taxnotes® international

Volume 87, Number 5 ■ July 31, 2017

Discretionary Benefits Provisions Under The MLI: A Virtuous Solution Or a Vicious Circle?

by Błażej Kuźniacki

Reprinted from *Tax Notes Int'l*, July 31, 2017, p. 451

Discretionary Benefits Provisions Under the MLI: A Virtuous Solution or a Vicious Circle?

by Błażej Kuźniacki

Błażej Kuźniacki

Błażej Kuźniacki is a research fellow at the Singapore Management University — Tax Academy Centre for Excellence in Taxation and of counsel at PATH Law LLP in Warsaw.

In this article, the author examines the discretionary benefits provisions in the multilateral instrument, finding that the provisions are flawed and proposing solutions to create more effective and efficient protection for both the government and the taxpayer.

Over 100 countries and jurisdictions have agreed to implement the four minimum standards of the OECD/G-20's base erosion and profit-shifting package via the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (multilateral instrument, or MLI). The OECD announced the adoption of the MLI on November 24, 2016, and a signing ceremony was held on June 7 in Paris.[1] All of the parties involved in the inclusive framework are facing a significant change in the area of international taxation and are under pressure to adopt positions on the MLI framework.

In May 2015 OECD Secretary-General Angel Gurría said, optimistically, that the BEPS project's proposals:

> represent the most fundamental changes to international tax rules in almost a century: they will put an end to double non-taxation, facilitate a better alignment of taxation with economic activity and value creation, and when fully implemented, these measures will render BEPS-inspired tax planning structures ineffective.[2]

Several authors have questioned whether Gurría's optimism was completely justified regarding these BEPS actions.[3]

This article undertakes a much narrower critical analysis, focusing on one element of action 6 — the discretionary benefits provisions. The discretionary benefits provision is a required part of the MLI's limitation on benefits rule (article 7(12)), but is optional under the principal purposes test (PPT) (article 7(4)).[4] Accordingly, this analysis will be relevant to countries and jurisdictions that use both the MLI's LOB rule and a PPT with the discretionary benefits provision; those that apply both provisions but do not include the PPT's optional discretionary benefits

[1] OECD, "Topics: Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting." The four minimum standards stem from actions 2, 6, 7, and 14 of the BEPS package and the MLI itself is the outcome of action 15. We reference "countries and jurisdictions" because some non-state, non-country jurisdictions such as the Turks and Caicos Islands, the Cayman Islands, and the British Virgin Islands are among the members of the Inclusive Framework on BEPS, which may become the signatories of the MLI. *See* article 2(1)(b) MLI.

[2] *See* OECD, "OECD Presents Outputs of OECD/G-20 BEPS Project for Discussion at G-20 Finance Ministers Meeting — Reforms to the International Tax System for Curbing Avoidance by Multinational Enterprises" (May 10, 2015).

[3] *See, e.g.*, Reuven S. Avi-Yonah and Haiyan Xu, "Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight," 6(2) *Harvard Bus. L. Rev.* 200-238 (Summer 2016).

[4] *See* article 7(3) MLI.

provision; and those jurisdictions that opt for the MLI's LOB rule exclusively.[5]

Goals of Discretionary Benefits Provisions

The MLI's LOB rule is set forth in article 7, paragraphs 8 through 13 of the MLI. In terms of wording and structure, it is largely a simplified version of the LOB rule in the action 6 report, with some modifications that replicate selected elements of a new LOB rule in the 2016 U.S. model.[6] The LOB rule is a specific yet complicated mechanism consisting of a series of objective tests focused on which entities are entitled to treaty benefits, namely:

(i) qualified persons entitled to all treaty benefits:

(1) individuals;

(2) contracting states and their authorities;

(3) nonprofit organizations and pension funds;

(4) companies meeting the publicly traded test;

(5) companies meeting the ownership test;

(ii) nonqualified persons entitled to treaty benefits for a specific item of income:

(6) companies meeting the active business test;

(7) companies meeting the derivative benefits test; and

(iii) other persons that do not fall within categories 1 to 7 but are entitled to treaty benefits for a specific item of income if:

(8) these persons are considered to be bona fide by tax authorities under the residual test (a kind of PPT known as competent authority relief).

The purpose of these tests is to raise the threshold for the subjective scope of tax treaties (specifically, articles 1, 3, and 4(1) of the OECD model). They limit treaty benefits to taxpayers who are: (a) residents of a contracting state, beneficial owners of relevant income, and also have a sufficient personal and economic nexus to their residence state (the qualified persons' test); (b) carry out real business activities in their residence state (the active business test); or (c) are not driven by abusive treaty-shopping motives (the derivative test and the residual bona fide test).[7]

The residual bona fide test in the MLI's LOB rule exists to counterbalance the strict mechanical approach, which could lead to a denial of treaty benefits in non-treaty-shopping cases. This test allows taxpayers to demonstrate that their scheme did not have obtaining tax treaty benefits as one of its principal purposes.[8] If they convince the relevant competent authority, treaty benefits will be granted to a specific item of income. Thus, under this test, treaty benefits are granted via a discretionary decision of the tax authorities. Therefore, it is also called the "discretionary benefits provision." It is the last resort for taxpayers seeking to qualify for treaty benefits under the MLI's LOB rule.

---

[5]The MLI includes a PPT as the default option because it is the only approach that can satisfy the action 6 minimum standard on its own. Optionally, a simplified LOB may supplement the PPT. Countries may also adopt the PPT as an interim measure and later switch to a detailed LOB rule. OECD, "Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (Nov. 24, 2016).

[6]*See* OECD, "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report" (Oct. 5, 2015). *See also* explanatory statement, *supra* note 5. The modifications were made in the course of follow-up work by OECD Committee on Fiscal Affairs Working Party No. 1 on Tax Conventions and Related Questions. For a comparison of the similarities and differences between the LOB provisions in the MLI and in the 2016 U.S. model, see David Dominguez, "Limitation on Benefits: Comparison Between the US LOB and the OECD LOB Proposed Under Action 6," in *Preventing Treaty Abuse* 293-310 (2016).

[7]*See* action 6 report, *supra* note 6. *See generally* Richard L. Doernberg and Kees van Raad, *The 1996 United States Model Income Tax Convention: Analysis, Commentary and Comparison* 172 (1997); Félix Alberto Vega Borrego, *Limitation on Benefits Clauses in Double Taxation Conventions* 92-93, 115 (2005); Luc De Broe and Joris Luts, "BEPS Action 6: Tax Treaty Abuse," 43(2) *Intertax* 122-130, 124 (2015); and Alexander Rust, "Art. 1: Persons Covered," in *Klaus Vogel on Double Taxation Conventions* 131 (2015).

[8]*See* action 6 report, *supra* note 6.

The discretionary benefits provision is included in article 7(12) of the MLI. It reads as follows:

> If *a resident of a Contracting Jurisdiction to a Covered Tax Agreement* is neither a qualified person pursuant to the provisions of paragraph 9, nor entitled to benefits under paragraph 10 or 11, the competent authority of the other Contracting Jurisdiction *may*, nevertheless, *grant the benefits* of the Covered Tax Agreement, or benefits *with respect to a specific item of income,* taking into account the object and purpose of the Covered Tax Agreement, but *only if such resident demonstrates to the satisfaction of such competent authority* that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under the Covered Tax Agreement. Before either granting or denying a request made under this paragraph by a resident of a Contracting Jurisdiction, the competent authority of the other Contracting Jurisdiction to which the request has been made shall consult with the competent authority of the first-mentioned Contracting Jurisdiction.[9] [Emphasis added.]

Hence, under this provision, tax authorities *may* grant treaty benefits to taxpayers even if the taxpayers fail to meet the criteria of the objective tests under the MLI's LOB rule. This safe harbor is important because the objective tests under the MLI's LOB rule apply fairly mechanically and, given the increasing scope, complexity, and diversity of international business relations, they may close off access to treaty benefits for taxpayers engaged in sound business practices or using long-standing business structures without a desire to obtain treaty benefits in an abusive manner.[10] However, article 7(12) of the MLI seems to be fairly ambiguous, and the discretion of competent authorities appears to be so wide that, as explained below, its application in favor of taxpayers is anything but clear.

The Process of Requesting Treaty Benefits

To obtain treaty benefits that have not been obtained under other portions of the MLI's LOB rule, taxpayers must ask the competent authority of the contracting state to grant the benefits. Absent a request, the competent authority is not required to apply article 7(12) of the MLI to grant treaty benefits.[11] Requests may be presented by taxpayers before (for example, through an advance ruling request) or after the establishment, acquisition, or maintenance of the entity for which the request is made. If the request is made after the relevant action, the competent authority may grant treaty benefits retroactively.

Usually, the request to apply the reduced tax rate on withholding taxes will be filed by a resident of one contracting state (resident state) to the competent authority of the other contracting state (source state). But the request may also be submitted by a resident to its own state's competent authority if the requested treaty benefits are provided by the state of residence (for example, a request for an exemption or credit to eliminate double taxation).[12] This distinction is relevant for at least two reasons. First, as discussed later in this article, only in the latter case will the taxpayer be entitled to appeal the competent authority's decision to an independent body in its state of residence. Second, only in the former case, when the request is made to the

---

[9] As the explanatory statement says:

> To appropriately reflect the scope of the Convention, as well as the fact that individual tax treaties may have a variety of titles, the term 'Contracting Jurisdiction' is used in place of 'Contracting State', and the term 'a Covered Tax Agreement' is used in place of 'a Convention' (a tax treaty), in the OECD Model Tax Convention and the United Nations Model Double Taxation Convention between Developed and Developing Countries ('UN Model Tax Convention'), to refer to the parties to a Covered Tax Agreement, to reflect the fact that the Convention may modify agreements in relation to which one or more party is a non-State jurisdiction.

Supra note 5. In this article, the widely known terms "contracting state" and "tax treaties" will be used and can be aligned with the terms "contracting jurisdictions" and "covered tax agreements," respectively.

[10] *See* U.S. Treasury Department, United States Model Income Tax Convention of September 20, 1996: Technical Explanation.

[11] *See* Manuel Augusto Carrión Camayo, "Limitation on Benefits: Derivative Benefits and Discretionary Relief," in *Preventing Treaty Abuse* 249 (2016).

[12] *See* action 6 report, *supra* note 6.

source state, must the competent authority consult its counterpart in the other state before either granting or denying the request. Although the result of this consultation is not legally binding on the competent authority of the source state (the competent authority that receives the request has full discretion in deciding the response), the position of the resident state is likely to have an important effect on the grant or denial of treaty benefits. The consultation is sensible because the resident state will have more information about the tax situation and history of its own resident and can also apply domestic procedural rules toward them, for instance, to verify evidence provided by the taxpayer. As the OECD notes in the action 6 report, the consultation also helps ensure that contracting states treat similar cases in a consistent manner.

The OECD urges the competent authority that receives the request to process it expeditiously. In practice, however, it may take considerable time to reach a decision because applying the objective tests under the MLI's LOB rule seems extraordinarily complicated.[13] Moreover, the ruling may result in a denial of access to treaty benefits in situations in which there is no abusive treaty shopping. Consequently, the request will typically involve very complicated situations at the border between appropriate and inappropriate uses of tax treaties. This analysis demands considerable time and resources from the contracting states. Likewise, mutual agreement and arbitration procedures involving the discretionary benefits provision, like other dispute procedures, are immensely burdensome and time-consuming.[14]

Requests for the discretionary benefit will most likely prove the exception rather than the rule. Notably, the U.S. experience with the discretionary benefits provision in its treaties reveals that requests for this benefit occur infrequently.[15] Still, it is important to ensure they are handled in a fair manner and provide some level of foreseeability for taxpayers.

The Competent (Tax) Authority's Wide Discretion

An obvious feature of the discretionary benefits provision is that it gives the competent authority wide discretion in granting or denying treaty benefits. In the broadest case, the competent authority may deny benefits entirely, a power inherent in the use of the language "may grant" rather than "shall grant." "Shall," notably used in the discretionary benefits provision in the action 6 report, is stronger than the term "may," adopted in article 7(12) of the MLI. "Shall" suggests that the authority should generally exercise its discretion in favor of granting treaty benefits, so long as obtaining treaty benefits is not among the taxpayer's principal purposes in undertaking the transaction.[16] The OECD commentary on action 6 confirms that, reading the version of the discretionary benefits provision therein ("shall grant"), once it has been determined that the taxpayers have not sought to obtain treaty benefits as one of their principal purposes, the competent authority *is required* to grant treaty benefits.

Given the importance of wording in legal instruments,[17] the decision to use "may" instead of "shall" is likely intentional, and the linguistic distinction must be given meaning. Reading literally, the competent authority applying the MLI's discretionary benefits provision *may* or *may not* grant treaty benefits, even when the taxpayers did not have obtaining treaty benefits as one of their principal purposes. This interpretation, however, is unacceptable given the purpose of the provision, which is to grant treaty benefits in the situation described above, and therefore must be

[13] *Cf.* Qunfang Jiang, "Treaty Shopping and Limitation on Benefits Articles in the Context of the OECD Base Erosion and Profit Shifting Project," 3 *Bulletin for International Taxation* 139-148 (2011); De Broe and Luts, *supra* note 7; De Broe, "Tax Treaty and the EU Law Aspects of the LOB and PPT Provision Proposed by BEPS Action 6," in *Base Erosion and Profit Shifting (BEPS): Impact for European and International Tax Policy* 231-237 (2016); and Adrian Wardzynski, "The Limitation on Benefits Article in the OECD Model: Closing Abusive (Undesired) Conduit Gateways," 9 *Bulletin for International Taxation* 471-479 (2014). *See also* John Bates et al., "LOB Articles in Income Tax Treaties: The Current State of Play," 41(6/7) *Intertax* 395-404 (2013).

[14] *See* Pascal Janssens et al., "The End of Intra-Group Financing . . . or Not Just Yet? — Part 1," 7 *European Taxation* 289-290 (2015).

[15] *See* Bates et al., *supra* note 13; and Robert Culbertson and Christine Halphen, "United States National Report: Advance Rulings," 84b *Cahiers de Droit International Fiscal* 627 (1999).

[16] *See* Rust, *supra* note 7. For a discussion of this limitation on benefits, see the section titled "Obtaining Treaty Benefits as a Principal Purpose," *infra.*

[17] With respect to the language of tax treaties, see H. David Rosenbloom, "Where's the Pony? Reflections on the Making of International Tax Policy," *Tax Notes Int'l*, Jan. 11, 2010, p. 153.

rejected.[18] For the sake of clarity, the word "may" in article 7(12) of the MLI should be replaced with "shall."

For now, assume that the competent authority is willing to grant the treaty benefits. It may grant the requesting taxpayer all of the benefits provided for under the tax treaty or limit the grant to specific benefits, such as a particular item of income. In the former case, the taxpayers are treated as qualified persons, while in the latter case it is as if they had passed the active business test or the derivative test under the MLI's LOB rule. The OECD's action 6 report adds that the competent authority may set out specific conditions, such as putting a time limit on the duration of any treaty benefit granted.

Fortunately, the MLI's discretionary benefits provision places some limitations on the competent authority's discretion, at least regarding whether to grant the treaty benefits to taxpayers. The competent authority *may* grant treaty benefits (1) "taking into account the object and purpose of the treaty," but only if (2) "the taxpayer demonstrates to the satisfaction of such competent authority that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under the [tax treaty]." Thus, the authority must examine both the treaty itself and the evidence submitted by the taxpayers. Still, the authority's discretion remains relatively wide since these criteria are not precise and thus prone to a subjective application.[19]

'The Object and Purpose of the Tax Treaty'

When deciding whether or not to grant treaty benefits, the MLI first directs the competent authority to take into account "the object and purpose of the tax treaty." This seems somewhat superfluous since the legally binding rule of treaty interpretation in article 31(1) of the Vienna Convention on the Law of Treaties requires interpreters to adhere precisely to the object and purpose of the treaty. As a codification of international customary law regarding treaties, all treaties, including tax treaties, must be interpreted according to the VCLT.[20] This holds true whether the treaties were implemented before or after VCLT entered into force and even regardless of whether the VCLT has been formally implemented into a country's legal system.[21] Thus, the wording of any tax treaty, including the provision equivalent to article 7(12) of the MLI, must *always* be interpreted in light of its purpose (and context).[22]

The OECD's action 6 report does not include any commentary about taking the purpose of the tax treaty into account while applying the discretionary benefits provision, likely because the phrasing of the provision in the action 6 report does not include the direct reference to the treaty's purpose. Guidance for applying the MLI's version can be found instead in article 31(2) of the VCLT, which indicates that an understanding of the purpose of a treaty should be derived from the wording of its provisions and also from its preamble, if one exists.

Clearly, the purpose of the discretionary benefits provision, along with the whole of the MLI's LOB rule, is to prevent treaty shopping. The purpose of the entire treaty is, in turn, reflected in the new preamble proposed by article 6(1) of the

[18] According to article 31(1) of the Vienna Convention on the Law of Treaties (VCLT), terms in tax treaties must be interpreted not only by taking into account their ordinary meaning, but also considering their purpose and context.

[19] *Cf.* J. Calejo Guerra, "Limitation on Benefits Clauses and EU Law," 51(2/3) *European Taxation* 92 (2011).

[20] For a comprehensive discussion of interpretation of tax treaties under the VCLT, see Frank A. Engelen, *Interpretation of Tax Treaties Under International Law* (2004); Klaus Vogel and Rainer G. Prokisch, "General Report: Interpretation of Double Taxation Conventions," 78a *Cahiers de Droit Fiscal International* (1993); Ulf Linderfalk, *On the Interpretation of Treaties: The Modern International Law as Expressed in the 1969 Vienna Convention on the Law of Treaties* (2007); and Sir Ian Taggart Sinclair, *The Vienna Convention on the Law of Treaties* (1984).

[21] *See, e.g.*, the International Court of Justice's judgment in *Kasikili/Sedudu Island (Bots. v. Namib.)*, 1999 ICJ 1045 (Dec. 13, 1999); and the European Court of Human Rights' judgment in *Golder v. the United Kingdom*, 57 ILR 200 (Feb. 21, 1975). *See also* De Broe, *International Tax Planning and the Prevention of Abuse* 235 (2008); David A. Ward, *The Interpretation of Income Tax Treaties With Particular Reference to the Commentaries on the OECD Model* 15-16 (2005); and Vogel and Prokisch, *supra* note 20.

[22] Article 31(1) VCLT does not require an interpreter to determine the ordinary meaning of a treaty's term in the abstract but in the context of the treaty and in light of its object and purpose. *See* International Law Commission, "Draft Articles on the Law of Treaties With Commentaries 1966," *Yearbook of the International Law Commission 1966*, Vol. II, para. 12, at 221. This means that when applying tax treaties, all the linguistic, purposive, and contextual approaches to the interpretation of treaties should be taken into account together, not merely the linguistic approach.

MLI, which says that the intention of the tax treaty is 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). [Emphasis added.]

The MLI also allows states, at their option, to precede the quoted text with an expression of their desire "to further develop their economic relationship and to enhance their co-operation in tax matters."

Ultimately, tax treaties seek to eliminate international double taxation in order to promote the exchange of goods and services as well as the movement of capital and persons.[23] Hence, the discretionary benefits clause requires the competent authority to ensure the elimination of double taxation without incentivizing treaty shopping.

Obtaining Treaty Benefits as a Principal Purpose

The second criterion for granting treaty benefits under article 7(12) of the MLI uses the more forceful language "only if" to describe when benefits can be granted. Thus, the competent authority *may* grant treaty benefits to taxpayers *only if* the taxpayers demonstrate that neither the establishment, acquisition, or maintenance of the entity at issue nor the conduct of their operations had the procurement of treaty benefits as one of its principal purposes.

Here, the burden of proof lies with taxpayers. The action 6 report explains that the taxpayers must convince the competent authority that there were clear, nontax business reasons for the formation, acquisition, or maintenance of the entity and for the conduct of operation in the other contracting state. Unsurprisingly, it has proved exceptionally difficult to persuade the competent U.S. tax authorities to grant treaty benefits, even when the views of the competent authorities of the smaller states of residence (that is, the U.S. tax treaty partners) favor the company.[24]

In response to complaints about the lack of guidance for determining whether one of the principal purposes was the obtainment of treaty benefits, the commentary in the OECD's action 6 report provides some examples and identifies some factors to guide the exercise of the competent authority's discretion in this regard. The fact, for example, that taxpayers could be entitled to the same benefits under other tax treaties, including when the taxpayer could obtain a similar result without interposing the company claiming the benefits, is not sufficient to allow a company to obtain treaty benefits under the discretionary benefits provision. Instead, other favorable business factors must establish a substantial relationship between the taxpayers and their chosen state of residence.

Other factors relevant to the competent authority's exercise of discretion on this point include:

- the history, structure, ownership, and operations of the taxpaying entities making the request;
- whether those taxpayers are preexisting entities that were recently acquired by nonresidents for nontax reasons;
- whether the taxpayers carry on substantial business activities;
- whether the income for which the benefits are requested is subject to double taxation; and
- whether the establishment or use of the taxpayers gives rise to nontaxation or reduced taxation.[25]

[23] This is reiterated in several places in the action 6 report, including the suggested revisions to the commentary on article 1. Ultimately, the purpose of tax treaties is to enhance international commerce between contracting states. The first operational purpose, applicable in all circumstances, is to eliminate double taxation. The second operational purpose, applicable in appropriate circumstances only, is to prevent tax evasion and tax avoidance. *See* Brian J. Arnold, *Introduction to Tax Treaties* 10 (2015). To achieve the second purpose and ensure it applies without doubt, the OECD proposed to amend tax treaties via the action 6 report and now by implementing the minimum standard under the MLI.

[24] *See* KPMG, "Initial Analysis of 2016 U.S. Model Treaty" (Feb. 23, 2016).

[25] For analysis of how the last two items follow from the provision's charge to the competent authority to consider the purpose of the tax treaty, see the section immediately before this one.

Because the discretionary benefits provision typically applies at the crossroads between abusive and non-abusive actions,[26] it is also important to ascertain how narrowly the taxpayers failed the objective tests under the LOB provision.[27]

Even under these guidelines, which are neither specific, nor exhaustive, nor legally binding, the competent authority has the power to take a discretionary approach (if not outright arbitrary) to deciding if, without any conclusive proof, the taxpayers satisfied the conditions in article 7(12) of the MLI. This is recognized by the OECD's commentary in its action 6 report, which provides that the rule "grants broad discretion to the competent authority and, as long as the competent authority has exercised that discretion in accordance with the requirements of the paragraph, it cannot be considered that the decision . . . results in taxation not in accordance with the provisions of the Convention."

The OECD also clearly states that obtaining benefits under a tax treaty need not be the sole or even dominant purpose for the establishment, acquisition, or maintenance of the taxpayer and the conduct of his operations to defeat a claim for coverage. It is sufficient that at least one of the principal purposes was to obtain treaty benefits.

This prompts the following question: Is it realistic to imagine that any diligent businessperson engaged in cross-border operations would *not* consider it one of their principal purposes in designing a transaction to operate in the most favorable manner as to the imposition of international taxation, including securing the benefits of tax treaties?[28] Given that taxes represent one of the most significant business costs[29] and the use of tax treaties will normally reduce them, it would be astonishing to find a businessman who would not make that effort.[30] The overwhelming majority will obviously do so. This is especially true for transactions that might trigger the discretionary benefits clause, cases at the brink between abusive and non-abusive situations in which obtaining treaty benefits is especially likely to be a key consideration. Therefore, it is hard to envision many transactions that would justify the granting of treaty benefits under the discretionary benefits provision.

Unilateral Guidelines, Bilateral Memoranda

On a more positive note, the OECD encourages contracting states to publish guidelines on the types of cases that will and will not qualify for discretionary benefits. Somewhat surprisingly, however, the OECD's intent is to discourage taxpayers from submitting vexatious requests rather than to increase legal certainty. Although tax administrations publishing guidance is not bad per se and may shed light on the potential application of the discretionary benefits provision, it is also not all that helpful because it would have minor legal value.[31] In particular, it would not constitute a legally binding interpretative source for the interpretation of a given tax treaty under article

[26] This is because the discretionary benefits provision only applies to situations in which the taxpayer failed to meet the requirements to obtain treaty benefits under the MLI's LOB rule's objective provisions. In those situations, the procurement of treaty benefits is clearly a decisive factor for entering into a transaction or establishing an arrangement.

[27] *See, e.g.*, Netherlands-United States Income Tax Treaty — Technical Explanation on Article 26(7) of the Convention Between the Kingdom of the Netherlands and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (Dec. 18, 1992) ("Further, the fact that a Netherlands corporation failed to satisfy one of the tests under the substantive rules of Article 26, but failed to do so by a narrow margin, would generally be a factor that, in combination with one or more of the factors described above, would weigh in favor of favorable consideration by the United States competent authority.") (text of treaty available via Tax Analysts; note: this language is not included in the most recent technical explanation for the Netherlands-U.S. treaty dated March 8, 2004). *See also* Rust, *supra* note 7, at 139; and Vega Borrego, *supra* note 7, at 221.

[28] *See* Philip Baker and Tizhong Liao, "Improper Use of Tax Treaties: The New Commentary on Article 1 and the Amended Article 13(5)," 66(11) *Bulletin for International Taxation* 600 (Oct. 17 2012).

[29] For instance, withholding tax on dividends is almost always among the first five – often even one of the first three — leading corporate cost categories. *See* Jeffrey Owens, "Abusive Tax Shelters: Effects of Tax Destruction?" *Tax Notes Int'l*, Dec. 5, 2005, p. 873; and Błażej Kuźniacki, "Tax Optimization of Dividend Payments — Selected Methods," PTE Toruń Working Papers 17/2012.

[30] *See, e.g.*, De Broe and Luts, *supra* note 7.

[31] The guidelines are no more than a legal opinion from tax administration experts. They are not legally binding domestically and may, at best, be of secondary interpretive value comparable to authoritative literature: informative and persuasive, but only informally authoritative at best. *See, e.g.*, Alexander Rust and Vogel, "Introduction," in *Klaus Vogel on Double Taxation Conventions, supra* note 8; Martti Nieminen, "Dual Role of the OECD Commentaries – Part 1," 43(11) *Intertax* 636 (2015); and Nieminen, "Dual Role of the OECD Commentaries – Part 2," 43(12) *Intertax* 775 (2015).

31(1) of the VCLT.[32] Guidance is unilateral, expressing the intention of only one of two contracting states, thus contradicting the principle of common interpretation.[33]

It would be better, therefore, to use a memorandum of understanding between the contracting states to supplement the tax treaty.[34] Once agreed to and concluded, an MOU would be a legally binding resource for interpreting the tax treaty under article 31(2) of the VCLT and would express the common intention of both states. Beyond the legal matters, this is also a preferable path for global and policy-oriented reasons relevant to ensuring the successful application of legal solutions proposed in the action 6 report and the MLI generally.

Some countries — the Netherlands is a good example — are more than willing to allow entities formed within their borders to rely on their tax treaty network for the indirect benefit of residents of third countries or jurisdictions (treaty shopping).[35] Likewise, some developing and middle- to high-income jurisdictions, such as Singapore, seem happy to accept the foreign direct investment that flows from treaty shopping. On the other hand, there are countries, like the U.S., that are generally against treaty shopping.[36] Differences on these fundamental issues are likely to trigger different approaches to the application of LOB rules or other anti-treaty-shopping measures. The effect of these differences is proportional to the amount of discretion available in a given LOB rule. Because discretion under the derivative benefits provision is vast, the interpretation of the phrase "one of principal purposes" may also vary significantly between contracting states. This may render the discretionary benefits provision essentially inapplicable or limit application to a few specific situations that may not focus on the provision's goal of preventing abusive treaty shopping.

An MOU can help avoid divergent applications of the discretionary benefits provision by the competent authorities of the contracting states. It also provides a degree of certainty to taxpayers. A good example is the MOU on article 26(7) of the Netherlands-U.S. tax treaty.[37] Likely because the U.S. is aware that the Netherlands is a notorious "treaty seller" and applies a very different approach to defining what constitutes abusive and non-abusive use of tax treaties, the MOU was deemed the best solution to prevent the inappropriate application of the discretionary benefits provision. Without this memorandum, taxpayers would suffer from a lack of legal certainty and the tax authorities might disagree over the provision's application.

Just as different jurisdictions have different views on what constitutes abusive and non-abusive treaty shopping,[38] their competent authorities take different positions on granting treaty benefits under the discretionary benefits provision. Wide discretion combined with the lack of any specific guidance in this regard only enhances this undesired diversity. Unilateral guidance can only help so much. MOUs can be

---

[32] Only materials prepared by both contracting states may be used in the interpretation of treaties; unilateral guidelines are merely a supplementary tool for interpretation. This stems from the fact that only bilateral materials express a common intention of the contracting states. *See* Vogel and Prokisch, *supra* note 20.

[33] *See, e.g.*, D.A. Ward, "Use of Foreign Courts' Decisions in Interpreting Tax Treaties," in *Courts and Tax Treaty Law* 161 (2005); and Rust and Vogel, "Introduction," *supra* note 31.

[34] *See* Bates et al., *supra* note 13.

[35] *See, e.g.*, Baker and Liao, *supra* note 28.

[36] *See* Avi-Yonah, "Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy," University of Michigan Public Law research paper No. 318 (2013); and Luc De Broe et al., "Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions," 7 *Bull. for Int'l Tax'n* 383 (2011).

[37] This memorandum lists six nonexclusive factors that should be considered when interpreting the discretionary benefits provision under the LOB provision in the Netherlands-U.S. tax treaty (article 26(7)) and determining whether the establishment, acquisition, or maintenance of an entity resident in one of the states has or had as one of its principal purposes the acquisition of benefits under the treaty. Specifically, it says:

> The competent authority of the State in which the income in question arises may consider the following factors (among others): (1) The date of incorporation of the corporation in relation to the date that this Convention entered into force; (2) The continuity of the historical business and ownership of the corporation; (3) The business reasons for the corporation residing in its State of residence; (4) The extent to which the corporation is claiming special tax benefits in its country of residence; (5) The extent to which the corporation's business activity in the other State is dependent on the capital, assets, or personnel of the corporation in its State of residence; and (6) The extent to which the corporation would be entitled to treaty benefits comparable to those afforded by this Convention if it had been incorporated in the country of residence of the majority of its shareholders.

See Netherlands-United States Income Tax Treaty — Technical Explanation, *supra* note 27.

[38] *See* De Broe et al., *supra* note 36, at 382; Michael Littlewood and Kyle Rainsford, "Hong Kong's Treaty Network: Are the US, Germany and Australia Sensibly Standing Aloof? Or Sadly Missing Out?" 1 *British Tax Review* 79 (2014); Wardzynski, *supra* note 18, at 473-474; and Avi-Yonah, "Back to the Future? The Potential Revival of Territoriality," 62(10) *Bulletin for International Taxation* 473-474 (2018).

more helpful. It is disappointing that the OECD has not encouraged MOUs under the MLI.

The Restricted Right to an Independent Appeal

Notably, in most cases a taxpayer will be left without any right to appeal to an independent body in its state of residence regarding a decision issued under the discretionary benefit provision because typically these decisions will be issued by the authority of a foreign (source) state. The courts of the taxpayer's state of residence will not have the jurisdiction to rule on a decision by the tax authority of the source state. The taxpayers may, of course, ask the courts of the source state to review the ruling. However, defending their position in a foreign court would be more time-consuming and expensive than doing so in domestic court.

An independent review of government officials' decisions is a basic human right, one recognized in the constitutions of many states.[39] The combination of a rule that essentially gives a tax authority wide discretion in granting or refusing treaty benefits, a decision that involves a clear conflict of interest between the authority and the taxpayer, and the absence of any (realistic) right of appeal to a court or other independent body appears to be an unacceptable solution under the law of democratic states.

The rules on arbitration under the MLI[40] do not resolve this problem. These provisions are voluntary, and many states do not include them in their tax treaties.[41] Even if a treaty includes the rules, arbitration is pertinent only to unresolved issues arising from the mutual agreement procedure between the competent authorities of the contracting states. Moreover, the OECD says that as long as the competent authority has exercised its discretion in accordance with the requirements of the discretionary benefits provision, the decision of the competent authority cannot be considered an action resulting in taxation that is not in accordance with the tax treaty equivalents of article 25(1) of the OECD model.[42] Since the competent authority will decide whether its own ruling complies with the requirements of the discretionary benefits provision, the OECD's solution is not good for taxpayers and hampers (or even eliminates) their right to judicial review of administrative decisions.

The sensible remedy seems to be to narrow the discretionary benefits provision to allow it to be applied only by the competent authority of the resident state of the taxpayers requesting treaty benefits under that provision. It should also give taxpayers an explicit right to appeal to the courts of the state concerned.[43] Still, this solution may not provide an effective and efficient judicial remedy for taxpayers. The U.S. case of *Starr International Company v. United States*[44] is illustrative in this regard.

The *Starr* case concerns the decision of the U.S. competent authority (the IRS) to deny benefits to a Swiss resident company (Starr) under the discretionary benefits provision of article 22(6) of the governing 1996 Switzerland-U.S. tax treaty.[45] The U.S. government claimed the court lacked jurisdiction to review a decision under the discretionary benefits provision because issues regarding that provision are left to the discretion of the competent authority (here, the IRS).[46]

---

[39] *Cf.* KPMG Ireland, "Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Fairness for Small Countries" (Dec. 2014).

[40] *See* Part VI, articles 18-26 MLI.

[41] At the time of the signature of the MLI on June 7, 2017, there were 25 signatories signing up for the arbitration provisions provided for in the MLI: Andorra, Australia, Austria, Belgium, Canada, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, the Netherlands, New Zealand, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland, and the U.K. This will lead to the introduction of arbitration to over 150 existing treaties. *See* OECD, "Multilateral Instrument: Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting — Information Brochure" (2017).

[42] *See* action 6 report, *supra note* 6.

[43] *See, e.g.*, KPMG Ireland's report, *supra* note 39.

[44] *See Starr International Co. v. United States*, No. 1:14-cv-01593 (D.D.C. 2016), *reconsidering* (D.D.C. 2015). For an academic discussion of the case, see Yariv Brauner, "United States: The *Starr Int'l* Case," in *Tax Treaty Case Law Around the Globe 2016* (2017). *See also* Marie Sapirie and Andrew Velarde, "Can Courts Review a Competent Authority's Decision?" *Tax Notes Int'l*, Mar. 16, 2015, p. 934.

[45] *See* Convention between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Income (Oct. 2, 1996). Starr sought to apply the discretionary benefits rule to receive a reduced treaty rate for withholding tax on dividends (15 percent compared with the 30 percent U.S. tax rate) received from a U.S. company.

[46] *See* Sapirie and Velarde, *supra* note 44.

In its ruling of September 18, 2015, the U.S. District Court for the District of Columbia found that the IRS's decision under the discretionary benefits provision could be reviewed because the treaty, read along with the accompanying technical explanation, provided a manageable standard for determining whether the IRS abused its discretion in denying Starr benefits. However, on February 2, 2016, the court issued another ruling agreeing with the U.S. government that judicial review of the decision in question could not dictate the outcome of the consultation process between the U.S. and Swiss competent authorities under the discretionary benefits provision. Thus, the court could not order the IRS to issue a specific monetary refund to Starr. Instead, the court said Starr could pursue a claim to set aside the IRS's decision to deny treaty benefits as arbitrary, capricious, or an abuse of discretion under the judicial review provision of the U.S. Administrative Procedure Act.[47]

This case demonstrates that receiving an effective and efficient judicial review of decisions issued under the discretionary benefits provision can prove very difficult, even if courts clearly have the jurisdiction to review such decisions. Something else is needed to resolve doubts regarding the judicial review of a competent authority's decision issued under the discretionary benefits provision. The best solution, as suggested by practitioners,[48] would seem to involve introducing a right of appeal to an independent, international, and binding arbitration tribunal.

The PPT and Other Antiabuse Rules

As noted in the introductory paragraphs of this report, the discretionary benefits clause is part of the MLI's LOB rule. This LOB rule is optional under the MLI. While much of our discussion has focused on the MLI's LOB rule, it is also important to consider how the discretionary benefits clause relates to the PPT. This is particularly important because a PPT is the default method for satisfying the action 6 report's requirements.

The PPT Generally

In accordance with the PPT, a benefit under the tax treaty shall not be granted for an item of income or capital if it is reasonable to conclude, with 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. Once a taxpayer fulfills this essential condition, a benefit can be denied only if the taxpayer cannot establish that granting of that benefit, in the face of relevant facts and circumstances, would be in accordance with the purpose of the relevant provisions of the tax treaty. From this perspective, the first (one of the principal purposes) and the second (in accordance with the purpose of the relevant provisions of the tax treaty) parts of the PPT are equally important for the question of granting or denying treaty benefits.[49]

Importantly, if both an LOB and a PPT are included in the same tax treaty, the PPT supplements rather than restricts the scope or application of the LOB provision.[50] By analogy, the same applies to the relationship between the PPT and other specific antiabuse rules (SAARs) in tax treaties.

Whenever means of obtaining treaty benefits are closed to taxpayers under tax treaty SAARs,

[47] Starr has filed such a claim with the court. As of July 2017, the case had not been decided.

[48] *See, e.g.*, KPMG Ireland's report, *supra* note 39.

[49] Commentator Michael Lang claims that even if the second condition under the PPT seems to be formulated as an exception to the rule (the first condition), it is irrelevant because the purpose of the treaty provisions will always need to be taken into account when granting or denying benefits and the second condition refers to the same purpose. His reasoning goes so far, however, that it deprives the PPT of any legal value, and in his view, the PPT "is a mere hint for the interpretation and totally expendable." *See* Lang, "BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties," *Tax Notes Int'l*, May 19, 2014, p. 655.

While some authors agree with Lang on this point (see Erik Pinetz, "Final Report on Action 6 of the OECD/G-20 Base Erosion and Profit Shifting Initiative: Prevention of Treaty Abuse," 70(1/2) *Bulletin for International Taxation* 117 (2016)), others do not. *See* Reinout Kok, "The Principal Purpose Test in Tax Treaties Under BEPS 6," 44(5) *Intertax* 408 (2016). I agree with the latter position given the large differences among contracting states in their interpretation of tax treaties from a strict, almost literal, interpretation to a more purposive style. *See* Frederik Zimmer, "General Report: Form and Substance in Tax Law," 87a *Cahiers de Droit Fiscal International* 61-62 (2002). While Lang's argument may be valid in states that follow a purposive approach to interpretation, it is not valid in states with a strict approach.

[50] *See* action 6 report, *supra* note 6.

there is no need to deny them under the PPT. For instance, if none of the tests under the MLI's LOB rule was passed and the competent authority did not grant treaty benefits upon request by the taxpayer, the treaty benefits will not be granted irrespective of the fact that the taxpayer's behavior entered the ambit of the PPT. In other words, once treaty benefits were not granted under tax treaty SAARs, it is entirely redundant to deny them under a tax treaty GAAR (the PPT). Indeed, there is nothing to deny. This is typical of how SAARs function toward GAARs, including a tax treaty GAAR such as the PPT.[51]

On the other hand, when a taxpayer is generally entitled to treaty benefits under the MLI's LOB rule — for example, a public company traded on a recognized exchange in the contracting state (a qualified person under article 7(9)(c) of the MLI) — the PPT may still deny treaty benefits for a specific transaction that falls within the category prohibited by the PPT. The action 6 report gives the example of a public company that enters into a conduit financing arrangement with the intent to provide a resident of a third state the benefit of lower-source taxation rates under a tax treaty. In this situation, the OECD explains, treaty benefits will be denied under the PPT because the general definitions, read in the context of the tax treaty as a whole and with particular attention to the new preamble, cannot be construed to authorize treaty-shopping transactions, even by resident public companies.

Thus, when a taxpayer enters into an arrangement or undertakes a transaction and one of the principal purposes is (directly or indirectly) to obtain treaty benefits in a manner contrary to the purpose of the MLI's LOB rule, the PPT will deny the benefits. Here, the PPT's role as a supplement to the MLI's LOB rule is very clear. Whenever a taxpayer's actions are taken to circumvent the MLI's LOB rule — for instance, via stepping-stone schemes — or to otherwise fall outside the LOB's scope, the PPT may be critical. The PPT may strengthen the MLI's LOB rule significantly by preventing taxpayers from circumventing the objective tests and helping to bar other schemes that might pass muster under the LOB.

The Discretionary Benefits Provision and the PPT

In the foregoing examples, the relationship between the PPT and other antiabuse provisions, in particular the MLI's LOB rule, is pretty clear. However, at least one issue raises concerns — the relationship between PPT and the discretionary benefits provision under the MLI's LOB rule. Please keep in mind that treaty benefits may be granted (or denied) under the PPT by local tax authorities, while only the competent authority is empowered to grant these benefits under the discretionary benefits provision included in the MLI's LOB rule. The question: Is it possible to deny treaty benefits under the PPT if the competent authority has granted them under the discretionary benefits provision? Under the rule of preference, which provides that the PPT applies notwithstanding any provisions of a tax treaty, the answer might be yes. But would it not be at least somewhat contradictory if a local tax authority applying the PPT could undermine the decision made by the competent authority, usually the country's highest tax authority, under the discretionary benefits provision?

This issue is further confused by the OECD's statement that the guidance provided in the commentary on the PPT should not be used to interpret the MLI's LOB rule and vice versa. Why not use, at least to the extent necessary, the same guidance for the interpretation of the PPT and the MLI's LOB rule, since both address the same problem — namely, treaty abuse? It seems particularly helpful to the extent that, minding any necessary changes, the wording of the discretionary benefits provision under the MLI's LOB rule resembles the PPT, with both rules referring to "one of the principal purposes." Indeed, the OECD did not obey its own restriction since its guidance as to the interpretation of "one of the principal purposes" included in paragraphs 64 and 65 of the commentary on the discretionary benefits provision is largely replicated in paragraphs 10 and 11 of the commentary on the PPT.

Accordingly, the similar conditions for application of the PPT and the discretionary benefits provision imply a possible overlap

---

[51] *See* Carlos Palao Taboada, "OECD Base Erosion and Profit Shifting Action 6: The General Anti-Abuse Rule," 69(10) *Bulletin for International Taxation* 605 (2015).

Discretionary Benefits Provisions Under the MLI: A Vicious Circle

between them. The rule of preference requires the application of the PPT regardless of the previous application of the discretionary benefits provision under the MLI's LOB rule. This means that it is possible that a decision by the local tax authorities under the PPT could override a previous decision of the highest tax authorities under the discretionary benefits provision. This becomes completely circular in light of article 7(4) of the MLI, an optional addition to the PPT that empowers the competent authority to grant treaty benefits that were previously denied under article 7(1) of the MLI.

Unfortunately, this is more of a vicious than a virtuous circle. The competent authority may grant tax benefits under the discretionary benefits provision; the benefits may be denied by the ordinary tax authorities under article 7(1) of the MLI; and the latter benefits may still be granted under article 7(4) of the MLI. The circular flow is illustrated in the figure.

The solution to this vicious circularity is to resolve the issue of the overlap between the PPT and the discretionary benefits provision in favor of the latter by changing the wording of the PPT: "Notwithstanding any provisions of a tax treaty, *except article 7(12) of the MLI*." Simply put, at the end of the day, a decision of the highest tax authorities should matter more than a decision by the local tax authorities. Moreover, giving the local tax authority the power to deny treaty benefits previously granted under the discretionary benefits provision included in the MLI's LOB rule seems like an attempt to transfer judicial power from the courts to the tax authorities, a move that deprives taxpayers of their basic human right to judicial review of administrative decisions.

This transfer of authority means that the division of powers in the field of international taxation may become unbalanced in favor of the executive. This procedural outcome should be avoided, not least because of the high risk to the constitutional division of powers and laws protecting human rights.[52]

Conclusion: A Vicious Circle

On its face, the discretionary benefits provisions could be seen as a positive solution for taxpayers and the last resort for taxpayers to obtain treaty benefits under the MLI's LOB rule and the PPT. Using these provisions, taxpayers may obtain treaty benefits even if they fail to meet the objective tests under the MLI's LOB rule (article 7(8-11) of the MLI) on eligibility for treaty benefits or if benefits were denied under the PPT (article 7(1) of the MLI).

This article argues, however, that the discretionary benefits are not a commendable solution. In practice, they are likely to significantly complicate the application of the MLI's LOB rule and the PPT, be unpredictable for taxpayers, and create awkward flows of decisions between ordinary tax authorities applying the PPT and superior tax authorities applying the discretionary benefits provisions of the MLI's LOB rule or the PPT. These decisions create a vicious circle.

To rectify the flaws of the discretionary benefits provisions under the MLI, I have suggested several solutions at various points in the article. Specifically, contracting states could add MOUs to their tax treaties and list factors to consider for purposes of applying the discretionary benefits provision under the MLI's LOB rule. Further, to give taxpayers the right to appeal the competent authority's decision under the discretionary benefits provision to a court or other independent body in their state of residence, the application of the provision could be limited to the competent authority of the resident state of the taxpayers requesting the treaty benefits. A right of appeal to an independent, international, and binding arbitration tribunal could also be introduced. Last, but not least, the circularity could be resolved by changing the wording of the PPT to "notwithstanding any provisions of a tax treaty, *except Article 7(12) of the MLI*." ■

[52]Johann Hattingh, "The Multilateral Instrument From a Legal Perspective: What May Be the Challenges?" 71(3/4) *Bull. Int'l Tax'n* (2017), sections 2 and 7-8; Luis Eduardo Schoueri and Ricardo André Galendi Júnior, "Interpretative and Policy Challenges Following the OECD Multilateral Instrument (2016) From a Brazilian Perspective," 71(6) *Bull. Int'l Tax'n* (2017), section 4.1; Avi-Yonah and Xu, *supra* note 3, at 208, 220-221. *See generally*, Baker and Pasquale Pistone, "The Practical Protection of Taxpayers' Fundamental Rights: General Report," 110b *Cahiers de Droit Fiscal International* 49-53 (2015). *See also* the section of this article titled "The Restricted Right to an Independent Appeal."