April 9, 2014

By email

Ms. Marlies de Ruiter
Head of the Tax Treaty, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
OECD/CTPA
taxtreaties@oecd.org

Re: Comments on Public Discussion Draft, "BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances"

Dear Ms. de Ruiter:

The National Foreign Trade Council (NFTC), organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial and service activities, and our members have for many years been significant investors in many countries, including all of the OECD member countries and the G20 countries.

NFTC seeks to foster an environment in which companies can be dynamic and effective competitors in the international business arena. To achieve this goal, businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment, and through direct investment in facilities abroad. As global trade grows, it is vital that companies be free from double taxation that can serve as a barrier to full participation in the international marketplace. Tax treaties provide the certainty and stability in the investment environment that is necessary to allow business to participate in the global marketplace. That is why NFTC has long supported the expansion and strengthening of the U.S. tax treaty network.

I am writing in response to the Public Discussion Draft released March 14, 2014, in connection with the BEPS Action Plan, entitled "BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" (the "Discussion Draft"). While NFTC is supportive of several of the proposed changes to the OECD Model Tax Convention (the "OECD Model"), NFTC believes that the OECD should reconsider its proposals to adopt the "main purpose test" articulated in Section A.1.*a) ii)* of the Discussion Draft and the title and preamble language articulated in Section B of the Discussion Draft. If the proposals were adopted, NFTC respectfully suggests revisions to take into account the concerns below. In addition, while NFTC believes a *balanced* limitation on benefits article could be a valuable tool in combatting

treaty shopping, an overly restrictive one, like that proposed in the Discussion Draft, will exclude many legitimate business enterprises not engaged in treaty shopping from the benefits of treaty protection and, accordingly, will do more harm than good. NFTC also recommends the adoption of a derivative benefits provision.

A. NFTC generally supports anti-treaty shopping provisions in treaties

NFTC generally supports the adoption of anti-treaty shopping provisions in treaties. In treaties, governments often reduce source country taxation on nonresidents. In order to be willing to do so, governments negotiate for reductions in foreign taxation on their own residents. As double and excessive taxation are reduced between the two states, trade between them is enhanced. If the residents of a non-treaty state are able to access an income tax treaty between two other states, the residents of that third country will have no reason to urge their government to make the concessions required to enter into an income tax treaty with either of the two aforementioned states; and that third country's government would gain nothing, and only lose revenue, by entering into such treaties. Thus, well-crafted anti-treaty shopping measures further the development of tax treaty networks.

However, if these measures are overly restrictive they can undermine the tax treaty network by shutting off legitimate businesses from access to treaties. Consequently, NFTC generally supports the adoption of anti-treaty shopping measures, but it also strongly believes that efforts in this regard must not distract from the primary purpose of income tax treaties, which is to prevent double taxation and provide taxpayers with a stable cross-border investment environment which one government alone cannot provide. As discussed more fully below, NFTC believes that the treaty shopping proposals in the Discussion Draft have not struck the right balance and are in need of revision.

B. Summary of the Discussion Draft's treaty shopping proposals

Section A.1.*a)* ("Treaty shopping") of the Discussion Draft recommends three changes to the OECD Model:

1) changing the title and preamble to express a wish to prevent tax avoidance and an intent to avoid creating opportunities for treaty shopping;

2) adding a "specific anti-abuse rule" (hereinafter, an "LOB provision"); *and*

3) adding a "more general anti-abuse rule" (hereinafter, a "Treaty GAAR").

C. The Treaty GAAR

(1) The Treaty GAAR undercuts the value of the LOB provision

Beginning with paragraph 7 of the current Commentary on Article 1 of the OECD Model (the "Commentary"), under the heading "Improper use of the Convention," the Commentary generally describes the principle contained in the Discussion Draft's Treaty GAAR, and provisions like the Discussion Draft's LOB provision. See, e.g., Commentary ¶¶ 9.5 and 20. Turning the Commentary discussion into OECD Model provisions with *both* the Treaty GAAR *and* the LOB provision, however, would have the perverse effect of rendering the benefit of the anti-abuse package in the OECD Model far less than the sum of its parts.

Without an LOB provision, a Treaty GAAR serves an anti-abuse purpose, although it requires more subjectivity than would an LOB provision. *With* an LOB provision, a treaty provides a series of bright-line tests for entitlement to treaty protection in order to serve the same purpose. The virtue of the LOB tests (as opposed to the Treaty GAAR) is that they foster the ultimate goals of income tax treaties in an administrable way that provides certainty in application. The Treaty GAAR *as an add-on* would provide little additional support for treaty policy, while undoing the administrability and certainty achieved by the LOB provision on its own.

Because of the objective nature of the LOB provision, it is well established that the provision can preclude treaty benefits in cases where there is no treaty shopping concern. If the objective tests are overly restrictive, as in the case of the model proposed in the Discussion Draft, legitimate business enterprises with no treaty shopping motivation will be deprived of the benefits of the treaty, undermining the fundamental goal of promoting bilateral trade and investment between residents of the treaty partners. A balanced LOB provision avoids this pitfall and achieves the certainty and administrability that an objective test provides. Including a subjective test like the Treaty GAAR in addition to an LOB provision does nothing to alleviate the limitations of the latter and sacrifices its administrability.

(2) The Treaty GAAR undercuts the value of the treaty network

Because of the subjective nature of the Treaty GAAR, it is virtually guaranteed that Contracting States will interpret and apply the Treaty GAAR differently. To the extent this occurs, benefits under any given treaty will not be bilateral in practice. Two Contracting States agree to make concessions in an income tax treaty *because* they are bilateral. When the architecture of the treaty guarantees that they will *not* be bilateral, it undermines the purpose of the treaty and understandably reduces each country's incentive to enter into one. Moreover, a Treaty GAAR will open the door to the effective renegotiation of a treaty's terms by one Contracting State, without that Contracting State having to either make concessions to the other Contracting State or terminate the treaty.

(3) Difficulties interpreting the Treaty GAAR

The Treaty GAAR conveys an inherently contradictory message: governments intend to confer treaty benefits, unless taxpayers intend to avail themselves of them—unless, perhaps, the tax-motivated behavior is consistent with the "object and purpose" of the relevant treaty provisions. We question whether any amount of guidance will ever cure this infirmity.

This contradictory message will make the Treaty GAAR difficult to interpret and apply in practice. The Discussion Draft shows that the drafters also wrestled with these contradictions. After stating in paragraph 31 that a treaty benefit need not be "the sole or dominant purpose" and may be just "one of the main purposes" of a transaction to constitute a "main purpose" of the arrangement or transaction, the Discussion Draft provides an example that appears to contradict these statements. Example C in paragraph 33 involves a company ("RCo") planning to establish a manufacturing plant in one of three countries. The example states that "[a]fter considering the fact that State S is the only one of these countries with which [RCo's state of residence] has a tax convention, the decision is made to build the plant in that State"; yet the example goes on to conclude that "it cannot reasonably be considered that one of the main purposes for building the plant is to obtain treaty benefits." If both of these assertions are true, then there is a subtlety here that can easily be missed by tax administrators and practitioners. The plant in question clearly was built *where* it was built *because* State S's treaty provided benefits. Thus, it *also* cannot reasonably be considered that one of the main purposes for building the plant *in State S* is *not* to obtain treaty benefits. While the NFTC agrees that treaty benefits should be granted under the facts of the example, the example clearly demonstrates that even in a common and straightforward business transaction such as the one in Example C, it will be difficult to judge whether or not treaty considerations are a "main" consideration. The examples in the Discussion Draft confirm that there is an exceptionally fine line between transactions that might invoke the Treaty GAAR and those that do not, which will cause taxpayers great angst in assessing the consequences of their everyday business transactions and will be unduly challenging for tax administrators to interpret.

We do not believe that paragraphs 19 through 33 of the Discussion Draft remedy the lack of clarity regarding when the Treaty GAAR will or will not deny treaty benefits. They do describe a number of situations in which the Treaty GAAR *might* preclude treaty protection, but they stop short of mandating such preclusion. Even in the seemingly abusive cases, the abuses meant to be prevented are highly contingent on peculiarities of the internal law of the country from whose tax treaty protection was sought. If a country's internal tax law is particularly vulnerable to abuse, treaty negotiators have historically tailored the treaty with that country accordingly, possibly even going so far as to adopt a Treaty GAAR if necessary. As a general OECD Model, however, adding the Treaty GAAR to the LOB provision would be counterproductive.

If the Treaty GAAR were to be incorporated into the OECD Model, there would need to be an express provision enabling any taxpayer to receive an advance ruling that the Treaty GAAR does not apply to a proposed transaction. Given the uncertainty that taxpayers would face in

interpreting a Treaty GAAR, tax administrators would be swamped with such requests. Expeditious handling would be burdensome to governments, yet necessary, which may call at the very least for measures to ensure such handling. In addition, if a general anti-abuse rule were to be added to the OECD Model, it should apply only in a case where obtaining a treaty benefit was "*the* main purpose" of the arrangement or transaction, rather than merely "*one of* the main purpose*s*" of the arrangement or transaction.

(4) Experience supports our view

The United States went through an instructive process in connection with the treaty and protocol it signed in 1999 with Italy. The negotiators included an LOB provision, but in addition, they included a general anti-abuse rule similar to the Discussion Draft's Treaty GAAR in the dividends, interest, royalties and other income articles. The Treasury Department indicated that it intended to include such provisions in the U.S. Model Income Tax Convention. Ultimately, the U.S.-Italy treaty was ratified only after being stripped of its Treaty GAAR provisions at the behest of the U.S. Senate, and the U.S. Model did not adopt such provisions. The problem was lack of clarity, which was demonstrated by the U.S. Treasury Department's inability to provide it to the Senate.

(5) Recommendation

Based on the concerns highlighted above, NFTC believes that the Treaty GAAR should not be incorporated into the OECD Model.

D. LOB provision

As we indicated above, the LOB provision proposed in the Discussion Draft is overly restrictive in several respects. It is extreme in its near conformity to the 2006 U.S. Model. Of the U.S. treaties now in force, a small minority include all the provisions of this model. For this reason there is relatively little experience from which to judge their workability as a whole.[1] Moreover, these provisions are miscast as a template for universal use in all bilateral negotiations, especially those between countries with robust tax systems. NFTC recommends that the Discussion Draft's version of the LOB provision be modified, and that the OECD devote additional study to the differences between the Commentary and Discussion Draft versions of LOB before any decision is made to adopt the Discussion Draft's version in its model. Below we set forth a series of concerns with the LOB provision as proposed in the

[1] Moreover, only *one* U.S. treaty in force, with New Zealand, contains all of these provisions and does not include a derivative benefits provision. As discussed below in Part E, the derivative benefits provision serves as a necessary backstop where the objective tests of other provisions prove to be overly restrictive.

Discussion Draft, along with a few examples illustrating just some of the difficulties we foresee.

(1) Same-country owner requirements

Of particular concern are the same-country requirements on both ultimate owners (persons who own a company's stock "directly or indirectly") and intermediate owners embedded in the ownership prong of the "ownership/base erosion test" (subparagraph 2 e) *i)* of the LOB provision). The corresponding provision in paragraph 20 of the current Commentary on Article 1, has no residence test for *intermediate* owners, and no same-country residence test for ultimate owners. Moreover, while there *is* a residence test for intermediate owners in the provisions of paragraph 20 of the Commentary on Article 1 and the Discussion Draft that entitle subsidiaries of publicly traded companies to treaty benefits, neither of those tests limit "good" ultimate *or* intermediate owners to residents of the same country as the company seeking treaty benefits. It is not clear what treaty abuse the same-country owner requirements in the ownership/base erosion provision is intended to address, especially when applied to treaties between countries where companies do substantial business, yet the requirement would have the unintended result of denying treaty benefits in many common business structures. For example, if a U.S. company and a non-U.S. company wanted to form a joint venture company in the non-U.S. company's residence country, the joint venture company would fail the ownership/base erosion test if the U.S. company held a majority interest.

As an example that arises from the residence requirements imposed on *intermediate* owners (a requirement not present in paragraph 20 of the Commentary on Article 1), a multinational group will often have regional holding companies for non-tax reasons. Assume a publicly traded company in Country A ("ACo") forms a regional holding company in Country B which has a subsidiary in Country C ("CSub") (among other subsidiaries). If the treaty between Country A and Country C were to include the Discussion Draft's version of the subsidiary of a publicly traded company test and ownership/base erosion test, CSub would fail to satisfy both tests. In such case, ACo's provision of services to CSub, for example, could raise questions whether CSub's profits are taxable in Country A notwithstanding that it has no "PE" in Country A within the meaning of Article 5.

The intermediate owner requirement in the derivative benefits provision included in paragraph 13 of the Discussion Draft could give rise to similar problems.[2] We would strongly urge the OECD to conduct further study of the consequences of such provisions before including them in its Model.

---

[2] We are not aware of a U.S. treaty currently in force that contains such a restriction. The proposed protocol (signed in January 2013) to the U.S.-Spain treaty is apparently the first to include an intermediate owner requirement in a derivative benefits test, and would require intermediate owners to be residents of either a member state of the European Union or a party to the North American Free Trade Agreement (but would *not* require them to be equivalent beneficiaries).

(2) Base erosion

The "base erosion" prong of the ownership/base erosion test and derivative benefits test is also overly restrictive in that payments to certain qualified persons (within the meaning of paragraph 2 of the LOB provision) can still be considered base eroding payments, thereby disqualifying a company from claiming treaty benefits. For a multinational group with a publicly traded parent, a payment to *any* group member other than the ultimate parent company would constitute a base eroding payment unless it satisfies the "ordinary course" exception (which applies only to payments for services or tangible property).[3] The proposal could cause ordinary business transactions with third parties to be problematic and also restrict the group's ability to make intergroup payments necessary to carry on its business operations (e.g., its ability to move cash to where it is needed in the group). Assume a publicly traded company in Country D ("DParent") wholly owns Country D subsidiary ("DSub") and DSub licenses intangible property to an unrelated country D corporation ("Customer") which is wholly owned by country D residents. If any treaty between Country D and another country were to include the Discussion Draft's version of the ownership/base erosion test, Customer might fail to satisfy such test because its third party royalty payments to DSub would constitute base eroding payments (even though DSub is considered a qualified person under the subsidiary of publicly traded company test). Similarly, assume DParent also owns a Country E subsidiary ("ESub") and DSub makes a loan to ESub. If the treaty between Country D and Country E were to include the Discussion Draft's version of the derivative benefits test, ESub might fail to satisfy such test because its interest payments to DSub would constitute base eroding payments. It is unclear what treaty abuse is being targeted by these rules, and their restrictive nature presents unwarranted complexities.

(3) Publicly traded test

Finally, the "publicly traded test" (subparagraph 2 c) *i)* of the LOB provision) is problematic. In addition to the requirement that the tested company's principal class of shares be regularly traded on one or more recognized stock exchanges, the test also requires that either (i) the principal class of shares be primarily traded on one or more recognized stock exchanges "located in" the company's state of residence (the "primarily traded requirement"), or (ii) the company's "primary place of management and control" be in the company's state of residence (the "managed and controlled requirement").

The primarily traded test fails to take two factors into account. First, in today's global business environment, it is not uncommon for a company's shares to be traded largely on exchanges outside its state of residence. To access the global capital markets, it is often necessary for a company to list and trade on a foreign exchange, and it may be that such foreign exchange is

[3] Both tests consider "arm's length payments in the ordinary course of business for services or tangible property" to be non-base eroding payments (the "ordinary course exception").

substantially larger than any exchange located in the company's home country. Of the U.S. treaties that have a primarily traded requirement, the majority allow a company's stock to be primarily traded on some recognized stock exchanges outside the country of residence, unlike the Discussion Draft provision. Second, stock exchanges with a physical "location" in the traditional sense are fast becoming a relic, as trading comes closer and closer to becoming an entirely digital enterprise.

If a company fails to satisfy the primarily traded requirement, its only route for claiming treaty benefits under the publicly traded test—which for several reasons is the test that NFTC members largely need to rely upon—would be to rely on the managed and controlled test. This result puts companies and tax administrators in a difficult position given the test's subjective nature. How practical is it to expect tax executives and administrators to determine, with the necessary degree of certainty on a year-to-year basis, whether executive officers and senior management employees of a multinational enterprise exercise day-to-day responsibility for *more* of the strategic, financial and operational policy decision making for the enterprise in *one* treaty country than in any other country, and whether their staff conduct *more* of the day-to-day activities necessary for preparing and making those decisions in that country than in any other country?

Some organizational structures, in particular those with multiple business segments and dispersed management, will undoubtedly lead to some arbitrary and capricious results, in addition to uncertainty regarding how the test is to be applied. These interpretive questions have yet to be addressed under the few U.S. treaties that use this version of the publicly traded test. Moreover, adopting an unclear and subjective test in the publicly traded test defeats the fundamental purpose of the LOB provision, especially as applied to companies like NFTC's members, which is to provide an objective and administrable measure that sufficiently prevents treaty shopping.

NFTC believes that the LOB provision adopted in the OECD model should use the language of the publicly traded test included in paragraph 20 of the current Commentary on Article 1.[4]

E. Derivative benefits

The provision set forth in paragraph 13 of the Discussion Draft (the "derivative benefits" test) would be a crucial addition to the LOB provision.[5] Derivative benefits provisions serve as a needed backstop to the other LOB provisions, making treaty benefits available in situations that involve no treaty shopping, but that nevertheless do not satisfy the objective tests in those other

---

[4] That test provides that a qualified person includes a company if "the principal class of its shares is listed on a recognised stock exchange . . . and is regularly traded on one or more recognised stock exchanges."

[5] See, however, the comment in Part D(1) above regarding the intermediate owner requirement in the Discussion Draft's example of a derivative benefits test, which we believe is unnecessary.

provisions. It would obviate the need to resort to paragraph 4 of the LOB provision (hereinafter, the "discretionary benefits" provision) in many cases where treaty abuse is very unlikely to be present. Making such resort unnecessary is critical to making the anti-abuse rules practicable.

However, the suggestion in paragraphs 14-16 of the Discussion Draft, namely to distinguish between "base eroding payments" and other payments for derivative benefits purposes, would drain much of the value of a derivative benefits test. The example in paragraph 15 assumes that State S gives the same treaty protection to royalties beneficially owned and derived by State T residents *and* State R residents. "Parent" satisfies the narrow requirements of the proposed definition of an "equivalent beneficiary," which implies that Parent is either publicly traded, a governmental entity, a charity, or a pension fund. State S has bargained for the benefit of the same low royalty rates with both State T and State R. Under these circumstances, there simply is no tax policy to be protected by discriminating between an OPCO 2 that is itself publicly traded or locally owned, and one that is owned by Parent. Granting OPCO 2 benefits in the first case, but not the second, would require recourse to discretionary benefits to achieve what seems to have been intended in both cases. This type of non-policy-based, accidental interference with treaty benefits defeats the purpose of an LOB provision.

F. Title and preamble

The Discussion Draft proposes the following new title: "Convention . . . for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion *and avoidance*" (emphasis added). The proposed preamble provides a declaration that the parties intend that the Convention eliminate double taxation "*without creating opportunities for* non-taxation or reduced taxation through tax evasion or avoidance."

The title should be conformed to the preamble in this respect. Absent clarification, this title could be interpreted to suggest that treaties can *increase* taxation that would not otherwise be imposed under domestic law. To the contrary, it is a well-established principle that treaties should only relieve taxation imposed under domestic law.

In addition, the authors of the Discussion Draft appear to expect that a treaty's incorporation of such a title and preamble language will be relevant to the interpretation and application of the treaty. This would seem to be true either in cases where treaty interpretation is governed by the Vienna Convention on the Law of Treaties (cited in the Discussion Draft), or by U.S. law.[6] The proposed preamble language should only be relevant when interpreting terms of a treaty that are ambiguous. This is generally consistent with the method of interpretation generally

[6] *See, e.g., Xerox Corp. v. United States,* 41 F.3d 647, 660 (Fed. Cir. 1994), *cert. denied,* 516 U.S. 817 (1995), where the opinion referred to the "clear purpose of avoidance of double taxation" of the 1975 U.S.-U.K. treaty (as amended) which happened also to be set forth in the title of that treaty: "Convention . . . for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains."

used by U.S. courts. Alternatively, the title and preamble language might broadly turn treaty interpretation into a subjective exercise, requiring a consideration of the context, object and purpose of treaty provisions to determine whether reduction of internal law tax is warranted, even when interpreting unambiguous treaty provisions. We urge that this latter approach be ruled out by the Commentary on any title and preamble provisions incorporated into the OECD Model.

* * *

NFTC appreciates the opportunity to comment on the Discussion Draft, and urges the OECD to consider these comments in its work on the OECD Model Tax Convention.

Sincerely,

Catherine Schultz
Vice President for Tax Policy
cschultz@nftc.org
202-887-0278 ext. 2023