Foreword: Tax Treaty Interpretation after BEPS

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This Special Issue of the *Bulletin for International Taxation* contains a series of articles prepared further to the two-day interdisciplinary conference organized in Lausanne on 19-20 December 2019 by the Max Planck Institute for Tax Law and Public Finance and the Tax Policy Center of the University of Lausanne. This foreword describes the background, purpose and structure of the conference as well as its main objectives, and presents the articles of this Special Issue.

1. Background, Purpose and Structure of the Conference

The starting point of the conference was the incorporation in double taxation conventions (DTCs) of the tax-treaty-related measures of the 2013 Base Erosion and Profit Shifting (BEPS) Action Plan. This new paradigm, which is being implemented by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), or simply through the regular amendment of DTCs, represents an unprecedented shift to a more multilateral tax treaty policy. These measures have also been incorporated in the 2017 updates of the OECD and UN Models. They include, for instance, new treaty rules regarding hybrid mismatches, dual residence and, more importantly, minimum standards in the area of tax treaty abuse and dispute resolution. This new multilateral framework features a new institutional and political dimension (the Inclusive Framework and the peer review of the implementation of the BEPS changes), further contributing to the formulation of treaty policy.

Against this background, the purpose of this conference was to explore whether and, if so, to what extent the new BEPS paradigm will impact the interpretation of DTCs. The issue is not straightforward. On the one hand, many things have not changed and remain identical. First of all, from a policy point of view, bilateral DTCs will continue to reflect the bargain and policy objectives of the relevant contracting states. To quote a passage from the Introduction to the 2017 OECD Model, it is quite clear that a relevant consideration for two contracting states to enter into a DTC will continue to be the level of “projected cross-border trade and investment”.[1]However, what constitutes an appropriate level of exchange of goods, services and capital is, by essence, for the treaty partners to decide. Second, the interpretation of DTCs will continue to be based on the customary rules of the Vienna Convention on the Law of Treaties (VCLT).[2]Third, the BEPS initiative has not affected the fundamental architecture of DTCs, with residence taxation continuing to prevail over source taxation. In 2013, the OECD BEPS Action Plan itself acknowledged that:

> while actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income”.[3]

In particular, and this is relevant to the problem of tax treaty abuse, the notion of residence embodied in article 4 of the OECD Model – often regarded as incorporating a weak nexus test – remains unchanged. One would also add that many of the BEPS treaty measures have been imported from existing provisions, treaty practice or case law. For example, according to the OECD itself, the Principal Purpose Test (PPT) – the minimum standard to combat tax treaty abuse – merely codifies the so-called “guiding principle” introduced in its commentaries in 2003.[4]Likewise, all the examples illustrating the application of the PPT to “conduit situations”[5]have been merely copied from an exchange of notes to the United Kingdom - United States Income Tax Treaty (2001) (as amended through 2002).[6]To mention another example, the changes introduced to the OECD Model in the field of commissionaire arrangements pursuant to BEPS Action 7 (Artificial

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1. *OECD Model Tax Convention on Income and on Capital* , Introduction, para. 15.2 (21 Nov. 2017), Treaties & Models IBFD.
2. *Vienna Convention on the Law of Treaties* (23 May 1969), Treaties & Models IBFD.
3. OECD Action Plan 2013, p. 12.
4. 2003 OECD Commentary, para. 9.5 ad Art. 1
5. 2017 OECD Commentary, para. 187 ad Art. 29
6. *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), Treaties & Models IBFD.

Avoidance of PE status) may also be seen as a codification of the substance-over-form interpretation already applied by several states. From this perspective, one could argue that the BEPS treaty changes merely represent a consolidation of things that were already known and around.

However, the "new" problem, which has largely convinced the authors to organize this conference, lies in the "holistic nature" of the BEPS initiative. Because this project was from the outset based on common pillars - coherence, substance and transparency – there is a natural interference of the work conducted in non-treaty areas for tax treaty purposes. Sometimes, this interference is explicit. A good example is the clause on special tax regimes suggested by the 2017 OECD Commentary. The commentaries provide that states may wish to choose to include in the definitions of article 3 of the OECD Model a clause stipulating, inter alia, that the benefits of article 12 (royalties) may be denied where income is paid to a connected person availing of a "special tax regime" in the state of residence[7]not satisfying the conditions imposed by the modified nexus approach pursuant to BEPS Action 5 on harmful tax practices.[8]More importantly, however, is the value of what could be perceived as implicit references to non-treaty BEPS Action items for purposes of interpreting and applying treaty provisions. For instance, when in relation to the PPT the commentaries refer to "substantive economic functions", does this mean that BEPS Actions 8-10 on aligning transfer pricing outcomes with value creation have acquired some relevance for purposes of interpreting treaty law? More generally, do the concepts of value creation (whether understood as an anti-avoidance tool or as a new principle governing the allocation of taxing rights) and single taxation, which have emerged or have been revitalized by some in the BEPS era, now have some bearing in tax treaty interpretation?

Last but not least, another phenomenon has emerged: the influence of multilateral standards on the interpretation of domestic and European law. The recent tendency of the Court of Justice of the European Union (ECJ) to define the notion of abuse in a way that resembles the PPT is an example of this trend.

Looking at things in this fashion, the authors quickly arrived at the conclusion that the topic deserved to be explored in a dedicated conference. In order to keep the discussion within manageable proportions, it was decided at the outset to carve out from the discussions the current work relating to the digitalization of the economy. As a result, the contributions in this issue only deal with these latest developments very marginally. It is, however, quite clear that the topic will need to be revisited – whether from the perspective of Pillar 1 or Pillar 2 - once this work has stabilized.

The structure of this issue mirrors that of the conference. It begins by setting the scene and looks as a starting point at the new framework of tax treaties from a general perspective (*see* section 2.). Next, the interpretation of selected treaty provisions is considered (*see* section 3.). Finally, the focus is placed on the interpretation of European Directives in light of the BEPS Action Plan (*see* section 4.).

2. The New Framework for Tax Treaties

The discussion here begins by considering the impact of the new preamble to the 2017 OECD Model on tax treaty interpretation. This preamble, which of course forms part of the context under article 32(2) of the VCLT, provides that contracting states intend to eliminate:

> double taxation […] 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 Convention for the indirect benefit of residents of third States).

What difference this new preamble will on its own have on tax treaty interpretation is relevant at least for two reasons. First, apart from mentioning that the preamble is context, the OECD Commentary does not discuss this issue. Rather, the preamble is mainly considered in the framework of article 29 of the OECD Model dealing with the entitlement to benefits, which is regarded as reflecting "[…] the intention of the Contracting States, incorporated in the preamble of the Convention".[9]Second, it is fair to say that, in existing tax treaty practice, the impact of preambles has so far been limited. For instance, in *Alta Energy Luxembourg S.A.R.L.* (2018),[10]the Canadian Tax Court noted that:

> [a] tax treaty is a multi-purpose legal instrument. The preamble of the Treaty states that the two governments desired "to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital." While indicative of the general purpose of the Treaty, this *statement remains vague regarding the application of specific articles of the Treaty* .[11][Emphasis added]

Luc De Broe and Jonathan Schwarz explore this question in two respective articles. De Broe, in particular, concludes that the new preamble will be of little or no help in the interpretation process, even when it comes to the application of the PPT.

7. *OECD Income and Capital Model Convention and Commentary: Commentary on Article 1* para. 85 (2017), Treaties & Models IBFD [unless otherwise indicated, references to the OECD Model and Commentary are to the 2017 version].
8. Para. 94 *OECD Model: Commentary on Article 1* : "[I]f a regime does not condition benefits either on the extent of research and development activities that take place in the Contracting State or on expenditures (excluding any expenditures which relate to subcontracting to a related party or any acquisition costs), which the person enjoying the benefits incurs for the purpose of actual research and development activities. Subdivision (*ii*) is intended to ensure that royalties benefiting from patent box or innovation box regimes are eligible for treaty benefits only if such regimes satisfy one of these two requirements.…
   Under either version of subdivision (*ii*), royalty regimes that have been considered by the OECD's Forum on Harmful Tax Practices and were not determined to be 'actually harmful' generally would not meet subdivision (*ii*) and, if so, would not be treated as special tax regimes".
9. *OECD Model: Commentary on Article 1* (2017), para. 1 ad art. 29
10. CA: TCC, 22 Aug. 2018, 2014-4359(IT)G, *Alta Energy Luxembourg S.A.R.L. v. The Queen* , 2018 TCC 152, Case Law IBFD.
11. *Alta Energy Luxembourg SARL v. R* , 21 ITLR, para. 77

Next, Adolfo Martín Jiménez analyses a fundamental issue to which we have already alluded, i.e. the challenges presented by the principle of value creation in formulating international tax policy and treaty interpretation and application. The author concludes that value creation is probably not the "light" that will resolve problems of treaty negotiation and interpretation. Martín Jiménez also notes the current uncertainty relating to the articulation of this concept and the PPT embodied in article 29(9) of the OECD Model and, ultimately, with the current work on the digitalization of the economy which seeks to tax MNE groups as a whole.

Finally, Johann Hattingh considers the relevance of BEPS materials for treaty interpretation. His analysis is based on the presumption that it matters to whom or to which group the question of the relevance of BEPS materials for tax treaty interpretation is posed. He draws on the concept of interpretive communities to argue that the framework for tax treaty interpretation has been differently impacted for tax advisors as opposed to national courts by the BEPS Project and its aftermath. This is mainly because law is no longer the exclusive or overriding consideration for advisors when evaluating the relevance of BEPS materials. For national courts, treaty interpretation based on BEPS materials is likely to continue among a path that will not necessarily lead to uniform outcomes in cases raising materially the same legal question of a BEPS nature. He shows that changes to the OECD Commentaries played a role in the divergent outcomes, which implicates the OECD's working methods. For example, the work of the OECD on the Commentaries may indeed, counterintuitively, hinder uniform tax treaty interpretation when significant changes or updates do not coincide with hard law amendments to the text of the Model and by extension the text of bilateral tax treaties. Hattingh projects that this trend of treaty interpretation with divergent outcomes in national courts can be expected to continue in the important area of granting tax treaty benefits. This, he shows, will concern the meaning and scope of the Principle Purpose Test because he contends that a central issue arising from the PPT examples developed in the OECD BEPS materials is the question whether the PPT contains an unexpressed commercial purpose test, which by implication will favour granting tax treaty benefits in the presence of underlying economic investment. He further postulates that complexity arises for treaty interpretation because BEPS materials are not exclusively produced by the OECD or G20 countries. He concludes that the landscape for tax treaty interpretation in the post-BEPS era is more plural than before.

3. The Multilateral Instrument (MLI)

The focus is then on the Multilateral Instrument. Werner Haslehner's contribution addresses whether the advent of the OECD's Multilateral Instrument will result in a new way of interpreting international tax rules. Haslehner concludes that the MLI will entail "very little true multilateralism" and that the international tax system remains fragmented and built on bilateral DTCs with only a thin overlay of multilateral agreement on selected issues. Further, the MLI does not set up a multilateral dispute resolution mechanism. Moreover, Haslehner observes that the conference of the parties has very little if any role in the interpretation and application of tax treaty rules. Further, and from a substantive perspective, the MLI has not generally reshaped the international tax system with the introduction of fundamentally new ideas, such as the single tax principle. Nathalie Bravo's paper in turn deals with the interpretation of tax treaties in light of reservations and opt-ins under the MLI. In particular, Bravo notes that the reasons for making a reservation to a provision of the MLI may be different from reserving party to reserving party. Therefore, she submits that reservations and optional and alternative provisions notified by the parties to the MLI cannot be used as an indication of the meaning that the parties intended to give in agreements not covered by the MLI.

4. Interpreting Selected Treaty Provisions

The next part of this Special Issue is dedicated to the interpretation of selected treaty provisions. The discussion concentrates first of all on the PPT, with two separate articles prepared by Robert Danon and Michael Lang. The PPT, which has been incorporated into article 29(9) of the OECD Model reads as follows:

> 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.

The question of the interpretation and effects of the PPT has already received a lot of attention in scholarly writing. Although article 29(9) of the OECD Model represents the minimum multilateral response to tax treaty abuse, it is fair to say that the impact of this clause on business models remains highly controversial. Is it a "business reality test"? Does it elevate the level of required "substance" in the state of residence to claim treaty benefits? And, in the affirmative, what is the meaning of "substance"?

Based on different perspectives, Danon and Lang arrive at the conclusion that the PPT is not by essence capable of fundamentally altering the conditions to access tax treaty benefits.

In his contribution, Danon begins by setting the scene and notes that the roots of treaty abuse – inter alia the residence test in article 4 of the OECD Model – have not been affected by the BEPS initiative. Turning to article 29(9) of the OECD Model, he submits that the interpretation of this provision remains naturally subject to the framework of article 31 of the VCLT. Accordingly, both the subjective and objective component of the PPT must be given proper weight. Further, Danon holds the view that the objective component of the PPT – the reference to the "the object and purpose of the relevant provisions of this Convention" – allows a purposive interpretation to be conducted beyond the wording of the relevant treaty provisions. This is the key difference with the standard interpretation of treaty law according to article 31 of the VCLT in which the purposive interpretation naturally plays a role but not beyond the actual wording of the treaty provisions at stake. Nevertheless, for purposes of applying article 29(9) of the OECD Model, the object and purpose of the relevant provisions of this Convention must be properly identified, and the commentaries are not always rigorous on this point. In the end, Danon concludes that the PPT is “just” a GAAR; therefore, it may not be used to build into tax treaties law requirements that were never intended (e.g. an enhanced nexus test in article 4 of the OECD Model).

The article prepared by Lang is, by contrast, based on a different reasoning. According to the author, there would be no difference between the role and impact of purposive interpretation within the framework of article 31 of the VCLT and when applying article 29(9) of the OECD Model. Therefore, he concludes that article 29(9) of the OECD Model does not represent a legal basis for denying tax treaty benefits. This provision merely emphasizes the necessity for an interpretation based on object and purpose in those cases in which one of the principal purposes of a transaction was to obtain a benefit. However, because purposive interpretation is also required in all other cases, the subjective element of the PPT would lose its significance. In other words, for Lang, the PPT would merely have a “signalling function”

One of the areas where the BEPS Action Plan had a major impact on day-to-day international tax practice is transfer pricing. Action Items 8-10 introduced largely new guidelines meant to emphasize substance over form, economic activity over formal contracts and “control” of risk over financial assumption of risk. In their article for this Special Issue, Georg Kofler and Isabel Verlinden address a number of issues in this context: How does the new paradigm in transfer pricing relate to GAARs and SAARs, in particular to existing and future CFC legislation? Can it be said that transfer pricing rules have to be understood in light of “value creation”? What does the unchanged wording of article 9 of the OECD Model tell us about the limitations to profit adjustments? Is this provision “restrictive” or “permissive” in nature, and what impact does the “savings clause” have on this problem?

5. Interpreting European Directives in Light of the BEPS Action Plan

European law plays a major role in the implementation of the BEPS Action Plan by Member States of the European Union. How does this influence the interpretation of primary and secondary EU law? This is the question addressed by Wolfgang Schön in his contribution to this Special Issue. On the one hand, recent secondary legislation, such as the Anti-Tax-Avoidance Directives, explicitly aims at a full and coherent introduction of the BEPS outcome into European law. However, this goal has to be aligned with the liberating forces of the internal market which inform the legal basis for directives under article 115 of the Treaty on the Functioning of the European Union (TFEU).[12]Going further, in some recent judgments, the ECJ has shown a tendency to interpret even long-standing concepts of primary EU law (e.g. the notion of abuse of law) and existing directives (e.g. the Parent Subsidiary Directive or the Interest Royalty Directive) in light of the BEPS Action Plan. In Schön’s view, this is hard to defend from a methodological point of view and out of sync with the fundamental policies adopted by the European treaties.

6. Interaction of Domestic Anti-Abuse Rules with DTCs

Finally, Vikram Chand and Craig Elliffe analyse the interaction of domestic anti-abuse rules with DTCs in the post-BEPS and digitalized world. In order to do so, a distinction is made between domestic anti-avoidance rules that counteract treaty abuse (e.g. when the taxpayer engages in a treaty shopping scheme) and domestic anti-avoidance rules that counteract abuse of domestic law (e.g. rules that impute income in the hands of resident taxpayers or deny deductions for payments made by resident taxpayers to non-residents). For the first type of domestic rules, Chand and Elliffe’s contribution proposes a four-step analysis as a way to approach such interaction and indicates that, depending on the exact nature and scope of the domestic rule, conflicts could arise with tax treaties. For the second type of domestic rules, the authors’ analysis also indicates that, depending on the exact nature and scope of the domestic rule, conflicts could arise with DTCs. The authors conclude that, from the tax treaty policy standpoint, if states wish to ensure that conflicts do not arise, the most appropriate way to achieve this would be to resort to a safeguard clause, i.e. a provision which authorizes a state to apply its domestic anti-avoidance rules. Such a provision may also be suitable for the rules that are being developed in the context of Pillar II of the digital economy debate.

7. Conclusions

With this Special Issue of the *Bulletin for International Taxation* , the conference organizers are proud to be able to present to a wider audience the majority of the papers delivered in Lausanne in December 2019. We leave it to our readers (and to the future) to decide whether the BEPS Action Plan and its ramifications represent a change of paradigm as regards the interpretation of tax treaty law and related legal instruments like EU law or domestic tax law covering international situations. In our view, it is important to raise awareness for the underlying intricate issues, to defend methodological rigor in this sensitive field and to avoid unintended consequences for the international tax system. The international treaty network depends on legal certainty and on a common understanding of the concepts employed and the policies pursued, which has emerged over the last 100 years. This task deserves care and discipline. We are grateful that so many excellent scholars and practitioners agreed to contribute to this venture, and we look forward to the future debate.

12. Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union , OJ C 115 (2008), EU Law IBFD.