

# Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups

**In this article, the author discusses treaty abuse in the Post-BEPS world and focuses on the practical impact of the Principal Purpose Test (PPT rule) for MNE groups. The article analyses in particular the meaning of substance under the PPT rule and the consequences of denial of treaty benefits.**

## 1. Introduction

7 June 2017 marked a turning point in the area of international taxation with the signing of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (“MLI”). The signing ceremony brought together 68 jurisdictions that agreed to introduce the tax treaty measures of the OECD/G20 Base Erosion and Profit Shifting (BEPS) initiative into their international tax policies. It is recognized that tax treaty abuse, which primarily affects source states, represents one of the most important BEPS concerns.<sup>1</sup> Accordingly, the outcome of OECD’s BEPS Final Report on Action 6 (“BEPS Action 6”), which has been transposed into part III of the MLI, is probably the item of the instrument that will have the most significant practical impact in future years.

After briefly reviewing the policy of tackling treaty abuse in the pre-BEPS era (*see* section 2.) and outlining the treaty measures provided under the MLI (*see* section 3.), the author focuses on the Principal Purpose Test (PPT rule) which serves as a minimum standard under the MLI and will be introduced in more than 1,100 tax treaties.<sup>2</sup> The author shows that states may not give to the PPT rule an interpretation that exceeds its OECD Commentaries, which, in the author’s view, represents binding

context under the Vienna Convention on the Law of Treaties (“VCLT”). Accordingly, he argues that the PPT rule should in essence be construed as a business reality test that applies to both abusive restructurings and conduit situations. As indicated by the OECD Commentaries, one of the key elements in deciding whether treaty benefits ought to be granted is whether an arrangement is “inextricably linked to a core commercial activity”.<sup>3</sup> The analysis thus focuses very much on substance, and transfer pricing principles may here be relied upon as guidance. That is, if the entity in the residence state exercises (respectively bears) the relevant functions and risks, it should be assumed that the arrangement is indeed linked to a core commercial activity.

Moreover, he shows that, when the PPT rule is applicable, a jurisdiction is not prevented from granting treaty benefits on the basis of a recharacterized fact pattern (for example, treaty benefits available before a restructuring) even if such jurisdiction has not opted for the discretionary relief mechanism provided by article 7(4) of the MLI. Furthermore, the author finds that, despite the use of the phrase “[n]otwithstanding any provisions of a Covered Tax Agreement”, the PPT rule may only come into play to the extent that the relevant factual situation is not covered by a specific treaty anti-avoidance rule (SAAR).

Finally, it is remarkable that BEPS Action 6 addresses conduit structures exclusively on the basis of the PPT rule (or an anti-conduit mechanism producing similar results) and makes no reference to the beneficial ownership concept in articles 10 to 12 of the 2014 OECD Model. In the author’s opinion, this is yet another confirmation that beneficial ownership is not an appropriate test to deal with conduit situations and should be construed restrictively pursuant to the 2014 OECD Commentaries. For this reason, he argues that states currently favouring a broad substance-oriented meaning of beneficial ownership coupled with the lack of a purpose test analysis should revisit this position. That is, the meaning of beneficial ownership should be aligned with its restrictive interpretation under the 2014 OECD Commentaries, and possible conduit situations should be examined pursuant to the PPT rule. This is because a broad and objective interpretation of beneficial ownership, which does not take into

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1. See A. Christians & S. Shay, *Assessing BEPS: Origins, Standards, and Responses*, General Report, 19 (IFA 2017).  
2. For another recent analysis of the PPT rule, *see also*, inter alia, V. Chand, *The Principal Purpose Test in the Multilateral Convention: An in-depth analysis*, 46 Intertax 1 (forthcoming 2018).

3. OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances - Action 6: Final Report* (OECD/G20 2015), International Organizations’ Documentation IBFD [hereinafter: *Action 6 Final Report*]; OECD Model Tax Convention on Income and on Capital: *Commentary on Article 29* para. 181 (21 Nov. 2017), Models IBFD.

consideration the intention of the taxpayer and focuses primarily on the criterion of economic interdependence, does not fully coincide with the analysis under the PPT rule. The PPT rule will indeed not simply apply because there is some sort of factual connection between the income received and the item paid to another person, but rather because the purpose of the transaction is abusive. Hence, as shown by the 2017 updated OECD Commentaries, the PPT rule will not apply where, despite the existence of such factual connection, the transaction is conforming to the standard commercial organization and behaviour of the group.

From a policy perspective, it is however unfortunate that the PPT rule has been drafted in such broad terms as its meaning becomes potentially very far-reaching as soon as it is detached from the 2017 updated OECD Commentaries. This may indeed lead to uncertainties and increased tax treaty disputes around the globe. Therefore, multinational enterprises will be well advised to ensure in advance and especially in the initial implementation phase that the scope that will be given to the PPT rule by the jurisdictions in which they operate coincides with the OECD interpretation.

## 2. Review of Selected Tax Treaty Anti-Avoidance Rules in the Pre-MLI World

### 2.1. Introductory remarks

Prior to moving to the responses of the MLI to treaty abuse, the author finds it appropriate to first review selected treaty anti-avoidance rules of the pre-BEPS era, notably the beneficial ownership requirement and the OECD guiding principle introduced in the 2003 OECD Commentaries. It would of course be beyond the scope of this article and unnecessary to discuss these well-known tests at length. However, a brief overview appears useful for at least three reasons. First of all, these rules will remain in place after the entry into force of the measures introduced by the MLI (in particular, the PPT rule). Accordingly, the question of the delineation of their respective scope will arise. Second, a presentation of the guiding principle is necessary since, according to the OECD, the PPT rule would merely represent a codification of this principle. Finally, once an anti-avoidance rule is found to be applicable, one issue that must be determined in practice is the consequences produced by the denial of treaty benefits.

### 2.2. Beneficial ownership as the initial response: Problems and limits

#### 2.2.1. Conflicting case law decisions

##### 2.2.1.1. Introductory remarks

It is fair to say that the beneficial ownership requirement, which was introduced in 1977 into the dividends,<sup>4</sup> interest<sup>5</sup> and royalties<sup>6</sup> articles, is seen by many states as the

4. OECD Income and Capital Model Convention art. 10(2) (11 Apr. 1977), Models IBFD [hereinafter: OECD Model (1977)].  
5. Id., at art. 11(2).  
6. Id., at art. 12(1).

initial response to treaty abuse. It is, of course, controversial whether beneficial ownership was initially introduced in the OECD Model for this purpose and, respectively, whether this requirement is really a genuine SAAR or merely a condition of application of these distributive rules. The fact remains, however, that the tax treaty practice of several countries – particularly those jurisdictions which construe beneficial ownership in a broad economic fashion<sup>7</sup> – relies on beneficial ownership to tackle treaty shopping situations. As will be shown in the following sections of this article, a broad economic interpretation of beneficial ownership does not necessarily equate the policy of BEPS Action 6, particularly when such policy is not combined with a principal purpose test.

The predominant view is that beneficial ownership should have an autonomous<sup>8</sup> and international fiscal meaning as noted, in particular, in the famous *Indofood* case;<sup>9</sup> the content of this meaning remains, however, heavily debated and controversial,<sup>10</sup> with, in essence, some jurisdictions adopting a rather formal and legal interpretation (see section 2.2.1.2.) and others favouring by contrast a broader substance-over-form approach (see section 2.2.1.3.).<sup>11</sup>

#### 2.2.1.2. Formal interpretation

An illustrative example of the formal interpretation of beneficial ownership is, of course, Canadian case law. In *Prévost*,<sup>12</sup> in particular, the Tax Court ruled in favour of the taxpayer and held that a Dutch company owned by Swedish and UK shareholders was the beneficial owner of Canadian-source dividends despite an obligation to distribute its profits to its shareholders pursuant to a shareholders' agreement. The court considered, inter alia, that the agreement did not impose any legal obligation on the Dutch entity.<sup>13</sup> Similarly, in *Velcro*,<sup>14</sup> beneficial ownership was upheld even though a company established

7. See sec. 2.2.1.3.  
8. This is the case where the context of art. 3(2) of the OECD Model requires a different interpretation. In this respect, see, among others, R. Danon, *Le concept de bénéficiaire effectif dans le cadre du MC OCDE: réflexions et analyse de la jurisprudence récente*, IFF Forum für Steuerrecht 2007 1, 38 et seq.  
9. *Indofood International Finance Ltd v. JP Morgan Chase Bank*, London branch, 2006, EWCA Civ 158.  
10. For a recent general scholarly contribution on the topic, see, in particular, A. Meindl-Ringler, *Beneficial Ownership in International Tax Law* (Wolters Kluwer 2016), and B. Baumgartner, *Das Konzept des beneficial owner im internationalen Steuerrecht der Schweiz* (Schulthess 2010).  
11. For recent reviews of national case law, see, in particular, Meindl-Ringler, *supra* n. 10, at 95 et seq.; R. Danon & Dinh, *La clause du bénéficiaire effectif*, in *Modèle de Convention fiscale OCDE concernant le revenu et la fortune* (Commentaire 2014) para. 121 et seq. (R. Danon et al. eds.) with regard to art. 1; and E. Kemmeren, *Preface to Articles 10 to 12*, in *Ekkehart Reimer & Alexander Rust, Klaus Vogel on Double Taxation Conventions* N 51 et seq. (4th ed., Kluwer Law International 2015).  
12. CA: TCC, 22 Apr. 2008, 231, *Prévost Car Inc. v. the Queen*, Tax Treaty Case Law IBFD.  
13. Id., para. 103.  
14. In this respect, see, among others, B. Arnold, *The Concept of Beneficial Ownership under Canadian Tax Treaties*, in *Beneficial Ownership: Recent Trends* 41 et seq. (M. Lang et al. eds., IBFD 2013), Online Books IBFD; A. Cockfield, *Tax Treaty Disputes in Canada*, in *A Global Analysis of Tax Treaty Disputes*, 146 et seq. (E. Baistrocchi ed., Cambridge University Press 2017); Danon & Dinh, *supra* n. 11, at para. 138 et seq. with regard to art. 1; and Meindl-Ringler, *supra* n. 10, at 225 et seq.

in the Netherlands was under the obligation to transfer approximately 90% of the royalties received to a company based in the Netherlands Antilles. The court focused in particular on the fact that the royalties were commingled with other funds of the Dutch entity.<sup>15</sup> In the Netherlands, the *Royal Dutch Oil Company* (“market maker case”) may also be regarded as a restrictive interpretation of beneficial ownership.<sup>16</sup> In this case, a UK resident stockbroker company, which had bought dividend coupons after the dividend had been declared but before it had been made payable, was considered the beneficial owner of this income.<sup>17</sup> Canadian<sup>18</sup> and Dutch scholars<sup>19</sup> recognize that these decisions establish a very low threshold for beneficial ownership that merely excludes agents, nominees and conduit companies with absolutely no discretion over the amounts received or compelled, on the basis of a legal obligation (and not merely factual circumstances), from transferring the income received to a non-resident. This interpretation is similar to that conveyed by the 2014 OECD Commentaries. This being said, a fact pattern such as the one submitted to the court in the market maker case also raises the question of the delineation between conduit situations on the one hand and abusive restructurings (i.e. the fact of assigning a right to a resident with a view to obtaining treaty benefits) on the other. While beneficial ownership is capable of addressing (some) conduit situations, it is by contrast quite clear that it does not cover situations in which treaty abuse is exclusively rooted in a last-minute restructuring. In fact, as will be seen in the following sections, in dealing with this fact pattern, the 2017 Commentaries to the PPT rule do not classify this situation as a conduit but rather as an abusive restructuring.

### 2.2.1.3. Substance-oriented interpretation

In other jurisdictions, beneficial ownership is by contrast construed on the basis of a substance-over-form analysis. In Switzerland, at least since the *Total Return Swap Case*, which was decided in 2015<sup>20</sup> and recently confirmed on numerous occasions,<sup>21</sup> this interpretation is clearly followed. In essence, Swiss case law defines beneficial own-

ership by reference to economic control and focuses on the criterion of interdependence between income and the obligation to transfer such income to non-residents on the basis of a legal arrangement or, more importantly in practice, simply factual circumstances.<sup>22</sup> The Federal Tribunal generally considers that economic control over the income received fails to exist where, on the basis of a legal or factual obligation, all or even just an essential portion of such income is being transferred to non-residents.<sup>23</sup> Moreover, Swiss case law draws a clear distinction between beneficial ownership and the general prohibition of abuse, which includes both an objective and a subjective element.<sup>24</sup> Accordingly, beneficial ownership ought to be construed in an objective manner and, therefore, does not incorporate any subjective element.<sup>25</sup> It consequently follows that the intention and motives that have led the taxpayer to select a particular arrangement or structure are irrelevant. In the same vein, the fact that a transfer of shares to a resident of a contracting state does not lead to a more favourable residual treaty rate than that initially applicable in the state of source was recently found to be irrelevant for the purpose of the beneficial ownership analysis.<sup>26</sup> In some decisions, however, a purpose-oriented analysis has been conducted against the taxpayer to confirm the absence of beneficial ownership.<sup>27</sup> This case law may thus lead to uncertainties where an economic interdependence exists between the funds but the arrangement nevertheless pursues a valid business purpose. As will be seen, from this perspective, Swiss case law is conceptually not in line with the policy of BEPS Action 6, which tackles conduit situations with a principal purpose test. In France, by contrast, the connection between beneficial ownership and the reservation of abuse (*fraude à la loi*) has been clearly established in the Bank of Scotland case.<sup>28</sup> The case concerned the sale by a US corporation to a UK bank, for a three-year period, of the usufruct of non-voting preferred shares issued by its wholly-owned French subsidiary. The UK bank acquired the usufruct by way of a one-off payment. The acquisition allowed the UK bank to receive in the three-year period a dividend whose amount was predetermined and guaranteed by the US corporation.<sup>29</sup> The *Conseil d'État* ruled that the UK bank was not the beneficial owner because,

15. CA: TCC 2 Apr. 2012, 57, *Velcro Canada Inc v. the Queen*, Tax Treaty Case Law IBFD. Para. 45 reads as follows: “[T]here was no pre-determined flow of funds. What there is is a contractual obligation by VHBV to pay to VIBV a certain amount of monies within a specified time frame. These monies are not necessarily identified as specific monies, they may be identified as a percentage of a certain amount received by VHBV from VCI, but there is no automated flow of specific monies because of the discretion of VHBV with respect to the use of these monies”.

16. NL: *Hoge Raad* (Supreme Court, HR), 6 Apr. 1994, no. 28 638 (commonly known as the “market maker case”), BNB 1994/217 and Tax Treaty Case Law IBFD.

17. Id.

18. Arnold, *supra* n. 14, at 49.

19. D.S. Smit, in *Beneficial Ownership: Recent Trends* 88 (M. Lang et al. eds., IBFD 2013).

20. CH: Federal Tribunal (FT), 5 May 2015, ATF 141 II 447; for a recent discussion of this case at an international level, see, in particular, R. Danon, *Tax Treaty Disputes in Switzerland*, in *A Global Analysis of Tax Treaty Disputes* 654 et seq. (E. Baistrocchi ed., 2017) O. Weidmann, *Swiss Swaps case*, 44 Intertax 8-9, 621 et seq. (2016).

21. CH: FT, 5 May 2015, 2C\_895/2012 (SMI Index future); CH: FT, 2 Oct. 2015, 2C\_383/2013 (single stock futures); CH: FT 22 Nov. 2015, 2C\_752/2014 (preferred equity certificates); see also CH: FT, 5 Apr. 2017, 2C\_964/2016.

22. Id.

23. *Swap Case*, *supra* n. 20, para. 5.2.4.

24. See, for example, CH: Federal Administrative Tribunal (FAT), 26 Aug. 2016, A-2902/2014, para. 4.3.3 (partially confirmed by FT judgment of 5 Apr. 2017, *supra* n. 21; Weidmann, *supra* n. 20, para. 4.5).

25. Id.

26. CH: FAT, 20 Dec. 2016, A-1426/2011, 5.3.2.3.

27. For example, in a case decided in 2014, the FAT held that, where the repositioning of an entity in the state of residence is regarded as abusive, there is a presumption that such entity may not be regarded as the beneficial owner (CH: FAT, 25 June 2014, A-4693/2013 (partially confirmed by CH: FT, 3 Dec. 2015, 2C\_753/2014) and A-4689/2013 (partially confirmed by CH: FT, 27 Nov. 2015, 2C\_752/2014), para. 8.4.). In a recent judgment, the FAT even referred to a purpose alien to treaty benefits, namely the objective to benefit from a favourable regime in Luxembourg (FAT judgment of 20 Dec. 2016, *supra* n. 26, at para. 5.2.2.3).

28. FR: *Conseil d'État* (CE), 29 Dec. 2006, No. 28314; see, among others, B. Gibert & Y. Ouamrane, *Beneficial Ownership – A French Perspective*, 48 Eur. Taxn. 1, 2 et seq. (2008); D. Gutmann, in M. Lang et al. (eds.), *supra* n. 14, at 167 et seq.; Danon & Dinh, *supra* n. 11, at para. 134 et seq. with regard to art. 1; Meindl-Ringler, *supra* n. 10, at 235 et seq.

29. Gibert & Ouamrane, *supra*, at 7.

in essence, (i) the sale of the usufruct was a disguised loan made by the UK bank to the US corporation, with the French subsidiary reimbursing the loan to the UK bank for its parent company through the payment of dividends; and, applying the reservation of abuse in the analysis, (ii) the temporary cession of the usufruct in respect of non-voting preferred shares was an arrangement made with the only intention of obtaining treaty benefits.<sup>30</sup> As was observed in relation to the market maker case,<sup>31</sup> however, it is controversial whether this second element falls within the scope of beneficial ownership, even when construed broadly. Similarly, in Spain, in the Real Madrid cases,<sup>32</sup> the notion of abuse was also relied upon to justify a broad meaning of beneficial ownership. In the United Kingdom, the broad meaning given to beneficial ownership in the *Indofood* decision<sup>33</sup> also gave rise to uncertainties, for example in the field of capital market transactions involving SPVs.<sup>34</sup> In its guidance, HM Revenue & Customs thus referred to the notion of abuse, but rather in order to carve out the application of beneficial ownership in *bona fide* situations: “Where there is no abuse ... there is no need, in practice, to apply the international fiscal meaning of beneficial ownership”.<sup>35</sup> Based in particular on the *Bank of Scotland* decision, some commentators, in the same vein, have argued that an intentional element should form part of the beneficial ownership analysis.<sup>36</sup> While desirable from a policy perspective, however, this approach is unsatisfactory because building a purpose test into beneficial ownership is at odds with its literal wording. By contrast, as will be seen, this shortcoming may be overcome by the PPT rule, provided, of course, that it is correctly construed.

It is not the purpose of this article to revisit the case law on beneficial ownership around the globe,<sup>37</sup> but simply to emphasize again the different meaning given to the term across jurisdictions, despite the evolution of the OECD Commentaries, upon which the author will now focus.

## 2.2.2. Evolution of the OECD commentaries

### 2.2.2.1. Uncertainties raised by the 1977 and 2003 Commentaries

When it was introduced into the OECD Model in 1977, beneficial ownership was essentially meant to deny treaty

benefits to agents and nominees.<sup>38</sup> However, the *Double Taxation Conventions and the Use of Conduit Companies* report published by the OECD in 1986<sup>39</sup> resulted in amendments to the 2003 Commentaries to articles 10, 11 and 12 clarifying that:

[a] conduit company cannot 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.<sup>40</sup>

The 2003 update to the OECD Commentaries then added confusion to the meaning of beneficial ownership by stating that the term should not be:

used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.<sup>41</sup>

### 2.2.2.2. Narrowing of beneficial ownership in the 2014 Commentaries

The 2014 Commentaries may be regarded as lowering, once again, the threshold of beneficial ownership<sup>42</sup> and bringing the expression close to its original meaning. This intention is suggested by a number of passages of the 2014 Commentaries, as well as by the context in which they were adopted. First of all, the 2014 OECD Commentaries state that:

[t]he term “beneficial owner” is intended to address difficulties arising from the use of the words “paid to” in relation to dividends rather than difficulties related to the ownership of the shares of the company paying these dividends.<sup>43</sup>

Second, the denial of the quality of beneficial owner to the recipient on the ground that the income is being forwarded seems to be limited to cases in which such income, based on legal documents or facts and circumstances, is “constrained by a contractual or legal obligation” to pass on the payment received to another person.<sup>44</sup> This definition embodies a subtle but important difference if compared with a pure substance-over-form approach of beneficial ownership such as that which is currently favoured under Swiss case law. That is, under this case law, the existence of an obligation to transfer the income received may stem from a legal arrangement or simply from the facts.

30. Id.  
31. Case no. 28 638, *supra* n. 16.  
32. See A.M. Jiménez, in M. Lang et al. (eds.), *supra* n. 14, at 127 et seq.  
33. See *supra* n. 9.  
34. INTM332060, N 2; P. Baker, *United Kingdom: Indofood International Finance Ltd v. JP Morgan Chase Bank NA*, in M. Lang et al. (eds.), *supra* n. 14, at 27 et seq.  
35. INTM332060, N 2.  
36. See, in particular, Gutmann, *supra* n. 28, at 171-172, militating in favour of including an intentional element into beneficial ownership.  
37. The meaning of beneficial ownership is currently capturing attention at EU level further to several pending Danish cases before the ECJ raising the question of the meaning of beneficial ownership under EU direct tax directives and the relationship of this meaning with that under the OECD Commentaries. On beneficial ownership of interest, see C-115/16, C-118/16, C-119/16, C-299/16 and C-682/16, and on beneficial ownership of dividends, see C-116/16 and C-117/16.

38. *OECD Model Tax Convention on Income and on Capital: Commentary on Articles 10* para. 12 (28 Jan. 2003), Models IBFD; *OECD Model: Commentary on Article 12* para. 4 (1977).  
39. See OECD, *Double Taxation Conventions and the Use of Conduit Companies*, adopted by the OECD Council on 27 Nov. 1986, N 14.  
40. OECD, *2002 Reports Related to the OECD Model Tax Convention*, Part I. Restricting the Entitlement to Treaty Benefits, 27 (OECD, May 2003) [hereinafter: *OECD Model 2002 Reports*]; *OECD Model Commentary on Article 10* para. 12.1 (2003); Id., *Commentary on Article 11* para. 8.1; Id., *Commentary on Article 12* para. 4.1.  
41. *OECD Model 2002 Reports*, *supra*, at 26; *OECD Model: Commentary on Article 10* para. 12 (2003); Id., *Commentary on Article 11* para. 8; Id., *Commentary on Article 12* para. 4.  
42. Danon & Dinh, *supra* n. 11, at para. 142 with regard to art. 1. In the same vein, among others, A. Wardzynski, *The 2014 Update to the OECD Commentary: A Targeted Hybrid Approach to Beneficial Ownership*, 43 *Intertax* 2, 190 (2015).  
43. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 10* para. 2 (26 July 2014), Models IBFD.  
44. Id.

Under the 2014 Commentaries, by contrast, the facts may only serve as a tool to prove the existence of a legal or contractual obligation.<sup>45</sup> Accordingly, if the recipient of the income “does have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person the recipient is the ‘beneficial owner’”.<sup>46</sup> Moreover, the 2014 OECD Commentaries state that:

this type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions, or typical distribution obligations of pension schemes and of collective investment vehicles...<sup>47</sup>

and further, that:

whilst the concept of “beneficial owner” deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.<sup>48</sup>

Finally, the idea that the threshold of the beneficial ownership requirement has been reduced also flows from the context surrounding the foregoing amendments. Indeed, in the field of arrangements involving financial institutions, in particular, it was found that a definition of beneficial ownership that is overly broad could have unintended effects on certain transactions pursuing legitimate purposes.<sup>49</sup>

While the foregoing statement may be interpreted to mean that beneficial ownership is a test that is only capable of addressing conduit situations as opposed to abusive restructurings, the foregoing passage may also be construed to suggest that, as it is put into effect by the 2014 OECD Commentaries, beneficial ownership is of very limited use in conduit situations.

### 2.2.3. Confirmation of the 2014 policy by BEPS Action 6

In the author’s view, some support for this latter interpretation may be found in BEPS Action 6. First of all, in relation to article 29 of the 2017 update to the OECD Model, the new Commentaries state that the PPT rule covers:

limitations on the taxing rights of a Contracting State in respect of dividends, interest or royalties arising in that State, and paid to a resident of the other State (who is the beneficial owner) under Article 10, 11 or 12.<sup>50</sup>

The new Commentaries to articles 10, 11 and 12 also mirror this policy:

The provisions of article 29 and the principles put forward ... will apply to prevent abuses, including treaty shopping situ-

ations where the recipient is the beneficial owner of the dividends.<sup>51</sup>

These passages thus confirm that the PPT rule would apply in a situation in which beneficial ownership is upheld, which could be read to suggest that beneficial ownership does not cover all conduit cases as it is to be construed restrictively in accordance with the 2014 OECD Commentaries. Second, in accordance with BEPS Action 6, the MLI and the 2017 updated OECD Commentaries provide, as will be discussed, that states wishing to opt out of including the PPT rule in order to favour an LOB clause are to supplement such clause with specific rules to address conduit structures. BEPS Action 6 and the 2017 updated OECD Commentaries stipulate that:

[t]hese rules would deal with such conduit arrangements by denying the benefits of the provisions of the Convention, or of some of them (e.g. those of Articles 7, 10, 11, 12 and 21), in respect of any income obtained under, or as part of, a conduit arrangement. They could also take the form of domestic anti-abuse rules or judicial doctrines that would achieve a similar result.<sup>52</sup>

The new Commentaries also contain a number of examples<sup>53</sup> highlighting the function and scope of such rules. These examples are also applicable to the PPT rule. Illustrative in this respect is example C.<sup>54</sup> In this example, TCO is a company resident in state T, which does not have a tax treaty with state S, and loans 1,000,000 to SCO, a company resident in state S that is a wholly-owned subsidiary of TCO, in exchange for a note issued by SCO. TCO later realizes that it can avoid the withholding tax on interest levied by state S by assigning the note to its wholly-owned subsidiary RCO, a resident of state R (the treaty between states R and S does not allow source taxation of interest in certain circumstances). Therefore, TCO assigns the note to RCO in exchange for a note issued by RCO to TCO. The note issued by SCO bears interest at 7% and the note issued by RCO bears interest at 6%. The 2017 updated OECD Commentaries note that:

[t]he transaction through which RCO acquired the note issued by SCO constitutes a conduit arrangement because it was structured to eliminate the withholding tax that TCO would otherwise have paid to State S.<sup>55</sup>

It is remarkable that the final report on BEPS Action 6 does not contain any reference to the possibility of relying on the beneficial ownership concept in articles 10, 11 and 12 of the OECD Model to address these conduit situations. In the author’s opinion, the fact that these cases fall within the scope of the PPT rule and, respectively, the principles dealing with conduit arrangements as regards states not wishing to apply the PPT rule, is a further indication that beneficial ownership should now be understood in a restrictive manner and that it is ineffective in dealing with most modern conduit situations.<sup>56</sup> The structure of

45. In the same vein, Kemmeren, *supra* n. 11; Weidmann, *supra* n. 20, at 231.  
46. OECD Model: *Commentary on Article 10* para. 12.4 (2014).  
47. Id., at para. 2.  
48. Id.  
49. See Danon, *supra* n. 20, at 656.  
50. Action 6 Final Report, at 65-66; 2017 Update to OECD Model Tax Convention on Income and on Capital: *Commentary on Article 29* para. 175 (21 Nov. 2017).

51. Id., *Commentary on Article 10* para. 12.5.  
52. OECD, *supra* n. 3, 65-66, OECD Model: *Commentary on Article 29* para. 187.  
53. OECD, *supra* n. 3, 66 and 69, OECD Model: *Commentary on Article 29* para. 187.  
54. OECD, *supra* n. 3, 66-67, OECD Model: *Commentary on Article 29* para. 187.  
55. Id.  
56. See also Action 6 Final Report, at 18.

the 2017 OECD Model also confirms this interpretation. Indeed, article 29 (entitlement to benefits) is to be applied after the distributive rules. Accordingly, if conduit structures were caught by beneficial ownership, the need to resort to article 29 would not arise (systematic argument).

As will be shown, the policy of BEPS Action 6 also implies that even if a state, contrary to the OECD approach, attaches a broad substance-oriented but objective meaning to beneficial ownership, conduit arrangements must nevertheless be tackled by the PPT rule or, if an LOB is favoured, by distinct rules relating to conduit structures framed in accordance with the new OECD Commentaries and achieving a similar result. This is because a broad but objective interpretation of beneficial ownership in conduit situations may not necessarily be equated to the PPT rule, which allows, in addition, the purpose of the arrangement to be taken into account.

#### 2.2.4. *Synthesis*

The outcome of BEPS Action 6 confirms that, in line with the 2014 OECD Commentaries, beneficial ownership must be construed narrowly. That is, the term only excludes from the scope of treaty benefits persons acting as agents, nominees or, more broadly, those that are constrained by a *contractual* or *legal* obligation to pass on the payment received to another person. By contrast, beneficial ownership does not deal with conduit situations involving merely a factual or functional connection between the income received and the item paid out. The current tax treaty practice of several jurisdictions, however, departs from this formal interpretation and construes beneficial ownership to include those conduit situations involving a mere economic and functional connection between the streams of income. Yet, the need to include an intentional element or purpose test in the analysis then becomes controversial as this subjective component is at odds with the literal meaning of beneficial ownership. The second problem is that, even if it is construed broadly, beneficial ownership is not capable of dealing with cases in which a potential abuse stems from the mere assignment of rights to a resident. For these reasons, the evolution of tax treaty policy gradually led to an increased focus on general anti-avoidance rules (GAARs) with, in particular, the insertion of a guiding principle in the 2003 OECD Commentaries.

### 2.3. Increased focus on GAARs

#### 2.3.1. *In general*

A second approach to tackle treaty abuse is, of course, to rely on a GAAR, whether of a treaty or domestic nature. The question of whether domestic anti-avoidance measures may be reconciled with tax treaty obligations is, however, highly debated<sup>57</sup> and may also be approached

57. S. van Weeghel, *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions* 25 (IBFD 2010); B. Arnold & S. van Weeghel, *The Relationship between Tax Treaties and Domestic Anti-Abuse Measures*, in *Tax Treaties and Domestic Law* Vol. 2, 89 et seq. (G. Maisto ed., IBFD 2006), Online Books IBFD; L. de Broe, *International Tax Planning and Prevention of Abuse* 403 et seq. (IBFD 2008).

from the perspective of treaty override.<sup>58</sup> In 2003, the OECD Commentaries were amended in an attempt to deal with the problem. The approach taken at the time, which is useful to summarize briefly hereafter, relies on two pillars. First, for the purpose of denying treaty benefits in the case of abuse, states may alternatively choose to rely on their domestic anti-avoidance rules (*see* section 2.3.2.1.) or on the principle of good faith enshrined in article 31 of the VCLT in the sense of an unwritten prohibition of abuse (*see* section 2.3.2.2.). In other words, the prevention of abuse may have a domestic or treaty foundation. Second and more importantly, the 2003 update introduces a “guiding principle” that states should observe when deciding to refuse treaty benefits. As will be shown, the nature of this guiding principle is unclear. Furthermore, it is fair to say that the 2003 update of the Commentaries has not resolved but rather continued to exacerbate the tension between domestic anti-avoidance rules and treaty obligations.<sup>59</sup> Hence, within the framework of BEPS Action 6, the OECD response to these tensions was precisely to move the guiding principle from its Commentaries to the OECD Model itself in the form of a PPT rule.

#### 2.3.2. *Position of the OECD Commentaries*

##### 2.3.2.1. *Compatibility of domestic anti-avoidance rules with tax treaties*

The analysis of the compatibility of domestic anti-avoidance rules with tax treaties would deserve a study of its own and is outside the scope of the present contribution. Thus, it may be simply observed that the 2003 OECD Commentaries address the compatibility of domestic anti-avoidance rules (for example, rules based on “substance over form”, “economic substance” and other general anti-abuse rules) and arrives at the conclusion that these rules do not conflict with treaty obligations.<sup>60</sup> In essence, this reasoning is based on the idea that such rules are part of the basic principles set by domestic tax laws for determining which facts give rise to a tax liability. These rules are thus not addressed in tax treaties and are, according to the OECD, therefore not affected by them.<sup>61</sup>

This position was already controversial in 2003, so that it led several states to formulate observations on it, notably Ireland,<sup>62</sup> Luxembourg,<sup>63</sup> the Netherlands<sup>64</sup> and Switzerland.<sup>65</sup> Switzerland, in particular, observed that:

domestic tax rules on abuse of tax conventions must conform to the general provisions of tax conventions, especially where the convention itself includes provisions intended to prevent its abuse ....<sup>66</sup>

In fact, the language used by the 2003 Commentaries suggests that the position of the OECD is not really a reso-

58. C. de Pietro, *Tax Treaty Override* 107 (Wolters Kluwer 2014).

59. Van Weeghel, *supra* n. 57, at 25; Arnold & van Weeghel, *supra* n. 57, at 89 et seq.; De Broe, *supra* n. 57, at 403 et seq.

60. *OECD Model: Commentary on Article 1* paras. 9.2 and 22 (2003).

61. *Id.*, at paras. 9.2 and 22.1.

62. *Id.*, at para. 27.5.

63. *Id.*, at para. 27.6.

64. *Id.*, at para. 27.7.

65. *Id.*, at para. 27.9.

66. *Id.*, at paras. 9.2 and 22.1.

lute stance. First of all, as will be shown, the application of domestic anti-avoidance is not unlimited. Rather, the scope of these rules seems to be limited by the guiding principle. Second, the OECD Commentaries nuance the position taken by noting that:

[w]hilst these rules do not conflict with tax conventions, there is agreement that member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused.<sup>67</sup>

In light of the foregoing, it seems logical that the OECD would have seized the opportunity provided by the BEPS initiative to firmly advocate a policy that, on the one hand, gives GAARs a treaty foundation and, on the other hand, switches off the application of domestic anti-avoidance in a treaty context. While the first objective was accomplished with the PPT rule, the principle that domestic anti-avoidance rules do not conflict with tax treaties remains unchanged. Rather, the 2017 updated OECD Commentaries elegantly try to reconcile domestic anti-avoidance rules with the PPT rule. In this context, the PPT rule is then assigned the function of limiting, if necessary, the scope and effect of domestic anti-avoidance rules to the extent that these rules will not be compatible with the new treaty GAAR.<sup>68</sup> With a view to keeping this article within manageable proportions, this latter issue will not be discussed further. Rather, the author focuses exclusively on the interaction between the PTT rule and specific treaty SAARs.

### 2.3.2.2. *The unwritten prohibition of abuse*

The second option referred to by the 2003 OECD Commentaries, which is favoured by some countries, relies on the object and purpose of tax conventions as well as the obligation to interpret them in good faith pursuant to article 31 of the VCLT.<sup>69</sup> In this respect, the OECD Commentaries note that:

[o]ther States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions.<sup>70</sup>

This second approach acknowledges the idea, which is supported by some commentators, that the application of tax treaties is subject to an unwritten prohibition of abuse. In the well-known ApS case, the Swiss Supreme Court endorsed a similar reasoning.<sup>71</sup> The Federal Tribunal defined this concept by referring to the “look-through”, “bona fide” and “activity” provisions suggested by the 2014 Commentaries.<sup>72</sup> It must certainly be acknowledged

that the bona fide clause resembles the guiding principle described below in the sense that it is also based on a purpose test:

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 do not have as primary purpose the obtaining of any benefits under this Convention.<sup>73</sup>

However, as the author has argued,<sup>74</sup> these provisions are merely drafting suggestions that states may decide to incorporate into their tax treaties. Accordingly, it is not possible to define a general and unwritten prohibition of abuse on the basis of specific drafting suggestions. Rather, for the purpose of determining what constitutes an abuse, the Federal Tribunal should have referred to the guiding principle addressed in the next section.

### 2.3.2.3. *The guiding principle*

As referred to earlier, in 2003, a “guiding principle” was introduced in the OECD Commentaries in order to tackle treaty abuse. Subsequently, the 2014 Commentaries provide that:

[i]t is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. 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.<sup>75</sup>

The guiding principle incorporates a subjective (“a main purpose”) and objective (“more favourable tax position”) requirement. According to the OECD, the PPT rule merely represents a codification of this guiding principle, as will be discussed. Thus, the conditions of the guiding principle will be discussed and compared with those of the PPT rule.

The nature and function of the guiding principle under the 2003 OECD Commentaries is controversial. A first possibility is to consider that the guiding principle is in fact a treaty GAAR. A second possibility is to consider, by contrast, that the guiding principle represents a general standard which states are required to comply with when denying treaty benefits on the basis of a domestic or a treaty GAAR. This second interpretation flows from the structure of the 2003 OECD Commentaries to Article 1 of the OECD Model. Indeed, the denial of treaty benefits on the basis of domestic or treaty principles is discussed respectively under paragraphs 9.2 and 9.3 of the

67. Id., at para. 22.2.

68. *Action 6 Final Report*, at 82 et seq.; *OECD Model: Commentary on Article 1* para. 74 (2017).

69. *OECD Model: Commentary on Article 1* para. 9.3 (2003).

70. Id.

71. CH: FT, 28 Nov. 2005, 2A.239/2005.

72. *OECD Model: Commentary on Article 1* para. 13 et seq. (2014); indeed, the FT stated as follows: “Wenn es im Abkommen – wie hier – an einer ausdrücklichen Missbrauchsregelung fehlt, ist ein Abkommensmissbrauch gestützt auf die Transparenzklausel jedoch nur dann anzuneh-

men, wenn die betreffende (dänische) Gesellschaft zusätzlich keine echten wirtschaftlichen bzw. aktiven Geschäftstätigkeiten ausübt”. (see OECD, *supra* n. 69, at para. 3.6.3.).

73. *OECD Model: Commentary on Article 1* para. 19 (2014).

74. R. Danon, *Le concept de bénéficiaire effectif dans le cadre du MC OCDE: Réflexions et analyse de la jurisprudence récente*, IFF Forum für Steuerrecht 1, 38 et seq. (2007).

75. *OECD Model: Commentary on Article 1* para. 9.5 (2014).

2003 Commentary to Article 1. Paragraph 9.4 then goes on to say that:

[u]nder both approaches, therefore, it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.

Finally, paragraph 9.5 of the 2013 Commentary to Article 1 of the OECD Model sets out the guiding principle, which clearly suggests that it represents a general limitation to both approaches. From this perspective, the approach followed by paragraph 9.5 is similar to that favoured by the 2010 OECD Commentaries in relation to article 15(2)(b) of the OECD Model.<sup>76</sup> Indeed, while the 2010 Commentaries update allows the state of source to apply its own domestic tax definition of employment income to deny the application of article 15(2) of the 2014 OECD Model,<sup>77</sup> the Commentaries contain several principles designed to distinguish a contract for services from an employment relationship. Similar to the guiding principle, these criteria represent a “maximum standard” under which the state of source could deny the application of article 15(2) of the 2014 OECD Model. This maximum standard may be used, in particular in the context of a mutual agreement procedure.<sup>78</sup>

By contrast, the PPT rule introduced by BEPS Action 6 and the MLI represents, of course, a genuine treaty GAAR. As a matter of fact, the 2017 updated OECD Commentaries now even seem to equate the guiding principle to the PPT rule in the sense that where the applicable tax treaty does not contain such a rule, benefits could be directly denied on the basis of the guiding principle.<sup>79</sup> However, given the introduction of the PPT rule in the text of the 2017 OECD Model and in numerous tax treaties further to the BEPS outcome, the question of the status and function of the guiding principle will obviously be less important.

The OECD Commentaries do not expressly address the impact of domestic and treaty GAARs on conduit and abusive restructuring cases. It is, however, quite clear that these rules have a broader scope than beneficial ownership and would thus not only come into play in a (limited) conduit but also in other fact patterns. For example, a treaty GAAR complying with the guiding principle may be used to deny the application of a more favourable distributive rule (for instance, a lower residual withholding tax on dividends) in the context of a rule shopping case.

This being said, where a treaty SAAR is already applicable to a given factual situation, the question arises as to whether a more general treaty anti-avoidance rule may still be applied to the same factual situation. The answer to this question under the 2014 OECD Commentaries is discussed in section 2.3.3. with a view to contrasting it,

76. For a recent discussion, see, for example, R. Danon, *La notion d'employeur au sens de l'art. 15(2)(b) MC OCDE. Analyse critique du commentaire OCDE et impact sur les CDI suisses*, IFF Forum für Steuerrecht, 89 et seq. (2012).

77. This would typically concern states defining “employment income” by reference to a substance-over-form approach.

78. *OECD Model: Commentary on Article 15* para. 8.12 (2010).

79. *OECD Model: Commentary on Article 1* para. 61 (2017).

at a later stage, with the approach favoured in relation to the PPT rule.

### 2.3.3. Relation between treaty SAARs and GAARs

The author now turns to the last problem that he would like to discuss in relation to treaty abuse in the pre-BEPS era, namely the relation between treaty SAARs and GAARs. The issue is not specifically addressed by the OECD Commentaries. However, it flows from the OECD Commentaries that the OECD clearly considers that specific and general anti-avoidance rules complement each other with states being encouraged to resort to both measures. Hence, paragraph 9.6 of the Commentaries to article 1 states that:

[t]he potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy.

In a second interesting statement, which has already been mentioned, the 2014 Commentaries acknowledge that the scope of beneficial ownership is by essence limited and therefore may not cover all fact patterns leading to treaty abuse:

[W]hilst the concept of “beneficial owner” deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.<sup>80</sup>

In the author’s opinion, the issue becomes relevant where a specific and a general anti-avoidance rule are potentially applicable to the same fact pattern.<sup>81</sup> Suppose that the dividend article of the applicable tax treaty contains a holding period requirement (SAAR) designed to prevent abusive share transfers. Assume as a second example that a state construes the beneficial ownership requirement broadly (such as Switzerland for instance) and applies such test to deny treaty benefits in conduit situations. Would a domestic or treaty GAAR still be applicable to the same fact pattern in these two instances, namely the abusive restructuring and the conduit situation?

I have argued elsewhere that the problem should be settled pursuant to the *lex specialis derogat legi generali* principle. Accordingly, to the extent that the SAAR covers the factual situation at issue, the latter may not, in addition, be tested in light of a GAAR. Therefore, under this line of reasoning, the application of a GAAR is only of a subsidiary nature.<sup>82</sup> In Switzerland, the Federal Administrative

80. *OECD Model: Commentary on Article 10* para. 2 (2014).

81. See Danon, *supra* n. 8, at 49 et seq.

82. *Id.*; see also, previously in the same vein, D. Ward, *Abuse of Tax Treaties* 184 (Kluwer Law Online 1995): “One consequence, however, is that where a general anti-abuse provision has been written into a treaty, it may not be possible to imply that the parties intended the continued application of any ... other anti-abuse rule that might, in due course, receive international acceptance”; of the same opinion, see L. de Broe & E. von Frenckell, *La notion de “bénéficiaire effectif”*, 81 *Archiv für*



Tribunal expressly endorsed this opinion in judgments of 25 June 2014.<sup>83</sup> As a matter of fact, the Federal Tribunal had already gone in the same direction – albeit without exploring the consequences of this reasoning – in a judgment of 2006 holding that a treaty GAAR could only come into play “en l’absence de normes spéciales”.<sup>84</sup> This position is the most compatible with article 31 et seq. of the VCLT. First of all, it is in line with the literal interpretation, which, in the field of tax treaty interpretation, is of predominant importance as the text is generally deemed to reflect the common intention of the parties. Accordingly, if the parties have agreed to tackle a specific fact pattern using a SAAR, it must be considered that the same factual situation may not fall within the scope of a GAAR (literal argument). Second, if a fact pattern covered by a SAAR could also be reviewed in light of a GAAR, the SAAR would become meaningless and would have no scope of its own (systematic interpretation).<sup>85</sup> It must, however, be pointed out that the scope of the SAAR should be clearly ascertained. Hence, if a state favours a restrictive interpretation of beneficial ownership in line with the 2014 OECD Commentaries with the result that this notion only targets some blatant conduit arrangements, it goes

without saying that the GAAR would remain applicable to the more sophisticated conduit situations.

This being said, with the general introduction of the PPT rule in tax treaties, the question will arise as to whether the foregoing reasoning will be able to be maintained in the post-BEPS world. As will be shown, the PPT rule applies indeed “[n]otwithstanding any provisions of a Covered Tax Agreement”. This language could therefore militate in favour of a cumulative application of SAARs and GAARs to the same factual situation. However, as the author will demonstrate, the foregoing position remains, in essence, valid if the PPT rule is properly construed and its 2017 updated OECD Commentaries are contextually taken into account.

The author now moves to the BEPS responses to treaty abuse, beginning with a general overview of the measures stemming from BEPS Action 6 and then distinguishing between minimum standards (*see* section 3.2.), on the one hand, and recommendations (*see* section 3.3.), on the other. The author then focusses on the PPT rule (*see* section 4.).

### 3. Overview of the BEPS Responses to Treaty Abuse

#### 3.1. Introductory remarks

As previously stated, the BEPS responses to treaty abuse have been laid down in part III of the MLI. In line with the outcome of BEPS Action 6, the MLI distinguishes, however, between minimum standards and those provisions that states may choose to apply (opt-in) or not to apply (opt-out).

#### 3.2. Minimum standards

##### 3.2.1. Amendment to the preamble text

The minimum standards that jurisdictions are required to include in their tax treaties (through the MLI or bilaterally on the basis of an amending protocol) are the following:

To begin, an express statement amending the preamble text of tax treaties states the following:

Intending to eliminate double taxation with respect to the taxes covered by this agreement 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 agreement for the indirect benefit of residents of third jurisdictions).<sup>86</sup>

Pursuant to the compatibility clause of article 6(2) of the MLI, this text will then be included in the CTAs in lieu of or in the absence of an identical preamble language. In addition, the parties may choose to include the following language: “Desiring to further develop their economic relationship and to enhance their co-operation in

Schweizerisches Abgaberecht 5, 287-288 (2012/2013); M. Lang, *BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties*, 658 *Tax Notes Int'l* (2014), illustrates this reasoning using a good example: “if, for example, the immovable property clause of art. 13 (4) of the OECD Model covers the alienation of shares ‘deriving more than 50 per cent of their value directly or indirectly from immovable property’, it is hard to understand why the general anti-abuse rule should in some cases reduce the percentage to 50 percent or less”; A.B. Moreno, *GAARs and Treaties: From the Guiding Principle to the Principal Purpose Test. What Have We Gained from BEPS Action 6* p.440 (Kluwer Law Online 2017).

83. CH: FAT, 25 June 2014, A-4693/2013 (partially confirmed by CH: FT, 3 Dec. 2015, 2C\_753/2014) and A-4689/2013 (partially confirmed by CH: FT, 27 Nov. 2015, 2C\_752/2014), para. 7.6:

Dans tous les cas, l’interdiction (générale et implicite) de l’abus de droit (au sens d’utilisation abusive d’une convention) ne saurait être invoquée lorsque l’état de fait litigieux est déjà soumis à un dispositif anti-abus spécifique par la convention concernée elle-même (par exemple la règle sur le bénéficiaire effectif; cf. R. Danon, in: IFF 2007/1, p. 49). Si tel est le cas, ce volet du litige ne pourra plus être réexaminé à la lumière de l’interdiction de l’abus de droit. L’application de ce concept général dans ce cadre priverait en effet le dispositif anti-abus spécifique de toute portée et ne serait pas compatible avec le principe de l’interprétation littérale des conventions. En revanche, la réserve générale de l’abus de droit demeure applicable, à titre subsidiaire, aux autres composantes de l’état de fait (par exemple parce qu’une société, pourtant bénéficiaire effectif d’un revenu, a été intercalée dans le seul but de contourner l’impôt). Ce raisonnement s’applique aussi lorsque le dispositif anti-abus du droit international est implicite, comme cela arrive parfois avec la règle du bénéficiaire effectif (sur tout ce sujet et avec des exemples, cf. R. Danon, in: IFF 2007/1, p. 51).

Hence, under this case law, where a fact pattern falls within the scope of a SAAR, the GAAR may not be applied to the same fact pattern. The existence of abuse under the GAAR may, however, constitute a factual indication that the conditions laid down by the SAAR are satisfied and that treaty benefits should be denied (same judgments, para. 8.4):

Toutefois, et bien qu’il ne faille pas confondre la notion d’abus de droit et celle de bénéficiaire effectif (cf. consid. 6.6 et 7.6 ci-dessus), ces arguments peuvent servir d’indices complémentaires pour confirmer le fait que la recourante ne revêt pas la qualité de bénéficiaire effectif du dividende. En effet, lorsque l’intercalation d’une société constitue un abus de droit, il y a tout lieu de présumer que celle-ci ne sera pas non plus le bénéficiaire effectif de ses revenus. Il se justifie donc d’examiner, par surabondance de motifs, la problématique de l’abus de droit.

84. CH: FT, 4 Apr. 2006, 2A.416/2005, para. 4.2.

85. Danon, *supra* n. 8, at 49 et seq.

86. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* art. 6(1) (24 Nov. 2016), Treaties IBFD (hereinafter: “MLI”); OECD, *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, para. 75 et seq. (24 Nov. 2016), Treaties IBFD [hereinafter: *Explanatory Statement*].

tax matters”.<sup>87</sup> Because, under article 31(2) of the VCLT, the context of a treaty includes its preamble, BEPS Action 6 notes that the foregoing statement and objectives ought to be taken into account when interpreting and applying the provisions of the relevant tax treaty.<sup>88</sup> According to the OECD, this holds true in particular as regards the interpretation of the PPT rule. However, certain authors rightly submit that this line of reasoning should not be blown out of proportion. In particular, the fact that the prevention of tax avoidance is now listed among the objectives of the OECD Model does not mean that a treaty must at any rate be construed so as to achieve that objective. The treaty’s object and purpose is only one of the elements that need to be considered for interpretation purposes and it cannot override its clear substantive provisions.<sup>89</sup> In the author’s opinion, the following distinctions should be made. First of all, although in the future it will be clear from the preamble of tax treaties that the latter should not be used to create double non-taxation, their primary objective will continue to be the avoidance of double taxation. Accordingly, this hierarchy may not be ignored in the interpretative process. Second and most importantly, the objectives in the preamble should not be used to deny treaty benefits beyond the text or the scope of the potentially applicable treaty anti-avoidance provision. However, on this latter point, the PPT rule raises problems. Indeed, while the objective criterion of the rule requires an analysis to be made in light of the “object and purpose of the relevant provisions of the Covered Tax Agreement”,<sup>90</sup> in most instances, “the object and purpose of the tax convention”<sup>91</sup> is relied upon instead because it generally appears difficult to assign a particular objective to the applicable treaty rule.

### 3.2.2. Introduction of a PPT rule or LOB clause with anti-conduit mechanism

With respect to substantive treaty anti-avoidance rules, jurisdictions may implement the minimum standards in several fashions. First, states may opt for the PPT rule combined with a simplified LOB clause.<sup>92</sup> As a general rule, however, the principle of symmetry applies. Accordingly, where one party chooses to apply the simplified LOB and the other does not, the simplified LOB would generally not apply, and, by default, the PPT rule would apply between the parties.<sup>93</sup> BEPS Action 6 stresses that LOB clauses and the PTT rules are provisions that complement each other.<sup>94</sup> While an LOB clause is indeed based on objective criteria and provides certainty, it is, however, limited to certain specific treaty shopping situations and should not address any other forms of treaty abuse, such

87. Art. 6(3) MLI.

88. *Action 6 Final Report*, at 92.

89. L. De Broe, *Tax Treaty and EU Law aspects of the LOB and PPT provision proposed by BEPS action 6*, in *Institute for Tax Law 203-204* (Kluwer/Schulthess 2017).

90. Art. 7(1) MLI.

91. See, for example, *Action 6 Final Report*, at 59 et seq.; *OECD Model: Commentary on Article 29* para. 182, Examples A, B, C, D (2017).

92. Art. 7(6) MLI; *Explanatory Statement*, at para. 100.

93. *Id.*

94. *Action 6 Final Report*, at 20.

as conduit financing arrangements. For this reason, therefore, the PTT rule is needed.<sup>95</sup>

Based on the foregoing, states are given two alternative options. A first alternative is to opt for the PPT rule alone.<sup>96</sup> However, in this particular instance, the state choosing to apply the PPT alone may still permit the application of the simplified LOB on an asymmetrical basis.<sup>97</sup> The second alternative concerns states that favour LOB clauses but do not wish to include, for various reasons, a PPT rule in their tax treaties. Article 7(15)(a) of the MLI allows these states to opt out of the PPT rule, provided that they supplement the LOB clause with a mechanism designed to deal with conduit arrangements. This mechanism may take the form of a treaty PPT rule restricted to conduit arrangements, domestic anti-abuse rules or simply judicial doctrines achieving a similar result. An example of this policy is, of course, the US conduit financing treasury regulations.<sup>98</sup> The policy principle, however, is that these various options should achieve a similar result to that of the PPT rule.<sup>99</sup>

In essence, therefore, the PPT rule is the only approach that is considered to be able to achieve the minimum standard on its own,<sup>100</sup> which is yet another reason justifying the focus of this article and the extensive analysis of this rule.<sup>101</sup>

## 3.3. Recommendations

### 3.3.1. Introductory remarks

In addition to the foregoing minimum standards, the MLI, in line with BEPS Action 6, contains a number of specific anti-abuse rules designed to tackle particular forms of treaty abuse.<sup>102</sup> However, for all of these SAARs, an opt-out mechanism is provided so that states may freely reserve the right not to apply them to their CTAs. In order to keep this article within manageable proportions, the author therefore presents these rules briefly hereafter, merely outlining their policy objectives. The relationship and interaction of these specific provisions with the PPT rule will also be addressed.

95. *Id.*, at 19.

96. OECD, BEPS Action 6 – Peer review 2017, 11, available at <http://www.oecd.org/tax/treaties/beps-action-6-preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstance-peer-review-documents.pdf>.

97. Art. 7(7) MLI.

98. § 1.881-3 – Conduit financing arrangements.

99. *Action 6 Final Report*, at 19, 65–66; *OECD Model: Commentary on Article 29* para. 187 (2017).

100. *Explanatory Statement*, at para. 75 et seq.

101. However, states also enjoy a certain level of flexibility with regard to how they will implement the PPT rule itself. Art. 7(15)(b) MLI states that they may reserve the right to apply the PPT rule provided by the MLI to CTAs that already contain a similar rule. In that case, states must submit to the Depository the list of CTAs and corresponding treaty provisions concerned (art. 28(8)(e) MLI). If they decide not to make that reservation, states must also submit to the Depository the list of CTAs and treaty provisions that will be superseded by the PPT rule. Should both contracting states make that notification, the PPT rule will apply “in lieu” of the anti-abuse provision contained in the CTA. However, in the absence of such notification by one or both contracting states, the PPT rule applies only to the extent that those anti-abuse provisions are incompatible with the PPT rule (art. 7(17)(a) MLI, second phrase).

102. *Action 6 Final Report*, at 20.

### 3.3.2. Dividend transfer transactions

The first provision, which is included in article 8 (dividend transfer transactions), is designed to tackle the abusive restructurings described which lead to the application of a more favourable treaty (treaty shopping) or distributive rule (rule shopping). For this purpose, a holding period is introduced into the dividend. Accordingly, in its 2017 updated version, article 10(2)(a) of the OECD Model<sup>103</sup> provides:

5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends 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).<sup>104</sup>

The author observes that this problem has already been discussed in earlier Commentaries on Article 10. These earlier Commentaries indeed stated that the reduced rate (5%) provided in paragraph 2 should not be granted in cases of abuse, and which recommend that states introduce in their tax treaties a specific PPT rule stipulating that treaty benefits should only be granted if the holding “was not acquired primarily for the purpose of taking advantage of this provision”.<sup>105</sup> The approach taken by the new dividend transaction rule is, however, different in the sense that it is based on an objective criterion, namely the holding period.

### 3.3.3. Capital gains from alienation of real estate entities

The second updated amendment concerns article 13(4) of the OECD Model.<sup>106</sup> As it stands, this provision allows the state in which immovable property is situated to tax capital gains realized by a resident of the other contracting state on shares of companies that derive more than 50% of their value from such property. This rule may also be extended to gains resulting from the alienation of interests in other entities, such as partnerships or trusts.<sup>107</sup> However, as mentioned earlier, the application of article 13(4) of the OECD Model may be avoided if, shortly before the sale of the shares, assets are contributed to the entity to dilute the proportion of the value of these shares resulting from immovable property located in the state of source. In order to address this form of abuse specifically, article 13(4) of the 2017 OECD Model has been amended as follows:

Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as

defined in Article 6, situated in that the other State may be taxed in that other State.<sup>108</sup>

However, a broader policy issue, which is not addressed by the MLI, but which was analysed in an IMF/OECD/UN/WBG discussion draft released on 1 August 2017 and opened for comments until 25 September 2017, is the question of whether and, if so, under what conditions, capital gains resulting from offshore indirect transfers (OITs) should generally be taxable by the country in which the asset indirectly sold is located.<sup>109</sup>

### 3.3.4. Anti-abuse rule for low-taxed PEs in triangular cases

The third rule introduced by article 10 of the MLI is an anti-abuse rule for permanent establishments (PEs) situated in third jurisdictions. This rule targets states exempting – on the basis of treaty (article 23A of the OECD Model) or domestic law – profits attributable to a low-taxed PE situated in a third country. The policy of this rule, which was inspired by US treaty practice, is that the state of source should not be expected to grant treaty benefits where, in a triangular situation, income paid to a resident of the other contracting state is exempt on the ground of its allocation to a PE situated in a third country. The problem is not new and has been addressed in previous OECD documents and referred to in its Commentaries.<sup>110</sup> This provision has been inserted in article 29(8)(a) of the 2017 updated OECD Model and reads as follows:

Where (i) an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats such income as attributable to a permanent establishment of the enterprise situated in a third jurisdiction, and (ii) the profits attributable to that permanent establishment are exempt from tax in the first-mentioned State, the benefits of this Convention 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] 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. In such a case any income to which the provisions of this paragraph apply shall remain taxable according to the domestic law of the other State, notwithstanding any other provisions of the Convention.

In the case of low-taxed passive income, however, the rule would, of course, not apply if, despite generally exempting profits attributable to PEs, the state of residence applies a “switch-over clause” leading to the ordinary taxation of the passive income in that state.

In addition, the clause contains an active business test exclusion in the sense that it would not apply where income emanates from, or is incidental to, the active conduct of a business through a permanent establishment, which excludes an investment business that is not carried

103. In the 2017 updated *OECD Model Commentary*, Luxembourg reserved the right not to include this holding period. *OECD Model: Commentary on Article 10* para. 118 (2017).

104. See *Explanatory Statement*, at para. 118 et seq.

105. *OECD Model: Commentary on Article 10* para. 17 (2014).

106. Art. 9 MLI.

107. *OECD Model: Commentary on Article 13* para. 28.5 (2017).

108. *Action 6 Final Report*, at 71; *OECD Model: Commentary on Article 13* para. 28.9 (2017). art. 13 N 28.9.

109. See discussion draft, *The Platform for Collaboration on Tax, The Taxation of Offshore Indirect Transfers – A Toolkit*; available at [www.oecd.org/tax/discussion-draft-toolkit-taxation-of-offshore-indirect-transfers.pdf](http://www.oecd.org/tax/discussion-draft-toolkit-taxation-of-offshore-indirect-transfers.pdf).

110. *OECD Model: Commentary on Article 24* at para. 31 (2017).

on by a bank, insurance enterprise or registered securities dealer.<sup>111</sup> Where the conditions of article 29(8)(a) would otherwise be met, however, a discretionary relief mechanism remains available.<sup>112</sup>

### 3.3.5. Savings clause

Last but not least, article 11 of the MLI deals with the introduction of a “savings clause”.<sup>113</sup> Article 1(3) of the 2017 updated OECD Model thus states that

[t]his Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28.

As expected, several jurisdictions (in particular France, Germany, Hungary, Ireland, Luxembourg and Switzerland) have reserved the right not to include the savings clause in their tax treaties.<sup>114</sup>

## 4. The PPT Rule

### 4.1. Presentation and origin of the rule

According to the OECD, the PPT rule as provided under articles 7(1) of the MLI and 29(9) of the 2017 OECD Model would merely codify the guiding principle embodied in paragraph 9.5 of the 2003 Commentary to Article 1<sup>115</sup> as already presented. As is clear from the following comparison, the text of the PPT rule is materially not fully identical to that of the guiding principle.

Guiding principle (paragraph 9.5 of the OECD Model Commentary on Article 1)	PPT rule (article 29(9) of the 2017 OECD Model)
“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”.	“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 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”.

There are indeed two obvious differences. First, unlike the guiding principle, the PPT rule applies “[n]otwithstanding the other provisions of this Convention”. Second, the PPT rule comes into play “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 the Covered Tax Agreement”. On this second point, the PPT rule is regarded as controversial since

it shifts the burden of proof to the taxpayer.<sup>116</sup> The tax administration must indeed only demonstrate that “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 benefit”.

From the taxpayer’s perspective, it must then be “established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement”.<sup>117</sup> The compatibility of this division of the burden of proof with domestic and EU law is debatable.<sup>118</sup>

Turning now to the substantive analysis of the PPT rule, the author distinguishes between its material scope, on the one hand, and its requirements, on the other.

### 4.2. Material scope

#### 4.2.1. “A benefit under the Covered Tax Agreement”

As to its material scope, the PPT rule first of all refers to “a benefit”. According to BEPS Action 6 and the 2017 updated OECD Commentaries, the term “benefit” includes all limitations (e.g. a tax reduction, exemption, deferral or refund) on taxation imposed on the state of source under the distributive rules,<sup>119</sup> the relief from double taxation<sup>120</sup> and the protection afforded to residents and nationals of a contracting state under the non-discrimination provision.<sup>121</sup> In particular,<sup>122</sup> the PPT rule is potentially appli-

cable to dividends,<sup>123</sup> interest,<sup>124</sup> royalties<sup>125</sup> and capital gains.<sup>126</sup> There is a scholarly discussion with regard to whether the term “benefit” refers to the taxation of one contracting state or to the overall tax burden in both con-

111. Id., art. 29(8)(b).  
 112. Id., art. 29(8)(c). The existence of a loss situation may typically consist of a valid ground for a discretionary relief.  
 113. For a critical discussion, see, among others, G. Kofler, *Some Reflections on the ‘Saving Clause’*, 44 Intertax 8/9 (2016), available at <http://www.kluwerlawonline.com/TAXI2016048>; V. Chand, *Should States Opt for the Saving Clause In the Multilateral Instrument*, Tax Notes International, 689 et seq. (2017).  
 114. OECD Model: Commentary on Article 1 para. 117 (2017).  
 115. Action 6 Final Report, at 55, OECD Model: Commentary on Article 29 para. 169 (2017).

116. De Broe, *supra* n. 89, at 216; Lang, *supra* n. 82, at 658; V. Chand, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties* 190 (Schulthess 2017); Moreno, *supra* n. 82, at 435.  
 117. Action 6 Final Report, at 55; OECD Model: Commentary on Article 29 para. 170 (2017): “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”.  
 118. De Broe, *supra* n. 89, at 216.  
 119. OECD Model: Commentary on Article 6 and Article 22 (2017).  
 120. OECD Model: Commentary on Article 23 A and B (2017).  
 121. OECD Model: Commentary on Article 24 (2017).  
 122. Action 6 Final Report; OECD Model: Commentary on Article 29 para. 175 (2017).  
 123. OECD Model: Commentary on Article 10 (2017).  
 124. OECD Model: Commentary on Article 11 (2017).  
 125. OECD Model: Commentary on Article 12 (2017).  
 126. OECD Model: Commentary on Article 13 (2017).

tracting states combined.<sup>127</sup> In the author's opinion, the term "benefit" exclusively covers the reduction of domestic taxation that the state applying the tax treaty must accept under the applicable distributive rule (for example, a reduction of source taxation in the case of dividends, interest and royalties).<sup>128</sup>

The benefit to which the PPT rule refers must be provided "under this Convention". As correctly pointed out by commentators, it consequently follows that the PPT may not be used to deny a benefit stemming exclusively from domestic law (for example, a participation exemption) or another tax treaty<sup>129</sup>. Similarly, for these reasons, a lower domestic corporate income tax in the residence state is not a covered benefit for the purpose of the PPT rule.

#### 4.2.2. "In respect of an item of income or capital"

The PPT rule is applicable "in respect of an item of income or capital". Therefore, the PPT rule is a provision that requires an item-by-item of income analysis. In other words, where an entity derives different kinds of income, the PPT rule could lead to the denial of treaty benefits for some income streams, but not for others. From this perspective, the PPT rule is similar to the beneficial ownership requirement and differs from an LOB provision, which, on the contrary, focuses on whether the taxpayer is a "qualified person".

#### 4.2.3. Impact on conduit and transfer situations

Like the guiding principle, the scope of the PPT also extends to both conduit and abusive restructuring cases. The application of the PPT rule to restructuring situations first of all follows from the language of the term "arrangement or transaction", which should be construed broadly.<sup>130</sup> Indeed, the 2017 updated OECD Commentaries mention that these terms include:

the creation, assignment, acquisition or transfer of the income itself, or of the property or right in respect of which the income accrues. These terms also encompass arrangements concerning the establishment, acquisition or maintenance of a person who derives the income, including the qualification of that person as a resident of one of the Contracting States, and include steps that persons may take themselves in order to establish residence.<sup>131</sup>

Second, the expression "resulted directly or indirectly in that benefit" also confirms this analysis.<sup>132</sup> Therefore, this notion implies that treaty benefits may, for instance, be denied by the state of source if these benefits indirectly result from an abusive restructuring. Hence, as discussed by the 2017 updated OECD Commentaries, this would typically hold true where a resident of a third state trans-

fers a loan granted to a subsidiary in the source state ("state S") in exchange for promissory notes. In these circumstances, the PPT rule may apply if it is established that one of the principal purposes of transferring its loan to a resident of the residence state ("state R") was to obtain the benefit of the R-S tax treaty.<sup>133</sup> Other examples of potentially problematic restructurings referred to by the 2017 updated OECD Commentaries are transfers of residence to a contracting state,<sup>134</sup> assignment to a resident (independent financial institution) of the right to the payment of dividends that have been declared but have not yet been paid,<sup>135</sup> or the sale by a non-resident to a resident of the usufruct of newly issued non-voting preferred shares in exchange for a price corresponding to the present value of the dividends to be paid on the preferred shares over a three-year period.<sup>136</sup> These fact patterns are well known in tax treaty practice and, as previously mentioned, have, in particular, been dealt with in France in the *Bank of Scotland* case<sup>137</sup> and in the Netherlands in the *Royal Dutch Oil Company* ("market maker case") decision.<sup>138</sup> The fact that these situations are not classified as conduit situations but rather fall under the general Commentaries to the PPT rule shows that the abuse in these instances is more rooted in a restructuring than in an ownership element.

The PPT rule also covers those restructurings that are expressly dealt with in the MLI, namely, in particular, dividend transfer transactions<sup>139</sup> and abusive situations falling within the scope of the revised article 13(4) of the OECD Model.<sup>140</sup> Where a state has reserved the right not to apply these provisions, the PPT rule would thus apply by default to those situations. A more delicate situation is involved where states have opted for these specific rules. In such a case, the relationship between these provisions and the PPT must be settled. The issue is discussed in the following sections.

Finally, it is beyond doubt that the PPT rule also applies to conduit arrangements. The examples given by the 2017 updated OECD Commentaries to illustrate conduit situations may indeed also be considered as *exemplifying* the application of the PPT rule in these instances.<sup>141</sup>

#### 4.2.4. Relationship with BEPS Action 7 (splitting of contracts)

Article 5(3) of the OECD Model provides that "[a] building site or construction or installation project consti-

133. *Action 6 Final Report*, at 57; *OECD Model: Commentary on Article 29* para. 176 (2017).

134. *Action 6 Final Report*, at 58; *OECD Model: Commentary on Article 29* para. 180 (2017).

135. *Action 6 Final Report*, at 59; *OECD Model: Commentary on Article 29* para. 182, Example A (2017).

136. *Action 6 Final Report*, at 59-60; *OECD Model: Commentary on Article 29* para. 182, Example B (2017).

137. FR: CE, 29 Dec. 2006, No. 28314; see, among others, Gibert & Ouamrane, *supra* n. 28; Gutmann, *supra* n. 28, at 167 et seq.; Danon & Dinh, *supra* n. 8, at para. 134 et seq. with regard to art. 1; Meindl-Ringler, *supra* n. 10, at 235 et seq.

138. Case no. 28 638, *supra* n. 16.

139. Art. 8 MLI.

140. Art. 9 MLI.

141. *Action 6 Final Report*, at 59-60; *OECD Model: Commentary on Article 29* para. 182 (2017).

127. De Broe, *supra* n. 89, at 208; Lang, *supra* n. 82, at 657.

128. Of the same opinion, De Broe, *supra* n. 89, at 208.

129. If this other tax treaty is applicable, the latter, however, likely contains its own anti-abuse rules, in particular a PPT rule.

130. *Action 6 Final Report*, at 57; OECD, *supra* n. 50, at 235, art. 29 N 177.

131. *Action 6 Final Report*, at 57; OECD, *supra* n. 50, at 235, art. 29 N 177. An example of an "arrangement" would be where steps are taken to ensure that meetings of the board of directors of a company are held in a different country in order to claim that the company has changed its residence (OECD, *supra* n. 50, at 235, art. 29 N 177).

132. See also Lang, *supra* n. 82, at 659.

tutes a permanent establishment only if it lasts more than twelve months". The Final Report on BEPS Action 7 ("BEPS Action 7") and the 2017 updated OECD Commentaries recognize that this twelve-month threshold may lead to abuse.<sup>142</sup> It has indeed been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period of less than twelve months and attributed to a different company, which was, however, owned by the same group. In order to deal with the following, a specific SAAR is recommended.<sup>143</sup> The discussion of this specific SAAR would be beyond the scope of this article. The author, however, observes that, having reserved the right not to apply this specific SAAR to their CTAs,<sup>144</sup> countries may, as expressly confirmed by BEPS Action 7 and the 2017 updated OECD Commentaries, tackle this fact pattern on the basis of the PPT rule.<sup>145</sup>

### 4.3. The components of the PPT rule

#### 4.3.1. Subjective component: "One of the principal purposes"

From a subjective perspective, the PPT rule requires the objective to obtain the treaty benefit at issue to be "one of the principal purposes" of the arrangement or transaction put into place. This condition requires an objective

142. OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: Final Report*, 42-43 (OECD/G20 2015), International Organizations' Documentation IBFD [hereinafter: *Action 7 Final Report*]; *OECD Model: Commentary on Article 5* para. 52-53 (2017).

143. Art. 14 (1) MLI:

For the sole purpose of determining whether the period (or periods) referred to in a provision of a Covered Tax Agreement that stipulates a period (or periods) of time after which specific projects or activities shall constitute a permanent establishment has been exceeded: a) where an enterprise of a Contracting Jurisdiction carries on activities in the other Contracting Jurisdiction at a place that constitutes a building site, construction project, installation project or other specific project identified in the relevant provision of the Covered Tax Agreement, or carries on supervisory or consultancy activities in connection with such a place, in the case of a provision of a Covered Tax Agreement that refers to such activities, and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding the period or periods referred to in the relevant provision of the Covered Tax Agreement; and b) where connected activities are carried on in that other Contracting Jurisdiction at (or, where the relevant provision of the Covered Tax Agreement applies to supervisory or consultancy activities, in connection with) the same building site, construction or installation project, or other place identified in the relevant provision of the Covered Tax Agreement during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise.

According to the 2017 updated OECD Commentaries, the following factors would, in particular, be relevant in order to determine whether activities are connected: (i) whether the contracts covering the different activities were concluded with the same person or related persons; (ii) whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons; (iii) whether the activities would have been covered by a single contract absent tax planning considerations; (iv) whether the nature of the work involved under the different contracts is the same or similar; and (v) whether the same employees are performing the activities under the different contracts.

144. Art. 14 (3) MLI.

145. *Action 6 Final Report*, at 42-43; *OECD Model: Commentary on Article 5* para. 52-53 (2017).

analysis of the aims and objects of all persons involved in putting the arrangement or transaction in place or being a party to it.<sup>146</sup> In other words, as is often the case with GAARs, the subjective component is objectified by a "reasonableness" criterion as evidenced by the expression "if it is reasonable to conclude". This is, therefore, a factual analysis and all circumstances surrounding the arrangement or event must be considered on a case-by-case basis.<sup>147</sup> However, in the author's opinion, the interpretation of this requirement is controversial because the text of the PPT rule and its 2017 updated OECD Commentaries may be read as supporting both a broad and a narrow meaning of this requirement. On the one hand, it must only be "reasonable to conclude" that one of the principal purposes was to secure a benefit.<sup>148</sup> Therefore, it is not necessary to find conclusive proof of the intent of a person concerned with an arrangement or transaction.<sup>149</sup> On the other hand, the 2017 updated OECD Commentaries also state the following:

It should not be lightly assumed, however, that obtaining a benefit under a tax treaty was one of the principal purposes of an arrangement or transaction and merely reviewing the effects of an arrangement will not usually enable a conclusion to be drawn about its purpose.<sup>150</sup>

The subjective requirement of the PPT rule has been heavily criticized by some commentators. The difficulty of identifying an intention on the basis of an objective analysis is first outlined.<sup>151</sup> The most important criticism concerns the fact that, as confirmed by the 2017 updated OECD Commentaries, the reference to "one of the principal purposes" means that:

obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the principal purposes was to obtain the benefit.<sup>152</sup>

The 2017 updated OECD Commentaries then go on to state that if, for various reasons, a person sells a property but, before the sale, becomes a resident of one of the contracting states, and one of the principal purposes for doing so is to obtain a benefit under a tax treaty, the PPT rule could apply notwithstanding the fact that there may also be other principal purposes for changing the residence, such as facilitating the sale of the property or the reinvestment of the proceeds of the alienation.<sup>153</sup> Considered in this light, the text of the PPT rule thus makes it easier for tax administrations to assume abuse since it is by no means required that the "sole purpose" of the arrangement must consist in obtaining a tax benefit.<sup>154</sup> As correctly pointed out by De Broe (2008), it is conceptually unacceptable to deny treaty benefits to a taxpayer merely

146. *Action 6 Final Report*, at 57-58; *OECD Model: Commentary on Article 29* para. 178 (2017).

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. See, for example, Lang, *supra* n. 82, at 658; Moreno, *supra* n. 82, at 436.

152. *Action 6 Final Report*, at 58; *OECD Model: Commentary on Article 29* para. 180 (2017).

153. *Action 6 Final Report*, at 58; *OECD Model: Commentary on Article 29* para. 180 (2017).

154. Lang, *supra* n. 82, at 659.

because the obtaining of such benefits is one of the principal motives, if that taxpayer is also able to present important economic motives that are unrelated to taking advantage of the tax treaty.<sup>155</sup> This criticism is not new and was also made at the time the guiding principle was introduced into the 2003 OECD Commentaries.<sup>156</sup> It was suggested that a reference to the “sole purpose” or to the “predominant purpose” would have been more appropriate.<sup>157</sup>

#### 4.3.2. Objective component: “The object and purpose of the relevant provisions”

The PPT rule also focuses on an objective element, namely the question of whether the benefit “would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement”. There is a scholarly discussion on the question of whether the objective criterion of the PPT rule should be examined in light of the objective of the applicable treaty provision or by reference to the treaty as a whole.<sup>158</sup> It is quite clear that if the proper weight<sup>159</sup> is given to the text of the PPT rule, the objective and purpose of the relevant treaty provision should solely be taken into account.<sup>160</sup>

However, this approach raises several practical difficulties as it is generally not obvious to assign a specific purpose to treaty provisions such as the distributive rules whose general objective is simply to allocate taxing rights with a view to eliminating double taxation.<sup>161</sup> Presumably for this reason, the approach has only been followed by the OECD in one example discussed in its 2017 updated OECD Commentaries. In this case, following the entry into force of a tax treaty between states R and S, a company resident in state R decides to increase its shareholding in a subsidiary located in state S up to 25% primarily in order to obtain the benefit of the lower rate of tax provided by article 10(2) (a) of the S-R treaty. In this example, however, the Commentaries (correctly) arrive at the conclusion that granting treaty benefits would not be contrary to this provision:

- .....
155. De Broe, *supra* n. 89, at 210; of the same opinion, Lang, *supra* n. 82, at 659.
156. *OECD Model: Commentary on Article 1* para. 9.5 (2003).
157. See, in particular, De Broe, *supra* n. 57, at 325; in Switzerland, in a judgment rendered in 2010 in relation to an abusive restructuring, the FAT endorsed a similar reasoning and held that an abuse may only come into play when “die Gestaltung einzig und allein für Zwecke der Steuerersparnis gewählt worden ist” (CH: FAT, 23 Mar. 2010, A-2744/2008, RF 2010, at 652, para. 3.10); See also R. Danon & T. Obrist, *La théorie des “anciennes réserves”*, *Revue fiscale*, 621 et seq. (2010); in subsequent judgments (see e.g. CH: FAT, 25 June 2014, A-4693/2013, at para. 7.3, confirmed by CH: FT, 3 Dec. 2015, 2C\_753/2014; CH: FAT, 26 Aug. 2016, A-2902/2014, at para. 4.3.3, partially confirmed by CH: FT, 5 Apr. 2017, 2C\_964/2016), however, the FAT has, in line with the case law of the FT (CH: FT, 28 Nov. 2005, 2A.239/2005), defined abuse by reference to the *bona fide* clause incorporated into the *OECD Model Commentary* as drafting suggestion (*OECD Model: Commentary, supra* n. 60, at para. 13 et seq.). As outlined above, this reasoning which de facto also leads to a reasoning based on a “principal purpose” test is, however, methodologically erroneous as it amounts to arbitrary import drafting suggestions into the applicable tax treaty.
158. See, among others, De Broe, *supra* n. 89, at 213; Chand, *supra* n. 116, at 187; Moreno, *supra* n. 82, at 435.
159. Within the meaning of *Vienna Convention on the Law of Treaties* art. 31(1) (23 May 1969), *Treaties* IBFD.
160. In the same vein, Moreno, *supra* n. 82, at 437; De Broe, *supra* n. 89, at 213.
161. *Id.*

The facts and circumstances reveal that the decision to acquire these additional shares has been made primarily in order to obtain the benefit of the lower rate of tax provided by Article 10 (2) a) of the treaty. In that case, although one of the principal purposes for the transaction through which the additional shares are acquired is clearly to obtain the benefit of Article 10 (2) a), paragraph 9 would not apply because it may be established that granting that benefit in these circumstances would be in accordance with the object and purpose of Article 10 (2) a). That subparagraph uses an arbitrary threshold of 25 per cent for the purposes of determining which shareholders are entitled to the benefit of the lower rate of tax on dividends and it is consistent with this approach to grant the benefits of the subparagraph to a taxpayer who genuinely increases its participation in a company in order to satisfy this requirement.<sup>162</sup>

By contrast, in the other examples, “the object and purpose of the tax convention”<sup>163</sup> is referred to in order to determine whether treaty benefits should be granted. Hence, to deny treaty benefits, it is contended that “it would be contrary to the object and purpose of the tax convention to grant the benefit of that exemption under this treaty-shopping arrangement,”<sup>164</sup> and in cases in which the PPT rule does not apply, the fact that “the general objective of tax conventions is to encourage cross-border investment”<sup>165</sup> is put forward.

The foregoing shows that there is an inherent conceptual difficulty to apply the PPT rule which may entail uncertainties if the decision to deny treaty benefits is simply made on the basis of the general purpose of the treaty as modified by the MLI.

## 4.4. Selected EU law perspective

### 4.4.1. EU primary law

In addition to the foregoing criticisms, the PPT rule has also raised several compatibility concerns from an EU law perspective.<sup>166</sup> Looking at the compatibility of the PPT rule with EU law would deserve a study of its own and is thus beyond the scope of this article. However, the author observes that the possible frictions of the PPT rule with EU primary law concern, inter alia, the certainty and proportionality principles.<sup>167</sup> Legal certainty forms part of the fundamental principles of EU law.<sup>168</sup> As referred to, for example, by the Court of Justice of the European Union

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162. *Action 6 Final Report*, at 61; *OECD Model: Commentary on Article 29* para. 182, Example E (2017).
163. See, for example, *Action 6 Final Report*, at 59 et seq.; OECD, *supra* n. 50, at 236, Examples A, B, C, D, art. 29 N 182.
164. See, for example, *Action 6 Final Report*, at 59; *OECD Model: Commentary on Article 29* para. 182, Example A (2017).
165. See, for example, *Action 6 Final Report*, at 59; *OECD Model: Commentary on Article 29* para. 182, Example C (2017).
166. A.P. Dourado, *Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6*, 56 *Intertax* 1 (2015); Moreno, *supra* n. 82, at 435.
167. See PT: ECJ, 3 Oct. 2013, Case C-282/12, *Fazenda Pública v. Itelcar - Automóveis de Aluguer, Lda*, para. 44, ECJ Case Law IBFD; BE: ECJ, 5 July 2012, Case C-318/10, *Société d’investissement pour l’agriculture tropicale SA (SIAT) v. État Belge*, paras. 58-59, ECJ Case Law IBFD; P. Baker, *The BEPS Action Plan in the Light of EU Law: Treaty Abuse*, 408 *BTR* (2015) *BTR*, no 3, at 408; see also De Broe, *supra* n. 89, at 229 and UK: ECJ, 13 Nov. 2014, Case C-112/14, *European Commission v. United Kingdom of Great Britain and Northern Ireland*, para. 27, ECJ Case Law IBFD.
168. See, for example, DE: ECJ, 21 Sept. 1983, Case C-205/82, *Deutsche Milchkontor GmbH and others v. Federal Republic of Germany*.

(ECJ) in the SIAT case, it follows from this principle that an anti-avoidance rule must meet:

the requirements of the principle of legal certainty, in accordance with which rules of law must be clear, precise and predictable as regards their effects, in particular where they may have unfavourable consequences for individuals and undertakings.<sup>169</sup>

Whether the PPT rule is in breach of the legal certainty principle is, however, controversial among scholars.<sup>170</sup> The principle of proportionality implies, in particular, that where an abuse is found to exist, the taxpayer should be given the opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification that there may have been for that transaction.<sup>171</sup> Furthermore, it is settled case law that a general presumption of fraud and abuse is not justified.<sup>172</sup> From this perspective, the division of the burden of proof under the PPT is controversial.<sup>173</sup> Moreover, the fact that the PPT rule does not expressly reserve genuine economic activities seems equally at odds with the notion of abuse under EU law. In a recommendation of 28 January 2016, the European Commission, however, addressed this latter point by proposing a slightly modified version of the PPT rule to be included in tax treaties concluded by Member States.<sup>174</sup>

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 benefit, unless it is established that it reflects a genuine economic activity or that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.<sup>175</sup>

Hence, under this revised version, the objective component of the PPT rule is complemented by a “genuine economic activity” test, which, according to the Commission, is necessary to align the PPT rule with the case law of the ECJ.<sup>176</sup>

#### 4.4.2. EU secondary law (Parent-Subsidiary Directive)

Turning to EU secondary law, this reservation in favour of genuine activities may also be found in the GAAR clauses recently included in the revised version of the Parent-Subsidiary Directive 2015<sup>177</sup> and in the Anti-Tax Avoidance

169. SIAT (C-318/10), point 58.

170. For a recent critical discussion and overview of the scholarly controversy, see for, example, D. Weber, *Reasonableness Test of the Principal Purpose Test* *Erasmus Law Rev.* 8, 48-59 (2017).

171. *European Commission v. United Kingdom* (C-112/14), para. 27.

172. See, inter alia, BE: ECJ, 26 Sept. 2000, Case C-478/98, *Commission of the European Communities v. Kingdom of Belgium*, para. 45, ECJ Case Law IBFD; SIAT (C-318/10), para. 38.

173. De Broe, *supra* n. 89, at 238; E Traversa & A Herbain, *General Assessment of BEPS and EU Law: Hybrid Mismatches, Interest Deductions, Abuse of Tax Treaties and CFC rules* 306 (Schulthess 2016).

174. Commission Recommendation (EU) 2016/136 of 28 January 2016 on the Implementation of Measures against Tax Treaty Abuse (Notified under Document C(2016) 271), preamble, (7), EU Law IBFD.

175. *Id.*, at preamble, (2).

176. *Id.*, at preamble, (7).

177. Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/

Directive 2016.<sup>178</sup> Article 1(2) of the revised version of the Parent-Subsidiary Directive, for example, provides that:

Member States shall not grant the benefits of this Directive to an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

In turn, article 1(3) stipulates that “an arrangement or a series of arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality”. As can be seen, this language, which refers to “the main purpose or one of the main purposes,” differs from the terminology used by the treaty PPT rule, which uses, instead, the expression “one of the principal purposes”. Also on this point, the compatibility of the directive with EU law is subject to a scholarly discussion. For some commentators, the expression “the main purpose or one of the main purposes” should receive a restrictive interpretation in the sense that only transactions where the sole or predominant purpose is to obtain the tax benefit provided by the directive may be caught by its anti-abuse rule.<sup>179</sup> In essence, this reasoning relies on the case law of the ECJ relating to the anti-abuse rule of the Merger Directive,<sup>180</sup> which similarly uses the terms “principal objective or one of the principal objectives”. In *Kofoed*, the ECJ clarified that this language referred to “transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by Community law”.<sup>181</sup> In *Foggia*, the ECJ used a slightly different terminology but nevertheless held that:

a merger operation based on several objectives, which may also include tax considerations, can constitute a valid commercial reason provided, however, that those considerations are not predominant in the context of the proposed transaction<sup>182</sup>

and:

where the merger operation has the sole aim of obtaining a tax advantage and is not carried out for valid commercial reasons, such a finding may constitute a presumption that the operation has tax evasion or avoidance as one of its principal objectives.<sup>183</sup>

.....  
EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC (Text with EEA relevance), available at <http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32015L2366> [hereinafter: PSD Directive 2015].

178. Council Directive (EU) 2016/1164 of 12 July 2016 Laying down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, EU Law IBFD [hereinafter: ATAD 2016].

179. F. Debelva & J. Luts, *The General Anti-Abuse Rule of the Parent-Subsidiary Directive*, 55 *Eur. Tax'n* 6, 225 (2015), *Journals IBFD*.

180. Council Directive 2009/133 EC of 19 October 2009 on the Common System of Taxation Applicable to Mergers, Divisions, Partial Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States and to the Transfer of the Registered Office of an SE or SCE between Member States (codified version), L 310/34, EU Law IBFD [hereinafter: EU Merger Directive (2009/133)].

181. DK: ECJ, 5 July 2007, Case C-321/05, *Hans Markus Kofoed v. Skatteministeriet*, para. 38, ECJ Case Law IBFD.

182. PT: ECJ, 10 Nov. 2011, Case C-126/10, *Foggia – Sociedade Gestora de Participações Sociais SA v. Secretário de Estado dos Assuntos Fiscais*, para. 35, ECJ Case Law IBFD.

183. *Id.*, para. 36.



Another author notes that a main purpose test *prima facie* deviates from the well-known notion of “wholly artificial arrangement”<sup>184</sup> applied by the ECJ in the area of fundamental freedoms.<sup>185</sup> At the same time, however, the ECJ has also acknowledged that an arrangement may be artificial in whole or in part.<sup>186</sup> From this perspective, it is argued that the PPT rule could be reconciled with the EU law notion of abuse, as the latter also allows only part of a transaction to be regarded as artificial, the existence of business reasons for another part of the arrangement being irrelevant.<sup>187</sup> This being said, the issue to be settled remains the question of whether the OECD PPT rule introduces a lower threshold of abuse as it does not, unlike these European directives, include any express exclusion in favour of genuine activities. A literal reading certainly could suggest so. However, as will be shown, it flows from the examples in the 2017 updated OECD Commentaries that the PPT rule is in fact very much to be construed as a genuine activity test.<sup>188</sup> Finally, the impact of the PPT rule may also be looked at from the perspective of the reservation contained in article 1(4) – formerly article 1(2) – of the Parent-Subsidiary Directive. This provision indeed states that “[t]his Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion, tax fraud or abuse”. Since article 1(4) also refers to “agreement-based provisions”, it is settled that the PPT rule could be applied by Member States, provided, however, that its application is in line with EU law.<sup>189</sup> Relevant in this context, in particular, is the awaited judgment delivered by the ECJ on 7 September 2017 in the *Eqiom* case (formerly *Holcim*).<sup>190</sup> The case concerned the application of the Parent-Subsidiary Directive and the exemption from withholding tax on dividend distributions made by a French subsid-

ary to a Luxembourg company owned by a company in Cyprus, which was in turn controlled by a company with its seat in Switzerland. At issue in the present case was a former provision of the French Tax Code (*Code Général des Impôts*), which provided for a reversal of the burden of proof in the case of dividends paid to an EU entity directly or indirectly controlled by residents of non-EU Member States. Specifically, the withholding tax exemption provided by the Directive was not available “unless that legal person provides proof that the principal purpose or one of the principal purposes of the chain of interests is not to take advantage of the exemption”. The ECJ assessed this provision both from the perspective of the reservation contained in the Directive and EU primary law. To begin with, the ECJ noted that the reservation in favour of domestic agreement-based provisions should be construed restrictively.<sup>191</sup> Accordingly, in line with the principle of proportionality (necessity aspect) and following the *Cadbury Schweppes* case law,<sup>192</sup> the objective of a given measure should only be to prevent “conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, the purpose of which is unduly to obtain a tax advantage.”<sup>193</sup> From this perspective, the ECJ held that a measure, such as that at issue, which shifts the burden of proof to the taxpayer simply because the EU parent company is controlled by residents of third states, is disproportionate:

The imposition of a general tax measure automatically excluding certain categories of taxpayers from the tax advantage, without the tax authorities being obliged to provide even *prima facie* evidence of fraud and abuse, would go further than is necessary for preventing fraud and abuse.<sup>194</sup>

For the same reason, the ECJ finally held that the French provision entailed an unjustified restriction to freedom of establishment.<sup>195</sup>

It is submitted that the findings of the ECJ in this case – in particular, the question of the division of the burden of proof – must be taken into account by Member States when applying the PPT rule contained in their tax treaties, since it constitutes an agreement-based provision under article 1(4) of the Directive. Moreover, the reasoning of the ECJ, which is founded on general and well-known principles of EU law, is also applicable to the interpretation of the GAAR clause of the Parent-Subsidiary Directive.

#### 4.5. Synthesis

The foregoing considerations allowed the author to demonstrate that the text of the PPT rule may be construed broadly and that this provision runs the risk of denying treaty benefits to bona fide business transactions. Furthermore, there are tensions between the literal wording of the OECD PPT rule and EU law. These ten-

- .....
184. See, inter alia, UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, para. 51, ECJ Case Law IBFD.
185. D. Weber, *The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive: Background, Impact, Applicability, Purpose and Effect*, 110 *Intertax* 2 (2016).
186. UK: ECJ, 13 Mar. 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, para. 81, ECJ Case Law IBFD; Weber, *supra* n. 185.
187. Weber, *supra* n. 185.
188. In the same vein, Weber, *supra* n. 185, at 98 et seq.
189. De Broe, *supra* n. 89, at 244.
190. FR: ECJ, 7 Sept. 2017, Case C-6/16, *Eqiom SAS, formerly Holcim France SAS, Enka SA v. Ministre des Finances et des Comptes publics*, ECJ Case Law IBFD. See also, recently and delivered at the time this article goes to press, DE: ECJ, 20 Dec. 2017, joint cases C-504/16 and C-613/16, *Deister Holding AG and Juhler A/S versus Bundeszentralamt für Steuern*. In this case, the ECJ held that secondary and primary EU law must be interpreted as precluding a Member State’s tax legislation which, where persons have holdings in a non-resident parent company who would not be entitled to the refund or exemption from withholding tax if they received the dividends from a resident subsidiary directly, denies, provided one of the conditions set by that legislation is satisfied, relief from tax on income from capital tax on distributions of profits to that parent company. Notably, the ECJ observed (para. 73) that:

The fact that the economic activity of a non-resident parent company consists in the management of its subsidiaries’ assets or that the income of that company results only from such management cannot per se indicate the existence of a wholly artificial arrangement which does not reflect economic reality. In that context, the fact that the management of assets is not considered to constitute an economic activity for the purposes of value-added tax is irrelevant, since the tax at issue in the main proceedings and value-added tax are governed by distinct legal regimes, each pursuing difference objectives.

- .....
191. Id., para. 26.
192. *Cadbury Schweppes* (C-196/04).
193. *Eqiom SAS* (C-6/16), para. 30.
194. Id., para. 32. See also FR: ECJ, 8 Mar. 2017, Case C-14/16, *Euro Park Service*, paras. 55 and 56, ECJ Case Law IBFD.
195. Treaty on the Functioning of the European Union of 13 December 2007, arts. 49 and 54, OJ C115 (2008), EU Law IBFD [hereinafter: “TFEU”]; *Eqiom SAS* (C-6/16), para. 52 et seq.

sions concern, in particular, the interpretation of the notion of “principal purpose”, the division of the burden of proof and the absence of an express reservation in favour of genuine activities.

The author will now reconsider these findings in light of the examples contained in the 2017 updated OECD Commentaries to the PPT rule, which, in his opinion, constitute binding context in the interpretative process. The author shows that, if these examples are relied upon, the application of the PPT rule in practice should not produce a result that is too far apart from a genuine activity test.

#### 4.6. The practical application of the PPT rule in the 2017 updated OECD Commentaries

##### 4.6.1. In general

The examples provided in the 2017 updated OECD Commentaries give nuance to the literal wording of the PPT rule and suggest that (i) “one of the principal purposes” is less far-reaching, and (ii) the rule is substance oriented.<sup>196</sup> Therefore, treaty benefits are generally not denied where genuine business activities are taking place. This conclusion is supported by several passages of the 2017 updated OECD Commentaries.

In relation to the first observation, example C of the 2017 updated OECD Commentaries may be mentioned. In this case, a company resident in state R, active in the business of producing electronic devices, is considering establishing a manufacturing plant in a developing country in order to benefit from lower manufacturing costs. After a review of possible locations, the only jurisdiction with which state R has concluded a tax treaty is selected. In this particular instance, the Commentaries nevertheless note that “it cannot reasonably be considered that one of the principal purposes for building the plant is to obtain treaty benefits”.<sup>197</sup> Rather, “the principal purposes for making that investment and building the plant are related to the expansion of RCO’s business and the lower manufacturing costs of that country”, and the fact that the choice fell on the only jurisdiction with which state R has concluded a tax treaty is simply ignored.

Second, the importance of substance and genuine activities flows from the Commentaries on several occasions. To begin with, the 2017 updated OECD Commentaries note that:

where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit.<sup>198</sup>

More concretely, example G of the Commentaries is illustrative of the role of local substance. In this example, a group is considering establishing a regional company for the purpose of providing group services to these compa-

196. For a recent detailed discussion of these examples, see Chand, *supra* n. 2 (forthcoming).

197. *Action 6 Final Report*, at 60; *OECD Model: Commentary on Article 29* para. 182, Example C (2017).

198. *Action 6 Final Report*, at 58, *OECD Model: Commentary on Article 29* para. 181 (2017).

nies, including management services, such as accounting, legal advice, human resources, financing, treasury services such as managing currency risks and arranging hedging transactions, as well as some other non-financing related services. State R is selected because of its comprehensive double taxation network and, in particular, because it has concluded tax treaties with the five jurisdictions within which the group owns subsidiaries. In this example, the application of the PPT rule is denied with a clear emphasis on the importance of local substance to arrive at this result:

Assuming that the intra-group services to be provided by RCO, including the making of decisions necessary for the conduct of its business, constitute a real business through which RCO exercises substantive economic functions, using real assets and assuming real risks, and that business is carried on by RCO through its own personnel located in State R, it would not be reasonable to deny the benefits of the treaties concluded between State R and the five States where the subsidiaries operate unless other facts would indicate that RCO has been established for other tax purposes or unless RCO enters into specific transactions to which paragraph 9 would otherwise apply....<sup>199</sup>

A similar reasoning is followed in example K, which concerns a resident company owned by an institutional investor:

The decision to establish the regional investment platform in State R was mainly driven by the availability of directors with knowledge of regional business practices and regulations, the existence of a skilled multilingual workforce, [...] RCO employs an experienced local management team to review investment recommendations from Fund and performs various other functions which, depending on the case, may include approving and monitoring investments, carrying on treasury functions, maintaining RCO’s books and records, and ensuring compliance with regulatory requirements in States where it invests.<sup>200</sup>

It follows from the foregoing that substance is one of the key elements allowing the taxpayer to demonstrate that the subjective element of the PPT rule is not satisfied, namely that obtaining the relevant treaty benefit is not one of the principal purposes of the arrangement or transaction that resulted directly or indirectly in that benefit. Within the EU internal market, substance is, of course, linked to the EU notion of genuine activities. How should substance be construed in third-state relations? In the author’s opinion, it follows from the Commentaries to the PPT rule that, in determining whether an arrangement is “inextricably linked to a core commercial activity”, transfer pricing principles may serve as guidance. That is, if the entity in the residence state exercises and respectively bears the relevant functions (for example, the “DEMPE functions” in the case of an IP company) and risks, it should be assumed that the arrangement is indeed linked to a core commercial activity. *A fortiori*, this condition would also be satisfied in the case of an IP company whose income derived from the State of source qualifies as privileged income under a nexus based IP box regime within the meaning of BEPS Action 5. Such income would indeed undoubt-

199. *Action 6 Final Report*, at 62; *OECD Model: Commentary on Article 29* para. 182, Example G (2017).

200. *OECD Model: Commentary on Article 29* para. 182, Example K (2017).

Fact pattern	2017 OECD Commentary para. 187 ad art. 29	Exchange of letters to art. 3(1)(n) US-UK	Conduit?
Issuance of preferred shares by SCO to RCO with corresponding contract with TCO	Example A	Example 1	Yes
TCO owns RCO (manufacturing) and SCO (distributor)	Example B	Example 2	No
Loan from TCO to SCO (interest 7%); assignment of note to RCO (interest 6%)	Example C	Example 3	Yes
Acquisition funding to SCO by an unrelated bank (RCO); historic large deposits by TCO	Example D	Example 4	No
Holding company (RCO), licensing (TCO-RCO) and sublicensing (RCO-SCO); small spread; group practice	Example E	Example 5	No
Centralized cash management (RCO) for TCO and subsidiaries	Example F	Example 6	No

edly be linked to substantial R&D activities in the residence state.<sup>201</sup>

#### 4.6.2. Conduit arrangements

Interestingly, the 2017 updated OECD Commentaries also focuses on substance, business rationale and commercial organization when looking at the application of the PPT rule to possible conduit structures. From a policy perspective, it is interesting to observe that the examples illustrating the application of the PPT rule in relation to conduit arrangements have been directly inspired from those laid down in the exchange of letters to the conduit arrangement clause of article 3(1)(n) of the 2001 United States-United Kingdom tax treaty. In essence, the application of this provision is subject to two requirements. That is, the existence of a conduit arrangement which, in essence, occurs where a resident “pays, directly or indirectly, all or substantially all of that income (at any time or in any form) to another person who is not a resident of either Contracting State” and, finally, a main purpose test.<sup>202</sup> During the work conducted in relation to BEPS Action 6, this clause was considered<sup>203</sup> at some point but was ultimately not regarded as an appropriate option as

the phrase “pays, directly or indirectly, all or substantially all” was found to give rise to uncertainties.<sup>204</sup> The fact remains, however, that the examples agreed between the US and UK competent authorities are, as shown in the Table, identical to the ones of the new commentaries in relation to conduit situations.<sup>205</sup>

Particularly interesting in this respect is example E. In this example, a company resident in state R is the holding company for a manufacturing group in a highly competitive technological field. The manufacturing group conducts research in subsidiaries located around the world. Any patents developed in a subsidiary are licensed by that subsidiary to the holding company in state R, which then licenses the technology to other subsidiaries that need it. The holding company generally keeps only a small spread with respect to the royalties it receives, so that most of the profit goes to the subsidiary that incurred the risk with respect to the development of the technology. One subsidiary of the group, a company resident in a non-treaty jurisdiction, happens to have developed a process that will, in particular, substantially increase the profitability of another sister company located in state S. According to the standard practice of the group, the holding company thus sublicenses the technology developed by the company in the non-treaty jurisdiction to its subsidiary in state S. The end result, therefore, is that the holding company is paying out to an entity located in a non-treaty jurisdiction substantially all of the royalties it derives from state S. The question thus arises as to whether, with respect to this particular income stream, the holding company could be regarded as conduit arrangement. The question is answered in the negative. In order to arrive at this conclusion, the 2017 updated OECD Commentaries note:

In this example, there is no indication that RCO established its licensing business in order to reduce the withholding tax payable in State S. Because RCO is conforming to the standard commercial organization and behaviour of the group in the way

201. This is, however, not to say that only IP income falling within the scope of the modified nexus approach would meet the substance test under the PPT rule. Such substance test indeed appears closer to a transfer pricing analysis, which is less restrictive than the modified nexus approach (in particular, in outsourcing situations).

202. Specifically according to this provision, the term “conduit arrangement” means a transaction or series of transactions:

i) which is structured in such a way that a resident of a Contracting State entitled to the benefits of this Convention receives an item of income arising in the other Contracting State but that resident pays, directly or indirectly, all or substantially all of that income (at any time or in any form) to another person who is not a resident of either Contracting State and who, if it received that item of income direct from the other Contracting State, would not be entitled under a convention for the avoidance of double taxation between the state in which that other person is resident and the Contracting State in which the income arises, or otherwise, to benefits with respect to that item of income which are equivalent to, or more favourable than, those available under this Convention to a resident of a Contracting State; and (ii) which has as its main purpose, or one of its main purposes, obtaining such increased benefits as are available under this Convention.

203. OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2014 Deliverable*, OECD/G20 Base Erosion and Profit Shifting Project (16 Sept. 2014), International Organizations’ Documentation IBFD.

204. See Meindl-Ringler, *supra* n. 10, at 348 et seq.

205. *Convention between the Government of 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) (as amended through 2002) [hereinafter: *UK-US Income Tax Treaty*].

that it structures its licensing and sub-licensing activities and assuming the same structure is employed with respect to other subsidiaries carrying out similar activities in countries which have treaties which offer similar or more favourable benefits, the arrangement between SCO, RCO and TCO does not constitute a conduit arrangement.<sup>206</sup>

In the author's opinion, the foregoing demonstrates that the PPT rule is not just triggered because of the existence of an interdependence between two income streams (for example, in the case of a licensing and sublicensing situation). Rather, obtaining the relevant treaty benefit must also be one of the principal purposes of the arrangement or transaction. That is, the arrangement must typically be structured to eliminate the withholding tax that would otherwise have been paid to the state of source<sup>207</sup> or on flow-through dividends.<sup>208</sup> This distinction between the existence of an economic interdependence (conduit situation), on the one hand, and the subjective element of a PPT rule, on the other, is perfectly illustrated in article 3(1)(n) of the 2001 United States-United Kingdom tax treaty. From a UK perspective, it is observed that:

even though the specific fact pattern, as presented, meets the first part of the definition of a 'conduit arrangement' ... on balance the conclusion would be that "the main purpose or one of the main purposes" of the transactions was not the obtaining of UK/US treaty benefits. So the structure would not constitute a conduit arrangement.<sup>209</sup>

From this perspective, therefore, the approach taken under the PPT rule is different from the one that could be favoured under a broad interpretation of beneficial ownership – such as the one adopted, for instance, under Swiss case law – which only focuses on the existence of an interdependence between two income streams and tends to ignore the underlying purposes of the structure or arrangement.

This being said, there is one difference between the OECD PPT rule and the US-UK conduit arrangement clause. Unlike the OECD PPT rule, the US-UK clause specifically provides that it covers only situations in which one of the main purposes of the transaction is to increase the benefits under the applicable tax treaty beyond what the ultimate recipient would have received if he had received the payment directly.<sup>210</sup> It is submitted that the same result may be achieved by the OECD PPT rule. First of all, the fact that the arrangement or transaction does not lead to an increase in tax treaty benefits should be taken into account to assess whether obtaining the benefit of the newly applicable tax treaty was really one of the princi-

206. *Action 6 Final Report*, at 67; *OECD Model: Commentary on Article 29* para. 187, Example E (2017).

207. *See Action 6 Final Report*, at 66; *OECD Model: Commentary on Article 29* para. 187, Examples A and C (2017).

208. *See Action 6 Final Report*, at 66; *OECD Model: Commentary on Article 29* para. 182, Example B (2017).

209. *UK-US Income Tax Treaty*, art. 3(1)(n), Example 5.

210. Art. 3(1)(n) *UK-US Income Tax Treaty*: "and who, if it received that item of income direct from the other Contracting State, would not be entitled under a convention for the avoidance of double taxation between the state in which that other person is resident and the Contracting State in which the income arises, or otherwise, to benefits with respect to that item of income which are equivalent to, or more favourable than, those available under this Convention to a resident of a Contracting State".

pal purposes of the relevant arrangement or transaction. Second, should this be the case and the PPT rule is found to be applicable, the (identical) treaty benefits originally available should, in any event, be granted.

#### 4.6.3. Importance of the OECD Commentaries to the PPT rule

In light of the foregoing, it is therefore fair to say that there is a divergence between the wording of the PPT rule and the examples illustrating its application in the OECD Commentaries. On the one hand, the literal wording of the PPT suggests that the rule could be given a broad meaning and could possibly impact transactions or arrangements pursuing a valid business purpose. On the other hand, the 2017 updated OECD Commentaries to the PPT rule clarify that the PPT rule is, in essence, a business reality test focusing on substance. In the author's opinion, the 2017 updated OECD Commentaries reflect the contextual meaning of the PPT, and therefore states may not give to this new rule a meaning that exceeds the interpretation conveyed by BEPS Action 6. It consequently follows that treaty benefits should not be denied as soon as an arrangement or a transaction is predominantly and "inextricably linked to a core commercial activity".<sup>211</sup> At the same time, however, this divergence between the literal wording of the PPT rule and its Commentaries is not ideal from a tax certainty point of view. From a corporate tax governance perspective, multinational enterprises will thus be well advised to ensure in advance and especially in the initial implementation phase that the scope given that may be given to the PPT rule by the jurisdictions in which they operate coincides with the OECD interpretation.

This being said, even if the PPT is construed in accordance with its 2017 updated OECD Commentaries, some difficulties still remain with regard to the consequences of denial of treaty benefits (*see* section 4.7.) and the relationship of the PPT rule with treaty SAARs (*see* section 4.8.).

### 4.7. The consequences of denial of treaty benefits

#### 4.7.1. The issue

Where the PPT rule is found to be applicable, another practical issue arising is the question of whether treaty benefits that would otherwise have been applicable in the absence of the problematic transaction or arrangement (for example, a 15% residual tax treaty rate instead of a 0% residual rate in a rule shopping situation)<sup>212</sup> may automatically be claimed. There is a scholarly discussion on this point because the PPT rule simply states that, when it applies, treaty benefits "shall not be granted". This wording could thus *prima facie* suggest that a return to "status quo" is not possible.

211. *Action 6 Final Report*, at p. 58, *OECD Model: Commentary on Article 29* para. 181 (2017).

212. De Broe, *supra* n. 89, at p. 217; Lang, *supra* n. 82, at 659.

#### 4.7.2. *With a discretionary relief clause*

This position seems to be confirmed by the MLI since the instrument includes an optional clause<sup>213</sup> that states may choose to include in their CTAs if they wish to allow treaty benefits on the basis of the facts, as they would in the absence of the abusive arrangement or transaction. Pursuant to this optional clause, states denying treaty benefits may treat the taxpayer 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 [...]. The competent authority of the Contracting State to which the request has been made will consult with the competent authority of the other State before rejecting a request made under this paragraph by a resident of that other State.<sup>214</sup>

Under this mechanism, therefore, the question of whether alternative treaty benefits should be granted is left to the discretion of the competent authority to which the request is made.<sup>215</sup> The 2017 updated OECD Commentaries note that this provision grants broad discretion to the competent authority for the purposes of these determinations.<sup>216</sup> The application of this rule is illustrated through a classical rule-shopping situation. An individual who is a resident of state R and who owns shares in a company resident in state S assigns the right to receive dividends declared by that company to another company resident in state R which owns more than 10% of the capital of the paying company for the principal purpose of obtaining the reduced rate of source taxation provided for in article 10(2)(a). In such a case, if it is determined that the benefit of article 10(2)(a) should be denied pursuant to the PPT rule, this discretionary relief mechanism would then allow the competent authority of state S to grant the benefit of the reduced rate of 15% provided under article 10(2)(b) if that competent authority determined that such benefit would have been granted in the absence of the assignment to another company of the right to receive dividends.<sup>217</sup> From a policy perspective, this conclusion is obviously correct. However, this interpretation does not flow clearly from the text of article 7(4) of the MLI. The

213. Art. 7(4) MLI.

214. Art. 7(4) MLI.

215. *Action 6 Final Report*, at 19, 64–65; *OECD Model: Commentary on Article 29* para. 185 (2017).

216. *Action 6 Final Report*, at 19, 64–65; *OECD Model: Commentary on Article 29* para. 185 (2017):

The provision does require, however, that the competent authority must consider the relevant facts and circumstances before reaching a decision and must consult the competent authority of the other Contracting State before rejecting a request to grant benefits if that request was made by a resident of that other State. The first requirement seeks to ensure that the competent authority will consider each request on its own merits whilst the requirement that the competent authority of the other Contracting State be consulted if the request is made by a resident of that other State should ensure that Contracting States treat similar cases in a consistent manner and can justify their decision on the basis of the facts and circumstances of the particular case. This consultation process does not, however, require that the competent authority to which the request was presented obtain the agreement of the competent authority that is consulted.

217. *Action 6 Final Report*, at 19, 64–65; *OECD Model: Commentary on Article 29* para. 185 (2017).

wording of this provision indeed suggests that the person to whom alternative treaty benefits may be granted (“treat that person ... would have been granted to that person”) should be the same as the one to whom the treaty benefits claimed are denied pursuant to the PPT rule (“denied to a person”). However, as shown by the foregoing example, and where a recharacterization takes place, alternative treaty benefits are often granted by reference to another taxpayer (i.e. typically to the initial owner of the shares in an abusive restructuring). For these reasons, as will be suggested, a rule not referring to a specific taxpayer would have been preferable.

#### 4.7.3. *Without a discretionary relief clause*

Irrespective of the foregoing, the question arises as to whether it may be inferred that where such an optional mechanism is not included into the applicable tax treaty, the state of source is not allowed to grant treaty benefits on the basis of a recharacterized fact pattern as this would then contravene the literal wording of the PPT rule (“shall not be granted”).<sup>218</sup> In the author’s opinion, this position may not be supported for several reasons. First of all, the expression “shall not be granted” must be read in relation to the “principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit”. Where, however, treaty benefits are granted on the basis of a recharacterized fact pattern (for example, a 15% residual tax treaty rate instead of a 0% residual rate in a rule shopping situation),<sup>219</sup> these benefits are no longer linked to an abusive arrangement. Therefore, the PPT rule may not restrict these latter benefits. In the author’s view, the object and purpose of the PPT does not contradict this interpretation. Second, the systematic argument contending that, if a discretionary relief mechanism is not included into the tax treaty, it may then be inferred that the PPT rule prevents the state of source from granting treaty benefits on the basis of a recharacterized fact pattern is, in the author’s opinion, not a valid one. Indeed, a systematic argument may only be put forward where one provision that is actually included into the tax treaty is used to elucidate the scope of another provision. Accordingly, where the discretionary relief mechanism does not form part of the relevant tax treaty, the scope of the PPT rule should solely be determined on the basis of its literal wording, object and purpose and relationship with other provisions of this treaty. Last but not least, as the BEPS outcome expressly provides for the possibility of granting treaty benefits on the basis of the facts as they would be in the absence of an abuse, it must be considered that states wishing to do so – either on the basis of their practice or an express discretionary relief mechanism – still meet the minimum standard provided by BEPS Action 6.

Based on the foregoing, the author concludes that, when applying a PPT rule and denying treaty benefits, a jurisdiction may still grant treaty benefits on the basis of a recharacterized fact pattern, even if such jurisdiction has reserved the right not to include the discretionary

218. Along these lines, Moreno, *supra* n. 82, at 440 et seq.

219. De Broe, *supra* n. 89, at 217; Lang, *supra* n. 82, at 659.

relief mechanism provided under article 7(4) of the MLI in its CTAs. This would, for example, concern Switzerland which has reserved the right not to apply this provision but whose case law and practice regarding abusive restructurings (“old reserves theory”) support the granting of treaty benefits on the basis of a recharacterized fact pattern.<sup>220</sup> However, from a policy and tax certainty perspective, the introduction of an automatic relief mechanism would have been preferable to a mere discretionary clause.<sup>221</sup>

#### 4.7.4. Suggested alternative clause

The foregoing interpretation could also be codified by a provision stipulating:

Where a benefit under this Convention is denied under paragraph ... , the competent authority of the Contracting State shall nevertheless grant the benefit or different benefits with respect to a specific item of income or capital which would have been granted in the absence of the transaction or arrangement referred to in paragraph ....

This rule differs from article 7(4) of the MLI in two respects. First of all, the relief is automatic. For the reasons already explained, this result complies with the minimum standard of BEPS Action 6. Second, for the sake of clarity, a reference to a particular person is removed as the person by reference to whom alternative benefits are granted may not necessarily be the same as the one to whom treaty benefits are denied pursuant to the PPT rule.

#### 4.7.5. Selected EU law perspective

The author finally observes that a similar question comes into play in relation to the GAAR clauses of the Parent-Subsidiary and ATAD Directives.<sup>222</sup> While these clauses do not expressly deal with the consequences stemming from the existence of an abuse, it has been correctly argued that a return to status quo would be the most desirable interpretation in light of the case law of the ECJ. For example, in the *Halifax* case, the ECJ held that “[i]t must also be borne in mind that a finding of abusive practice must not lead to a penalty, for which a clear and unambiguous legal basis would be necessary”<sup>223</sup> and “it follows that

220. In Switzerland, this fact pattern is tackled by the “old reserves theory”, which in a treaty context essentially leads to the application of the (treaty residual) withholding tax rate on the reserves generated before the share transfer. See, in particular, FAT judgments of 23 Mar. 2010, A-2744/2008, *supra* n. 157, at 652 et seq., and of 31 Aug. 2016, A-5692/2015; see also, with further references to the Swiss administrative practice, Danon & Obrist, *supra* n. 157, at 621 et seq.; R. Danon, *Cession transfrontalière de droits et de participations*, in *Evasion fiscale. Une approche théorique et pratique de l’Evasion fiscale* 136 et seq. (Pierre-Marie Glauser ed., Schulthess Verlag 2010); S. Oesterhelt, *Altreservenpraxis*, FStR, 99 et seq. (2017).

221. The author understands that this was not possible due to the reluctance expressed by several states. However, in the internal market, the question now arises as to whether such a discretionary mechanism could fall within the scope of State aid rules (art. 107 et seq. TFEU).

222. Art. 1 PSD Directive 2015 amending art. 1 (2); similarly, art. 6 ATAD 2016; see, among others, Weber, *supra* n. 183, at 126; Debelva & Luts, *supra* n. 179, at 223 et seq.; L. De Broe & D. Beckers, *The General Anti-Abuse Rule of the Anti-Tax Avoidance Directive: An Analysis Against the Wider Perspective of the European Court of Justice’s Case Law on Abuse of EU Law*, 133 EC Tax Rev. 3 (2017).

223. UK: ECJ, 21 Feb. 2006, Case C-255/02, *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v.*

transactions involved in an abusive practice must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice”.<sup>224</sup> This reasoning was again reaffirmed in the *Cussens* case recently decided by the ECJ.<sup>225</sup> The interpretation advocated by this study, therefore, is the most compatible with EU law.

### 4.8. The relationship of the PPT rule with treaty SAARs

#### 4.8.1. Introductory remarks

One important practical issue that needs to be clarified is the relationship of the PPT rule with other anti-avoidance rules. In order to keep the discussion within manageable proportions, the author only discusses the relationship between the PPT rule and treaty SAARs.

#### 4.8.2. The issue: “Notwithstanding any provisions of a Covered Tax Agreement”

As already discussed, the issue of the relationship between a GAAR – such as a PPT rule – and a SAAR is well known. According to the opinion favoured in this article, which is also endorsed by several other commentators, the problem should be settled by the *lex specialis derogat legi generali* principle: to the extent that the SAAR covers the factual situation at issue, the latter may not, in addition, be tested in light of a GAAR.

However, with the PPT rule, this reasoning becomes controversial because the rule applies “[n]otwithstanding any provisions of a Covered Tax Agreement”.<sup>226</sup> De Broe (2008) notes that, based on its literal wording, a transaction or arrangement may be caught by the PPT rule even where the test of other, specific (treaty-based) anti-abuse rules has already been passed. For the author, however, it would be unacceptable to first include a SAAR in a tax treaty that specifically circumscribes the taxpayer behaviour which the treaty partners consider abusive on the basis of objectively verifiable (often quantitative, safe harbour) parameters, only to subsequently apply the PPT rule to extend the legal consequences provided therein to other situations beyond the scope of that SAAR. The author submits, however, that the principle *lex specialis derogat legi generali* continues to apply to the PPT rule. Accordingly, it should follow that, if a purported abusive arrangement could be tackled under both the PPT rule and a SAAR, the SAAR should generally prevail, provided that the latter covers the same situation. As will be

*Commissioners of Customs & Excise, BUPA Hospitals Ltd, Goldsborough Developments Ltd v. Commissioners of Customs and Excise and University of Huddersfield Higher Education Corporation v. Commissioners of Customs and Excise*, para. 93, ECJ Case Law IBFD.

224. Id., para. 94.

225. IE: ECJ, 22 Nov. 2017, Case C-251/16, *Edward Cussens, John Jennings, Vincent Kingston v. T.G. Brosman*, para. 46, ECJ Case Law IBFD: “Where an abusive practice has been found to exist, the transactions involved must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice. That redefinition must, however, go no further than is necessary”.

226. See, in particular, Moreno, *supra* n. 82, at 440 et seq.; De Broe, *supra* n. 89, at 221; Lang, *supra* n. 82, at 658.

shown, this position, which may be supported by the 2017 updated OECD Commentaries to the PPT rule, corresponds to the one the author defends. Moreno (2017) also generally endorses the principle of *lex specialis derogat legi generali*. However, in relation to the interpretation of the expression “Notwithstanding any provisions of a Covered Tax Agreement”, he suggests a specific interpretation. That is, the provisions: to which the PPT rule refers would not be other SAARs but, rather, exclusively the distributive<sup>227</sup> and possibly the relief rules<sup>228</sup> whose application the taxpayer aims to provoke by means of an abusive behaviour.<sup>229</sup> Accordingly, Moreno (2017) concludes that, despite the clear statements contained in the 2017 updated OECD Commentaries, the PPT rule should be just applicable to arrangements leading to rule shopping, whereas treaty-shopping strategies should be considered to be covered comprehensively by the LOB clauses. For Moreno (2017), this approach would, in particular, be consistent with the wording of the PPT rule.<sup>230</sup> In the author’s opinion, this position may not be supported for several reasons. First, there is nothing in the wording of the PPT rule that could suggest that it would only cover rule shopping and other abusive restructuring cases. This interpretation could possibly be argued if, by contrast, the PPT rule had contained wording referring to a transaction “arranged or maintained”. However, the PPT rule is broader and refers, instead, simply to “one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit”. Second, as the author acknowledges, this interpretation is not at all supported by the Commentaries to the PPT which clearly state that the PPT is meant to cover conduit situations which are not addressed by LOB clauses.<sup>231</sup> In light of the fact that the 2017 Commentaries to the PPT rule are clearly of contextual relevance as regards its interpretation, this position is thus not sustainable also for this reason. Finally, the author observes that limiting the scope of application of the PPT to rule shopping cases is difficult to reconcile with the interpretation of beneficial ownership under the 2014 OECD Commentaries. Under these Commentaries, beneficial ownership is to receive a narrow meaning which entails that it cannot cover more sophisticated conduit arrangements. Accordingly, if the PPT rule were not to be applicable to these conduit situations, the latter would not be addressed by any treaty anti-avoidance rule.

In order to decide whether the PPT rule should apply, the only question which must be answered is whether any applicable SAAR covers the factual situation at issue. For that purpose, an essential issue which needs to be settled is the exact delineation of the scope of the SAAR, which is a matter of interpretation that must be analysed pursuant to article 31 et seq. of the VCLT.

It is submitted that the 2017 Commentaries clarify the relationship of the PPT rule with treaty SAARs in a way

227. OECD Model: Commentary on Articles 6-22 (2017).  
 228. OECD Model: Commentary on Article 23 A and B (2017).  
 229. Moreno, *supra* n. 82, at 441.  
 230. *Id.*  
 231. Action 6 Final Report, at 59-60; OECD Model: Commentary on Article 29 para. 182 (2017).

that corresponds to the foregoing interpretation. In the author’s opinion, this interpretation stems from paragraphs 171 and 173 of the 2017 Commentaries to article 29(9) of the OECD Model.

First of all, paragraph 171 stipulates that a benefit that is denied in accordance with an LOB provision is not a benefit to which the PPT rule would also apply.<sup>232</sup> It may thus be inferred from this passage that the PPT rule does not cover a factual situation, which an LOB clause would address as a *lex specialis*.<sup>233</sup>

Paragraph 173, on the other hand, concerns a situation in which a public company would be regarded as a qualified person under an LOB clause, but would enter into a conduit arrangement with respect to certain items of income. Here the 2017 updated OECD Commentaries state:

As long as that company is a “qualified person” [...], it is clear that the benefits of the Convention should not be denied solely on the basis of the ownership structure of that company, e.g. because a majority of the shareholders in that company are not residents of the same State.<sup>234</sup>

Furthermore, the object and purpose of an LOB clause is to establish a threshold for the treaty entitlement of public companies whose shares are held by residents of different states. The Commentaries then go on to say:

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.<sup>235</sup>

In the author’s opinion, paragraph 173 may be construed as meaning that the PPT rule remains applicable to the factual elements that are not covered by the relevant SAAR.<sup>236</sup> As already mentioned, this requires the scope of the SAAR to be determined on the basis of its interpretation. Since, in this particular example, the LOB clause covers the factual elements relating to the ownership structure of the company, these elements may not be reviewed in light of the PPT rule. By contrast, the fact that this company also enters into a conduit arrangement is a factual element that is not related to the ownership structure of this company. Therefore, to the extent that this second and distinct factual element is not addressed by the applicable SAAR, the PPT applies to it by default.

232. Action 6 Final Report, at 59-60; OECD Model: Commentary on Article 29 para. 171 (2017).  
 233. In the same vein, see Moreno, *supra* n. 82, at 440.  
 234. Action 6 Final Report, at 59-60; OECD Model: Commentary on Article 29 para. 173 (2017).  
 235. *Id.*  
 236. In the same vein, see Moreno, *supra* n. 82, at 441.

#### 4.8.3. Position: Treaty SAAR solely applies if it covers the same facts

In light of the foregoing, and taking into account the updated Commentaries, the author argues that the expression “Notwithstanding any provisions of a Covered Tax Agreement” should not be interpreted to mean that the PPT rule applies, in addition, to factual elements that are already covered by a treaty SAAR. Rather, in such a case, and as regards these factual elements only, the SAAR is, in the author’s opinion, solely applicable.

The Commentaries address the relationship between the PPT rule and an LOB clause. It is, however, submitted that the same reasoning applies to other treaty SAARs, in particular those which are recommended by the work on BEPS Action 6, namely the clauses relating to dividend transfer transactions<sup>237</sup> and to capital gains relating to real estate companies.<sup>238</sup> From a policy perspective, this interpretation also contributes to tax certainty in the sense that a fact pattern which is objectively and specifically covered by a SAAR may not, as a second step, be tested in light of the PPT rule. This position is, in fact, even more justified as regards the BEPS SAARs since the latter and the PPT rule are rooted in the work relating to BEPS Action 6 and were elaborated at the same time.

It consequently follows that the expression “Notwithstanding any provisions of a Covered Tax Agreement” used by the PPT rule refers to factual situations that are not covered by a treaty SAAR.

#### 4.8.4. Particular case of beneficial ownership

##### 4.8.4.1. Introductory remarks

The relationship between the PPT rule and beneficial ownership deserves special attention. Despite the existence and evolution of the OECD Commentary, the meaning given to beneficial ownership around the globe is far from being uniform with, in essence, some jurisdictions adopting a rather formal and legal interpretation and others favouring, by contrast, a broader substance-over-form approach. Hence, the scope of beneficial ownership as a SAAR may vary depending on the meaning it receives, which, according to the foregoing interpretation, could in turn affect the scope of application of the PPT rule.

Therefore, in order to keep the discussion within manageable proportions, the author here considers two situations, namely the case in which beneficial ownership receives the meaning it has under the 2014 OECD Commentaries (narrow interpretation, *see* section 4.8.4.2.) and the case in which it is, by contrast, defined according to an objective substance-over-form approach.<sup>239</sup>

237. Art. 8 MLI.

238. Art. 9 MLI.

239. *See* sec. 4.8.4.3.

##### 4.8.4.2. Analysis under the narrow meaning of the 2014 Commentaries

As previously mentioned, the 2014 OECD Commentaries have reduced the beneficial ownership threshold so that this requirement is to be construed in a narrow way and, thus, is of very limited use in conduit situations. The fact that the final report on BEPS Action 6 does not at all rely on beneficial ownership to address conduit cases, plus the fact that these situations should be tackled either by the PPT rule or through specific conduit rules producing the same effect, confirm this interpretation.

Therefore, where beneficial ownership receives the meaning it has under the 2014 OECD Commentaries, the relationship of the PPT rule with beneficial ownership is easy to settle: in the case of dividends, interest and royalties, the PPT would, in particular, apply where (i) the conduit situation is not covered by beneficial ownership (due to its narrow meaning), or (ii) the factual situation at issue is not one with which beneficial ownership is at all concerned, such as an abusive restructuring. This interpretation also flows from the 2017 updated OECD Commentaries to the PPT, which state that the rule would in particular apply to:

limitations on the taxing rights of a Contracting State in respect of dividends, interest or royalties arising in that State, and paid to a resident of the other State (who is the beneficial owner) under Article 10, 11 or 12.<sup>240</sup>

##### 4.8.4.3. Analysis under a broad substance and objective oriented meaning

Slightly more delicate, by contrast, is the case in which the state of source favours a broad and objective meaning of beneficial ownership (departing from the 2014 OECD Commentaries), such as in Switzerland. In essence, the two foregoing situations should here, again, be distinguished.

The first situation, and the easier to resolve, is the case in which treaty abuse is rooted in an abusive restructuring. In this first instance, it is quite clear that the PPT rule would be solely applicable because beneficial ownership, even construed broadly, is a test that focuses exclusively on the intensity of the ownership attributes of the recipient, or on the interdependence between the items received and transferred by the recipient in the state of residence.

The second situation, on the other hand, is more complicated. Indeed, if beneficial ownership is construed broadly and is capable of covering most conduit situations, it is then *prima facie* arguable that these situations should be exclusively tackled through the beneficial ownership requirement by virtue of the *lex specialis derogat legi generali* principle. The question may then be asked whether beneficial ownership would produce the same result as the PPT rule. In the author’s opinion, this would not always be the case. In Switzerland, for example, the focus is on the criterion of interdependence between the income and

240. *Action 6 Final Report*, at 65–66; *OECD Model: Commentary on Article 29* para. 175.



the obligation to transfer such income to non-residents. However, as previously shown, the intention and motives that have led the taxpayer to select a particular arrangement or structure are irrelevant. By contrast, the PPT rule is based on a different policy in which the purpose and business rationale of the transaction are taken into account. The PPT rule will thus not simply apply because there is some sort of interdependence between the two income streams but, rather, because the purpose of the transaction was to eliminate withholding tax in the source state. Hence, by mirrored reasoning, the PPT rule will not apply where, despite the existence of some sort of interdependence, the transaction is, for example, “conforming to the standard commercial organisation and behaviour of the group”.<sup>241</sup> Consequently, it follows that there may be instances in which treaty benefits could be denied on the basis of an objective and broad interpretation of beneficial ownership, whereas this would not have been the case under the PPT rule if it had applied in lieu of this broadly construed SAAR.

Is the foregoing result in line with the BEPS outcome? At first sight, the question could be answered in the affirmative using the argument that the introduction of the PPT rule merely constitutes a minimum standard and that states are free to adopt stricter measures or practices and judicial doctrines to counter treaty abuse (such

as a broad interpretation of beneficial ownership). In the author’s opinion, this interpretation may, however, not be supported. First of all, the outcome of BEPS Action 6 expresses a consensus as regards the way to address conduit situations (through a PPT rule). This consensus around this policy is so strong that, if states wish to opt out of the PPT rule, they must then adopt anti-conduit mechanisms that “achieve a similar result”.<sup>242</sup> It would therefore be at odds with these principles if states adopting the PPT rule could nevertheless continue to address conduit structures on the basis of principles based on a different policy.

*4.8.4.4. Position: Meaning of beneficial ownership must be aligned with the 2014 OECD Commentaries and BEPS policy*

In light of the foregoing, the author concludes that the BEPS outcome implies that conduit structures must now be tackled on the basis of a PPT rule (or a mechanism based on a similar policy) and that this outcome is yet another reason militating in favour of an alignment of beneficial ownership with the narrow meaning given to this term under the 2014 Commentaries. From this perspective, therefore, the position of states favouring a broad substance-oriented meaning of beneficial ownership coupled with the lack of a purpose test should be revisited.

241. *Action 6 Final Report*, at 67; *OECD Model: Commentary on Article 29* para. 187, Example E (2017).

242. *Action 6 Final Report*, at 65-66; *OECD Model: Commentary on Article 29* para. 187 (2017).