Executive summary

On 11 July 2017, the Organisation for Economic Co-operation and Development (OECD) released the draft contents of the next update to the OECD Model Tax Convention (the 2017 update). Significant parts of the 2017 update were previously approved as part of the Base Erosion and Profit Shifting (BEPS) Package. It also includes four areas that were not previously released. It does not necessarily reflect the final views of the OECD and its member countries.

Interested parties are invited to submit comments on the four new areas. After the consultation, it will be submitted for the approval of the Committee on Fiscal Affairs (CFA) and of the OECD Council.

A detailed analysis of this 2017 update will be covered in a subsequent EY Global Tax Alert.

Detailed discussion

The OECD Model Convention has been constantly reviewed and updated to address new tax treaty issues. Working Party No. 1 of the OECD’s CFA continuously works to update the OECD Model Tax Convention (MTC). The last update to the MTC was in 2014.¹
The draft 2017 update is primarily comprised of changes to the MTC that have been approved as part of the BEPS Package. However, it also contains changes resulting from follow-up work on the treaty-related BEPS measures, including changes resulting from the negotiation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the MLI), and changes related to the commentary on permanent establishments and the international shipping provision, which were under review prior to the BEPS project. Changes and additions will also be made for the observations, reservations and positions to the MTC of OECD member countries and non-member economies. These changes and additions are in the process of being formulated and will be included in the final version of the 2017 update.

**BEPS changes to the OECD MTC**

Some of the BEPS final reports contain tax treaty recommendations which among other things warrant changes to the MTC and its accompanying Commentary. The forthcoming 2017 MTC will therefore introduce the treaty-based recommendations contained in the BEPS final reports on Action 2 (Neutralising the Effects of Hybrid Mismatch Arrangements), Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status), and Action 14 (Making Dispute Resolution Procedures More Effective).

Some of the changes contained in the 2017 update include:

- Revisions to the title and preamble of the MTC to clarify that the intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion and avoidance, including through treaty shopping arrangements.
- An amendment to Article 1(2) of the MTC to include a rule on fiscally transparent entities whereby income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of one of the countries will be considered to be income of a resident only to the extent that the income is treated, for purposes of taxation by that country, as the income of a resident of that country. Further, it also includes a “saving clause” in Article 1(3) of the MTC, to confirm a country’s right to tax its residents without regard to the provisions of any tax treaty, other than those provisions that are intended to apply to residents.
- A change to address situations in which a person is considered a resident of both contracting states, Article 4(3) of the MTC will provide that in cases where a person other than an individual is a dual resident, the competent authorities of the two countries shall endeavor to determine by mutual agreement the country of residence having regard to the place of effective management, the place where it was incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, Article 4(3) provides that such person will not be entitled to any relief or exemption from tax provided by the treaty except to the extent and in such manner as may be agreed upon by the competent authorities.
- Changes to the definition of permanent establishment in Article 5 and the related Commentary.
- Changes to Article 10 (Dividends) to require a minimum holding period to access the 5% rate applicable to dividends, and related Commentary changes, including replacing paragraph 17 of the Commentary on Article 10 with a paragraph containing an alternative provision that would deny the benefit of the lower rate provided in Article 10(2) to certain collective investment vehicles that do not pay tax on their investment income. Moreover, the 2017 update contains changes to the article on capital gains (Article 13(4)), addressing transactions that seek to circumvent the application of that provision (gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State), and related Commentary changes.
- Changes to Articles 23 A (Exemption Method) and 23 B (Credit Method) and related changes to the Commentaries on Articles 10 (Dividends), 11 (Interests), 21 (Other Income), and 23 A and 23 B addressing issues relating to the relief of double taxation that arose during the work on new paragraphs 2 and 3 of Article 1 (Persons Covered).
- Changes to Article 25 and the related commentary which are intended to remove any doubt that, in a case where the competent authorities have agreed on a common meaning of an undefined term, the domestic law meaning of that term would not be applicable. Moreover changes to reflect the Mutual Agreement Procedure arbitration provision developed in the negotiation of the MLI.
Some items in the Action 6 final report needed further work and were not finalized when the OECD issued the 2015 report. The 2017 update contains the finalized version of this further work, including:

- Changes to the Commentary on Article 1 to include optional provisions to deny treaty benefits with respect to income benefiting from “special tax regimes” and in cases of certain subsequent changes to the domestic law of a treaty partner after the conclusion of a tax treaty.
- Changes to Articles 3 (General definitions) and 4 (Resident) and related Commentary changes, concerning the treaty residence of pension funds.
- The addition of a new Article 29 (Entitlement to Benefits) and related Commentary, which includes in the MTC a limitation on benefits (LOB) rule (simplified and detailed versions), an anti-abuse rule for permanent establishments situated in third States, and a principal purpose test (PPT) rule. As noted in the Action 6 final report, the two versions of the LOB rule and the anti-abuse rule for permanent establishments situated in third States as presented in the final report were draft provisions subject to changes, in the light of the versions of those rules that would be included in the 2016 United States Model Income Tax Convention, which had not been finalized at the time the Action 6 final report was approved. Those provisions, as they will appear in the 2017 update, have been finalized accordingly. The Commentary on Article 29 also contains three additional examples on the application of the PPT rule to non-CIV funds (which were not included in the Action 6 final report) which were released in draft form in a March 2016 discussion draft.
- The addition of new paragraph 1.1 to the Commentary on Article 5 (Permanent Establishment) that indicates that registration for the purposes of a value added tax or goods and services tax is, by itself, irrelevant for the purposes of the application and interpretation of the permanent establishment definition.
- Deletion of the parenthetical reference (other than a partnership) from subparagraph 2 a) of Article 10, which is intended to ensure that the reduced rate of source taxation on dividends provided by that subparagraph is applicable in the case where new Article 1(2) would have the effect that a dividend paid to a transparent entity would be considered to be income of a resident of a Contracting State because it is taxed either in the hands of the entity or in the hands of the members of that entity.

Implications

The draft 2017 update to the OECD MTC comprises changes that were approved as part of the BEPS Package (included in the 2015 final reports on BEPS Actions 2, 6, 7 and 14) and that were also included in the MLI adopted on 24 November 2016. It also includes four areas that have not been previously released.

It is important for companies to continue to monitor the developments in this area in the OECD and in the countries in which they operate, and to consider actively engaging with policymakers in this international tax debate.
Endnotes


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