries on Articles 1 and 29 of the 2017 OECD Model, one of the problems that arises is that the OECD Model and its Commentary are drafted as if the object and purpose would be identical for each country that would use it as a model for its tax treaties, while in reality that is not the case. It is not the case with respect to reciprocity and sometimes even not with respect to the assumption that an item of income is subject to the normal taxation regime of the residence country. While the BEPS Project is generally perceived as an effort to reign in tax planning by multinational companies and investors, the members of the OECD and the Inclusive Framework do, in fact, compete with each other, also through their tax systems, including tax treaties.<sup>61</sup> Often, one country's tax incentive is another country's tax loss.<sup>62</sup>

Against the overriding object and purpose of tax treaties (stimulating economic relations between countries), a relevant question could be whether an investment in the source country would have taken place in the absence of treaty shopping. For example, in the simple treaty shopping example provided above, would testing against the object and purpose be different if the ultimate investor would have invested directly but routed the investment via a treaty country to obtain benefits than if the investor would have refrained from investing altogether if no treaty benefits would have been available? Further, if a country is generally willing to serve as a residence country in treaty shopping arrangements, is it justified to invoke the object and purpose of the relevant provisions of the treaty if its interests as a source state are at stake?<sup>63</sup> What if the official tax treaty policy of the country of the ultimate investor and the source country is to limit source taxation on dividends to 5%, but they have not yet revised their bilateral tax treaty to that effect?<sup>64</sup>

Long before the BEPS programme emerged, an important assumption of all income tax treaties was that double taxation should be avoided but that an item of income should be taxed comprehensively, or at least be subject to the normal tax regime of a state. If that assumption would be viewed comprehensively, regardless of the bilateral treaty relationship and the reciprocity implied in that relationship, one could say that each time an income tax treaty was instrumental in (i) the avoidance of double taxation; and (ii) the imposition of single taxation, the object and purpose of the tax treaty would be achieved. Therefore, if TCo, resident in State T, would structure its ownership of shares in SCO, resident in State S, via RCO, resident in State R, in order to reduce the State S withholding tax that would otherwise, when levied, not be creditable against the State T tax, juridical or economic double taxation would be avoided and the dividend income would be subject to State T tax, or would at least be subject to the State T tax regime, and possibly exempt if a participation

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61. Even after the entry into force of the MLI, that may effectively be the case for tax treaties if its signatories would, in practice, apply different standards of the application of art. 29(9). Within the European Union, one standard will emerge after the ECJ has had its say about the general anti-avoidance rule in various directives. It may even be that for the European Union, also in respect of third countries, the standard will be lower than was intended by the OECD following the *Action 6 Final Report*.

62. S. van Weeghel & F. Emmerink, *Global Development and Trends in International Anti-Avoidance*, 67 Bull. Intl. Taxn. 8, p. 428 et seq. (2013), Journals IBFD.

63. This example is probably moot in respect of covered agreements following the entry into force of the MLI.

64. This seems to have been the case in the *Prévost* case (2009), in which, at some point around and after the time at which the relevant dividend distributions took place, the tax treaties between Canada and Sweden and Canada and the United Kingdom, respectively, were amended, and the source-country rates on dividends in art. 10(2)(a) were reduced to the rate provided for in the Canada-Netherlands tax treaty.

exemption was applicable. Viewed from the overarching principles expressed in the first paragraph of the Introduction to the OECD Model, in a broader perspective, one could argue that the result is acceptable. However, the lack of reciprocity stands in the way of that conclusion, at least if the conclusions of paragraph 7 of the Conduit Companies Report are valid today, i.e. that treaty shopping is unsatisfactory because, inter alia, the principle of reciprocity is breached and the balance of sacrifices incurred in tax treaties by the contracting parties is altered. Further, as also stated in the Report, the state of residence of the ultimate income beneficiary has little incentive to enter into a treaty with the state of source.<sup>65</sup>

Even though the object and purpose may have lacked a common denominator for treaties not based on the 2017 OECD Model and prior to modification as a result of the MLI, it seems that a common denominator following from the PPT does emerge and that it is the clear intention that countries that have embraced the minimum standard of BEPS Action 6 are guided by the Commentary on Article 29(9) of the 2017 OECD Model and the examples therein.<sup>66</sup> Nevertheless, as will be discussed in section 9., the application of the second prong of the PPT may still be difficult and also troublesome from a more holistic policy perspective.

## 7. Commentary on Article 29(9): Some Coherence Questions

Before the focus is placed on some coherence issues, preliminary attention on the scope of application of article 29(9) of the 2017 OECD Model is appropriate. Paragraphs 172 and 173 of the Commentary on Article 29(9) of the 2017 OECD Model provide as follows:

172. Conversely, the fact that a person is entitled to benefits under paragraphs 1 to 7 does not mean that these benefits cannot be denied under paragraph 9. *Paragraphs 1 to 7 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.*

173. Paragraph 9 must be read in the context of paragraphs 1 to 7 and of the rest of the Convention, including its preamble. This is particularly important for the purposes of determining the object and purpose of the relevant provisions of the Convention. Assume, for instance, that a public company whose shares are regularly traded on a recognised 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” as defined in paragraph 2, it is clear that the benefits of the Convention *should not be denied solely on the basis of the ownership structure of*

65. See *supra* n. 11, para. 7 Conduit Companies Report.

66. The members of the Inclusive Framework have effectively given up the possibility to use a tax treaty with one or more particular countries to attract investments from third countries. If they wish to reduce tax for inbound investment, they will have to do so by amendment of their domestic law or entering into a larger number of tax treaties than would otherwise have been the case. One could say that, in this respect, the minimum standard of BEPS Action 6 has reduced their policy options. While many countries may find that a small sacrifice, some may have been less pleased with the “superimposed” standard. In this context, it is interesting to note the observations in US: Federal Income Tax Project, *International Aspects of United States Income Taxation II, Proposals of the American Law Institute on United States Income Tax Treaties*, pp. 162-163 (1992) [hereinafter ALI Project], in particular the following:

In effect, the analysis leading to a proper framing of a treaty-shopping provision would seek to identify the point at which the detrimental effects of treaty-shopping on a country’s source jurisdiction and its ability to negotiate reciprocal source-taxation concessions offset the advantages of a treaty that does not unduly burden normal commerce.

However, this balance is struck, treaty-shopping rules should be framed in appreciation of the basic purpose of income tax treaties to facilitate international trade and investment.

*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 c) of paragraph 2 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 9 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 9 would apply to deny that benefit because subparagraph c) of paragraph 2, 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 authorising treaty-shopping transactions entered into by public companies. [Emphasis added]

It is implied in this part of the Commentary that improper use of the convention, as addressed in article 29, effectively has two parts. One part relates, in the words of the cited Commentary, to the legal nature, ownership and general activities of the residents of a contracting state. This part effectively addresses the reality of the connection of the taxpayer with the state of its residence for the purposes of the tax treaty. One could see this part as a backstop against improper use of the convention when article 4 fails to secure a sufficiently relevant connection with the state of residence to justify the granting of treaty benefits.<sup>67</sup> This connection is often referred to as the “nexus” with the state of residence.<sup>68</sup> A sufficient nexus can be tested by looking at the shareholders “behind” the resident, but also by looking at its activities, e.g. whether it conducts trade or business in the state of residence and whether there is a sufficiently strong connection between that trade or business and the income in respect of which treaty benefits are claimed. However, a sufficient nexus of the taxpayer with its state of residence is not enough for it to be entitled to tax treaty benefits. If that resident would enter into an arrangement or transaction that would effectively result in the availability of tax treaty benefits to persons for whom those benefits were not intended – including the taxpayer itself in the case of “rule shopping” – treaty benefits should, nevertheless, not be available. This latter part of article 29 can be referred to as the “abusive transactions” part or test. It is clear that the LOB test of article 29(1)-(8) relates mostly to the nexus and that article 29(9) covers both the nexus and the abusive transactions test, but if a tax treaty contains an LOB clause, the nexus part of the PPT is effectively covered by the LOB clause and the PPT’s range of operation is limited to the abusive transactions part. To be clear: if a resident passes the LOB test, a treaty benefit can still be denied if the arrangement or transaction it entered into had obtaining that benefit as one of the principal purposes and it could not be established that granting that benefit would be in accordance with the object and purpose of the relevant provisions of the convention.

One would expect that the preamble, article 29(1)-(8), article 29(9), the Commentary on Article 1 relating to improper use of the Convention and the entire Commentary on Article 29 of the 2017 OECD Model would be fully consistent and supportive of a coher-

67. Cf. ALI Project, at p. 150:  
 Although for technical reasons a limitation of benefits provision is not drafted as a modification of the basic definition of “resident”, [...] it may be thought of as an attempt to refine the residence concept, disqualifying those legal entities which, although in principle subject to the residence country’s tax jurisdiction, are positioned so that their income is not in fact sufficiently subject to taxation in that country to warrant the extension to them of treaty reductions of source-based taxation.

68. The ALI Project, at p. 154, distinguishes, in respect of a US-style limitation-on-benefits (LOB) clause, between (i) a test based on ownership; (ii) a “publicly traded” test; and (iii) a business nexus test. In this article, the notion of nexus will be used for any of these three aspects.

ent approach to the object and purpose of the treaty or the relevant provisions thereof, as the case may be. It is therefore somewhat confusing to read, in paragraph 171 of the Commentary on Article 29, that “the guidance provided in the Commentary on paragraph 9 should not be used to interpret paragraphs 1 to 8 and vice versa”, but on the other hand, in paragraph 173, that “paragraph 9 must be read in the context of paragraphs 1 to 7 and the rest of the Convention, including its preamble”. This is confusing, because paragraphs 1-8, on the one hand, and paragraph 9, on the other hand all address the theme of improper use of the Convention and, to an extent, contain overlapping notions. It seems inevitable that the guidance provided in the Commentary on Article 29(9) has an influence on the interpretation of the other paragraphs and vice versa.

Whether the guidance on paragraphs 1-8, on the one hand, and paragraph 9, on the other hand should be used in the interpretation of any part of article 29 of the 2017 OECD Model depends, in the first place, on the text of the relevant article 29 that is interpreted. In other words, it depends on which variation is present in the bilateral tax treaty that is applied: (i) the simple LOB provision and the PPT; (ii) the detailed LOB provision and the PPT; or perhaps (iii) the detailed LOB provision supplemented with an anti-conduit provision but without the PPT. Of course, the guidance on paragraphs 1-8 and 9 could not be accorded the same value in the absence of paragraphs 1-8 or 9, as the case may be, as would be the case in the presence of the relevant provision. Therefore, what exactly is the relationship between the two sets of guidance? Broadly, the improper use addressed by article 29 pertains to ownership and/or base erosion (the nexus part) and to abusive transactions, including rule shopping, e.g. a dividend-stripping transaction entered into by a qualified person. If a tax treaty contains a PPT only, that test covers both forms of improper use, i.e. the nexus part and the abusive transactions part, but if a tax treaty contains a “full” article 29, regardless of whether the LOB provisions are simplified or detailed, the LOB test covers ownership/nexus and the PPT covers abusive transactions. As suggested in paragraph 173 of the Commentary on Article 29(9), if a treaty resident is a “qualified person” as defined in paragraph 2, the purpose, i.e. a tax avoidance motive for establishing the company, can no longer be used to deny treaty benefits based on article 29(9), but of course, any transactions entered into by it can be tested with the PPT.<sup>69</sup>

A coherent approach to the interpretation of article 29 of the 2017 OECD Model implies – certainly in cases in which it includes an LOB provision and principal purposes provision – that the whole Commentary on Article 29 of the 2017 OECD Model is used, where relevant, in the interpretation of any paragraph of the article. In any event, regardless of the weight one would give to the Commentary, the LOB provision itself would be part of the relevant context for the interpretation of the PPT and vice versa.

As article 29 of the OECD Model is, to a significant extent, inspired by US tax treaty policy, it is useful to look at the technical explanation of article 22 of the US Model Income Tax Convention (2006).<sup>70</sup> This explanation, in its relevant part, provides as follows:

Article 22 contains anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two

69. See Kuźniacki, *supra* n. 2, at p. 245, who seems to suggest that the PPT can even override the LOB clause in respect of a nexus in the case that the conditions of an existing LOB test in a tax treaty would have been met. That conclusion is clearly at odds with the *OECD Model: Commentary* (2017) and with a reasonable interpretation of the tax treaty.

70. *United States Model Income Tax Convention* (15 Nov. 2006), Models IBFD.

countries. In general, the provision does not rely on a determination of purpose or intention but instead sets forth a series of objective tests. A resident of a Contracting State that satisfies one of the tests will receive benefits regardless of its motivations in choosing its particular business structure.

The rationale of article 22, i.e. an LOB test, is clear: providing for a practical and self-executing mechanism to eliminate the subjective determination as to the principal purpose in relation to ownership and the nexus. The United States addresses abusive transactions through domestic anti-abuse provisions. The technical explanation of the Switzerland-United States Income Tax Treaty (1996)<sup>71</sup> is revealing:

Of course, the fundamental problem presented by this approach [determining the purpose of the ownership structure] is that it requires the tax administration to make a subjective determination of the taxpayer’s intent. In order to avoid the administrative burdens of such an approach, Article 22 sets forth a series of mechanical tests. The assumption underlying each of these tests is that a taxpayer that satisfies the requirements of any of the tests probably has a real business purpose for the structure it has adopted, or has a sufficiently strong nexus to the other Contracting State (e.g., a resident individual) to warrant benefits even in the absence of a business connection, and that *this business purpose or connection outweighs any purpose to obtain the benefits of the Convention*. [Emphasis added]

The “abusive transactions” part of improper use is not addressed in article 22:

Article 22 and the anti-abuse provisions of domestic law complement each other, as Article 22 effectively determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (e.g., business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. If the entity is determined to be the beneficial owner of the income after application of these internal law principles, Article 22 then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.

Returning to Article 29 of the 2017 OECD Model, one can note an intriguing apparent inconsistency between the discretionary relief provision of paragraph 5 and the PPT of paragraph 9.<sup>72</sup> The mechanism of paragraph 9 seems to be clear: even if it is reasonable to conclude that obtaining a treaty benefit was one of the principal purposes of an arrangement or transaction, treaty benefits will be granted if it is established that granting that benefit would be “in accordance with the object and purpose of the relevant provisions of the Convention”. However, in the discretionary relief provision of the LOB test, if none of the tests that are a substitute for determining the intent are met, even if granting a benefit would be in accordance with the object and purpose of the Convention, treaty benefits will nevertheless be denied if the treaty resident cannot “demonstrate that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under this Convention” – at least that is what the text of article 29(5) of the 2017 OECD Model seems to suggest, even though that text does refer to the “object and purpose of this Convention”.<sup>73</sup> The difference is possibly a casualty caused by the fact that the PPT seems to have its origin in UK<sup>74</sup> law and tax treaties, and the LOB

71. *Convention between the United States of America and Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income* (2 Oct. 1996), Treaties IBFD.  
 72. See, however, Piantavigna, *supra* n. 2, at p. 212.  
 73. As evidenced by para. 108 *Commentary on Article 29(5) of the OECD Model* (2017), art. 29(5) grants broad discretion to the competent authority. See also US: District Court for the District of Columbia, 2 Feb. 2016, Case No. 14-cv-01593 (CRC), *Starr International Company, Inc. v. United States of America*.  
 74. See, inter alia, De Broe, *supra* n. 33, at para. 511.

clause is clearly derived from US tax treaty practice.<sup>75</sup> It is conceivable that reconciliation of the two concepts in all respects was given less than full attention in the process that led to their adoption in the 2017 OECD Model.

It seems that, in the discretionary relief provision and also in the technical explanation of article 22 of the US Model Income Tax Convention (2006), overriding importance is given to the subjective test. Whether or not one sees a subjective test as a proxy for the objective test, in the pursuit of interpreting a tax treaty and its relevant provisions in light of the object and purpose, the subjective test ought to be merely an agent to achieve that goal and not take precedence. Accordingly, the test in the discretionary relief provision ought to be whether, if benefits would be denied based on the LOB clause, granting treaty benefits would nevertheless be in accordance with the object and purpose of the relevant provisions of the Convention.<sup>76</sup>

## 8. The Examples: Guidance in Search of a Principle?

This section will examine the examples provided in the Commentary on Article 29(9) of the 2017 OECD Model. It does so against the background of the observations regarding the nexus in the previous sections., but will also address the consistency with other articles of the OECD Model and their interpretation in light of the Commentary. The examples that serve to clarify the application of article 29(9) either address the principal purpose prong of the PPT or the object-and-purpose prong, or both.<sup>77</sup> The distinction is not always clear. Some address the nexus, while some address abusive transactions. In respect of some of the examples, one may wonder whether it is indeed implied that the relevant conditions of the operative provisions of the treaty have been complied with, e.g. the example in paragraph 176 of the Commentary on Article 29(9) of the 2017 OECD Model and Example L in paragraph 182, for which – certainly against the background of the Commentary on Article 11 of the OECD Model – one could wonder whether the company called RCO would be the beneficial owner of the income.<sup>78</sup> Example I makes the reader wonder why it was included at all. There is no abuse, and the application of the treaty in respect of the performers and copyright holders is straightforward.

The first example, in paragraph 176, serves to clarify that a set of transactions may, in part, be driven by valid commercial reasons, but for another part by a principal purpose of obtaining a treaty benefit. The example deals with the assignment of a receivable in exchange for a receivable in what then seems to be a classic back-to-back conduit structure, in which the intermediary is left with an interest spread of 10 basis points. Assuming that article 29(9) of the 2017 OECD Model only comes into play if treaty benefits would other-

75. See, inter alia, *Action 6 Final Report*, at p. 11.

76. Cf., in relation to EU law, A. Martín Jiménez, *Towards a Homogeneous Theory of Abuse in EU (Direct) Tax Law*, 66 Bull. Intl. Taxn. 4/5, p. 291 (2012), Journals IBFD.

77. See, for a comprehensive discussion of the examples that purport to explain the PPT in the *Action 6 Final Report*, V. Chand, *The Principal Purpose Test in the Multilateral Convention: An In-Depth Analysis*, 46 Intertax 1, p. 27 et seq. (2018).

78. See also the examples in para. 187 of the *OECD Model: Commentary on Article 29* (2017). These purport to cover conduit arrangements in the absence of a PPT. As observed by Danon, *supra* n. 4, at p. 49, these examples seem to have been inspired by the exchange of letters to the conduit arrangement clause of art. 3(1)(n) of the *Convention between the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains* (24 July 2001), Treaties IBFD.

wise be available, i.e. the intermediary would have to be respected as the beneficial owner of the interest income, the question arises as to how this example aligns with the Commentary on Article 11 of the 2017 OECD Model and with the requirement that a detailed LOB clause without a PPT must be supplemented with an anti-conduit rule. One could say that either (i) this example suffers from a lack of coordination with the Commentary on Article 11; or (ii) as suggested by Danon, the reach of the beneficial ownership condition, following various incarnations of the Commentary, is now essentially limited to agents and nominees only.<sup>79</sup> That leaves its relationship with an anti-conduit rule unexplained. The other remarkable element of the example is that it focuses on the principal purpose only, disregarding the possibility that for the intra-group transferee, the receivable would be attributable to “the active conduct of a business” and thus provide for a relevant nexus.

Example A and Example B do not question the nexus of the taxpayer with the state of residence, but rather address abusive transactions. Example A seems directly derived from the so-called Royal Dutch case.<sup>80</sup> This example also carries with it slight tension with the Commentary relating to beneficial ownership, in particular paragraph 12.4, last sentence of the Commentary on Article 10 of the 2017 OECD Model, according to which “Article 10 refers to the beneficial owner of a dividend as opposed to the owner of the shares, which may be different in some cases”. Is the inference that the transfer of the right to receipt of dividends is not problematic if the transferer of the right is entitled to equivalent treaty benefits as the transferee of the right?<sup>81</sup> The example is somewhat simplistic because, by its character, it relates to portfolio dividends (for a further reduction of dividend tax, continued ownership of shares is required), and dividend stripping would rarely show itself in this obvious fashion. Rather, in trades in international financial markets, the principal purpose to avoid dividend tax can generally be inferred only from the pricing of derivatives, such as equity swaps and stock options.

Example B bears resemblance to the *Bank of Scotland* case.<sup>82</sup> Again, the example relates to abusive transactions rather than to the nexus.

Example C – and, to an extent, also Example D – are confusing. The pursuit of treaty benefits by interposing an entity in a treaty country or perhaps by moving the residence of a company to a treaty country is what caused the concern that treaty benefits would be granted in a way not intended by the contracting states. However, Example C is not about the interposition of a company or the transfer of residence; it is about the decision to invest in the source state (State S in the example). It seems that the State R-State S tax convention in that example, regardless of the principal purpose, does exactly what a tax treaty is meant to do, i.e. remove barriers to investment by genuine residents of State R in State S. Treaty shopping concerns are not in sight; the example is awkward.

To a certain extent, the same is true for Example D. In that example, the tax treaty between State R and State S is relevant for RCO’s decision to invest in shares in companies resident in State S. Again, this would only give rise to treaty shopping concerns if RCO would have

79. See Danon, *supra* n. 4, at pp. 36 and 55.

80. NL: Hoge Raad, 6 Apr. 1994, Case No. 28 638, BNB 1994/217, with a case note by F.W.G.M van Brunshot.

81. See also Baéz Moreno, *supra* n. 52, at pp. 438-439, who raises the issue of arbitrariness of the operation of certain rules, in particular the difference between arts. 10 and 13, and the resulting problems for a purposive interpretation.

82. FR: Administrative Court of Appeal Paris, 23 May 2005, No. 51, 2005, 2019, *Ministre de l’Economie, des Finances et de l’Industrie v. Société Bank of Scotland*.

an insufficiently strong nexus with State R. That does not seem to be the case (a majority of investors in RCO are residents of State R), but the example mentions a number of investors that are residents of third states, and thus the example becomes very fuzzy – is this an example that deals with treaty shopping by residents of third states, for which the nexus question becomes relevant, or is it, as is the case with example C, an example that lacks relevance? This example shows a certain resemblance with Example K, discussed further in this section.

Example E deals with a phenomenon that is sometimes referred to as “rule shopping”.<sup>83</sup> A shareholder that has a relevant nexus to the residence state increases interest to 25% of the shares of SCO in order to benefit from the further reduction of the source-state tax pursuant to article 10(2)(a) of a newly concluded tax treaty. Interestingly, the Commentary relating to Example E, referring to the arbitrariness of the 25% threshold, states that it is consistent with this arbitrary threshold to grant benefits to a taxpayer that genuinely increases its participation in the company in order to satisfy the percentage threshold. Paragraph 17 of the Commentary on Article 10 of the 1977 OECD Model provides the very same example, but concludes that the reduced rate should not be available if the holding was increased shortly before the dividends became payable, primarily for the purpose of securing the reduced rate. The key is probably in the word “genuinely” as used in the example (a taxpayer who genuinely increases its participation). In other words, a taxpayer who increases the interest to 25% just prior to the payment of a dividend and then reduces the interest right after the payment of the dividend, whether pursuant to a forward agreement or not, would not be entitled to the reduced rate, but the taxpayer who does so “genuinely” would be entitled to the benefits. In the text of article 10(2)(a) of the 2017 OECD Model, the genuine nature of the ownership is now built in through the 365-day holding period requirement. The example refers to the 2017 OECD Model, but presumably, Example E must be construed in such a manner that for tax treaties that contain article 29(9), either in the treaties themselves or by virtue of the MLI, the same result occurs in the absence of a holding period requirement.<sup>84</sup> However, there can still be a consistency question. For example, what if a “super-dividend” is expected and, just before the distribution, the participation is increased (and not thereafter decreased)? How is a super-dividend different from the repurchase of shares or even a partial sale of shares, in which cases article 13 may prevent the source state from levying tax altogether? How does this example compare with the example in the Commentary on Article 1 of the 2017 OECD Model, paragraph 56, dealing with a change of residence of a taxpayer just before the alienation of shares, and with the similar example in the Commentary on Article 29(9), paragraph 180? In each case, while the taxpayer’s actions are motivated by a principal purpose to obtain treaty benefits, one could argue that the object and purpose of the treaty provisions are not violated because the taxpayer “in substance” meets the conditions of the tax treaty provisions, very much like the individual who buys bonds in respect of which the interest is exempt in order to encourage saving in the example provided above in section 7. The issue, of course, is that in both examples, the income has accrued prior to the realization thereof. Is it in accordance with the object and purpose of article 10(2)(a) to grant treaty benefits in the case that a taxpayer increases participation,

83. See Baéz Moreno, *supra* n. 52, at pp. 438-439.

84. See Arnold, *supra* n. 15, at p. 249 et seq. Subsequent to the introduction of the holding period requirement, the question arises as to the “genuineness” in the case that the holding period is met but the participation decreases immediately after the dividend distribution. This is particularly relevant in the case of a “super-dividend”.

but not in accordance with the object and purpose of article 13(5) if a taxpayer (genuinely) changed residence prior to the alienation of the shares? These are borderline cases in which the question seems to be whether a treaty benefit should effectively be granted in accordance with the status of the taxpayer during the accrual of the income or gain (which is an issue known as “compartmentalization” for tax treaty purposes) or whether the treaty should be applied in accordance with the clear wording of the relevant provisions.<sup>85</sup> One could rightfully argue that (i) the treaty provision should be applied in accordance with the clear wording in cases in which an increase of ownership or change of residence is not merely temporary; and (ii) countries that wish to preserve taxation rights relating to periods with a relevant nexus to their territories should do so through exit taxes or should otherwise introduce explicit domestic law and/or tax treaty rules that would not only preserve the taxing right, but also prevent double taxation.

Also, Example F, dealing with an acquisition of a family-owned holding company, is somewhat fuzzy. If the acquired company is a family-owned holding company of which the shares are mostly owned by residents of the same state, the implication is that the holding company is part of a business that is conducted in that state. One would expect, if such a company is then acquired by residents of a third country, that the business presence in the country of residence of the acquired company would provide for a sufficient nexus in order for it to benefit from that country’s tax treaties. In other words, the nexus outweighs the motive. However, the example and its conclusion that treaty benefits would be available seems to turn on the business purpose of the transaction rather than the presence of a sufficient nexus.<sup>86</sup>

Example G deals with a regional group services company providing management services (such as accounting, legal advice and human resources), financing and treasury services (such as managing currency risk and arranging hedging transactions) and the like. Underlining that the regional company would conduct a real business, exercising substantive economic functions, using and assuming real risks and the like, the example concludes that it would not be reasonable to deny the benefits of the treaties concluded by the residence state of that regional company and other states where the subsidiaries operate. However, it leaves open the question of whether that conclusion is based on the absence of a principal purpose to obtain the treaty benefits or whether that purpose exists but granting benefits would be in accordance with the object and purpose of the relevant treaties.<sup>87</sup> The example shows a remarkable similarity with the carve-out from the “active conduct of a business” in article 29(3)(a)(i)-(iv) of the 2017 OECD Model. This is one of the inconsistencies in article 29 that is difficult to understand.

Although Example H, like Example G, provides real guidance, the reasoning is not quite clear. One would expect that with an active business conducted in State R and, apparently, a functional connection between that business and its assets, the relevance of the principal purposes for its establishment would give way to its nexus in the country of residence, i.e. it

85. See D. Smit, *Timing Issues under Double Tax Treaties: The Dutch Approach*, 44 *Intertax* 1, p. 29 et seq. (2016).

86. Cf. the ALI Project, at p. 179: “[I]f third-country ownership of the legal entity involved arose from an acquisition and there have been no fundamental changes in the structure of its business, in most cases treaty benefits should not be denied.”

87. See also the criticism by De Broe, *supra* n. 33, at p. 100.

would be in accordance with the object and purpose of the relevant tax treaty to grant the benefits of the treaty.

Example I seems to be out of place. The example merely states the obvious: an agent that acts on behalf of the beneficial owners can, of course, be authorized to process the royalty withholding tax for the beneficial owners based on the applicable treaties between the source state of the royalties and the residence states of each right holder. It is difficult to see how article 29(9) of the 2017 OECD Model would be relevant in this context, assuming that each right holder would be a genuine resident of the relevant treaty country and would not have entered into abusive transactions.

Example J deals with rule shopping in a case in which the nexus of the taxpayer with the state of residence is not questioned, but the transactions executed clearly go against the object and purpose of the treaty and are tax-motivated.

Example K deals with an investment fund and, in that respect, is somewhat comparable with Example D. It is an important example because it deals with a relevant nexus to the residence state in the case of investments. As will be suggested below, the business nexus provisions of article 29 of the 2017 OECD Model and the principles of the authorized OECD approach (AOA) could serve as useful agents in the determination of a relevant nexus, but neither of these two concepts apply directly and easily to investment funds. The example underlines that the establishment by the “Fund” in State T of a regional investment platform in State R was mainly driven by the availability of a knowledgeable and skilled workforce, but also by the extensive tax convention network of that state. The example concludes that treaty benefits should be available to the regional investment subsidiary, referring to, *inter alia*, the intent of tax treaties “to provide benefits to encourage cross-border investment”. Although the example is not explicit in this respect, it seems to stand for the proposition that an investment fund in which none of the investors are resident in the state of residence of the fund can nevertheless be entitled to the benefits of tax treaties concluded by the fund’s state of residence, provided that its workforce has business knowledge, is skilled, reviews the investment management recommendations made by the fund and the like. That activity is then the relevant nexus that outweighs the purpose of benefitting from tax treaties. Perhaps one could see this as a variation of the business nexus approach, although, as remarked above, the curiosity remains that, in the context of article 29(3), making or managing investments do not seem to qualify. In addition, in reality, investment management is often not performed by a fund or collective investment vehicle (CIV), but rather by a fund manager through a service arrangement. In a broader context, the approach of the example and the conclusion seem justifiable because investment funds have significant potential to generate an additional layer of tax between the investee company (of which the profit is taxed in the country of its residence) and the investor (taxed in the country of its residence). If the investment fund is recognized as a separate entity but not entitled to treaty benefits, withholding taxes levied by the investee state would not be reduced by any tax treaty, would generally not be creditable in the ultimate investor state and accordingly would cause economic double taxation arguably not in accordance with the object and purpose of relevant tax treaties. Especially in the case of CIVs, the relative importance of the object and purpose of tax treaties to avoid double taxation and the reciprocity element of the nexus inquiry compete with each other.

Example L, dealing with securitization, is a somewhat awkward example. It is intriguing in a number of respects. Firstly, as in respect of the example in paragraph 176 of the Commentary of the 2017 OECD Model, one could raise the question as to whether the company in the example could be considered the beneficial owner of the loans and other receivables and the interest received by it. The example reiterates that RCO is fully debt-funded and that its single share has no economic value. It also states that RCO is taxed in State R on income earned and is entitled to a full deduction for interest payments made to investors. In a typical securitization structure, even though the securitization company is the legal owner of the loan portfolio, it has no economic interest whatsoever. The vehicle is under a contractual obligation to pass on the income to the investors. In this respect, the statement that RCO is taxed in State R on income earned and is entitled to a full deduction for interest payments made to investors is meaningless to the extent that it purports to demonstrate that RCO's own ownership interest is meaningful. It is not. Compare this with paragraphs 10.1 and 10.2 of the Commentary on Article 11 of the 2017 OECD Model:

For these reasons, the report from the Committee on Fiscal Affairs entitled "double taxation conventions and the use of conduit companies" concludes that a conduit company can not normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

10.2 In these various examples (agent, nominee, conduit company acting as fiduciary or administrator), the direct recipient of the interest is not the "beneficial owner" because that recipient's right to use and enjoy the interest is constrained by a contractual or legal obligation to pass on the payment received to another person.

It seems that a securitization company would be the prototype of a conduit company.<sup>88</sup> Although it is the direct recipient of the interest, its right to use and enjoy the interest is

88. Cf. the reaction of HM Revenue and Customs to the *Indofoods* decision (UK, Court of Appeal, 2 Mar. 2006, EWCA Civ 158, *Indofood International Finance Ltd. v. JP Morgan Chase Bank, London Branch*), available at <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm332060>, cited here in its relevant part:

Capital market transactions involving Special Purpose Vehicles (SPVs)

1. Many capital market transactions involve SPVs which may not satisfy the test of beneficial ownership under an "international fiscal meaning". Securitisation programmes, for example, in respect of mortgage backed loans and other debt receivables are commonplace ways of raising finance. Typically such programmes involve a SPV which issues bonds to third party investors and employs the proceeds from the bonds to purchase the receivables or debt secured on the receivables (see below where these are quoted Eurobonds). The SPV is typically required to pass on the income received from the underlying assets to the bondholders (subject to hedging arrangements and less a small spread to cover fees etc). Where the SPV is resident outside the UK, an application will have to be made by the non-resident to enable the interest that is backed by the receivables to be paid gross to the SPV. The SPV in such an arrangement may not be the beneficial owner of the income under the international fiscal meaning; it often has very narrow powers over the income and its obligations to the bondholder mean that it is unlikely to "enjoy the full privilege to directly benefit from the income".
2. However, as indicated above in applying the beneficial ownership concept in the context of Double Taxation Conventions (DTCs), regard should be had to the objective of the DTC. Where there is no abuse of the DTC, there is no need, in practice, to apply the "international fiscal meaning" of beneficial ownership. The object of the treaty is likely to be met just as easily using the UK domestic law meaning of beneficial ownership.
3. HMRC will also accept that there is no need to invoke the "international fiscal meaning" of beneficial ownership to deny treaty benefits where the lender receiving income directly from the SPV (the "true" beneficial owner of the interest) would, if they had been the direct recipient of the interest, have been entitled to treaty benefits as a resident of a state with which the UK has a DTC with zero withholding on interest. It is not necessary for the beneficial lender in this scenario to

constrained by a contractual or legal obligation to pass on the payment received to other persons, i.e. the investors. However, if one assumes that the securitization vehicle is the beneficial owner, several questions arise. In reality, the establishment of a securitization company in a particular state does have as one of the principal purposes obtaining the benefit of reduced source-state taxation in respect of interest. A robust securitization framework and the like are important, but the availability of tax treaty benefits is generally *conditio sine qua non*. The example reiterates that “the intent of tax treaties is to promote benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 9 applies to an investment, it is necessary to consider the context in which the investment was made”. The example then concludes that benefits should be available to the securitization company. It seems that the only rationale that could carry that conclusion is the fact that the notes are widely held by investors and perhaps that the notes are listed on a recognized stock exchange. The analogy that comes to mind, again disregarding the beneficial-ownership theme addressed above, is the “publicly traded” test of article 29(2)(c) of the 2017 OECD Model. If that is indeed the rationale, this example should have far-reaching consequences for CIVs. It is difficult to see why, with respect to the relevant circumstances, a CIV in which the units are widely held by investors would be different from the securitization company of Example L.

Example M, dealing with a real estate fund that owns a holding company that in turn owns property companies in third states, concludes that treaty benefits should be available, but the reasoning is only partly consistent with the reasoning used in Examples D (dealing with a CIV) and K (dealing with a subsidiary of an institutional investor) in that it does not only reiterate the commercial and legal reasons to locate RCO in State R, but also makes the point that it would not obtain treaty benefits that are better than the benefits to which its investors would have been entitled had they made the same investments directly.

In addition to the above examples that purport to clarify the application of the PPT, the Commentary on Article 29 of the 2017 OECD Model, in paragraph 187, also contains examples of transactions that should or should not be regarded as conduit arrangements. These examples do not purport to clarify the application of the PPT, but rather serve to identify “conduit arrangements” that need to be addressed by specific anti-conduit rules in the absence of a PPT. While the examples of paragraphs 176 and 182 serve to clarify a clause that is part of the 2017 OECD Model, the examples of paragraph 187 merely address “conduit arrangements” without drafting suggestions for the clause that these examples purport to be the context for. As observed by Danon, these examples seem to be inspired by the exchange of letters to the conduit arrangement clause of article 3(1)(n) of the United Kingdom-United States Income and Capital Tax Treaty (2001).<sup>89</sup> That clause is a combination of a base erosion test and a PPT. The examples, however, do not clearly distinguish between these two parts of the test and, moreover, some of the examples, in particular Examples A, C, D and E, seem to imply that the RCOs in these examples are to be regarded as the beneficial owners of the income at issue, while that is not evident against the background of the Commentaries on Articles 10, 11 and 12 of the 2017 OECD Model. Example F suffers from a lack of consistency with the provisions of article 29(3)(a)(i)-(iv) of the 2017 OECD Model, very much like Example G mentioned above.

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 have made a formal claim for treaty benefits in order to assess what entitlement to claim would have arisen.

89. See Danon, *supra* n. 4, at pp. 49-50.

The examples provided in paragraphs 176, 182 and 186 leave the reader with the wish that the examples would better explain which principles were being applied and why precisely based on those principles treaty benefits would be granted or denied, as the case may be. Also, the consistency with other provisions of the OECD Model and its commentaries is not always apparent. The application of the PPT would benefit from a set of clear examples that are firmly underpinned by principles that are clearly articulated.

### 9. A Sensible Synthesis?

A sensible synthesis of the potentially problematic interpretation of article 29(9) of the 2017 OECD Model could emerge as follows. If obtaining a treaty benefit was not one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, benefits will be accorded, provided, of course, that the conditions of the operative provisions of the tax treaty are otherwise met. In the determination of whether these conditions have been met, facts are established, sham analysis is performed and domestic attribution rules are applied when appropriate, but the “guiding principle” is not used to “stretch” beneficial ownership or other operative rules of the tax treaty. If it is reasonable to conclude that obtaining a benefit was indeed one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, testing for conformity with the “object and purpose of the relevant provisions of the Convention” is approached as follows. Firstly, the principal purpose of the tax treaty is to avoid double taxation. This purpose surfaces prominently in various examples that purport to clarify the application of article 29(9). Secondly, the treaty should not facilitate tax avoidance, but that condition is operationalized as follows. The condition is satisfied if the treaty resident has a sufficient nexus with the state of residence or if equivalent benefits would have been available had any investment been made directly in the state of source and if the income attributed to the treaty resident is subject to the normal tax regime in the state of residence.<sup>90</sup> Disregarding the possible presence of abusive transactions, a sufficient nexus would, in the words of the above-cited part of the technical explanation to the Switzerland-United States Income Tax Treaty (1996), “outweigh any purpose to obtain the benefits of the Convention”. A sufficient nexus with the residence state limits the benefits inquiry to the resident and not to the ultimate income beneficiary in a third state – an approach, one could say, that is in fact intended by the contracting states. Again, this would only cover the nexus part of the PPT and not the abusive transactions part.

The question then is of what type of nexus would be sufficiently strong to justify the initial granting of treaty benefits. Of course, one could look at the various examples and derive a principle, but one could also start with the principle or look at treaty provisions from which a principle emerges more easily than from the examples. It seems that the LOB provision of article 29 of the 2017 OECD Model is a good candidate. Disregarding, for the moment, the anti-conduit rule that needs to supplement the detailed LOB provision in the absence of a PPT, the LOB clause was deemed sufficient to meet the minimum standard of BEPS Action 6 in respect of a nexus and thus must be regarded as a proxy for a sufficiently strong nexus by the members of the OECD to the extent that they have not made relevant reservations

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90. Cf. para. 84 of the *OECD Model: Commentary on Article 29(4)* (2017), dealing with derivative benefits and the issue of “special tax regimes”. Should there be more intermediate entities in the corporate chain, the principle would apply in respect of each intermediate entity.

and/or observations.<sup>91</sup> The LOB clause, apart from the base reduction rule, essentially has two tests: (i) a “look-through” test in order to determine whether the treaty resident is sufficiently owned by “genuine” residents of the relevant state; and (ii) in the absence of such ownership, an “active conduct of a business” test to determine whether the income in respect of which tax treaty benefits would be granted is sufficiently connected with real economic activity in the state of residence of the taxpayer. In essence, the “headquarters” test is based on the same notion. The “publicly traded” test is a somewhat alien element, as it does not address the nexus, but the motive. It stands for the proposition that widely held ownership implies a sufficient nexus since it is unlikely that a publicly traded corporation would have been set up for tax avoidance purposes.<sup>92</sup> The “active conduct of a business” test will be further explored below. First, the conclusion seems to be justified that, in general, the “nexus” part of any PPT should be deemed satisfied if the taxpayer would have met the conditions of an LOB provision as per the terms of article 29 even when there is no such provision in the tax treaty that is being applied (that is, if a country has not made a reservation on that provision).<sup>93</sup> If the members of the Inclusive Framework found this clause to be sufficient to meet the minimum standard in respect of a nexus, it would be inconsistent to find that the PPT would have to be applied on a stricter basis in the absence of an LOB clause. In other words, the LOB clause would de facto serve as a safe harbour in respect of a nexus in the application of the PPT.

It is clear that the elements of the “active conduct of a business” test are not aligned with other parts of the OECD Model.<sup>94</sup> For example, while the nexus notion is the core of the allocation of taxing rights pursuant to articles 5 and 7 of the OECD Model and, in that context, of the exceptions to articles 10, 11, 12 and 13, the “active conduct of a business” test of the LOB test is potentially narrower in scope. The “active conduct of a business” test is also not aligned with certain notions arising from the BEPS Project, notably the modified nexus approach and the tightened transfer pricing rules in Actions 8-10.

Danon has suggested that in the context of royalties, the modified nexus approach might provide guidance, in the sense that an entity that would qualify for benefits under that approach would be deemed to have a sufficient nexus.<sup>95</sup> While that approach could certainly provide for a useful indicator of a nexus, the disadvantages are that its elements are more the product of a political compromise than of a solid theoretical approach, and, more importantly, it only covers article 12 of the OECD Model and not the other articles that limit source-state taxation. Martín Jiménez sees a close connection between the PPT and the “active conduct of a business” test of the LOB clause and, more importantly, establishes a clear connection with Actions 8-10 of the BEPS Project to the effect that, upon compliance

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91. The only reservations in respect of art. 29 of the *OECD Model* (2017) are from Belgium, Hungary, Luxembourg, Portugal, Switzerland and the United States, and none of these reject the nexus concept of the LOB clause as incorporated in the *OECD Model* (2017). The only observation in respect of the *OECD Model: Commentary on Article 29* (2017) is from the United States, and this observation relates to the relative sizes of the economies in the context of the “active business” test only (para. 77).
  92. See other possible rationales offered by the ALI Project, at pp. 158-159. The ALI Project suggests that “the strongest rationale for the ‘publicly-traded’ exception is the fact that when the stock ownership in a corporation is dispersed there is not an identity of economic interest between the entity and its shareholder. Rather, the corporation itself may be regarded as being ‘the real party in interest.’”
  93. See *supra* n. 91.
  94. See, for a detailed description of the “active conduct of a business” test, F.A. Vega Borrego, *Limitation on Benefits Clauses in Double Taxation Conventions* pp. 167-184 (Kluwer Law International 2017).
  95. See Danon, *supra* n. 4, at p. 48.

with the OECD Transfer Pricing Guidelines (TP Guidelines),<sup>96</sup> no room would be left for the denial of tax treaty benefits based on the application of the LOB or PPT clause, as the case may be.<sup>97</sup> While there is intuitive appeal to that approach, it seems that the reach of the TP Guidelines and that of the LOB and PPT clauses are quite different. If a company that is part of a multinational enterprise performs very little activity, adds little value and, in compliance with the TP Guidelines, earns margins that are commensurate with that activity, this does not imply that it should be entitled to tax treaty benefits. When one looks for a meaningful presence in the state of residence of the taxpayer, it seems that the attribution principles of article 7 of the OECD Model could provide for a useful guideline. In other words, if the presence of a permanent establishment (PE) in a state and the attribution of profits to that PE in accordance with the AOA constitute a sufficient nexus with that state to give that state taxation rights in respect of those profits and to have the other state avoid double taxation either by granting an exemption or a credit, why would the application of that principle by analogy not be usable as a proxy for a sufficient nexus to outweigh the purpose to obtain the benefits of the Convention in the application of the PPT? Of course, that conclusion would only cover the nexus part of the PPT, and the abusive transactions part would still need to be satisfied. A problem, one could say, with the application of the AOA is that its acceptance is less than universal. That seems to be a problem that can be overcome. Generally, article 7 of a tax treaty is interpreted either pursuant to the AOA or pursuant to another method of attributing profits to a PE. In both cases, part of the purpose of that exercise is first, of course, to determine whether there is a PE, and second to determine how much profit can be attributed to that PE.

This approach would, to a significant degree, be in line with the rationale of article 29(3) of the 2017 OECD Model in both its simplified and detailed versions.<sup>98</sup> The fact that the scope of article 29(3) is, in certain respects, narrower than that of articles 5 and 7 can possibly be explained by the fact that article 29(3), on the one hand, and articles 5 and 7, on the other hand, do not originate from the same policy goals.<sup>99</sup> Articles 5 and 7 deal with a sufficient nexus to tax and exempt or give credit, as the case may be, and article 29(3) addresses abuse. The notion used in article 29(3) and also in article 29(8) is not that income is “attributable to”, but rather that it “emanates from” the active conduct of a business. While the Commentary on Article 7 of the 2017 OECD Model contains ample guidance with respect to the question of when income is “attributable to” a PE, the guidance with respect to the question of when income “emanates from” the active conduct of a business is limited to paragraphs 74-76 of the Commentary on Article 29(3), which is guidance that, according to paragraph 167 of the Commentary on Article 29(8), also controls the meaning for the pur-

96. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2017), International Organizations’ Documentation IBFD.

97. A. Martín Jiménez, *Tax Avoidance and Aggressive Tax Planning as an International Standard – BEPS and the “New” Standards of (Legal and Illegal) Tax Avoidance*, in *Tax Avoidance Revisited in the EU BEPS Context* p. 55 (A.P. Dourado ed., IBFD 2017), Online Books IBFD: “Thus, Actions 8-10 BEPS create a sort of exception for Action 6 (either LOB or PPT clauses): when MNLs [Multinational Groups] comply with the standard of Actions 8-10 in terms of transfer pricing, it seems that the OECD wants to exclude the application of other anti-avoidance rules at treaty level.”

98. Cf. the ALI Project, at p. 160: “In these ‘active-business’ cases, it is presumed that the legal entity is subject to substantial tax in its country of residence; and the functional relationship between the business it conducts and the treaty-protected income it receives is taken as evidence that the entity is not merely serving as a conduit for income which might ‘normally’ have been routed elsewhere.”

99. See Martín Jiménez, *supra* n. 97, at pp. 50-51, who seems to imply that the “active trade or business” test is, in fact, broader than the scope of arts. 5 and 7.

poses of the exception in subparagraph b) of article 29(8).<sup>100</sup> If one looks at the examples in paragraph 75, the meaning of the notion “emanates from” indeed seems narrower than that of “attributable to”. The examples suggest that there needs to be an “upstream” or “downstream” business connection between the companies that receive (and respectively pay) the relevant income in respect of which treaty benefits would be claimed. However, one could seriously question why a nexus that is sufficient to tax income (and exempt or give credit) is not enough for entitlement to treaty benefits, subject again to the abusive transactions test. The ultimate question here is whether the wish to reign in abuse or consistency in treaty application should prevail. In the latter case, the nexus part of the PPT should be deemed satisfied if, in the hypothetical application of article 7 with respect to a treaty resident, the relevant income in respect of which treaty benefits are sought would be attributed to it.

A problem with applying the “active conduct of a business” provisions of article 29(3) and 29(8) and the attribution principles of article 7 of the 2017 OECD Model by analogy is that these are not directly applicable with respect to holding and group services companies and CIVs.<sup>101</sup> Nevertheless, the rationale of each set of provisions could be applied by analogy. Holding and group services activities are explicitly carved out from the “conduct of active business” provision by virtue of article 29(3), but the rationale for that carve-out does not readily present itself.<sup>102</sup> It seems that the members of the OECD have diverging views regarding the question of whether a carve-out is appropriate.<sup>103</sup> If the relevant company has a sufficient nexus with the country of residence, the principal purpose should give way to that nexus. In that respect, the principles of the AOA could be applied through the lens of article 29. The test would then be whether sufficient involvement by relevant people (significant people functions) are undertaken through the holding or group services company in its country of residence. With respect to CIVs, the Commentary on Article 1(23)-(48) and the Commentary on Article 29(55)-(67) of the 2017 OECD Model display the struggle to come to a coherent approach. It provides for various approaches, varying from a look-through approach, a pro rata approach and an approach akin to the “publicly traded” test in the LOB provision of article 29. The “publicly traded” test of the LOB provision serves as a proxy for the widely held ownership of companies.<sup>104</sup> Applied to CIVs, one could require these to have widely held ownership. Thus, in the case of CIVs, these nexus requirements would be

100. Art. 29(8) *OECD Model* (2017) itself contains two remarkable inconsistencies. Firstly, the benefits of the tax treaty “shall not apply to any item of income on which the tax in the third jurisdiction is less than the lower of [rate to be determined bilaterally] of the amount of that item of income and 60 per cent of the tax that would be imposed in the first-mentioned State on that item of income if that permanent establishment were situated in the first-mentioned State”. Against the background of treaty shopping concerns, the test ought to be whether (i) if the resident would have been a resident of the third country, equivalent benefits would have been available; and (ii) the income attributable to the PE is subject to the same taxation regime as would be applicable to a resident of that third country. The second inconsistency is that art. 29(8)(d) *OECD Model* (2017) introduces yet a third ground in art. 29 in addition to those in art. 29(6) (the absence of a principal purpose of obtaining benefits) and art. 29(9) (that granting a benefit would be in accordance with the object and purpose of the relevant provisions of the treaty), based on which benefits can be granted, i.e. if benefits are denied to a resident pursuant to art. 29(8)(a) and (b), benefits can still be granted if they would be “justified in light of the reasons such resident did not satisfy the requirements of [paragraph 8] (such as the existence of losses)”.

101. Also not with respect to certain special-purpose entities, such as securitization companies.

102. Neither the *OECD Model: Commentary on Article 29(3)* (2017) nor the Technical Explanation of the *United States Model Income Tax Convention* (20 Sept. 1996), Models IBFD, offer rationale for the carve-out.

103. See para. 73 of the *OECD Model: Commentary on Article 29(3)* (2017).

104. See para. 15 of the *OECD Model: Commentary on Article 29* (2017).

replaced by a “widely held ownership” requirement, as per Example L in the Commentary on Article 29(9) of the 2017 OECD Model.<sup>105</sup>

## 10. Some Thoughts on Multilateralism versus Bilateralism

As explored by Broekhuijsen, the 1963 OECD Model was preceded by a multi-decade exploration of the possibility to draft and implement a comprehensive multilateral tax treaty.<sup>106</sup> Those efforts failed, but the Convention on Mutual Administrative Assistance in Tax Matters, with 125 jurisdictions participating, is an example of a successful multilateral convention.<sup>107</sup> More recently, the MLI, with close to 100 signatories, shows that multilateral consensus on major issues is feasible, although such consensus likely is easier to achieve in respect of anti-abuse measures than in respect of the avoidance of double taxation. This is relevant in the context of the improper use of tax treaties. As was already indicated in the Conduit Companies Report, treaty shopping is unsatisfactory because of (i) a breach of the principle of reciprocity; (ii) the resulting absence of an incentive to enter into a tax treaty with source states; and (iii) the risk that income is subject to inadequate taxation in a way unintended by the contracting states. As long as one comprehensive multilateral income tax convention does not exist, the above concerns will continue to exist. As long as the avoidance of double taxation is largely accomplished through bilateral tax treaties with differing levels of source-state taxation and in the absence of bilateral tax conventions in many other cases, treaty shopping concerns will continue to exist. Against the background of the overriding object and purpose of income tax treaties, i.e. removing the obstacles that double taxation presents to the development of economic relations between countries, one could question the current construct. The avoidance of double taxation is pursued on a bilateral basis, which inherently causes differences in the allocation of taxing rights and/or the level of source-state taxation, but the improper use of bilateral tax treaties is dealt with on a multilateral basis through the MLI or the implementation of the BEPS Action 6 minimum standard in bilateral tax treaties. The multilateral approach with respect to the “proper use” norm almost implies that that norm would be identical for all bilateral tax treaties, which is evidently not the case, but also creates uncertainty that does not further the removal of obstacles to the development of economic relations between countries. That uncertainty is exacerbated by the differing views of OECD member countries as shown in the commentaries on various provisions of the OECD Model. If one looks at the operative provisions of the OECD Model that are most relevant in the context of treaty shopping (articles 10, 11, 12 and 13) and takes into account that the members of the OECD have endorsed these articles to the extent that they have not made a reservation, the logical conclusion is that, in many cases, there is multilateral consensus that may not have been implemented on a bilateral basis for reasons often unknown, such as a lack of capacity to negotiate or renegotiate a

105. See, however, the ALI Project, at p. 159, in respect of the “publicly traded” test in the US-style LOB clause: “Thus, for example, a publicly traded investment company could qualify even if in fact wholly owned by residents of third countries. The draftsmen may have supposed that ‘special measures’ clauses drafted into the treaties were sufficient to forestall this possibility. If not, however, publicly traded companies engaged in making portfolio investments should be excluded.” However, the ALI Project does not offer a rationale for the exclusion of investment companies.

106. D.M. Broekhuijsen, *A Multilateral Tax Treaty: Designing an Instrument to Modernise International Tax Law* p. 9 et seq. (Wolters Kluwer 2018).

107. OECD, *Convention on Mutual Administrative Assistance in Tax Matters* (OECD 2011), available at [https://read.oecd-ilibrary.org/taxation/the-multilateral-convention-on-mutual-administrative-assistance-in-tax-matters\\_9789264115606-en#page1](https://read.oecd-ilibrary.org/taxation/the-multilateral-convention-on-mutual-administrative-assistance-in-tax-matters_9789264115606-en#page1).

treaty or a lack of relevance given to insufficient economic relations between countries. One could seriously question whether, in respect of the “lack of reciprocity” and “lack of incentive” problems with treaty shopping, the onus should not be on the countries that are members of the OECD.<sup>108</sup> As almost 100 countries have shown to be willing and able to conclude the MLI, the arguments relating to reciprocity and incentives ought to have diminishing relevance. That leaves, of course, the “subject to inadequate taxation” argument.<sup>109</sup> While this argument is very important, two sides of it can be addressed. One side is exchange of information. With the Convention on Mutual Administrative Assistance in Tax Matters and the Multilateral Competent Authority Agreement, a fairly comprehensive infrastructure for exchange of information exists. Provided that this system is fully operationalized and operates in a satisfactory manner and information on relevant cross-border income would be available in the source state and the residence state of any intermediate entity and the ultimate beneficiary, the remaining question is whether the cross-border income would be subject to the normal taxation regime in any relevant country. Also, in this respect, one could question whether the onus should be on the members of the OECD or on the taxpayer. The BEPS programme contains all the elements to ascertain that cross-border income would be subject to normal taxation regimes.

Perhaps the mechanisms developed in the OECD Treaty Relief and Compliance Entrance (TRACE) project, in particular, the TRACE implementation package approved by the OECD Committee on Fiscal Affairs on 23 January 2013, could be applied by analogy.<sup>110</sup> Each entity claiming treaty benefits would then have to certify that its direct and indirect shareholders would be tax-resident in countries that would be party to the Multilateral Competent Authority Agreement, and in the case of base-eroding payments, this obligation would extend to information pertaining to the recipients of these payments. This approach would have the potential to replace the nexus part of the PPT. Of course, the “abusive transactions” part of the PPT, to the extent that the type of transaction potentially addressed by it would not be covered by domestic substance-over-form rules, would remain relevant.

When thinking about the future design of the PPT, one should not lose sight of the fact that the reduction of source-state taxation through treaty shopping is certainly not always aimed at avoiding all taxation. In many cases, withholding taxes lead to economic double taxation (in the case of dividends) or imply an inability to credit because of tax credit limitations and sometimes are almost confiscatory in effect. In addition, failing the implementation of the TRACE measures, the refund of withholdings in excess of treaty rates remains a protracted effort.

## 11. Conclusion

The adoption of the PPT is a milestone in the development of tax treaty law in the context of the improper use of tax treaties. Its development spans over 40 years of case law, doctrine and work by the OECD. The evolution of the thinking of the OECD is evident from the historic overview in section 2. Some countries were less than keen to restrict the entitlement to tax treaty benefits, while others saw the improper use of tax treaties as a phenomenon

108. Cf. the ALI Project, at pp. 166-167.

109. See *supra* n. 11, at para. 7 b).

110. OECD, Treaty Relief and Compliance Entrance (TRACE) Implementation Package (OECD 2013), available at [http://www.oecd.org/ctp/exchange-of-tax-information/TRACE\\_Implementation\\_Package\\_Website.pdf](http://www.oecd.org/ctp/exchange-of-tax-information/TRACE_Implementation_Package_Website.pdf).

that needed to be restrained. The tension caused by the improper use of tax treaties grew over the years and culminated in the treaty shopping statistics published by the OECD in its 2013 BEPS Report. During the years of discussion, in the absence of a treaty-based GAAR, the OECD sometimes tested the limits of treaty interpretation with elastic boundaries of the beneficial ownership criterion and the introduction of the “guiding principle” in the Commentary on Article 1 in 2003, while revenue authorities tested their chances with beneficial ownership, substance-over-form, abuse-of-law and other statutory or court-developed anti-abuse doctrines. As is known, the results have varied widely. The adoption of the minimum standard of BEPS Action 6 will probably result in almost universal adoption of the PPT rather than the LOB. The PPT may prove to be a very potent weapon in the hands of tax authorities around the world, if only because of the reversal of the burden of proof.

As implied in the wording of article 29(9) of the 2017 OECD Model, it will only be activated if tax treaty benefits would otherwise be available. In testing that availability, domestic sham, substance-over-form and attribution rules will remain relevant, and so will the treaty criterion of beneficial ownership, but none of these instruments need to be stretched in the presence of the PPT as a backstop. In other words, adoption of the PPT will likely reduce the need and inclination to test the boundaries of other instruments used to reign in improper use of tax treaties.

The design of the PPT clearly puts the onus of establishing the object and purpose of the relevant provisions of the tax treaty on the taxpayer. As demonstrated in this article, the “guiding principle” has been elevated from the Commentary on the OECD Model to treaty text, and the difficulty to establish the object and purpose or to assess the object and purpose in the case of conflicting directions now seems to be the difficulty of the taxpayer rather than that of the revenue authority, although it remains to be seen how courts will deal with this changed design in practice. The reach and potency of the PPT have the potential to create significant uncertainty in the application of tax treaties, not the least because the Commentary on Article 29(9) of the 2017 OECD Model and the examples provided therein fail to articulate a clear principle. While, to an extent, that uncertainty may serve a policy goal, i.e. deterring the improper use of tax treaties, it may also hamper achieving the overarching object and purpose of tax treaties, i.e. removing obstacles to international trade and investment. It is thus important that a clear principle emerges in order to further consistent interpretation of tax treaties in the states that have adopted the PPT in their tax treaties. This interpretation must strike a balance between the various and sometimes varying goals of the tax treaty as discussed in this article.

Against the background of the acceptance of an LOB clause as a sufficient means to meet the minimum standard of BEPS Action 6 in respect of a nexus, it must be accepted that a taxpayer that would have met the conditions of that LOB provision in a hypothetical application thereof in the absence of an LOB clause meets the nexus element of the PPT. The OECD should amend the Commentary to eliminate the anomaly that the Commentary on Article 29(1)-(8) of the 2017 OECD Model would not be relevant in the interpretation of article 29(9) and vice versa.<sup>111</sup>

111. The OECD should also consider amending the discretionary relief provision of art. 29(3) *OECD Model* (2017) and the *OECD Model: Commentary on Article 29* (2017) to achieve consistency, i.e. provide in art. 29(3) that discretionary relief should be granted if that would be in accordance with the object and purpose of the relevant provisions of the treaty rather than revert to the principal purpose.

When the income attribution principles enshrined in article 7 of the 2017 OECD Model are sufficient to justify taxing rights in the source state and to exempt or give credit, as the case may be, in the residence state, the application of those principles by analogy to determine a sufficient nexus with the residence state emerges as another possibility to satisfy the nexus element of the PPT.

If a holding or group services company has a sufficient nexus with the country of residence, the principal purpose should give way to that nexus. In that respect, the principles of the AOA could be applied through the lens of article 29 of the 2017 OECD Model. The test would then be whether sufficient involvement by relevant people (significant people functions) is undertaken through the holding company in its country of residence.

With respect to CIVs, against the background that the “publicly traded” test of the LOB provision serves as a proxy for the widely held ownership of companies, one could regard CIVs as having a sufficient nexus with the residence state if the CIV has widely held ownership.

Finally, it is submitted that in the brave new world of multilateralism with regard to tax treaty relationships, it should be considered to let the historic treaty shopping concerns relating to a “lack of reciprocity” and “lack of incentive” give way to the principal purpose of tax treaties to avoid double taxation and let the granting of tax treaty benefits turn on the question of whether sufficient safeguards exist to ascertain that (i) granting those benefits would not create possibilities for tax evasion; and (ii) cross-border income would be subject to normal taxation regimes.