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Mélanie Massant

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THE RELEVANCE AND ROLE OF ECONOMIC SUBSTANCE UNDER THE FIRST TEST OF THE PPT

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Table of Contents

Abstract

The aim of this paper is to determine the relevance and role of economic substance of an interposed company in a treaty shopping situation, for purposes of the first of two tests foreseen by the Principal Purpose Test (article 29(9) OECD Model). Economic substance refers to the objective factors (e.g. employees, personnel, functions and risks) that indicate that a company carries out economic activities.

Introduction

In 2013, the OECD and G20 came up with a comprehensive action plan containing 15 different Actions to combat base erosion and profit shifting ('BEPS'). According to the OECD, treaty abuse, and in particular treaty shopping, is one of the most important sources of BEPS concerns.

BEPS Action 6, titled 'Preventing the granting of treaty benefits in inappropriate circumstances' describes the work to be done in this area. At a minimum, countries should agree to include in the preamble of their tax treaty the express statement that their common intention is to eliminate double taxation "without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements".

To implement such common intention, the Contracting States could choose to include in their tax treaty either (i) a stand-alone Principal Purpose Test ('PPT'), (ii) a PPT in combination with an Limitation on Benefits ('LOB') rule or (iii) an LOB-rule, supplemented by anti-conduit rules. Most States chose to include a stand-alone PPT in their tax treaty[2].

The PPT foresees that a tax treaty benefit shall not be granted if the following two tests are cumulatively fulfilled:

It is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that tax treaty benefit was one of the principal purposes of the arrangement or transaction; and

Granting that benefit in these circumstances would contradict the object and purpose of the relevant treaty provisions.

The PPT is rather vague and therefore many questions arise as to its correct interpretation and application. This paper addresses one such question: **what is the relevance and role of the economic substance of an interposed company in a treaty shopping situation for purposes of applying the PPT?**

2 Only 13 jurisdictions have chosen the option to implement the PPT together with an LOB-rule and an additional 7 jurisdiction have agreed to implement an LOB in cases where their treaty partner has chosen to adopt that measure. See OECD/G20 BEPS Project, Prevention of tax treaty abuse – Sixth peer review report on treaty shopping, 20 March 2024.

Although this question applies to both tests of the PPT, this paper only addresses the first test. Not because the second test is less important, but to ensure a thorough analysis of the first test within the constraints of a single paper. The absence of an analysis of the second test in this paper does, however, not restrict the analysis of the first test, given that both tests require a separate and independent analysis.[3]

In academic literature, this first test is often referred to as the 'subjective test', whereas the second test is often referred to as the 'objective test'.[4] Since this is rather confusing, especially since it gives the false impression that the first test is based on the subjective intentions of the parties involved, this paper will simply refer to the 'first test' of the PPT.

The paper is structured as follows: to better understand the research question, section 2 will explain what is meant by treaty shopping and economic substance. Section 3 then gives an overview of the academic literature regarding the relevance and role of economic substance, which shows that there is no consensus on this topic. Section 4 is the core of the paper and analysis in detail the first test, with the aim of determining the relevance and role of economic substance of a company that is used in a treaty shopping situation, thereby relying on the interpretation method provided by art. 31 of the Vienna Convention. Section 5 provides a conclusion.

It must be noted that there are some limitations to this paper. First of all, this paper does not aim to determine what *should* be the relevance and role of the economic substance of a company for purposes of the first test of the PPT, but merely what *is* the relevance and role as intended by the OECD. Even though the PPT as it stands today might be flawed on some points, this paper does not aim to provide recommendations to remedy these flaws. The analysis in this paper relies on the PPT as it stands today. Secondly, this paper does not aim to determine when a company is considered to have sufficient economic substance. Both aspects deserve a separate and in-depth analysis.

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3 The following authors also agree that both test require a separate analysis: W Schön, 'The Role of "Commercial Reasons" and "Economic Reality" in the "Principle Purpose Test" under Art.29(9) OECD Model Tax Convention 2017' (2022) 3 Max Planck Institute for tax law and public finance, Working Paper 1, p.6; G. Maisto, D. Gutmann, A. Jimenez and R. Danon, "The Prohibition of Abuse of Rights After the ECJ Danish Cases", 49 *Intertax* 6/7 (2021), p. 501. Other authors, however, favor a holistic approach: e.g. M. Lang, "BEPS Action 6: Introduction an anti-abuse rule in tax treaties", 74 *Tax Notes International* 7 (2019), p. 11; B. Kuzniacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application", 10 *World Tax Journal* (2018), p. 249.

4 See for instance: R. Danon, "The PPT in Post-BEPS Tax Treaty Law: It Is a GAAR but Just a GAAR!", 74 *Bulletin for international taxation* 4/5 (2020); A. Mithe, "Critical Analysis of the Principal Purpose Test and the Limitation on Benefits Rule: A World Divided but It Takes Two to Tango", 129 *World Tax Journal* 1 (2020); V. Chand, "The Principal Purpose test in the Multilateral Convention: an in-depth analysis", 46 *Intertax* 1 (2018).

Some terminology explained

To understand the research question of this paper, the term economic substance and treaty shopping first need to be explained.

Economic substance is an undefined term that is used in varying contexts and with varying descriptions. In this paper, the term is used to refer to the objective factors that indicate that a company carries out economic activities. Such objective factors include the companies employees, premises, assets, functions and risks. Also several other legal scholars use the term economic substance to refer to such objective factors.[5]

It is important not to confuse the term economic substance, as used in this article, with the *economic substance doctrine* known in the US[6] and other substance-over-form doctrines known in many countries.[7] These doctrines rely on the economic substance *of an arrangement*, and do not necessarily take into account the economic substance *of a company* (i.e. its employees, premises, assets, functions and risks). In general, arrangements are said to lack economic substance[8] when they are artificial (or non-genuine or abusive) and when they lack valid (or bona fide, genuine, sound, commercial, economic, business) reasons (or motives, purposes, objectives). The many vague terms used to describe when an arrangement lacks economic substance indicates that this is not an easy analysis. The economic substance of an arrangement is however not discussed in this paper.

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5 S. Kostikidis, *Residence and economic substance of subsidiary corporations in international and European tax law - Series on International Taxation*, (Kluwer Law International 2024); P. Pistone, J. Nogueira, A. Turina, and I. Lazarov, Abuse through the use of shell companies and arrangements for tax purposes in the European Union: Feedback on the EU consultation by the IBFD Task Force on EU law, 4 International Tax Studies 7, (2021); R. Danon, T*he PPT in Post-BEPS tax treaty law: it is a GAAR but just a GAAR!*, 74 Bull. Intl. Tax 4/5, (2020), Journals IBFD; O., Koriak, *The Principal Purpose Test under BEPS Action 6: Is the OECD proposal compliant with Eu law?*, 56 Eur. Taxn. 12, (2016), IBFD Journals; D. Weber, *The new common minimum anti-abuse rule in the EU Parent-Subsidiary directive: background, impact, applicability, purpose and effect*, 44 *Intertax* 2 (2016).

6 The economic substance doctrine was codified in the US IRC in section 7701(o) in 2010.

7 See the IFA Reports 103a on Seeking anti-avoidance measures of general nature and scope – GAAR and other rules (2018). See, in particular the reports on Austria, Chile, Fina

8 Also referred to as 'commercial substance' or merely 'substance'.

Treaty shopping is also an undefined term. According to the OECD, treaty shopping generally refers to situations where a person who is not a resident of a Contracting State, i.e. a third-state resident, seeks to indirectly obtain benefits from a tax treaty to which it has no access due to its status as a non-resident of either Contracting State, often through complex structures and arrangements, for instance by establishing a letterbox company (also referred to as shell company or conduit company), which has no or minimal substance or activities, and those benefits were not intended to be granted to such non-resident company.[9] Worded differently, treaty shopping generally describes the situation where a third-state resident *'shops into'* a treaty between two Contracting States to which it does not have access because it is not a resident of either state, often (but not always) by establishing an intermediary company.

This general understanding of treaty shopping provided by the OECD is however very vague and merely an attempt by the OECD to describe what is 'generally referred to' as treaty shopping. Also other arrangements which do not comply with all the key characteristics as described above, can be considered treaty shopping by the OECD. For instance, where a third-state resident does not 'establish' an intermediary company, but 'uses' an existing, related or unrelated, company as an intermediary company to obtain the benefits of a treaty to which it does not have access. That these arrangements also fall under the term treaty shopping according to the OECD can be derived from the PPT Examples, where the OECD refers to two such arrangements as 'treaty shopping arrangements'.[10]

Important to note is that not every treaty shopping arrangement is abusive. The distinction between *accepted* treaty shopping arrangements and *abusive* treaty shopping arrangements, is made by the PPT.[11] Only if a treaty shopping arrangement fulfils both tests of the PPT, can the arrangement be considered abusive.

9 Question 30 of the FAQ on the MLI provided by the OECD, available at https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/beps-mli/mli-frequently-asked-questions.pdf.; site of the OECD on "preventing tax treaty abuse": https://www.oecd.org/en/topics/sub-issues/preventing-tax-treaty-abuse.html; see also L. De Broe, *International Tax Planning & Prevention of Abuse under Domestic Tax Law, Tax Treaties & EC-Law* (IBFD Doctoral series 2008), p. 1–10.

10 See Example A and B in the OECD Commentaries on art. 29(9), para. 182, where the taxpayer used an existing, unrelated, entity for treaty shopping purposes;

11 Or by an LOB-provision, depending on how the jurisdiction decided to implement the minimum standard of BEPS Action 6.

Academic literature on the relevance and role of economic substance

This section provides an overview of the academic literature regarding the relevance and role of the economic substance of a company used in a treaty shopping situation for purposes of the PPT in general and for purposes of the first test of the PPT specifically.

It is important to keep in mind that, for purposes of this paper, economic substance refers to the economic substance of a company, i.e. the the objective factors (e.g. employees, personnel, functions and risks) that indicate that a company carries out economic activities. It is however not always clear whether an author, who argues for or against the economic substance for purposes of the analysis of the PPT, applies a similar understanding of economic substance. Some authors, for instance, when referring to the relevance of economic substance, are actually referring to the economic substance of an arrangement rather than the economic substance of a company.[12] Furthermore, when an author refers to the economic substance of an arrangement, it is not clear whether they also consider the economic substance of a company relevant. It is therefore not always straightforward to determine the authors' views on the relevance and role of economic substance *of a company*.

In what follows, a distinction is made between the 'relevance' of economic substance and the 'role' thereof. The *relevance* of economic substance concerns the question whether or not the economic substance of a company has to be taken into account when applying (the first test of) the PPT. If it is determined that economic substance is relevant, it must be determined what the consequences are for the analysis of the (first test of the) PPT. This concerns the question of the *role* of economic substance. To answer this question, a distinction should be made between the 'presence' of economic substance and the 'absence' thereof.

12 Arrangements that are said to lack economic substance, are referred to as artificial/ non-genuine/abusive arrangements that lack valid/bona fide/ genuine/ sound, commercial/economic/business reasons/motives/purposes/objectives.

Relevance

There is no consensus in the academic literature regarding the relevance of the economic substance of a company used in a treaty shopping situation for the analysis of the PPT.

Some authors argue that it is *irrelevant*.[13] These authors rely on the literal wording of the PPT, which does not include an explicit or implicit reference to economic substance.14 Other authors argue that it ís relevant.[15] To support this view, many authors refer to the PPT Examples as well as para. 181 of the OECD Commentaries on art. 29(9), which states that it is unlikely that obtaining a tax treaty benefit was one of the principal purposes of an arrangement "where an arrangement is inextricably linked to a core commercial activity".

Among the authors that consider that the economic substance of a company is relevant for the analysis of the PPT, a distinction can be made between the authors that consider the economic substance relevant for the analysis of the first test only[16], the authors that consider it relevant for the second test only[17], and the authors that consider it relevant for both tests[18].

Among the authors that consider the economic substance of a company relevant for the first test, it is not clear whether they consider it relevant for all

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13 See W. Schön, "The Role of 'Commercial Reasons' and 'Economic Reality' in the 'Principle Purpose Test' under Art.29(9) OECD Model Tax Convention 2017", 3 Max Planck Institute Working Paper (2022), p. 2; G. Maisto, "Chapter 25: Counteracting Tax Treaty Abuses from a European Perspective: Frictions and Interactions between the OECD PPT and the ATAD GAAR" in G. Köfler, A. Rust and G. Mason (eds), *Thinker, teacher, traveler: reimagining international tax - essays in honor of H. David Rosenbloom* (2021), p. 353.

14 To support this position, several of these authors refer to the contradiction with the wording of the ATAD GAAR which implicitly refers to the economic substance of a company: The ATAD GAAR applies to arrangements that are "put into place for valid commercial reasons which reflect economic reality". See Art. 6 of the Council Directive 2016/1164 of 12 July 2016, Laying Down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, OJ L 193

15 See R. Danon, "The PPT in Post-BEPS Tax Treaty Law: It Is a GAAR but Just a GAAR!", 74 *Bulletin for international taxation* 4/5 (2020), p.257; S. Baerentzen, "Danish Cases on the Use of Holding Companies for Cross-Border Dividends and Interest – A New Test to Disentangle Abuse from Real Economic Activity?", 12 World Tax Journal 3 (2020), p. 37; S. Van Weeghel, "A Deconstruction of the Principal Purposes Test", 11 World Tax Journal (2019), sec. 9; R. Danon, "Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups", 72 *Bulletin for International Taxation* (2018), p. 50; D. Duff, "Tax Treaty Abuse and the Principal Purpose Test - Part II", 66 *Canadian tax journal* (2018), p. 983; B. Kuzniacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application", 10 *World Tax Journal* (2018), p. 257; V. Chand, "The Principal Purpose Test in the Multilateral Convention: An in-Depth Analysis" 46 *Intertax* 1 (2018), p. 32-34

16 E.g. R. Danon, "The PPT in Post-BEPS Tax Treaty Law: It Is a GAAR but Just a GAAR!", 74 *Bulletin for international taxation* 4/5 (2020), p.257.

17 E.g. S. Van Weeghel, "A Deconstruction of the Principal Purposes Test", 11 *World Tax Journal* (2019), sec. 9.

18 E.g. B. Kuzniacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application", 10 *World Tax Journal* (2018).

cases that are analysed under the PPT or only for particular ones, and if so what the distinguishing factor is.[19] Furthermore, a distinction can be made between the authors that consider only the 'presence' of economic substance to be relevant, and those that consider the only the 'absence' thereof to be relevant for the analysis of the first test. Sometimes both are considered relevant and sometimes it is not clear.

There are thus many differing views on whether or not the economic substance of a company that is used in a treaty shopping situation, is relevant for purposes of the analysis of the first test of the PPT.

Role

There is also no consensus regarding the *role* of economic substance, i.e. what it means for the analysis of the first test if a company does or does not have economic substance. Among the authors that consider the 'absence' of economic substance relevant, most of them argue that the absence of economic substance indicates that obtaining a tax treaty benefit was one of the principal purposes.[20] Some authors, however, take it a step further and argue that the absence of economic substance automatically leads to the fulfilment of the first test.[21] A potential consequence of such view is that passive holding companies, which lack economic substance, are automatically considered to have been set up for purposes of obtaining tax treaty benefits.[22] This, in essence, adds an additional substance requirement to the first test, which cannot be derived from the PPT's wording. Among the authors that consider the 'presence' of economic substance relevant, most of them argue that it is a possible proxy to exclude the fulfilment of the first test or 'one of the key

19 Among the authors that consider the economic substance of a company relevant for the analysis of the first test, some seem to argue that the economic substance becomes irrelevant when there are economic purposes. See G. Maisto, D. Gutmann, A. Jimenez and R. Danon, "The Prohibition of Abuse of Rights After the ECJ Danish Cases", 49 *Intertax* 6/7 (2021), p.495.

20 O. Marres and I. de Groot, 'De Algemene Antimisbruikbepaling in de Moeder-Dochterrichtlijn (Deel 2)", 7107 WFR (2015), p. 911.

21 C De Pietro, 'Tax Abuse and Legal Pluralism: Towards Concrete Solutions Leading to Coordination Between International Tax Treaty Law and EU Tax Law' (2020) 29 EC Tax Review 84, 90.

22 E. Palmitessa, "Interplay Between the Principal Purpose Test in the Multilateral BEPS Convention and the Beneficial Ownership Clause as Treaty Anti-Avoidance Tool Targeting Holding Structures," 46 *Intertax* 1 (2018),p. 66.

elements' allowing the taxpayer to demonstrate that the first test is not fulfilled.[23] However, there are also authors here that take it a step further and argue that the presence of economic substance automatically leads to the non-fulfilment of the first test. R. Danon, for instance, states that 'treaty benefits should not be denied *as soon* as an arrangement or a transaction is inextricably linked to a core commercial activity' [own emphasis].[24] R. Danon thus seems to believe that the existence of a core commercial activity, which is evidenced by the presence of economic substance, should *a priori* exclude the fulfilment of the first test.[25] This view, however, does not take into account that treaty shopping can also be achieved by using an existing, related or unrelated, company, which has economic substance.

The above shows that there are many different views on the relevance and role of economic substance in the academic literature. This paper aims to determine what the OECD intended the relevance and role of economic substance to be, thereby relying on the interpretation method as provided by art. 31 of the Vienna Convention (see sec. 4.1).

23 R. Danon, "Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups", 72 Bulletin for international taxation 1 (2018), p.48; R. Danon, "The PPT in Post-BEPS Tax Treaty Law: It Is a GAAR but Just a GAAR!", 74 Bulletin for international taxation 4/5 (2020), p.257; See G. Maisto, D. Gutmann, A. Jimenez and R. Danon, "The Prohibition of Abuse of Rights After the ECJ Danish Cases", 49 Intertax 6/7 (2021), p.495; D. Duff, "Tax Treaty abuse and the Principal Purpose Test - Part II", 66 Canadian Tax Journal (2018), p.983; B. Kuzniacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application", 10 *World Tax Journal* (2018), p.271; O. Marres and I. de Groot, 'De Algemene Antimisbruikbepaling in de Moeder-Dochterrichtlijn (Deel 2)", 7107 WFR (2015), p. 911; D. Weber, "The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law", 10 *Erasmus Law Review* 1 (2017), p. 108–109.

24 R. Danon, "Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups", 72 *Bulletin for international taxation* 1 (2018), p. 50.

25 W. Schön, "The Role of 'Commercial Reasons' and 'Economic Reality' in the 'Principle Purpose Test' under Art.29(9) OECD Model Tax Convention 2017", 3 Max Planck Institute Working Paper (2022), p. 3.

Analysis of the first test of the PPT

This section analyses in detail how the first test of the PPT works, given that the relevance and role of economic substance can only be determined if it is clear how the first test must be applied. This section starts off by clarifying which method of interpretation is used to determine the application of the PPT.

Interpretation of the PPT

For the first test of the PPT to be fulfilled, it must be reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining a tax treaty benefit was one of the principal purposes of the arrangement or transaction that resulted directly or indirectly in that benefit".

This test contains many undefined terms, such as 'principal'. According to art. 3(2) of the OECD Model Convention, an undefined treaty term should have the meaning that it has under the law of the state applying the treaty (i.e. domestic law), unless the context requires otherwise. There is however no consensus in the legal literature on how art. 3(2) should be read. More specifically there is no consensus on the importance of domestic law for the interpretation of undefined treaty terms. On the one hand, some authors, among which Avery-Jones[26], argue that art. 3(2) prescribes that reference should, in first instance, be made to the domestic law of the source state to interpret undefined treaty terms. On the other hand, other authors, among which Lang[27], argue that reference to domestic law

26 J. Avery- Jones, *A fresh look at article 3(2) of the OECD Model,* 74 Bull. Intl. Taxn. 11 (2020), IBFD Journals; J. Avery-Jones, *Treaty Interpretation – Global Tax Treaty Commentaries*, sec. 4.8 (2021), IBFD Commentaries.

27 M. Lang, *Tax treaty interpretation: a response to John Avery Jones*, 74 Bull. Intl. Taxn. 11 (2020), Journals IBFD.

should only be used exceptionally, as a last resort.[28] The latter authors argue that undefined treaty terms require an *autonomous international treaty meaning.* Only if an autonomous international treaty meaning cannot be determined, may reference be made to domestic law. To come to such an *autonomous international meaning*, the interpretation method as provided by articles 31 of the Vienna Convention shall be followed. Art. 31 of the Vienna Convention prescribes that a treaty term shall be interpreted in good faith in accordance with the ordinary meaning to be given to the treaty term in their context and in light of the object and purpose of the tax treaty.

There are several arguments to be made for why the undefined terms used in the PPT require an interpretation based on articles 31 of the Vienna Convention to come to an *autonomous international meaning*, rather than an interpretation that starts by looking at domestic law of the state applying the PPT.

First of all, it seems that the OECD intended the PPT terms to have an *autonomous international meaning*, rather than a meaning based on domestic law.[29] This can be derived from several factors. First of all, the exact same wording was meant to be implemented in the more than 2.000 tax treaties that choose to implement the PPT. Furthermore, the OECD explicitly confirms the desire for an interpretation based on article 31 of the Vienna Convention in the Explanatory Statement to the MLI.[30] In addition, the PPT, that has been implemented in the more than 2.000 tax treaties, finds its origin in the same document (i.e. BEPS Action Plan 6) which contains Commentaries to help clarify the application of the PPT. Secondly, only an autonomous international meaning of the PPT terms, with very limited or no reliance on domestic law, will lead to an understanding of the PPT terms that applies equally in all contracting states, irrespective of their legal systems

28 This is also widely accepted by domestic courts. See for instance CH: Federal Supreme Court, 10 September 2017, 143 II 257, 6.2 and CH: Federal Supreme Court, 9 May 2012, 2C_604/2011, 4.1 where the court rules that reference to domestic law under art. 3(2) is an *ultima ratio*. See also DK: RA, 23 December 1987, Case 1169-1987, ref. 162: "Domestic tax rules shall be applied only unless the context otherwise requires. The meaning of this restriction according to the [National Tax] Board's opinion may be summed up as follows: Where a term of the treaty, as used in any treaty provision, does not give a clear indication of its meaning it is necessary to try to establish the intentions of the contracting parties. In so doing guidance should be sought from the terminology of the treaty as a whole, its structure and systematic approach, the function of the article in question, its introduction and historical context as well as other relevant circumstances. Only if such an investigation does not lead to any result should recourse be made to the meaning of the term under domestic law of the state applying the treaty."

29 C. Elliffe, *The Meaning of the Principal Purpose Test: One Ring to Bind Them All*?, 11 World Tax J. 1, sec. 1.3 (2019) Journals IBFD.

30 Paragraph 12 of the Explanatory Statement to the MLI states that a treaty "shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose", as prescribed by art. 31 of the Vienna Convention.

(common law as opposed to civil law) and irrespective of their domestic GAARs.[31] If the PPT were to be interpreted on the basis of the domestic law of the state applying the PPT, it is very likely that the PPT will be interpreted inconsistently. The consequences of such inconsistent interpretations are problematic. On the one hand, it could lead to tax competition, whereby jurisdictions might accept treaty shopping as a means to attract international investment, or, on the other hand, it could lead to tax jurisdictions aggressively applying the PPT to raise revenue.[32] The lack of consistency in the interpretation of the PPT also carries along other problems: costly litigation, commercial uncertainty, expensive administration and a potential reduction in cross-border investment.[33]

There are thus ample arguments for why the PPT *should* have an autonomous international meaning, rather than a meaning determined on the basis of domestic law.[34] There is however no assurance that all jurisdictions will adhere to an international autonomous meaning. It remains possible that tax authorities and courts will interpret the PPT inconsistently, by relying on their own domestic understanding of the PPT terms.

Given the preference for an *autonomous international meaning* and given that this was also the intention of the OECD, I will interpret the PPT terms on the basis of the interpretation method provided by art. 31 of the Vienna Convention, which prescribes an interpretation based on the ordinary meaning of the treaty term in their context and in the light of their object and purpose.

Even though the ordinary meaning of a term depends on the context, as well as the object and purpose of the tax treaty, art. 31 of the Vienna Convention, does not exclude that dictionary meanings can provide a useful starting point.[35]

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31 B. Kuzniacki, *The principal purpose test (PPT) in BEPS Action 6 and the MLI: Exploring challenges arising from its legal implementation and practical application*, 10 World Tax J. 2, p. 243 (2018), Journals IBFD.

32 C. Elliffe, *The Meaning of the Principal Purpose Test: One Ring to Bind Them All*?, 11 World Tax J. 1, sec. 1.3 (2019), Journals IBFD.

33 C. Elliffe, *The Meaning of the Principal Purpose Test: One Ring to Bind Them All*?, 11 World Tax J. 1, sec. 1.3 (2019), Journals IBFD.

34 See also: C. Elliffe, *The Meaning of the Principal Purpose Test: One Ring to Bind Them All*?, 11 *World Tax J.* 1, sec. 1.3 (2019), Journals IBFD; B. Kuzniacki, T*he principal purpose test (PPT) in BEPS Action 6 and the MLI: Exploring challenges arising from its legal implementation and practical application*, 10 *World Tax J.* 2, p. 243 (2018), Journals IBFD; V. Kolosov, *International/OECD guidance on the application of the principal purpose test in tax treaties*, 71 Bull. Intl. Taxn. 3/4 (2017), Journals IBFD.

35 F. Engelen, *Interpretation of Tax Treaties under International Law,* sec. 6.4.4 (Doctoral series IBFD 2005). In the academic literature, several authors have also referred to the dictionary meaning of PPT terms to establish their ordinary meaning, see for instance: C. Elliffe, *The meaning of the Principal Purpose Test: One ring to bind them all?*, 11 World Tax J. 1, p. 63-64 (2019), Journals IBFD; I. Zahra, *The Principal Purpose Test: A Critical Analysis of Its Substantive and Procedural Aspects – Part 1*, 73 World Tax J. 11, p. 614 (2019), Journals IBFD.

According to the OECD, the OECD Commentaries on the PPT are also "of particular relevance" for the interpretation of the PPT.[36] Even though it is not clear how the OECD Commentaries fit into the interpretation method as prescribed by the Vienna Convention, there is a general consensus among academics that the OECD Commentaries play an important role for the interpretation of tax provisions that rely on the OECD Model[37] Tax authorities, courts, taxpayers and academics frequently use the OECD Commentaries, which have become a widely accepted guide, to interpret tax treaty provisions based on the OECD Model. The OECD Commentaries on the PPT, which provide general guidance on its application, have been transposed from BEPS Action 6 and are included in paragraphs 169 through 197 of the OECD Commentaries. They will hereafter be referred to as the *PPT Commentaries*. Para. 182 and 187 of the PPT Commentaries provide a number of examples in an attempt to explain how the PPT should be applied to particular arrangements. These Examples are hereafter referred to as the *PPT Examples*.

Other than the PPT Commentaries and other OECD materials, such as the Explanatory Statement to the MLI and BEPS Action 6, which has almost entirely been incorporated into the PPT Commentaries, there are very few resources available that could help interpret the PPT. This is unfortunate, especially given that the wording of the PPT and the PPT Commentaries are often ambiguous and unclear (eg. 'reasonable to conclude', 'principal').[38] Caselaw is also of little to no help given

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36 Explanatory Memorandum to the MLI, para. 12.

37 W. Haslehner, *Introduction*, in *Klaus Vogel on double taxation conventions,* vol. I, sec. 3, p. 54 (5th ed. A. Rust & E. Reimer eds., Wolters Kluwer 2022); J. Bossuyt, *The legal status of extrinsic instruments for the interpretation of tax treaties*, p. 769 (IBFD 2021), Online Books IBFD; A. Navarro, *International tax soft law instruments: the futility of the static v dynamic interpretation debate,* 48 Intertax 10, p. 849 (2020); M. Nieminen, *Dual role of the OECD Commentaries – Part 1*, 43 Intertax 11, p. 651-652 (2015); B. Arnold, *The Interpretation of Tax Treaties: Myth and Reality,* 64 Bull. Intl. Taxn. 2, p. 8 (2010), Journals IBFD; D. Ward, *The role of the Commentaries on the OECD Model in the tax treaty interpretation process*, 60 Bull. Intl. Taxn 3, p. 99 (2006), Journals IBFD; P. Wattel and O. Marres, *The legal status of the OECD Commentary and static and ambulatory interpretation of tax treaties*, 43 Eur. Taxn. 7, p. 229 (2003), Journals IBFD; H. Ault, *The role of the OECD Commentaries in the interpretation of tax treaties*, 22 Intertax 4, p. 144 (1994); OECD, *Recommendation of the Council Concerning the Model Tax Convention on Income and on Capital,* p. 3 (1997); D. Ward, *Principles to be applied in interpreting tax treaties*, 25 Can. Tax J. 3, p. 268 (1977); Regarding the relevance of the OECD Commentaries for the PPT in particular: V. Kolosov, *International/OECD guidance on the application of the principal purpose test in tax treaties,* 71 Bull. Intl. Taxn. 3/4, sec. 4.1 (2017), Journals IBFD; Regarding the OECD Commentaries on the PPT specifically, see S. Landsiedel, *The principal purpose test's burden of proof: should the OECD commentary on article 29(9) specify which party bears the onus?",* 13 World Tax J. 1, p. 108 (2021), Journals IBFD and V. Kolosov, *International/OECD guidance on the application of the principal purpose test in tax treaties,* 71 Bull. Intl. Taxn. 3/4, sec. 4.1 (2017), Journals IBFD.

38 For criticism on the PPT Commentaries, see e.g. A. Mithe, *Critical Analysis of the Principal Purpose Test and the Limitation on Benefits Rule: A World Divided but It Takes Two to Tango*, 12 World Tax J. 1, p. 149 (2020), Journals IBFD; E. Palmitessa, *Interplay Between the Principal Purpose Test in the Multilateral BEPS Convention and the Beneficial Ownership Clause as Treaty Anti-Avoidance Tool Targeting Holding Structures*, 46 Intertax 1, p. 60 (2018); R. Cunha, *BEPS Action 6: Uncertainty in the Principal Purpose Test Rule,* 1 Global Taxation 2, p. 185 (2016); L. De Broe and J. Luts, *BEPS Action 6: Tax treaty abuse,* 43 Intertax 2, p. 133 (2015); M. Lang, *BEPS Action 6: Introducing an anti-abuse rule in tax treaties*, 74 Tax Notes International 7, p. 659 (2019).

that only one case has been ruled so far where the PPT has been applied. Other than confirming what could be derived from the PPT Commentaries, the case did not add much value.[39] In addition, caselaw on the guiding principle[40] or domestic GAAR's which are similar to the PPT, are only relevant to a limited extent.[41]

The PPT wording and the OECD Commentaries on the PPT are thus the main sources of interpretation to determine the application of the first test of the PPT.

'One of the' principal purposes vs. 'the' principal purpose

Merely looking at the wording of the PPT, it can be concluded that the first test requires that only one of several principal purposes was to obtain a tax treaty benefit. An arrangement can thus have several principal purposes. The OECD Commentaries on art. 29(9) further clarify that "obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the principal purposes was to obtain the benefit" (§ 180). To illustrate this, an example is given whereby a person changes its residency right before it sells a property and one of the principal purposes of the change of residency was to obtain a tax treaty benefit. Even though there could be various principal purposes for the change of residency apart from obtaining the tax treaty benefit, such as facilitating the sale of the property or the reinvestment of the proceeds of the alienation, the example concludes that, if one of the principal purposes was to obtain a tax treaty benefit, the PPT could apply "notwithstanding the fact that there may also be other principal purposes for changing residence". Therefore, according to the OECD, an arrangement or transaction can have multiple principal purposes, and for the first test to be met, it suffices that only one of these principal purposes was to obtain a tax treaty benefit.

The first test will thus still be met even if the taxpayer can prove that the arrangement was also motivated by equally important purposes not related to

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39 See M. Massant, *Lowy: the first PPT case*, Kluwer International Tax Blog, March 24 2025; M. Massant, *Principal Purpose Test: de eerste uitspraak is een feit*, Fiscoloog Internationaal 495 (2025).

40 According to the PPT Commentaries, the PPT is a codification of the guiding principle (para. 169 PPT Commentaries). The guiding principle is included in para. 61 of the OECD Commentaries on art. 1 and reads as follows: "a guiding principle is that the benefits of a [tax treaty] should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions".

41 Such cases may, at most, constitute supplementary means of interpretation, as prescribed by art. 32(2) of the Vienna Convention. See B. Kuźniacki, *The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application*, 10 World Tax J. 2, p. 243 (2018), Journals IBFD; Supplementary means of interpretation may only be used to confirm the meaning resulting from the application of art. 31(1) VC, or to determine the meaning when the interpretation on the basis of art. 31(1) leaves the meaning ambiguous or obscure or leads to a result which is manifestly absurd or unreasonable.

obtaining a tax treaty benefit. The fact that the taxpayer *also* targeted a tax treaty benefit, is enough for the test to be met.[42]

Requiring that merely one of the principal purposes was to obtain a tax treaty benefit, rather than requiring it to be *the* principal, predominant or sole purpose, has however been subject to a lot of criticism.[43] Several authors argue that, by referring to 'one of the principal purposes' rather than 'the sole or predominant principal purpose', the first test applies a very low threshold of abuse since it will be satisfied by almost every reasonable and diligent businessman that takes into account the effect of tax treaties on its business decisions. However, as will be discussed in section 4.4., even though every businessman might take into account tax treaty benefits when deciding to undertake an arrangement or transaction, this does not mean that obtaining a tax treaty benefit is one of the 'principal' purposes 'of the arrangement or transaction'.

Nonetheless, some authors argue that the phrase 'one of the principal purposes' should be replaced by 'the primary (or essential, main, predominant, sole) purpose'.[44] In that case the test cannot be met if there are other purposes for the arrangement that are equally important to obtaining a tax treaty benefit. Some authors even argue that, even though it would be better to change the wording of the PPT, the first test as it stands today should still be interpreted restrictively, meaning that the first test will only be met when obtaining a tax treaty benefit is

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42 D. Danon, "Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups", 72 *Bulletin for international taxation* 1 (2018), p. 44; D. Duff, "Tax Treaty abuse and the Principal Purpose Test - Part II", 66 *Canadian Tax Journal* (2018), p.983; R. Kok, "The Principal Purpose Test in Tax Treaties under BEPS 6", 44 *Intertax (2016)*, p. 408; M. Lang, "BEPS Action 6: Introducing an Anti-abuse Rule in Tax Treaties", 74 Tax Notes International 7 (2014), p.659; I. Zahra, "The Principal Purpose Test: A Critical Analysis of Its Substantive and Procedural Aspects – Part 1", 73 *World Tax Journal* 609 (2019), p. 614.

43 A. Mithe, "Critical Analysis of the Principal Purpose Test and the Limitation on Benefits Rule: A World Divided but It Takes Two to Tango", *World Tax Journal* 129 (2020), p. 149; V. Chand, "The Principal Purpose Test in the Multilateral Convention: An in-Depth Analysis" 46 *Intertax* 1 (2018), p.23; B. Kuzniacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application", 10 *World Tax Journal* (2018), p. 255; D. Duff, "Tax Treaty abuse and the Principal Purpose Test - Part II", 66 *Canadian Tax Journal* (2018), p.979; R. Danon, "Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups", 72 *Bulletin for international taxation* 1 (2018), p.44; L. De Broe, "Tax Treaty and EU Law Aspects of the LOB and PPT Provision Proposed by BEPS Action 6" in R. Danon (ed), *Base Erosion and Profit Shifting (BEPS) - Impact for European and international tax policy* (2017), p. 210; R. Kok, "The Principal Purpose Test in Tax Treaties under BEPS 6", 44 *Intertax* (2016), p. 407-408; L. De Broe and J. Luts, "BEPS Action 6: Tax treaty abuse", 43 *Intertax* 2 (2015), p. 132; C. Taboada, "OECD Base Erosion and Profit Shifting Action 6: The General Anti-Abuse Rule", 69 *Bulletin for international taxation* 10 (2015), p.604.

44 V. Chand, "The guiding principle and the Principal Purpose Test", 37 *International Taxation* 12 (2015), p. 487; L. De Broe and J. Luts, "BEPS Action6: Tax treaty abuse", 43 *Intertax* 2 (2015), p.132; B. Kuzniacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application", 10 *World Tax Journal* (2018), p. 257; B. Kuźniacki, "Constitutional Issues Arising from the Principal Purpose Test: The Lesson from Poland" (2018) 27 *Studia Iuridica Lublinensia* 2, p. 103.

the predominant or sole purpose.[45] This restrictive interpretation is however clearly in contrast with the literal wording of the PPT, on the basis of which it suffices that obtaining a tax treaty benefit is only 'one of the principal purposes', and the PPT Commentaries, which state that obtaining the tax treaty benefit need not be the sole or dominant purpose. Furthermore, requiring a strict interpretation could impose an unrealistically high threshold and potentially render the first test ineffective.

In conclusion, in contrast to what some authors claim, the first test must be interpretated to mean that it suffices that 'one of the principal purposes' is to obtain a tax treaty benefit. Section 4.4 will show that this does not imply a low threshold of abuse.

Objective analysis

The first test of the PPT is often referred to as the 'subjective element' of the PPT, which seems to imply that a *subjective* analysis is needed, based on the subjective intentions of the parties involved. However, as will be shown hereafter, it can be derived from the wording of the PPT, as well as the PPT Commentaries and the included Examples, that the first test requires an *objective* analysis, based on facts and circumstances.[46]

First, the PPT explicitly stipulates that the purposes must be determined "having regard to all relevant facts and circumstances". Second, the PPT refers to the *purpose* of the arrangement or transaction itself, rather than the *reasons* of the taxpayer for setting up the arrangement.[47] A *purpose* refers to an aim, an object or end that an arrangement is supposed to achieve[48], whereas a *reason* refers to

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45 L. De Broe, "Tax Treaty and EU Law Aspects of the LOB and PPT Provision Proposed by BEPS Action 6" in R. Danon (ed), *Base Erosion and Profit Shifting (BEPS) - Impact for European and international tax policy* (2017), p.241; D. Weber, "The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law", 10 *Erasmus Law Review* 48 (2017), p.51.

46 See also other authors who argue that the first test of the PPT requires an objective, rather than a subjective, analysis: C. Elliffe, "The meaning of the Principal Purpose Test: One ring to bind them all?", 11 *World Tax Journal* 1 (2019), p.63-64; I. Zahra, "The Principal Purpose Test: A Critical Analysis of Its Substantive and Procedural Aspects – Part 1", 73 *World Tax Journal* 609 (2019), p. 614; D. Duff, "Tax Treaty abuse and the Principal Purpose Test - Part II", 66 *Canadian Tax Journal* (2018), p.977; B. Kuzniacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application", 10 *World Tax Journal* (2018), p.261; D. Weber, "The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law", 10 *Erasmus Law Review* 48 (2017), p. 56.

47 Duff argues that the use of the term "purpose of the arrangement or transaction" reaffirms the objective nature of the test. See: D. Duff, "General Anti-Avoidance Rules Revisited: Reflections on 'Tim Edgar's Building a Better GAAR'", 68 *Canadian tax journal* 579 (2020), p.598.

48 Meriam-Webster Dictionary.

an explanation for something that has happened or that somebody has done.[49] To determine the reason for setting up an arrangement, one has to look at the subjective intentions of the persons that set up the arrangement, whereas, to determine the purpose of an arrangement, one has to look at the objective facts and circumstances surrounding the arrangement. Take the example of a taxpayer who sets up an arrangement to obtain a tax advantage because he needs the saved taxes to increase the wage of his employees. These subjective reasons of the taxpayer, which are practically impossible to determine[50], are irrelevant.[51] What counts, is the purpose of the arrangement, which is to obtain a tax advantage. The fact that the PPT refers to the *purpose* of the arrangement, thus reinforces the need for an objective analysis of the arrangement.[52]

Third, the need for an objective analysis can also be derived from the OECD Commentaries on art. 29(9), which state that determining the purposes of an arrangement is a "question of fact which can only be answered by considering all circumstances surrounding the arrangement or event on a case-by-case basis" (§ 178). The Commentaries further clarify that "it is not necessary to find conclusive proof of the intent of a person concerned with an arrangement or transaction, but it must be reasonable to conclude, after an objective analysis of the relevant facts and circumstances, that one of the principal purposes of the arrangement or transaction was to obtain the benefits of the tax convention" (§178). The Commentaries, however, also sate that for purposes of the first test, "it is important to undertake an objective analysis of the aims and objects of all persons involved in putting that arrangement or transaction in place". Even though they confirm that an objective analysis is necessary, they refer to the aims of the persons, rather than of the arrangements or transactions. The OECD thus recognizes that the reasons of the parties involved in putting up an arrangement may also play a role, but that such reasons should be determined on the basis of an objective analysis.

Fourth, the need for an objective analysis can also be derived from the PPT Examples, where the conclusions are based on objective criteria taking into account

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49 Meriam-Webster Dictionary.

50 E. Pinetz, "Final Report on Action 6 of the OECD/G20 Base Erosion and Profit Shifting Initiative: Prevention of Treaty Abuse", 70 *Bulletin for International Taxation* (2016), p. 116.

51 See L. De Broe, *International Tax Planning & Prevention of Abuse under Domestic Tax Law, Tax Treaties & EC-Law* (IBFD Doctoral series 2008), part 4, sec. 1.2.1.3.

52 See also: C. Elliffe, The Meaning of the Principal Purpose Test: One Ring to Bind Them All?", 11 *World Tax Journal* 1 (2019), p. 67; .P Piantavigna, "The Role of the Subjective Element in Tax Abuse and Aggressive Tax Planning", 10 *World Tax Journal* 193 (2018), p.209; C. Taboada, "OECD Base Erosion and Profit Shifting Action 6: The General Anti-Abuse Rule", 69 *Bulletin for international taxation* 10 (2015), p.605.

the various facts and circumstances, rather than on the subjective intentions of the parties involved.[53]

Lastly, several authors argue that the need for an objective analysis can also be derived from the reference to reasonability in the PPT ('reasonable to conclude').[54] They refer to the legal system of common law countries which often include such a reasonableness test to objectify the subjective element of a GAAR.[55] The HMRC guidance to the UK GAAR[56], for instance, clarifies that "the expression 'reasonable to conclude' shows that this is an objective test".[57] The PPT Commentaries seem to confirm this view when stating that the determination of the first test requires "reasonableness, suggesting that the possibility of different interpretations of these events must be *objectively* considered" (own emphasis). Some authors, however, do not agree with this view and argue that the reference to reasonability rather indicates a low burden of proof of tax authorities, who merely need to prove that it is 'reasonable' to conclude that obtaining a tax treaty benefit was one of the principal purposes.[58] On the basis of this interpretation, the tax authorities do not need to produce full evidence of the principal purpose. Consequently, these authors argue

53 See also: C. Elliffe, The Meaning of the Principal Purpose Test: One Ring to Bind Them All?", 11 World Tax Journal 1 (2019), p. 71; D. Weber, "The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law", 10 *Erasmus Law Review* 48 (2017), p.50.

54 C. Elliffe, "The meaning of the Principal Purpose Test: One ring to bind them all?", 11 *World Tax Journal* 1 (2019), p. 63; S. Landsiedel, "The principal purpose test's burden of proof: should the OECD commentary on article 29(0) specify which party bears the onus?", *World Tax Journal* (2021), p. 106; B. Kuzniacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application", 10 *World Tax Journal* (2018), p.255; P. Piantavigna, "The Role of the Subjective Element in Tax Abuse and Aggressive Tax Planning", 10 *World Tax Journal* 193 (2018), p. 211; D. Duff, "Tax Treaty abuse and the Principal Purpose Test - Part II", 66 Canadian Tax Journal (2018), p.983; D. Weber, "The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law", 10 *Erasmus Law Review* 48 (2017), p. 49–51; R. Kok, "The Principal Purpose Test in Tax Treaties under BEPS 6", 44 *Intertax* (2016), p.408.

55 R. Krever, "General Report", in M. Lang et al (eds.), *GAARs – A Key element of tax systems in the post-BEPS world,* IBFD 2016: "Although the concept of a 'purpose' sounds inherently subjective, it can be fashioned in a more objective manner by, for example, adopting an objective test such as whether it is reasonable to conclude that the taxpayer's main purpose was to obtain a tax benefit".

56 HMRC, General anti-abuse rule (GAAR) guidance, 16 July 2021, sec. C3.3, available at: https://www.gov.uk/government/publications/tax-avoidance-general-anti-abuse-rules.

57 See on the reasonableness test of the UK GAAR: P Harris, *The Profits Tax GAAR: An Aid in the Hopeless Defense against Dark Arts, Studies in the History of Tax Law* (Hart Publishing 2017) p. 229: While it has been historically accepted that this is a subjective test, the change to "it would be reasonable to conclude" turns this into an objective test.

58 R. Danon, "Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups", 72 Bulletin for international taxation 1 (2018), p. 44; L De Broe, "Fighting Treaty Shopping after the MLI" in BJ Arnold (ed), *Tax Treaties after the BEPS Project - A tribute to Jacques Sasseville* (Canadian Tax Foundation 2018), p. 100–101; M. Lang, "BEPS Action 6: Introducing an Anti-abuse Rule in Tax Treaties", 74 *Tax Notes International* 7 (2014), p. 658; E. Pinetz, "Final Report on Action 6 of the OECD/G20 Base Erosion and Profit Shifting Initiative: Prevention of Treaty Abuse", 70 *Bulletin for International Taxation* (2016), p. 116.

that the tax authorities will be tempted to presume that obtaining a tax treaty benefit was one of the principal purposes merely because of the presence of a tax treaty benefit. For this reason, LANG argues that the first test runs the risk of not gaining any relevance.[59] The PPT Commentaries, however, explicitly state that no conclusions can be drawn from merely reviewing the effects of an arrangement (§ 178). Furthermore, the above PPT Commentaries and examples show that an objective analysis is needed, whereby all relevant facts and circumstances must be taken into account. This is not an easy test and does not give the tax authorities the possibility to merely presume abuse.[60] The PPT Commentaries confirm that it "should not be lightly assumed" that obtaining a tax treaty benefit was a principal purpose (§ 178). The reference to reasonability in the PPT was thus likely included to emphasize the need for an objective analysis, rather than to foresee a low burden of proof.

An objective analysis also offers advantages as opposed to a subjective analysis. First of all, although still challenging, it is easier to determine the purpose of an arrangement, based on facts and circumstances, rather than the subjective intentions of the parties involved, which is practically impossible.[61] Secondly, an objective analysis makes the first test arrangement-based rather than taxpayer-based.[62] As a consequence, the PPT also applies to taxpayers that are merely indirectly involved in an abusive arrangement and had no intention of obtaining a tax treaty benefit.[63] See for instance the example provided in the OECD Commentaries (para. 176), where a parent company transfers its loan to its subsidiary, located in another state, to benefit from a reduced WHT on interest foreseen by a treaty between the state of the subsidiary and the source state. The PPT may deny the treaty benefit to the subsidiary, even though the subsidiary might not have intended to obtain a treaty

59 M. Lang, "BEPS Action 6: Introducing an Anti-abuse Rule in Tax Treaties", 74 *Tax Notes International* 7 (2014), p.659.

60 D. Weber, "The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law", 10 *Erasmus Law Review* 48 (2017), p. 50.

61 See LANG, who also argues that it is impossible to prove an intention or motive in M. Lang, "BEPS Action 6: Introducing an Anti-abuse Rule in Tax Treaties", 74 *Tax Notes International* 7 (2014), p. 658.

62 L. De Broe, "Tax Treaty and EU Law Aspects of the LOB and PPT Provision Proposed by BEPS Action 6" in R. Danon (ed), *Base Erosion and Profit Shifting (BEPS) - Impact for European and international tax policy* (2017), p.212; C. Elliffe, The Meaning of the Principal Purpose Test: One Ring to Bind Them All?", 11 *World Tax Journal* 1 (2019), p. 64; M. Gomes, "The DNA of the Principal Purpose Test in the Multilateral Instrument", 47 *Intertax* 66 (2019), p. 79.

63 L. De Broe, "Tax Treaty and EU Law Aspects of the LOB and PPT Provision Proposed by BEPS Action 6" in R. Danon (ed), *Base Erosion and Profit Shifting (BEPS) - Impact for European and international tax policy* (2017), p.212; M. Gomes, "The DNA of the Principal Purpose Test in the Multilateral Instrument", 47 *Intertax* 66 (2019), p.79; M. Lang, "BEPS Action 6: Introducing an Anti-abuse Rule in Tax Treaties", 74 *Tax Notes International* 7 (2014), p. 659; C. Taboada, "OECD Base Erosion and Profit Shifting Action 6: The General Anti-Abuse Rule", 69 *Bulletin for international taxation* 10 (2015), p. 605.

benefit. Furthermore, an objective analysis also ensures that the PPT also applies to arrangements that were set up by persons, such as tax specialists, other than those who obtain the tax benefits, who may not even be aware of the tax benefits or how they are obtained.[64] Another important advantage of an objective analysis, is that it is more likely for two similar arrangements to be treated the same, irrespective of the intention of the taxpayers. This increases the consistency of decision-making between different jurisdictions and, in turn, creates an opportunity for substantial precedential value for tax administrations and courts.[65]

In conclusion, the above shows that the first test requires an objective analysis, based on facts and circumstances, rather than an subjective analysis based on the subjective intentions of the parties involved.[66] This does not mean, however, that the subjective intentions of the taxpayers are completely irrelevant. The intentions of the taxpayers can give an indication of the purpose of the arrangement, as long as these intentions can be verified on the basis of facts and circumstances.

Principal purpose of the arrangement to obtain a tax treaty benefit

On the basis of the previous subsections we have established that the first test will be fulfilled when it can be concluded, on the basis of an objective analysis, that one of the principal purposes was to obtain a tax treaty benefit.

This section analyses in detail each subpart of the first test of the PPT in detail to understand how the test should be applied and thus how the objective analysis needs to be carried out. Three different subparts can be identified. Each subpart is a condition that needs to be fulfilled for the first test to be fulfilled. First, obtaining a tax treaty benefit should be a 'purpose'. Second, obtaining a treaty benefit should be a purpose 'of the arrangement or transaction'. And third, obtaining a treaty benefit should be a 'principal' purpose of the arrangement or transaction.

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64 D. Duff, "General anti-avoidance rules revisited: reflections on Tim Edgar's building a better GAAR", 68 *Canadian Tax Journal* 2 (2020), p. 598.

65 C. Elliffe, The Meaning of the Principal Purpose Test: One Ring to Bind Them All?", 11 World Tax Journal 1 (2019), p.65.

66 Some authors disagree: M. Lang and O. Nesterov-Surmenko, "Chapter 9: The principal purpose test of article 29(9) OECD Model (2017), in G. Kofler et al. (eds), *Anti-Abuse Rules and Tax Treaties* (Wolters Kluwer 2024), p. 214; W. Schön, "The Role of 'Commercial Reasons' and 'Economic Reality' in the 'Principle Purpose Test' under Art.29(9) OECD Model Tax Convention 2017", 3 *Max Planck Institute Working Paper* (2022), p. 9; D. Weber, "The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law", 10 *Erasmus Law Review* 1 (2017), p. 56.

'Purpose' of obtaining a tax treaty benefit

First of all, it must be determined whether obtaining a tax treaty benefit could be considered *a purpose* of the arrangement.

A purpose refers to an aim, object or end that an arrangement is supposed to achieve, which has to be determined on the basis of an objective analysis. Therefore, if an arrangement leads to a tax treaty benefit, as identified on the basis of an objective analysis, it could be argued that a purpose of the arrangement was to obtain that benefit. However, the PPT Commentaries state that "merely reviewing the effects of an arrangement will not usually enable a conclusion to be drawn about its purposes" (para. 178). The effects of an arrangement can thus be an indicator but they are not decisive. The tax authorities may thus not merely refer to a large tax treaty benefit to conclude that obtaining that benefit was one of the principal purposes.[67] The obtainment of a tax treaty benefit could still be a side-effect of an arrangement that was set up for other purposes. It is however not clear how to determine whether the tax treaty benefit was a purpose or a side-effect.

There is one situation where the tax treaty benefit can be considered a side-effect rather than a purpose and that is if an equivalent benefit already existed without the arrangement in place. Think for instance of the following example. Company A, located in State A, directly holds company B, in state B and the dividends paid from company B to company A are subject to a reduced WHT of 5% on the basis of the tax treaty between State A and State B. The domestic WHT of State B, which is 30% does not apply, thanks to the tax treaty. Company A decides to interpose a company in State C. As a consequence, the dividends that are now paid from company B to the interposed company are subject to a reduced WHT of 5% on the basis of the tax treaty between State A and the State of the interposed company. There is still a tax treaty benefit because the tax treaty benefit is determined by comparing the tax consequences resulting from the arrangement (5% WHT) with the consequences that would have resulted under the domestic law absent the tax

67 D. Weber, "The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law", 10 *Erasmus Law Review* 48 (2017), p. 50.

treaty (30% WHT).[68] The reduced WHT could however not be considered a purpose of the arrangement because such a benefit also existed absent the arrangement.[69]

Therefore, if an arrangement leads to a tax treaty benefit, but an equivalent benefit exists absent the arrangement, then it should be concluded that the first test is not fulfilled. In all other cases where the arrangement leads to a tax treaty benefit, the PPT could still apply if it can be determined that the purpose of obtaining a tax treaty benefit was a 'principal' purpose (see sec. 4.4.3) of the arrangement or transaction (see sec. 4.4.2).

Principal purpose 'of any arrangement or transaction'

Before analysing whether a purpose can be considered a 'principal' purpose, it is important to note that, according to the wording of the PPT, obtaining a tax treaty benefit must be a principal purpose of 'any arrangement or transaction that resulted in that benefit'. It must thus be determined whether obtaining a tax treaty benefit was a principal purpose of *the arrangement* (or transaction).

As already mentioned in section 4.3., the fact that the PPT refers to the purpose of the arrangement or transaction, rather than the purpose of the taxpayer, confirms that the first test requires an objective analysis, based on the relevant facts and circumstances, rather than a subjective analysis, based on the subjective intentions of the taxpayer.

However, an additional conclusion can be drawn from the fact that the relates to the arrangement or transaction: the purpose relates to the arrangement and not to location where the arrangement was set up. Worded differently, the first test is not necessarily fulfilled when one of the principal purposes of choosing state A as the location for setting up a particular arrangement was to obtain tax treaty benefits. The test will only be fulfilled if a principal purpose of the arrangement itself was also to obtain a tax treaty benefit.

This conclusion is confirmed in the PPT Examples. This is most clear in Example C of the PPT Examples. In this Example, the taxpayer, located in State R,

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68 P. Blessing, "Article 29: Entitlement to Benefits (Global Perspective) – Global Tax Treaty Commentaries" in R. Vann (eds.) *Global Tax Treaty Commentaries*, IBFD 2020, p. 20; M. Lang, "BEPS Action 6: Introducing an Anti-abuse Rule in Tax Treaties", 74 *Tax Notes International* 7 (2014), p. 657; D. Duff, "Tax Treaty abuse and the Principal Purpose Test - Part II", 66 *Canadian Tax Journal* (2018), p.969.

69 See also a case ruled by the Indian tribunal regarding a rule in the India-UAE double tax treaty according to which *"an entity which is a resident of a Contracting State shall not be entitled to the benefits of this Agreement if the main purpose or one of the main purposes of the creation of such entity was to obtain the benefits of this Agreement that would not be otherwise available".* The court ruled that when treaty protection was anyway available, though under a different kind of provision of another tax treaty, the taxpayer cannot be said to have been created for the purpose of availing India-UAE tax treaty benefits. See *Martrade Gulf Logistics v India* [28 November 2017], Income tax appellate tribunal, case nr. 7-9/Rjt/2011.

decided to establish a manufacturing plant in a developing country to expand its business and lower its manufacturing costs. After a preliminary review regarding a possible location for the manufacturing plant, taking into account whether the possible States are suitable for the expansion of the business and foresee lower manufacturing costs, three States were identified. Out of these three States, the taxpayer decided to establish the plant in State S because this was the only State with which State R had concluded a tax treaty. It could thus be argued that a principal purpose of choosing State S was to obtain a tax treaty benefit. However, the Example concludes that, "whilst the decision to invest in State S is taken in the light of the [tax treaty benefits], it is clear that the principal purposes for making that investment and building that plant are related to the expansion of Rco's business and the lower manufacturing costs of that country". Therefore, "it cannot reasonably be considered that one of the principal purposes for building the plant is to obtain [tax treaty] benefits". Worded differently, even though it could be argued that a *principal purpose of choosing State S* was to obtain a tax treaty benefit, this does not mean that a *principal purpose of the arrangement itself*, i.e. the establishment of the plant, was to obtain tax treaty benefits.

Several other PPT Examples confirm that, even when the location for setting up an arrangement was mainly driven by tax treaty benefits, this does not necessarily mean that obtaining those tax treaty benefits was a principal purpose of the arrangement itself. In Examples G, K, L and M the taxpayer decided to interpose a company, Rco, in State R, between itself and its subsidiaries. In these Examples, it is stated that the taxpayer decided to establish Rco in State R, "after a review of possible locations", and that this decision was, amongst others, "mainly driven by […] the extensive tax treaty network of State R" or that the existence of tax treaty benefits was at least "taken into account". In Example D, the decisions of Rco, a collective investment vehicle, on where to invest, also "take into account the existence of [tax treaty benefits] provided under State R's extensive tax treaty network". Even though it could be argued that in these cases one of the principal purposes of choosing a particular State to set up the arrangement, was to obtain a tax treaty benefit, the Examples nevertheless concluded that obtaining a tax treaty benefit was not one of the principal purposes *of the arrangement*. The Examples thus imply that the principal purpose of choosing a particular location to set up the arrangement may be mainly driven by tax treaty benefits, without having this mean that a principal purpose *of the arrangement* itself was also to obtain a tax treaty benefit. Examples D, K and L thereby state that "considering the existence of a benefit is not sufficient to trigger the application of the [PPT]". To explain this statement, the OECD refers to the intention of tax treaties, which is to encourage cross-border investment by granting tax treaty benefits.

In conclusion, to determine whether obtaining a tax treaty benefit was a principal purpose of an arrangement, an objective analysis is required, based on the relevant facts and circumstances, and it will not be sufficient to argue that one of the principal purposes of choosing a particular location was to obtain tax treaty benefits.

'Principal' purpose of obtaining a tax treaty benefit

For the first test to be met, obtaining a tax treaty benefit must be one of the 'principal' purposes, as opposed to a secondary or ancillary purpose. The question thus arises when a purpose can be considered a 'principal' purpose. The following will show that a purpose can only be considered a 'principal' purpose, if no other purpose is more important. As a consequence, if another purpose is more important than the purpose of obtaining a tax treaty benefit, the latter cannot be considered a 'principal' purpose.

Relevance of economic purposes

The term 'principal' is an undefined treaty term. As mentioned in section 4.1., the dictionary meaning of an undefined treaty term can be a starting point to determine their ordinary meaning. In the English dictionaries, 'principal' is defined as 'among the most important, prominent, leading, main' (Oxford Dictionary), 'first in order of importance' (Cambridge Dictionary) and 'most important' (Merriam Webster Dictionary). The definition of principal thus implies that, for purposes to be considered 'principal' purposes, no other purpose may be considered more important. If other purposes are more important than the purpose of obtaining a tax treaty benefit, those other purposes will be considered the principal purposes whereas the purpose of obtaining a tax treaty benefit will be considered a secondary or even ancillary purpose. It can thus be derived from the dictionary meaning of 'principal' that the purposes must be assessed in some sort of priority or hierarchy.[70] Therefore, the relative importance of obtaining a tax treaty benefit,

70 See also a UK case on the UK GAAR, which requires that obtaining the tax benefit was "a main purpose or one of the main purposes" (UK Finance Act 2013, section 206-215), where the UK tribunal had stated that the determination of whether a *main* objective (purpose) of the relevant transactions was the obtaining of certain allowances, envisages that there may be a range of objectives motivating the transactions, which "must be assessed on some sort of priority or hierarchy and then some basis applied to separate those which are of *sufficient significance* to count as 'main' from those which are not. The issue is then which side of the line falls any objective of obtaining the allowances" (own emphasis) (in *Lloyds TSB Equipment Leasing (No.1) Ltd v. Revenue and Customs*, [2012] UKFTT 47 (TC), para. 388 and affirmed by the Court of Appeal in *Revenue and Customs v. Lloyds TSB Equipment Leasing (No.1) Ltd.*, [2014] EWCA Civ 1062, para. 52); See also another UK case on the UK GAAR, where the court states that 'main' cannot just be equated with "more than trivial" because even though a main purpose will always be more than trivial, the converse is not true. A purpose can be more than trivial without being a main purpose. 'Main', the court argues, "has a connotation of importance" (in Travel *Document Service & Ladbroke Group International vs. Revenue & Customs*, (2018) EWCA Civ 549, para 48).

i.e. the importance thereof as compared to the other purposes, is crucial to determine whether it is a 'principal' purpose. Worded differently, other purposes can potentially rebut the fulfillment of the first test, if they are considered more important.

There is however no consensus in the academic literature on the relevance of other purposes as a means to rebut the fulfillment of the first test.[71]

These other purposes, other than the purpose to obtain a tax treaty benefit, are hereafter referred to as 'economic purposes'. Economic purposes can be interpreted broadly and do not only include purposes whereby the aim is to increase profit, but also other purposes, such as regulatory purposes, labor law purposes and so on. It can however be derived from the PPT Commentaries that the purpose of obtaining treaty benefits from *other* tax treaties cannot be considered an economic purpose that can rebut the fulfillment of the first test (para. 181). The OECD provides an example to clarify this: assume that a taxpayer, resident of state A, enters into a conduit arrangement with a financial institution, resident in state B, in order for that financial institution to invest, for the ultimate benefit of that taxpayer, in bonds issued in a large number of states with which State B, but not State A, has tax treaties. The OECD concludes that, if the facts and circumstances reveal that the arrangement was set up for the principal purpose of obtaining benefits from all these treaties, it should not be considered that obtaining the benefit under the State A-State B treaty was not one of the principal purposes.

The relevance of economic purposes can also be derived from the PPT Commentaries, where the OECD states that "where an arrangement can *only* be reasonably explained by a [tax treaty benefit], it may be concluded that one of the principal purposes of that arrangement was to obtain the benefit" (own emphasis). This statement, which is admittedly rather vague, can be read to mean that it may be concluded that one of the principal purposes of an arrangement was to obtain a tax treaty benefit if the arrangement cannot be explained by economic benefits, i.e. if no economic purposes can be identified. Worded differently, the absence of economic purposes implies the fulfillment of the first test. As already mentioned, the

71 Authors that agree with the relevance of other purposes: G. Maisto, D. Gutmann, A. Jimenez and R. Danon, "The prohibition of abuse of rights after the ECJ Danish cases", 59 *Intertax* 6/7 (2021), p. 495; B. Kuzniacki, "The principal purpose test (PPT) in BEPS Action 6 and the MLI: Exploring challenges arising from its legal implementation and practical application", 10 *World Tax Journal* 2 (2018), p.248; V. Chand, "The Principal Purpose Test in the Multilateral Convention: An in-depth Analysis", 46 *Intertax* 1 (2018), p. 23 (who argues that "if the proper factual inquiry leads to the conclusion that non-tax purposes outweigh tax purposes, then the taxpayer does not satisfy the subjective element"); Authors that disagree: O. Koriak, 'The Principal Purpose Test under BEPS Action 6: Is the OECD Proposal Compliant with EU Law?' 56 European Taxation 12 (2016), p.557; C. Panayi, "The Compatibility of the OECD G20 Base Erosion and Profit Shifting Proposals with EU Law", 70 *Bulletin for International Taxation* (2016), p.109; E. Pinetz, "Final Report on Action 6 of the OECD/G20 Base Erosion and Profit Shifting Initiative: Prevention of Treaty Abuse", 70 *Bulletin for International Taxation* (2016), p. 116..

Commentaries are however rather vague and some authors[72] come to an opposite conclusion. They read the above-mentioned paragraph in the PPT Commentaries as follows: for a purpose to be a principal purpose of an arrangement, it must be 'the only reasonable explanation for the arrangement', and thus the only purpose.[73] This reading however contradicts the wording of the PPT ('one of the principal purposes') and the PPT Commentaries, which explicitly state that obtaining a tax treaty benefit need not be the sole purpose of the arrangement (see *supra*, sec. 5.1).

Confirmation of the relevance of the economic purposes can also be found in the PPT Examples, where the economic purposes of the arrangements are often considered to determine whether obtaining a treaty benefit was one of the principal purposes. More specifically, the identified economic purposes of the arrangements were the following: to expand the business (Example C and F), to lower manufacturing costs (Example C), to provide regional group services to subsidiaries (Example G), to protect the taxpayer from liabilities, to facilitate debt financing, to make/dispose of/manage investments and to administer claims for WHT relief (Example M) and to manage the foreign activities that the taxpayer could not manage itself from its state of residence (Example H). In all of the PPT Examples where economic purposes where identified by the OECD, the OECD concluded that obtaining a treaty benefit was not one of the principal purposes.[74] On the other hand, in most of the PPT Examples where no economic purposes were identified, the OECD concluded that obtaining a treaty benefit was one of the principal purposes.[75] There is thus a link between the presence/absence of economic purposes and the conclusion of the OECD regarding the first test of the PPT.

Economic purposes must be in line with reality

The above shows that economic purposes are relevant for the analysis of the first test, as they could potentially rebut the fulfillment of this test if they are considered more important than the purpose of obtaining a tax treaty benefit. However, it is quite evident and it can be derived from the PPT Commentaries that a mere statement of the parties involved regarding the purpose of the arrangement,

72 L. De Broe and J. Luts, "BEPS Action6: Tax treaty abuse", 43 *Intertax* 2 (2015), p.132.

73 C. Taboada, "OECD Base Erosion and Profit Shifting Action 6: The General Anti-Abuse Rule", 69 *Bulletin for international taxation* 10 (2015), p. 604.

74 PPT Examples C, F, G, H, M.

75 PPT Examples A,B, E, J.

will not be sufficient.[76] The Commentaries state that "a person cannot avoid the application [of the PPT] by merely asserting that the arrangement or transaction was not undertaken or arranged to obtain the [tax treaty benefits]". Furthermore, as explained in section 5.2., the first test requires an objective analysis, based on facts and circumstances. The economic purposes that were put forward by the taxpayer (hereafter: 'the alleged economic purposes') must thus be identifiable on the basis of an objective analysis. Worded differently, the alleged economic purposes must be supported by the relevant facts and circumstances. An alleged economic purpose that is supported by the relevant facts and circumstances will hereafter be referred to as an economic purpose that is 'in line with reality'. Only economic purposes that are in line with reality, and are considered more important than the purpose of obtaining a treaty benefit (see sec. 4.4.3.3.), could potentially rebut the fulfilment of the first test.

Unfortunately, there is no guidance as to which facts and circumstances are relevant to determine whether an economic purpose is in line with reality.

It would however make sense that, if the relevant arrangement concerns the setting up of an intermediary company and the alleged purpose for doing so is related to the carrying out of economic activities by that intermediary company, the presence or absence of the economic substance of the company will be relevant to determine whether the alleged economic purpose is in line with reality, given that economic substance refers to the objective factors that indicate that a company carries out economic activities. For example, if the alleged purpose of setting up an intermediary company was for that company to provide group services to all of the subsidiaries located in the same region (see Example G of the PPT Examples), the economic substance of that intermediary company, consisting of a.o. its personnel, assets, functions and risks that are needed to carry out the relevant group services, must support such alleged purpose. If the intermediary company indeed has the economic substance that supports the alleged purpose, the purpose is considered in line with reality and can therefore potentially rebut the fulfilment of the first test, if it can also be considered that such purpose is more important than the purpose of obtaining a tax treaty benefit (see next section). If, on the other hand, the company does not have the economic substance which supports the alleged economic purpose, that purpose cannot be considered in line with reality and can therefore not rebut the fulfilment of the first test.

It is however less straightforward whether the economic substance of a company is also relevant in a situation where an existing company, rather than a

76 PPT Commentaries, para. 179.

newly established company, is used in a treaty shopping situation. Such existing companies, related or unrelated to the taxpayer, might already have economic substance before it was used for treaty shopping purposes. In such cases, a distinction needs to be made between the economic substance that is related to the alleged purpose for using that company as an intermediary, and the economic substance that has nothing to do with that alleged purpose. Take the example where an existing manufacturing company is allegedly interposed for that company to provide group services to all the subsidiaries located in the same region. In such case, the economic substance related to the manufacturing activities will be irrelevant, whereas the economic substance related to the carrying out of group services will be relevant to determine whether the alleged economic purpose is in line with reality.

The above shows that the relevance of the economic substance of a company that is used in a treaty shopping situation depends on the alleged economic purpose (i.e. whether or not the purpose is related to the carrying out of economic activities) and on whether the intermediary company is a newly established company or an existing company.

The relevance of economic substance for purposes of the first test is confirmed in the PPT Commentaries (para. 181), which state that it is unlikely that obtaining a tax treaty benefit will be considered one of the principal purposes "where [the] arrangement is inextricably linked to a core commercial activity". Given that a core commercial activity requires economic substance, it can be derived from the Commentaries that the presence of economic substance, supporting the existence of a core commercial activity, has the potential of rebutting the first test.[77]

The PPT Examples also confirm the relevance of the economic substance for the analysis under the first test when the alleged purpose for using a company as an intermediary is related to the carrying out of economic activities by that

77 See the following authors, who also argue that the relevance of economic substance can be derived from para. 181 of the PPT Commentaries: R. Danon, "Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups", 72 *Bulletin for International taxation* 1 (2018), p. 48; D. Duff, "Tax treaty abuse and the Principal purpose test – Part II", *Canadian Tax Journal* 66 (2018), p. 983; V. Chand, "The Principal Purpose Test in the Multilateral Convention: An in-depth Analysis", 46 *Intertax* 1 (2018), p. 23.

intermediary company.[78] In the PPT Examples G, H and K, a company was interposed for economic purposes that were related to the carrying out of economic activities. In Example G**,** Tco, located in State T, interposed a regional company, Rco, located in State R, between itself and five of its subsidiaries, located in neighbouring States. The economic purpose of interposing Rco, was to have a regional group company that provides group services to the five subsidiaries. Such services would include management, financing, treasury and other non-financing related services. In this example, it is assumed that the group services provided by Rco constitute 'a real business, through which Rco exercises substantive economic functions, using real assets and assuming real risks and that business is carried on by Rco through its own personnel located in state R'. In Example H, Rco was interposed between Tco and Tco's subsidiary, all located in different States. The alleged economic purpose of interposing Rco in State R was for Rco to provide the foreign activities that Tco could not manage from its own residence State due to practical issues, such as transportation, time differences, limited availability of personnel fluent in foreign languages and so on. The foreign activities include divers business activities, such as wholesaling, retailing, manufacturing, financing and domestic and international investment. In this Example it is stated that "Rco possess the human and financial resources that are necessary to perform these activities" and it is concluded that "it is clear that Rco's activities constitute the active conduct of a business". And in Example K, a Fund had established a regional investment platform, set up to carry out regional investment activities. In analysing whether the first test was met in these situations, the facts and circumstances that were taken into account included the economic substance of the interposed company. It is stated that "Rco employs an experienced local management team to review investment recommendations from Fund and performs various other functions which, depending on the case, may include approving and monitoring investments, carrying on treasury functions, maintaining Rco's books and records, and ensuring compliance with regulatory requirements in States where it invests". It is also mentioned that "the board of directors of Rco is appointed by Fund and is composed of a majority of resident

78 See the following authors, who also argue that the relevance of economic substance can be derived from the PPT Examples: D. Duff, "Tax Treaty Abuse and the Principal Purpose Test - Part II", 66 *Canadian tax journal* 947 (2018), p. 983; B. Kuzniacki, "The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from its Legal Implementation and Practical Application", 10 *World Tax Journal* 2 (2018), p. 267; R. Danon, "Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups", 71 *Bulleting for International taxation* 1 (2018), p. 48; D. Weber, "The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law", 10 *Erasmus Law Review* 1 (2017), p. 50; V. Chand, "The Principal Purpose Test in the Multilateral Convention: An in-depth Analysis", 46 *Intertax* 1 (2018), p. 23; R. Cunha, "BEPS Action 6: Uncertainty in the Principal Purpose Test Rule," *Global Taxation* 1 (2016), p. 187.

directors with expertise in investment management, as well as members of Fund's global management team".

It is of course also possible that the economic purpose of an arrangement is not related to the carrying out of economic activities. For example, a real estate fund may establish a holding company in a different state than itself and its subsidiaries as a way to protect the fund from the liabilities and potential claims against the fund's subsidiaries that hold the immovable property. A holding company could also be interposed to group together the subsidiaries that the taxpayer holds in a particular region. The Report on Letterbox Companies[79] of the European Commission, also gives an overview of what it considers to be legal (as opposed to illegal, fraudulent and abusive) uses of 'letterbox companies', whereby letterbox companies refers to companies that do not carry out any economic activity in their state of residence. Such legal uses include the setting up of a company for purposes of risk isolation[80], asset transfer[81] or securitization of loans[82].

In those cases, it is self-evident that it is irrelevant for the analysis of the first test whether or not the company that is used as an intermediary has economic substance, given that the company does not need any economic substance. In such cases, other facts and circumstances will be relevant to determine whether the alleged economic purpose is in line with reality.

The irrelevance of economic substance when the alleged economic purpose of an arrangement does not relate to the carrying out of economic activities, is confirmed in **Example E** of the Examples included in para. 187 of the PPT Commentaries, which relate to conduit arrangements. In this Example, Tco developed patents and licensed them to Rco, who subsequently licensed the patents to Sco. Rco is a holding company and directly holds both Tco and Sco. In return for the license, Sco paid royalties to Rco, who subsequently paid on the royalties to Tco. So instead of a direct license agreement and royalty payment between Tco and Sco, Rco is interposed. Since Rco does not have to carry out economic activities, it is irrelevant whether or not Rco has economic substance. The Example does not specify what

79 European Commission, Directorate General for Justice and Consumers, 'Letterbox Companies: Overview of the Phenomenon and Existing Measures: Final Report.' Publications Office 2021, p. 68 (hereafter referred to as the Report on Letterbox Companies).

80 An entity can decide to set up an SPV as a way to isolate any risks associated with a project of the entity.

81 Since the transfer of assets is sometimes burdensome and complicated, an entity can decide to create an SPV that owns the assets, to then subsequently sell the SPV with the assets as a whole or as part of an M&A deal.

82 A bank can for instance separate mortgage-backed securities from its other obligations by creating an SPV. The SPV then allows investors of the mortgage-backed securities to receive payments for these loans before other creditors of the bank.

the economic purpose is of interposing Rco, but it can be argued that it was done for efficiency purposes, given that Rco has multiple subsidiaries who license patents and multiple other subsidiaries who need those patents. It seems obvious that it is more efficient to group those licenses in a holding company, rather than have every subsidiary that has a patent, license them to every subsidiary that needs that patent. The facts and circumstances that are considered relevant do not include the (absence of) economic substance of Rco.

It is thus not always necessary that an interposed company has economic substance to prevent the application of the PPT. Worded differently, the absence of economic substance does not necessarily lead to fulfilment of the first test of the PPT.[83] Only if the alleged purpose of interposing a company is related to the carrying out of an economic activity, will the economic substance of the interposed company be relevant.

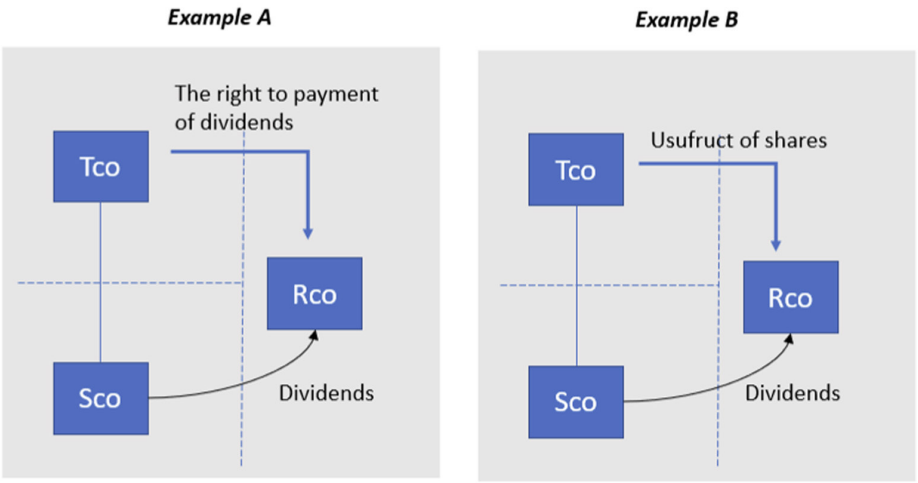
Irrespective of whether economic substance is relevant for purposes of the first test of the PPT, other facts and circumstances will also have to be taken into account to determine whether an alleged economic purpose is in line with reality. As already mentioned, it is however not clear which other facts and circumstances are relevant.

It is however not clear from the wording of the PPT, nor from the PPT Commentaries which other facts and circumstances are considered relevant. The PPT Examples can however give some indications. First of all, In Example E, reference is made to the fact that the holding company that was used as an intermediary between two subsidiaries located in different states, "is conforming to the standard commercial organisation and behaviour of the group". The Commentaries add that this conclusion however only holds true if "the same structure is applied with respect to other subsidiaries carrying out similar activities in other countries which have treaties which offer similar or more favourable benefits". This is however a very particular case and thus makes it difficult to draw general conclusions. Second, in Example D, regarding a collective investment vehicle, the OECD considered that the limited amount of investments (15%) of the holding company that led to treaty benefits, was a relevant factor when determining whether obtaining the treaty benefits was one of the principal purposes of using the holding company as an intermediary. Third, In Example D and K, the OECD refers to the fact that the company that was used as an intermediary, had filed their tax returns and paid their taxes on income in their state of residence. In conclusion, the standard commercial

83 See also Maisto, Guttman, Jimenez and Danon, who state the "the PPT does not necessarily require that a core commercial or substantial activity be exercised in a contracting state" in G. Maisto, D. Gutmann, A. Jimenez and R. Danon, "The Prohibition of Abuse of Rights After the ECJ Danish Cases", 49 *Intertax* 6/7 (2021), p. 502.

organization and behavior of the group, the amount of investments that benefit from a tax treaty and the fact that a company that is used for treaty shopping purposes, could be considered relevant facts and circumstances that should be considered when analyzing whether obtaining a tax treaty benefit was one of the principal purposes.[84]

Finally, It can also be concluded on the basis of the ordinary meaning of principal that, if no economic purpose can be identified, by default obtaining a tax treaty benefit will be a principal purpose. This is also confirmed in the previously mentioned paragraph in the PPT Commentaries, where it is stated that "where an arrangement can *only* be reasonably explained by a [tax treaty benefit], it may be concluded that one of the principal purposes of that arrangement was to obtain the benefit" (own emphasis). Examples A, B, E and J of the PPT Examples also confirm that if no economic purpose can be identified, obtaining a tax treaty benefit will be considered (one of) the principal purpose(s). In such cases, it will also be irrelevant whether or not the company that is used for treaty shopping purposes has economic substance.



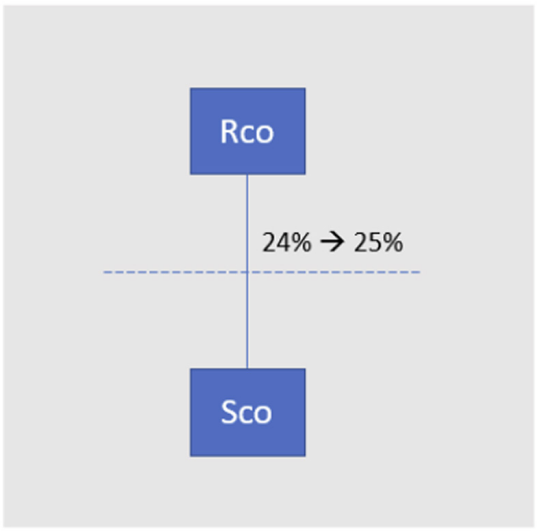
In **Example A and B**[85] (as depicted above), Tco has a wholly-owned subsidiary

84 In the *Lowy* case (the first and only case on the PPT), concerning an arrangement including a Luxembourg company that was interposed between the taxpayer and its subsidiaries, the Indian Court also considered relevant the fact that only a limited amount of investments of the Luxembourg company benefited from the applicable tax treaty and the fact that the Luxembourg company had filed its tax returns and paid its taxes in Luxembourg, when concluding that obtaining a treaty benefit was not of the principal purposes of interposing the Luxembourg company. See SC Lowy P.I. (LUX) S.A.R.L., vs. ACIT, 30 December 2024. For a more detailed analyses on this case, see M. Massant, "Lowy: the first PPT case", *Kluwer International Tax Blog*, March 24 2025.

85 Example A is based on the *Dutch Oil Company* case ruled by the Hoge Raad of the Netherlands in 1994 (NL: Hoge Raad, HR 6 April 1994, nr. 28 368, BNB 1994/217); Example B is based on the *Bank of Scotland* case ruled by the Supreme Administrative Court of France in 2006 (FR: *Conseil d'Etat*, 29 Dec 2006, (2006) 9 ITLR 683, *Ministre de L'Economie, des Finances et de L'Industrie v. Société Bank of Scotland).*

located in State S, from which it receives dividends. In Example A, Tco enters into an agreement with an independent financial institution (Rco) on the basis of which Tco assigns the right to payment of the dividends to that institution. In Example B, Tco enters into an agreement with a financial institution (Rco) on the basis of which the institution acquires the usufruct of newly issued- non-voting preferred shares of Tco's subsidiary which gives the institution the right to receive the dividends attached to these shares. No potential economic purposes were identified for the arrangements that led to a tax treaty benefit. The Examples therefore rightfully conclude that "in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the arrangement between Tco and Rco was for Rco to obtain the [tax treaty benefit]".

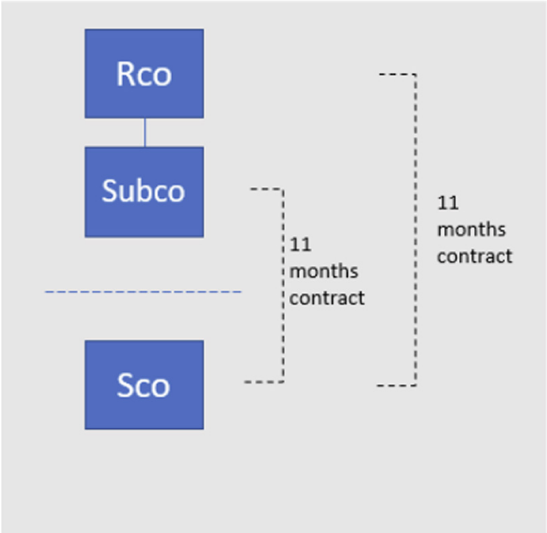
Example E



In **Example E**[86] (depicted above)**,** a company had increased its shareholding percentage in its wholly-owned subsidiary from 24% to 25%. Again, there were no economic purposes identified for the arrangement that led to a tax treaty benefit. The Example therefore rightfully concludes that "one of the principal purposes of increasing the participation to 25% is clearly to obtain [the tax treaty benefit]".

86 This is not a treaty shopping case, because, given that Rco's residence is not disputed, he is entitled to rely on the treaty between its residence state, State R, and the state where the dividend originates, State S. The Example is however still useful to understand the application of the PPT to treaty shopping situations, since the PPT applies the in the same manner, irrespective of the type of treaty abuse.

Example J



And finally, in **Example J**[87] (depicted above), the taxpayer and its recently incorporated wholly-owned subsidiary had both concluded a contract with a company located in another State, whereby the taxpayer would be jointly and severally liable for the performance of its subsidiary. No economic purposes were identified for the splitting up of the contract, which led to a tax treaty benefit. The Example thus rightfully concludes that "one of the principal purposes for the conclusion of the separate contract was for [the taxpayer and its subsidiary] to each obtain the [tax treaty benefit]".

In conclusion, the above shows that for an economic purpose to rebut the fulfilment of the first test, such economic purpose must be in line with reality. The economic substance of a company is thereby only relevant if an economic purpose can be identified that relates to the carrying out of economic activities. In case of all other economic purposes, the economic substance of the company is irrelevant to determine whether an economic purpose is in line with reality. If it can be concluded that the alleged economic purposes is in line with reality, the next step is to determine whether the economic purpose is more important than the purpose of obtaining a tax treaty benefit. The next section delves into this aspect of the first test.

Economic purposes must outweigh the purpose of obtaining a tax treaty benefit

The above has shown that an economic purpose can rebut the fulfilment of the first test if it is in line with reality and if that purpose is more important than

87 Similar to Example E, this is not a treaty shopping case.

the purpose of obtaining a tax treaty benefit. If, on the other hand, the purpose of obtaining a tax treaty benefit is equally important or more important than the economic purpose, the first test will be considered fulfilled. Unfortunately, it is not clear how to determine whether the economic purpose is more important than (i.e. outweighs) the purpose of obtaining a tax treaty benefit.[88] This is however essential for the analysis of the first test of the PPT.

It could be argued that an economic purpose outweighs the purpose of obtaining a tax treaty benefit if the arrangement is "inextricably linked to a core commercial activity". This follows from the previously mentioned para. 181 of the PPT Commentaries, which states that it is 'unlikely' that obtaining a tax treaty benefit was one of the principal purposes if the arrangement is inextricably linked to a core commercial acidity. It could thus be argued that if an intermediate company carries out a core commercial activity, which is evidenced by its economic substance, the economic purpose of using that company as an intermediary is likely to outweigh the purpose of obtaining a tax treaty benefit.[89] However, as the Commentaries state, it is merely "unlikely" that the first test is fulfilled when an intermediate company carries out a core commercial activity, as evidenced by its economic substance. Furthermore, as previously mentioned, if the intermediary company was an already existing company, it should not matter whether that company carries out a core commercial activity, if that activity has nothing to do with the purpose of using that company as an intermediary.

It could also be argued that it derives from the PPT Examples that economic purposes that are in line with reality, as evidenced by the presence of economic substance, are likely to be more important than the purpose of obtaining a tax

88 See also: LANG, who states that it remains unclear as to which criteria apply between principal purposes and secondary purposes, on the one hand, and between different principal purposes, on the other (in M. Lang, "The Signalling Function of Article 29(9) of the OECD Model – The 'Principal Purpose Test,'" 74 *Bulletin for International Taxation* 4/5 (2020), p. 267). More recently, he argued that it is an impossible undertaking to make a distinction (in M. Lang and O. Nesterov-Surmenko, "Chapter 9: The principal purpose test of article 29(9) OECD Model (2017", in G. Kofler et al. (eds), *Anti-Abuse Rules and Tax Treaties* (Wolters Kluwer 2024), p. 213); Similarly, CUNHA states that the OECD does not define 'principal purpose' or indicate how tax officers will classify different tax and non-tax purposes as 'principal' or 'secondary' (in R. Cunha, "BEPS Action 6: Uncertainty in the Principal Purpose Test Rule," *Global Taxation* 1 (2016), p. 185); L. DE BROE states that the OECD does not provide any guidance on how one should distinguish between principal purposes and ancillary purposes on the one hand, and between various principal purposes on the other hand (in L. De Broe and J. Luts, "BEPS Action 6: Tax Treaty Abuse,", 43 *Intertax* 2 (2015), p.131); PALMITESSA states that the OECD Model Convention is significantly ambiguous in defining what a 'principal purpose' is and in distinguishing between 'principal' and 'secondary' purposes (in E. Palmitessa, "Interplay Between the Principal Purpose Test in the Multilateral BEPS Convention and the Beneficial Ownership Clause as Treaty Anti-Avoidance Tool Targeting Holding Structures," 46 *Intertax* 1 (2018),p. 60).

89 See also MITHE, who argues that the purpose of obtaining a tax treaty benefit will be "relegated to the position of an ancillary purpose and will not be considered a principal purpose" if an arrangement is linked to a core commercial activity. She argues that the OECD's position is "borne from a rather ideal presumption that the commercial purpose significantly outweighs the tax purpose", in A. Mithe, "Critical Analysis of the Principal Purpose Test and the Limitation on Benefits Rule: A World Divided but It Takes Two to Tango", *World Tax Journal* 129 (2020), p. 151.

treaty benefit.[90] This is because, ass mentioned in [X], all PPT Examples where an economic purpose was identified, in combination with the economic substance of the interposed company, the OECD concluded that obtaining a treaty benefit was not a principal purpose. However, given that the PPT examples are not sufficiently clear as to why the OECD came to its conclusion and given that the PPT Examples are not binding, no direct conclusions can be drawn from them.

WEBER puts forward a possible criterion to determine whether the purpose of obtaining a tax treaty benefit is more important than the economic purpose, which would lead to the fulfilment of the first test. He argues that when the tax benefits are much higher than the economic benefits, one can come to the conclusion that obtaining the tax treaty benefit was the principal purpose. He gives the example where a restructuring leads to a tax treaty benefit of EUR 10 million less tax paid and an economic benefit of EUR 30.000 in reduced administrative costs.[91] By analogy, it could be argued that the economic purpose outweighs the purpose of obtaining a tax treaty benefit, when the economic benefit is much higher than the tax benefit. There are however some shortcomings to this view. First of all, it is often very difficult or even impossible to quantify the economic benefit of a transaction, let alone quantify the tax treaty benefit. And secondly, this might lead to inconsistent outcomes for the same kind of arrangement depending on the relative importance of the tax treaty benefit as opposed to the economic benefit.

Some authors argue that obtaining a tax treaty benefit was a principal purpose where it is reasonable to conclude that the relevant arrangement and transactions would not have been executed in the absence of the tax treaty benefit that the rule is aimed at denying.[92] This is however not necessarily true. Think of a situation similar to Example C of the PPT Commentaries, where a taxpayer company wants to expand its business and sets up a new manufacturing plant for this purpose. Let us assume that the estimated economic benefit of setting up a new manufacturing plant is 30M (= added economic benefit - costs of setting up a manufacturing plant). The taxpayer must decide on where to set up the manufacturing plant. Assume that, if it were to set up the plant in state A or B, it would have tax costs

90 V. Chand, "The Principal Purpose Test in the Multilateral Convention: An in-Depth Analysis" 46 Intertax 1 (2018), p. 23; C. Elliffe, The Meaning of the Principal Purpose Test: One Ring to Bind Them All?", 11 World Tax Journal 1 (2019), p. 72; A. Mithe, "Critical Analysis of the Principal Purpose Test and the Limitation on Benefits Rule: A World Divided but It Takes Two to Tango", *World Tax Journal* 129 (2020), p. 151.

91 D. Weber, "The Reasonableness Test of the Principal Purpose Test Rule in OECD BEPS Action 6 (Tax Treaty Abuse) versus the EU Principle of Legal Certainty and the EU Abuse of Law Case Law", 10 *Erasmus Law Review* 1 (2017), p. 57.

92 G. Maisto, "Chapter 25: Counteracting tax treaty abuses from a European perspective: frictions and interactions between the OECD PPT and the ATAD GAAR", in Kofler et al. (eds.), *Thinker, teacher, traveler: reimagining international tax - essays in honor of H. David Rosenbloom* (IBFD Books 2021), p. 352.

of 40M (for instance because it would have to pay WHT on dividends at domestic rates). Therefore, the taxpayer decides to set up the plant in State C, because the applicable tax treaty provides for a treaty benefit, lowering the tax costs by half, to 20M. In the absence of the tax treaty benefit provided by the treaty with State C, the taxpayer would not have set up the plant because the economic benefit of 30M would be eroded by the tax costs 40M. Only if the tax costs are lower than the economic benefit, will the taxpayer be willing to set up the plant. This does not mean however that obtaining the treaty benefit was necessarily one of the principal purposes of setting up the plant. Several arguments could be made to argue that obtaining a tax treaty benefit was not one of the principal purposes of setting up the plant: First of all, on the basis of above-mentioned theory of WEBER, one could argue that obtaining the tax treaty benefit was not a principal purpose because the economic benefit, which amounts to 30M, is higher than the tax benefit, which amounts to 20M (the tax costs of 40M are lowered by half thanks to the tax treaty benefit).Second, on the basis of the PPT Commentaries (para. 181), it could be argued that obtaining a treaty benefit was not a principal purpose because the arrangement is 'inextricably linked to a core commercial activity', assuming the facts and circumstances show that the plant carries out a core commercial activity. Third, on the basis of the PPT Examples and in particular example C, it could even be argued that obtaining a tax treaty benefit was not a principal purpose because the alleged economic purpose of wanting to expand its business is in line with reality, as evidenced by its economic substance. As argued above, the Examples imply that an alleged economic purpose which is in line with reality, as supported by economic substance, is likely to outweigh the purpose of obtaining a tax treaty benefit. So, even though the arrangement would not have been executed in the absence of the tax treaty benefit, it is still possible that obtaining the tax treaty benefit was not one of the principal purposes.

The above shows that there is thus still a lot of uncertainty regarding how to determine whether an economic purpose can be considered more important than the purpose of obtaining a tax treaty benefit and it will vary from case to case depending on the facts and circumstances. From the viewpoint of the OECD and the member states, it is arguably better to have arrangements fulfil the first test even if there were also economic purposes that are in line with reality and that were more important than obtaining a treaty benefit, than to have arrangements being excluded from the first test because the taxpayers fabricated an equally important economic purpose. The arrangements that fulfil the first test are not necessarily denied a tax treaty benefit because it must still be determined whether granting the treaty benefit would contradict the object and purpose of the relevant treaty provisions. It does however lead to uncertainty for taxpayers, who might be

dissuaded to invest abroad if they run the risk of setting in motion the application of the PPT by fulfilling the first test and consequently having to prove that granting the treaty benefit would not contradict the relevant treaty provision.

Conclusion

It can be concluded on the basis of the above that the relevance of economic substance for the first test of the PPT depends on two cumulative factors. First of all, there must be a potential economic purpose that can explain the arrangement. If no economic purpose can be identified, such as in PPT Examples A, B, E and J, it is not relevant for the first test whether or not the interposed company has economic substance. And secondly, if an economic purpose can be identified, such economic purpose must be related to the carrying out of economic activities. If the economic purpose is not related to the carrying out of economic activities, the economic substance of the company is not relevant (such as in Example E of the conduit examples).

Once it is determined that the economic substance of the interposed company is relevant for the analysis of the first test, and after determining whether the company does or does not have economic substance, it must be determined what this means for the first test. A distinction must thereby be made between the presence and the absence of economic substance.

On the basis of the above analysis, it can be concluded that, if the stated economic purpose relates to the carrying out of economic activities, the absence of economic substance means that the economic purpose is not in line with reality. As a consequence, the taxpayers cannot refer to such economic purpose to exclude the fulfilment of the first test. On the other hand, if the company does have economic substance, the economic purpose will be considered in line with reality and could potentially exclude the fulfilment of the first test. In contrast to the opinion of several authors, the first test cannot be excluded by merely referring to the presence of economic substance. First of all, other facts and circumstances might be needed to confirm that the economic purpose is in line with reality. Furthermore, even if the economic purpose is in line with reality, the economic purpose is not necessarily more important than the purpose of obtaining a tax treaty benefit. It must thus first be determined that the economic purpose, which is in line with reality, is more important than the purpose of obtaining a tax treaty benefit, before it can exclude the fulfilment of the first test. it is however not clear

how to determine whether an economic purpose is more important than the purpose of obtaining a tax treaty benefit. Furthermore, there are arguments to be made that the presence of economic substance is an indication that the economic purpose is more important, but this is not entirely clear.