O.E.C.D. RECEIVES PUBLIC COMMENTS ON PROPOSED CHANGES TO THE MODEL TAX CONVENTION

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Tags
O.E.C.D.
L.O.B.
Permanent Establishment
Tax Residency
Tax Treaties
Withholding Tax

On August 11, 2017, the O.E.C.D. released comments on the draft 2017 updates (the "Draft Contents") to the O.E.C.D. Model Tax Convention (the "O.E.C.D. M.C.") prepared by the Committee's Working Party 1 and published on July 11, 2017. The comments relate to O.E.C.D. proposals that were not previously subject to consultation. They were submitted by the B.E.P.S. Monitoring Group ("B.M.G."), the Business and Industry Advisory Group ("B.I.A.C."), the International Chambers of Commerce, and other interested parties.

Other proposed amendments in the Draft Contents were approved under the O.E.C.D.'s B.E.P.S. consultations. They have been released for information only. These provisions mainly relate to Article 5 (Permanent Establishment) and the B.E.P.S. Action 7 Final Report on Preventing the Artificial Avoidance of Permanent Establishment Status.

This article summarizes the changes to the O.E.C.D. M.C. that were open for public comment and the suggestions received and provides additional observations, including an examination of the interplay between the Draft Contents and existing U.S. approaches to these issues. Amendments to the O.E.C.D. M.C. that were approved under the B.E.P.S. consultations were discussed in a previous edition of *Insights*.[1]

PARAGRAPH 2 OF ARTICLE 3 AND THE COMMENTARY – TREATY INTERPRETATION

Proposal and Public Comments

The Draft Contents provide that if the competent authorities agree to an interpretation of a treaty provision that is not defined in the treaty under a mutual agreement procedure, this interpretation should override domestic law. Under prior regulations, absent a definition in the treaty, a term was to be construed under the domestic law of the taxing state.[2] The proposed amendment of paragraph 2 of Article 3 and the Commentary was included as a result of follow-up work on B.E.P.S. and intended to clarify the legal status of a mutual competent authority agreement.

In the B.M.G.'s view, however, this change would go far beyond a mere clarification. To the contrary, it raises policy issues concerning the agenda of creating a supranational resolution of tax treaty disputes. Tax treaties are generally incorporated directly into domestic law. Consequently, their provisions are subject to interpretation

1 "O.E.C.D. Issues Proposed Changes to Permanent Establishment Provisions Under Model Tax Convention," *Insights* 9 (2017).

2 O.E.C.D. M.C., Article 3, paragraph 2.

by domestic courts. Notwithstanding a certain weight courts would normally give to the views of the administrative authorities, they are typically reluctant to accept that those views could override their jurisdiction to interpret domestic law. However, this could be the result of including the provision in a tax treaty. Accordingly, this proposed amendment could be the source of confusion rather than clarification. Moreover, the B.M.G. points out that the provision is being included without adequate public discussion. Based on the foregoing, it thus recommends that countries should not include this provision in their tax treaties.

Observations

In a U.S. context, the suggested deference to mutual agreements by the competent authorities for interpretation purposes is not new. Nearly every U.S. income tax treaty contains a section authorizing the competent authorities of the contracting states to resolve by mutual agreement any difficulties or doubts arising as to the interpretation of the treaty.[3] Do U.S. courts follow these interpretations? This is a separate issue.

Treaty interpretation is a sensitive topic. Like the Code, U.S. income tax treaties are subject to judicial interpretation, and U.S. courts generally follow established norms of statutory interpretation in resolving treaty disputes. It has been generally accepted that the starting point for interpreting a U.S. income tax treaty is the language of the treaty itself. Only if a term lacks a definition in the treaty is deference given to other sources, such as the history of and legislative material on the treaty provision, domestic law (as stipulated in Article 3 paragraph 2 of the U.S. Model Tax Treaty), and interpretation thereof. In some instances, administrative guidance in the form of regulations has been utilized in the interpretation of treaties.[4] Still, the U.S. courts' position on the significance of I.R.S. interpretation has been unequivocal.

Most recently, the reluctance of courts to abide by the tax administration's interpretations of tax law – whether domestic or treaty-related – has been evidenced in the landmark decision of *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commr*.[5] *Grecian* dealt with the tax implications of the redemption of a U.S. partnership interest by a foreign partner under domestic U.S. law and the U.S.-Canada Income Tax Treaty. Explaining the considerations in construing rules that do not contain an explicit rule for the case at issue, the court held that:

> Our level of deference to agency interpretations of law varies. Where the interpretation construes an agency's own ambiguous regulation, that interpretation is accorded deference * * * . On the other hand, where a revenue ruling improperly interprets the text of relevant statutes and has inadequate reasoning, we afford it no deference at all. * * * Between these poles, we follow revenue rulings to the extent that they have the 'power to persuade.'

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[3] U.S. Model Tax Treaty, art. 3, para. 2; see, *e.g.*, U.S.-Netherlands Income Tax Treaty (1992), art. 3, para. 2.

[4] *E.g.*, the definition of "trade or business" under the limitation on benefits clause in the U.S. Model Tax Treaty. Usually, reference is made to Code §367(a) and regulations promulgated thereunder to ascertain the meaning. U.S.-Netherlands Income Tax Treaty, Technical Explanation to Article 26.

[5] 149 T.C. 3 (2017); discussed in detail in "Foreign Partner Not Subject to U.S. Tax on Gain from Redemption of U.S. Partnership Interest," *Insights* 8 (2017).

“The constitutionality of a mandated override of domestic law by a mutual competent authority agreement undermines jurisprudence.”

In fact, certain U.S. courts have accorded a revenue ruling no more weight than a contention of any party to litigation.[6] It is, after all, the opinion of the Commissioner of Internal Revenue and has not gone through the rigorous procedures required of an I.R.S. regulation.

Even though U.S. treaties include the authority for competent authorities to reach an agreement on the interpretation on terms that are not defined in the treaty, this does not mean that courts accorded greater weight to such interpretations as compared to unilateral administrative guidance. This is illustrated in the case of *Xerox Corp. v. United States*.[7]

The case involved an ongoing dispute by certain U.S. shareholders in U.K. corporations concerning the U.S. government’s interpretation of Article 23 paragraph 1 of the U.S.-U.K. Income Tax Treaty with respect to the amount of U.S. foreign tax credit available to a direct investor. While the case was pending, and with the approval of the Claims Court, the U.S. Competent Authority invoked the mutual agreement procedure under the U.S.-U.K. treaty and entered into negotiations with the U.K. Competent Authority. After several years of correspondence and meetings between the U.S. and U.K. competent authorities, an agreement emerged in December 1986 in the form of an exchange of letters between representatives of the I.R.S. and the Inland Revenue. The U.S. government cited this agreement and certain other documents to support its construction of Article 23 paragraph 1. With respect to the agreement, the lower court observed:

> Moreover, [the] plaintiff can hardly minimize the importance of the Competent Authority Agreement as an expression of the intent of the treaty parties, since Article 25(3) of the Convention specifically empowered the competent authorities ‘to resolve . . . any difficulties or doubts arising as to the interpretation or application of the Convention.’ Courts have traditionally been reluctant to impinge on the judgments of competent authorities charged by the treaty states with responsibilities of interpretation and implementation.[8]

In contrast, the appellate court accepted the taxpayer’s argument that the agreement did not address the key aspects of the issue before the court.

It remains to be seen whether an O.E.C.D.-level consensus can be reached on this point. The constitutionality of a mandated override of domestic law by a mutual competent authority agreement undermines jurisprudence. For that reason, its policy is questionable and may be subject to challenge in the courts. Furthermore, even if O.E.C.D. consensus is achieved, countries may express reservations, and in any event, U.S. courts do not appear to be bound by this type of provision.

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6 See, *e.g.*, *Crow v. Commr.*, 85 TC 376 (1985), regarding Rev. Rul. 79-152, which was issued in anticipation of litigation and was determined by the court not to “constitute a consistent and long standing administrative position with prior congressional or judicial approval” and thus was not due any special deference as an agency interpretation of treaty.

7 14 Cl. Ct. 455, 88-1 USTC ¶ 9231 (Cl. Ct. 1988), rev’d, 94-2 USTC ¶ 50,623 (Fed. Cir. 1994), reh’g denied, reh’g denied (February 7, 1995), cert. denied, 116 S. Ct. 72 (1995), action on decision, CC-1997-001 (recommending nonacquiescence).

8 *Id.*

ARTICLE 29 –ENTITLEMENT TO BENEFITS

Proposal and Public Comments

The new Article 29 (Entitlement to Benefits) of the Draft Contents contains three significant provisions: a limitation on benefits ("L.O.B.") rule (simplified and detailed versions), an anti-abuse rule for permanent establishments ("P.E.'s") situated in third countries, and a principal purposes test ("P.P.T.") rule. A footnote clarifies that the choice of which to incorporate into a treaty is left to the contracting states.

While the B.M.G. acknowledges the importance of an anti-abuse provision in tax treaties as part of the O.E.C.D.'s B.E.P.S. Project, it points out the complexities that countries face in implementing such provisions. The B.M.G. notes that most countries are likely to prefer the inclusion of the P.P.T., as this would allow them to apply the domestic anti-abuse provisions that are considered most appropriate. However, certain states, such as the U.S., may object to this approach, which seemingly permits too much discretion at the level of tax administrations. In this scenario, the U.S. could insist on the inclusion of a detailed L.O.B. provision. According to the B.M.G., the detailed rules are complex, difficult to apply in practice, and – as shown by the various revisions of the L.O.B. clause in the U.S. Model Tax Treaty – inadequate to prevent "ingenious and continually developing avoidance techniques."

The Draft Contents include a detailed version of the L.O.B. provision that has not been subject to public consultation. A previous version, produced as part of B.E.P.S. Action 6, was considered provisional pending finalization of the U.S. Model Tax Treaty. A similar was presented to the U.N. Committee of Experts and discussed at its December 2016 and April 2017 meetings. According to the B.M.G., it might be useful for the Commentary on the O.E.C.D. M.C. to refer to the U.N. model and point out any differences between the O.E.C.D. and U.N. texts.

Observations

Since 1979, all U.S. treaties ratified by the Senate have contained an L.O.B. provision of one sort or another, as have certain earlier treaties. The purpose of the L.O.B. article is to determine whether a resident of a treaty country has a sufficient connection with that country to justify entitlement to treaty benefits.

On February 17, 2016, the U.S. Treasury Department released a new draft of the U.S. Model Tax Treaty (the "2016 Model Treaty"), which is the baseline text the Treasury will use in negotiating tax treaties.[9] According to an accompanying Treasury press release, the 2016 Model Treaty "includes a number of new provisions intended to more effectively implement the Treasury Department's longstanding policy that tax treaties should eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance." In other words, the Treasury felt compelled to make adjustments that are in line with the B.E.P.S. initiative.[10]

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[9] Technical Explanation to the draft were, however, not issued.

[10] Interestingly, the five draft updates of the U.S. Model Tax Treaty preceding the 2016 draft were released on May 20, 2015 by Treasury, two days before the O.E.C.D. issued its revised discussion draft B.E.P.S. Action 6: Prevent Treaty Abuse (Action 6) and shortly before the United States was scheduled to meet with the O.E.C.D. in June 2015.

However, the 2016 Model Treaty was drafted in a prior administration, and in 2017, the current administration initiated a review of I.R.S. regulations to identify recent legislation that it views as complex, burdensome, and expensive for business. The Treasury Department has already selected eight regulations for withdrawal or modification, and the review is ongoing. Whether the 2016 Model Tax Treaty will fare any better than the other eight regulations is an open question at this time.

The fundamental differences between the 2016 Model Treaty and the prior 2006 model are that it likely will be more difficult to qualify for treaty benefits under the new standards, and for those companies that are able to qualify, the benefits will be more restrictive. While some of these changes are intended to be taxpayer favorable – such as including a derivative benefits test in the U.S. Model Tax Treaty for the first time, albeit of limited scope, and adding a new test for eligibility for "headquarters companies" – most of the changes add additional restrictions to treaty eligibility.

The treaty's L.O.B. article is intended to police "treaty shopping" by requiring residents of a treaty country to satisfy any of several objective tests that generally would indicate that a person has sufficient nexus to the treaty jurisdiction to conclude that person is not treaty shopping. Business entities generally can qualify for benefits of a treaty under the publicly traded company test, the subsidiary of a publicly traded company test, the ownership/base erosion test, the active trade or business test, or (where a treaty includes it) the derivative benefits test. The 2016 Model Treaty places significant additional restrictions on these tests that likely will make it difficult for many companies to qualify for treaty benefits and, at a minimum, will add additional complexity and uncertainty to nearly all companies' determinations of whether they qualify for treaty benefits.[11]

In light of the foregoing, the suggestion to clarify differences between the L.O.B. versions found in the Draft Contents and the U.N. model is on point. However, the criticism of the detailed L.O.B. clause as an inadequate tool to limit B.E.P.S. is overreaching.

Is the U.S. Model Tax Treaty's L.O.B. clause complex and not always clear in its application? Yes. Is there room for improvement? Yes. Technology enables and enhances new business models that take advantage of tax loopholes; this has been a challenge and will remain so in the future. That domestic anti-abuse rules provide a more adequate means of combatting tax avoidance involving multinational groups is questionable. In addition, one person's view of an abusive purpose is another person's view of proper planning and profit maximization.

Thus, even though the U.S. Model Tax Treaty is not perfect, experience can be drawn from the long-standing practice under its L.O.B. provision. Certain objective tests have proven adequate and others may be helped by revision.

Furthermore, the 2016 Model Treaty may serve as basis for discussion. The Luxembourg treaty may serve as an example. On June 22, 2016, the Treasury announced that the U.S. and Luxembourg were in the process of negotiating a protocol to the existing U.S.-Luxembourg Income Tax Treaty and that Luxembourg had introduced a bill in parliament with the text of an amendment to be included in the protocol

[11] For a detailed discussion of the revised L.O.B. article see "2016 Model Treaty – L.O.B. Revisions," *Insights* 3 (2016).

relating to the definition of a P.E. The amendments reflect changes introduced in the 2016 Model Treaty, proving that the process can be kept flexible to address new challenges.

COMMENTARY ON ARTICLE 5 – P.E. AND V.A.T.

Proposal and Public Comments

The Draft Contents include a new paragraph 1.1 to the Commentary on Article 5 of the O.E.C.D. M.C. This addition is intended to clarify that registration for value added tax ("V.A.T.") or goods and services tax ("G.S.T.") is by itself not relevant to the application and interpretation of the P.E. definition.[12]

The B.M.G., the B.I.A.C., the I.C.C., and other interested parties unanimously welcome changes to the Commentary on Article 5 regarding the definition of a P.E. They support the proposal to specify that the treatment of a foreign enterprise for V.A.T. or G.S.T. purposes is not in itself material to the determination of a P.E.; a company registering for V.A.T. or G.S.T. should not be negatively impacted for income tax purposes. According to one comment, this should specifically hold true if a foreign enterprise appoints a third party (*e.g.*, a tax professional) or a related party (*e.g.*, a local subsidiary) to carry out registration and representation before the relevant tax authorities. The B.I.A.C. recommends a cross-reference in the Commentary to the V.A.T. and G.S.T. guidelines and the B.E.P.S. Action 1 Final Report, which states that registration for V.A.T. or G.S.T. purposes does not constitute a P.E. for direct tax purposes. Only the B.M.G. adds that, while not constituting a P.E., voluntary or mandatory registration for V.A.T. or G.S.T. purposes could serve as indicia for local tax authorities to scrutinize a potential creation of a P.E.

Commentators highlighted the compliance time and costs associated with V.A.T. and G.S.T. registration. It was also pointed out that in a Federal tax system, such as those adopted by the U.S. or Canada, taxpayers may deal with compliance and administration on sales taxes at more than one level of government, which may create a huge administrative and compliance burden.

Observations

The proposed addition that no deference on the creation of a P.E. should be made merely based on registration for V.A.T. or G.S.T. purposes constitutes an important victory for taxpayers. It would serve the U.S. Model Treaty well to follow suit. One benefit may be that taxpayers feel less deterred from complying with the increasing amount of reporting obligations. To draw a distinct line between income tax and indirect taxes is welcomed and should be looked to as an example.

COMMENTARY ON ARTICLE 4 – PERMANENT HOME AND HABITUAL ABODE

Proposal and Public Comments

The draft changes address the situation where residential real estate is rented to an

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[12] Paragraph 5 in the Commentary on Article 5.

unrelated person and whether this could be regarded as a permanent home available to the landlord for the purposes of the residence tiebreaker rule. The changes are made in paragraph 13 of the Commentary on Article 4 and refer to Article 4(2)(a) of the O.E.C.D. M.C. Further changes to clarify the meaning of "habitual abode" in the tiebreaker rule are made in paragraphs 17 and 19 of the Commentary to Article 4 and by the addition of new a paragraph 19.1 to the Commentary.

Some commentators considered that further clarification is needed in the proposed Article 4 changes regarding residence (*e.g.*, in relation to the issue of whether a house in a particular jurisdiction is available to the taxpayer).

Observations

It appears appropriate to deny a person treaty benefits if the claim is based on ownership of a home that is rented out and not actually available.

While this amendment targets claims of residence and access to treaty benefits, it also provides clarification under the opposite circumstances (*i.e.*, when a person is no longer deemed to be a resident of a treaty country). The latter would support determinations upon the transfer of residence by a person from one country to another.

Left open is a fact pattern where the property is owned by a person assigned abroad by his or her employer and the lease under which the house is rented has an early termination provision that is triggered in the event the individual returns early from the foreign assignment.

ARTICLE 10 PARAGRAPH 2(A) – REDUCED WITHHOLDING TAX ON DIVIDENDS FOR PARTNERSHIPS

Proposal and Public Comments

The draft changes include the deletion of the phrase "(other than a partnership)" from paragraph 2(a) of Article 10. The subparagraph has been changed to ensure that the reduced rate of withholding tax on dividends levied by the state of source applies where relevant to a transparent entity. This may be illustrated by the following example:

> A company resident in State A pays a dividend to a partnership, P, which State B treats as a transparent entity. One of P's partners, C, is a resident of State B. The part of that dividend that State B treats as the income of the partner C will, for the purposes of paragraph 2 of Article 1 of the convention between States A and B, be treated as a dividend paid to a resident of State B. If the other requirements under the treaty (e.g., minimum ownership requirement under Article 10, L.O.B. clause) are met, C would be eligible to the preferential withholding tax rate.

This change has been made because, under the new paragraph 2 of Article 1 of the O.E.C.D. M.C., income derived by an entity that is fiscally transparent under the laws of either contracting state is considered to be income of a resident of a contracting state to the extent that it is treated as income of a resident of that state

for tax purposes. The change to paragraph 2(a) of Article 10 therefore ensures that the reduction of withholding tax on dividends provided for in that article can apply to dividends paid to a transparent entity where the relevant conditions apply. New paragraphs 11 and 11.1 have also been added to the Commentary on Article 10 in relation to this change.

This amendment was welcomed by the B.M.G.

Observations

In a U.S. context, these amendments are not new. The clarification can be found in U.S. income tax treaties.

One example is the U.S.-France Income Tax Treaty (the "Treaty"). Paragraph 3 of Article 4 of the Treaty provides that an item of income, profit, or gain derived by a fiscally transparent entity is considered to be derived by a resident of a contracting state to the extent that the resident is treated under the taxation laws of the state of residence as deriving the item of income. This applies to any resident of a contracting state that derives income, profit, or gain through an entity that is treated as fiscally transparent under the laws of either contracting state, where such entity is formed or organized in either contracting state or in a state that has concluded an agreement containing a provision for the exchange of information with a view to the prevention of tax evasion with the contracting state from which the income, profit, or gain is derived.[13] The Technical Explanation to the Treaty takes it a step further and explains the treatment of partners resident in third countries. The former should be eligible for treaty benefits under the tax treaty with his or her country of residence.

"An item of income, profit, or gain derived by a fiscally transparent entity is considered to be derived by a resident of a contracting state to the extent that the resident is treated under the taxation laws of the state of residence as deriving the item of income."

The Technical Explanation to Article 4.3 of the Treaty provide the following example:

> For example, if a corporation resident in France distributes a dividend to an entity that is formed or organized in the United States, and is treated as fiscally transparent for U.S. tax purposes, the dividend will be considered derived by a resident of the United States only to the extent that the taxation laws of the United States treat one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax laws) as deriving the dividend income for U.S. tax purposes. In the case of a partnership, the persons who are, under U.S. tax laws, treated as partners of the entity would normally be the persons whom the U.S. tax laws would treat as deriving the dividend income through the partnership. Thus, it also follows that persons whom the United States treats as partners but who are not U.S. residents for U.S. tax purposes may not claim any 3 benefits under the Convention for the dividend paid to the entity. Although these partners are treated as deriving the income for U.S. tax purposes, they are not residents of the United States for purposes of the Convention. If, however, they are treated as residents of a third country under the provisions of an income tax convention which that country has with France, they may be entitled to claim a benefit under that convention. In contrast, if an entity is organized under U.S. laws and is classified as a corporation for U.S.

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[13] Treasury Technical Explanation to the 2009 Protocol (2010) (the "Technical Explanation").

> tax purposes, dividends paid by a corporation resident in France to the U.S. entity will be considered derived by a resident of the United States since the U.S. corporation is treated under U.S. taxation laws as a resident of the United States and as deriving the income.
>
> Because the entity classification rules of the State of residence govern, the results in the examples discussed above would obtain even if the entity were viewed differently under the tax laws of France (e.g., as not fiscally transparent in the first example above where the entity is treated as a partnership for U.S. tax purposes or as fiscally transparent in the second example where the entity is viewed as not fiscally transparent for U.S. tax purposes).

The Draft Contents ensure that income of fiscally transparent entities or arrangements is treated, for the purposes of the O.E.C.D. M.C., in accordance with the principles reflected in the 1999 report of the Committee on Fiscal Affairs entitled "The Application of the O.E.C.D. Model Tax Convention to Partnerships."[14] That report provides guidance and examples on how the provision should be interpreted and applied in various situations.[15] The report, however, dealt exclusively with partnerships and while the Committee recognized that many of the principles included in the report could also apply with respect to other non-corporate entities, it expressed the intention to examine the application of the O.E.C.D. M.C. to these other entities at a later stage. As indicated in paragraph 37 of the report, the Committee was particularly concerned with "cases where domestic tax laws create intermediary situations where a partnership is partly treated as a taxable unit and partly disregarded for tax purposes." Whilst this may create practical difficulties with respect to a very limited number of partnerships, it is a more important problem in the case of other entities, such as trusts. For this reason, the Committee decided to deal with this issue in the context of follow-up work to this report. It will be interesting to see how the clarification for trusts will be structured.

CONCLUSION

While the U.S. has been publically criticized for its lack of commitment to the B.E.P.S. initiative, the examples outlined in the foregoing show that the O.E.C.D. M.C. may derive insights from the U.S. Model Tax Treaty and draw on the U.S. experience and revisions. Examples include the competent authority interpretation and a detailed L.O.B. article. In return, some of the clarifications included in the Draft Contents (*e.g.*, V.A.T. registration not creating a P.E. by itself and a lack of nexus in the case of rented property) could be food for thought when it comes to amending the 2016 U.S. Model Tax Treaty.

With respect to the Draft Contents, it remains to be seen whether approval will be

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[14] Reproduced in Volume II of the full-length version of the O.E.C.D. M.C., p. R(15)-1.

[15] Paragraph 2 addresses this particular situation by referring to entities that are "wholly or partly" treated as fiscally transparent. Thus, the paragraph not only serves to confirm the conclusions of the report but also extends the application of these conclusions to situations that were not directly covered by the report (subject to the application of specific provisions dealing with collective investment vehicles; see Commentary on Article 1, paragraphs 22-48). Draft Contents, Commentary to Article 1, paragraph 4.

reached on an O.E.C.D. level. In any event, the O.E.C.D. M.C. and U.S. Model Tax Treaty are moving closer to each other. Hence the question remains whether the O.E.C.D. is moving closer to the U.S., the U.S. is moving closer to the O.E.C.D., or each is drawing upon the experience of the other to improve its model.

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