Executive summary

On 11 July 2017, the Organisation for Economic Co-operation and Development (OECD) released the draft contents of the 2017 update to the OECD Model Tax Convention (the 2017 update).

The 2017 update is primarily comprised of changes to the OECD Model Tax Convention (MTC or Convention) and Commentary that have been approved as part of the Base Erosion and Profit Shifting (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 to 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.

The 2017 update 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 by 10 August 2017. After the consultation, the 2017 update will be submitted for the approval of the Committee on Fiscal Affairs (CFA) and of the OECD Council later this year.
Detailed discussion

Background

The OECD MTC 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 Convention. The last update to the MTC was in 2014.2

On 11 July 2017, the OECD released the draft contents of the 2017 update to the OECD MTC. The contents of the 2017 update will be incorporated in a revised version of the OECD MTC that will be published in the next few months. The 2017 update reflects work carried out by the CFA since 2011 on a variety of issues.

Some of the BEPS final reports contain tax treaty recommendations which among other things warrant changes to the MTC and its accompanying Commentary. The update incorporates all of the treaty-based changes to the OECD MTC as a result of the work on the BEPS project. 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),3 Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances),4 Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status),5 and Action 14 (Making Dispute Resolution Procedures More Effective).6

While this 2017 update affects both the Articles of the MTC and the Commentary, most of the changes are to the Commentary.

Changes to the OECD MTC

Article 1 (Persons Covered)

In general, Article 1 provides that the Convention applies to residents of one or both Contracting States. The 2017 update revises Article 1 to include two new paragraphs: paragraph 2 (the transparent entity provision) and paragraph 3 (the “savings clause”). These paragraphs were included in the Action 2 and Action 6 final reports respectively and are unchanged from those final reports.

The Commentary to Article 1 also includes optional provisions to deny specific treaty benefits with respect to income benefiting from “special tax regimes.” In addition, in cases of certain subsequent changes to the domestic law of a treaty partner after the conclusion of a tax treaty, optional provisions are included in the Commentary that would deny treaty benefits in certain cases. Draft proposals of these optional provisions were included in the Action 6 final report, where the OECD acknowledged that these proposals would be reviewed in light of similar proposals contained in the draft of the 2016 Model Income Tax Convention released by the United States (2016 US Model).7

The provision for special tax regimes and definition of “special tax regime” in the 2017 update closely follow the provision and definition in the 2016 US Model. Similarly, the provision for subsequent changes to domestic law in the 2017 update closely follows Article 28 (Subsequent Changes in Law) of the 2016 US Model. The 2017 update also adds new Commentary related to these two optional provisions.

Article 4 (Resident)

The 2017 update contains two main changes to Article 4 of the OECD MTC. First, the definition of “resident of a Contracting State” in paragraph 1 of Article 4 now includes “recognized pension funds” as a result of the follow-on work under the final report on BEPS Action 6.8 The Commentary to Article 4 was amended to explain that this article was modified to remove any doubt about the fact that a pension fund that meets the definition of recognized pension fund in paragraph 1 of Article 3 constitutes a resident of the Contracting State in which it is established. The effect of this will depend to a large extent on the domestic law and on the legal characteristics of the pension funds established in each Contracting State as well as on the other provisions of the MTC where the definition might be relevant.

In light of this first change to Article 4, the definition of the term recognized pension fund was added in subparagraph (i) of Article 3 of the MTC. Accordingly, a recognized pension fund of a State means “an entity or arrangement established in that State that is treated as a separate person under the taxation laws of that State and:

- (i) that is established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that State or one of its political subdivisions or local authorities; or

- (ii) that is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in subdivision (i).”
Several additions were added to the Commentary on Articles 3 and 4 to the OECD MTC to clarify that a recognized pension fund will constitute a resident of a Contracting State regardless of whether that pension fund benefits from a limited or complete exemption from taxation in that State. Given the considerable diversity in the legal and organizational characteristics of pension funds around the world, the intent of the changes to the Commentary is to provide detailed guidance as to how to interpret the various clauses constituting the definition of a recognized pension fund including: (i) what “arrangements” can qualify as a recognized pension fund (including examples in that respect); (ii) when will an entity or arrangement be considered to have been constituted and used solely for the purpose of administering or providing retirement or similar benefits to individuals; and (iii) when will an entity or arrangement be considered to be subject to an appropriate regulatory framework.

Second, the tie-breaker rule for determining the treaty residence of dual-resident persons other than individuals changed as a result of the final report on BEPS Action 6. The Revised paragraph 3 of Article 4 provides 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 (PoEM), the place where it was incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, paragraph 3 of Article 4 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. The Commentary on Article 4 further explains that some countries consider it preferable to deal with such cases of dual residence using the PoEM as a tie-breaker, which was the tie-breaker used in previous versions of the MTC. Countries having this view are free to include an alternative paragraph 3 which uses the PoEM as the tie-breaker in their treaties.

### Article 5 (Permanent Establishment)

The 2017 update contains changes to the definition of Permanent Establishment (PE) in Article 5 and the related Commentary. All of the changes to the definition of PE in Article 5 are the result of the final report on BEPS Action 7, while the changes to the Commentary to Article 5 are the result of not only the final report on BEPS Action 7, but also of work carried by the OECD since 2011. Paragraphs 4 (specific activity exemptions), 5 (depend agent clause) and 6 (independent agent clause) of Article 5 of the MTC were revised as a consequence of the BEPS project to restrict the scope of the specific activity exemptions, broaden the definition of dependent agent and narrow the definition of independent agent. Further, paragraph 4.1 containing the so-called anti-fragmentation clause and paragraph 8 containing the definition of closely related enterprises were added to Article 5 also as a result of the BEPS project. In parallel to these amendments and additions to Article 5, the Commentary to this article was updated to incorporate the changes recommended by the final report on Action 7.

Moreover, the Commentary to Article 5 contains a number of changes that are intended to clarify the interpretation of the term PE and that are the result of two discussion drafts released by the OECD in 2011 and 2012. These amendments include, for example:

- The meaning of “at the disposal of” in paragraph 1 of Article 5, clarifying that this will depend on the enterprise having the effective power to use that location, as well as the extent of the presence of the enterprise at that location, and the activities that it performs there, providing examples in that respect.

- An individual home office PE, clarifying that even though part of the business of an enterprise may be carried on at an individual’s home office, that should not lead to the automatic conclusion that that location is at the disposal of that enterprise simply because that location is used by an individual (e.g., an employee) who works for the enterprise, and will depend on the facts and circumstances of each case, providing examples in that respect.

- Whether a farm can be a PE.

The Commentary to Article 5 notes that some of these changes were intended to clarify the interpretation of this article and, as such, should be taken into account for the purposes of the interpretation and application of tax treaties concluded before the 2017 update because they reflect the consensus of the OECD member countries as to the proper interpretation of existing provisions and their application to specific situations. Conversely, changes to the Commentary to Article 5 related to the addition of paragraphs 4.1 and 8, and the modification of paragraphs 4, 5 and 6 of the Article that were made as a result of the final report on BEPS Action 7, should be taken into account prospective only and, as such, do not affect the interpretation of the former provisions of the OECD MTC and of treaties.
Finally, the Commentary to Article 5 also notes that whether a PE exists in a State during a given period must be determined on the basis of the circumstances applicable during that period, and not the circumstances applicable during a past or future period.

**Article 25 (Mutual Agreement Procedure)**

The 2017 update contains changes to Article 25 and the related Commentary which are intended to make dispute mechanisms more effective in light of the work carried under the BEPS Action 14. The changes, therefore, reflect the other treaty-based recommendations contained in the final report on Action 14. Under the revised Article 25, a taxpayer is allowed to present a case for Mutual Agreement Procedure (MAP) to the competent authority agreement of either Contracting State, as opposed to the previous wording which only permitted that taxpayers present MAP cases to the competent authority of the State where the taxpayer is tax resident.

Paragraph 5 of Article 25 includes the essential conditions of the arbitration process. This paragraph is revised so that the two-year period, from which taxpayer can request that an unresolved issue is solved through arbitration, is now counted from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities. Moreover, it has now been added in paragraph 5 of Article 25 that the request had to be submitted to the competent authorities in writing.

The last sentence of paragraph 5 of Article 25 requires competent authorities to agree on the mode of application of the arbitration and, therefore, it can be expected that most of the procedural aspects of the arbitration process will be determined in an agreement between the competent authorities. The OECD MTC contains a sample mutual agreement on the implementation of paragraph 5 of Article 25. This sample has been revised in the 2017 update. Furthermore, the Commentary to Article 25(5) notes that Part VI of the MLI provides a good example of a convention that includes many of the procedural aspects of the arbitration process.

**Addition of a new Article 29 (Entitlement to Benefits)**

New Article 29 has been added to incorporate the minimum standard agreed to as part of the work on BEPS Action 6, to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements. The 2017 update notes that the provisions to be included in the article will depend on how the Contracting States decide to implement the minimum standard. For example, the minimum standard may be implemented through the adoption of paragraph 9 of Article 29 (relating to the principle purpose test (PPT)) only, through the adoption of the detailed version of paragraphs 1 to 7 of Article 29 (similar to the US-style Limitation on Benefits (LOB) provision) that is described in the Commentary on Article 29 together with the implementation of an anti-conduit mechanism as described in paragraph 187 of that Commentary, or through the adoption of paragraph 9 together with any variation of paragraphs 1 to 7 described in the Commentary to Article 29. Paragraphs 1 through 7 of Article 29 are bracketed within the MTC itself and the simplified and/or detailed versions of paragraphs 1 to 7 are set forth in the Commentary. Paragraph 8 of Article 29 is a specific anti-abuse provision with respect to so-called triangular cases where income attributable to a PE in a third State is subject to low taxation.

These provisions were included in the Action 6 final report and generally follow the same. However, in that report, the OECD acknowledged that the LOB and triangular provisions were in draft and would be reconsidered after the United States released the final 2016 US Model. Changes in the 2017 update generally follow the 2016 US Model.

**Limitation on benefits (Paragraphs 1-7)**

Paragraphs 1 through 7 set forth the LOB provisions, details of which are included in the Commentary rather than the MTC itself. Compared to the LOB provisions contained in the Action 6 final report, the 2017 update adds a headquarters company test and revises other provisions to more closely follow the LOB article contained in the 2016 US Model. Further, in some cases, the simplified and detailed versions of the paragraphs that were outlined in the Action 6 final report have been consolidated into one paragraph. As noted above, where the minimum standard is implemented through the LOB, the detailed version of paragraphs 1 to 7 must be utilized together with an anti-conduit mechanism as described in paragraph 187 of the Commentary.

The following provisions have been revised compared to the Action 6 final report:

**Qualified persons (Paragraph 2)**

Paragraph 2 defining “qualified persons” includes several changes. First, the simplified and detailed versions of subparagraph (b) relating to political subdivisions and
their agencies has been condensed into one paragraph and has been modified to include a reference to an agency or instrumentality of the Contracting State. This change follows the language of the 2016 US Model, and the OECD Commentary explains that an agency or instrumentality is an entity that exclusively performs functions of a governmental nature.

Second, the 2017 update makes structural changes to the publicly-traded companies test. In particular, subparagraph (c) includes simplified and detailed versions of the tests for publicly-traded companies while new subparagraph (d) includes a detailed version of the test for affiliates of publicly-traded companies. The separate test for affiliate companies is generally similar to the test in the 2016 US Model, and includes ownership and base erosion tests, as well as a requirement for intermediate owners in the case of indirect ownership. The associated Commentary has been updated to reflect these changes.

Third, a simplified version of subparagraph (d)/(e) relating to the non-profit organizations and recognized pension funds has been added. The Action 6 final report only contained a detailed version.

Fourth, the ownership/base erosion test of subparagraph (e)/(f) has a simplified and detailed version. The detailed version has been revised from the Action 6 final report and generally follows the ownership/base erosion test in the 2016 US Model. Specifically, the ownership prong requires an intermediate owner to be a “qualified intermediate owner” and the base erosion prong measures the gross income of a “tested group.” The definitions of “qualified intermediate owner” and “tested group” follow the 2016 US Model. The associated Commentary has been updated to reflect the changes.

Moreover, the detailed version of the Commentary has an alternate provision for States that want to deny benefits to persons who benefit from special tax regimes, and includes two examples illustrating the base erosion test.

The Commentary in the 2017 update has been updated to reflect the changes to the qualified person provisions set forth in paragraph 2 of Article 29.

The 2017 update combines the simplified and detailed versions of the active conduct of a business test outlined in the Action 6 final report into one version. Further, the new provision incorporates the active trade or business test from 2016 US Model. Similar to the 2016 US Model provision, the active conduct of a business test requires a factual connection between the actively conducted business in the residence country and the item of income for which benefits are sought. Specifically, the 2017 update requires that the treaty-benefitted income “emanate from or is incidental to” the business that is actively conducted by the resident in the residence state. The new provision also specifies four activities that do not qualify as an active conduct of a business:

- Operating as a holding company
- Providing overall supervision or administration of a group of companies
- Providing group financing (including cash pooling)
- Making or managing investments (unless carried on by a bank, insurance enterprise, or registered securities dealer in the ordinary course of business)

The Commentary in the 2017 update reflects the changes to the derivative benefit provisions, and includes examples illustrating how the provision applies.

Derivative benefits (Paragraph 4)

The 2017 update contains a simplified and a detailed version of the derivative benefits test. The simplified version of this test evaluates the owners of the entity seeking treaty benefits to determine whether the owners are considered to be equivalent beneficiaries. In contrast, the detailed version of the test has ownership and base erosion prongs, both of which must be met in order to qualify for treaty benefits. The test also requires that each intermediate owner meets certain requirements. In addition, the 2017 update provides alternative proposals of the detailed version of the derivative benefits test. The most comprehensive of the three alternatives follows the derivative benefits test in the 2016 US Model. The second alternative of the detailed version is less comprehensive and is applicable to States that do not consider that provisions on special tax regimes and notional deductions with respect to equity should be included in their treaties. The third alternative would only apply the derivative benefits test to dividend payments.

The Commentary in the 2017 update reflects the changes to the derivative benefit provisions, and includes examples illustrating how the provision applies.

Headquarters company (Paragraph 5)

The 2017 update adds a headquarters company test that was not in the Action 6 final report. This test would permit companies that serve as an active headquarters company of a multinational corporate group to receive treaty benefits in certain circumstances. The test generally follows the
headquarters company test in the 2016 US Model. Companies that wish to qualify for treaty benefits as a headquarters company must meet six requirements, and the associated Commentary describes each of these requirements.

Discretionary Relief (Paragraph 6)
The 2017 update revises the discretionary relief provision from the Action 6 final report by combining the simplified and detailed versions into one paragraph. In general, the provision gives competent authorities discretion to grant treaty benefits if the person requesting the benefit “demonstrates to the satisfaction of the competent authority” that one of the principal purposes of the establishment, acquisition, maintenance, or conduct of its operations was not to obtain treaty benefits. Additionally, the competent authorities must consult with each other before granting or denying treaty benefits.

Anti-abuse rule for PEs situated in third states (Paragraph 8)
Paragraph 8 sets forth the triangular PE rule. This rule was included in draft form in the Action 6 final report. The rule denies treaty benefits in cases where a State exempts the income of an enterprise of that State that is attributable to a PE situated in a third jurisdiction, and that PE was created solely because that third jurisdiction does not tax, or offers a preferential treatment, to that income. The triangular PE rule does not apply if:

- The income bears a significant level of tax in the State in which the PE is situated.
- The income emanates from, or is incidental to, the active conduct of a business through the PE.

Where a treaty benefit is denied, a resident of a State may request the competent authority of the other State to grant benefits. That competent authority has discretion to grant treaty benefit but must consult with the competent authority of the resident.

Principal purpose test (Paragraph 9)
Paragraph 9 sets forth the PPT rule. The rule is generally unchanged from the Action 6 final report, but the 2017 update includes three new non-collective investment vehicle (CIV) examples in the related Commentary. These examples were first released in a January 2017 public discussion draft and are generally unchanged from the discussion draft.

Changes related to Article 8 (International Shipping and Air Transport)
The 2017 update contains changes to the provisions dealing with the operation of ships and aircraft in international traffic and their employees, namely Articles 3 (general definitions), 6 (income from immovable property), 8 (international shipping and air transport), 13 (capital gains), 15 (income from employment) and 22 (taxation of capital) of the MTC. These changes are the result of the consultation process launched by the OECD on 15 November 2013, wherein the OECD invited all interested parties to comment on a discussion draft containing the proposed changes.

Under the revised definition of the term “international traffic,” international traffic means “any transport by a ship or aircraft, except when the ship or aircraft is operated solely between places in a Contracting State and the enterprise that operates the ship or aircraft is not an enterprise of that State.” The accompanying Commentary explains that the definition was amended to ensure that it also applies to a transport by a ship or aircraft operated by an enterprise of a third State. As a consequence of this amendment, the revised paragraph 3 of Article 15 would apply to a resident of a Contracting State who derives remuneration from employment exercised aboard a ship or aircraft operated by an enterprise of a third State.

Further, Article 8 of the MTC was amended so that the taxing right is no longer left to the Contracting State in which the PoEM of the enterprise is situated. Instead, the taxing rights are assigned to the State of the enterprise. The revised Commentary to Article 8 of the MTC notes that, based on a review of the treaty practices of OECD and non-OECD countries, the majority of these countries have as a practice the same approach as the amendment, i.e., States preferred to assign the taxing right to the State of the enterprise and not to the State where the PoEM of the enterprise is situated. However, the Commentary also acknowledges that some States may prefer to continue to use the previous formulation.

As a consequence of the revised Article 8 of the MTC, paragraph 2 of Article 6 was slightly revised to delete the reference to “boats” in the definition of “immovable property.” Although the Commentary to Article 6 remains unchanged, the above amendment does not effectively change the scope of the definition of immovable property because the term “boats” will still fall within the meaning of the word “ship,” which is intended to be given a wide
Lastly, there are a few other changes to the MTC. For example, paragraph 2 of Article 3 of the MTC is amended 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. The corresponding changes to the Commentary to Article 2 note that most States, however, do not consider that interest and penalties accessory to taxes covered by Article 2 are themselves included within the scope of Article 2 and, accordingly, would generally not treat such interest and penalties as payments to which all the provisions concerning the rights to tax of the State of source (or situs) or of the State of residence are applicable, including the limitations of the taxation by the State of source and the obligation for the State of residence to eliminate double taxation. Nevertheless, where taxation is withdrawn or reduced in accordance with a mutual agreement under Article 25, interest and administrative penalties accessory to such taxation should be withdrawn or reduced to the extent that they are directly connected to the taxation (i.e., a tax liability) that is relieved under the mutual agreement.

Other changes

The 2017 update contains other changes that are the result of the BEPS project. Among the changes, there is a revised title and preamble of the MTC clarifying 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. The revised title and preamble are products of the work under BEPS Action 6.

Furthermore, and also coming from work on BEPS Action 6, there are 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)(a) to certain CIVs that do not pay tax on their investment income. Moreover, the 2017 update also contains changes to the article on capital gains (Article 13(4)), which are as well the product of the work on BEPS Action 6. Changes to Article 13(4) address 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).

Changes for consultation

The 2017 update contains a number of changes that have not previously been released for comments (changes for consultation).

First, there are two changes for consultation relating to the tie-breaker rule for dual-resident individuals which aim at clarifying the application of such a rule. On one hand, the revised paragraph 13 of the Commentary on Article 4 addresses the issue of whether a house rented to an unrelated person can be considered to be a “permanent home available to” the landlord for purposes of the tie-breaker rule in Article 4(2)(a). On the other, the revised paragraphs 17 and 19, and the new paragraph 19.1, to the Commentary on Article 4 clarify the meaning of “habitual abode” in the tiebreaker rule in Article 4(2)(c). It is clarified that the test to determine whether an individual lives habitually in one of the two States but not in the other during a given period will not be satisfied by simply determining in which of the two Contracting States the individual has spent more days during that period. Instead, the habitual abode notion refers to the frequency, duration and regularity of stays that are part of the routine of an individual’s life and are therefore more than transient.
Although the Commentary to the OECD MTC is generally not considered binding on taxpayers and the judiciary of OECD member countries, it can be important in understanding tax treaties that follow the OECD Convention.

As noted above, the 2017 update reflects some, though not all, of provisions contained in the 2016 US Model. For example, some of the provisions within the LOB Article of the 2016 US Model are reflected in the 2017 update with some modifications. However, no US tax treaties currently reflect the new provisions contained in the 2016 US Model, and no technical explanation to that model has been issued. Nevertheless, the commentary to the MTC, which provides additional detail and some examples relating to the LOB provisions contained therein may be helpful in determining how those provisions might be applied.

The 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.

With respect to the changes for consultation, the OECD invites interested parties to submit comments by 10 August 2017.

Implications
The OECD MTC is the basis for many bilateral tax treaties. Furthermore, the OECD Convention and its Commentary influence the interpretation of tax treaties in many countries.

Second, there is a change for consultation relating to the addition of new paragraph 1.1 to the Commentary on Article 5 (PE) indicating that registration for the purposes of a Value Added Tax (VAT) or Goods and Services Tax (GST) is, by itself, irrelevant for the purposes of the application and interpretation of the PE definition in the MTC. Thus, when applying the definition of PE one should not, therefore, draw any inference from the treatment of a foreign enterprise for VAT/GST purposes.

Lastly, there is a change for consultation relating to the 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) of the MTC 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.

With respect to the changes for consultation, the OECD invites interested parties to submit comments by 10 August 2017.

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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

12. Ibid.

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EYG no. 04453-171Gbl
1508-1600216 NY
ED None

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