

Some Reflections on the ‘Saving Clause’

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Action 6 of the Organization for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting project deals with tax treaty abuse and proposes inter alia, the inclusion of a seemingly innocuous ‘saving clause’ as new Article 1(3) OECD Model Tax Convention (OECD MC). This clause is aimed at preserving the taxing rights of the residence State. While it changes little with regard to the basic set-up of the OECD MC in one-taxpayer situations, it opens the doors for both Contracting States to tax their residents specifically in two-taxpayer situations which may arise, for example, in cases involving hybrid entities, Controlled Foreign Companies regimes, and transfer pricing adjustments. This article reviews the background of this new OECD MC provision, its longstanding use in US treaty policy, as well as some aspects of its breadth, impact and – intended and arguably unintended – consequences.

I INTRODUCTION

Action 6 of the Organization for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project deals with various forms of tax treaty abuse. The final report was issued in October 2015¹ and not only contains a broad range of widely discussed anti-avoidance provisions,² but also a seemingly innocuous ‘saving clause’³ to be included in the OECD Model Tax Convention (OECD MC) as new Article 1(3).⁴ As noted by the OECD, the majority of treaty provisions are merely intended ‘to restrict the right of a Contracting State to tax the residents of the other Contracting State’ but not the right to tax its own residents, specifically in situations where two Contracting States tax the same income on a residence-basis because

they allocate that income to different taxpayers.⁵ While the existing OECD MC Comm. has already rejected arguments that certain provisions could be interpreted as limiting a Contracting State’s right to tax its own residents in the context of partnerships and Controlled Foreign Companies (CFC) rules,⁶ the OECD concluded that such principle ought to be reflected as a general rule in the OECD MC itself.⁷ That is a novelty: While a saving clause is a longstanding feature of US tax treaty policy,⁸ to which the OECD explicitly refers,⁹ few other countries have so far adopted it,¹⁰ which may, in turn, be explained by the fact that it has never been part of the OECD or UN MC.¹¹

The proposed saving clause in Article 1(3) preserves (‘saves’) the right of a Contracting State to tax its residents irrespective of any other provision of a tax treaty, unless it

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¹ OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report* (Oct. 2015).

² See for first analyses of the suggested limitation on benefits clause and ‘principle purpose test’, e.g., L. De Broe & J. Luts, *BEPS Action 6: Tax Treaty Abuse*, 43 *Intertax* 122 (122 et seq.) (2015).

³ Sometimes also referred to as a ‘savings clause’ (see, e.g., the terminology used by the US Tax Court, 19 May 1986, *Duncan v. Commissioner*, 86 TC 971).

⁴ It should be noted that throughout this article I will refer to proposed Art. 1(3) OECD MC as if it were already included in the Model Convention, even though the respective update to the OECD MC is expected only for 2017. See Pt 109 of OECD, *OECD/G20 Base Erosion and Profit Shifting Project – Frequently Asked Questions* (2015).

⁵ OECD, *supra* n. 1, at 86 (para. 61).

⁶ See, e.g., Art. 1 para. 6.1 (taxation of resident partners of foreign partnerships) and para. 23 (taxation of controlled foreign companies rules) OECD MC Comm.

⁷ OECD, *supra* n. 1, at 86 (para. 62).

⁸ See *infra* s. 2.

⁹ OECD, *supra* n. 1, at 86 (para. 62).

¹⁰ A saving clause is, e.g., found in Japan’s treaty with Canada (Art. 25(2) and (3) of the 1986 DTC; see, e.g., N. Matsuda, *New Developments Regarding Japan’s Tax Treaties*, BIT 2011 439 (440)) and some Philippines’ treaties (see A. Rust, *Klaus Vogel on Double Taxation Conventions* (E. Reimer & A. Rust eds., 4th ed., Kluwer 2015), Art. 1 m.no. 49).

¹¹ See also De Broe & Luts, *supra* n. 2, at 122 (138).

is 'turned off' by one of the specific exceptions. It reads as follows:

3. This 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 [23 B], 24 and 25 and 28.

The principle underlying a saving clause is quite understandable for countries that have a system based on worldwide taxation and tax treaties that are based on the credit method to avoid double taxation (rather than the exemption method). In such context it can well be argued that a treaty's only function is to limit the taxing jurisdiction of the source State, but not the taxing powers of the residence State any more than is necessary to avoid double taxation.¹² That idea, however, does not seem to be the guiding light of the OECD's proposal, as the proposed saving clause changes little with regard to the basic set-up of the OECD MC in one-taxpayer situations, largely leaving the few instances of exclusive source State taxation untouched.

Indeed, on its face, Article 1(3) OECD MC, just like its parallel in Article 1(4) of the 2016 US Model Income Tax Convention (US MC), is not limited to situations that raise tax avoidance concerns. Read in light of the exceptions, the purpose of the saving clause 'is to prevent the tax treaty from restricting residence taxation *in an unintended way*'.¹³ Drafted as a quite general provision, however, it quasi-automatically addresses anti-abuse concerns specifically where, based on a national anti-avoidance provision, the same income is effectively attributed to different taxpayers by the two Contracting States. However, since the saving clause does not remove the obligation to grant relief from double taxation, such situations may raise complex issues as to which of the two residence States has to give relief for which tax. This problem is explicitly addressed by the proposed inclusion of a new phrase in Article 23 A(1) and Article 23 B(1) that removes taxes that are solely based on a taxpayer's

residence from the relief obligation of the other Contracting State.¹⁴

Depending on one's perspective, Article 1(3) may seem as a wolf in sheep's clothing. Drafted as a general provision preserving residence-based taxation, it changes little in the set-up of the OECD MC with regard to the 'normal' allocation of taxing rights where only one taxpayer is involved.¹⁵ It does, however, effectively open the door for Contracting States to apply their domestic anti-avoidance provisions in order to tax their own residents without regard to a treaty's distributive rules with only an obligation to grant relief for income sourced in the other Contracting State.¹⁶ The saving clause therefore fits well in the overall objective of Action 6 of the BEPS project, which also addresses cases 'where a person tries to abuse the provisions of domestic tax law using treaty benefits'.¹⁷ It would also remove the doubts voiced by scholarship and domestic courts with regard to the compatibility of national anti-avoidance measures and tax treaties,¹⁸ and provide explicit expression to the position taken in the 2003 update to the OECD MC Comm., according to which tax treaties neither affect domestic general-anti-avoidance rules and/or judicial doctrines nor conflict with CFC regimes.¹⁹ Hence, and rather than leaving the preservation of domestic anti-avoidance provisions solely to special clauses drafted in bilateral treaty negotiations, as was recommended in the 1977 OECD MC Comm.,²⁰ the proposed saving clause implicitly addresses all those issues at once.²¹

This article will address some of the issues raised by the proposed saving clause in Article 1(3) OECD MC. After providing some background with regard to the saving clause in the US Model Convention (Section 2), the scope of the OECD's proposal will be examined: This not only includes a closer look at the details of the proposal (Section 3), but also its intended effect with regard to domestic CFC rules and hybrid entities and its (likely) unintended consequences with regard to the arm's length standard provided in Article 9(1) OECD MC (Section 4). Brief conclusions follow at the end (Section 5).

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¹² See A. A. Rossi, *The Saving Clause of Pending U.S.-Italy Tax Treaty*, 30 *Tax Notes Int'l* 1351 (1351) (30 June 2003); J. Schuch & N. Neubauer, *The Saving Clause: Article 1(3) of the OECD Model*, in *Base Erosion and Profit Shifting (BEPS)* 27 (31) (M. Lang, P. Pistone, A. Rust, J. Schuch and C. Staringer eds., Linde 2016).

¹³ J. Sasseville, *A Tax Treaty Perspective: Special Issues*, in *Tax Treaties and Domestic Law* 37 (50) (G. Maisto ed., IBFD 2006) (italics in the original).

¹⁴ See *infra* s. 3.2.

¹⁵ See *infra* s. 3.1.

¹⁶ See *infra* s. 4.

¹⁷ OECD, *supra* n. 1, at 78 et seq. (paras 53 et seq.).

¹⁸ For a brief overview see Schuch & Neubauer, *supra* n. 12, at 27 (46–49).

¹⁹ See Art 1 paras 9.2, 22.1 and 23 OECD MC. Comm. 2003.

²⁰ See Art. 1 para. 7 of the 1977 OECD MC Comm., where it was noted that States with domestic anti-avoidance provisions 'will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws'.

²¹ That idea was already expressed in literature, suggesting that Contracting States should include a saving clause in their bilateral tax treaties to bar taxpayers from arguing a conflict between domestic anti-abuse provisions and the provisions of a tax treaty. See Sasseville, *supra* n. 13, at 37 (52–55).

2 THE SAVING CLAUSE IN THE US MC

The OECD specifically mentions the saving clause in the US MC,²² and indeed the United States has always insisted on such a provision in tax treaties to be able to continue to tax its residents (individuals and corporations) and citizens as if the tax treaty had not come into effect. Those clauses generally operate on the basis of reciprocity and hence save the respective taxation of the US as well as of its treaty partner.²³ However, the United States is special insofar as it not only taxes its residents, but also its citizens on their worldwide income,²⁴ and both residents and citizens are covered by a typical US 'saving clause'.²⁵ The operation of such saving clause:

is that one first reads the rest of the Treaty and, if the effect is that the Treaty would otherwise prevent the US from taxing, then the US may still tax by virtue of the saving clause as if the Treaty had not come into effect. Its purpose is primarily to preserve the right of the US to continue to tax its citizens (who are liable to tax on their worldwide income regardless of residence) when the [other Contracting State] is given exclusive right to tax them under the Treaty as [its] residents, but it applies also to US residents (after determining dual residence in accordance with the Treaty).²⁶

From a US perspective, such saving clause therefore simply keeps intact and preserves ('saves') the US's basic jurisdictional principle of taxing the worldwide income of its resident individuals, whatever their nationality, its citizens, wherever they reside, and its corporations,

however insignificant their other contacts with the US.²⁷ This is also reflected by the US's reservation to Article 1 of the OECD MC, in which '[t]he United States reserves the right, with certain exceptions, to tax its citizens and residents, including certain former citizens and long-term residents, without regard to the Convention'.²⁸ However, the effect of this jurisdictional reservation for the taxation of non-resident citizens is mitigated by the foreign tax credit provision in US tax treaties so that the taxing right of the US is in effect secondary to that of the taxpayer's country of residence.²⁹ Indeed, the provisions on relief from double taxation are excepted from the saving clause³⁰ and trigger quite complicated issues with regard to resourcing of income and multistage crediting in case of the taxation of non-resident citizens.³¹

All current US tax treaties contain a saving clause, though varying in their exact wording and scope. Such clauses have a long history and date back to the first comprehensive treaties concluded by the US in 1939³²: Both, the treaty with Sweden³³ and with France³⁴ spelled out in the provisions on 'Relief From Double Taxation'³⁵ that:

[n]otwithstanding any other provision of this Convention, the United States of America in determining the income and excess-profits taxes, including all surtaxes, of its citizens or residents or corporations, may include in the basis upon which such taxes are imposed all items of income taxable under the revenue laws of the United States of America as though this Convention had not come into effect.³⁶

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²² OECD, *supra* n. 1, at 86 (para. 62).

²³ Sasseville, *supra* n. 13, at 37 (49); Schuch & Neubauer, *supra* n. 12, at 27 (35).

²⁴ Sec. 7701(a)(30) IRC; R. Mason, *Citizenship Taxation*, 89 S. Cal. L. Rev. (forthcoming).

²⁵ However, according to Art VII of the 1973 DTC with the Union of Soviet Socialist Republics (USSR) (TIAS 8225), which still applies to the former Soviet Republics Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan and Uzbekistan, '[t]his Convention shall not restrict the right of a Contracting State to tax a citizen of that Contracting State', and hence only upholds citizenship taxation.

²⁶ UK Special Commissioners of Income Tax, 19 Nov. 2008, *Bayfine UK Products Bayfine UK v Revenue & Customs* (2008) UKSPC SPC00719, para. 41.

²⁷ See, e.g., J. G. White, *Income Tax Treaties*, 52 A.B.A. J. 756 (759) (1966). Indeed, the traditional view of US tax treaties, i.e., that they did not reduce or affect the tax burden of US persons, also informed the US discussion and eventual rejection about granting tax sparing credits. See H. D. Rosenbloom & S. I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 Colum. J. Transnat'l L. 359 (384) (1980).

²⁸ See Art. 1 para. 27 OECD MC Comm.

²⁹ See, e.g., P. F. Postlewaite & D. S. Makarski, *The A.L.L. Tax Treaty Study – A Critique and a Modest Proposal*, 52 Tax Lawyer 731 (787) (1999). However, the operation of the tax credit, as interpreted by US courts (see, e.g., US Tax Court, 6 Oct. 2010, *Savary v. Commissioner*, T.C. Summary Opinion 2010–150 (2010); US Tax Court, 21 Feb. 2012, *LeTourneau v. Commissioner*, T.C. Memo 2012–45 (2012)) can be quite unsatisfactory; for discussion of the *Savary* case concerning a non-resident citizen's income as a flight attendant see B. J. Arnold, *Tax Treaty News*, 65 BIT 2011, 118 (118–119).

³⁰ See, e.g., Art. 1(5)(a) of the 2016 US MC and the US Tech. Expl. on Art. 1(4) and (5) of the 2006 US MC.

³¹ See, e.g., Art. 23(3) and (4) of the 2016 US MC. See for an instructive example of the complexities raised in the case of a hybrid entity UK Special Commissioners of Income Tax, *supra* n. 26, England and Wales High Court (Chancery Division), 23 Mar. 2010, *Bayfine UK v HMRC* (2010) EWHC 609 (Ch), and England and Wales Court of Appeal (Civil Division), 23 Mar. 2011, *Bayfine UK v HM Revenue and Customs* (2011) EWCA Civ 304.

³² It might be noted that a limited US tax treaty with France from 1932 (49 Stat. 3145, T.S. No. 885) did not contain a specific saving clause but rather achieved a similar result by limiting the application of the treaty to citizens and corporations created or organized under the respective law. Also, a 1936 rudimentary agreement with Canada (50 Stat. 1399, T.S. No. 920), stipulated in its Art. II that '[t]he provisions of this convention shall not apply to citizens of the United States of America domiciled or resident in Canada'.

³³ 54 Stat. 1759, T.S. No. 958.

³⁴ 59 Stat. 893, T.S. No. 988.

³⁵ While the saving clause was initially included in the Relief From Double Taxation article, in most treaties entered into since the early 1970s the saving clause has been included in the rules on the Personal Scope or the General Rules.

³⁶ See Art. XIV(a) of the DTC US-Sweden 1939 and Art- 14(A) of the DTC US-France 1939, respectively.

Those 1939 treaties established one of the cornerstones of US treaty policy, that is, 'that tax treaties should not generally affect taxation by the United States of its citizens and residents'.³⁷ Subsequent treaties as well as the US Models 1976/77,³⁸ 1981, 1996,³⁹ 2006⁴⁰ and 2016⁴¹ have upheld this basic concept, but refined and expanded it, so that the current saving clause and its exceptions in Articles 1(4) and (5) of the 2016 US MC read as follows:

4. Except to the extent provided in paragraph 5 of this Article, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may be taxed in accordance with the laws of that Contracting State.

5. The provisions of paragraph 4 of this Article shall not affect

a) the benefits conferred by a Contracting State under paragraph 3 of Article 7 (Business Profits), paragraph 2 of Article 9 (Associated Enterprises), paragraph 7 of Article 13 (Gains), subparagraph (b) of paragraph 1, paragraphs 2, 3 and 6 of Article 17 (Pensions, Social Security, Annuities, Alimony and Child Support), paragraph 3 of Article 18 (Pension Funds), and Articles 23 (Relief From Double Taxation), 24 (Non-Discrimination) and 25 (Mutual Agreement Procedure); and b) the benefits conferred by a Contracting State under paragraph 1 of Article 18 (Pension Funds), and Articles 19 (Government

Service), 20 (Students and Trainees) and 27 (Members of Diplomatic Missions and Consular Posts), upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that Contracting State.

A typical saving clause therefore preserves the US taxation of resident citizens with foreign-source income⁴² as well of non-resident citizens and non-citizen residents, each with their foreign⁴³ and domestic⁴⁴ income. The effects of a saving clause are hence twofold: It upholds the right to tax income of residents that would otherwise be allocated exclusively to the foreign State under a complete distributive rule,⁴⁵ as well as the right to tax income of citizens residing in the other Contracting State although a complete distributive rule reserves exclusive taxation for the residence State.⁴⁶ It not only 'saves' the right to include income into the domestic tax base but also, for example, the computation of the tax itself.⁴⁷ Moreover, it also 'saves' the application of anti-avoidance rules (for example, CFC rules) and the taxation of US persons with an interest in a foreign partnership or a disregarded entity.⁴⁸

This basic approach has been developed over time, and three evolutionary changes may be highlighted: First, modern US saving clauses explicitly address the situations of dual-residents by referring to the residence Article of the treaty (Article 4 of the 2016 US MC), that is, the US does not reserve the right to apply its own domestic definition of 'resident'. 'Residents' for purposes of the treaty and thus for the saving clause 'include corporations and other entities as well as individuals who are not treated as residents of the other country under the treaty

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³⁷ Rosenbloom & Langbein, *supra* n. 27, at 359 (374); *see also* Sasseville, *supra* n. 13, at 37 (49) ('fundamental feature of US treaty policy'). Some former US treaties that did not contain an explicit saving clause but reached the same result by defining resident of the treaty partner so as to preserve the right of the US to tax its citizens. *See, e.g.*, with regard to the 1945 DTC US-UK, 60 Stat. 1377, T.I.A.S. No. 1546, US Court of Appeals Second Circuit, 14 Feb. 1962, *Maximov v. United States*, 299 F.2d 565 (571) (2d Cir. 1963) (affirmed by the US Supreme Court, 29 Apr. 1963, 373 US 49, 53 (1963)), and Rev.-Rul. 59-56, 1959-1 C.B. 739.

³⁸ For the early developments of a US model treaty *see* Rosenbloom & Langbein, *supra* n. 27, at 359 (383 et seq.); K. Vogel, H. A. Shannon, R. L. Doernberg & K. van Raad, *United States Income Tax Treaties* (1989) Part I 87 et seq.; *see also, e.g.*, T. S. G. Bissell, *The Treasury's Model Income Tax Treaty: An Analysis and Appraisal*, 3 Int'l Tax J. 8 (8 et seq.) (1976-1977); M. Burge & S. Packer, *New US Model Income Tax Treaty*, 10 Intertax 1982, 53 (53 et seq.).

³⁹ United States Model Income Tax Convention of Sept. 20, 1996.

⁴⁰ United States Model Income Tax Convention of Nov. 15, 2006.

⁴¹ United States Model Income Tax Convention of Feb. 17, 2016.

⁴² US Tax Court, 23 June 1992, *Lindsey v. Commissioner*, 98 TC 672 (concerning a specific credit limitation in former US domestic law).

⁴³ US Tax Court, *supra* n. 3, at 971 (974) (concerning a US citizen resident in Canada and deriving income from personal services rendered in Canada); US Tax Court, 9 June 2014, *Abrahamsen v. Commissioner*, 142 TC 405 (concerning income from services to a foreign government of US residents).

⁴⁴ US Tax Court, 27 June 1956, *Crerar v. Commissioner*, 26 TC 702; US Tax Court, 17 May 1963, *Perkins v. Commissioner*, 40 T.C. 330; US Tax Court, 27 May 1980, *Filler v. Commissioner*, 74 T.C. 406.

⁴⁵ US Tax Court, *supra* n. 44, at 406 (concerning a US citizen resident in France earning employment income in the US that would otherwise be taxable in France under Art 15 of the 1967 US-France DTC, 19 U.S.T. 5280, 1968-2 C.B. 691); US Tax Court, *supra* n. 43, at 405 (concerning a US resident's income from government service under Art 19 of the 1989 DTC US-Finland); Rev.-Rul. 59-56, 1959-1 C.B. 739 (concerning the cutting and sale of timber in Germany by a US citizen under Art IX of the 1954 US-Germany DTC, 5 U.S.T. 2768, T.I.A.S. No. 3133).

⁴⁶ US Tax Court, *supra* n. 44, at 330 (concerning an annuity received by a US citizen resident in Italy under Art X(2) of the 1956 DTC US-Italy 1956, TIAS 3679); Rust, *supra* n. 10, at Art. 1 m.no. 45. *See also* the example provided in the US Tech. Expl. on Art. 1(4) of the 2006 US MC: '[I]f a resident of the other Contracting State performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of the other Contracting State is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (i.e., without regard to Code section 894(a)).'

⁴⁷ US Tax Court, *supra* n. 44, at 702 (concerning the applicable tax rate).

⁴⁸ *See infra* ss 4.1 and 4.2.

tiebreaker provisions governing dual residents'.⁴⁹ If, therefore, a non-citizen resident of the United States under domestic law (for example, a 'green card' holder) is also a resident of the treaty partner State under its law, and the tiebreaker rules of Article 4 determine that he is a resident of that other State, then he will not be subject to the saving clause but rather be entitled to US benefits under the tax treaty.⁵⁰ The US Technical Explanations hence note that the US 'would not be permitted to apply its statutory rules to that person to the extent the rules are inconsistent with the treaty', but further clarify that such person will still 'be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability'.⁵¹ As for dual resident corporations, however, the 2006 US Model had aligned domestic with treaty residency based on the place of incorporation,⁵² while under the 2016 US Model a dual resident company 'shall not be treated as a resident of either Contracting State for purposes of its claiming the benefits provided by this Convention'.⁵³

Second, the provisions of the saving clause take precedence over the other provisions in the treaty, unless the other provisions are specifically excepted from the saving clause.⁵⁴ Such exceptions that 'turn off' the saving clause are foreseen because the saving clause 'is overbroad in certain respects' so that 'it is necessary to accompany [it] with specific exceptions'.⁵⁵ Article 1(5) of the 2016 US Model takes a twofold approach: Some exceptions are provided in a general manner for certain treaty benefits, for example, corresponding transfer pricing adjustments, relief from double taxation, non-discrimination, and the mutual agreement provision (Article 1(5)(a) of the 2016 US MC); these exceptions – and hence specifically the

provisions that grant relief from double taxation – apply to all taxpayers including US citizens and residents.⁵⁶ Others apply only to residents who are neither citizens nor have been 'admitted for permanent residence', that is, 'green card' holders,⁵⁷ such as the rules on government service, students, teachers, and diplomats (Article 1(5)(b) of the 2016 US MC).⁵⁸ Essentially, a teacher or student from the treaty partner does not lose the benefits of the respective treaty provision by staying in the United States long enough to be considered a resident for tax purposes, provided that she does not become a US citizen or immigrant.⁵⁹ Historically, however, such exceptions were not always explicitly listed in the treaty but were rather implicit: While for some older treaties such exceptions were sometimes promulgated only in domestic US regulations,⁶⁰ other exceptions were developed by practice based on the notion that the saving clause does not apply 'when its application would contravene policies reflected in the convention'.⁶¹ Two examples stand out: A treaty's non-discrimination clause would apply even if such clause were not explicitly excepted from the saving clause.⁶² Also, 'agreements made by the competent authorities may nevertheless inure to the benefit of a citizen or resident of the United States ...',⁶³ so that this treaty provision may well result in a waiver of US taxing jurisdiction on its citizens or residents even if the treaty provision on the mutual agreement procedure is not explicitly excepted from the saving clause.

Third, and finally, when the US introduced an expatriation tax in 1966⁶⁴ that upheld, under certain circumstances, US domestic taxation of persons who had renounced their citizenship as if they had retained US citizenship for a period of ten years, that provision was

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⁴⁹ See, e.g., the Joint Committee on Taxation Explanation of the US-Netherlands DTC in JCS-15-93 NO 5 (1993), 34.

⁵⁰ See also US Tech. Expl. on Art. 1(4) of the 2006 US MC; Rossi, *supra* n. 12, at 1351 (1352); Rust, *supra* n. 10, at Art. 1 m.no. 46.

⁵¹ US Tech. Expl. on Art. 1(4) of the 2006 US MC, noting that, '[f]or example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident'.

⁵² Under US domestic tax law, a company is taxed on its worldwide income if it is a 'domestic corporation', i.e., a corporation created or organized in the United States or under the law of the United States or of any State (§ 11(a), (d) and § 7701(a)(4), (5) IRC). The US Model reflects that the United States treat the place of incorporation as the (sole) criterion for corporate residence, i.e., the US's approach generally deems a corporation to be a resident of the state under whose laws it is created or organized (Art. 1(4) US MC 2006). See also, e.g., Rosenbloom & Langbein, *supra* n. 27, at 359 (384); Vogel, Shannon, Doernberg & Raad, *supra* n. 38, at Part II 167–169; Y. Brauner, *United States, in Residence of Companies under Tax Treaties and EC Law* 855 (875–876 and 882–883) (G. Maisto ed., IBFD 2009).

⁵³ See Art. 4(4) of the 2016 US MC.

⁵⁴ US Tax Court, *supra* n. 44, at 406 (410–411); US Tax Court, *supra* n. 3, at 971 (974).

⁵⁵ Rosenbloom & Langbein, *supra* n. 27, at 359 (383).

⁵⁶ Rust, *supra* n. 10, at Art. 1 m.no. 48; Schuch & Neubauer, *supra* n. 12, at 27 (33–34).

⁵⁷ See, e.g., the Joint Committee on Taxation Explanation of the US-Netherlands, *supra* n. 49, at 35.

⁵⁸ See also US Tech. Expl. on Art. 1(5) of the 2006 US MC.

⁵⁹ See, e.g., Bissell, *supra* n. 38, at 8 (10).

⁶⁰ See, e.g., the old Treas. Reg. § 521.103(e) for the 1948 DTC US-Denmark; Treas. Reg. § 505.103(e) for the 1948 DTC US-Netherlands; Treas. Reg. § 507.103(e) for the 1945 DTC US-UK.

⁶¹ General Counsel Memorandum (GCM) 34616 (Sept. 22, 1971).

⁶² General Counsel Memorandum (GCM), *supra* n. 61; Rev.-Rul. 72-330, 1972-2 C.B. 444; Rev.-Rul. 72-589, 1972-2 C.B. 451.

⁶³ Technical Explanation of Art. 4 of the 1970 DTC US-Finland, as cited in General Counsel Memorandum (GCM), *supra* n. 61.

⁶⁴ See § 877(a) IRC, initially introduced by the Foreign Investors Act of 1966, Pub. L. No. 94-455, 90 Stat. 1520 (1620–1624).

also reflected in subsequent treaty practice⁶⁵ as well as in the 1976/77 US Model,⁶⁶ as was the extension of that tax to former long-term residents⁶⁷ in the 1996 US Model. Such a provision is still found in the 2016 US MC, even though the former expatriation tax has been replaced by a mark-to-market exit tax for individuals expatriating on or after 17 June 2008,⁶⁸ making it therefore superfluous for expatriations after that date.⁶⁹

3 THE SAVING CLAUSE IN THE OECD MC

3.1 Scope of the Saving Clause

The OECD's saving clause is certainly much less complex than Articles 1(4) and (5) of the 2016 US MC. This is largely due to the fact that the Article 1(3) neither 'saves' the taxation of citizens (and hence does not have to solve the conflicting rights to tax income of citizens of one Contracting State residing in the other Contracting State),⁷⁰ nor does it address the taxation of former residents (for example, through 'trailing taxes'⁷¹).⁷² However, Article 1(3) deals with potential dual-residency situations, as the term 'resident' used in Article 1(3) is defined in Article 4,⁷³ so that a single State of residency can be determined under the tiebreaker rules.⁷⁴ Thus, Article 1(3) 'does not apply to an individual or legal person who is a resident of one of the Contracting States under the laws of that State but who, for the purposes of the Convention, is deemed to be a resident only of the other Contracting State'.⁷⁵

That said, the effect of the proposed saving clause in basic one-taxpayer situations is mainly to preserve the right to tax income of residents that would otherwise be

allocated exclusively to the source State under a complete distributive rule.⁷⁶ However, this 'preservation' is subject to exceptions,⁷⁷ that is, the saving clause is 'turned off' for

- the correlative and corresponding adjustments under Article 7(3) and Article 9(2) OECD MC
- the taxation of resident individuals that derive income in respect of services rendered to the other Contracting State or a political subdivision or local authority thereof under Article 19 OECD MC
- the taxation of students under Article 20 OECD MC
- relief from double taxation under Articles 23 A and 23 B OECD MC
- the non-discrimination provisions of Article 24 OECD MC
- the mutual agreement proceedings under Article 25 OECD MC; and
- the taxation of a resident individual who is a member of the diplomatic mission or consular post of the other Contracting State under Article 28.

The saving clause is therefore surprisingly limited in scope in the basic situation that both Contracting States attribute the same income to the same taxpayer. Indeed, the instances where there might be exclusive taxation in the source State under the distributive rules are either excepted from the saving clause in the first place (that is, Articles 19 and 20 OECD MC), or the exclusive source State taxation becomes a concurrent taxation with the residence State being obliged to give relief under Article

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⁶⁵ While the IRS had initially taken the position that even absent a specific 'expatriation' provision in the saving clause itself the United States retains the right to tax former citizens resident in the treaty partner (see Rev.-Rul. 79-152, 1979-1 C.B. 237), that interpretation was not shared by the judiciary (US Tax Court, 26 Aug. 1985, *Crow v. Commissioner*, 85 T.C. 376, concerning Art XVII DTC US-Canada 1942). See also Rust, *supra* n. 10, at Art. 1 m.no. 47.

⁶⁶ See Bissel, *supra* n. 38 at 8 (9).

⁶⁷ As expanded by the Health Insurance Portability and Accountability Act 1996, Pub. L. 104-191, 110 Stat. 1936.

⁶⁸ See § 877A IRC, as introduced by the Heroes Earnings Assistance and Relief Tax Act of 2008 Pub. L. 110-245, 122 Stat. 1624.

⁶⁹ See O. Halabi, *Expatriation Tax – Renouncing a Tax Treaty*, 66 BIT 2012, 377 (382).

⁷⁰ See also Rust, *supra* n. 10, at Art. 1 m.no. 45.

⁷¹ Such limited saving clauses are, however, sometimes found in bilateral tax treaties. See, e.g., Art. 13(6) of the 1977 Switzerland-UK DTC, which provides: 'The provisions of paragraph 5', i.e., the exclusive taxation right of the alienator's residence State of gains from the alienation of property not otherwise mentioned in Art 13, 'shall not affect the right of the United Kingdom to levy according to its law a tax chargeable in respect of gains from the alienation of any property on a person who is, and has been at any time during the previous six fiscal years, a resident of the United Kingdom or on a person who is a resident of the United Kingdom at any time during the fiscal year in which the property is alienated.'

⁷² The OECD addresses issues concerning the potential escape from taxation by giving up residency separately with a focus on 'departure taxes' or 'exit taxes' that may apply, e.g., to accrued pension rights and accrued capital gains. See OECD, *supra* n. 1, at 89-90 (paras 65-67).

⁷³ See OECD, *supra* n. 1, at 88 (para. 63) (proposed new Art. 1 para. 26.21 OECD MC Comm.).

⁷⁴ As for dual-resident corporations, for which the current tiebreaker in Art. 4(3) OECD MC is based on the place of effective management, the OECD proposes to replace that automatic rule in favor of a competent authority determination of residence, also providing that in the absence of such agreement such dual-resident corporation shall in principle 'not be entitled to any relief or exemption from tax provided by this Convention'. See OECD, *supra* n. 1, at 72 et seq. (paras 45 et seq.).

⁷⁵ OECD, *supra* n. 1, at 88 (para. 63) (proposed new Art. 1 para. 26.21 OECD MC Comm.); see also, e.g., Schuch & Neubauer, *supra* n. 12, at 27 (36).

⁷⁶ See also, e.g., Schuch & Neubauer, *supra* n. 12, at 27 (40).

⁷⁷ See OECD, *supra* n. 1, at 86-87 (para. 63) (proposed new Art. 1 para. 26.19 OECD MC Comm.). The OECD also notes that Contracting States may, of course, include any other provision in the list of exceptions where it is intended to affect the taxation of a Contracting State's residents (see the proposed new Art. 1 para. 26.20 OECD MC Comm.). For a more detailed discussion of these exceptions see Schuch & Neubauer, *supra* n. 12, at 27 (37-40).

23 A or Article 23 B (that is, Article 8 OECD MC). From a US perspective, it is sensible to not exclude Article 8 from the US saving clause, as the US MC adopts a residence-based taxation of shipping and air transportation profits.⁷⁸ It is not clear, however, that the same holds true for the OECD MC: Currently, Article 8 OECD MC establishes exclusive taxation in the Contracting State where the enterprise's place of effective management is located, that is, in the (functional) source State for the enterprise, which can be different from the taxpayer's State of residence, for example, in the case of individuals or partnerships running a shipping or air transportation enterprise.⁷⁹ If such distribution of taxing rights is intended for reasons of simplicity and administrability, Article 8 OECD MC should therefore either be excepted from the saving clause⁸⁰ or be changed to establish exclusive taxation in the residence State.⁸¹

If the same taxpayer is a resident of both States the dual residence provisions of a tax treaty will resolve residence in favour of one of them for the purpose of applying the treaty, so that only a single residence State is at issue. But a tax treaty is usually silent about what to do when they are different persons.⁸² Those situations are at the core of the OECD's proposal:

26.17 Whilst some provisions of the Convention (e.g. Articles 23 A and 23 B) are clearly intended to affect how a Contracting State taxes its own residents, the object of the majority of the provisions of the Convention is to restrict the right of a Contracting State to tax the residents of the other Contracting State. In some limited cases, however, it has been argued that some provisions could be interpreted as limiting a Contracting State's right to tax its own residents in cases where this was not intended (see, for example, paragraph 23 above, which addresses the case of controlled foreign companies provisions).

26.18 Paragraph 3 confirms the general principle that the Convention does not restrict a Contracting State's right to tax its own residents except where this is intended and lists the provisions with respect to which that principle is not applicable.⁸³

Here, in effect, the saving clause preserves the application of certain residence-based anti-avoidance rules (for example, CFC rules) as well as the taxation of residents deriving income from an interest in a foreign partnership or a disregarded entity. Therefore, and while at its face not being an anti-avoidance measure as such, the inclusion of a saving clause means that each Contracting State can freely apply its domestic anti-abuse rules and judicial doctrines to its residents, even if such an application would otherwise result in a conflict with a treaty provision.⁸⁴ While the OECD certainly views that effect as a mere confirmation of its long-standing position already spelled out in the OECD MC Comm. since the 2003 Update,⁸⁵ one could reasonably make the *e contrario* argument that domestic anti-avoidance measures may indeed be in conflict with tax treaties that do not yet include a saving clause.⁸⁶

The proposed saving clause certainly also raises a number of timing issues, for example whether it is a static or a dynamic provision. It has been argued, for example, that the saving clause can only preserve domestic taxation that was in place at the date the treaty went into effect or, at most, fundamentally similar subsequent taxation, as this is the framework upon which the treaty has been negotiated.⁸⁷ Neither wording nor object and purpose seem to support such a narrow reading. Quite to the contrary, the saving clause makes sure that conflicts between domestic law and treaty law are permanently avoided, so that the residence State also has 'the opportunity to pursue treaty overrides without having to violate its obligations under the tax treaty',⁸⁸ although, of course, making fundamental changes without consulting the treaty partner may be unwise diplomatically.

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⁷⁸ See Art. 8(1) of the 2016 US MC and, e.g., G. Kofler, *Klaus Vogel on Double Taxation Conventions* (E. Reimer & A. Rust eds., 4th ed., Kluwer 2015), Art. 8 m.no. 5.

⁷⁹ See, e.g., Kofler, *supra* n. 78, at Art. 8 m.no. 6).

⁸⁰ See also Sasseville, *supra* n. 13, at 37 (54); Schuch & Neubauer, *supra* n. 12, at 27 (41).

⁸¹ It should therefore be noted that a 2013 OECD discussion draft proposes to amend Art. 8(1) OECD MC to grant the exclusive taxing right for profits from the operation of ships or aircraft in international traffic to the enterprise's residence State (see OECD, *Proposed Changes to the OECD Model Tax Convention Dealing with the Operation of Ships and Aircraft in International Traffic – Public Discussion Draft* (15 Nov. 2013–15 Jan. 2014)).

⁸² UK Special Commissioners of Income Tax, *supra* n. 26, at para. 38.

⁸³ See OECD, *supra* n. 1, at 86 (para. 63) (proposed new Art. 1 paras 26.17 and 26.18 OECD MC Comm.).

⁸⁴ De Broe & Luts, *supra* n. 2, at 122 (139); Schuch & Neubauer, *supra* n. 12, at 27 (49).

⁸⁵ For some details on that update, which fundamentally altered the OECD's view on the improper use of tax treaties and the relationship of treaties and domestic anti-abuse provisions, see, e.g., R. Matteotti, *Interpretation of Tax Treaties and Domestic General Anti-Avoidance Rules – A Sceptical Look at the 2003 Update to the OECD Commentary*, 33 Intertax 2005, 336 (336 et seq.), and the short summary by D Broe & Luts, *supra* n. 2, at 122 (123–124). A comprehensive overview is given in the contributions in IFA (ed.), *Tax treaties and tax avoidance: application of anti-avoidance provisions*, CDFI 95a (2010).

⁸⁶ For such *e contrario* argument see De Broe & Luts, *supra* n. 2, at 122 (139).

⁸⁷ See for a discussion of such arguments with regard to the introduction of CFC rules in the US M. G. Beemer, *Revenue Act of 1962 and United States Treaty Obligations*, 20 Tax L. Rev. 125 (149–151) (1964).

⁸⁸ See Schuch & Neubauer, *supra* n. 12, at 27 (43); along the same lines Beemer, *supra* n. 87, at 125 (149–151).

3.2 Relief from Double Taxation

Article 1(3) OECD MC itself excepts the benefits of the provisions on relief from double taxation in Article 23 A and Article 23 B OECD MC from the saving clause. This raises the issue how such relief should be given when the two Contracting States tax the same income but take a different perspective on who is the taxpayer, that is, a situation where two residence States are involved. This can be the case with regard to hybrid entities⁸⁹ but also, more generally, with different approaches to income attribution under anti-avoidance rules. The approach taken by the OECD in that respect is to disregard the existence of the entity and look through to the respective item of income. That means that a Contracting State is only required to grant relief:

when income was taxable in the other State under treaty provisions allowing that other State to tax the relevant income as the State of source or as a State where there is a permanent establishment to which that income is attributable.⁹⁰

This result is achieved by introducing a new phrase that excludes solely residence-based taxation from the relief obligation of the other State under Article 23 A(1) and Article 23 B(1), respectively, and 'clarifies'⁹¹ to what extent exemption or credit must be granted. For example, the (tentatively)⁹² proposed wording of Article 23 A(1) is:

1. Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State), the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.⁹³

Of course, the addition of the phrase '(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State)' has no bearing on situations where both countries identify the same person as the taxpayer.

Since in such a case Article 4 identifies one single State as the residence State for purposes of the treaty (and hence for purposes of Article 1(3)⁹⁴ and Article 23 A or Article 23 B alike), there can never be two residence States and hence never a situation where one residence State might potentially be in a situation to give relief for a residence-based tax of the other State.⁹⁵ The new wording of Articles 23 A and 23 B, respectively, therefore seems to be limited to conflicts of two residence-based taxes. The OECD explains⁹⁶

11.1 In some cases, the same income or capital may be taxed by each Contracting State as income or capital of one of its residents. This may happen where, for example, one of the Contracting States taxes the worldwide income of an entity that is a resident of that State whereas the other State views that entity as fiscally transparent and taxes the members of that entity who are residents of that other State on their respective share of the income. The phrase '(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State)' clarifies that in such cases, both States are not reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer and that each State is therefore only obliged to provide relief of double taxation to the extent that taxation by the other State is in accordance with provisions of the Convention that allow taxation of the relevant income as the State of source or as a State where there is a permanent establishment to which that income is attributable, thereby excluding taxation that would solely be in accordance with paragraph 3 of Article 1. Whilst this result would logically follow from the wording of Articles 23 A and 23 B even in the absence of that phrase, the addition of the phrase removes any doubt in this respect.⁹⁷

The proposed saving clause in Article 1(3) is also subject to the exception of the non-discrimination provisions of Article 24 OECD MC. The non-discrimination provisions may therefore restrict the residence State's taxing rights where the application of its domestic laws would lead to a prohibited discrimination of its own residents. This may have an impact, for example, on domestic thin-capitalization rules.⁹⁸

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⁸⁹ See OECD, *supra* n. 1, at 89 (para. 64) (proposed new Art. 23 para. 11.1 OECD MC Comm.).

⁹⁰ OECD, *supra* n. 1, at 88 (para. 64).

⁹¹ Indeed, the OECD notes that '[w]hilst this result would logically follow from the wording of Articles 23 A and 23 B even in the absence of that phrase, the addition of the phrase removes any doubt in this respect'. See OECD, *supra* n. 1, at 89 (para. 64) (proposed new Art. 23 para. 11.1 OECD MC Comm.). For a critical assessment of that conclusion in the area of partnership taxation see *infra* s. 4.2.

⁹² As the OECD notes, the draft proposal for changes to Articles 23 A and 23 B was put forward during the last stages of that work and it is intended to finalize the work on that draft proposal in the first part of 2016, which will allow changes that could result from that work to be considered as part of the negotiation of the multilateral instrument that will implement the results of the work on treaty issues mandated by the BEPS Action Plan. See OECD, *supra* n. 1, at 88 (para. 64).

⁹³ See OECD, *supra* n. 1, at 88 (para. 64).

⁹⁴ See OECD, *supra* n. 1, at 88 (para. 63) (proposed new Art. 1 para. 26.21 OECD MC Comm.).

⁹⁵ See also UK Special Commissioners of Income Tax, *supra* n. 26, at para. 44.

⁹⁶ See OECD, *supra* n. 1, at 89 (para. 64) (proposed new Art. 23 para. 11.1 OECD MC Comm.).

⁹⁷ See OECD, *supra* n. 1, at 89 (para. 64).

⁹⁸ De Broe & Luts, *supra* n. 2, at 122 (139).

4 INTENDED AND (POSSIBLY) UNINTENDED CONSEQUENCES

4.1 CFC Rules

The Final Report on Action 6 of the OECD BEPS project discusses at quite some length a number of cases where a person tries to abuse the provisions of domestic tax law using treaty benefits. The OECD's clear focus of the proposed saving clause is 'to prevent interpretations intended to circumvent the application of a Contracting State's domestic anti-abuse rules (as illustrated by the example of controlled foreign companies rules).'⁹⁹ That issue is certainly not new. Already for the 1939 tax treaty between the US and Sweden it was noted that the saving clause:

gives the United States the right to subject to tax its citizens living in Sweden as though the convention had not been adopted. It also permits the United States to take into account items of income from sources within Sweden in determining the classification of personal-holding companies and of foreign personal-holding companies.¹⁰⁰

Both the regime on Personal Holding Companies (introduced in 1934¹⁰¹) and on Foreign Personal Holding Companies (introduced in 1937¹⁰²) addressed different types of unwanted avoidance of shareholder-level taxation. While the former regime targeted specific corporations and imposed an additional tax on the undistributed profits of a corporation, under the latter regime the pro rata share of undistributed income of a specifically defined foreign personal holding company was to be included in the gross income of shareholders that were US citizens or residents.¹⁰³ The Foreign Personal Holding Companies regime also formed a precedent for the introduction of CFC rules ('Subpart F') in the early 1960s.¹⁰⁴ Those rules were aimed

at preventing US persons (citizens, residents, corporations, partnerships, trusts and estates) from avoiding tax by shifting income away from the United States or from foreign non-tax haven countries to foreign tax havens. If the conditions of those provisions are fulfilled, each US shareholder must currently include its pro rata share of 'Subpart F' income of a CFC (for example, interest, dividends, rents, royalties, foreign base company sales income) in its gross income, and, conversely, is entitled to a foreign tax credit with respect to its subpart F inclusion to the same extent it would have been allowed a foreign tax credit upon an actual distribution.¹⁰⁵ However, during the legislative process for 'Subpart F' concerns were expressed as to the compatibility of that regime with US treaty obligations.¹⁰⁶ While the administration's position was and is that the CFC regime imposed a tax on the US shareholder of a foreign entity and was hence covered by the saving clause¹⁰⁷ (which invites the question, however, how that issue would be resolved if a tax treaty does not contain a saving clause¹⁰⁸), the treaty issue was effectively abridged by a specific provision in domestic law that elevated the CFC regime above inconsistent US income tax treaty obligations.¹⁰⁹

However, within the realm of the OECD MC and its current lack of a saving clause, the discussion about the compatibility of domestic CFC regimes with a State's tax treaty obligation is ongoing. While some treaties explicitly state that domestic CFC rules do not conflict with the respective treaty,¹¹⁰ most treaties do not, so that this question remains one of interpretation. Although the features of domestic CFC regimes vary widely and such regimes may operate,¹¹¹ for example, to create deemed distributions of the CFC income or to pierce the corporate veil (and essentially treat the CFC as a partnership or flow-through entity for the purposes of attributing CFC income),¹¹² two broad positions on their compatibility with tax treaties can be identified:

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⁹⁹ OECD, *supra* n. 1, at 86 (para. 62).

¹⁰⁰ See the Technical Memorandum in Ex. Rept. No. 18, 76th Cong., 1st Sess., reprinted in 2 *Legislative History of United States Tax Conventions* (1962), 2343.

¹⁰¹ Revenue Act of 1934, 84 Stat. 680.

¹⁰² Revenue Act of 1937, 50 Stat. 813.

¹⁰³ For discussions of those regimes see, e.g., G. G. Tyler & J. P. Ohl, *The Revenue Act of 1934*, 83 U. Pa. L. Rev. 607 (608–612) (1935); R. E. Paul, *The Background of the Revenue Act of 1937*, 5 U. Chi. L. Rev. 41 (49–56) (1937); W. D. Popkin, *Taxation of Foreign Incorporated Pocketbooks with Nonresident Alien Shareholders*, 20 Rutgers L. Rev. 268 (268 et seq.) (1966). See also the short description by the Office of Tax Policy – Department of the Treasury, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations – A Policy Study* (Dec. 2000) 5–7 and 106–110.

¹⁰⁴ Revenue Act of 1962, Publ. L. 87–834, 76 Stat. 960.

¹⁰⁵ See §§ 951–964 IRC and the extensive analysis of this regime by the Office of Tax Policy – Department of the Treasury, *supra* n. 103.

¹⁰⁶ For a detailed account of that discussion see Beemer, *supra* n. 87, at 125 (125 et seq.).

¹⁰⁷ See also UK Special Commissioners of Income Tax, *supra* n. 26, at para. 60; L. De Broe et al, *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, 65 BIT 2011, 375 (379); De Broe & Luts, *supra* n. 2, at 122 (138).

¹⁰⁸ See D. Sandler, *Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries*, 163 (2d ed., Kluwer 1998).

¹⁰⁹ See S. 31 of the Revenue Act of 1962, Publ. L. 87–834, 76 Stat. 960.

¹¹⁰ This is, e.g., Canada's general treaty practice (see De Broe et al, *supra* n. 107, at 375 (379)), and such clauses are found in some other treaties as well (see Rust, *supra* n. 10, at Art. 1 m.no. 94).

¹¹¹ For a concise analysis of such rules see OECD, *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report* (Oct. 2015).

¹¹² The OECD does not recommend one specific approach, as '[b]oth approaches seem equally appropriate in terms of dealing with BEPS and therefore the question of how to treat attributed income could be left for jurisdictions to decide in a manner that is coherent with domestic law'. See OECD, *supra* n. 111, at 63 (para. 118). For a more detailed discussion see paras 23 et seq. of the OECD Report entitled *Double Taxation Conventions and the Use of Base Companies* (adopted by the Council of the OECD on 27 Nov. 1986).

While some argue that already the distributive rules in Article 7(1) and/or Article 10(5) OECD MC restrict the application of CFC regimes,¹¹³ the majority view (and also the view of the OECD since the 2003 Update to the OECD MC Comm.¹¹⁴) seems to be that neither Article 7(1) nor Article 10(5) OECD MC or any other distributive rule restricts the application of CFC rules as such.¹¹⁵ This latter position, of course, puts the focus on the relief of double taxation under Article 23 OECD MC, and here the picture gets blurred. The OECD stresses that, in a CFC regime that pierces the corporate veil in which income is attributed to the taxpayer, 'each item of the income would have to be treated under the relevant provisions of the Convention (business profits, interest, royalties)', while under a deemed dividend approach the amount 'is clearly derived from the base company thus constituting income from that company's country', leaving it open whether that amount falls under Article 10 or Article 21 OECD MC.¹¹⁶ Focusing on CFC rules that attribute income to shareholders, there still remain a number of questions and issues under the different methods to avoid double taxation, that is, exemption (Article 23 A OECD MC) or credit (Article 23 B OECD MC). Let us assume that the treaty in question resembles Article 23 A OECD MC and provides exemption for all income (Article 23 A(1)) except for dividends and interest, for which a credit

is granted (Article 23 A(2)). One could, for example, take the view that if the residence State of the CFC taxes all of the income of the CFC (whether attributable to a permanent establishment or not, and whether from sources within or without its jurisdiction) such taxation would still be 'in accordance with the provisions of this Convention' so that the shareholder's residence State would have to exempt all the income.¹¹⁷ Neither the OECD nor scholarship seems to go that far. Rather a look-through approach seems to be favoured to determine whether – if the legal form of the CFC were ignored – the underlying income is attributable to a permanent establishment in the source State or not.¹¹⁸ If yes, exemption has to be granted.¹¹⁹ If not, for dividends and interest income an analogy to the Partnership Report¹²⁰ is made to argue for the obligation of the shareholder's State to credit the underlying tax. Even following this line of argument, however, the amount of the credit to be granted remains disputed: While some limit the credit obligation to the amount 'which the [CFC's] state would have been allowed to levy had it attributed the income to the [shareholder]',¹²¹ that is, the reduced withholding tax under Articles 10 and 11 OECD MC if that income has its source in the CFC's residence State, respectively,¹²² others argue for a credit in the amount of tax actually paid by the CFC to its residence State on that income.¹²³

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¹¹³ French Conseil d'État, 28 June 2002, n° 232276, *Société Scheider Electric*, Revue de Droit Fiscal 1150 (2002), translation in 4 ITR 1077 (2002) (with regard to Art. 7(1) OECD MC), with remarks by D. Gutmann, R. J. Danon & H. Salome, *French-Swiss Point of View on the Société Scheider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law*, 31 Intertax 2003, 156 (156 et seq.). See also, e.g., E. Reimer, *Klaus Vogel on Double Taxation Conventions* (E. Reimer & A. Rust eds., 4th ed. Kluwer 2015), Art. 7 m.no. 57 (with regard to Art. 7(1) OECD MC), and the observation by Belgium in Art. 1 para. 27.4 OECD MC Comm. This, of course, presupposes that the CFC's State's perspective on the taxpayer and the income were decisive and that Art. 7(1) OECD MC provides protection not only against taxing claims of the source State but also against tax claims of a meta-residence State, i.e., the shareholder's State, and/or that the Art. 10(5) OECD MC prohibits the shareholder's residence State from taxing undistributed profits of a non-resident company. See for that discussion, e.g., M. Lang, *CFC Regulations and Double Taxation Treaties*, 57 BIT 2003, 51 (51 et seq.).

¹¹⁴ See Art. 1 para. 23, Art. 7 para. 14 and Art. 10 para. 37 OECD MC Comm. (also note, however, the observations by Belgium, Ireland, Luxembourg, the Netherlands Switzerland in Art. 1 paras 27.4, 27.5, 27.6, 27.7 and 27.9 OECD MC Comm.), as well as the proposed Art. 1 para. 26.8 in OECD, *supra* n. 1, 85 (para. 59). For a more detailed discussion see paras 34 et seq. of the OECD, *supra* n. 112.

¹¹⁵ See, e.g., Court of Appeal of England and Wales (Civil Division), 25 June 1997, *Bricom Holdings Ltd v IRC*, (1997) STC 1179 (holding that CFC income is outside of scope of a tax treaty and, therefore, that CFC legislation cannot conflict with the provisions of a tax treaty, because the UK CFC rule merely provides a measure by which a notional sum is calculated and apportioned to the UK shareholder and on which the UK tax is charged) (comments by D. Sandler, *Tax Treaties and Controlled Foreign Company Legislation – a World Premier in the United Kingdom: Bricom Holdings v IRC*, BTR 1996, 544 (544 et seq.)); Japanese Supreme Court, 29 Oct. 2009, Case No. 2008 (Gyou Hi) 91 (comments by A. Asatsuma, *Supreme Court Judgement: Anti-Tax Haven (CFC) Legislation does not Infringe Japan–Singapore Tax Treaty*, 64 BIT 2010, 517 (517 et seq.)). The Swedish Regeringsrätten, 3 Apr. 2008, Case 2655-05 (comments by M. Hilling, *The Swedish Supreme Administrative Court Totally Disregards Tax Treaty: A Critical Analysis of a CFC Judgment*, 36 Intertax 2008, 455 (455 et seq.)) did not address the tax treaty issue but rather applied the later-in-time rule. See also for the argument that the attribution of income is a domestic matter not addressed by a treaty, e.g., W. Haslehner, *Klaus Vogel on Double Taxation Conventions* (E. Reimer & A. Rust eds. 4th ed. Kluwer 2015), Art. 10 m.no. 143.

¹¹⁶ Art. 10 para. 38 OECD MC Comm., also noting that '[u]nder some of these legislation or rules the taxable amount is treated as a dividend with the result that an exemption provided for by a tax convention, e.g. an affiliation exemption, is also extended to it', while '[i]t is doubtful whether the Convention requires this to be done'. Also, in the OECD BEPS Report on CFC Rules, the OECD confirmed the applicability of Art. 23 OECD MC by noting that a State applying CFC rules 'also needs to take into account [...] that country's tax treaty obligations' and that '[t]he elimination of double taxation found in bilateral tax treaties may vary considerably from the wording of Articles 23 A and 23 B of the Model Tax Convention on Income and on Capital: Condensed Version (OECD, 2010). States should therefore carefully review the relevant provisions of their tax treaties when designing their CFC regimes in order to make sure that they are not inadvertently required to apply the exemption method to income that they wish to tax under these regimes'. See OECD, *supra* n. 109, at 68–69 (paras 136 and 137).

¹¹⁷ For such conclusion in the area of hybrid entities see OECD, *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation No. 6 (1999), para. 129, referring also to paras 102 et seq.

¹¹⁸ See, e.g., Art. 10 para. 38 OECD MC Comm.; A. Rust, *CFC Legislation and EC Law*, 36 Intertax 2008, 492 (494–496); Rust, *supra* n. 10, at Art. 1 m.no. 94; Haslehner, *supra* n. 115, Art. 10 m.no. 143 with note 258.

¹¹⁹ So, e.g., Rust, *supra* n. 118, at 492 (494–496); Rust, *supra* n. 10, at Art. 1 m.no. 94; B. Kuźnuacki, *The Need to Avoid Double Economic Taxation Triggered by CFC Rules under Tax Treaties, and the Way to Achieve It*, 43 Intertax 2015, 758 (767–772).

¹²⁰ OECD, *supra* n. 117.

¹²¹ See, e.g., Rust, *supra* n. 118, at 492 (494–496).

¹²² Certainly, additional complexities exist under that approach if the income has its source not in the CFC's residence State but in a third country so that multiple tax treaties might have to be considered by the shareholder's residence State; see on that problem Kuźnuacki, *supra* n. 119, at 758 (770).

¹²³ See, e.g., Kuźnuacki, *supra* n. 119, at 758 (771–772).

Against this background, the OECD's proposal to introduce a saving clause in Article 1(3) is clearly aimed at upholding residence taxation and hence at avoiding any doubts about the compatibility of CFC legislation with the distributive rules of tax treaties.¹²⁴ Implemented in a tax treaty, Article 1(3) would certainly void potential arguments about the treaty's distributive rules barring the application of CFC rules, as those treaty rules 'shall not affect the taxation, by a Contracting State, of its residents' on their share of CFC income,¹²⁵ just as there is no doubt that the US may apply its CFC rules under its tax treaties.¹²⁶ Since the 'benefits granted under ... 23 A [23 B]' are excepted from the saving clause, however, relief from double taxation must be given. In that respect the OECD made a tentative proposal to address the question of relief in such situations through an update to Articles 23 A and 23 B. These amendments should express that:

Articles 23 A and 23 B of the OECD Model only required a Contracting State to relieve double taxation when income was taxable in the other State under treaty provisions allowing that other State to tax the relevant income as the State of source or as a State where there is a permanent establishment to which that income is attributable.¹²⁷

Focusing again on the exemption method under Article 23 A for sake of illustration, the new wording¹²⁸ introduces a limit to a residence State's obligation to exempt income that may be taxed in the other Contracting State in accordance with the provisions of this Convention, and this limit is where the Convention's provisions 'allow taxation by that other State solely because the income is also income derived by a resident of that State'. A fair reading of this provision suggests a twofold effect on CFC regimes: First, the residence State of the CFC is not

obliged to exempt the CFC's income from its own residence-based taxation only because the other Contracting State taxes the CFC's shareholders with their share of the CFC income based on the saving clause under Article 1(3) OECD MC¹²⁹ (even though such taxation may otherwise arguably be 'in accordance with the provisions of this Convention'¹³⁰). Second, and conversely, it also removes any obligation of the residence State of the CFC's shareholders to grant relief for CFC income that is taxed by the CFC State on a residence-basis (though otherwise 'in accordance with the provisions of this Convention'¹³¹) unless that income also has its source in that State or is attributable to a permanent establishment there. Such reading also seems to be in conformity with the look through approach taken so far in the current OECD MC Comm. and by legal scholars.¹³²

4.2 Hybrid Entities

Another issue the saving clause addresses is taxation with regard to hybrid entities,¹³³ where the Contracting State in which the entity (for example, a partnership) is established treats that entity as opaque and hence as a taxpayer, whereas the other Contracting State in which the participants (for example, the partners) are resident views the entity as transparent and wishes to tax its residents on their respective share of income. One of the main issues is whether Article 7(1) OECD MC, absent a permanent establishment in the other State, or another distributive rule (for example, Article 12 OECD MC) provides for exclusive taxation in the entity's residence State and thereby excludes taxation by the partners' residence State. Such reading of the OECD MC is neither unreasonable nor uncommon.¹³⁴ It has, however, been rejected by the

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¹²⁴ As noted before, the OECD clearly states that the introduction of a saving clause is also 'to prevent interpretations intended to circumvent the application of a Contracting State's domestic anti-abuse rules (as illustrated by the example of controlled foreign companies rules)'. See OECD, *supra* n. 1, at 86 (para. 62) and also the proposed new Art. 1 paras 26.17 and 26.18 of the OECD MC Comm. See also Rust, *supra* n. 10, at Art. 1 m.no. 93; De Broe & Luts, *supra* n. 2, at 122 (137–139); Kuźnuacki, *supra* n. 119, at 758 (760).

¹²⁵ See, e.g., Sasseville, *supra* n. 13, at 37 (51–52); De Broe & Luts, *supra* n. 2, at 122 (137–139); Schuch & Neubauer, *supra* n. 12, at 27 (37); see also UK Special Commissioners of Income Tax, *supra* n. 26, para. 60.

¹²⁶ See, e.g., UK Special Commissioners of Income Tax, *supra* n. 26, at para. 60; Sandler, *supra* n. 108, at 161–163; De Broe et al, *supra* n. 107, at 375 (379); De Broe & Luts, *supra* n. 2, at 122 (138).

¹²⁷ OECD, *supra* n. 1, at 88 (para. 64).

¹²⁸ See *supra* s. 3.2.

¹²⁹ See the proposed update to the commentary in OECD, *supra* n. 1, at 89 (para. 64) (proposed Art. 23 para. 11.1 OECD MC Comm.).

¹³⁰ See UK Special Commissioners of Income Tax, *supra* n. 26, para. 55 (noting that 'having included the saving clause in the Treaty it has become part of the Treaty and so logically taxation in accordance with the saving clause is "in accordance with this Convention"'), and England and Wales Court of Appeal (Civil Division), *supra* n. 31, at para. 41 (finding that 'the imposition of taxation "in accordance with" art 23 must be capable of including the imposition of tax utilizing the saving clause').

¹³¹ See for this understanding in the context of partnership taxation OECD, *supra* n. 117, at para. 129, referring also to paras 102 et seq.

¹³² See, e.g., Art. 10 para. 38 OECD MC Comm.; Rust, *supra* n. 118, at 492 (494–496); Rust, *supra* n. 10, at Art. 1 m.no. 94; Kuźnuacki, *supra* n. 119, at 758 (767–772).

¹³³ See OECD, *supra* n. 1, at 86 (para. 61).

¹³⁴ See with respect to Art. 7(1) OECD MC, e.g., Court of Appeal of England and Wales (Civil Division), 19 May 1989, *Padmore v. Inland Revenue Commissioners*, (1989) STC 493; England and Wales High Court (Chancery Division), *supra* n. 31, at para. 67 (finding that in a hybrid entity situation 'Article 7 gives the prima facie right on the [entity's residence State] exclusively to tax the [entity's] profit (as the [entity's] profit is the business profit of an enterprise of [its residence State]). Article 1 (3) (the saving clause) preserves the US's right to tax the [hybrid entity's] profit in the hands of [its parent company]'), and along the same lines England and Wales Court of Appeal (Civil Division), *supra* n. 31, at paras 21, 25–26. For further references in the context of CFC legislation see the discussion *supra* in s. 4.1.

OECD in the Partnership Report¹³⁵ and the subsequent amendment of the OECD MC Comm. in 2000.¹³⁶ The OECD MC Comm. states in that respect:

Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State's right to tax the partnership on its income do not apply to restrict that other State's right to tax the partners who are its own residents on their share of the income of the partnership. Some states may wish to include in their conventions a provision that expressly confirms a Contracting State's right to tax resident partners on their share of the income of a partnership that is treated as a resident of the other State.¹³⁷

In the Partnership Report itself, however, the OECD had still noted a lack of international consensus on that interpretation.¹³⁸ Example 16 of the Partnership Report, which triggered the above-mentioned amendment of the OECD MC Comm.,¹³⁹ may serve as an illustration. While the Partnership Report states that the treaty clearly prevents State R from taxing the royalties which are taxable in the hands of the entity, a resident of State P, it discussed two opinions on the issue of whether State R can tax its partner B. The majority of delegates considered that the royalty article affected taxation based on source, not residence, so that State R could tax its partner.¹⁴⁰ A minority of delegates, however, took the position that the treaty provided for exclusive taxation of the royalty in State P and so State R could not tax, 'unless the case fell under the application of CFC rules or the Convention included a special provision allowing State R to tax its residents in such circumstances (for example, a specific provision applicable to partnerships or a so-called 'saving clause' such as is found in Conventions concluded by the United States)'.¹⁴¹ Hence, a saving clause makes it clear that a Contracting State is not prevented by a distributive rule, for example, the royalties provision in Article 12 OECD MC or the business profits rule in Article 7(1),¹⁴² from taxing the partners who are its residents even if the

partnership qualified as a resident of the other Contracting State. It should follow then logically that the partner's residence State (that is, State R) 'must also give the benefits of Article 23 to partner B',¹⁴³ and the saving clause does not change that conclusion. A literal understanding of the proposed new wording of Article 23 A(1) OECD MC, however, would likely change the picture: Let us first consider the OECD's solution to Example 16 of the Partnership Report. Leaving timing issues aside, the OECD considers that relief must be given by State R irrespective of whether a permanent establishment (to which the royalties may be attributed) exists in State P, as 'the tax levied by State P will still have been levied in accordance with the provisions of the Convention since State P is allowed to tax partnership P as its resident'.¹⁴⁴ Quite to the contrary, under the proposed wording of Article 23 A(1) OECD MC taxation by State P 'solely because the income is also income derived by a resident of that State' would not count as being taxation 'in accordance with the provisions of this Convention'. Arguably, therefore, State R would be exempt from its obligation to give relief (unless, of course, State P exercises its taxing rights as the State of the permanent establishment). That result seems odd, specifically since the Report on Action 6 states that the result would 'logically flow from the wording' of existing Articles 23 A and 23 B,¹⁴⁵ which is certainly not the case given the OECD's conclusions in the Partnership Report.

Moreover, the saving clause also addresses the taxation of the hybrid entity itself. Example 17 of the Partnership Report discusses the question if State P may tax the hybrid entity on a royalty sourced in its territory or if it would lose its taxing right because of the exclusive allocation of taxing jurisdiction to the recipient's residence State in Article 12(1) OECD MC. Again, a minority and a majority view were discussed: While under the minority view State P would be 'obliged to relieve the potential resulting double taxation by applying Article 12 to exempt the income in the hands of the partners, thus leaving the exclusive taxing right with State R',¹⁴⁶ the majority view considered that

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¹³⁵ OECD, *supra* n. 117, at paras 125–129.

¹³⁶ Art. 1 para. 6.1 OECD MC Comm.

¹³⁷ Art. 1 para. 6.1 OECD MC Comm.

¹³⁸ See the discussion of the minority and majority views in OECD, *supra* n. 117, at paras 126–127; see also UK Special Commissioners of Income Tax, *supra* n. 26, para. 63.

¹³⁹ OECD, *supra* n. 117, at para. 128.

¹⁴⁰ OECD, *supra* n. 117, at para. 127.

¹⁴¹ See OECD, *supra* n. 117, at para. 126.

¹⁴² See for that conclusion, e.g., UK Special Commissioners of Income Tax, *supra* n. 26, at paras 39 et seq.; England and Wales High Court (Chancery Division), *supra* n. 31, at paras 67–68; and England and Wales Court of Appeal (Civil Division), *supra* n. 31, at paras 25–26. See also Sasseville, *supra* n. 13, at 37 (51).

¹⁴³ OECD, *supra* n. 117, at para. 129.

¹⁴⁴ OECD, *supra* n. 117, at para. 129, referring also to paras 102 et seq. See also, e.g., UK Special Commissioners of Income Tax, *supra* n. 26, para. 55, and England and Wales Court of Appeal (Civil Division), *supra* n. 31, at para. 41.

¹⁴⁵ See OECD, *supra* n. 1, at 89 (para. 64) (proposed new Art. 23 para. 11.1 last sentence OECD MC Comm.).

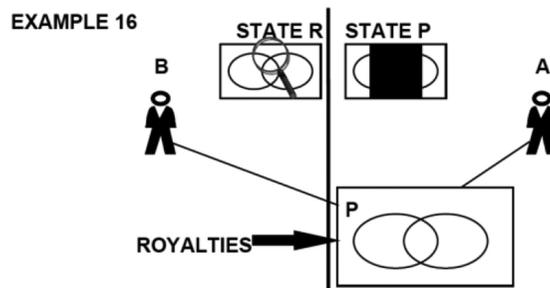
¹⁴⁶ OECD, *supra* n. 117, at para. 132.

State P would not be limited in its taxing rights by a treaty as ‘the situation involves a purely domestic matter from the perspective of State P; it is simply taxing the domestic source income of a resident taxpayer and nothing in the Convention can limit that right’.¹⁴⁷ A saving clause would essentially confirm the majority’s result that State P’s right to tax the royalty income in the hands of the entity is not limited.¹⁴⁸ Oddly again, however, while the Partnership Report suggests that State R would give relief for State P tax even if no permanent establishment exists in State P,¹⁴⁹ arguably no such obligation would arise under the proposed wording of Article 23 A(1) OECD MC (because in the absence of a permanent establishment State P taxes purely as a residence State).

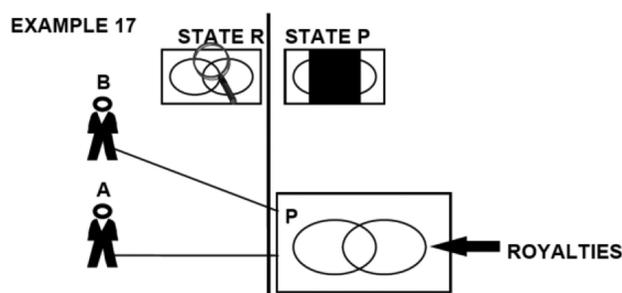
As a side note, the saving clause in Article 1(3) OECD MC also interacts with the OECD’s proposal to include a specific provision dealing with fiscally transparent entities in Article 1(2) OECD MC.¹⁵⁰ Focusing on hybrid entities, that new provision deems income received by a hybrid entity (for example, a partnership) to have accrued to a resident of a Contracting State to the extent that this Contracting State treats the income as accrued to one of its residents (for example, a partner). This, in turn, triggers the obligation of the source State to apply, for example, the limitations under Article 11 OECD MC for interest payments to an entity in the other Contracting State that it qualifies as in transparent, to the extent the other Contracting State views the entity as transparent and allocates income to a partner resident there. However, as confirmed by the saving clause, Article 1(2) OECD MC ‘does not restrict in any way a State’s right to tax its own residents’ and does likewise not remove the obligation to grant relief from double taxation under Article 23 A or Article 23 B OECD MC.¹⁵¹ Hence, the saving clause preserves the right to tax its residents in situations illustrated in Examples 16 and 17 of the Partnership Report.¹⁵²

Example 16 of the Partnership Report: P is a partnership established in State P. Partner B is a resident of State R while partner A is a resident of State P. State P treats the partnership as a taxable entity while State R treats it as a transparent

entity. P derives royalty income from State R that is not attributable to a permanent establishment in State R. P has an office in State P and may therefore be considered to have a permanent establishment in State P.



Example 17 of the Partnership Report: P is a partnership established in State P. A and B are P’s partners who reside in State R. State P treats P as a taxable entity while State R treats it as a transparent entity. P derives royalty income from State P that is not attributable to a permanent establishment in that state.



4.3 Transfer Pricing and Article 9(1) OECD MC

Two-taxpayer-situations also arise with regard to transfer pricing and arm’s length adjustments under Article 9(1) OECD MC, as this provision exclusively deals with transactions between associated enterprises, that is, two separate but related taxpayers each resident in different Contracting State. The potential impact of the saving clause, however, depends on how one views the effect of

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¹⁴⁷ *Ibid.*, para. 131.

¹⁴⁸ See also Schuch & Neubauer, *supra* n. 12, at 27 (45–46).

¹⁴⁹ OECD, *supra* n. 117, at para. 133 with reference to paras 94 et seq.; see for that understanding also, e.g., UK Special Commissioners of Income Tax, *supra* n. 26, paras 61.

¹⁵⁰ See OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report* (2015) 139 et seq. (para. 434–435).

¹⁵¹ *Ibid.*, 143 (para. 435) (proposed new Art. 1 para. 26.16 OECD MC Comm.). It might be noted that the 2014 Deliverable for Action 2 already contained a proposal for the inclusion of Art. 1(2), which, in turn, stated in its last sentence that [i]n no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State’s right to tax the residents of that State (OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements – 2014 Deliverable*(2014) 85 et seq. (paras 130–131)). That limited saving clause was superfluous in light of Action 6 and its proposal of a saving clause. It was hence dropped from the wording of Art. 1(2) in the Final Report. See also Schuch & Neubauer, *supra* n. 12, at 27 (44).

¹⁵² See also Schuch & Neubauer, *supra* n. 12, at 27 (44–46).

Article 9(1) OECD MC, that is, whether Article 9(1) OECD MC 'is held to be "restrictive" or merely "illustrative" in its scope'.¹⁵³ The minority view takes the position that Article 9(1) OECD MC – while permitting the adjustment of profits up to the arm's length amount – does not prohibit the taxation of a higher amount in appropriate circumstances.¹⁵⁴ The majority view in case law,¹⁵⁵ among tax administrations¹⁵⁶ and in legal scholarship,¹⁵⁷ however, correctly considers that a Direct Taxes Code (DTC) provision similar to Article 9(1) OECD MC obliges the Contracting States to use Article 9 OECD MC's specific allocation norm and therefore prohibits an adjustment of the profits of the resident company to any amount exceeding the arm's length profit. As demonstrated elsewhere, a mere 'illustrative' understanding would make Article 9(1) OECD MC superfluous.¹⁵⁸ This also seems to be the perspective of the OECD when it notes that '[n]o rewriting of the accounts of associated enterprises is authorized if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis)'.¹⁵⁹ One important feature of such 'restrictive force' of Article 9(1) OECD MC is that pricing adjustments that are not based on considerations concerning appropriateness of pricing but are instead based merely on formal grounds (for example, lack of clear and *a priori* agreements) are prohibited.¹⁶⁰

Assuming, for sake of the argument, that Article 9(1) OECD MC indeed has such restrictive force, it would arguably be irrelevant under a saving clause based on Article 1(3) OECD MC, as each of the enterprises involved in a transfer pricing issue is a resident of its Contracting State and each of those residence States is relieved from its obligation to comply with the arm's length principle when it makes primary adjustments. As the US Court of Appeals for the Ninth Circuit reasoned in *Xilinx*, US domestic law 'does not conflict with the tax treaty in these circumstances, because' – as per the saving clause in Article 1(4) of the 1997 Ireland-US DTC – 'the treaty expressly allows a contracting state to apply its domestic laws to its own citizens, even if those laws conflict with the treaty'.¹⁶¹

By not including Article 9(1) OECD MC in the exceptions from the saving clause Contracting States would take the position that this paragraph is not intended to restrict a State's right to make transfer pricing adjustments to its resident companies whether or not those adjustments comply with the arm's length principle.¹⁶² That outcome seems rather strange and it is hard to understand why the OECD opens the door to deviations from the arm's length principle under the auspices of the saving clause when, on the other hand, it views Article 9(1) OECD MC as the 'authoritative statement' on the arm's length principle¹⁶³ and bases several hundreds of pages of transfer pricing guidelines on that notion.¹⁶⁴

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¹⁵³ Paras 29–30 and 50 of the 1987 Report on Thin Capitalization (adopted by the Council on 26 Nov. 1986), published in: OECD, *Thin Capitalisation – Taxation of Entertainers, Artists and Sportsmen*, Issues in International Taxation No. 2 (1987).

¹⁵⁴ For a discussion of the Belgian tax authorities' position, see L. De Broe, *International Tax Planning and Prevention of Abuse* (2008) 513 with note 645. This position is possibly also underlying para. 7 of FC/WP 7 on 'Apportionment of Profits', FC/WP7(70)1 (June 1970), where it is noted that Art. 9 is 'merely permissive' and 'that what Article 9 permits is not prohibited elsewhere in the Convention'.

¹⁵⁵ See, e.g., German Bundesfinanzhof, 11 Oct. 2012, I R 75/11; German Bundesfinanzhof, 17 Dec. 2014, I R 23/13; German Bundesfinanzhof, 24 Mar. 2015, I B 103/13; German Bundesfinanzhof, 24 June 2015, I R 29/14. For analysis of the German case law see M. Weiss, *The Impact of Article 9 of the OECD Model on German Taxation*, 56 ET 2016, 51 (51 et seq.). Possibly different Federal Court of Australia, 25 June 2010, *SNF (Australia) Pty Ltd v. Commissioner of Taxation*, (2010) FCA 635, para. 49.

¹⁵⁶ E.g., paras 18 and 184–186 of Australian Taxation Ruling 94/14 of 31 May 1994 ('treaty provisions will prevail'); para. 6 of the Austrian Transfer Pricing Guidelines of 28 Oct. 2010, BMF-010221/2522-IV/4/2010 ('Sperrwirkung', i.e. 'barrier effect'); para. 1.2.3. of the German Administrative Principles – Business Restructurings of 13 Oct. 2010, BMF IV B 5 – S 1341/08/10003, BStBl I. 774 (2010) (English translation published in 18 ITPJ 65 (2011)) ('begrenzen', i.e., 'restrict').

¹⁵⁷ See, e.g., G. Maisto, *General Report*, in *Transfer pricing in the absence of comparable market prices*, 19 (60) (IFA ed., 1992) CDFI Vol. 77a ; M. Lang, *Unterkapitalisierung, in Aktuelle Entwicklungen im Internationalen Steuerrecht*, 127 (131–133) (W. Gassner, M. Lang & E. Lechner eds., 1994); G. M. M. Michielse, *Treaty Aspects of Thin Capitalization*, 51 BIFD 1997, 565 (568–569); J. A. Nitikman, *The Interaction of Canada's Thin Capitalization Rule and the Canada – United States Tax Treaty*, 26 ITJ 2000, 20 (43–44); P. Baker, *Double Taxation Conventions*, Art. 9 m.no. 9B.14; F. C. de Hosson, *Codification of the Arm's Length Principle in the Netherlands Corporate Income Tax Act*, 30 Intertax 2002, 189 (192–193); D. Gosch, *Wechselbeziehungen zwischen internationalen und nationalen Gewinnkorrekturvorschriften*, in *Gestaltung und Abwehr im Steuerrecht, Festschrift für Klaus Korn* 391 (396) (D. Carlé et al. eds., 2005); De Broe, *supra* n. 13, at 513; J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (2010) 195–199; A. Bullen, *Arm's Length Transaction Structures – Recognizing and restructuring controlled transactions in transfer pricing* (2011) 70–72. Contra possibly Sasseville, *supra* n. 13, at 37 (53) (arguing that the word 'may' in Art.9(1)OECD MC implies that the provision is merely permissive).

¹⁵⁸ Kofler, *supra* n. 78, Art. 9 m.no. 12 et seq. with further references.

¹⁵⁹ Art. 9 para. 3 OECD MC Comm. Moreover, and specifically with respect to thin capitalization rules, that Art. 9(1) OECD MC 'does not prevent the application of national rules on thin capitalization insofar (but only insofar) as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation' (Art. 9 para. 3(a) OECD MC Comm.), implying that it otherwise would bar the application of such rules.

¹⁶⁰ German Bundesfinanzhof, 11 Oct. 2012, I R 75/11; German Bundesfinanzhof, 17 Dec. 2014, I R 23/13; German Bundesfinanzhof, 24 Mar. 2015, I B 103/13; German Bundesfinanzhof, 24 June 2015, I R 29/14; see also German Finanzgericht Köln, 22 Aug. 2007, 13 K 647/03, 56 EFG 161 (2008); German Finanzgericht Hamburg, 31 Oct. 2011, 6 K 179/10, 21 IStR 2012, 290. See, however, also the non-application notice of the German Ministry of Finance, arguing that arm's length adjustments to the terms of a transaction are not barred by Art. 9 OECD MC; see German Ministry of Finance of 30 Mar. 2016, IV B 5 – S 1341/11/10004-07.

¹⁶¹ See US Court of Appeals Ninth Circuit, 27 May 2009, *Xilinx, Inc. v. Commissioner*, 567 F.3d 482 (withdrawn on 13 Jan. 2010, and – without reference to the saving clause – newly decided by US Court of Appeals Ninth Circuit, 22 Mar. 2010, *Xilinx, Inc. v. Commissioner*, 598 F.3d 1191).

¹⁶² See also Sasseville, *supra* n. 13, at 37 (53).

¹⁶³ Art. 9 para. 1 OECD MC Comm.

¹⁶⁴ See Wittendorff, *supra* n. 154, at 103.

Excepting Article 9(1) OECD MC from the saving clause would therefore be the prudent approach. If Contracting States were concerned about, for example, the interaction of their CFC regimes with the arm's length principle, they should address such problem in their bilateral negotiations rather than through subjecting Article 9(1) OECD MC to a general saving clause.

Also, the odd effects do not stop with Article 9(1) OECD MC: Likewise, the obligation to make a corresponding adjustment under Article 9(2) OECD MC (which provision is excepted from the saving clause) is imposed on the other Contracting State, but only if that State believes the primary adjustment to be justified in both principle and amount.¹⁶⁵ This seems unlikely to occur if the first adjusting State applies whatever standard it pleases (for example, formulary apportionment) without regard to any limits set by Article 9(1) OECD MC.¹⁶⁶ One might even ask if double taxation arising from a deviation from the arm's length principle of Article 9(1) OECD MC may still open the door to a mutual agreement procedure under Article 25 OECD MC, which requires that 'the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention'. One might reasonably query if taxation based on the saving clause is 'in accordance with the provisions' of a DTC,¹⁶⁷ which would literally exclude taxpayers from finding relief through competent authority negotiations. This can, however, not be a correct understanding as Article 25 OECD MC itself is excepted from the saving clause, implying that a mutual agreement proceeding is still possible in cases of residence-based taxation (including transfer pricing adjustments), as otherwise the exception of Article 25 OECD MC from the saving clause would be meaningless.

Not excepting Article 9(1) OECD MC from the saving clause also seems to shift the interaction of various provisions in the OECD MC: For example, compliance with Article 9(1) OECD MC also implies compliance with the non-discrimination provisions of Article 24(4) and (5) OECD MC, for example, in the context of thin-capitalization rules.¹⁶⁸ If, however, a Contracting State deviates from Article 9(1) OECD MC under the saving clause, such deviation may be scrutinized under the non-

discrimination provisions, all of which are excepted from the saving clause.¹⁶⁹

In the European Union (EU) taxpayers can at least take recourse to the EU Arbitration Convention.¹⁷⁰ This Convention provides a process for the elimination of double taxation in transfer pricing cases by agreement between the Contracting States, which procedure may include, if necessary, referring the matter to an independent advisory body (that is, an arbitration panel).¹⁷¹ The EU Arbitration Convention is firmly based on the arm's length standard as the principle for profit adjustments (Article 4 of the Convention),¹⁷² so that taxpayers can have recourse to that principle even if a Contracting State's domestic law would go beyond it and would also be permitted to do so under a saving clause.

5 CONCLUSIONS

The proposed 'saving clause' in Article 1(3) OECD MC preserves ('saves') residence-based taxation, subject to a number of explicit exceptions, specifically the obligation to provide relief from double taxation. While the inclusion of such clause is long-standing US treaty practice, it comes as a novelty for most other countries and it remains to be seen if this clause will form a part of the multilateral instrument under Action 15 of the OECD BEPS Project, which has been announced for the end of 2016.¹⁷³

The main impact of the proposed the saving clause will be on two-taxpayer situations. Here, it opens the doors for both Contracting States to tax their respective residents. With regard to hybrid entities and CFC rules, the inclusion of the saving clause in tax treaties would largely elevate the interpretation that is now found in the OECD MC Comm. and the Partnership Report to the level of binding international law, adding, however, some complexities on the level of relief from double taxations. While the Partnership Report advocates that relief has to be granted in the residence State of the partners for all taxes levied by the partnership State on the partnership, the application of the proposed saving clause in conjunction with the proposed amendment of Article 23 OECD MC would no

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¹⁶⁵ See with further references Kofler, *supra* n. 78, Art. 9 m.no. 113.

¹⁶⁶ Possibly more optimistic Schuch & Neubauer, *supra* n. 12, at 27 (38).

¹⁶⁷ See for such understanding in the context of a hybrid entity under the UK-US DTC UK Special Commissioners of Income Tax, *supra* n. 26, para. 55, and England and Wales Court of Appeal (Civil Division), *supra* n. 31, at para. 41.

¹⁶⁸ See Kofler, *supra* n. 78, Art. 9 m.nos. 44–45.

¹⁶⁹ See also De Broe & Luts, *supra* n. 2, at 122 (122 et seq.).

¹⁷⁰ Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, (1990) OJ L 225/10, as amended.

¹⁷¹ For details see, e.g., Kofler, *supra* n. 78, Art. 9 m.nos. 131 et seq.

¹⁷² See also Pt. 6.1(a) of the Revised Code of Conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, (2009) OJ C 322/1.

¹⁷³ See OECD, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 – 2015 Final Report* (2015).

longer require the residence State of the partners to give relief unless the partnership State exercises its taxing right as the State of the permanent establishment. With regard to transfer pricing adjustments, the saving clause may have the – arguably unintended – consequence to permit any and every deviation from the arm's length standard of Article 9 (1) OECD MC, making the avoidance of double taxation in that area even more complex. In the EU, however, the Arbitration Convention can help taxpayers to eventually achieve relief from economic double taxation based on the arm's length principle.

Finally, additional complexities may arise from the adoption of the EU Commission's proposal for an Anti-Tax Avoidance Directive,¹⁷⁴ which foresees a number of residence-based anti-avoidance measures such as a switch-over clause and CFC rules that are targeted towards low-tax third countries. While such clauses may potentially be in conflict with tax treaty provisions, EU law generally takes supremacy over treaties between EU Member States and third countries.¹⁷⁵ However, a swift and broad introduction of a saving clause through the multilateral instrument could help avoid potential conflicts.

Notes

¹⁷⁴ Proposal for a Council directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, COM(2016) 26 final (28 Jan. 2016).

¹⁷⁵ For (tax) treaties with third countries the Treaty on the Functioning of the European Union (TFEU) contains a differentiating rule: According to Art 351 TFEU, the 'rights and obligations arising from agreements concluded before 1 Jan. 1958 or, for acceding States, before the date of their accession, between one or more Member States on the one hand, and one or more third countries on the other, shall not be affected by the provisions of the Treaties' (but incompatibilities shall be eliminated; Art 351(2) TFEU), which, *a fortiori*, means that EU law takes precedence over post-accession treaties with third countries (and hence may directly impact the respective Member State's – but, of course, not the third State's – tax system; for analysis see, e.g., Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht* (Linde, 2007), 421 et seq.). Generally, therefore, for post-accession tax treaties the supremacy of EU law would imply that once it is implemented into a Member State's domestic law, it will arguably 'override' tax treaty provisions that would be more beneficial for taxpayers (see also, e.g., Haslehner, *The Commission Proposal for an Anti-BEPS Directive: Some Preliminary Comments* (5 Feb. 2016), available at kluwertaxblog.com).