Active Business Test in the MLI’s LOB rule: The Second and Third Subtests

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Introduction

This is the second part of the input dealing with the MLI’s LOB rule. It focuses on the second and the third subtests under the MLI’s LOB rule, i.e. the concept of income emanating from or being incidental to the taxpayer’s active conduct of business in a State of residence and a State of source or income derived from a connected person, respectively. The first subtest – the active conduct of a business, was analysed in the previous input of the author. This part also provides the final conclusions and postulates *de lege ferenda* concerning the active business test in the MLI’s LOB rule.

Second Subtest: Income emanating from or being incidental to the taxpayer’s active conduct

of business in a State of residence

Once we know, at least to a certain extent, what the “active conduct of a business” is (see the first part of this input), let us assume that a taxpayer is engaged in such an activity in its State of residence. For instance, it could be a company carrying on substantial managerial and operational activities through its officers and/or employees, e.g. a typical manufacturing company.

The “active status” of this company is not enough to obtain treaty benefits. They may be obtained by the company only if an item of income derived by the company from the other Contracting State *emanates from* (Action 6 Report uses the term “in connection with”), or *is incidental to*, the company’s active conduct of business.[1]

The item by item approach requires the identification of the business to which an item of income is attributable where more than one business is conducted in the State of source and only one of the businesses generates an income emanating from or being incidental to the taxpayer’s active conduct of business in a State of residence. In such cases, each item of income emanating from or being incidental to a business conducted in the State of residence must be isolated from those that neither emanate from nor are incidental to that business. The former items of income are eligible for the treaty benefits while the latter are not. For instance, royalties would constitute a treaty benefited item of income to the extent that they are derived by a taxpayer from the business to which the underlying intangible property is attributable (e.g. manufacturing).[2] On the other hand, royalties derived from intellectual property unrelated to the taxpayer’s business are excluded from the scope of treaty benefited income.[3]

An income emanates from the company’s active conduct of business

An *income emanates from* a company’s active conduct of business, as explained in the Commentary,[4] if the income producing activity in the State of source is a line of business that *forms a part of* or is *complementary to* the business conducted in the State of residence by the company receiving that income.

The Commentary to the MLI’s LOB rule indicates that, generally, if the activities in both Contracting States are similar – for instance if the two activities (one in the residence and the second in the source State) involve the design, manufacture or sale of the same products or type of products; or if the both activities form different parts in the line of business (e.g. in the production or selling chain), then the business activity in the source State may be considered to *form part of* a business activity conducted in the resident State. The Commentary further explains that the line of business conducted in the residence State may be: (i) *upstream* to the activity in the source State by providing inputs for a manufacturing process that occurs in the source State; (ii) downstream to the activity in the source State by selling the output of manufacturing process that occurs in the source State; or (ii) *parallel* to the activity in the source State by selling the same sorts of products that are being sold by the business carried on in the source State.

In contrast to *forming part of* a business activity, for two activities to be *complementary*, they neither need to be similar nor relate to the same types of products or services. Instead they need to be a part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. This will be the case, for instance, if customers will be interested in purchasing products or services from the distinct businesses together.

An income which is incidental to the company's active conduct of business

The last category of an item of income which can benefit from a tax treaty is the income which is *incidental to* the company's active conduct of business. In that regard, the Commentary on the MLI's LOB rule says that an item of income derived from the source State is *incidental to* the business carried on in the residence State if production of the item facilitates the conduct of the business in the residence State. The Commentary gives an example of income derived from the temporary investment of working capital of a resident of one Contracting State.

An impact of the attribution rule: Parallel or complementary activities

The attribution rule means that activities conducted by connected persons to a taxpayer count as activities of the taxpayer who is receiving the income from the connected persons. This rule matters for determining whether an income emanates from or is incidental to the taxpayer's conduct of business. For example, active businesses conducted by subsidiaries wholly owned by their parent, a purely holding company, will be attributed to the parent and the parent company will be considered to be conducting active business, irrespective of its status purely as a holding company. Likewise, the income of the parent company may be considered to emanate from or be incidental to the parent's active conduct of business in a State of residence even though the parent does not carry out such business by itself. Therefore the attribution rule may allow holding companies with a minimal economic substance or business purpose to obtain treaty benefits needs.

In line with the attribution rule, the concepts of *parallel* or *complementary* activities allow one to assume that the business of one taxpayer in certain situations may constitute the business of another. Such activities, however, do not objectively generate the income that emanates from or is incidental to the taxpayer's active conduct of a business. This may be the case, however, if the activities are part of the same value chain, and are mediated, for example, through an upstream or downstream connection of activities between a taxpayer who derives the income and other taxpayers who pay that income to the first taxpayer.

It would therefore be wise to limit the scope of the concept of income emanating from or being incidental to the taxpayer's active conduct of a business to upstream and downstream connections with other taxpayers (the connected persons). If this is not done, the purpose of the active business test and the whole LOB rule will be in jeopardy.

Third subtest: Income emanating from or being incidental to the taxpayer's active conduct of business in a State of source or income derived from a connected person

The third subtest consists of an additional requirement which must be met in the two following situations: (i) a taxpayer is engaged in a business in the other State (typically via a foreign branch which may or may not constitute the taxpayer's permanent establishment), and from such activity the taxpayer receives an item of income; or (ii) that taxpayer receives an item of income from the other State through a "connected person". In either situation, it is not enough to pass the first and the second subtest to obtain treaty benefits in relation to the items of income received by the taxpayer. To this end, the business activity carried on by the taxpayer in its residence State to which the item is related (from which it emanates or is incidental to such activity) must be *substantial* in relation to the same activity or a complementary business activity carried on by the taxpayer or its connected person in the other State (Article 7(1) b) of the MLI). It must be based on all the facts and circumstances (Article 7(1) b) of the MLI *in fine*) and must be made separately for each item of income derived from the source State by the taxpayer, as under the second subtest.

Accordingly, the third subtest is a classic comparative test under which the following comparators should be taken into account: the comparative sizes of the businesses in each Contracting State, the nature of the activities performed in each Contracting State, and the relative contributions made to that business in each Contracting State. The OECD further explains that generally in making each determination or comparison, due regard must be given to the relative sizes of the economies and the markets in the two Contracting States.[5] Such approach is justified by the fact that what from an absolute perspective may seem to be a small business activity, may be substantial from the relative perspective of small economy.[6]

In the OECD's view, the third subtest focuses only on potential abusive activities, and does not hamper non-abusive activities, even though the taxpayers receiving the income in a Contracting State may be very small in relation to the entity generating the income in the other Contracting State.[7] This, at first glance, would seem to be the correct approach insofar as the third subtest is supposed to prevent a third country's resident from obtaining treaty benefits by interposing a company in a Contracting State and attributing merely insignificant business activities to that company. Under an in-depth examination, however, the OECD's approach seems far too generous.

This is because, first, the subtest requires an activity in the residence State to be substantial in comparison to the same or complementary activity in the source State. The income generated by these activities do not need to be compared. This presupposes that an intermediary with substantial activity, regardless of the amount of income received by it, would not be used for abusive treaty shopping practices. This assumption, however, overlooks the attribution rule pursuant to which activities of connected persons are to be considered to be the activities of the intermediary. Under that rule, the intermediary does not need to carry on a substantial business activity to be considered as doing so. It is enough that the activities are carried on by the subsidiaries (=connected persons) of the intermediary. As a result, the third subtest allows treaty benefits to be awarded to an intermediary that does not in fact carry out a substantial activity in its residence State (=the lack of a sufficient nexus) but nevertheless receives a significant income which may further be paid to its parent in the form of tax deductible expenses (=the significant potential for base erosion).

Second, the comparison suggested by the OECD under the Action 6 Report is indirect, since it takes into account the activity conducted and the size of the market of each Contracting State separately. A direct comparison, in turn, would require it to take into consideration the business activity in the residence State in relation to the business activity in the source State. The indirect comparison may lead to an outcome similar to that from an application of the concepts of *parallel* or *complementary* activities – it will not focus on activities generating income that objectively emanates from or is incidental to the active conduct of a business. The direct comparison, on the contrary, could lead to an outcome similar to that of an application of the concepts of upstream or downstream connection of activities – it will cover activities in the same value chain, hence generating income which objectively emanates from or is incidental to the active conduct of a business. The indirect comparison is therefore detrimental to the purpose of the active business test and the MLI's LOB rule per se. It would make sense to replace it with the direct comparison approach.

Third, substantiality as a comparative measurement is so vague as to be not only unsuitable for preventing treaty abusive practices but it also has an overkilling potential, for example in situations in which a company engaged in the active conduct of a business is acquired by an unrelated, much larger company of a third country. As a result of such a merger, the acquired company may no longer be considered to be conducting a substantial activity relative to the activity conducted in the source State by that company or its connected person.

To rectify this anomaly, the substantiality comparison could be explained more precisely than by the current Commentary on the MLI's LOB rule. Reference could be made, for example, to quantitative facts and data, such as the relative value of assets, gross income, or payroll expenditure, along with the qualitative circumstances of the business activity in each Contracting State, such as operational risks managed through functions performed and relevance of activities. The Memorandum of Understanding regarding the US–Netherlands Income Tax Treaty (1992)[8] is illustrative in this regard. An explicit and precise explanation of what *substantial business activity* means could be added to the wording of the active business test under Article 7(10) of the MLI.

Fourth, and in relation to tax treaties with European Union (EU) Member States, a definition of the "active conduct of a business" could be replaced with the definition of "genuine business activity" as understood under the EU law.[9] The active business test would thereby grant treaty benefits to a taxpayer (e.g. a resident company) who is genuinely exercising a fundamental freedom (e.g. freedom of establishment and/or free movement of capital). This seems to be the best way to ensure compatibility of the MLI's LOB rule with EU law[10] which at present is somewhat questionable.[11]

Finally, one could consider applying the active business test together with the base erosion test. In the case of the active business test, however, it would be superfluous to apply the base erosion test as well to prevent abusive treaty shopping because an entity with a sufficient economic nexus (economic substance and business purpose) with its State of residence is very unlikely to be used for abusive purposes. This is why the addition of the base erosion test to the active business test is not advocated by this author.

Conclusions and postulates *de lege ferenda*

The analysis shows that it is relatively easy for taxpayers engaged in abusive treaty shopping practices to get round the active business test because of its use of the concepts of parallel or complementary activities. Hence, it is commendable to amend the active business test, especially that this test, once properly drafted, would seem to be one of the most important tests for dealing with treaty shopping in an efficient manner and for achieving the ultimate purpose of the tax treaties. Indeed, the aim of the proposal below is to draw attention to economic substance and/or business purpose. This allows to bring the LOB rule closer to the concept of artificiality reflecting the modern view of the abuse of law, including domestic tax law, tax treaties and EU law.[12] The structure and wording of the active business test is as follows.

Article 1(1): A resident of a Contracting State is a qualified person only if such a person, at the time at which the benefit may be granted, is either: a) an individual; b) a Contracting State, or political subdivision or local authority thereof, or a person that is wholly-owned by such State, political subdivision or local authority; c) a pension fund; d) a charitable organisation; e) a person, other than an individual, if

- is engaged in the active conduct of a business in the Contracting State of which it is a resident (other than making or managing investments for the person's own account, unless these activities are banking or insurance carried on by a bank or an insurance company);
- The determination of the term "active conduct of a business" shall be based on the factors agreed by the Contracting States as set forth in the Memorandum of Understanding. In any case, the term "active conduct of a business" shall stem from the treaty autonomous definition of the term "business". For residents of Member States of the European Union, the term "active conduct of a business" shall be identified with the term "genuine economic activity", as understood under European Union law.

The proposal aims to facilitate the achievement of the ultimate purpose of tax treaties, and although it is only illustrative, countries and jurisdictions might use it as a guide to the wording and structure of tax treaties under (re-)negotiation under specific bilateral dynamics.

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[1] See Article 7(10) a) of the MLI.

[2] See OECD 2015 n. 3, paragraph 51 of the Commentary on the MLI's LOB rule at p. 39. For instance, if, under Example 5 in the Action 6 Report (p. 39), GCO or HCO were to pay royalties to ECO, such royalties could be considered as emanating from the business of ECO and hence benefiting from the tax treaties concluded between ECO's residence State and GCO's residence State/HCO's residence State.

[3] See G. S. Cooper, *Tax Treaty Policy of Developing Countries post-BEPS*, 4

School of Accountancy Research Paper Series, p. 19 (Paper No: 2016-S-45, 2016), p. 13.

[4] The Commentary uses the term “income is derived *in connection with*”. This term is used interchangeably with the term “income emanating from” for the purpose of the current analysis.

[5] See OECD 2015 n. 3, paragraph 54 *in fine* of the Commentary on the MLI’s LOB rule at p. 40.

[6] See Rust 2015 n. 9, marg. n. 86 and 88 at p. 138; J. Bates et al., *LOB Articles in Income Tax Treaties: The Current State of Play*, 41 Intertax 6/7, 2013, p. 399.

[7] See OECD 2015 n. 3, paragraph 56 of the Commentary on the MLI’s LOB rule at p. 41.

[8] *Convention Between the Kingdom of the Netherlands and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (18 Dec. 1992), Treaties IBFD.

[9] See, for instance, the CJEU judgments in the following cases: *Cadbury Schweppes*, C-196/04, paragraphs 64-68; *Eurofood*, C-341/04, paragraphs 35-36; *Factortame*, C-221/89, paragraph 34. See also the European Free Trade Association (EFTA) Court’s judgement in the *Olsen* case, E-3/13 and E-20/13, paragraphs 95-97.

[10] See P. Baker, *The BEPS Action Plan in the Light of EU Law: Treaty Abuse*, British Tax Review 4, 2015, pp. 412-413 in relation to the derivative benefits test.

[11] See F. Debelva, D. Scornos, J. van den Berguen and P. van Braband, *LOB Clauses and EU-Law Compatibility: A Debate Revived by BEPS?*, 24 EC Tax Review 3, 2015, pp. 132 et seq.; Guerra 2011 n. 19, pp. 85 et seq.; G. Kofler, *European Taxation Under an ‘Open Sky’: LOB Clauses in Tax Treaties Between the U.S. and EU Member States*, Tax Notes International 2004, 5 July, pp. 45 et seq.

[12] Cf. B. Moreno, *GAARs and Treaties: From the Guiding Principle to the Principal Purpose Test. What Have We Gained from BEPS Action 6?*, 45 Intertax 6/7, 2017, p. 440; W. Schön, *Legalität, Gestaltungsfreiheit und Belastungsgleichheit als Grundlage des Steuerrechts*, in *Gestaltungsfreiheit und Gestaltungsmissbrauch im Steuerrecht*, R. Hüttermann (ed.), Köln: O. Schmidt, 2010, pp. 59–61.

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