



27 January 2010
Canada

Mr Jeffrey Owens
Director, CTPA
OECD
2, rue André Pascal
75775 Paris
France

Dear Mr Owens,

Re: Taxand comments on the draft changes to the commentary on the OECD model tax convention dealing with the application of tax treaties to state owned entities, including Sovereign Wealth Funds

On 25 November 2009 the OECD Committee on Fiscal Affairs invited public comments on draft changes (the "Draft Changes") to the Commentary on the OECD Model Tax Convention dealing with the application of tax treaties to state-owned entities, including Sovereign Wealth Funds. Taxand is pleased to provide the following comments and observations on the Draft Changes.

General Comments

State-owned entities ("SOEs"), including sovereign wealth funds ("SWFs"), have attracted considerable economic, political and tax policy attention in recent times. One of the major difficulties when dealing with SOEs is the lack of a precise definition of what constitutes a SOE. However, the definition determines how SOEs will fare in any given country when it comes to taxation at source. SOEs may either enjoy full or partial tax exemption based on the principle of



sovereign immunity or they may benefit from the exempting provisions of a tax treaty.

In the tax treaty context, SOEs raise the usual three questions that underlie any discussion about treaty benefits, namely: (1) which entities should be eligible for treaty exemptions?; (2) what kinds of income should be exempt?; and (3) what kinds of exemptions should be available? It is submitted that the Commentary to the Convention should attempt to provide guidance on each of the three questions.

Specific Comments

1) Scope of Application of Convention Beyond Wholly-Owned SOEs

The Draft Changes centre on the first question, but mainly by stating the issues raised by SOEs within the existing framework of the Convention, such as for example, the issue of reconciling domestic sovereign immunity which renders an SOE tax exempt in its home jurisdiction and the definition of “resident of a Contracting State” in Article 4 of the Convention. It is understandable that, in light of the lack of consensus in individual countries and internationally on the appropriate tax treatment of SOEs, with tax neutrality and reciprocity of exemptions being just two of the issues, the Commentary to the Convention would lack a position on the normative scope of the application of the Convention. Nevertheless, in light of the substantial involvement of SOEs in economic activity and the complexity of some of the structures through which SOEs participate in economic activity, it may be desirable at least to reflect in the wording of the Commentary to the Convention that the Convention may apply to entities beyond “States, their subdivisions and their wholly-owned entities.”

The current version of the Draft Changes contemplates the case of SOEs (including SWFs) that are wholly-owned by the States, their political subdivisions or local authorities, statutory bodies or agencies or instrumentalities of States.

It is submitted that other forms of participation of States and their public authorities in economic



activity should probably also come within the scope of application of the Convention, such as for example where States and their public authorities act in conjunction with private entities, bodies or persons, through joint ventures, partnerships, common proprietorships, or other similar partly-owned vehicles, for the achievement of goals of a public interest.

The percentage of participation should not be relevant, neither should effective control or other circumstances affecting the configuration of such investment, as long as the characterization of the income is done on a proportional basis and the income is duly apportioned in order to benefit from the terms of the applicable tax treaty.

Where these vehicles are taxable persons under the tax legislation of either of the contracting States, the States should negotiate how to rule the potential application of tax credits or other benefits that could be available in the country of residence of the vehicle, and even their access to the benefits of the tax treaty.

In other instances effective control may matter. The only recognized connecting factor in the Convention and the Draft Changes between States and what are considered SOEs under the Convention is indeed only ownership. However, some States grant, pursuant to domestic tax legislation, exemptions to foreign governments by also applying control tests so that, for example, effective practical control (through, for example, a minority ownership stake coupled with creditor rights) would establish a sufficient nexus between the State and an entity and would bring the entity within the purview of the exempting legislation. The Draft Changes should at the very least be cognizant of this fact.

2) Other Types of Income

As was mentioned above, the Draft Changes mainly address the question of which entities should be eligible for treaty benefits. However, it would be beneficial to include Commentary dealing also with types of income of SOEs, beyond dividends and interest, such as capital gains or royalties,



that could qualify for treaty benefits. This would be in keeping with the economic reality and would also keep up with the treatment afforded to those other types of income by some of the States.

For real estate related income, the States could negotiate a reasonable and fair mutual solution in connection with potential sources of income such as rent or gains upon the transfer of such real estate, or even exclude them from the benefits otherwise applicable.

3) Off-Shore SWFs

The position taken in the Draft Changes on SWFs established off-shore is not entirely clear. Whereas paragraph 6.9 states that “[I]n many cases, these entities [for example, SWFs] are totally exempt from tax and the question may arise as to whether they are entitled to the benefits of the tax treaties concluded by the State in which they are set up.” This should be contrasted with the wording in paragraph 8.5, which states that “when a sovereign wealth fund is an integral part of the State, it will likely fall within the scope of the expression “[the] State and any political subdivision or local authority thereof” in Article 4.” [emphasis added in both paragraphs].

Paragraph 6.9 suggests that an off-shore SWF of a particular State would benefit from the treaty of the offshore jurisdiction, while paragraph 8.5 seems to say that the SWF would be considered to be resident in the State itself, provided that it was an “integral part” of the State. Another difficulty with paragraph 8.5 is that it does not clarify what constitutes an “integral part” of the State. Perhaps it would be helpful to adopt a definition that is similar to the definition of a “controlled entity” in US Code Sec. 892. US Code Sec 892 states that a “controlled entity” is defined as an entity that is separate in form from a foreign sovereign or otherwise constitutes a separate judicial entity, provided that it meets four additional criteria: (1) it is wholly owned and controlled by a foreign sovereign (directly or indirectly through one or more controlled entities); (2) it is organised under the laws of the foreign sovereign by which it is owned; (3) its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no part of its earnings inuring to the benefit of any private person); and (4) its assets vest in the foreign sovereign upon dissolution. The



US definition of “controlled entity” seems a better starting point for purposes of clarifying paragraph 8.5 than the definition of “integral part” of a foreign sovereign in US Code Sec. 892, which in itself is rather open ended.

4) Some Suggested Wording Changes

In light and in addition to our observations above, we wish to propose the following specific changes to the wording of the Draft Changes:

Paragraph 6.9

6.9. Issues may arise, however, in the case of entities set up and wholly-owned, ***directly or indirectly***, by a State or one of its political subdivisions or local authorities. Some of these entities may derive substantial income from other countries and it may therefore be important to determine whether tax treaties apply to them (this would be the case, for instance, of sovereign wealth funds: see paragraph 8.5 of the Commentary to Article 4). In many cases, these entities are totally exempt from tax and the question may arise as to whether they are entitled to the benefits of the tax treaties concluded by the State in which they are set up. In order to clarify the issue, some States modify the definition of “resident of a Contracting State” in paragraph 1 of Article 4 and include in that definition a “statutory body” or an “agency or instrumentality” of a State, a political subdivision or local authority ***or “anybody or entity performing a substantially similar role for, or on behalf of, a State, political subdivision or local authority thereof” that is exempt from domestic taxation under the laws of that State***, which would therefore cover wholly-owned entities that are not considered to be a part of the State or its political subdivisions or local authorities.

Paragraph 13.2

13.2. Similarly, some States refrain from levying tax on dividends paid to other States and some of their, ***directly or indirectly***, wholly-owned entities, at least to the extent that such dividends are



derived from activities of a governmental **and not an industrial or commercial nature**. Some States are able to grant such an exemption under their interpretation of the sovereign immunity principle (see paragraphs 6.10 and 6.12 of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law. States wishing to do so may confirm or clarify, in their bilateral conventions, the scope of these exemptions or grant such an exemption in cases where it would not otherwise be available. This may be done by adding to the Article an additional paragraph drafted along the following lines:

Notwithstanding the provisions of paragraph 2, dividends referred to in paragraph 1 shall be taxable only in the Contracting State of which the recipient is a resident if the **direct or indirect** beneficial owner of the dividends is that State or a political subdivision or local authority thereof.

Paragraph 7.4

7.4. Some States refrain from levying tax on income derived by other States and some of their wholly-owned entities (e.g. central bank), at least to the extent that such income is derived from activities of a governmental **and not an industrial or commercial nature**. Some States are able to grant such an exemption under their interpretation of the sovereign immunity principle (see paragraphs 6.10 and 6.12 of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law. In their bilateral conventions, many States wish to confirm or clarify the scope of these exemptions with respect to interest or to grant such an exemption in cases where it would not otherwise be available. States wishing to do so may therefore agree to include the following category of interest in a paragraph providing for exemption of certain interest income from taxation in the State of source:

“a) is, **directly or indirectly**, that State or the central bank, a political subdivision or local authority thereof.”



We appreciate this opportunity to provide comments and hope the above are of assistance in preparing the final version of the changes to the Commentary. We would be pleased to discuss this further and / or to participate in any future discussion on these matters. More information on how to contact us and about Taxand is provided as Appendix I. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate.

Kind regards,

Ash Gupta & Helena Plecko, Taxand Canada

Ramon Tejada & Carlos J. Rodriguez, Taxand Spain



APPENDIX I

CONTACT DETAILS

Ash Gupta

Taxand Canada

T. +1 416 369 7366

E. ash.gupta@gowlings.com

Helena Plecko

Taxand Canada

T. +1 604 891 2770

E. helena.plecko@gowlings.com

Ramon Tejada

Taxand Spain

T. +34 91 514 52 00

E. ramon.tejada@garrigues.com

Carlos J. Rodriguez

Taxand Spain

T. +34 93 253 37 00

E. carlos.j.rodriguez@garrigues.com

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