IFA Grupo Mexicano, A.C

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Via e-mail

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Ms. Marlies de Ruiter,
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Dear Ms. De Ruiter,

On behalf of IFA Grupo Mexicano, A.C. (Mexican Branch of the International Fiscal Association) kindly find below the comments on the Public Discussion Draft on the Follow-up Work on BEPS Action 6: "*Preventing treaty abuse*".

COMMENTS ON THE FOLLOW-UP WORK ON BEPS ACTION 6: PREVENTING TREATY ABUSE

A. Issues related to the LOB provision

1. Collective investment vehicles: application of the LOB and treaty entitlement

Comments are invited as to whether the recommendations of the 2010 CIV Report continue to be adequate for widely-held CIVs and whether any improvements should be made to the conclusions included in that Report. Comments are invited, for example, on whether it would be advisable to provide for a preferred approach with respect to issues related to the tax treaty entitlement of the income of CIVs and the application of the LOB to CIVs, and if yes, on what that approach should be.

Comments:

Although recommendations of the 2010 CIV Report continue to be adequate for widely-held CIVs, it is advisable to further discuss on granting a preferred approach with respect to issues related to the tax treaty entitlement of income of CIVs and the application of the LOB to CIVs, regardless that some of these issues have been included in paragraphs 6.4 to 6.38 of the Commentary on Article 1 of the Convention.

The discussion has been raised on whether a CIV is a "person" and if so, Contracting States should clarify that for purposes of their conventions the definition of "person" should be modified to include them.

The second issue that arises is the one related to determine whether a CIV is in fact a "resident" of a Contracting State, which would lead to the application of treaty benefits.

Finally, even where it is determined that a CIV is indeed a "person" and a "resident" of a Contracting State, the question would be if it qualifies as the beneficial owner of the income it receives.

All these discussions have been generally resolved in paragraphs 31 to 43 of the Commentary on the LOB rule. However, the concern on whether a CIV could be granted treaty benefits and therefore claim benefits on its own regard still persists.

The restriction of benefits to CIVs through anti-abuse or anti-treaty shopping rules as suggested in paragraphs 52 through 57 of the 2010 CIV Report continue to be applicable.

The inclusion of any such rules will entirely be left to negotiators since all characteristics of the different types of CIV forms, according to domestic legislation of each Contracting State, should be taken into account.

2. Non- CIV funds: application of the LOB and treaty entitlement

Comments are invited as to whether the preceding paragraphs accurately describe the treaty entitlement issues of sovereign wealth funds, pension funds and alternative funds / private equity funds. Comments are also invited as to how to address these issues without creating opportunities for treaty shopping.

As regards more specifically the situation of pension funds, comments are invited on:

- *Whether and how the issue of the treaty residence of pension funds should be addressed.*

- *Whether changes should be made to paragraph 69 of the Commentary on Article 18, which deals with the source taxation of income of foreign pension funds, in order to ensure that two States that follow similar approaches with respect to the taxation of retirement savings consider more thoroughly the appropriateness of including in their bilateral treaty a provision exempting such investment income from source taxation in order to achieve greater neutrality with respect to the taxation of capital.*

- *Whether drafting changes should be made to the alternative provision included in paragraph 69 of the Commentary on Article 18 (e.g. restricting its application to portfolio investment income).*

- *How the 50% ownership test applicable to pension funds could be modified in order to address cases where it may produce inappropriate results (e.g. in the case of the individual retirement fund of a pensioner who moves abroad) without creating opportunities for treaty-shopping.*

- *How the description of pension funds found in subparagraph 2 d) of the LOB rule ("person that ... was constituted and is operated exclusively to administer or provide pension or other similar benefits") could be clarified.*

Comments:

According to paragraphs 8.6 and 8.7 of the Commentary on Article 4, in many States, a person such as a pension fund, is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax; however, in some States, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws.

Based on the above, we are of the opinion that a precision should be included in the LOB rule to specifically establish that a pension fund would be treated as a "resident" of the State in which it is established because the pension fund is subject to comprehensive taxation in that State, even when the income is taxed at a zero rate or is exempt from tax. This would be a wording similar to that included in paragraph 6.12 of the Commentary on Article 1 in the case of CIVs.

As far as the provision stated above is included in the LOB rule, no need would there be to change paragraph 69 of the Commentary on Article 18, since no doubt would there be that even when income is derived by a resident of the other Contracting State constituted and operated exclusively to administer or provide pension benefits, such entity would be a "resident" of a Contracting State, thus subject to benefits and limitation of benefits established under treaty provisions.

According to paragraph 2 d) ii), a resident of a Contracting State shall be a qualified person at a time when a benefit would otherwise be accorded by the Convention if, at that time, the resident is a person, other than an individual, that *was constituted and is operated exclusively to administer or provide pension or other similar benefits*, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident in either Contracting State.

Clarification could be made by including a commentary on the LOB rule stating that the provision was drafted with the only intention of granting treaty benefits exclusively to persons constituted to administer or provide pension or other similar benefits but only to the extent that this task is limited to performing such activities. In no way a person constituted for such purpose may perform activities different to those specifically addressed in paragraph 2 d) ii).

3. Commentary on the discretionary relief provision of the LOB rule

Suggestions are invited as to possible factors or examples that could be included in the Commentary on the discretionary relief provision of paragraph 5 of the LOB rule in order to clarify the circumstances in which that provision is intended to apply.

Comments:

In line with the Commentary included in paragraph 19 of the Report, we consider that clarification is indeed needed since not all tax authorities may be in line with the intention of extending treaty benefits per the LOB rule to persons who, in principle, are not subject to them. Given that paragraph 5 provides a discretionary ability to the competent authority of a Contracting State, certain guidance should be provided in order to eliminate subjectivity upon a request by a resident of a Contracting State.

Some authorities, mainly in civil law countries, have a 'form over substance' approach, regardless that they seem to be moving away from it. In these specific cases, some kind of guidance should be provided as to set up rules that enable a unification of criterion that align the way authorities should resolve such requests.

Apparently the last sentence of paragraph 5 of the LOB rule may establish some sort of mutual agreement, since it provides that the competent authority to which the request has been made will *consult* with the competent authority of the other State before rejecting a request made under said paragraph. However, neither the LOB rule nor the Commentary itself, provides clarification in case an authority decides to reject a request and the other authority is not in agreement with such resolution.

Indeed paragraph 68 of the Commentary on paragraph 5 of the LOB rule encourages States to publish guidelines on the types of cases that they consider will and will not qualify for discretionary relief, but no general guidance is provided as under which basis these general guidelines should be drafted.

6. Issues related to the derivative benefit provision

Suggestions are invited on possible changes that could be made to the derivative benefit provision (paragraph 4 of the LOB rule), the definition of equivalent beneficiary (paragraph 6 of the LOB rule) or other provisions of the Model Tax Convention in order to assist in the work on other parts of the Action Plan and ensure that the inclusion of a derivative benefit provision would not raise BEPS concerns whilst providing that cases where intermediate companies are used for valid commercial reasons are not excluded from treaty benefits.

Comments:

We understand that the discussion draft recommends the inclusion of a specific anti-abuse rule as established by paragraph 4 of the LOB rule. Such provision specifically refers to examples included in treaties concluded by the United States (US) with the general US approach to these type of anti-abuse rules.

Many income treaties concluded with the US that have LOB provisions contain a "derivative benefits" clause in such provision. In general, according to the US approach, a company that does not satisfy any of the other LOB tests may qualify for treaty benefits if a specified percentage of its shares is owned, directly or indirectly, by a given number of "equivalent beneficiaries" and a base erosion test is satisfied.

This would, for example, ensure that an entity owned by non-resident shareholders (i.e.: equivalent beneficiaries) may qualify for treaty benefits, even if the other LOB tests are not satisfied, when it is clear that such entity was not used for treaty shopping purposes.

In line with the US approach, an "equivalent beneficiary" generally means any person that:

a) In connection with certain European country treaties, is a resident of a member state of the European Union (EU), any state of the European Economic Area (EEA), a party to the North American Free Trade Agreement (NAFTA), or in some cases Switzerland or Australia (a "Qualifying Country");

b) Is entitled to the benefits of a comprehensive income tax treaty between such Qualifying Country and the Contracting State from which treaty benefits are claimed and satisfies certain LOB requirements (even if that treaty has no LOB article); and

c) In the case of dividends, interest, royalties, and possibly certain other items (such as insurance premiums), would be entitled under the treaty between the qualifying country and the

Contracting State in which the income arises, to a rate of tax with respect to the particular class or item of income for which benefits are claimed that is "at least as low as" the rate provided for under the treaty between the Contracting States.

We consider that the derivative benefits rule as drafted in paragraph 4 of the LOB rule, cannot only be utilized to obtain a more favorable local tax regime, but may allow third-country residents to achieve a lower tax rate by investing through an entity resident in another jurisdiction than would otherwise be available if those residents invested directly in a Contracting State.

8. Timing issues related to the various provisions of the LOB rule

Comments are invited on the rules concerning the temporal aspects of the various provisions of the LOB rule (paragraph 16 of the Report). One particular issue on which comments are invited is whether it would be possible for an entity to become, or cease to be, publicly-listed without such event triggering a new taxable period and, if yes, whether this could create a problem for the application of the LOB.

Comments:

Aside of publicly-listed entities, another temporal aspect that should be taken into account is that related to CIVs, under the different scenarios provided in paragraphs 36 through 43 of the Commentary on the LOB rule. In these cases, a resident of a Contracting State shall be a qualified person if at that time the resident is: a) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the CIV are owned by residents of a Contracting State in which the collective investment vehicle is established or by equivalent beneficiaries, or b) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established.

In any of the cases mentioned above, it might happen that throughout that time the beneficial interests in the CIV can be owned by a person different than a resident of the Contracting State in which the CIV is established, or that the owner of such beneficial interests is no longer a resident of the Contracting State in which the CIV is established.

If that were the case, this situation might be solved through paragraph 5 of the Commentaries on the LOB rule; however, the waiting might take too long for the person requesting for confirmation of the competent authority to resolve if it is indeed entitled to treaty benefits. Furthermore, in many cases, it would be very hard or almost impossible to define who the owner of the beneficial interests is, situation which would very likely end in double taxation or non-taxation relief under the LOB rule.

Depending on domestic legislation, a situation may occur in which an entity residing in a Contracting State becomes a publicly-listed entity throughout the taxable period that includes that time, as provided by paragraph 2 of the LOB rule.

This particular issue is not dealt within the LOB rule itself nor its Commentaries. If given the circumstances an entity becomes a publicly-listed entity which does not fulfill any of the thresholds provided under subparagraph c) –again under domestic legislation–, then it would definitely lose treaty benefits, even when before becoming publicly-listed, it was a resident of a Contracting State subject to treaty benefits.

This would definitely disincentive entities wishing to become publicly-listed companies to take part of a recognized stock exchange, situation that would have economic repercussions that go beyond tax implications.

9. Conditions for the application of the provision on publicly-listed entities

Comments are invited as to whether and how subparagraph 2 c) of the LOB rule (the "publicly-listed entity" provision) could be modified to take account of the concerns of small countries that do not have important stock exchanges whilst ensuring that a publicly-listed entity has a sufficient nexus with a country to warrant the application of the provision.

Comments:

Residents of a Contracting State are entitled to treaty benefits. However, a resident will only be entitled to the benefit of the treaty if the entity meets at least one of the tests to determine if the entity claiming the treaty has sufficient nexus with the country to justify awarding the benefit of the treaty.

A possible test in addition to those established in subparagraph 2 c) i) of the LOB rule could be drafted as follows:

> *"c) a company or other entity, if, throughout the taxable period that includes that time*
>
> > *i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:*
> >
> > > *A) its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or*
> > > *B) the company's or entity's primary place of management and control is in the Contracting State of which it is a resident; or*
> > > ***C) has an active trade or business in the Contracting State in which the company's or entity's shares are traded; or***"

By including subdivision i) C), a company resident in a Contracting State will be entitled to the benefits of the convention, even when requirements under subdivision i) A) or i) B) are not met, as long as it fulfills this last requirement.

For example, if a company does not have its principal class of shares being traded on one or more recognized stock exchanges located in the Contracting State of which the company or entity is a resident (because its residence is in a small country) nor its primary place of management and control is in the Contracting State of which it is a resident, it will be entitled to treaty benefits as long as it has an active trade or business in the Contracting State in which the company's or entity's shares are traded, assuming that the shares are being traded in a recognized stock exchange of the other Contracting State.

This will ensure that a publicly-listed entity of a small country has sufficient nexus with the other Contracting State, in order to be awarded with the application of treaty benefits. Indeed having an active trade or business in the other Contacting State, will have as a consequence that source income earned by the publicly-listed entity of the small country in the other Contracting State is subject to treaty benefits, where applicable.

As indicated in paragraph 44 of the Commentary on paragraph 3 of the LOB rule, a resident of a Contracting State may qualify for benefits under paragraph 3 whether or not it also qualifies under paragraph 2.

The additional subdivision i) C) will be similar to the "active business" provision set forth in paragraph 3 of the LOB rule, but in this case it will only be a conditional test to determine whether or not the issuer of the shares is a "qualified person" under paragraph 2.

10. Clarification of the "active business" provision

Comments are invited as to possible clarifications that could be made concerning the interpretation and application of the "active business" provision found in paragraph 3 of the LOB rule (paragraph 16 of the Report).

Comments:

Per the last sentence of paragraph 48 of the Commentary on paragraph 3 of the LOB rule, '*Since a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in the active conduct of a business for purposes of paragraph 3'*.

A headquarters company should be subject to the generally applicable income taxation rules in its country of residence. This means that this type of company should be subject to income taxation rules to which any other company would be subject to.

Typically, activities carried on by a headquarters company or even by a holding company consist precisely on managing investments, risks and banking for a Group of companies. Hence, these type of activities are the core business or core activities for which they were formed. Establishing that performing any such activities would not be considered to be the active conduct of a business, drives away the intention of groups of companies to constitute a headquarters or holding company with the final purpose of diminishing risks and achieving corporate efficiency.

The limitation of benefits to a headquarters company would only make sense if one of the countries has or introduces a special tax legislation that imposes a lower tax rate on headquarter companies than that imposed to any other company, provides for a special tax regime or grants incentives to a headquarters company that lead to lower taxation.

We consider that the wording included in last sentence of paragraph 48 of the Commentary on paragraph 3 of the LOB rule should be modified to state the following:

> "(…) ~~*Since a headquarters operation is in the business of managing investments*~~*, A company that functions solely as a headquarters company will* ~~*not*~~ *be considered to be engaged in the active conduct of a business for purposes of paragraph 3, unless it carries out banking, insurance or dealer business that are not part of the headquarters company business*."

B. Issues related to the PPT rule

14. Aligning the parts of the Commentary on the PPT rule and of the Commentary on the LOB discretionary relief provision that deal with the principal purposes test

Comments are invited as to possible inconsistencies between the Commentary on how the phrase "did not have as one of its principal purposes the obtaining of benefits under this Convention" should be applied in the context of the discretionary relief provision of the LOB rule (paragraph 16 of the Report) and how the phrase "obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit" should be interpreted in the context of the PPT rule (paragraph 17 of the Report).

Comments:

The phrase in the context of the LOB rule does not mention that the arrangement or transaction must result directly or indirectly in a certain unwanted benefit, unlike the phrase in the context of the PPT rule, for which we could conclude that for purposes of determining if a certain situation which indirectly derived a treaty benefit is abusive of a treaty, we might end up determining that for purposes of the LOB rule it may not be the case because the LOB rule does not mention "that resulted directly or indirectly" for which we may conclude that the phrase only makes reference to a situation where the transaction resulted directly in an unwanted benefit.

For purposes of the PPT rule however, it might so be the case, since the phrase in said context does include situations where an arrangement or transaction resulted "directly or indirectly" in a certain benefit. Hence one of the inconsistencies which may derive from the different wording of these two phrases.

In this case, the phrase in the PPT rule (includes "that resulted directly or indirectly") proved to be broader than that of the LOB rule (by not mentioning "that resulted directly or indirectly" one could interpret that it makes reference only to situations where a transaction resulted "directly" in a benefit).

Another inconsistency comes from the fact that the phrase in the context of the LOB rule does not limit the actions of a taxpayer to an arrangement or transaction, while the PPT rule does. For this, in case a taxpayer carries out an action which may not qualify as an arrangement or transaction, but might have as one of its principal purposes the obtaining of benefits under the Convention, this may be regarded as treaty abusive for purposes of the LOB rule but not for purposes of the PPT rule.

In this case the phrase in the LOB rule context proved to be broader than that in the PPT rule context, because it covered any action which derived in a benefit, and not only arrangements or transactions which derived in a benefit.

Thus, the two rules which we understand aim the same target, will have different unwanted results.

15. Whether some form of discretionary relief should be provided under the PPT rule

Commentators are invited to suggest examples where some form of discretionary relief would be justified following the application of the PPT rule.

Comments:

Before suggesting specific examples where some form of discretionary relief would be justified following the application of the PPT rule, we would like to stress that in our opinion the PPT rule as drafted seems discretionary already and seems to be punishing any situation where one of the principal purposes of a transaction is the obtaining of a treaty benefit in case the tax authority finds that obtaining to be not in accordance with the object and purpose of the relevant provisions of the Convention.

We agree that when carrying out a transaction or arrangement, if the principal purpose of that transaction or arrangement was the obtaining of a benefit under a tax treaty, and the taxpayers carried out artificial arrangements for such purpose, said situation is abusive of a tax treaty.

However, we find deriving a benefit from a tax treaty to be natural. This is, we believe the purpose of the execution between countries of tax treaties is to grant benefits to their taxpayers in order to encourage cross-border investments by not punishing them with double taxation.

Thus, if only one of the principal purposes, but not the principal purpose of a transaction was to derive a benefit under a tax treaty, this should not be regarded as abusive of a treaty, unless the transaction carried out is artificial.

We believe it is too broad to leave it to the tax authority to determine when a treaty benefit is in accordance with the object and purpose of the relevant provisions of the Convention. In our opinion, as explained above, only in case that the principal purpose of a transaction was to derive a treaty benefit and said transaction was artificial, the treaty benefit should be considered as not in accordance with the object and purpose of the relevant provisions of the tax treaty.

Many other issues of uncertainty derive for the taxpayers from the PPT rule, as to when and how will it be determined that a tax benefit is in accordance with the object and purpose of the relevant provisions of the tax treaty. Should the taxpayer request a ruling before a transaction and wait until the tax authorities issue said ruling in order to carry out a transaction which market conditions require it to be carried out at a given moment? Should the taxpayer bare the uncertainty that the transaction it carried out might be totally and discretionally disregarded by the tax administration in the future because said administration considers the tax benefits were not in accordance with the object and purpose of the Convention?

We do know this was subject to discussion under the first draft written on Action 6 in March, 2014 and that many tax practitioners and organizations delivered comments in this sense and that this is not subject to discussion under the current discussion draft of Follow-up work on BEPS Action 6. Nonetheless, our point is that if the PPT rule, which we consider very discretionary already, should be final, then at least it should certainly provide for relief in all cases, and not only discretionary relief.

This is, in our opinion, in every case and not in a discretionary manner, where the tax authority by making use of this powerful PPT rule disregards a certain transaction carried out by a taxpayer because in its opinion one of the principal purposes of said transaction was the obtaining of a benefit that is not in accordance with the object and purpose of the relevant provisions of the tax treaty, then said tax authority should be obliged to establish which transaction the taxpayer did carry out (in cases of relative and not absolute simulation) and, as a consequence, the applicable benefits of the tax treaty should follow.

In summary, if the tax administration re-characterizes a transaction (which it must do in case of a relative simulation), it must allow the tax benefits under the tax treaty that are applicable to the transaction said to be truly carried out by the taxpayer.

Thus, if for example the tax administration considers that the taxpayer is simulating a sale of shares for which it denies the application of Art. 13(5) of the Model Tax Convention, then said administration should establish if the simulation is absolute or relative, and if it is relative, it must establish which transaction the taxpayer did carry out, which in its opinion might have been receiving cross-border dividends, and then, said tax administration must allow the application of the benefits for cross-border dividends under the tax treaty in order to respect the taxpayers' rights.

We suggest the tax administration grants the taxpayer this benefit in case the taxpayer does not contend the tax administration's decision of disregarding the sale of shares or until a final ruling has been issued on the matter in case the taxpayer alleged it did carry out a sale of shares, under a mutual agreement procedure or under litigation.

Another example would be the following:

SCo, a company resident of Sate S, is the subsidiary of TCo, a company resident of State T. State T has a tax convention with State S under which any dividend paid by SCo to TCo is subject to a withholding tax on dividends of 5 per cent, while any interest paid to TCo is subject to a 10 per cent withholding. TCo enters into a loan agreement with SCo, pursuant to which SCo must pay TCo interest and withhold taxes at the 10 per cent. Should the tax administration interpret that TCo did not lend SCo any funds but invested in SCo said funds, said tax administration should not merely disregard the loan agreement and deny the application of the 10 per cent withholding rate, but it must establish with evidence, what other transaction it believes the taxpayer did carry out and grant the applicable tax benefits that may derive from the State S-State T tax treaty, which for dividends, is a withholding tax rate of 5 per cent.

This, in case SCo did not challenge the tax administration's denial of the 10 per cent withholding rate on interest, or while the matter is being decided in case the taxpayer did challenge said denial.

16. Drafting of the alternative "conduit-PPT rule"

Comments are invited on the various features of the "anti-conduit rule" in paragraph 15 of the Commentary on the PPT rule (paragraph 17 of the Report).

Commentators (Sic) are also invited on possible examples that could be included in the Commentary in order to illustrate the application of this "anti-conduit rule".

Comments:

We share the opinion of many others that some features of the "conduit-PPT rule" are too broad. E.g.: the "all or substantially all" threshold is too high and uncertain (What shall be interpreted as "substantially all"?) and the reference to a payment made "directly or indirectly" and "at any time" is too broad, since a company may make a payment to another unrelated company, which may many years later make a payment to a third party, which may or may not be related to the first company. In our opinion it would be very harsh to qualify said transaction as a "conduit arrangement" and it would disregard the taxpayers' freedom to distribute funds or make investments.

Also, in our opinion this “conduit-PPT rule” in most of the cases shall result to be repetitive since the beneficial ownership rule already covers cases where benefits of Articles 10, 11 and 12 will not be accorded to a taxpayer in respect to income obtained by said taxpayer through another party which was entitled to tax treaty benefits that the first taxpayer would not have been entitled to should it had received the income directly and not through said other party.

Thus, we believe that if the “conduit-PPT rule” is more general and covers benefits of many provisions of the Convention (e.g. those of Articles 7, 10, 11, 12 and 21) as mentioned in paragraph 15 of the Commentary on the PPT rule, then there would be no need to have a beneficial ownership rule, as so many anti-abusive rules, general and specific, might result overlapping, excessive or confusing.

With regard to letter a) of paragraph 15 of the Commentary on the PPT rule (paragraph 17 of the Report), we believe it is unnecessary to include cases where one or more persons receive an item of income to which tax treaty benefits are applied under a certain tax treaty, which are equivalent to those benefits said person or persons would have received had they received that item of income direct from the other Contracting State and not through a resident of the other Contracting State.

This is, we believe it is too broad and unfair to deny the application of tax treaty benefits if it is proved that the equivalent benefits would have been derived had that taxpayer received the income directly and not through another party or a company believed to be “conduit”. As a consequence, we suggest removing the words “equivalent to, or” from letter a) of paragraph 15 of the Commentary on the PPT rule, as follows:

> “a) which is structured in such a way that a resident of a Contracting State entitled to the benefits of this Convention receives an item of income arising in the other Contracting State but that resident pays, directly or indirectly, all or substantially all of that income (at any time or in any form) to one or more persons who are not resident of either Contracting State and who, if they received that item of income direct from the other Contracting State, would not be entitled under a convention for the avoidance of double taxation between the State of which those persons are resident and the Contracting State in which the income arises, or otherwise, to benefits with respect to that item of income which are ~~equivalent to, or~~ more favourable than, those available under this Convention to a resident of a Contracting State; and”

For these purposes, it is worth noting that letter b) of paragraph 15 of the Commentary on the PPT rule only makes reference to “increased benefits as are available under this Convention” and not to benefits “which are equivalent to those available under this Convention to a resident of a Contracting State”, which shows inconsistency.

We also believe that letter b) of paragraph 15 of the Commentary on the PPT rule (paragraph 17 of the Report) contradicts the whole spirit of the “conduit-PPT rule”. This is, we understand the “conduit-PPT rule” is suggested as an alternative in cases where the PPT rule is found to be unacceptable for some States (probably because of its high discretionary features and likeness of deriving many litigations against it).

Notwithstanding this, letter b) of the “conduit-PPT rule” is even broader than the PPT rule itself, since it establishes that the benefits of the provisions of the tax treaty or of some of them will not be accorded in respect of any income obtained under, or as part of, a conduit arrangement, which for example is a transaction or series of transactions "which has as one of its principal purposes obtaining such increased benefits as are available under this Convention". In this regard, at least the PPT rule provides that said benefits are to be denied "unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention".

In the case of letter b) of the "conduit-PPT rule" however, apparently a "conduit arrangement" means a transaction or series of transactions which has one of its principal purposes obtaining such increased benefits as are available under the tax treaty, without mentioning as the PPT rule does, that the tax administration must reasonably conclude, having regard to all relevant facts and circumstances that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted in that benefit and that it must be established that the benefit (or the increased benefits in this case) are not in accordance with the object and purpose of the relevant provisions of the tax treaty.

The following examples illustrate the application of the "anti-conduit rule" and were drafted considering the examples listed in the exchange of notes between the United Kingdom and the United States concerning the application of the "conduit arrangements" rules of the 2001 treaty between these two States, as suggested by paragraph 36 of the Draft:

- Example A: TCo, a publicly-traded company resident in State T, owns all of the outstanding stock of RCo, a company resident in State R. SCo, a company resident in State S, which does not have a tax treaty with State R, would like to purchase a minority interest in RCo, but believes that the 30 per cent State R domestic withholding tax on dividends would make the investment uneconomic. TCo proposes that RCo instead issue preferred stock to TCo, paying a fixed return of 4 per cent plus a contingent return of 20 per cent of RCo's net profits. The maturity of the preferred stock is 1 year. SCo will enter into a separate contract with TCo pursuant to which it pays to TCo an amount equal to the issue price of the preferred stock and will receive from TCo after one year the redemption price of the stock. During said year, TCo will pay to SCo 4 per cent plus 20 per cent of RCo's net profits.

This arrangement constitutes a conduit arrangement because: (i) TCo did not have valid business reasons to carry out said transaction, but only participated in the transaction in order to achieve a reduction in State R withholding tax for SCo. It cannot be considered it is a valid business reason for TCo to contract with SCo, since the fixed return rate is not at arm's length conditions but at the same rate as that agreed with RCo and (ii) the maturity of the preferred stock is of less than 2 years, which might be considered a reasonable period in which a taxpayer may invest for valid commercial reasons and not only to obtain tax treaty purposes.

- Example B: TCo, a publicly-traded company resident in State T, owns all of the outstanding stock of RCo, a company resident in State R. SCo, a company resident in State S, which does not have a tax treaty with State R, would like to purchase a minority interest in RCo, but believes that the 30 per cent State R domestic withholding tax on dividends would make the investment uneconomic. TCo proposes that RCo instead issue preferred stock to TCo, paying a fixed return of 4 per cent plus a contingent return of 20 per cent of RCo's net profits. The maturity of the preferred stock is 20 years. SCo will enter into a separate contract with TCo pursuant to which it pays to TCo an amount equal to the issue price of the preferred stock and will receive from TCo after 20 years the redemption price of the stock. During the 20 years, TCo will pay to SCo 3.75 per cent plus 20 per cent of RCo's net profits.

This arrangement does not constitute a conduit arrangement because: (i) the fixed return rate of 3.75 per cent agreed between TCo and SCo is at arm's length conditions and (ii) the maturity of the preferred stock is 20 years, which is such a long period that contributes to believe there are valid business reasons for said investment and not an artificial arrangement to turn around State R's domestic withholding.

- Example C: TCo, a company resident in State T, has issued only one class of stock, common stock that is 100 per cent owned by RCo, a company resident in State R. RCo also has only one class of common stock outstanding, all of which is owned by SCo, a company resident in State S, which does not have a tax treaty with State T. RCo is engaged in the manufacture of electronics products, and TCo serves as RCo's exclusive distributor in State T. Under paragraph (X) of Article (X) (Limitation on Benefits), RCo will be entitled to benefits with respect to dividends received from TCo, even though RCo is owned by a resident of a third country.

This seems to be a perfectly acceptable and normal commercial structure with real economic activity in both State R and State T. The payment of dividends by subsidiary companies is a normal feature of commercial life. Accordingly, in the absence of evidence that dividends were flowed through to SCo in terms of the beneficial ownership provision of this Convention, these transactions would not constitute a conduit arrangement.

- Example D: SCo, a company resident in State S, a country that does not have a tax treaty with State T, loans $1'000,000 to TCo, its wholly- owned State T subsidiary in exchange for a note issued by TCo. Two years later, SCo needs cash flow to carry out its daily activities and cannot afford to await for TCo's payment. Thus, SCo realizes it can access to cash easily by assigning the note issued by TCo to an unrelated party at an arm's length price and for an upfront price. This assignment was made having examined the scenario of many third parties which offered equal market conditions, and that a benefit may derive from the tax treaty executed by State R, which is RCo's country of residence and State T, by avoiding the State T withholding tax by assigning the note to said unrelated party. Accordingly, SCo assigns the note to RCo in exchange for a note issued by RCo. The TCo note pays 7 per cent and the RCo note pays 6.75 per cent, having a discount difference of .25 per cent.

The loan was assigned at an arm's length basis, to an unrelated party and to easily access to cash flow. It was specifically assigned to a resident of State R, which has a tax treaty with State T by which there is no withholding of tax on interest, having examined other options with unrelated parties under the same market conditions but which were not residents of countries with which State T had a tax treaty, thus turning the transaction more convenient from an economic aspect, which is a valid and a core business reason for all taxpayers.

As a consequence, the transaction does not constitute a conduit arrangement as defined in the treaty.

- Example E: SCo, a company resident in State S, a country that does not have a tax treaty with State T, loans $1'000,000 to TCo, its wholly- owned State T subsidiary in exchange for a note issued by TCo. SCo later realizes that it can avoid the State T withholding tax by assigning the note to its wholly-owned subsidiary, RCo. Accordingly, SCo assigns the note to RCo in exchange for a note issued by RCo. The TCo note pays 7 per cent and the RCo note pays 6.75 per cent.

Unless more elements are provided, there is no valid business reason in this transaction although the 6.75 per cent seems to be agreed at an arm's length basis.

Thus, it could be derived that the loan was assigned to avoid State T income tax on the payment of interest and that the transaction constitutes a conduit arrangement as defined in the treaty as both the objective definition and the motive test at Article (X) (X) and (x) respectively are met and there are no other valid business reasons.

- Example F: SCo, a company resident in State S, which does not have a tax treaty with State T, owns all of the stock of TCo, a company resident in State T. SCo has for a long time done all of its banking with RCo, a company resident in State R, because the banking system in State S is relatively unsophisticated. As a result, SCo tends to maintain a large deposit with RCo. RCo is unrelated to SCo and TCo. When TCo needs a loan to fund an acquisition, SCo suggests that TCo deal with RCo, which is already familiar with the business conducted by SCo and TCo. TCo discusses the loan with several different banks, all on terms similar to those offered by RCo, but eventually enters into the loan with RCo, in part because interest paid to RCo would not be subject to State T withholding tax, while interest paid to banks organized in State S would be.

The fact that the State R-State T tax treaty benefits are available if TCo borrows from RCo, and that similar benefits might not be available if it borrowed elsewhere, is clearly a factor in TCo's decision (which may be influenced by advice given to it by its 100 per cent shareholder). It may even be a decisive factor, in the sense that, all else being equal, the availability of treaty benefits may swing the balance in favor of borrowing from RCo rather than from another lender. However, whether the obtaining of treaty benefits was "one of the principal purposes" of the transaction would have to be determined by reference to the particular facts and circumstances.

Similarly, for the "conduit-PPT rule" to apply it would have to be established that the interest paid by TCo was "flowing through" RCo to SCo as explained by the beneficial ownership provision of this treaty. The fact that SCo has historically maintained large deposits with RCo might, if anything, be a counter-indication.

On the specific facts as presented, the transactions would not constitute a conduit arrangement as defined by the treaty.

However, if RCo's decision to lend to TCo was dependent on SCo providing a matching collateral deposit to secure the loan, the indication would be that SCo was in substance lending to TCo direct but in form routing the loan through a bank with whom it has a close relationship in order to obtain the benefit of the treaty. In such circumstances the transactions would constitute a conduit arrangement as defined by the treaty.

- Example G: RCo, a publicly-traded company resident in State R, is the holding company for a manufacturing group in a highly competitive technological field. The manufacturing group conducts research in subsidiaries located around the world. Any patents developed in a subsidiary are licensed by the subsidiary to RCo, which then licenses the technology to its subsidiaries that need it. RCo keeps only a small spread with respect to the royalties it receives, so that most of the profit goes to the subsidiary that incurred the risk with respect to developing the technology. SCo, a company resident of State S, with which State T does not have a tax treaty, has developed a process that will substantially increase the profitability of all of RCo's subsidiaries, including TCo, a company resident of State T. According to its usual practice, RCo licenses the technology and sub-licenses the technology to its subsidiaries. TCo pays a royalty to RCo, substantially all of which is paid to SCo.

Because SCo is conforming to the standard commercial organization and behavior of the group in the way that it structures its licensing and sub-licensing activities and assuming the same structure is employed with respect to other subsidiaries carrying out similar activities in countries which have treaties which offer similar or more favorable benefits, the inference would be that the absence of a treaty between State S and State T is not influencing the motive for the transactions described.

Therefore even though the specific fact pattern, as presented, meets the first part of the definition of a "conduit arrangement" at Article (X) (X) (x), on balance the conclusion would be that "one of the principal purposes" of the transactions was not the obtaining of State R-State T treaty benefits. So the structure would not constitute a conduit arrangement.

- Example H: SCo is a publicly-traded company resident in Country S, which does not have a tax treaty with State T. SCo is the parent of a worldwide group of companies, including RCo, a company resident in State R, and TCo, a company resident in State T. TCo is engaged in the active conduct of a trade or business in State T. RCo is responsible for coordinating the financing of all of the subsidiaries of SCo. RCo maintains a centralized cash management accounting system for SCo and its subsidiaries in which it records all inter-company payables and receivables. RCo is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. RCo enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of RCo are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. RCo has 50 employees, including clerical and other back office personnel, located in State R.

SCo lends to RCo $10 million in exchange for a 10-year note that pays interest annually at a rate of 5 per cent per annum. On the same day, RCo lends $10 million to TCo in exchange for a 10-year note that pays interest annually at a rate of 8 per cent per annum. RCo des not enter into a long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

TCo appears to be a real business performing substantive economic functions, using real assets and assuming real risks. RCo appears to be bearing the interest rate and currency risk. It is assumed that the transactions are typical of RCo's normal treasury business and that that business was carried on in a commercial manner.

So, on the specific facts presented, the transactions would not constitute a conduit arrangement as defined by the treaty.

17. List of examples in the Commentary on the PPT rule

Commentators are invited to suggest additional examples that could be included in paragraph 14 of the Commentary on the PPT rule (paragraph 17 of the Report). For example, representatives of investment funds are invited to suggest an additional example that would deal with the non-tax motivated use of a special purpose vehicle in order to pool the investment of various institutional investors from different countries.

We drafted these two examples considering those that are included in paragraph 14 of the Commentary on the PPT rule (paragraph 17 of the Report). We suggest adding them after Example E of said paragraph as follows:

"14. The following examples illustrate the application of the paragraph:"

(…)

- Example F: TCo, a company resident of State T, owns shares of SCo, a company listed on the stock exchange of State S. State T does not have a tax convention with State S and, therefore, any dividend paid by SCo to TCo is subject to a withholding tax on dividends of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, there is no withholding tax on dividends paid by a company resident of a Contracting State and beneficially owned by a company resident of the other State. TCo needs cash flow to finance its operations and cannot afford to wait for SCo to distribute it dividends. Once TCo has explored many options, it enters into an agreement with RCo, an independent financial institution resident of State R, pursuant to which TCo assigns to RCo the rights to the payment of dividends that have been declared but have not yet been paid by SCo. This assignment is agreed at a discount determined on an arm's length basis.

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that even though one of the principal purposes for the arrangement under which TCo assigned the right to the payment of dividends to RCo was for RCo to obtain the benefit of the exemption from source taxation of dividends provided for by the State R-State S tax convention, this is not contrary to the object and purpose of the tax convention, but rather is in accordance to them, since it is encouraging cross-border investments.

This, because: (i) there were valid business reasons for carrying out the above transactions such as (a) for TCo obtaining from RCo cash flow before than originally agreed with SCo and probably at a higher amount than if the assignment had been executed with a resident of a State with which State S does not have a tax treaty and (b) for RCo obtaining dividends at a discount price, which is lower than the price it would have paid if it had invested directly and originally in SCo had that chance may in fact actually been available to RCo; (ii) the consideration for the assignment was fixed at an arm's length basis and (iii) RCo was an independent financial institution.

- Example G: SCo, a company resident of State S, is the subsidiary of TCo, a company resident of State T. State T does not have a tax convention with State S and, therefore, any dividend paid by SCo to TCo is subject to a withholding tax on dividends of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, the applicable rate of withholding tax on dividends paid by a company of State S to a resident of State R is 5 per cent. TCo is in the need of cash flow and cannot afford to wait until SCo distributes it dividends. Therefore, TCo analyzed the many options that arose to sell its usufruct to residents of different states. TCo concluded that if it entered into an agreement with RCo, an unrelated financial institution resident of State R and a qualified person under subparagraph 3 a) of this Article, considering State R has a tax treaty applicable with State S, a greater benefit could derive compared to executing the same agreement with another party which State of residence did not have a tax treaty with State S.

Thus RCo acquires the usufruct of newly issued non-voting preferred shares of SCo for a period of three years. TCo is the bare owner of these shares. The usufruct gives RCo the right to receive the dividends attached to these preferred shares. The amount paid by RCo to acquire the usufruct corresponds to the present value of the dividends to be paid on the preferred shares over the period of three years (discounted at the rate at which TCo could borrow from RCo and determined at an arm's length basis).

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that although one of the principal purposes of the arrangement under which RCo acquired the usufruct of the preferred shares issued by SCo was to obtain the benefit of the 5 per cent limitation applicable to the source taxation of dividends provided for by the State R-State S tax convention, said transaction would add to TCo's business income, which is the purpose of any business and hence a valid and natural business reason encouraged in a cross-border context by the State R-State S tax convention. In this manner, it would be in accordance to the object and purpose of the tax convention to grant the benefit of that limitation.

What would not be a valid business reason is if TCo is presented with many options, all of which offer the same features except that the one with RCo offers it a greater benefit because there is a tax treaty between State R and State S, and nonetheless for other hidden or counter-productive reasons, TCo chooses a different option.

As in the previous example, it is reasonable to conclude that the tax treaty benefit must not be denied because: (i) there were valid business reasons for carrying out the above transactions such as (a) for TCo obtaining from RCo cash flow before than originally agreed with SCo and probably at a higher amount than if the usufruct had been sold to a resident of a State with which State S does not have a tax treaty and (b) for RCo obtaining dividends at a discount price, which is lower than the price it would have paid if it had invested directly and originally in SCo had that chance may in fact actually been available to RCo; (ii) the consideration for the usufruct was fixed at an arm's length basis; (iii) RCo is an independent financial institution; (iv) the term of three years seems long enough to consider this was not a sham transaction but a real investment and (v) the dividends will not be flowed through RCo to TCo, but RCo is the beneficial owner of said dividends.

C. Other issues

19. The design and drafting of the rule applicable to permanent establishments located in third States

The anti-abuse rule included in paragraph 42 of the Report is currently restricted to cases where the profits of the PE are exempt in the State of the enterprise to which the PE belongs. Are there other situations where the rule should apply?

Are the exceptions included in subparagraph e) and f) of the anti-abuse rule sufficient to address cases where the rule would otherwise affect arrangements that are not tax-motivated?

Do these exceptions raise potential BEPS concerns?

Comments:

We find it suitable to restrict the situation where the profits of the PE are exempt in the State of residence of the enterprise to which the PE belongs.

However, we have some comments on this new anti-abuse rule as it is drafted.

We think there might be inconsistencies in the wording of paragraphs 40 and 41 of the Report and 71 of the Commentary on Article 24 of the Convention.

At times it seems that the state where the PE is situated is the third state, and at times it seems that it is the State of source, which adds to the confusion.

For instance, paragraph 40 of the Report states the following:

> "40.… Where the State of residence exempts, or taxes at low rates, profits of such permanent establishments situated in third States, the State of source should not be expected to grant treaty benefits with respect to that income".

In this case, we understand the State of residence is State R and RCo is a resident therein and the owner of a PE situated in a third State (State T). We derive that paragraph 40 of the Report makes reference to a situation where State R exempts, or taxes at low rates, profits of the PE situated in State T and thus suggests that the State of source (State S) should not be expected to grant treaty benefits with respect to that income under the State R-State S tax treaty.

However, paragraph 41 of the Report reads as follows:

> "41. The last part of paragraph 71 of the Commentary on Article 24 deals with that situation and suggests that an anti-abuse provision could be included in bilateral conventions to protect the State of source from having to grant treaty benefits where income obtained by a permanent establishment situated in a third State is not taxed normally in that State:"

From said paragraph we interpret that an anti-abuse provision could be included in bilateral conventions to protect the State of source (State S) from having to grant treaty benefits where income obtained by a PE situated in a third State (State T) is not taxed normally in that State (State T).

The inconsistency relies on the fact that under paragraph 40 of the Report what seems to matter is that the profits of the PE are exempt or low-taxed in the State of residence (State R), whereas under paragraph 41 of the Report what seems to matter is that the income of the PE situated in a third State is not taxed normally in that State (State T).

On the other hand, paragraph 71 of the Commentary on Article 24 of the OECD Model Tax Convention states the following:

> "71. .. Another question that arises with triangular cases is that of abuses. If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment".

From said paragraph, it seems that the third State (State T) is the State of source (State S), which we believe is different in paragraphs 40 and 41 of the Report.

We believe a third State is a state different from the State of residence (State R) and the State of source (State S) under the State R-State S tax treaty, this is, that the third State is not a party to said tax treaty.

Last, we believe that the paragraph 2 on the Commentary to this new anti-abuse provision, should be adjusted to remove the reference to "discretionary relief provision of paragraph 5 of Article [X]", since as we explained above, said relief should not be discretionary but mandatory in cases of relative simulations of acts found to have occurred according to the tax administration.

We find that the exception included in subparagraph e) is not sufficient when it does not recognize that holding companies have as their main core business activity simply holding investments, for which in that case, the income derived from the other Contracting State shall be considered to derive in connection with, or to be incidental to, the active conduct of a business carried on in the third State through the permanent establishment, and the exception to the exception ("other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance enterprise or registered securities dealer, respectively") is over-inclusive and shall not be applicable in the case of holding companies which regime is specifically recognized and so agreed by the Contracting State itself under its domestic laws in order to encourage inbound investments.

Also, we find the exception included in subparagraph f) to be insufficient since it should not only cover royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the enterprise through the permanent establishment, but it should cover any royalty which is paid over intangibles that were or are acquired at an arm's length value and any royalties which are paid at an arm's length value.

In our opinion these exceptions do not raise potential BEPS concerns, since other anti-abuse rules remain applicable, such as the beneficial ownership rule for the case of dividends, interest and royalties, the specific rules each item of income may have, and the many other general and specific anti-abuse rules such as those proposed in the deliverable on Action 6 of the BEPS Action Plan.

20. Proposed Commentary on the interaction between tax treaties and domestic anti-abuse rules

Apart from the changes described above, are there other clarifications/additions that should be made to the Commentary changes in paragraph 49 of the Report?

Comments:

We believe there is a typo in the suggested new paragraph 9 of the Commentary on Article 1 when it says: *"... Whilst this facilitates their application and provide greater certainty, it may sometimes result in the application of such a rule in a case…"* We think it should instead read *"Whilst this facilitates their application and provides greater certainty, it may sometimes result in the application of such a rule in a case…"*

On the other hand, apart from the changes described in paragraph 49 of the Report, we would like to see clarifications on the presence or absence in a treaty of the specific mention that there is no conflict or, even if there is a conflict, the application of the domestic rules is allowed.

This is, is there a difference between a treaty executed between State R and State T that specifically mentions that the application of Controlled Foreign Corporations (CFC) or thin capitalization rules is allowed under the treaty, with respect to a treaty between State R and State S that does not specifically mention that the application of those domestic rules is allowed?

In our opinion there is a difference and unless the Contracting States so specifically agreed, it should be understood that the application of the domestic CFC or thin capitalization rules results in a treaty override, denying taxpayers benefits that the Contracting States had agreed to grant them under the treaty.

In order to grant more legal certainty, in our opinion it should be recognized that there is a difference between the fact that the Contracting States included a specific provision in a tax treaty allowing the application of domestic CFC or thin capitalization rules, compared to the fact that one of said Contracting States when entering into a tax treaty with another State did not include such specific provision. We are not certain that if the "saving clause" is included in the Convention, this problem would be solved.

The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA Branch, and in no case in the name or on behalf of Central IFA or IFA as a whole.

We hope you find these comments interesting and useful. We remain yours for any questions or comments you may have.

*   *   *

Sincerely,

IFA Grupo Mexicano, A.C.