EY Global Services Limited
Becket House
1 Lambeth Palace Road
London SE1 7EU
United Kingdom

Tel: +44 (0) 207 980 0286
ey.com

9 April 2014

Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2, rue André Pascal
75775 Paris Cedex 16
France

By e-mail: taxtreaties@oecd.org

Comments on OECD Discussion Draft on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

Ladies and Gentlemen:

EY appreciates the opportunity to submit these comments to the OECD on the Discussion Draft on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances dated 14 March 2014.

The OECD's work on the Model Tax Convention and the related Commentary has been critically important to the ongoing expansion of the global network of bilateral tax treaties. These tax treaties serve to reduce or eliminate double taxation which unrelieved would be a significant barrier to cross-border trade and investment. We recognize the need to protect against the granting of tax treaty benefits in inappropriate circumstances. At the same time, we would underscore the importance of ensuring that tax treaty benefits are granted in appropriate circumstances.

For the reasons discussed below, we are concerned that the recommendations in the Discussion Draft with respect to the incorporation of anti-abuse rules in tax treaties go too far and would interfere with the proper functioning of tax treaties for their intended purposes. We urge the OECD to reconsider its recommendations in order to strike an appropriate balance that allows tax treaties to achieve the objective of facilitating cross-border trade and investment.

Limitation on Benefits Test

The Discussion Draft proposes a two-prong approach to addressing potential treaty abuse, recommending the incorporation in tax treaties of both a more objective test in the form of a limitation on benefits (LOB) provision and a more subjective test that reflects a general anti-abuse rule in the form of a main purpose test.

LOB provisions are structured as a series of alternative mechanical tests that are intended to be relatively objective. However, mechanical tests by their nature cannot cover every circumstance that can arise. Thus, such tests – even multiple alternative tests – may not allow treaty benefits in situations where such benefits would be appropriate. In order to reduce the risk of inappropriate denial of access to treaty benefits, the

mechanical tests of an LOB provision must be as broad as possible and must be supplemented with an effective rule allowing the discretionary provision of treaty benefits when the mechanical tests otherwise would not achieve the right result.

LOB provisions should include the full range of alternative mechanical tests in order to cover the range of circumstances that can arise. The Discussion Draft's formulation of an LOB provision should be expanded to include additional mechanical tests. For example, a headquarters company test should be added. A test that addresses the special circumstances of collective investment vehicles also should be added.

The mechanical tests in an LOB provision should not include conditions that make application of a test unrealistic in practice. In this regard, the LOB provision in the Discussion Draft includes restrictions on intermediate ownership in several of the tests. Given the complex organizational structures of global businesses, restrictions of this type on ownership through intermediate entities would render these tests inapplicable in many cases. We believe that these restrictions are not necessary to serve the policy objectives of the particular tests and recommend that their inclusion be reconsidered.

As noted above, even a series of mechanical tests would not capture all situations where treaty benefits are appropriate. For this reason, LOB provisions typically include a discretionary benefits provision under which the competent authority can make a determination to grant treaty benefits in an appropriate case. Given what is at stake, it is essential that the discretionary benefits provision operates effectively in practice. We believe that the OECD should include work on improving the operation of discretionary benefits provisions as an element of its work on Action 14 with respect to improving the mutual agreement procedure under treaties.

The global nature of business today and the complexity of tiers of ownership in corporate groups mean that a so-called derivative benefits test is an essential element of an LOB provision. However, the Discussion Draft cites concerns that such a test could apply to cover arrangements that involve what is viewed as BEPS activity and provides an example that is intended to illustrate these concerns. The example involves a transfer of royalty-generating intangible property by a parent company, which is in a country that has a treaty with the country where the royalty is generated, to a subsidiary in a third country that also has a treaty with such country but that taxes royalties at a preferential tax rate.

This example does not involve an arrangement that should be viewed as raising issues with respect to qualification for treaty benefits. Any concerns with respect to the particular arrangement described do not seem to involve a concern about treaty shopping because the same treaty results would have applied if the intangible property had remained in the parent company. Any issue with respect to the transfer of the intangible property to the subsidiary, which seems to be a focus of the concern expressed in the Discussion Draft, would seem to be a matter for the parent company country that could be dealt with under its domestic law. It would not seem to be a concern of the source country to be dealt with by denying treaty benefits in this narrow case.

We do not believe that this example and the concern referenced provide sufficient justification for not including a derivative benefits test in the LOB provision set forth in the Discussion Draft. To the contrary, we believe that inclusion of a derivative benefits test that allows consideration of comparable benefits in a third-country treaty is essential to the functioning of an LOB provision.

Treaty-based GAAR Provision – Main Purpose Test

The Discussion Draft recommends inclusion in tax treaties of a general anti-abuse rule that would apply in addition to all other limitations and qualifications and could deny treaty benefits where the other limitations and qualifications, including the recommended LOB provision discussed above, all are satisfied. The Draft would deny treaty benefits "if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the main purposes of any arrangement or transaction that resulted directly or indirectly in that benefit." An exception to this denial of benefits would apply if "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 Discussion Draft notes the intent to supplement the main purpose test with detailed commentary explaining the functioning of the test and providing examples.

We are concerned that inclusion of this "main purpose" test would create significant uncertainty regarding the availability of treaty benefits that would seriously erode the functioning of treaties. The test is broad and subjective and the exception incorporated in the test is vague and subjective. Businesses will not know whether they qualify for benefits of a treaty until after the fact, potentially long after the fact. Similarly, a treaty country will not know how its treaty partner is interpreting and applying the test, either currently or in the future, with the potential for significant deviations from the intended or expected implementation of the treaty and substantial imbalances between the countries.

The Discussion Draft notes that this main purpose test is intended to "provide a more general way to address treaty shopping avoidance cases, including treaty shopping situations that would not be covered by the specific anti-abuse rule in [the recommended limitation on benefits provision] (such as certain conduit financing arrangements)." The reference to "certain conduit financing arrangements" is the only indication of the purpose for or intended aim of the main purpose test. The examples provided in the Discussion Draft to illustrate the application of the test all are arrangements that involve conduit features or accommodation parties:

- The example in paragraph 27 involves a transfer of a loan in exchange for promissory notes at almost the same interest rate.
- The first negative example in paragraph 33 involves a financial institution that seems to be acting as an accommodation party in an assignment of dividends that have been declared but not yet paid.
- The second negative example in paragraph 33 involves another financial institution that similarly seems to be acting as an accommodation party, this time in a usufruct of newly issued non-voting preferred shares.

We would suggest that the concerns underlying these types of arrangements could better be addressed through a targeted rule aimed at conduit financing arrangements or other transactions in which qualification for treaty benefits depends on an accommodation party. Indeed, the OECD has experience with more targeted rules and with addressing conduit companies in particular that it could draw on to craft an appropriately tailored rule that it could recommend. The OECD's recent work on the beneficial ownership concept could be leveraged here as well.

A more targeted rule would create significantly less uncertainty and would cause substantially less collateral damage than the proposed main purpose test. The particular examples provided in the Discussion Draft are

not helpful in explaining the reach of the broader main purpose test. As an illustration, the example in paragraph 27 involves a loan that was transferred to a new intermediate company in exchange for promissory notes. The example concludes that the proposed provision would deny treaty benefits "if the facts of the case show that one of the main purposes" for transferring the loan was for the intermediate company to obtain treaty benefits with respect to the interest. However, the example does not come to a conclusion based on the stated facts. Moreover, it is not clear if the result would be different if the loan instead were transferred in exchange for an equity interest in the intermediate company. In other words, the reach, if any, of the proposed main purpose test beyond conduit type arrangements is not clear.

In this regard, it is important to remember that this main purpose test is being proposed in combination with a robust LOB provision. The Discussion Draft recognizes that the LOB provision "will address a large number of treaty shopping situations based on the legal nature, ownership in, and general activities of, residents" of a treaty country. Therefore, the main purpose test is intended to operate only as a form of backstop to the application of the LOB provision. The main purpose test is much too broad for the intended purpose of backstopping the recommended LOB provision and the specific aim of capturing certain conduit financing arrangements that might not be caught by the LOB provision. A much more narrowly targeted rule would be better suited to this objective.

While we appreciate the inclusion of an exception from the denial of treaty benefits for situations where "it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions" of the treaty, this exception is overly vague and subjective. The two examples illustrating this exception provide little guidance because there is no clear analysis or principles that support the conclusion that treaty benefits are available in those cases.

- The first positive example in paragraph 33 involves a decision to build a plant in a treaty country. The explanation focuses on the main purpose for building the plant which is related to business expansion and lower local manufacturing costs. However, these factors are true of all three countries under consideration for location of the plant and the company in the example chose the one country that had a treaty with the parent jurisdiction. The example cites the general treaty objective of encouraging cross-border investment as the rationale for concluding that the treaty benefits are appropriate.
- The second positive example in paragraph 33 involves a collective investment vehicle that holds dividend-paying investments in corporations in a country with which its home country has a treaty. The example here too cites the general treaty objective of encouraging cross-border investment and concludes that treaty benefits are appropriate unless the investment is part of an arrangement or relates to another transaction undertaken with a main purpose of obtaining treaty benefits.

These examples would be more useful if they included clearer guidance that could be extrapolated to other situations in order to evaluate the potential availability of the exception from the denial of treaty benefits.

If it is concluded that it is necessary to include a main purpose test as part of the recommended approach to addressing treaty abuse, we urge the OECD to make modifications to the test to make it more workable and to reduce the uncertainty that would be created by this subjective test. A formulation that looks to "the" main purpose instead of "one of the main purposes" would be easier to apply and would provide more certainty. In addition, the presence of active business operations of the group in either the residence country or the source

country should be a presumptive rebuttal of any main purpose inquiry. The inclusion of such an exception would help to reduce some of the subjectivity of the main purpose test.

The discussion of the treaty-based general anti-abuse provision in the Discussion Draft also in several places references the use of domestic law general anti-abuse rules to override treaties. We found this discussion especially troubling. Moreover, with the recommendation of an LOB provision in tandem with a treaty-based general anti-abuse rule, it appears that there could be situations where a transaction would have to run the gauntlet of the application of the LOB provision and the treaty-based general anti-abuse rule plus unilateral application of a domestic law general anti-abuse rule. We urge the OECD to take the opportunity to recommend unequivocally that anti-abuse rules with respect to tax treaty benefits must be included in the treaty itself.

Finally, the Discussion Draft recommends the use of targeted specific anti-abuse rules to address qualification for particular treaty benefits. In this regard, the Discussion Draft notes that although the main purpose test will address these situations, "targeted specific anti-abuse rules generally provide greater certainty for both taxpayers and tax administrations." We agree that more specific rules provide greater certainty than do more general rules.

We believe that the use of targeted specific anti-abuse rules that support particular treaty provisions is a better approach than the main purpose test. Such rules could be used to supplement and backstop the LOB provision which applies more generally. Indeed, such rules could be used to address the conduit financing arrangements that have been identified as the target of the main purpose test. We urge the OECD to consider replacing the recommendation for a treaty-based general anti-abuse rule with an approach that uses targeted specific anti-abuse rules in tandem with an appropriately crafted LOB provision.

One of the areas where a targeted specific rule is recommended is the determination of residence for treaty purposes in the case of dual-resident entities. The Discussion Draft proposes the elimination of the tie-breaker rule currently contained in the OECD model and its replacement with a rule that would require affirmative competent authority action. Under the proposed rule, a dual resident entity generally would not be entitled to any treaty benefits unless the competent authorities affirmatively agree to treat it as resident of one country or the other.

The question of residence is a fundamental one and most of the benefits of a treaty turn on it. Leaving a determination as to residence to the competent authorities does not seem practical or appropriate given the resource constraints of the competent authorities, the significant other responsibilities of such competent authorities, and the difficulties that competent authorities can have in reaching agreement.

The issues associated with reforming the current tie-breaker rule for treaty residence determinations are necessarily intertwined with Action 14 on improving the functioning of the mutual agreement procedure. We urge that potential modifications to the tie-breaker rule be separated from the work on addressing treaty abuse and instead be examined as part of the work on Action 14 where any modifications can be coupled with approaches designed to facilitate resolution by the competent authorities.

*****

If you have questions or would like further information regarding any of the points discussed above, please contact Barbara Angus (barbara.angus@ey.com), Jim Tobin (james.tobin@ey.com), or me (alex.postma@ey.com).

Yours sincerely
On behalf of EY

Alex Postma