Dear Sir or Madam:

The United States Council for International Business appreciates the opportunity to present comments on the consultation paper concerning Treaty Shopping – The Problem and Possible Solutions. These comments may be posted to the Finance Department’s website under USCIB’s name. Prior to addressing the questions posed by the Department of Finance, USCIB has some general comments pertaining to the consultation paper.

The work of the G20 and the OECD on issues relating to base erosion and profit shifting has brought renewed focus onto the area of international taxation. Public pressure to ensure that companies pay “their fair share” of tax has created pressure for governments to act quickly. While we understand this pressure, we also believe that the OECD is correct when it seeks to discourage unilateral action in the face of these problems noting that unilateral measures “could lead to global tax chaos marked by the massive re-emergence of double taxation.”

We are increasingly seeing governments acting or proposing to act prematurely on BEPS related issues. The OECD is moving ahead promptly with developing approaches to deal with tax treaty abuse. The OECD plans to issue a discussion draft on this topic in March 2014, to hold a public consultation in April/May of 2014, and publish changes to the model tax treaty and recommendations for changes to domestic law in September of 2014. This is a very aggressive time table. The Canadian Finance Ministry certainly ought to be considering and developing its position on these issues; we would urge you, however, not to proceed to adopting any rules in advance of the completion of the OECD’s work in September 2014. Otherwise, the likelihood that the rules will not reflect the multi-lateral discussion and consensus is quite high.

1 USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing the International Chamber of Commerce, the International Organization of Employers and the Business and Industry Advisory Committee to the OECD, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

2 OECD BEPS Action Plan page 10.
As an initial substantive point, we would like to mention the distinction between the beneficial ownership concept and LOB provisions. The OECD concept of beneficial ownership is closely linked to the concept of a nominee, agent or conduit. Beneficial ownership may be lacking where a person has no meaningful entitlement to an item of income that in form it receives. This understanding of the beneficial ownership concept can be and often is adopted by domestic law outside of a treaty, as has long been the case in the United States. The U.S. Treasury Department’s Technical Explanation of the 2007 Protocol to the treaty between the United States and Canada states specifically that “with respect to payments of income, profits or gain arising in a Contracting State . . ., the term ‘beneficial owner’ is defined under the internal law of the country imposing tax (i.e., the source State).”

The purpose of an LOB provision is to curtail the practice of treaty shopping, which is related to, but distinct from, the concept of beneficial ownership. The focus of tax treaty LOB articles is principally to police the interposition of a treaty-resident entity between a payment and a non-treaty resident person, even where the interposed entity has full beneficial ownership of its assets and income. Because the aims of an LOB provision are different, even if overlapping, from the aims of a beneficial ownership concept, Canada may wish to pursue both the enactment of domestic legislation on beneficial ownership which reflects the OECD concept and a new treaty policy incorporating LOB provisions to address treaty shopping concerns more broadly.

We would suggest that the traditional “conduit” concept of beneficial ownership not be confused with “main purpose” or “substance” inquiries. In our experience, these subjective tests accomplish very little other than to create uncertainty, impeding free commerce. Moreover, we urge Canada not to conflate conduit concepts with LOB and derivative benefit concepts, as it did unsuccessfully in Prevost Car. Because the holding company in that case was a true joint venture and not a conduit, any concern Canada had in that case would best be addressed by appropriate provisions in its treaties and not by the adoption of overly broad domestic rules. We believe that taxpayers covered by treaties should have the ability to know whether they qualify for treaty benefits based on reasonably objective and clear tests.

**Question 1 - The Government invites stakeholders to comment on the advantages and disadvantages of a domestic law approach, a treaty based approach, or a combination of both.**

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3 For example, according to the U.S. Treasury’s Technical Explanation of the an early LOB provision (with The Netherlands), “Article 26 assures that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries -- residents of the other Contracting State -- and are not extended to residents of third States that do not have a substantial business in, or business nexus with, the other Contracting State. For example, a resident of a third State might establish an entity resident in a Contracting State for the purpose of deriving income from the other Contracting State and claiming source State benefits with respect to that income. Absent Article 26, the entity generally would be entitled to benefits as a resident of a Contracting State, as long as it qualified as a resident of a Contracting State under Article 4 (Resident) and the form of the transaction was respected by the competent authorities of the Contracting States.” 93 TNI 212-11; Doc 93-31955.
USCIB acknowledges the difficulties involved in renegotiating the many existing bilateral treaties and the likelihood that such an effort would be extremely time-consuming. In light of these concerns, we believe the most effective way forward is a combined approach. A combined approach would permit Canada to address its concerns across all of its treaty relationships, but would also respect the existing bilateral treaty with the United States and would permit Canada to develop tailored rules that may be more appropriate in the context of a particular bi-lateral relationship. It is also important to ensure that any domestic “anti-abuse’ provisions are reasonable and respect the shared expectations of the treaty partners.

**Question 2** – The Government invites stakeholders’ comments on the relative merits of the various approaches to treaty shopping identified by the OECD as well as whether there are other approaches and types of rules that should be considered by Canada in evaluating how best to address the problem of treaty shopping.  

The following types of rules are generally described in the Commentary to Article 1 of the OECD Model Convention:

- The **look-through approach** disallows treaty benefits to a company owned or controlled, directly or indirectly, by persons who are not residents of a contracting state;
- The **subject-to-tax approach** provides that treaty benefits in the country of source are granted only if the income in question is subject to tax in the country of residence; and
- The **channel approach** disallows treaty benefits in cases where an intermediary company receives what would be treaty-protected income if more than 50% of that income is paid to satisfy claims (deductible amounts) of a person not resident in the country of the intermediary company and who has, directly or indirectly, a substantial interest in (or exercises management or control over) the company.

The Commentary indicates that these solutions are of a general nature and need to be accompanied by specific provisions to ensure that treaty benefits will be granted in *bona fide* cases. This recognizes that these specific anti-treaty shopping rules may be over-inclusive and, accordingly, require some exceptions in order to ensure the measure is appropriately targeted to treaty shopping. Such exceptions could include:

- a general *bona fide* provision – where the company can establish that its principal purpose is motivated by business reasons and not to obtain tax benefits under the Convention;
- a business activity provision – where the company is engaged in substantive business operations in the residence state and the income on which treaty benefits is sought is connected with such operations;
- an amount of tax provision – where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident;
- a stock exchange provision – where the principal class of shares of the company is registered on an approved stock exchange in a contracting state; and
- an alternative relief provision – where the third country residents owning the intermediary company are resident in countries that have tax conventions with the contracting state.

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4 The boxed language below is taken from the consultation paper and reproduced here for convenience in commenting on the different approaches.
from which relief from taxation is claimed and those conventions provide no less tax relief than that claimed under the particular convention (also referred to as a derivative benefits provision).

The OECD Commentary also sets out an approach for states wishing to address treaty shopping in a comprehensive way. This approach is essentially a US-style limitation of benefits (LOB) article, similar to Article XXIX A of the Canada-US Treaty. Under this approach, only persons satisfying specific and objective tests are eligible for treaty benefits. The premise underlying this approach is that if any of the objective tests for eligibility are satisfied, the requisite treaty shopping motive is not present and treaty benefits should be granted.

USCIB generally supports a properly designed US-style LOB provision. Despite this, USCIB is of the view that the US approach can be overly detailed and thus overly restrictive. The current version of the US LOB provision may deny benefits to companies resident in a treaty country and subject to full residency based taxation. It is therefore important that Canada (and the broader international community) should not adopt a US-style LOB without a careful review of the breadth or narrowness of each provision.

With respect to the three anti-treaty shopping approaches (the look-through, subject-to-tax and channel approaches), these are essentially steps on a continuum with the channel approach being a more precise combination of the look-through and subject-to-tax approaches. Because consistency and predictability are highly valued, the channel approach is probably preferable to the more subjective look-through or subject-to-tax tests.

With respect to the specific provisions to ensure that treaty benefits will be granted in bona fide cases, USCIB has the following comments:

1. With respect to the bona fide provision, requiring establishing a "business reason" can be read narrowly to be co-extensive with the business activity test that follows that test above. For example, reasons, such as managing indirect taxation or, in the case of the US, state or local taxation, could be wrongly construed as lacking a business purpose. USCIB believes that the test should be for the taxpayer to establish that the resident company was not established, maintained or operated with the main purpose of obtaining tax treaty benefits.

2. With respect to the business activities test, this is an important test that recognizes the connection between activities in the residence jurisdiction and the income derived from the source jurisdiction and it is critical that it be part of any anti-treaty shopping approach.

3. With respect to an amount of tax test, this test is both difficult to apply and inappropriate. It may be possible to measure with ease a reduction in withholding tax. If however, the residence country imposes tax on a net basis and expenses need to be allocated to that income, how is that determined? If the income is fully subject to residence country tax, but the amount of that tax is less than the amount of tax that would have been withheld
because the rate on net income is lower and the income bears expenses, is it appropriate to deny treaty benefits? We believe it is not. This illustrates that most countries’ statutory withholding tax rates on dividends, interest and royalties are excessive. A 30% tax on gross income exceeds the tax on net income in many countries. A 30% tax on gross interest or royalty income could be confiscatory if the entity earning the income has significant expenses associated with earning that income. Further, a 15% tax on portfolio dividends is simply bringing the withholding tax rate on gross income down to a reasonable level, in recognition of the fact that it is a proxy for a net income tax, and should not be dependent on whether the income is taxed in the payee’s country.

4. With respect to the stock exchange provision, this is an important provision that recognizes that publicly traded entities cannot be looked-through and that there are significant restrictions on the ability of publicly traded entities to be used for treaty-shopping purposes. The origin of the publicly traded exception was based on the belief that publicly traded entities were primarily owned by local shareholders, so that an entity traded on a residence country exchange was considered a resident of that country. We believe that a modern LOB provision should not be limited to companies trading on local exchanges but rather recognize the globalization of the market, acknowledge the difficulty of looking through a public company as well as the difficulty of using such a company for treaty shopping purposes, and extend the provision to regional exchanges and possibly a broader scope of exchanges agreed to by the competent authorities.

5. With respect to an alternative relief provision, this is another important provision that is fundamentally based on the fact that an entity should not be considered to be treaty shopping if the owners of that entity could have achieved the same benefit directly or by using an entity established in their country of residence. Thus, a so-called “derivative benefits” provision is a reasonable and highly important feature of any LOB provision.

**Question 3** – *The Government invites stakeholders’ views on whether a general approach is preferred over a relatively more specific and objective approach.*

As mentioned above, USCIB prefers a US-style LOB provision to a general anti-abuse rule because of the greater certainty such an approach provides. A GAAR should not be layered on top of an LOB provision. Despite this support for a US-style LOB, USCIB is of the view that the US approach can be overly detailed and thus overly restrictive, so proper design of the LOB provision, as mentioned above, is important.

**Question 4** – *The Government invites stakeholders’ views on whether a main purpose test, if enacted in domestic tax laws, would be effective in preventing treaty shopping and achieve an acceptable level of certainty for taxpayers.*
USCIB believes that a main purpose test is too uncertain and thus is not to be preferred.\(^5\)

**Question 5** – *The Government invites input on which of the approaches (a main purpose approach or a more specific approach) strikes the best overall balance between effectiveness, certainty and simplicity, and ease of administration.*

USCIB believes that the determination of which alternative strikes the better balance would depend on the details of the specific approach. USCIB believes that a well-designed LOB would be preferable to a main purpose approach. A main purpose test that requires an advance ruling process (although that is not mentioned in the paper) would be extremely cumbersome. Even a main purpose test that does not explicitly require a ruling may in effect require an advance determination, if the risk of disallowance is great. A main purpose test may also result in inconsistent application because of the subjective element of determining purpose. Further, a main purpose test that does not require an advance ruling may give taxpayers unacceptable leeway in deciding that they have an acceptable main purpose.

**Question 7** – *The Government invites stakeholders to comment on whether or not a domestic anti-treaty shopping rule should apply if a tax treaty contains a comprehensive anti-treaty shopping rule.*

USCIB believes that a domestic rule should not apply if a pre-enactment tax treaty contains a comprehensive anti-treaty shopping rule. Post-enactment tax treaties with comprehensive anti-shopping rules ought to explicitly cover the interaction of the domestic law rule with the comprehensive anti-treaty shopping article. In our view, the later-in-time and more specific treaty ought to control and the treaty should say that explicitly.

Sincerely,

William J. Sample  
Chair, Taxation Committee  
United States Council for International Business

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\(^5\) Although we advocate for a main purpose test in interpreting a business reason above, there are important differences. Most importantly, the business reason test allows an entity that has been excluded from treaty benefits a means of demonstrating that it should be entitled, rather than a test that every entity must satisfy before it may qualify for treaty benefits. Also, there are other alternative tests that an entity may apply to prove that it should be entitled to treaty benefits. Thus, the subjective nature of the test is less important because it will apply less frequently.