THE INTERACTION OF DOMESTIC ANTI-AVOIDANCE RULES WITH TAX TREATIES

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Abstract

Tax avoidance schemes, including cross-border tax avoidance schemes, are counteracted at the domestic law level through the application of domestic anti-avoidance rules such as judicial doctrines; statutory general anti-avoidance rules or statutory specific anti-avoidance rules. The issue then arises as to what is the impact of tax treaties on such domestic anti-avoidance rules. In general, it is accepted that tax treaties are rules that limit domestic law and if a conflict arises between the domestic law and tax treaty – the latter prevails. However, whether this position is correct with respect to domestic anti-avoidance rules is highly questionable, especially, in light of the 2003 controversial update to the OECD Commentary, the update to the UN Commentary in 2011 and the OECD/G20 BEPS deliverables. Accordingly, in the thesis, the author analyses the interaction of domestic anti-avoidance rules with tax treaties, in particular, the question of whether the effects of applying domestic anti-avoidance rules, from a source or residence States perspective, can be curtailed by tax treaties? The analysis takes into consideration the various domestic and tax treaty related changes proposed by the BEPS Action Plan, notably, Action 6 on preventing treaty abuse. Moreover, the thesis makes policy recommendations in the form of treaty provisions that States can incorporate in their tax treaty network in order to ensure that conflicts do not arise between domestic anti-avoidance rules and tax treaties.

Résumé

L'évasion fiscale, y compris les montages abusifs transfrontaliers, est contrecarrée au niveau du droit interne par l'application de règles anti-abus internes, telles que des règles jurisprudentielles ou des règles légales générales ou spécifiques anti-abus. La question se pose alors de connaître l'impact des conventions fiscales sur de telles règles anti-abus internes. Il est en général admis que les conventions fiscales constituent des règles limitant le droit interne, et que, en cas de conflit entre le droit interne et une convention fiscale, c'est celle-ci qui primera. Cependant, la question de savoir si cette position est correcte en ce qui concerne les règles anti-abus internes est très discutable, en particulier à la lumière de la mise à jour 2003 controversée du commentaire OCDE, de la mise à jour 2011 du Commentaire ONU et des résultats BEPS attendus de l'OCDE et du G20. Ainsi, l'auteur analyse dans sa thèse l'interaction entre des règles anti-abus internes et les conventions fiscales, et examine en particulier la question de savoir si les conséquences de l'application de règles anti-abus internes, que ce soit du point de vue de l'Etat de source ou de résidence, peuvent être limitées par des conventions fiscales. L'analyse prend en compte les divers changements proposés dans le domaine interne et conventionnel par le Plan d'Action BEPS, en particulier par l'action 6 concernant utilisation abusive des conventions fiscales. En outre, des recommandations de principe sont faites dans la thèse, sous la forme de dispositions conventionnelles pouvant être intégrées par les Etats dans leur réseau de conventions fiscales afin d'éviter que des conflits ne surgissent entre des règles anti-abus internes et des conventions fiscales.

Key words: tax avoidance, treaty shopping, rule shopping, base erosion, profit shifting, transfer of residence, tax deferral, domestic anti-avoidance rules, judicial doctrines, sham, substance over form, economic substance, step transaction, business purpose, abuse of law, fraus legis, statutory GAAR, statutory SAAR, anti-treaty shopping, anti-rule shopping, thin capitalization, interest limitation, anti base erosion rules, controlled foreign company, switch over clause, exit taxes, extended tax liability, domestic law, tax treaty, treaty override, abuse of tax treaties, abuse of domestic law, base erosion and profit shifting, limitation of benefits clause, guiding principle, principal purpose test, saving clause, fundamental freedoms, directives, safeguard clause

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Abbreviations

General

Art.	Article
BEPS	Base Erosion and Profit Shifting
CFA	Committee of Fiscal Affairs
CFC	Controlled Foreign Company
EBIDTA	Earnings Before Interest Depreciation Taxation and Amortization
EFTA	European Free Trade Agreement
EC	European Community
EU	European Union
FC	Fiscal Committee
FMV	Fair Market Value
GAAR	General Anti-Avoidance Rule
IBFD	International Bureau of Fiscal Documentation
IFA	International Fiscal Association
ILC	International Law Commission
ITLR	International Tax Law Reports
LOB	Limitation of Benefit
MAP	Mutual Agreement Procedure
No.	Number
OECD	Organisation for Economic Cooperation and Development
p.	Page
pp.	Pages

Para.	Paragraph
Paras.	Paragraphs
PPT	Principal Purpose Test
SAAR	Specific Anti-Avoidance Rule
TFEU	Treaty on the Functioning of the European Union
TP	Transfer Pricing
UK	United Kingdom
UN	United Nations
US	United States
USA	United States of America
USD	United States Dollar
Vol.	Volume
WP	Working Party

Courts

AHC	Australian High Court
ASAC	Austrian Supreme Administrative Court
CTC	Canadian Tax Court
CFCA	Canadian Federal Court of Appeals
CSC	Canadian Supreme Court
DSC	Dutch Supreme Court
ECHR	European Court of Human Rights
ECJ	Court of Justice of the European Union
FSAC	Finnish Supreme Administrative Court
FSC	French Supreme Court
GFFC	German Federal Fiscal Court
ICJ	International Court of Justice

ITAT	Indian Income Tax Appellate Tribunal
ISC	Supreme Court of India
JSC	Japanese Supreme Court
KSC	Korean Supreme Court
SATC	South African Tax Court
SSCA	South African Supreme Court of Appeals
SPSC	Spanish Supreme Court
SSAC	Swedish Supreme Administrative Court
SFCA	Swiss Federal Commission of Appeal
SFSC	Swiss Federal Supreme Court
UK SC	UK Special Commissioners
UK HOL	UK House of Lords
UK HC	UK High Court
UK COA	UK Court of Appeals
UK SSC	UK Supreme Court
US TC	US Tax Court
US FC	US Court of Federal Claims
US COA	US Court of Appeals
US SC	US Supreme Court

PART I: INTRODUCTION

1. Introduction

1.1. Cross border tax avoidance

1. Cross border tax avoidance[1], which, particularly leads to BEPS is a problem for every State[2] because it adversely affects a tax system[3]. This is mainly because tax avoidance practices are contrary to "*fiscal equity, have serious budgetary effects and distort international competition and capital flows*"[4].

2. At the outset, it should be noted that tax avoidance does not mean tax evasion. There is general agreement that tax evasion[5] refers to criminal activity that is punishable by criminal sanctions as it involves the use of illegitimate means to evade the payment of tax[6]. Tax avoidance, on the other

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1 Also known as "*aggressive tax planning*" or" *unacceptable tax planning*". LAMPREAVE, Avoidance, p. 50.

2 ARNOLD, 2003 changes, p. 244.

3 PREBBLE, PREBBLE, Tax Avoidance, p. 22; THURONYI, Comparative tax, p. 151.

4 OECD, Tax Evasion Report, Para. 10.

5 Also known as "*tax fraud*". LAMPREAVE, Avoidance, p. 50.

6 *Commentators*: THURONYI, Comparative tax, p. 157; LAMPREAVE, Avoidance, p. 49; TOOMA, Thesis, p. 14; KARIMERI, Avoidance, p. 297; FREEDMAN, Interpretation, p. 70; KELLOUGH, Tax Avoidance, p. 1821; LI, SANDLER, Abuse, p. 894; BAKER, Tax avoidance, pp. 6-9; FROMMEL, Avoidance, p. 57; SEELY, GAAR, p. 4. *Courts*: The ISC (Justice Reddy) has held that "*tax evasion is illegal*". See ISC: Commercial Tax Officer v. MC Dowell and Company Limited, 1986 AIR 649 (SC), April 17th 1985; The UK HOL (Lord Goff) has held that tax evasion is a "*label which is perhaps better kept for those transactions which are traditionally so described because they are illegal*". See UK HOL: Craven (Inspector of Taxes) v White, [1988] STC 476, July 21st 1988; The Privy Council in New Zealand has held that "*Evasion occurs when the commissioner is not informed of all the facts relevant to an assessment of tax. Fraudulent evasion may lead to a criminal prosecution as well as reassessment"*. See Privy Council: Commissioner of Inland Revenue v Challenge Corporation Ltd, [1986] STC 548, October 20th, 1986; The ECJ has held that "*tax evasion…is illegal"*. See ECJ: Halifax plc and others v Customs and Excise Commissioners, Case No: C-255/02, February 21st 2006; The OECD considers tax evasion as a "*term that is difficult to define but which is generally used to mean illegal arrangements where liability to tax is hidden or ignored, i.e. the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities"* OECD, Glossary of Tax Terms; The Committee of experts on international cooperation in tax matters provide that "*Tax evasion is usually associated with the commission of a criminal offense. It can be considered to consist of willful and conscious non-compliance with the laws of a taxing jurisdiction which can include a deliberate*

hand, can be distinguished from tax evasion[7]. The key distinction is that tax evasion is illegal whereas tax avoidance is not[8].

3. Tax avoidance is not synonymous with tax mitigation[9] either but the distinction between them is much harder to define. Tax mitigation can be defined as a reduction in tax in such a way that the taxing legislation clearly encourages or permits[10]. In contrast, tax avoidance seems to exist somewhere between tax evasion and tax mitigation and is generally understood to mean a reduction in tax in such a way that the transaction undertaken by a taxpayer falls within the letter of the law but runs counter to

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concealment of facts from revenue authorities. Tax evasion is an action by which a taxpayer tries to escape legal obligations by fraudulent or other illegal means. It may result from the evasion of tax on income that arises from illegal activities, such as smuggling, drug trafficking, and money laundering. In a broader sense, tax evasion may also encompass a reckless or negligent failure to pay taxes legally due, even if there is no deliberate concealment of income or relevant information. Notwithstanding unintended evasion normally leads to only a tax payment with interest and penalties". See COMMITTEE OF EXPERTS, Tax evasion, Para. 71.

7 However, it has been argued that the distinction between tax avoidance and tax evasion is blurred for the tax authorities as tax avoidance has been treated as tax evasion. TLRC, Countering tax avoidance, p. 10; COMMITTEE OF EXPERTS, Tax evasion, Para. 73.

8 *Commentators*: THURONYI, Comparative tax, p. 157; LAMPREAVE, Avoidance, p. 49; TOOMA, Thesis, p. 14; KARIMERI, Avoidance, p. 297; KELLOUGH, Tax Avoidance, p. 1821; FROMMEL, Avoidance, p. 57; SEELY, GAAR, pp. 4-6; ARNOLD, 2003 changes, p. 244; STRENG, YODER, JAAR, p. 599. *Courts*: The ISC (Justice Reddy) has held that "*Tax avoidance, it seems, is legal*". See ISC: Commercial Tax Officer v. MC Dowell and Company Limited, 1986 AIR 649 (SC), April 17th 1985; The ECJ has held that "*With respect to the notion of tax avoidance in the United Kingdom, it is legal"*. See ECJ: Halifax plc and others v Customs and Excise Commissioners, Case No: C-255/02, February 21st 2006, footnote 72; The OECD considers tax avoidance as a "*A term that is difficult to define but which is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow"* OECD, Glossary of Tax Terms; The Committee of experts on international cooperation in tax matters provide that *"Tax avoidance… involves the attempt to reduce the amount of taxes otherwise owed by employing legal means. Tax avoidance occurs when persons arrange their affairs in such a way as to take advantage of weaknesses or ambiguities in the tax law. Although the means employed are legal and not fraudulent, the results are considered improper or abusive"*. See COMMITTEE OF EXPERTS, Tax evasion, Para. 73.

9 Also known as "*tax planning*" or "*acceptable tax avoidance*". LAMPREAVE, Avoidance, p. 49.

10 PREBBLE, PREBBLE, Tax Avoidance, p. 22; THURONYI, Comparative tax, p. 156; LAMPREAVE, Avoidance, p. 49; TOOMA, Thesis, p. 17; ITP, Fundamentals, pp. 51-53; BAKER, Tax avoidance, p. 9; SEELY, GAAR, pp. 4-6.

its spirit and purpose[11]. Courts have generally provided a similar distinction. To illustrate, Lord Templeman in the *Challenge Corporation case*[12] outlined the difference between tax avoidance and mitigation. He defined tax mitigation as occurring "*where the taxpayer obtains a tax advantage by reducing his income or by incurring expenditure in circumstances in which the taxing statute affords a reduction in tax liability"*. In contrast, tax avoidance arises "*when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had"*. Likewise, Lord Nolan in the *Willoughby case*[13] outlined the difference between tax avoidance and mitigation by providing that "*The hall mark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hall mark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option"*[14].

1.2. The response to cross-border tax avoidance at the domestic tax law level: Domestic anti-avoidance rules

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11 PREBBLE, PREBBLE, Tax Avoidance, p. 22; THURONYI, Comparative tax, p. 156; LAMPREAVE, Avoidance, p. 50; TOOMA, Thesis, p. 17; ITP, Fundamentals, pp. 51-53; BAKER, Tax avoidance, p. 9.

12 See Privy Council, New Zealand: Commissioner of Inland Revenue v Challenge Corporation Ltd, [1986] STC 548, October 20th 1986.

13 UK HOL: Inland Revenue Commissioners v Willoughby and related appeal, [1997] STC 995, July 10th 1997.

14 The OECD has put forward a similar distinction. OECD, Tax Evasion Report, Annex II; The Committee of experts on international cooperation in tax matters provide that "*Many countries make a distinction between acceptable tax avoidance and unacceptable tax avoidance. Unacceptable tax avoidance is achieved by transactions that are genuine and legal but involves deceit or pretense or sham structures; it is an indirect violation or an improper use of the tax laws or treaties. Acceptable tax avoidance methods or tax planning however reduces tax liability through transaction or other activities that are intended by legislation"*. See COMMITTEE OF EXPERTS, Tax evasion, Para. 74.

1.2.1. Introductory comments

4. Domestic anti-avoidance rules are rules of domestic tax law that are intended to curb avoidance of tax (including avoidance of tax in cross-border situations)[15]. The rules can either be established through judicial precedent[16] or introduced by the legislature in statutory law[17].

1.2.2. The judicial response to tax avoidance

5. It is fair to say that tax avoidance thrives on the literal interpretation of the tax legislation[18]. Thus, in order to strike down a tax avoidance scheme a literal interpretation of the legislation should be discounted. In this respect, it should be noted that a court's approach towards statutory (tax legislation) interpretation is of primary importance as the approach adopted by courts gives an indication as to how restraining or accommodating the legal climate of a State is vis-à-vis tax avoidance[19]. Generally, if a court adopts an approach to interpreting tax legislation, which takes into consideration the purpose or intention behind it then such an approach will less likely leave room for tax avoidance. On the other hand, if a court disregards the purpose or intention of the legislation in the interpretation process then such an approach will more likely foster tax avoidance[20]. While courts in several jurisdictions consistently recognize the right of taxpayers to avoid taxes by means that are within the law[21] – they have nonetheless also found that tax laws should be interpreted so as to prevent their avoidance by the use of transactions that have no economic or commercial or business rationale. Thus, through their process of statutory interpretation, courts tend to develop judicial anti-avoidance doctrines to curb tax avoidance. The most common judicial doctrines applied by Courts are the "*sham*", "*simulation*",

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15 GERZOVA, POPA, Anti Avoidance, p. 421.

16 The question arises as to whether it is possible for Courts to develop anti-avoidance rules or doctrines. The author submits that the answer to this question varies from jurisdiction to jurisdiction. Generally, in the US, it has been contended that no constitutional rule has prohibited the courts from developing anti-avoidance rules. However, in other jurisdictions such as Canada, it is contended that courts cannot create anti-avoidance rules. ZIMMER, JAAR, pp. 40-41.

17 MICHEL, Anti Avoidance, p. 414.

18 FREEDMAN, Interpretation, p. 63; FREEDMAN, Tax Avoidance, p. 1039.

19 PEREZ, BAEZ, 2003 changes, pp. 139-143.

20 THURONYI, Comparative tax, p.151; KARIMERI, Avoidance, p. 298; ZIMMER, JAAR, p. 37.

21 VOGEL, Commentary, p.116; VOGEL, 2015 Commentary, p.124; ZIMMER, JAAR, p. 47.

"*substance over form*", "*economic substance*", "*step transaction*", "*fraus legis*", "*business purpose*" or "*abuse of rights*" doctrines. These doctrines attempt to interpret the tax legislation in manner which curtails tax avoidance. However, it should be noted that no State applies all of these doctrines nor are they applied consistently from one State to another.

1.2.3. The legislative response to tax avoidance

6. Once the legislature identifies a tax avoidance scheme, the most common response is to introduce a SAAR that combats that particular tax avoidance transaction [22]. However, a common outcome following the enactment of a SAAR is that taxpayers, more often than not, find new avoidance opportunities not curtailed by such SAARs. Accordingly, as a general measure to counter tax avoidance, States may introduce a statutory GAAR. Though similar to judicial anti-avoidance doctrines, there is considerable variation in the form that the statutory GAARs take. Nevertheless, the various forms have approximately the same effect in the sense that the statutory GAAR is a tool to deny the tax benefits of tax avoidance transactions or arrangements believed not to have any commercial substance or business purpose[23]. Many States currently have SAARs in place as opposed to statutory GAARs [24] but this trend may change in light of international developments, especially, the OECD's BEPS project.

[22] EY, GAAR, p. 2.
[23] EY, GAAR, p. 2.
[24] EY, GAAR, pp. 4-9.

1.3. Tax treaties

1.3.1. The residence vs source principle

7. In general, States use the "*residence*" concept to tax their taxpayers (natural or juridical persons) on a worldwide income basis (or at least for some income categories). The right to tax on a worldwide basis stems from the fact that a resident taxpayer has close personal and economic ties to that country. Similarly, States use the "*source*" concept to tax non- residents. The right of the source State to tax on a limited basis stems from the fact that such a taxpayer derives income from the territory of that country. Thus, more often than not, when a resident of one country derives income from another country, both the residence and source States exercise their taxing rights over that item of income thereby giving rise to double taxation[25].

1.3.2. Types of double taxation

8. Double taxation, in cross-border scenarios, can either be juridical or economical double taxation. Juridical double taxation is defined as "*the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods*" [26]. Conversely, economic double taxation is defined as a situation wherein "*two different persons are taxable in respect of the same income or capital*" [27]. Such double taxation can have a harmful effect on the movement of persons, capital, goods, services and technology between countries.

1.3.3. Tax treaties: Their role and structure

9. To reduce the harmful effects of double taxation, States enter into tax treaties. The role of these international agreements is to foster cross-border movement of persons, capital, goods, services and technology by eliminating double taxation[28]. Such agreements, which are primarily based on the OECD Model Convention (last updated in 2014 – all references in this thesis will be made to 2014 version of the OECD Model unless stated otherwise), "*limit the content of tax law of both contracting States*"[29] and, in general, do not

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25 VOGEL, Commentary, p. 9; VOGEL, 2015 Commentary, p. 12.
26 2014 OECD Comm. Introduction, Para. 1.
27 2014 OECD Comm. Art 23. Para. 2.
28 VOGEL, Commentary, p. 10; VOGEL, 2015 Commentary, p. 13.
29 VOGEL, Commentary, p. 20; VOGEL, 2015 Commentary, p. 22.

impose taxes.

10. The OECD Model consists of seven chapters. Chapter I deals with the "*scope"* (Art. 1-2) of the treaty. Chapter II deals with "*definitions*" (Art. 3-5) of treaty terms. Chapter III and IV, which deal with the core provisions of these agreements provide the "*distributive rules*" (Art. 6-22) that allocate taxing rights among States with respect to items of income and capital. Chapter V deals with rules for the residence State to provide "*relief*" from double taxation by either utilizing the exemption method (Art. 23A) or credit method (Art. 23B). Moreover, Chapter VI contains "*special provisions*" that deal with non-discrimination (Art. 24), dispute resolution (Art. 25), exchange of information (Art. 26), assistance in collection of taxes (Art. 27), members of diplomatic missions and consular posts (Art. 28) and territorial extension (Art. 29). Finally, Chapter VII of the model contains provisions with respect to entry into force (Art. 30) and termination of a tax treaty (Art. 31).

1.4. Purpose of the thesis: to analyze the interaction of domestic anti-avoidance rules with tax treaties

11. Tax avoidance schemes, including cross border tax avoidance schemes, are counteracted at the domestic law level through domestic anti-avoidance rules such as judicial doctrines; statutory GAARs and SAARs. The purpose of this thesis is to analyse the impact of tax treaties on such domestic anti-avoidance rules as it is generally accepted that tax treaties are rules that limit domestic law and if a conflict arises between the domestic law and tax treaty – the latter prevails[30]. However, whether this position is correct, especially with respect to domestic anti-avoidance rules, is questionable. Accordingly, the thesis discusses the interaction of domestic anti-avoidance rules with the provisions of tax treaties to ascertain if a conflict exists and the extent to which such domestic rules are limited by tax treaties.

[30] VOGEL, Commentary, p. 20; VOGEL, 2015 Commentary, p. 22; VAN RAAD, Fundamental rules, pp. 587-590.

1.5. Previous studies on this topic

12. The thesis topic has been discussed and debated by the OECD and the UN on several occasions and the view of these international organizations has evolved over a period of time (from 1961 – 2015: *see chapter 8*). The topic has also been discussed at several IFA congresses. For instance, it was briefly discussed as part of a congress subject during the 37th IFA congress held in Venice (1983)[31]. Thereafter, the topic was discussed in a detail at a seminar held during the 48th IFA congress in Canada (1994)[32]. The topic was, once again, briefly touched upon in the 56th IFA congress held in Oslo (2002)[33]. Subsequently, it was discussed and debated as part of a congress subject during the 64th IFA congress held in Rome (2010)[34]. In addition, several commentators have explored the topic in books[35] or articles[36]. However, to date, no thesis has been published which exclusively deals with this subject in a holistic manner. In 2013, the OECD launched its project on BEPS[37]. It is reasonable to predict that pursuant to this project several States will introduce domestic anti-avoidance rules or restore the effectiveness of existing anti-avoidance rules to counteract BEPS[38]. Accordingly, it is important to analyse whether such domestic measures might be curtailed by tax treaties.

1.6. Thesis methodology and structure

13. The thesis analyses the interaction of domestic anti-avoidance rules with tax treaties. Clearly, all the domestic anti-avoidance rules of all States cannot be analysed. Consequently, the author has restricted himself to analyzing only domestic anti-avoidance rules that can be used to counteract cross-border tax avoidance schemes. Accordingly, the questions arise as to what the typical cross border tax avoidance schemes are and what are the most

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31 UCKMAR, Tax Avoidance.
32 IFA, Abuse.
33 ZIMMER, JAAR.
34 VAN WEEGHEL, Tax Avoidance.
35 For instance, see DE BROE, Thesis; VAN WEEGHEL, Thesis; ARNOLD, VAN WEEGHEL, Abuse.
36 For instance, see ARNOLD, 2003 changes; PEREZ, BAEZ, 2003 changes; MARTIN JIMENEZ, 2003 changes.
37 2013 OECD, Addressing BEPS.
38 2013 OECD, Addressing BEPS, p. 10.

common domestic anti-avoidance rules that can be used to counteract such schemes? These questions are dealt with in the *second part* of the thesis. This part starts by providing a general overview of the types of schemes that taxpayers undertake to reduce the source or the residence State's tax base (*see chapter 2*). Thereafter, this part provides a comparative overview of the judicial doctrines, statutory GAARs or SAARs that are applied by the source or residence States to counteract cross-border tax avoidance schemes. A comparative analysis is essential as the scope; application and outcome of a domestic anti- avoidance rule can vary significantly from one jurisdiction to another. This part also lays down the method for ascertaining the "*effect*" of applying domestic anti-avoidance rules (*see chapter 3*). Later on in the thesis, these effects, applicable from the source or residence State's perspective, are tested against the provisions of tax treaties to ascertain whether a conflict arises or not. Of course, it is impossible to compare the tax systems of all States. Thus, the comparative analysis is restricted to domestic anti-avoidance rules that are applied in cross-border scenarios in both common law States (such as Canada, India, USA and UK) and civil law States (such as France, Germany, the Netherlands and Switzerland)[39].

14. As the thesis analyses the interaction of domestic anti-avoidance rules with tax treaties, as an initial step, it is essential to examine the relationship between tax treaties and domestic law or tax law (as domestic anti-avoidance rules are a part of domestic tax law). In particular, the question arises as to how tax treaties are incorporated in domestic law so as to apply to a taxpayer and, when applied, how do States resolve conflicts between their domestic law and tax treaty law? Ideally, if a conflict arises the tax treaty prevails as it can be considered to be "*lex specialis*". However, do all States agree with this position, especially with respect to posterior domestic law rules? A related concern is the issue of treaty override: essentially, can States override their treaty obligations? Does such an override conflict with the provisions of international law, in particular, Art. 26 and Art. 27 VCLT? What remedies are available to the compliant States? This analysis lays down the basis for examining whether the application or introduction of a posterior domestic anti-avoidance rule can be considered to be a treaty override or not? These issues are explored in the *third part* of this thesis (*see chapter 4*).

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39 ZIMMER, JAAR, p. 22.

15. Also, prior to analysing the interaction of domestic anti-avoidance rules with tax treaties, it is essential to lay down the basis for tax treaty interpretation. This is examined in the *fourth part* of this thesis. It is well accepted that the VCLT governs the interpretation of treaties. Nevertheless, the question arises as to the extent to which the VCLT's interpretation principles, found in Art. 31 and Art. 32, are relevant for the interpretation of tax treaties? (*see chapter 5*). The majority of the tax treaties in the world are based on the OECD Model. Further, it is widely accepted that the OECD Commentary plays an important role in the interpretation of a tax treaty based on the OECD Model. Accordingly, the role of the OECD Commentary in the tax treaty interpretation process needs to be determined as the OECD's position on the interaction of domestic anti-avoidance rules with tax treaties has evolved over a period of time. Even the impact of the UN Commentary that accompanies the UN Model (last updated in 2011 – all references in this thesis will be made to the 2011 version of the UN Model unless stated otherwise) needs to be examined. This is because, at the moment of writing this thesis, the view expressed in the UN Commentaries on the interaction of domestic anti-avoidance rules with tax treaties was more comprehensive and structured than that in the commentaries to the OECD Model. Also, the commentary in the BEPS 2014 report on preventing tax treaty abuse (hereafter "2014 TTA report") as well as the BEPS 2015 report on preventing treaty abuse (hereafter "2015 Final TTA report") is inspired by the UN Commentary (*see chapter 6*). Even though the provisions of the VCLT govern the interpretation of tax treaties, a tax treaty cannot be viewed in isolation from domestic law. This is because several provisions of tax treaties, notably Art. 3(2) of the OECD Model, provide that treaty terms have to be interpreted in light of the relevant domestic law. An analysis of Art. 3(2) is essential for this thesis in order to determine the extent to which such domestic law definitions can be incorporated into a tax treaty (*see chapter 7*).

16. The *fifth part*, which is the core of the thesis, analyses the interaction of domestic anti- avoidance rules with tax treaties. The view of the OECD and the UN, as expressed, in various versions of the working documents, reports and commentaries is put forward. Furthermore, the view of the OECD, as provided in the 2014 TTA report and 2015 Final TTA report, is also discussed. The view of these international organizations is examined in chronological order as expressed in various statements issued in the period from 1961 to 2015 (*see chapter 8*). Thereafter, the author comments on

selected issues that arise from the views expressed by the OECD and UN that are relevant to the issue at stake. Notably, the author discusses the role of the OECD Commentary and UN Commentaries in interpreting previously concluded tax treaties (especially tax treaties concluded before 2003); the object and purpose of tax treaties; the guiding principle (the PPT rule too) and its various components; the observations made by States to these Commentaries and the saving clause (*see chapter 9*). An analysis of these issues is essential in order to debate on the interaction of domestic-anti avoidance rules with tax treaties.

17. It is contended that no conflict should arise between a tax treaty and a domestic anti-avoidance rule if the former contains a provision (safeguard clause) to preserve the latter. The author analyses whether this position is correct or not and the impact of such a position on other treaties concluded by the same State that do not contain such a clause (*see chapter 10*). It is also contended that a conflict does not arise between a tax treaty and a domestic anti-avoidance rule when the treaty contains an undefined term and that term is then defined pursuant to a domestic anti-avoidance rule as a result of Art. 3(2) or a provision that refers to the domestic law. The author analyses whether this position is correct or not and puts forward the limits to such a position (*see chapter 11*).

18. Thereafter, the author discusses the interaction of domestic anti-avoidance rules with tax treaties in situations where the tax treaty does not contain a safeguard clause or any treaty GAAR (such as PPT rule) or a comprehensive SAAR such as the LOB clause. To elaborate, the effects of applying domestic anti-avoidance rules, as ascertained previously (*see chapter 3*), are tested against the provisions of tax treaties. To begin with, the author tests the interaction of sham/simulated transactions (*see chapter12)* with treaty provisions. Then, the interaction of domestic anti-avoidance rules, when applied from the source State's perspective, with treaty provisions is considered. Specifically, the domestic anti-avoidance rules that re-determine the taxpayer (*see chapter 13*), re-characterize an item of income (*see chapter 14*), deny a treaty benefit (*see chapter 15*) or deny interest deductions (*see chapter 16*) are tested with tax treaties. Finally, the interaction of domestic anti-avoidance rules, when applied from the residence State's perspective, and treaty provisions is examined. Specifically, domestic anti-avoidance rules that deem non-residents to be residents in a jurisdiction (*see chapter 17*), impute income derived by a non

resident taxpayer to a resident taxpayer (*see chapter 18)*, deem a taxpayer to dispose of its assets prior to its migration (*see chapter 19)* and deny relief from double taxation to a taxpayer (*see chapter 20*) are considered in the light of treaty provisions.

19. It should be noted that the author follows a common structure in the aforementioned chapters to discuss the interaction of domestic anti-avoidance rules with tax treaties *(chapters 13-20*). Each chapter starts by presenting the effect of the domestic anti-avoidance rule and puts forward a case study to demonstrate is applicability. Thereafter, the view expressed by the OECD, UN and courts (from around the world)[40] on the interaction of that domestic anti-avoidance rule with tax treaties is discussed. The author then provides his own view on the impact of tax treaties on the domestic anti-avoidance rule in question. He also comments on whether the introduction or application of the anti-avoidance rule, after the conclusion of a tax treaty, amounts to treaty override or not based on his previous findings (*see chapter 4*).

20. In the *sixth part* of the thesis, the author analyses the relationship between various domestic anti-avoidance rules and various treaty anti-avoidance rules and finally presents a case study (from the source States perspective) to illustrate the interaction between domestic anti-avoidance rules and tax treaties, in particular, whether treaty SAARs or treaty GAARs prevent the application of domestic anti-avoidance rules (*see chapter 21*).

21. It should be noted that the thesis deals with the interaction of domestic anti-avoidance rules with tax treaties. EU law that is relevant to taxes i.e. the fundamental freedoms (such as the free movement of workers, the freedom of establishment, the free movement of capital and the freedom to provide services), the EU directives (such as the Parent-Subsidiary directive, Interest and Royalties directive and the Merger Directive) and the case law of the ECJ in tax matters will not be examined in detail. Nevertheless, as EU law does have an impact on the application of domestic anti-avoidance rules, a high level analysis of the interaction of domestic anti-avoidance rules with

[40] In the author's opinion, a decision rendered by the highest Court of State A, on a treaty concluded by State A, is not binding on a tax treaty concluded by State B with State C. Nevertheless, references can be made to such decisions to interpret the State B and State C tax treaty. See WARD, Courts, pp. 185-187. Also, *see section 7.2.6.2.*

EU Law is undertaken for the sake of completeness. Essentially, the limitations imposed by EU law are discussed (*see chapter 22*).

22. Finally, in the *eighth part* of the thesis, the author concludes his main findings (*see chapter 23*) and provides model provisions that States can incorporate into their treaties (treaty policy) to ensure that conflicts do not arise between their domestic anti-avoidance rules (even those introduced after the conclusion of a treaty) and their tax treaties (*see chapter 24*).

1.7. Limitations

23. With respect to the research underpinning the analysis in the thesis, it should be noted that there was a language limitation. Given, the author's Indian background, the author is fluent in English and Hindi. However, as the thesis also analyses the law and jurisprudence of non-English speaking countries, on several occasions the author could not find appropriate English translations of non-English literature or when the literature was sourced the translations (in the author's view) were not appropriate. Also, tax law is a dynamic subject. While writing the thesis, the author observed that the domestic tax law (approach of the legislature and the judiciary) in several jurisdictions was changing rapidly. Accordingly, the domestic law and jurisprudence examined in *chapter 3* represents material as available on Jan 1st 2015 (nevertheless, at the time of the thesis defense, this chapter has been updated with recent scholarly literature). The analysis in the other *chapters*, especially in *chapter 4* to *chapter 24* is up to date and reflects material as available on January 1st, 2016 (including the BEPS outcome).

PART II: CROSS-BORDER TAX AVOIDANCE SCHEMES AND THEIR COUNTERACTION MEASURES AT THE DOMESTIC TAX LAW LEVEL

2. Cross-border tax avoidance schemes

2.1. Preliminary remarks

24. In the following sections, the author provides a general overview of the typical cross-border tax avoidance schemes that are entered into by taxpayers. The schemes are discussed in a general manner and are not linked to a particular State. The domestic anti-avoidance rules that could be used to counteract such schemes are discussed in the next chapter.

2.2. Schemes targeting reduction of the source State tax base

2.2.1. Treaty or rule shopping

25. The term "*treaty shopping*" is used to refer to the situation in which a "*person who is not entitled to the benefits of a tax treaty makes use – in the widest meaning of the word – of an individual or legal person in order to obtain those treaty benefits that are not available directly*"[41]. The most prevalent way through which a taxpayer engages in treaty shopping is by setting up an intermediary entity (company or other entities similar to a company) in an intermediary jurisdiction[42]. To illustrate, on the assumption that a tax treaty does not exist between State R and State S, a tax resident of State R may prefer not to invest (via equity) directly in State S because the income derived from the investment may be subject to high withholding taxes (35%) in State S and immediate taxation in State R. Accordingly, on the assumption that a tax treaty based on the OECD Model exists between State T and State S, the State R tax resident may prefer to set up a company in State T that will receive the dividend income from the equity investment. The tax advantage of setting up the company in State T is that the tax resident of State R gets access to the T–S tax treaty[43]. As the provision on

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41 VAN WEEGHEL, Thesis, p. 119; De Broe also provides a similar definition. See DE BROE, Thesis, p. 10.

42 MARTIN JIMENEZ, Anti Abuse – I, p. 543; VOGEL, Commentary, p.118.

43 Art. 1 of the 2014 OECD Model provides that a tax treaty applies to "*persons*" who are "*residents*" of a State. A company can be regarded as a "*person*" when Art. 3(1)(a) is read in conjunction with Art. 3(1)(b). Moreover, a company can be regarded as a

"*dividends*"[44] provides that State S can tax the dividends up to a maximum rate of 5%, by creating the company, the tax resident of State R substantially reduces the withholding taxes in State S[45]. This kind of "*treaty shopping*" aims at reduction of taxes in the State of source.

26. In contrast to treaty shopping, a taxpayer could also engage in a phenomenon known as "*rule shopping*"[46]. Under a "*rule shopping*" exercise, the taxpayer does not search for a favourable tax treaty. A tax treaty already exists and the person who is entitled to benefit from it employs that treaty in the most favorable manner. Under such a scheme the taxpayer prefers to engineer a transaction is such a way that a particular distributive rule of the tax treaty will apply rather than any another one[47]. For instance, taxpayers could enter into transactions to convert dividends which are taxable at source (under Art. 10) into capital gains (Art. 13) which are taxable only in the State of residence. To elaborate, consider the following situation. Corp R, a resident of State R, owns a subsidiary viz., Corp S (with significant reserves), a resident of State S. In term of taxes, State S levies a domestic withholding tax of 35% on dividends paid by its resident corporations to non-residents. Further, States R and S have concluded a tax treaty based on the OECD Model. If Corp S distributes a dividend then State S will apply its domestic withholding tax which can ultimately be reduced under the R-S tax treaty in accordance with Art. 10(2) (5% or 15% depending on the percentage of shareholding). To avoid the State S withholding tax on dividends, Corp R sells the shares of Corp S to a related corporation ABC, which is also a resident of State S, in exchange for a promissory/loan note. This sale is taxable only in State R pursuant to Art. 13(5) of the R-S tax treaty – even if State S taxes capital gains derived by non-residents pursuant to its domestic law. Thereafter, ABC instructs Corp S to distribute a dividend. The receipt of dividend by ABC is mostly tax exempt (pursuant to a domestic dividend exclusion system for inter-corporate dividends or a domestic participation exemption regime). Soon afterwards, ABC uses those proceeds to pay off the promissory/loan note due to Corp R. Thus, by

"*resident*" for the purpose of Art. 4(1) as it is liable to tax in a State because it is either incorporated or its POEM management is located in that State. Accordingly, a company qualifies for treaty benefits. DE BROE, Thesis, pp. 11-13; MARTIN JIMENEZ, Anti Abuse – I, p. 544.

44 2014 OECD Model, Art. 10(2)(a).

45 For different variants of treaty shopping structures refer to DE BROE, Thesis, pp. 29-39.

46 MARTIN JIMENEZ, Anti Abuse – I, p. 543; VAN WEEGHEL, Thesis, p. 96.

47 MARTIN JIMENEZ, Anti Abuse – I, p. 543; VOGEL, Commentary, p.118.

27. engaging is such a transaction, Corp R converts dividend income falling under Art. 10(2)(a) or 10(2)(b) of the R-S tax treaty into a capital gain falling under Art. 13(5).

2.2.2. Base-eroding payments

28. Consider the situation of a parent company; resident in State R, that wishes to finance its wholly owned subsidiary, a resident of State S. Typically, the parent company can choose to fund the subsidiary with either debt or equity. If the parent company chooses debt then its return from the subsidiary will be in the form of interest. This interest is usually a tax-deductible expense for the subsidiary. However, if the parent company chooses equity then its return from the subsidiary will be in form of dividends. Unlike interest, dividends are not a tax-deductible expense for the subsidiary. Thus, in a cross-border situation, a parent company that wants to provide financing to its subsidiary may find it beneficial, for tax purposes, to provide financing through debt rather than equity. This is because the subsidiary can claim the interest expense as a deduction from its taxable base[48]. This tax advantage can further be optimized if the parent company sets up an intermediary entity in a low tax or zero tax jurisdiction, which, then carries out the financing activity. In such a situation, the subsidiary can claim the interest as a deduction from its taxable base while the intermediary maybe taxed at a low or zero tax rate. This tax advantage can be further optimized if the financing entity provides a hybrid financial instrument such as a profit participating loan or convertible loan to the subsidiary and this instrument is treated as debt in the State of the borrower and equity in the State of the lender. In such a situation, the subsidiary can claim the interest as a deduction from its taxable base while the parent may be able to claim a complete tax exemption for the dividends pursuant to a domestic participation exemption regime. Accordingly, funding via debt could in certain circumstances be more advantageous for taxpayers[49]. A similar outcome can also be achieved by eroding the tax base of the subsidiary either through excess royalty payments or management fees.

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[48] ITP, Fundamentals, p. 107; OECD, Discussion Draft on Financial Payments, pp. 6-7; KNÖLLER, Thin Cap, pp. 318-319.

[49] ITP, Fundamentals, p. 124; OECD, Discussion Draft on Financial Payments, pp. 6-7; OECD, Hybrid Mismatch Arrangements, Paras. 52-54.

2.3. Schemes targeting reduction of the residence State tax base

2.3.1. Deferral of or exemption from residence State taxes

29. Consider the "*treaty shopping*" case discussed previously (*margin no. 25*) from the perspective of State R. If the State R taxpayer invests directly into State S companies and earns income (for example passive income) - that income will be immediately taxable in State R. Thus, in order to avoid residence State taxes, the shareholder could also set up an intermediary entity (company) in State T. This intermediary is then used to carry out the investment activity in the source States. In such a case, the income generated from the source State will be taxable only in State T, unless and until, the intermediary company makes a distribution of income to the shareholder (usually as dividends). Thus, by inserting an intermediary company and carrying out the activities through it, the shareholder defers residence State taxes. The tax advantage can further be optimized if there is a treaty between State R and State T providing for a participation exemption regime (in Art. 23) which exempts dividends paid by State T companies to State R residents from State R taxes[50]. A similar outcome can be achieved if instead of operating with a legal entity, the taxpayer operates in State T with a PE located in a low tax jurisdiction and the treaty between State R and T exempts profits derived through foreign PE's[51].

2.3.2. Transfer of residence

30. Assume a taxpayer, who is a tax resident of State R (high-tax country) and at the same time owns shares in companies (which do not own immoveable property) resident in that jurisdiction. In such a case, if the taxpayer sells the shares and makes a gain, tax must be paid in State R. In order to avoid high taxes, the taxpayer migrates to a low-tax country, State T, and becomes a tax resident there. Subsequently, the shares are sold. If State R does not levy taxes on non-residents then the gains go tax-free. Furthermore, even though the tax is levied domestically, State R will not be able to tax the gain if it has entered into a tax treaty with State T based on

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50 DE BROE, Thesis, p. 8.

51 ITP, Fundamentals, p. 121.

the OECD Model. This is because Art. 13(5) of the OECD Model[52] provides that gains from the alienation of shares are taxable only in the residence state of the alienator. In many situations, State T may not tax the gain under its domestic tax law at all[53]. A similar outcome is achieved in the case of a taxpayer who is entitled to receive pension or similar rights in a high tax country but who migrates to a jurisdiction that does not tax pension or similar rights. This is because Art. 18 of the OECD Model[54] provides that pensions are taxable only in the State of residence of the recipient.

[52] 2014 OECD Model, Art. 13, Para. 5; This provision provides that gains from the alienation of any property, other than that referred to in Para. 1 (immoveable property), Para. 2 (PE), Para. 3 (ships, aircrafts, etc) and Para. 4 (immoveable property companies) shall be taxable only in the Contracting State of which the alienator is a resident.

[53] Pursuant to a participation exemption regime or a complete exemption from capital gains tax which is available in the domestic tax law.

[54] 2014 OECD Model, Art. 18. This provision provides that pensions are taxable only in the residence State of the recipient.

3. The effect of applying domestic anti-avoidance rules

3.1. Preliminary remarks

31. In this chapter, the author discusses the various domestic anti-avoidance rules that can be used to combat the cross-border tax avoidance schemes. The author focuses on providing a comparative overview of domestic anti-avoidance rules applied in both common law States (by focusing on the USA, the UK, Canada and India) and civil law States (by focusing France, Germany, the Netherlands and Switzerland)[55]. Based on this analysis, the author outlines the various "*effects*" of applying domestic anti-avoidance rules. The compatibility of such rules with tax treaties is discussed in Part V of this thesis.

3.2. Judicial anti-avoidance doctrines

3.2.1. Sham/Simulation doctrines

32. A legal transaction is ignored for tax purposes and its true nature is determined if it is a sham or is simulated. Accordingly, when a taxpayer presents to the tax authorities a transaction the legal reality of which is different under private or civil law then tax will be applied according to the actual legal reality and not the reality presented by that taxpayer.

33. In the UK, a sham arises for tax purposes when the parties to a transaction claim to have created legal rights that they never intended to create. The classical definition of sham can be traced to the *Snook case*[56] wherein Lord Diplock held that a sham "*means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create"*[57]. This formulation

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55 ZIMMER, JAAR, p. 22.

56 UK HOL: Snook v London & West Riding Investments Ltd, 1 All ER 518, January 17th 1967, p. 528.

57 THURONYI, Comparative tax, p. 157.

provides that for a sham to exist two conditions need to be satisfied. Firstly, the parties to a transaction must have the intention of creating dissimilar rights and obligations from those emerging from the relevant documentation. Secondly, the parties must have intended to give a false impression of those rights and obligations to third parties such as the tax authorities or courts. Consequently, a legal document will be a sham when the rights between the transacting parties evidenced on the face of the document were in fact never meant to be effective or to be acted upon. If the doctrine applies then the tax treatment will be determined in accordance with the correct legal facts as opposed to the fabricated facts set out in documents[58]. In UK tax law, the sham doctrine deals only with transactions in terms of their legal form and not with their business purpose or economic substance[59]. Accordingly, this doctrine is considered narrow in terms of its application[60] and is not invoked for tax avoidance schemes as in such schemes the parties comply with all legal aspects but act against the intention of the legislation[61].

34. Similarly, in the Canadian tax law sphere a sham transaction is a transaction in which the documents or acts of the parties attempt to give the appearance of creating legal results that are different from the actual legal rights and obligations[62]. The CSC has confirmed this position on several occasions[63]. To elaborate, in the *Cameron case*[64], the CSC relied on the definition of a sham as provided by Lord Diplock in the *Snook case* (*see margin no. 0*) to give a meaning to the concept of a sham. Thereafter, this position was confirmed in the landmark *Stubart Investment case*[65]. The CSC reiterated the *Snook* case and held that a sham transaction is "*a transaction conducted with an element of deceit so as to create an illusion calculated to lead the tax collector away from the taxpayer or the true nature of the transaction or simple deception whereby the taxpayer creates a facade of reality quite different from the disguised reality*"[66]. Subsequently, the CSC in

58 BALLARD, DAVISON, JAAR, pp. 571-572.
59 KORB, BANARJEE, JAAR, p. 23.
60 BALLARD, DAVISON, JAAR, p. 572.
61 FROMMEL, Avoidance, p. 60.
62 FEDERICO, Tax Avoidance, p. 4; SPRYSAK, Sham, p. 131; MITCHELL, Sham, pp. 304-305.
63 KELLOUGH, Tax Avoidance, p. 1836.
64 CSC: Minister of National Revenue v. Cameron, [1974] SCR 1062, June 29th 1972, pp. 1068-1069.
65 CSC: Stubart Investments Ltd v Queen, 1 SCR 536, June 7th 1984.
66 CSC: Stubart case, pp. 545-546.

the *Mcclurg case*[67], by relying on the *Stubart Investment case*, once again held that a transaction is a sham if it is undertaken to "*create a false impression in the eyes of a third party, specifically the taxing authority*"[68]. If the doctrine applies then the tax treatment will be determined in accordance with the correct legal facts as opposed to those set out in documents. Thus, from these decisions it can be ascertained that a "*sham"* should be intentional (the parties to the sham must jointly intend to create the appearance of legal rights or a relationship that differs from the actual rights or relationship) and should be undertaken to deceive a third party. The element of deceit, i.e. the presence of a common intention to create the appearance of a legal result, which is different from the actual legal result, is therefore necessary for a transaction to qualify as a sham[69]. It should be noted that the Canadian concept of a sham is independent of the business purpose test[70]. Justice Wilson has confirmed this in the *Stubart Investment case* wherein it was held that that the business purpose test and the sham test are two distinct tests[71]. It should also be noted that the sham doctrine does not look into the economic substance of the transaction. Accordingly, it has been opined that this concept has a very narrow and limited application in tax avoidance cases[72].

35. Also, in India, in the *Meenakshi case*[73], the ISC observed that a sham transaction arises when "*A purports to sell his property to B without intending that his title should cease or pass to B"*. This means that a sham transaction arises when the transferor and the transferee enter into a transaction while being completely aware of the fact that no effect will be given to it[74]. Likewise, in the *Azadi Bachao Andolan case*[75], the ISC referred to the definition of a sham as provided by Lord Diplock in the *Snook case* (*see margin no. 0*) to discuss the meaning of a sham transaction. The Court ruled that "*If the Court finds that notwithstanding a series of legal steps taken by an assessee, the intended legal result has not been achieved, the*

67 CSC: Mcclurg v. Canada, [1990] 3 SCR 1020, December 20th 1990.
68 KELLOUGH, Tax Avoidance, p. 1836.
69 MASSON, PORTER, JAAR, p. 192; SPRYSAK, Sham, p. 126.
70 MITCHELL, Sham, p. 306.
71 CSC: Stubart case, pp. 539-540.
72 FEDERICO, Tax Avoidance, p. 5.
73 ISC: Meenakshi Mills vs CIT, 1956 SCR 691, September 26th 1956.
74 WADHWA, SAHU, JAAR, p. 340.
75 ISC: Union of India vs Azadi Bachao Andolan, [2003] 132 Taxman 373 (SC), October 7th 2003.

Court might be justified in overlooking the intermediate steps, but it would not be permissible for the Court to treat the intervening legal steps as non-est based upon some hypothetical assessment of the 'real motive' of the assessee. In our view, the court must deal with what is tangible in an objective manner and cannot afford to chase a will-o'-the-wisp". Accordingly, these Apex Court judgments indicate that the concept of sham is narrow i.e. if the taxpayer carries out all the relevant legal steps to give effect to a transaction then that transaction cannot be treated as a sham.

36. In contrast to the aforementioned jurisdictions, in the US, the sham doctrine is widely applied. A sham can either be a sham in fact or a sham in substance. A factual sham arises where the transactions reported by the taxpayer never occurred or were only created on paper but never actually took place[76]. If the doctrine applies then the transactions reported by the taxpayer will be considered as non-existent for tax purposes[77]. On the other hand, a sham in substance arises when the purported transaction does not have any underlying economic substance and is undertaken solely for achieving a reduction in tax[78]. The leading case that deals with the sham in substance doctrine is the *Knetsch vs United States case*[79]. In this case the taxpayer had borrowed money at a high interest rate from an insurance company in order to invest in deferred annuity bonds offered by the same company that in turn provided a lower rate of return. The rationale for borrowing at a high interest rate and investing that amount in a low interest rate investment product was that the US tax law at the time provided that the taxpayer could deduct the interest expense completely against his taxable income while being subject to a lower rate of tax on the interest earned[80]. Accordingly, the taxpayer executed the transactions with the sole intention of generating interest deductions. The US SC held that the transaction undertaken by the taxpayer was a "*sham*", deprived of genuine economic results, because "*there was nothing of substance to be realized by [the taxpayer] beyond a tax deduction"*[81]. Consequently, the sham in substance doctrine provides that in the US a transaction will be respected for tax purposes and will not be considered as a sham if it has underlying economic

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76 THURONYI, Comparative tax, p. 157.
77 STRENG, YODER, JAAR, p. 596.
78 STRENG, YODER, JAAR, p. 597; ZIMMER, JAAR, p. 32.
79 US SC: Knetsch v. United States, 364 US 361 (1960), November 14th 1960.
80 THURONYI, Comparative tax, p. 163.
81 STRENG, YODER, JAAR, p. 596.

substance[82]. It should be noted that even though the court used the word "*sham*" on several occasions, the court did not indicate as to how it should be measured[83]. Moreover, it is widely regarded that the *Knetsch vs United States case* and the other US court cases that have dealt with this judicial doctrine have not clearly articulated the doctrine and therefore commentators have proposed that it be disregarded or subsumed within the other judicial anti-avoidance doctrines[84].

37. The sham transaction doctrine in civil law countries is known as simulation. In the Netherlands, relationships among the parties are ascertained on the basis of what has been agreed as opposed to what has been showcased to third parties (including tax authorities). Thus, simulation exists when the parties to a transaction show a set of documents to evidence a specific contract or transaction while agreeing amongst them to enter into a different contract or transaction. If the doctrine applies then the tax authorities are required to determine the actual relationships between the parties. Taxes will then be levied on the basis of actual relationships as opposed to simulated relationships[85].

38. Similarly, in Switzerland, the concept of simulation is derived from Art. 18(1), 1911 SCO. The SCO provides that "*When assessing the form and terms of a contract, the true and common intention of the parties must be ascertained without dwelling on any inexact expressions or designations they may have used either in error or by way of disguising the true nature of the agreement*". Therefore, where there is a conflict between the real intentions and the intention expressed in a contract, a person who receives such contract and knows that it does not express the real intentions of the parties, normally has to follow the real intentions and ignore what was expressed in the contract. It should also be noted that this doctrine does not look into the economic substance/business purpose of a transaction. Accordingly, it has a very narrow and limited application in tax avoidance transactions because in such transactions the parties usually intend to give the arrangements the desired legal effect.

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82 STRENG, YODER, JAAR, p. 610.
83 TOOMA, Thesis, p. 42; THURONYI, Comparative tax, p. 163.
84 TOOMA, Thesis, p. 43.
85 IJZERMAN, JAAR, pp. 452-453; WILDE, WISMAN, Avoidance, p. 11.

3.2.2. The substance over form doctrine

39. The substance over form doctrine is another anti-avoidance doctrine endorsed by courts, especially, in common law jurisdictions. However, the concept of substance does not have the same meaning in every jurisdiction.

40. In the UK, historically, in the *Duke of Westminster case*[86], the UK HOL advocated a literal interpretation of the tax legislation[87]. In this case, a Duke had household servants to whom he provided remuneration. The legislation at that time provided that salary paid to household servants was not deductible. However, the legislation allowed a deduction of annual payments made pursuant to a legal obligation, which could not be classified, as a contract for compensation for services. Accordingly, the Duke entered into deeds of covenant with his servants under which he undertook the obligation to pay them annual sums for a period of seven years. By doing this the Duke converted non-deductible salaries into deductible annuity obligations. Even though the deeds were structured as not for compensation service agreements, in essence, the servants were compensated for their services to the Duke. The case went to trial and Lord Tomlin famously observed that "e*very man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.…This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable"*[88]. This passage from the judgment meant that a taxpayer could arrange his affairs in any manner whatsoever, in order to reduce his tax liability. The form of a transaction that a taxpayer utilizes had to be respected and a Court cannot look behind the transaction for some underlying economic substance[89]. It also meant that a transaction was effective for tax purposes even if it had no business purpose and had been

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86 UK HOL: Duke of Westminster v Commissioners of Inland Revenue, 19 TC 490, May 7th 1935.

87 LI, Comparative Perspective, p. 8; TOOMA, Thesis, p. 55.

88 THURONYI, Comparative tax, pp. 172-174; BALLARD, DAVISON, JAAR, p. 573.

89 KORB, BANARJEE, JAAR, p. 22.

entered into solely for avoiding tax[90]. These conclusions were of course subject to the caveat that the taxpayer had successfully satisfied the legal requirements of the chosen form[91]. In essence, the case provided that the tax treatment of a transaction was determined by reference to its legal substance rather than its economic substance[92]. This is clearly illustrated by the fact that the Duke could deduct non-deductible wages by characterizing them as annuities. Therefore, transactions that were not shams, in the sense that, the parties to them had created legal rights that they intended to create, would be effective for tax purposes. Accordingly, "*substance*" in the UK at the time of the judgment meant only legal substance (however *see the discussion under the step transaction doctrine*).

41. Similarly, in the Canadian tax law sphere, prior to the introduction of the Canadian statutory GAAR, when substance over form was referred to, "*substance"* meant *"legal substance"* as compared to *"economic substance"*[93]. The CSC in various judgments has confirmed this position. For instance, it has been opined that in the *Stubart Investment case*, the CSC implicitly referred to the substance over form doctrine and held that "*as long as the "form" of the transaction (that is, the true legal rights and obligations of the parties as determined by non-tax law) is valid, that form will determine the economic and commercial realities of the transaction"*[94]. Similarly, in the *Continental Bank of Canada case*[95], the CSC upheld the view of a judge of a lower court who basically provided that "*substance over form*" in income tax law does not mean that the legal effect of a transaction is to be put aside. Neither does it mean that one can equate substance with

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90 LI, Comparative Perspective, p. 9; FREEDMAN, Interpretation, p. 57; FROMMEL, Avoidance, pp. 62-63.

91 TOOMA, Thesis, p. 55.

92 BALLARD, DAVISON, JAAR, p. 573; AULT, ARNOLD, CT, p. 168; A commentator provides that "*The concept of legal substance most often refers to the characterisation which emerges from a close study of the rights and obligations in a legal relation for instance whether a transaction should be characterised as a sale or a lease. The main function of the concept of legal substance is to point out that sham or simulation transactions and wrong legal characterisations by the taxpayer will be disregarded for tax purposes*". ZIMMER, JAAR, p. 24.

93 MASSON,PORTER, JAAR, p. 188; FEDERICO, Tax Avoidance, p. 6; KELLOUGH, Tax Avoidance, p. 1841; LI, Comparative Perspective, p. 12; ARNOLD, Tax Avoidance, pp. 18-22; LI, Economic Substance, p. 43.

94 KELLOUGH, Tax Avoidance, p. 1841.

95 CSC: Continental Bank of Canada *v.* Canada, [1998] 2 SCR 358, September 3rd 1998.

economic realities[96]. Likewise, in the *Shell Canada Case*[97], the CSC held that "*Courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form. There are, however, caveats to this rule. First, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect. Second, it is well established that a searching inquiry for either the "economic realities" of a particular transaction or the general object and spirit of the provision at issue can never supplant a court's duty to apply an unambiguous provision of the Act to a taxpayer's transaction. Where the provision at issue is clear and unambiguous, its terms must simply be applied*". As a result of these Court cases, it can be established that substance in the Canadian tax law sphere refers to legal substance. Essentially, in order to determine legal substance, an analysis of the legal documentation adopted by the taxpayer and an assessment as to whether the taxpayer acted in a manner in line with the rights and obligations formulated in that legal documentation needs to be undertaken[98]. If the taxpayer acts consistently with the legal rights and obligations then that transaction can be regarded as having the requisite substance. Thus, in Canadian tax law sphere, a taxpayer is entitled to arrange his affairs in the best way as possible so as to minimize his tax[99]. However to achieve this minimization, a taxpayers plan must be effective. In other words, the plan should be complete and implemented according to the relevant and applicable law. Consequently, if a transaction is not executed in a legal manner then such a transaction can be successfully challenged on the ground that the intended legal results were not achieved and hence the transaction is ineffective[100].

42. Indian Courts, which have been tremendously inspired by the UK Courts, have usually upheld the principle of legal substance over economic

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96 LI, Comparative Perspective, p. 12.

97 CSC: Shell Canada Ltd. *v.* Canada, [1999] 3 SCR 622, October 15th 1999.

98 LI, Economic Substance, p. 43.

99 CSC: Stubart case, pp. 539-540.

100 FEDERICO, Tax Avoidance, p. 5; KELLOUGH, Tax Avoidance, p. 1835; GOYETTE, HALVORSON, Tax Avoidance, p. 173.

100 FEDERICO, Tax Avoidance, p. 5; KELLOUGH, Tax Avoidance, p. 1835; GOYETTE, HALVORSON, Tax Avoidance, p. 173.

substance[101]. However, this position has not been free from controversy[102]. To explain, in the *Bank of Chettinad case*[103], the Privy Council, by relying on Lord Russell's observation in the *Duke of Westminster case* upheld that the legal substance principle was applicable in the Indian tax law sphere. Similarly, in the *Provident Investment case*[104], the ISC held that it was not open to courts to overlook the true legal nature of a transaction and look into the substance of the matter[105]. Likewise, in the *Raman case*[106], the ISC held that a taxpayer could avoid his tax liability by arranging his commercial affairs in any manner whatsoever such that the charge of tax is distributed and the arrangement is not prohibited (however *see margin nos. 58-61*).

43. In contrast to the approach taken in the aforementioned countries, the US courts have invoked the substance over form doctrine to re-classify a transaction in accordance with its economic substance if the transaction is contrary to the form. The application of this doctrine can be traced back to the *Gregory v. Helvering case*[107]. In that case, the US SC also held that "a*s a general rule, the incidence of taxation depends on the substance rather than the form of the transaction*". By doing so, the Court held that the transaction undertaken by the taxpayer was a dividend that was taxable as ordinary income to the taxpayer. Another example of the application of this doctrine is that a taxpayer would not be allowed to treat a financial instrument as a debt and generate an interest deduction if, in essence, that instrument is equity[108]. Furthermore, another case that is considered to be a leading judgment on this doctrine is the US SC's decision in the *Commissioner vs Court Holding Co case*[109]. In this case, the taxpayer owned a company that in turn owned an apartment. The taxpayer wished to sell the apartment. However, instead of routeing the sale directly through the company the taxpayer liquidated the corporation and had the building transferred to the shareholder. The shareholder then sold the apartment to the purchaser. The

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101 MAJUMDAR, PRASAD, Tax Avoidance, p. 371; WADHWA, SAHU, JAAR, pp. 345-346.

102 GAAR, Expert Committee Report, p. 20.

103 Privy Council: Bank of Chettinad Ltd. v. CIT, 8 ITR 522 (PC), June 2nd 1940.

104 ISC: CIT vs The Provident Investment Co, 1957 SCR 1141, May 15th 1957.

105 WADHWA, SAHU, JAAR, p. 337.

106 ISC: CIT v. A. Raman and Co, 67 ITR 11 (SC), July 18th 1967.

107 VARMA, WEST, Tax Avoidance, p. 829; STRENG, YODER, JAAR, p. 608; KEINAN, Step Transaction, p. 51.

108 STRENG, YODER, JAAR, p. 608; KEINAN, Step Transaction, p. 51.

109 US SC: Commissioner v. Court Holding Co., 324 U.S. 331 (1945), March 12th 1945; THURONYI, Comparative tax, p. 170.

main reason for routeing the sale through the shareholder was that if the apartment was sold directly by the company then the tax impact would be higher whereas if the shareholder sold the apartment the tax impact was lower[110]. In this regard, the Apex Court held that "*The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant... To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress"*[111]. The Court ruled against the taxpayer and held that the seller was the corporation. It should be noted that the substance-over-form doctrine is considered to be one of the most controversial areas of US tax law as courts do not follow a single or a consistent set of rules in applying this doctrine and often tend to apply it in addition to the other doctrines such as the business purpose and step transaction doctrines[112].

44. Another judicial doctrine that has been applied on a regular basis by the US courts and tax authorities is the economic substance doctrine[113]. The *Gregory vs Helvering case* is also considered to give effect to this doctrine[114]. In that case, the US SC also held that "*If what was done here was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of income tax, as it certainly was.… [But] the purpose of the section is plain enough; men engaged in enterprises … might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as realizing any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken*

110 THURONYI, Comparative tax, p. 171.

111 KEINAN, Step Transaction, p. 51.

112 TOOMA, Thesis, p. 49; KEINAN, Step Transaction, p. 54.

113 It is pertinent to highlight there is a debate over the relationship between the economic substance doctrine and the business purpose test. Some author's consider that the economic substance doctrine is a supplement to the business purpose doctrine. TOOMA, Thesis, p. 46. However, other author's consider that the economic substance doctrine encompasses the business purpose test. LI, Economic Substance, p. 33.

114 LI, Economic Substance, p. 36; LI, Comparative Perspective, p. 7; TOOMA, Thesis, p. 46; KEINAN, Economic Substance, p. 51.

for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution… To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations' … We cannot treat as inoperative the transfer of shares… The transfer passed title … and the taxpayer became a shareholder in the transferee. All these steps were real and their only defect was that they were not what the statute means by a 'reorganisation'". In other words, this meant that the taxpayer's transactions lacked economic substance and this was not what the US tax law vis-à-vis reorganizations intended[115].

45. Similarly, in the *Higgins vs Smith case*[116], the US SC, while deciding that that the taxpayer was not entitled to deduct a loss which resulted from his sale of securities to a company owned by him held that "*As so broad and unchallenged a principle furnishes only a general direction, it is of little value in the solution of tax problems. If, on the other hand, the Gregory case is viewed as a precedent for the disregard of a transfer of assets without a business purpose, but solely to reduce tax liability, it gives support to the natural conclusion that transactions which do not vary control or change the flow of economic benefits are to be dismissed from consideration…The Government may look at actualities, and, upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham, may sustain or disregard the effect of the fiction, as best serves the purposes of the tax statute"*. Likewise, in the *Knetsch vs United States case*, the US SC ruled against the taxpayer because the transaction in dispute "*had no substance or purpose aside from the taxpayer's desire to obtain a tax benefit"*. Also in the *Frank Lyon case*[117] – a case which dealt with a sale vs lease categorization[118] – the US SC indicated that a transaction will be respected for tax purposes if it has "*economic substance that is compelled or encouraged by business or regulatory realities, that is imbued with tax-independent considerations, and that is not shaped solely by tax-avoidance features to which meaningless labels are attached*".

46. Thus, if the doctrine applies then the tax benefits associated with the transaction are denied to the taxpayer[119]. Over the years, in determining

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115 LI, Comparative Perspective, p. 8.
116 US SC: Higgins v. Smith, 308 U.S. 473 (1940), January 5th 1940.
117 US SC: Frank Lyon Co. v. United States, 435 U.S. 561 (1978), April 18th 1978.
118 THURONYI, Comparative tax, p. 168.
119 STRENG, YODER, JAAR, p. 610.

whether transactions have economic substance, US Courts have developed a two-prong test ie an objective and subjective prong. The objective prong analyses the transactions economic substance or intrinsic value apart from the tax consequences whereas the subjective prong looks into the taxpayers motive and purpose in undertaking the transactions. The US Courts seem to be divided vis-à-vis the application of these two tests. Some Courts consider the tests to be interrelated (conjunctive application) while others consider the tests to be applicable on a standalone basis (disjunctive application)[120]. Under the conjunctive application method courts allow tax benefits only if the disputed transaction had both economic substance and business purpose whereas under the disjunctive application method, Courts allow benefits if a transaction had either economic substance or a business purpose. As the approach of the Courts was inconsistent - uncertainty prevailed among taxpayers[121].

3.2.3. The step transaction doctrine

47. In general, for the purpose of tax law, each transaction in a series of transactions must be evaluated separately. However, under this doctrine, separate steps in a transaction or a series of transactions are treated as a single transaction for tax purposes if the steps are interrelated and are focused towards obtaining a particular tax result[122]. If the doctrine applies then individual steps in a series of transactions are disregarded for tax purposes and the transactions will be taxed as a single combined transaction as opposed to individually/separate steps[123].

48. The origins of this doctrine in tax cases can be traced back to the decision of the US SC in the *Minnesota Tea Co. vs Helvering case*[124]. Over the years, the US Courts and tax authorities have articulated various tests for determining as to when to apply the step transaction doctrine. These tests are broadly classified as (i) the binding commitment test, (ii) the mutual

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120 LI, Comparative Perspective, p. 33; VARMA, WEST, Tax Avoidance, p. 828; LAMPREAVE, Substance, pp. 157-158.

121 SANCILIO, Substance, pp. 144-147.

122 TOOMA, Thesis, p. 43; STRENG, YODER, JAAR, p. 606; VARMA, WEST, Tax Avoidance, p. 832.

123 KEINAN, Step Transaction, p. 57; THURONYI, Comparative tax, p. 169.

124 US SC: Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938), January 17th 1938.

interdependence test and (iii) the end result test[125]. Under the binding commitment test, the narrowest of the three approaches, the US SC has ruled in the *Commissioner* vs *Gordon case*[126] that separate steps will be combined only if, at the time of the first step, the taxpayer was under a binding obligation to proceed with the later steps[127]. Under the mutual interdependence test, a series of transactions will be grouped together if the steps were so interdependent that the legal relations created by one transaction would have been meaningless without completion of the series[128]. Finally, under the end result test (which is considered to be a very broad test) a series of transactions will be stepped together if the parties' intent at the commencement of the transactions was to achieve the particular result and the steps were all entered into to achieve that result[129]. As the end result test focuses on the parties' intention it is a concept that is difficult to apply[130]. Due to these variants the step transaction doctrine, in the US, is considered to be a broad judicial anti-avoidance doctrine.

49. In the UK, after authorizing all kinds of outrageous tax avoidance schemes[131], pursuant to the principles established in the *Duke of Westminster's case*, the UK HOL changed its approach in the *Ramsay case*[132]. In that case, the taxpayer tried to create an artificial loss in order to set it off against a chargeable gain. To achieve this, a series of self-cancelling steps were entered into which supposedly created a (non-chargeable) gain mirrored by an (allowable) loss. From a legal perspective all documents were properly executed and the transaction fell within a literal interpretation of the tax legislation ie the artificial tax loss could indeed be offset against the chargeable gain[133]. Lord Wilberforce stated *"A subject is only to be taxed on clear words, not on the "intendment" or on the "equity" of an act. Any taxing act of Parliament is to be construed in accordance with this principle. What are "clear words" is to be ascertained upon*

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125 TOOMA, Thesis, p. 44; STRENG, YODER, JAAR, p. 606; VARMA, WEST, Tax Avoidance, p. 832.
126 US SC: Commissioner v. Gordon, 391 US 83 (1968), May 20th 1968.
127 KEINAN, Step Transaction, pp. 64-67.
128 KEINAN, Step Transaction, pp. 72-74; STRENG, YODER, JAAR, p. 606.
129 KEINAN, Step Transaction, pp. 67-72.
130 STRENG, YODER, JAAR, p. 606.
131 FROMMEL, Avoidance, pp. 64-65.
132 UK HOL: W T Ramsay Ltd v Inland Revenue Commissioners, [1981] STC 174, March 12th 1981.
133 BALLARD, DAVISON, JAAR, p. 576.

normal principles; these do not confine the Court to literal interpretation. They may, indeed should, be considered the context and scheme of the relevant act as a whole, and its purpose may, indeed should, be regarded"[134]. This meant that the courts should take into consideration the purpose, scheme and context of the taxing provisions while interpreting the tax statute and should not be confined to a literal interpretation approach[135]. In relation to the findings in the *Duke of Westminster case*, Lord Wilberforce stated, "G*iven that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance. This is the well-known principle of Inland Revenue Comrs v Duke of Westminster…this is a cardinal principle but it must not be overstated or over-extended"*[136]. In essence, the UK HOL, without disregarding the Westminster principle, held that such a principle should not be stretched[137]. Lord Wilberforce further stated that "*While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document or a transaction in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded; to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded...To force the courts to adopt, in relation to closely integrated situations, a step by step, dissecting, approach which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process. In each case the facts must be established, and a legal analysis made: legislation cannot be required or even be desirable to enable he court to arrive at a conclusion which corresponds with the parties' own intentions"*[138].

50. In a nutshell, it was argued that the UK HOL introduced a composite transaction doctrine (similar to the step transaction doctrine), which provided

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134 UK HOL: Ramsay case, p. 179.
135 LI, Comparative Perspective, p. 10.
136 UK HOL: Ramsay case, pp. 180-181.
137 BALLARD, DAVISON, JAAR, p. 576.
138 UK HOL: Ramsay case, p. 180-181. THURONYI, Comparative tax, pp. 174-176.

that in determining the tax treatment of a pre-ordained series of transactions any steps inserted merely to avoid tax could be disregarded with the effect that the transaction would be viewed and taxed as a whole[139]. Essentially the doctrine was seen as a re-characterization doctrine i.e. a doctrine which could re-characterize legal facts[140]. In this regard, it should be noted that Lord Wilberforce stated that the form should indeed be respected for transactions with the appropriate legal substance[141]. Accordingly, the UK HOL did not advocate an economic substance over form doctrine as such[142]. Also, Lord Wilberforce did not fully endorse a business purpose test but found that the business purpose test is relevant in rejecting steps in a series of transactions that have no business purpose and were only inserted for tax motivated reasons[143]. Thereafter, in the same year, in the *Burmah Oil case*[144], the UK HOL upheld the applicability of the composite transaction doctrine as applied in the *Ramsay case*. While delivering their judgment Lord Diplock and Scarman emphasized that the *Ramsay case* marked a significant change in the approach adopted by the UK HOL in its judicial role towards tax avoidance schemes[145]. Similarly, in the *Furniss vs Dawson case*[146], the UK HOL once again upheld the applicability of the composite transaction doctrine to a tax avoidance scheme. Nevertheless, Lord Brightman, by referring to the opinions of Lord Diplock and Lord Scarman in the *Burmah Oil Case,* set out the limitations of the *Ramsay* principle by providing that "*First, there must be a pre-ordained series of transactions; or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end... Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to*

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139 KORB, BANARJEE, JAAR, p. 23; ZIMMER, JAAR, pp. 41-46; FROMMEL, Avoidance, pp. 66-67; It is important to note that according to some commentators the Ramsay case has never been seen as introducing a judicial anti-avoidance rule but has always been viewed as proposing a purposive interpretation to tax statues. FREEDMAN, Interpretation, p. 57.

140 BALLARD, DAVISON, JAAR, p. 577.

141 TILEY, Tax Avoidance, p. 311.

142 FREEDMAN, Interpretation, p. 59.

143 LI, Comparative Perspective, p. 11; FREEDMAN, Interpretation, p. 58.

144 UK HOL: Inland Revenue Commissioners v Burmah Oil Co Ltd**,** [1982] STC 30, December 3rd 1981.

145 TILEY, Tax Avoidance, p. 312; TOOMA, Thesis, p. 57; FREEDMAN, Interpretation, p. 57; FROMMEL, Avoidance, pp. 67-68.

146 UK HOL: Furniss (Inspector of Taxes) v Dawson and related appeals, [1984] STC 153, February 9th 1984.

tax—not "no business effect." If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes."[147] Accordingly, if steps with no business purpose are inserted in a pre-ordained series of transactions then the inserted steps could be ignored[148]. This case confirmed the existence of a business purpose test but the test was confined only to the composite transaction doctrine and was not an independent or separate judicial anti-avoidance doctrine[149]. However, in the *Craven vs White case*[150], the UK HOL restricted the applicability of the composite transaction doctrine[151]. In this case, the UK HOL had to give its verdict on the question of whether the composite transaction doctrine could be applied to steps which took place further apart in time i.e. at the time when a step was inserted the end result was not known. In a 3-2 split decision the House of Lords held in favour of the taxpayer and provided that for the *"the Ramsay principle, as developed in Dawson, to be applied to a series of transactions containing an intermediate transaction designed to avoid tax, it was essential (a) that the series was, at the time the intermediate transaction was entered into, pre-ordained in order to produce a given result (b) that the intermediate transaction had no other purpose than tax mitigation (c) that there was, at that time, no practical likelihood that the pre-planned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life; and (d) that the pre-ordained events did in fact take place"* [152]. As a result of these findings, a pre-ordained series of transactions existed only when it was practically certain that at the time of the first step the second would follow[153]. This meant that the composite transaction doctrine was a narrow doctrine[154] and could not be applied beyond the binding commitment test (see the step transaction doctrine in the US approach) but this conclusion was still uncertain[155]. Nevertheless, the UK courts seem to have retreated from the applicability of such a doctrine and are currently re-emphasizing on the

147 Furniss Case p. 166; TILEY, Tax Avoidance, p. 314; FROMMEL, Avoidance, pp. 69-70.
148 BALLARD, DAVISON, JAAR, p. 579; FREEDMAN, Interpretation, p. 58.
149 LI, Comparative Perspective, p. 11; FREEDMAN, Tax Avoidance, p. 1040; FREEDMAN, Interpretation, p. 60. For a contrary view see HOFFMANN, Tax Avoidance, p. 200.
150 UK HOL: Craven (Inspector of Taxes) v White, [1988] STC 476, July 21st 1988.
151 FROMMEL, Avoidance, pp. 72-75.
152 UK HOL: Craven case, p. 477.
153 AULT, ARNOLD, CT, p. 168.
154 ZIMMER, JAAR, p. 47.
155 BALLARD, DAVISON, JAAR, pp. 580-586; THURONYI, Comparative tax, p. 178.

primacy of statutory interpretation by applying the purposive interpretation approach that applies the parliamentary purpose of the relevant legislation to the reality of the transactions undertaken by the taxpayer[156].

51. In the *MacNiven vs Westmoreland case*[157], the UK HOL revisited the scope of the *Ramsay* doctrine. They found that the *Ramsay case* had not introduced a new anti-avoidance principle that would apply in all cases but it was a part of the established purposive approach to the interpretation of statutes[158]. Lord Hoffmann, in his opinion, clearly stated that the UK HOL had developed no overriding judicial anti-avoidance rule. Thus, the composite transaction doctrine could not be considered an independent judicial anti-avoidance rule [159]. Nevertheless, the UK HOL did not completely disregard the composite transaction doctrine. The Lords found that the *Ramsay* approach should apply only when the tax law refers to commercial concepts and not legal concepts. In other words, steps which lacked business purpose could be ignored only if they did not come within the legal meaning of a particular statute[160].

52. Successively, in the *Barclays Mercantile Business Finance* case[161], the UK HOL reaffirmed the purposive interpretation (new) approach. They held that "t*he essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description"* [162]. The UK HOL restated that the *Ramsay case* did "*not introduce a new doctrine operating within the special field of revenue statutes"*[163]. Lord Hoffmann confirmed this in a publication. He stated "*The primacy of the construction of the particular taxing provision and the*

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156 LI, Comparative Perspective, p. 28.

157 UK HOL: MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd, [2001] STC 237, February 8th 2001.

158 THURONYI, Comparative tax, p. 180; LI, Comparative Perspective, p. 29.

159 FREEDMAN, Interpretation, p. 62.

160 AULT, ARNOLD, CT, p. 169; THURONYI, Comparative tax, p. 181; TOOMA, Thesis, pp. 56-57; FREEDMAN, Interpretation, p. 62.

161 UK HOL: Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes), [2005] STC 1, November 25th 2004.

162 UK HOL: Barclays case, Para. 32.

163 UK HOL: Barclays case, Para. 33; TOOMA, Thesis, pp. 56-57.

illegitimacy of rules of general application has been reaffirmed by [Barclays Mercantile]. Indeed it may be said that this case has killed off the Ramsay doctrine as a special theory of revenue law and subsumed it within the general theory of the interpretation of statutes"[164]. Further, in this judgment, the Law Lords also rejected the existence of a business purpose test as an anti-avoidance doctrine[165]. They stated that "*There have been a number of cases, such as IRC v Burmah Oil Co Ltd…Furniss (Inspector of Taxes) v Dawson…in which it has been decided that elements which have been inserted into a transaction without any business or commercial purpose did not, as the case might be, prevent the composite transaction from falling within a charge to tax or bring it within an exemption from tax…Cases such as these gave rise to a view that, in the application of any taxing statute, transactions or elements of transactions which had no commercial purpose were to be disregarded. But that is going too far" [166].*

53. It should also be noted that, in the *Barclays Mercantile case*, the UK HOL downgraded the commercial/legal approach as provided in the *MacNiven vs Westmoreland case* vis-à-vis the composite transaction doctrine to a useful insight[167]. They held that "*Lord Hoffmann in MacNiven said that if a statute laid down requirements by reference to some commercial concept such as gain or loss, it would usually follow that elements inserted into a composite transaction without any commercial purpose could be disregarded, whereas if the requirements of the statute were purely by reference to its legal nature (in MacNiven, the discharge of a debt) then an act having that legal effect would suffice, whatever its commercial purpose may have been. This is not an unreasonable generalisation, indeed perhaps something of a truism, but we do not think that it was intended to provide a substitute for a close analysis of what the statute means. It certainly does not justify the assumption that an answer can be obtained by classifying all concepts a priori as either 'commercial' or 'legal'. That would be the very negation of purposive construction" [168].*

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164 HOFFMANN, Tax Avoidance, pp. 197-206.
165 FREEDMAN, Tax Avoidance, p. 1040.
166 UK HOL: Barclays case, Para. 36.
167 FREEDMAN, Tax Avoidance, p. 1041; FREEDMAN, Interpretation, p. 62; AULT, ARNOLD, CT, p. 169; TOOMA, Thesis, p. 61.
168 Barclays case, Para. 38.

54. The importance of this decision in the *Barclays Mercantile* case is that the UK HOL laid down a set of principles for interpreting the tax legislation. These principles can briefly be summarized as follows: i) identify the facts of the transaction, and determine which law may apply ii) where the words of the law are clear and certain, they are applied to the transaction iii) only where the words are uncertain then the Courts look to the underlying purpose of the law[169]. Similarly, on the same day in the *Scottish Provident Institution case*[170], the UK HOL gave the tax legislation a "*wide practical meaning*[171]" to tackle a tax-avoidance scheme undertaken by the taxpayer. This meant that the case confirmed the purposive interpretation approach[172]. However, the Law Lords, in the *Scottish Provident case*, referred to the *Ramsay* principle and considered a series of transactions as a composite transaction. Accordingly, it has been argued that as the UK HOL went beyond the purposive interpretation approach, the Ramsay principle "*does not appear to be dead but only transmogrified*"[173].

55. The Tax Law Review Committee has summarized the discussion about the aforementioned case law as follows: *"In recent years, there has been a notable change in the emphasis of the judicial approach to tax avoidance. As in all areas of law, the jurisprudence is developing. This is not to deny the validity of older cases such as Furniss v. Dawson and Ramsay, but recent cases have shown that the application of the 'doctrines' arising from those cases does not simply rely upon determining whether there is a preordained series of transactions and steps inserted with no commercial purpose (other than the avoidance of a liability to tax). Instead, cases such as Macniven v. Westmoreland and Barclays Mercantile Business Finance Limited v. Mawson emphasise the need to apply the parliamentary purpose of the relevant legislation to the reality of the transactions undertaken by the taxpayer"*[174].

56. After these judgments, the courts in the UK have tried to tackle tax avoidance schemes by adopting a purposive interpretation approach. The courts tend to look beyond the literal language of the particular provisions to

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169 PWC GAAR, p. 49.

170 UK HOL: Inland Revenue Commissioners v Scottish Provident Institution, [2005] STC 15, November 25th 2004.

171 Scottish Provident Institution case, p. 16.

172 FREEDMAN, Interpretation, p. 69.

173 FREEDMAN, Interpretation, pp. 69-70; FREEDMAN, Tax Avoidance, p. 1042.

174 TLRC, Countering tax avoidance, p. 29.

seek the true meaning of the legislation from their wider context[175]. To put it another way, after the *Ramsay case*, the courts have seemed to consider the Parliament's intention when determining how tax legislation should be interpreted. This has enabled the judiciary to reclassify transactions according to their real legal effect and to interpret statute law having regard to its intended purpose[176]. This approach was indeed followed in the *Astall & Anor*[177] *and Tower Mcashback*[178] cases. Nevertheless, it has been opined that the courts have stretched the purposive interpretation process to a great extent[179] and this approach has not always been consistent and thus has created uncertainty among taxpayers[180].

57. In Canada, the step transaction doctrine has been applied in only in a limited number of cases. Accordingly, the application of this doctrine in Canadian tax law is haphazard and it is rare that courts invoke this doctrine to disregard separate transactions that constitute a series of transactions[181]. This observation is confirmed by the fact that in the *Stubart Investment case*, the CSC rejected the business purpose test – a test which is interlinked to the step transaction doctrine. However, this did not mean that the CSC advocated a literal interpretation approach in interpreting the Canadian tax legislation[182]. Mr. Justice Estey J by citing Driedger's book on the Construction of Statutes held that "t*oday there is only one principle or approach, namely, the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament*[183]*"*. This led to the adoption of the modern approach to statutory construction in Canada. The modern rule recognizes that the words of the legislation are of primary importance. If the words are unambiguous, then the courts should attribute to them their ordinary meaning. In the case when vagueness exits, the courts should determine the correct interpretation by looking at the context and the

175 AARONSON, GAAR Study, p. 17.
176 GATLEY, Avoidance, p. 3.
177 UK COA: Astall and another v Revenue and Customs Commissioners, [2010] STC 137, October 9th 2009.
178 UK SSC: Tower MCashback LLP 1 and another v Revenue and Customs Commissioners, [2011] STC 1143, May 11th 2001.
179 AARONSON, GAAR Study, Para. 3.13.
180 GATLEY, Avoidance, p. 5.
181 FEDERICO, Tax Avoidance, p. 7; ZIMMER, JAAR, p. 46.
182 KELLOUGH, Tax Avoidance, p. 1835; FREEDMAN, Tax Avoidance, p. 1044; MASSON, PORTER, JAAR, pp. 187-188.
183 CSC: Stubart case, pp. 578-579.

purpose of the statute i.e. the statute should be interpreted consistently with the object of the tax legislation as intended by Parliament[184]. Further, Mr. Justice Estey J also put forward interpretive guidelines[185], which although not equivalent to a business purpose test would be "*appropriate to reduce the action and reaction endlessly produced by complex, specific tax measures aimed at sophisticated business practices, and the inevitable, professionally-guided and equally specialized taxpayer reaction"*. This approach resembles the UK approach.

58. In India, the approach of the judiciary towards tackling tax-avoidance schemes changed in the five judge (constitution bench) Supreme Court ruling in the *McDowell case*[186]*, which* dealt with taxpayer adopting a strategy to avoid his indirect tax burden. In the case, Mr Justice Reddy observed that the principles enunciated in the *Duke of Westminster case* were no longer applicable in the Indian tax law sphere as the UK HOL had exorcised the *"form over substance"* principle in the English *Ramsay, Burmah Oil* and *Furniss vs Dawson cases.* This meant that courts could now probe into the underlying substance of the transaction as opposed to its legal form to thwart tax-avoidance schemes. On the other hand, Mr Justice Mishra, who wrote on behalf of the four other Judges, observed that "*Tax planning may be legitimate provided it is within the framework of law, Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges"*. There was difference in the approach of the two Judges in the sense that the rule laid down by Justice Reddy was broader as it prohibited all tax planning devices

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184 FEDERICO, Tax Avoidance, p. 10; LI, Economic Substance, p. 25; ARNOLD, Tax Avoidance, p. 7.

185 Federico summarizes the guidelines as follows "*The first guideline confirms that the lack of a business purpose might be relevant in deciding whether an expense resulted in an artificial or undue reduction of income under subsection 245(1). The second guideline repeats the rule according to which the legal validity of a transaction may be ignored for tax purposes if that transaction is ineffective or is a sham. The third guideline can be split up in three sub-guidelines. While the first simply confirms that a transaction cannot have retroactive effect, the other two imply that the business purpose test could be used, although only indirectly, to attack the artificiality of business transactions"*. FEDERICO, Tax Avoidance, p. 11.

186 ISC: Commercial Tax Officer v. MC Dowell and Company Limited, 1986 AIR 649 (SC), April 17th 1985; WADHWA, SAHU, JAAR, pp. 345-346.

even if they fell within the overall legal framework of the Indian Income tax law.

59. The approach of the judiciary changed once again in the *Union of India vs Azadi Bachao Andolan case* (*see section 12.3.1*). A lower division bench (two judges) of the ISC rendered the decision, which dealt with the interpretation of the India- Mauritius tax treaty and on the powers of the Central Board of Direct Taxes (CBDT) to issue circulars/notifications for the tax authorities. In the case, the ISC watered down the principles discussed in *Mc Dowell.* The Apex Court, by stating that there was tension between the view of Mr Justice Reddy and Mr Justice Mehra, held that "*We are afraid that we are unable to read or comprehend the majority judgment in McDowell & Co. Ltd.'s case (supra) as having endorsed this extreme view of Chinnappa Reddy,J, which, in our considered opinion, actually militates against the observations of the majority of the Judges…The basic assumption made in the judgment of Chinnappa Reddy, J. in McDowell & Co. Ltd.'s case (supra) that the principle in Duke of Westminster's case (supra) has been departed from subsequently by the House of Lords in England, with respect, is not correct"* [187]. The ISC, further, by quoting several paragraphs from the English case held that "*With respect, therefore, we are unable to agree with the view that Duke of Westminster's case (supra) is dead, or that its ghost has been exorcised in England. The House of Lords does not seem to think so, and we agree, with respect. In our view, the principle in Duke of Westminster's case (supra) is very much alive and kicking in the country of its birth. And as far as this country is concerned, the observations of (judge) in A. Raman & Co.'s case are very much relevant even today"*[188]. Finally, the ISC concluded the case by providing that "*The judgment of the Privy Council in Bank of Chettinad Ltd.'s case (supra), wholeheartedly approving the dicta in the passage from the opinion of Lord Russel in Duke of Westminster's case (supra), was the law in this country when the Constitution came into force. This was the law in force then, which continued by reason of Article 372. Unless abrogated by an Act of Parliament, or by a clear pronouncement of this Court, we think that this legal principle would continue to hold good. Having anxiously scanned McDowell & Co. Ltd.'s case (supra), we find no reference therein to having dissented from or overruled the decision of the Privy Council in Bank of*

[187] ISC: Para. 130, Azadi case.
[188] ISC: Para. 132, Azadi case.

Chettinad Ltd.'s case (supra)…. We are, therefore, unable to accept the contention of the respondents that there has been a very drastic change in the fiscal jurisprudence, in India, as would entail a departure. In our judgment, from Duke of Westminster's case (supra) to Bank of Chettinad Ltd.'s case (supra) …. despite the hiccups of McDowell & Co. Ltd.'s case (supra), the law has remained the same"[189]. The aforementioned passages from this case meant that the legal substance principle continued to be applicable in the Indian tax law sphere. This decision gave rise to a number of controversies. Nevertheless, the main issue that was raised by commentators related to the validity of the ruling. It was questioned how a Lower Bench could undermine the decision of the Constitutional Bench in McDowell. It was argued that as the *Azadi Bachao Andolan* case was decided *per incuriam* – since a Constitutional Bench's decision was binding on the Division Bench – the judgment had limited applicability.

60. In a landmark judgment, the Apex Court in the *Vodafone case*[190] (*see section 12.3.3*), which dealt with an indirect transfer of an Indian mobile communication company, clarified the relationship between the *McDowell* and *Azadi Bachao Andolan cases*. According to Mr. Chief Justice Kapadia, the ruling of Mr Justice Reddy in the *McDowell case* relates only "*to tax evasion through the use of colourable devices and by resorting to dubious methods and subterfuges. Thus, it cannot be said that all tax planning is illegal/illegitimate/impermissible*[191]". If the *McDowell case* is read in such a manner i.e. its principles apply only to tax evasion cases then "*in cases of treaty shopping and/or tax avoidance, there is no conflict between McDowell and Azadi Bachao*[192]". Likewise, Justice Radhakrishnan, after analysing several English cases, held that the UK HOL has not completely abandoned the *Duke of Westminster's* principle[193]. He observed that the tax authorities "*cannot tax a subject without a statute to support and in the course we also acknowledge that every tax payer is entitled to arrange his affairs so that his taxes shall be as low as possible and that he is not bound to choose that pattern which will replenish the treasury*[194]". However, it should be noted that the Apex Court did not accept that the form over substance doctrine will

189 ISC: Para. 145, Azadi case.
190 ISC: Vodafone International Holdings B.V. vs Union of India, Civil Appeal No.733 of 2012, January 20th 2012.
191 ISC: Para. 64, Ruling by Justice Kapadia, Vodafone case.
192 ISC: Para. 64, Ruling by Justice Kapadia, Vodafone case.
193 ISC: Paras. 75-90, Ruling by Justice Radhakrishnan, Vodafone case.
194 ISC: Paras. 117, Ruling by Justice Radhakrishnan, Vodafone case.

prevail in all circumstances. Mr. Chief Justice Kapadia observed that the tax authorities "*may invoke the "substance over form" principle or "piercing the corporate veil" test only after it is able to establish on the basis of the facts and circumstances surrounding the transaction that the impugned transaction is a sham…To give an example, if a structure is used for circular trading or round tripping or to pay bribes then such transactions, though having a legal form, should be discarded by applying the test of fiscal nullity"* [195]. Mr. Justice Radhakrishnan also confirmed this position and stated that the judicial anti-avoidance doctrines can be invoked when "*the transaction is shown to be fraudulent, sham, circuitous or a device designed to defeat the interests of the shareholders, investors, parties to the contract and also for tax evasion, the Court can always lift the corporate veil and examine the substance of the transaction"*[196]. To summarize, in the author's opinion, the Court provides that the substance over form principle/lifting the corporate veil doctrine can be invoked only if the transactions undertaken by the taxpayer are considered fraudulent (sham) or are inclined more towards tax evasion. Nevertheless, in the author's opinion the ISC has created a step transaction doctrine similar to the composite transaction doctrine.

61. This is because the decision in the *Vodafone case* states at several points that the tax authorities can apply the judicial anti-avoidance doctrines to a preordained transaction that is created for tax avoidance purposes. This view was essentially adopted from the *Ramsay case*. To ascertain whether a transaction is preordained, the Court provides that to "*find out whether a given transaction evidences a preordained transaction…one has to take into account the factors enumerated hereinabove, namely, duration of time during which the holding structure existed, the period of business operations in India, generation of taxable revenue in India during the period of business operations in India, the timing of the exit, the continuity of business on such exit"* [197]. With respect to these factors, the ISC held that "*Sale of CGP share, for exiting from the Indian Telecommunication Sector, in our view, cannot be considered as pre-ordained transaction, with no commercial purpose, other than tax avoidance. Sale of CGP share, in our view, was a genuine business transaction, not a fraudulent or dubious method to avoid capital gains tax"*[198]. Accordingly, the author suggests that this judgment has the

[195] ISC: Para. 68, Ruling by Justice Kapadia, Vodafone case.
[196] ISC: Para. 98-100, Ruling by Justice Radhakrishnan, Vodafone case.
[197] ISC: Para. 73, Ruling by Justice Kapadia, Vodafone case.
[198] ISC: Para. 126, Ruling by Justice Radhakrishnan, Vodafone case.

effect of creating a step transaction doctrine that is limited to the composite transaction doctrine (as seen in the UK approach) in the Indian tax law sphere. Thus, if a step in a transaction is created with the underlying purpose only of avoiding tax and if this step cannot be justified from a commercial or business perspective, the tax authorities may disregard it.

3.2.4. The business purpose doctrine

62. The business purpose doctrine states that a transaction is effective for tax purposes only if the taxpayer entered into it for legitimate business purposes. In the US tax law sphere, the doctrine has its genesis in the US SC's decision in the *Gregory v. Helvering case*[199]. In this case, the taxpayer wished to transfer the shares of a company (Monitor) held though a holding company (United) to herself. If United had transferred the shares of Monitor directly to the taxpayer then that transaction would have been considered as triggering a taxable dividend in the hands of the taxpayer. In order to avoid the tax, the taxpayer created a new corporation (Averill) and instructed United to transfer the shares of Monitor to Averill in exchange for Averill's shares which were issued directly to the taxpayer. Under the US tax law, at that period in time, the transfer of shares to Averill and the subsequent distribution of Monitors shares to the taxpayer on Averills liquidation would be considered tax neutral i.e. exempt from tax if it was done pursuant to a corporate reorganization. However, the Apex Court concluded that the reorganization was invalid for tax purposes notwithstanding the fact that the transaction was compliant with the literal text of the US tax law. This was because Averill served no business purpose and was incorporated solely to facilitate the transfer of shares to the taxpayer. The Court held that "*When [the statute] speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here ... [T]he transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose*". Accordingly, if a transaction is undertaken only for tax purposes ie if it lacks non-tax/business purpose then the tax benefit associated with the transaction is disregarded[200]. The business purpose doctrine is not restricted

[199] US SC: Gregory v. Helvering, 293 US 465 (1935), January 7th 1935.
[200] TOOMA, Thesis, p. 45.

to a corporate context ie it also applies to transactions undertaken by individuals. To elaborate, in the *Goldstein v. Commissioner case*[201], the taxpayer, a winner of the Irish sweepstakes, reduced the tax on some of her winnings by claiming excessive interest deductions against that income. The interest deductions were excessive as the taxpayer had borrowed money at a higher rate of interest and had invested the same proceeds in treasury bonds which offered a lower rate of return. This was done primarily to generate a tax deduction against the taxpayer's winnings[202]. The US COA (Second Circuit) disallowed the interest expense deduction on the basis that the borrowing transaction undertaken by the taxpayer had "*no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction*"[203]. As a result, it has been opined that the US Courts have moved to an approach wherein a purpose, other than a tax benefit, has to be demonstrated in order for a transaction not to be attacked by this doctrine[204].

63. Even though the doctrine is accepted in the US, it has been rejected in Canada. In the *Stubart Investment case*, Mr. Justice Estey J stated that he "*would therefore reject the proposition that a transaction may be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without an independent or bona fide business purpose*[205]. Likewise, Justice Wilson, by relying on Lord Tomlin's observation in the *Duke of Westminster case* ruled that *"A transaction may be effectual and not in any sense a sham (as in this case) but may have no business purpose other than the tax purpose. The question then is whether the Minister is entitled to ignore it on that ground alone. If he is, then a massive inroad is made into Lord Tomlin's dictum that "Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be…Indeed, it seems to me that the business purpose test is a complete rejection of Lord Tomlin's principle… I think Lord Tomlin's principle is far too deeply entrenched in our tax law for the courts to reject it*

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201 US COA: Goldstein v. Commissioner of Internal Revenue, 364 F.2d 734 (1966), July 22nd 1966.
202 THURONYI, Comparative tax, p. 164.
203 STRENG, YODER, JAAR, p. 608.
204 TOOMA, Thesis, p. 46.
205 CSC: Stubart case, pp. 575-576.

in the absence of clear statutory authority"[206]. This meant that the business purpose test is inapplicable in the Canadian tax law sphere[207].

3.2.5. Abuse of law or abuse of rights doctrine

64. In general terms, the "*abuse of law*" or "*abuse of rights*" doctrine is a legal concept that enforces restrictions on the use of a right if that use exceeds the boundaries of reasonable use and enforcement of the right[208]. This doctrine applies when a person abuses the law by exercising his rights in an abusive manner so as to injure others[209]. Rights are considered to be exercised in an abusive manner when a person who has the right to choose between several legal forms to reach a particular result exercises the right with malice or an improper motive[210]. In France, in addition to counteracting fictitious arrangements, the FSC has ruled that the *abuse of law* doctrine can also apply to transactions that are solely entered into to avoid tax[211]. If applicable, the tax authorities have the power to re-characterize a transaction that has generated a tax benefit even if the transaction is legally effective[212].

65. In Switzerland, the prohibition of abusive tax avoidance cases is derived from the 1907 SCC[213]. The SCC provides that *"The manifest abuse of a right is not protected by law"*[214]. One commentator has stated that "*This article enshrines the principle of prohibition of abuse of rights…that prohibits the improper use of a right to obtain advantages which have not been conceived of for that right. This means that abuse of rights is present if the use of a right is obviously contrary to the purpose for which it has been granted. The principle of prohibition of the abuse of rights is an ultima ratio measure that allows an apparent loophole in the law (unechte Gesetzeslücke) to be filled"*. The conditions for applying this doctrine are stricter than those of the judicial general anti-avoidance doctrine[215].

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206 CSC: Stubart case, pp. 539-540.
207 KELLOUGH, Tax Avoidance, p. 1835; MITCHELL, Sham, pp. 306-307; MASSON, PORTER, JAAR, p. 197; FREEDMAN, Tax Avoidance, p. 1043; LI, Economic Substance, p. 36; ARNOLD, GAAR, p. 168; ARNOLD, Tax Avoidance, pp. 1-2.
208 PREBBLE, PREBBLE, GAAR, p. 158.
209 THURONYI, Comparative tax, p. 158.
210 PREBBLE, PREBBLE, GAAR, p. 158.
211 AUSTRY, COLLET, Tax Avoidance, p. 314.
212 RAINGEARD, Avoidance, section 2.1; PREBBLE, PREBBLE, GAAR, p. 159.
213 THURONYI, Comparative tax, p.159.
214 Art. 2(2), SSC.
215 AMONN, JAAR, p. 565; ZIMMER, JAAR, p. 43.

3.2.6. Fraus legis and similar doctrines

66. Civil law countries apply doctrines that resemble the step transaction approach. For instance, Dutch Courts have been applying the "*fraus legis*" doctrine[216] as early as 1926[217]. The doctrine sets limitations on tax avoidance achieved through a literal interpretation of the law[218]. The doctrine provides that the tax authorities may substitute an established fact pattern that does not entail taxation with a fact pattern that leads to taxation[219]. In 1982, the DSC held that the facts can be substituted if tax minimization was the primary reason for entering into the transaction[220]. Subsequently, the Courts (since 1990) have gradually provided that the substitution takes place if tax avoidance is the taxpayer's predominant motive of the taxpayer for concluding legal transactions and (the tax effect emanating from the transactions is contrary to the purpose and intent of the law[221]. The conditions are cumulative[222].

67. Similarly, in Switzerland, tax law is given a literal interpretation unless and until a tax avoidance motive exists. If it does, then the judicial general anti-avoidance doctrine can be invoked (traditional approach)[223]. One commentator provides that in the *1933 Société pour l'industrie de l'aluminium*[224] *case*, the SFSC stipulated that the following three requirements have to fulfilled in order for this doctrine to be invoked ie "*(1) it must be apparent that the legal form chosen by the taxpayer is unwarranted, inappropriate or unusual and, in all cases, completely inappropriate to the economic facts (the objective element); (2) the decision must have been made by the taxpayer solely with the intention of saving tax (the subjective element); and (3) the method chosen by the taxpayer would have had to effectively lead to a substantial tax saving (the factual element)*"[225]. If these requirements are met then the real facts carried out by

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216 ARNOLD, VAN WEEGHEL, Abuse, p. 109; ZIMMER, JAAR, p. 38.
217 VANISTENDAEL, Tax Law, p. 39; WILDE, WISMAN, Avoidance, p. 10.
218 For a detailed explanation of this doctrine refer to IJZERMAN, JAAR, pp. 454-465.
219 VAN WEEGHEL, Thesis, pp. 165-167.
220 VANISTENDAEL, Tax Law, p. 39.
221 ARNOLD, VAN WEEGHEL, Abuse, p. 109; PETERS, ROELOFSEN, Tax Avoidance, p. 554; PIJL, Abuse, pp. 310-311; BOTERMAN, GULIK, Passive income, p. 501; VANISTENDAEL, Tax Law, p. 39.
222 IJZERMAN, JAAR, p. 454; WILDE, WISMAN, Avoidance, p. 12.
223 AMONN, JAAR, p. 565.
224 SFSC: Société pour l'industrie de l'aluminium, BGE 59 I 272, December 1st, 1933.
225 JUNG, Tax Avoidance, p. 774; JUNG, Treaty Shopping, p. 238.

the taxpayer are replaced by a set of fictitious facts. The tax authorities then crystallize a tax liability using these fictitious facts[226]. In contrast to this doctrine, other commentators in Switzerland suggest that in order to combat tax avoidance cases, a purposive interpretation method should be followed which would take into consideration the purpose of the whole provision (modern approach). If this approach is adopted then the economic effects/circumstances of the taxpayer will be taken into account rather than the legal form adopted by him[227]. Another commentator has suggested that the SFSC has more and more relied on the modern doctrine, but still applies traditional doctrine in certain cases[228].

3.3. Statutory GAARs

3.3.1. The GAAR landscape in common law jurisdictions

68. Introduced in 1987, the Canadian GAAR provisions are found in section 245 of the CITA[229]. The provisions were introduced as the Government's response to the *Stubart case* which rejected the business purpose test[230]. The explanatory notes to the GAAR provisions provide that the provisions were introduced "*to prevent abusive tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions. Consequently, the new rule seeks to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs"*[231].

69. This position has been confirmed by the CSC in the *Canadian Trust Co case* [232] wherein the Apex Court stated that the GAAR was introduced "*to negate arrangements that would be permissible under a literal interpretation of other provisions of the Income Tax Act, on the basis that they amount to*

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226 JUNG, Tax Avoidance, p. 775.
227 AMONN, JAAR, p. 565; JUNG, Tax Avoidance, p. 775.
228 AMONN, JAAR, p. 566.
229 Section 245, CITA.
230 FEDERICO, Tax Avoidance, p. 13; ARNOLD, Tax Avoidance, p. 29.
231 CANADIAN GAAR, Explanatory Notes, p. 461; PWC, GAAR, p. 40.
232 CSC: Canada Trust Co Mortgage Co v Canada, 8 ITLR 276, October 19th 2005, pp. 276-305.
232 CSC: Canada Trust Co Mortgage Co v Canada, 8 ITLR 276, October 19th 2005, pp. 276-305.

abusive tax avoidance"[233]. In order for the GAAR provision[234] to apply to a transaction (or a series of transactions) the Supreme Court has laid down three steps[235]. The first step is to determine whether there is a "*tax benefit*"[236] arising from a "*transaction*"[237]. The second step is to determine whether the transaction is an "*avoidance transaction*" [238] in the sense of not being arranged essentially for bona fide purposes other than to obtain tax benefits. The third step is to determine whether the avoidance transaction is "*abusive*"[239]. The burden is on the taxpayer to prove that there is no "*tax*

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[233] CSC: Canada Trust Co case, Para. 13.

[234] The provisions state "*Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction"*. Section 245(2), CITA.

[235] CSC: Canada Trust Co case, Para. 17.

[236] A tax benefit has been defined broadly as *"a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty"*. Section 245(1), CITA. It should be noted that when the GAAR provisions were enacted there were doubts as to whether the GAAR provisions applied to misuse or abuse of tax treaties. However, in 2005, the Canadian Government ended this controversy by amending the GAAR provisions retrospectively (from 1988) by including misuse or abuse of tax treaties within the scope of the GAAR. GOYETTE, HALVORSON, Tax Avoidance, p. 175.

[237] A transaction includes "*an arrangement or event"*. Section 245(1), CITA. Further, in the case of reference to a series of transactions or events "*the series is deemed to include any related transactions or events completed in contemplation of the series*". Section 248(10), CITA.

[238] An avoidance transaction means *"any transaction that a) would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit or b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit"*. Section 245(3), CITA.

[239] According to the CSC "*The third requirement for application of the GAAR is that the avoidance transaction giving rise to a tax benefit be abusive. The mere existence of an avoidance transaction is not enough to permit the GAAR to be applied. The transaction must also be shown to be abusive under s 245(4)*". CSC: Canada Trust Co case, Para. 36; Section 245(4) provides that the GAAR provisions will apply to a transaction "*only if it may reasonably be considered that the transaction (a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of (i) this Act,(ii) the Income Tax Regulations, (iii) the Income Tax Application Rules, (iv) a tax treaty, or (v) any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act*

benefit" or no "*avoidance transaction*" and it is for the tax authorities to establish that there is abusive tax avoidance[240]. In order to determine whether a transaction is "*abusive*" a two-stage analysis has to be undertaken. In the first stage, a unified textual, contextual and purposive analysis of the provisions conferring the tax benefit has to be undertaken in order to determine the object, spirit or the purpose of the provision at stake. Thereafter, in the second stage of the abuse analysis, it has to be determined whether the avoidance transactions respect or defeat the object, spirit or purpose of the provisions at stake. If these requirements are met then the GAAR provisions can be invoked to deny a tax benefit that is conferred on the taxpayer pursuant to the domestic law or through the provisions of a tax treaty[241]. If the existence of abusive tax avoidance is unclear then the benefit of the doubt goes to the taxpayer[242]. In a situation where the GAAR applies then any "*deduction, exemption or exclusion in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part; any such deduction, exemption or exclusion, any income, loss or other amount or part thereof may be allocated to any person; the nature of any payment or other amount may be re-characterized and the tax effects that would otherwise result from the application of other provisions of the Act may be ignored*[243].

70. In the US, prior to March 31st, 2010 the tax law did not contain a statutory GAAR. The economic substance doctrine created great uncertainty among taxpayers as significant disparities existed among courts in relation to the application of the doctrine[244]. Consequently, the doctrine was codified in the US tax law (code) pursuant to the Health Care and Education Reconciliation Act of 2010. It has been argued that the codification allows taxpayers and the Government greater clarity and uniformity in the application of the economic substance doctrine[245]. As a result of the

or in determining any amount that is relevant for the purposes of that computation; or (b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole".

240 CSC: Canada Trust Co case, Para. 66; GOYETTE, HALVORSON, Tax Avoidance, p. 176.

241 CSC: Canada Trust Co case, Para. 55; PWC, GAAR, p. 40; GOYETTE, HALVORSON, Tax Avoidance, p. 176.

242 CSC: Canada Trust Co case, Para. 66.

243 Section 245(5), CITA; PWC, GAAR, p. 41.

244 LAMPREAVE, Substance, p. 158.

245 SANCILIO, Substance, p. 163.

codification, the US tax law[246] provides that for any transaction to which the economic substance doctrine is relevant - a conjunctive two prong approach must be used to determine whether or not that transaction is regarded as having economic substance. The first prong requires that the transaction alters in a meaningful manner the economic position of the taxpayer (apart from tax purposes)[247]. Under this prong, the US tax authorities require taxpayers to present proof that their financial position has changed after entering into the transaction – independent of any tax benefit[248]. The second prong requires that the taxpayer has a substantial purpose (over and above tax purposes) for entering into such transaction[249]. This prong analyses whether or not there is a legitimate business purpose for a transaction. This involves an analysis of the taxpayer's intent. In order to satisfy this prong, the taxpayer must demonstrate a purpose other than a tax purpose, which often involves an examination of the subjective factors that motivated the taxpayer to enter into the transaction in question[250]. If the doctrine applies, then the taxpayer will be denied a tax benefit even though that taxpayer satisfies all the technical legal requirements to obtain such benefit. Further, the US tax law[251] also provides that a taxpayer is subject to penalties if the transaction does not contain economic substance.

71. In the UK, since 1998 the Government has been considering implementing a GAAR as a means to combat tax avoidance[252]. In December 2010, the Government constituted a Committee to consider whether a GAAR could deter and counter tax avoidance and at the same time provide certainty to taxpayers. The GAAR Committee published its report in November 2011[253] and recommended that a GAAR targeted at artificial and abusive tax avoidance schemes should be introduced as it would improve the UK's ability to tackle tax avoidance[254]. In the GAAR Committee's opinion "*At the moment, in the absence of any such anti-abuse rule, the task of judges in the Tax Tribunals and the Courts in dealing with abusive schemes is confined to*

246 Section 7701(o)(1), US IRC.
247 Section 7701(o)(1)(a), US IRC.
248 LAMPREAVE, Substance, p. 158.
249 Section 7701(o)(1)(b), US IRC.
250 LAMPREAVE, Substance, p. 159.
251 Section 6662(b)(6), US IRC; LAMPREAVE, Substance, pp. 160-161; SANCILIO, Substance, pp. 165-166.
252 MORTON, SKYES, Tax Avoidance, p. 805.
253 AARONSON, GAAR Study.
254 AARONSON, GAAR Study, Para. 1.1-Para. 1.8.

deciding whether such schemes succeed or fail by applying the normal principles of statutory interpretation to the tax provisions concerned. Judges inevitably are faced with the temptation to stretch the interpretation, so far as possible, to achieve a sensible result; and this is widely regarded as producing considerable uncertainty in predicting the outcome of such disputes. In practice this uncertainty spreads from the highly abusive cases into the centre ground of responsible tax planning. A GAAR specifically targeted at abusive schemes would help reduce the risk of stretched interpretation and the uncertainty which this entails"[255]. The Committee also provided an illustrative draft of the GAAR provisions, which it suggested to be introduced in the UK tax legislation[256]. In essence, the provisions were designed to combat abnormal arrangements that create an abusive tax result and which go beyond certain safeguards. If the safeguards are breached then the provisions apply and adjustments may be made to taxpayers transaction[257]. In the 2012 UK annual Budget, the Government had announced that it accepted the broad recommendation that had been put forward in the GAAR Committee Report[258].

72. Accordingly, via the Finance Bill 2013, the Government proposed the introduction of the GAAR provisions in the UK tax system[259]. That Finance Bill states that the GAAR provisions[260] will operate for the purpose of counteracting "*tax advantages*"[261] arising from "*tax arrangements*"[262] that

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255 AARONSON, GAAR Study, Para. 1.7 (iii).

256 AARONSON, GAAR Study, pp. 44-51.

257 AARONSON, GAAR Study, pp. 55-57.

258 HMRC, GAAR, p. 3.

259 UK, Finance Bill 2013, Part V, Section 203-212.

260 UK, Finance Bill 2013, Part V, Section 203(1). The taxes to which the UK GAAR provisions apply to are *"(a) income tax, (b) corporation tax, including any amount chargeable as if it were corporation tax or treated as if it were corporation tax, (c) capital gains tax, (d) petroleum revenue tax, (e) inheritance tax, (f) stamp duty land tax, and (g) annual tax on enveloped dwellings.* UK, Finance Bill 2013, Part V, Section 203(3).

261 A tax advantage is broadly defined to include "*(a) relief or increased relief from tax, (b) repayment or increased repayment of tax, (c) avoidance or reduction of a charge to tax or an assessment to tax, (d) avoidance of a possible assessment to tax, (e) deferral of a payment of tax or advancement of a repayment of tax, and (f) avoidance of an obligation to deduct or account for tax*". UK, Finance Bill 2013, Part V, Section 205. It should be noted that this definition is inclusive and is intended to have a very wide meaning. Also, the HMRC states that the aforementioned definition "*suggests that in ascertaining whether an advantage arises the actual tax position should be compared with another tax position. The appropriate comparator or alternative tax position will depend on the facts, but will usually derive from the arrangements that would have occurred absent the*

are "*abusive*"[263]. If it is determined that a tax arrangement is abusive, then the GAAR provides that making appropriate adjustments will counteract the tax advantage that the arrangement sets out to achieve[264]. In this respect, the GAAR provides that adjustments will be made to the extent that they can be considered to be "*just and reasonable*"[265]. The legislation does not define "*just and reasonable*". However, the HMRC guidance states that in most cases "*it will be a relatively straightforward exercise to decide what adjustments need to be made to achieve a just and reasonable result*"[266]. In other cases, the GAAR can disallow the transaction carried out by the taxpayer and can in this way adjust the tax consequences on the basis that an alternative transaction had been carried out[267]. Further, in relation to the form of counteraction, the GAAR provides that the counteraction can be in

abusive tax purpose (which may include no arrangement at all). In situations where there is more than one alternative arrangement that might have been adopted if the taxpayer had not adopted an abusive arrangement then the appropriate comparator would be the transaction that the taxpayer would most likely have carried out". HMRC, GAAR, p. 16.

262 The GAAR applies to abusive tax arrangements. Arrangements are considered to be tax arrangements *"if, having regard to all the circumstances, it would be reasonable to conclude that the obtaining of a tax advantage was the main purpose, or one of the main purposes, of the arrangements"*. UK, Finance Bill 2013, Part V, Section 204(1). Arrangements, on the other hand, are broadly defined to include "*any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable)"*. UK, Finance Bill 2013, Part V, Section 211.

263 Tax arrangements are abusive if "*they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances including— (a) whether the substantive results of the arrangements are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions, (b) whether the means of achieving those results involves one or more contrived or abnormal steps, and (c) whether the arrangements are intended to exploit any shortcomings in those provisions"*. UK, Finance Bill 2013, Part V, Section 204(2). The provisions further provide that " *Each of the following is an example of something which might indicate that tax arrangements are abusive— (a) the arrangements result in an amount of income, profits or gains for tax purposes that is significantly less than the amount for economic purposes, (b) the arrangements result in deductions or losses of an amount for tax purposes that is significantly greater than the amount for economic purposes, and (c) the arrangements result in a claim for the repayment or crediting of tax (including foreign tax) that has not been, and is unlikely to be, paid, but in each case only if it is reasonable to assume that such a result was not the anticipated result when the relevant tax provisions were enacted"*. UK, Finance Bill 2013, Part V, Section 204(4). Also see HMRC, GAAR, pp. 18-27.

264 UK, Finance Bill 2013, Part V, Section 206(1).

265 UK, Finance Bill 2013, Part V, Section 206(2); HMRC, GAAR, p. 11.

266 HMRC, GAAR, p. 11.

267 HMRC, GAAR, p. 11.

whatever form is appropriate i.e. it may take the form of "*an assessment, the modification of an assessment, amendment or disallowance of a claim, or otherwise*" [268]. Also, the GAAR provisions provides for consequential relieving adjustments where counteraction of the abusive tax advantage has been made[269].

73. In India, in order to counter aggressive tax planning, an intention of implementing a GAAR was expressed in the proposed DTC[270]. However, as the date of implementation of the proposed DTC was unclear, the GAAR provisions were instead codified in the current tax law[271]. Further, as the GAAR provisions were drafted as a broad set of provisions granting extensive powers to tax authorities to discard any arrangement entered into by the taxpayer, the Indian Central Board of Direct Taxes constituted a GAAR Committee to frame draft guidelines in order to clarify the applicability of these provisions. The GAAR Committee, then, released its draft guidelines and invited suggestions/comments from the public. After receiving comments from the public and various stakeholders a second report ('GAAR report') was issued by a revised Committee of GAAR Experts ("EC")[272]. It was proposed that the codified provisions would be effective from April 2013 onwards. However, pursuant to the EC's proposal their implementation was deferred to April 2016. Furthermore, in the Indian budget for the Financial Year 2015-16, it was announced that the GAAR provisions will apply from the Financial Year 2017-18. In essence, the provisions in the current tax law [273] provide that if the GAAR applies "*arrangements*" [274] entered into by a taxpayer can be classified as "*impermissible avoidance agreements*". An arrangement is regarded as an "*impermissible avoidance arrangement*" [275] if it is entered into by the

[268] UK, Finance Bill 2013, Part V, Section 206(5).
[269] UK, Finance Bill 2013, Part V, Section 207.
[270] Clause 123-125, IDTC.
[271] Section 95-102, IITA.
[272] GAAR, Expert Committee Report.
[273] The provisions state that "*Notwithstanding anything contained in the Act, an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and the consequence in relation to tax arising therefrom may be determined subject to the provisions of this Chapter*". Section 95, IITA.
[274] The term "*arrangement*" has been defined as "*any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not, and includes the alienation of any property in such transaction, operation, scheme, agreement or understanding*". Section 102, IITA.
[275] Section 96, IITA.

taxpayer with the main purpose of obtaining a "*tax benefit*"[276] and if the arrangement triggers the application of any of the following four tainted elements i.e.; it creates rights or obligations, which are not ordinarily created between persons dealing at arm's length; results, directly or indirectly, in the misuse, or abuse, of the provisions of the income tax law; lacks commercial substance or is deemed to lack commercial substance in whole or in part; or is entered into, or carried out, by means which are, or in a manner, which is not ordinarily employed for bona fide purposes. Interestingly, the third tainted element, provides for a "*commercial substance*" [277] test which basically states that a transaction can be disregarded if the substance or effect of the arrangement as a whole is inconsistent with its form. The EC states that this test results in "*the codification of substance v. form doctrine. It implies that where substance of an arrangement is different from what is intended to be shown by the form of the arrangement, then tax consequence of a particular arrangement should be assessed based on the ―substance of what took place. In other words, it reflects the inherent ability of the law to remove the corporate veil and look beyond form"*[278]. If the GAAR applies then a tax benefit under the domestic law or under a tax treaty may be denied to a taxpayer[279]. To elaborate the GAAR provisions can have far reaching effects so as to disregard, combine or re-characterize any step in, or a part or whole of, the impermissible avoidance arrangement; treat the impermissible avoidance arrangement as if it had not been entered into or carried out; disregard any accommodating party or treating any accommodating party

[276] The term tax benefit has been defined as "*(a) a reduction or avoidance or deferral of tax or other amount payable under this Act; or (b) an increase in a refund of tax or other amount under this Act; or (c) a reduction or avoidance or deferral of tax or other amount that would be payable under this Act, as a result of a tax treaty; or (d) an increase in a refund of tax or other amount under this Act as a result of a tax treaty; or (e) a reduction in total income including increase in loss, in the relevant previous year or any other previous year"*. Section 102, IITA.

[277] An arrangement lacks commercial substance if "*(a) the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or (b) it involves or includes— (i) round trip financing; (ii) an accommodating party; (iii) elements that have effect of offsetting or cancelling each other; or (iv) a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction; or (c) it involves the location of an asset or of a transaction or of the place of residence of any party hich is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party"*. Section 97, IITA.

[278] GAAR, Expert Committee Report, p. 27.

[279] Section 98, IITA.

and any other party as one and the same person; deem persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount; reallocate amongst the parties to the arrangement any income or expense[280].

3.3.2. The GAAR landscape in civil law jurisdictions

74. In France, the abuse of law doctrine was initially codified in the FTC in 1941[281]. Subsequently, it was amended with effect from January 1, 2009[282]. The provision provides that arrangements undertaken by a taxpayer that are fictitious (simulated transactions) amount to an abuse of law[283]. An abuse of law occurs when the transactions are real or legitimate. Specifically, abuse takes place when the transaction undertaken by the taxpayer is "*purely*" tax motivated and results in a tax advantage, the grant of which would be contrary to the "*purpose*" of the relevant provisions[284]. If invoked, the tax authorities can disregard the purported legal agreement between the parties and, accordingly tax the transaction on the basis of its actual substance[285]. The burden of proof rests on the tax authorities for the provision to be triggered.

75. In Germany, the statutory GAAR is provided in Section 42 of the German Tax Code (*Abgabenordnung*). The provision that was introduced in 1977[286], the enactment of which can be traced back to 1919[287], provides that "*tax law may not be circumvented by an abuse of possible legal arrangements. If there is such an abuse, the taxpayer shall be taxed as if he had chosen an adequate legal arrangement*"[288]. The provision has been interpreted by the GFFC in light of the fraus legis, economic substance and business purpose doctrines[289]. According to established case law, "*abuse of possible legal arrangements*" exists when a taxpayer chooses a legal structure that is inappropriate to the economic objective; that is aimed at achieving a reduction of the German tax burden; that cannot be justified by

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280 Section 98, IITA; GAAR, Expert Committee Report, pp. 29-30.
281 AUSTRY, COLLET, Tax Avoidance, p. 315.
282 AUSTRY, COLLET, Tax Avoidance, p. 317.
283 PREBBLE, PREBBLE, GAAR, p. 160.
284 AUSTRY, COLLET, Tax Avoidance, p. 317.
285 AULT, ARNOLD, CT, p. 477.
286 EY, GAAR, p. 48.
287 LINN, Tax Avoidance, p. 334; DE BROE, Thesis, p. 415; REIMER, Avoidance, pp. 4-7.
288 PREBBLE, PREBBLE, GAAR, p. 153.
289 LINN, Tax Avoidance, p. 337; DE BROE, Thesis, p. 415.

non-tax reasons and is contrary to the spirit of the provisions at stake (subjective element)[290]. If all the four conditions are satisfied then tax is due as if the taxpayer had chosen an adequate legal arrangement. In other words, the tax authorities can substitute the transaction and levy taxes based on the substance of the transaction and not the form[291].

76. In contrast to the aforementioned jurisdictions, even though the Dutch tax law provides for a statutory GAAR, due to the development of the fraus legis doctrine, the tax authorities no longer use the statutory GAAR (*richtige heffing*)[292]. Also, Swiss tax law does not have a statutory GAAR[293]. However, the judicial general anti-avoidance doctrine (*see margin no. 67*) is used to interpret Art. 21(2) of the SWTA, which is an anti-abuse provision vis-à-vis abusive tax refunds[294]. Specifically, the provision provides that the Swiss federal withholding tax will not be refunded in tax avoidance cases[295].

3.3.3. Common elements of GAARs

77. Statutory GAARs are used to achieve one or more of the following objectives: to target transactions that comply with a literal interpretation of the legislation but which generate tax advantages the State considers to be against the intention/purpose of the law; to apply an economic substance or business purpose test to determine whether a transaction is lawful or; to define the features of an artificial scheme, transaction or arrangement that has been designed to extract a tax advantage or apply an economic substance or business purpose test to determine if a transaction is bona fide[296]. Although it is generally accepted that statutory GAARs apply to tax avoidance and not to tax mitigation, drawing the line between the two is often contentious and problematic.

78. Further, an analysis of the statutory GAAR structures of common law or civil law States indicates that there are several commonalities within the

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[290] LINN, Tax Avoidance, p. 337; DE BROE, Thesis, p. 415; PREBBLE, PREBBLE, GAAR, p. 153; REIMER, Avoidance, pp. 7-10.
[291] LINN, Tax Avoidance, p. 337; DE BROE, Thesis, p. 415; PREBBLE, PREBBLE, GAAR, p. 153.
[292] PETERS, ROELOFSEN, Tax Avoidance, p. 553; WILDE, WISMAN, Avoidance, p. 11.
[293] JUNG, Tax Avoidance, p. 774; LINDER, SCHREIBER, Passive income, p. 730.
[294] JUNG, Tax Avoidance, p. 776; JUNG, EC Directive, pp. 113-114.
[295] JUNG, Treaty Shopping, p. 239.
[296] EY, GAAR, p. 10.

GAAR models used even though the rules are structured differently. In general, the GAAR provisions have some common design features which require a combination of the following features in order to be triggered: i) a "*transaction*" or "*arrangement*" needs to be identified; ii) the "*tax benefit*" or "*tax advantage*" from the transaction/arrangement needs to be quantified; iii) it has to be proven that the "*transaction" or "arrangement*" satisfies the purpose test, in the sense that, a main purpose (or one of the main purpose) of entering into the "*transaction" or "arrangement*" was to obtain a "*tax benefit*" or "*tax advantage*" or the "*transaction" or "arrangement*" was undertaken for other than bonafide purposes and iv) the "*transaction" or "arrangement*" is "*impermissible*" or "*abusive*" of a tax provision[297]. No consistency exists with respect to which party bears the burden of proof in regard to establishing whether the statutory GAAR is triggered. Sometimes it falls exclusively on the taxpayer or tax authorities and sometimes it is shared[298].

79. If triggered, the GAAR provisions can have far reaching effects, which may lead to cancelation of the "*tax benefit*" or "*tax advantage*" associated with the "*transaction" or "arrangement*". There is no global consistency in the form the counteraction takes. For instance, tax authorities could deny tax benefits associated with the transaction; re-characterize an item of income; re-determine a taxpayer to whom income is allocated or deny deductions.

3.4. Statutory SAARs

3.4.1. TP rules

80. Several States have legislated TP rules[299]. The rules provide that the transactions between related parties should be carried out on an arms length basis i.e. at conditions and/or prices at which independent parties would carry out the transaction. It is debated whether such rules are a statutory GAAR or a SAAR[300]. In the author's opinion, this provision is a SAAR as it applies only to "*associated enterprises*" as opposed to all taxpayers. Such

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297 ZIMMER, JAAR, pp. 43-46.

298 EY, GAAR, p. 13.

299 For instane – for the Netherlands, see WILDE, WISMAN, Avoidance, pp. 22-24; For Germany, see REIMER, Avoidance, pp. 25-26; For Austria, see BERGMANN, Avoidance, p. 6; For France, see RAINGEARD, Avoidance, section 3.1.

300 POGORELOVA, Abuse, pp. 683-693.

rules could authorize structural [301] and/or price related adjustments to transactions undertaken by related parties if they are not at arm's length. Even the provisions of Art. 9(1) of the OECD Model [302] allow the tax authorities of a State to adjust the profits of the enterprises resident in that State, if as a result of the special relations between that enterprise and other associated enterprises resident in other States, the profits of the first enterprise have been diverted to the other associated enterprises, due to the fact that they operate with each other on a non-arm's length basis[303]. Where the tax authorities have adjusted the profits, Art. 9(2) of the OECD Model[304] is aimed at eliminating the economic double taxation that may arise pursuant to Art. 9(1)[305]. A detailed analysis of these rules is outside the scope of this thesis. Nevertheless, the author, at various points in his analysis, discusses the impact of Art. 9 on domestic anti-avoidance rules (in particular rules to limit interest deductions such as thin capitalization rules).

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301 2010 OECD TP Guidelines, Paras. 1.64-1.69.

302 Art. 9(1) of the OECD Model provides that "*Where a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State; and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly*". 1977 OECD Model. Art. 9, Para. 1. The provision is reproduced in the same format in the 2014 OECD Model. Art. 9, Para. 1.

303 2014 OECD Comm. Art. 9, Para. 2.

304 Art. 9(2) of the OECD Model provides that "*Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other*". 1977 OECD Model. Art. 9, Para. 2. The provision is reproduced in the same format in the 2014 OECD Model. Art. 9, Para. 2.

305 2014 OECD Comm. Art. 9, Para. 5.

3.4.2. Source State measures

3.4.2.1. Measures to counteract treaty and rule shopping

3.4.2.1.1. Anti-treaty shopping provisions

81. The domestic law of some States contains legislation that is designed to limit taxpayers' ability to reduce source State taxes through the use of conduit entities established in jurisdictions with favourable tax treaty networks.

82. For instance, introduced in 1994, Section 50d(3) of the German tax law [306] contains an anti-treaty shopping provision under which an intermediary entity, established in a treaty jurisdiction, is not entitled to treaty benefits (lower withholding tax rates) subject to certain conditions being satisfied. Essentially, the intermediary entity is not entitled to treaty benefits if its shareholders would not be entitled to receive the benefits had they received the German source income directly or if the income of the intermediary entity is not classified as active based on the following requirements: i) the gross income of the intermediary entity does not result from its own business activities and thus does not qualify as active income or ii) the intermediary entity receives passive income and there are no business purposes or non-tax reasons for interposing the intermediary entity and the intermediary entity is unable to operate in its market place as it is inadequately equipped[307]. If the rule applies, the intermediary entity is not disregarded for tax purposes but treaty benefits are not extended to it[308].

83. Similarly, under US tax law; the use of intermediary conduit entities is counteracted by specific conduit financing regulations. These rules, which were introduced in 1993 [309], target foreign taxpayers who are using intermediary entities to obtain reduced withholding taxes available pursuant to US tax treaties. The rules are triggered when i) there is a "*financing arrangement*" wherein two or more financing transactions are linked by an intermediary entity and ii) the participation of the intermediary entity reduces the tax imposed under the US tax law provisions iii) the

306 SCHIFFER, JOCHIMSEN, Treaty shopping, p. 517.
307 SCHIFFER, JOCHIMSEN, Treaty shopping, p. 518.
308 KESSLER, EICKE, Tax Planning, p. 504.
309 INFANTI, Abuse, pp. 384-385.

participation of the intermediary entity is pursuant to a tax avoidance plan and iv) the intermediary entity is related to the borrower or lender or unrelated but "*would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity has engaged in the financing transaction with the intermediary entity*" [310]. If the rules are triggered then the US tax authorities have the power to re-characterize financing transactions made through an intermediate, as direct financing transactions[311].

3.4.2.1.2. Anti-rule shopping provisions

84. The domestic laws of several States have SAARs to counteract rule-shopping transactions. The nature of the SAAR would depend on the rule shopping transaction. For instance, to counteract dividend stripping the tax law of several States provide for SAARs. The common denominator in these rules is that such rules re-characterize as dividends, the capital gain derived by the non-resident. For instance, Canadian tax law[312] provides anti-surplus stripping rules[313]. The rules apply if the following three conditions are satisfied: i) a non-resident person alienates the shares ("subject shares") of a Canadian corporation ("subject corporation") to another Canadian corporation ("purchaser corporation") ii) the non-resident person does not deal at arm's length with the purchaser corporation and iii) immediately after the disposition, the subject corporation is "*connected*" with the purchaser corporation. If all the conditions are satisfied then the purchaser corporation is deemed to have paid a dividend to the non-resident person, which in turn, is subject to the final 25% withholding tax.

85. Likewise, the US tax law[314] contains rules on "*brother-sister*" transactions. These rules, which are broad in nature, prevent a taxpayer from withdrawing the current or accumulated earnings and profits (E&P) of a US corporation as capital gains through related party stock sales. The rules

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[310] Section 881, US IRC read in conjunction with US Treasury regulations, 1.881-3; DOERNBERG, International Tax, p. 91; VARMA, WEST, Tax Avoidance, p. 835; CASTRO, Treaty Shopping, p. 306.

[311] DOERNBERG, International Tax, p. 91.

[312] Section 212.1, CITA; The origin of these rules can be traced back to the year 1917 and previous versions of the CITA. For a historical overview of these rules see STIKEMAN, COUZIN, Surplus Stripping, pp. 1844-1860.

[313] LI, SANDLER, Abuse, p. 933.

[314] Section 304, US IRC.

provide that – if one or more persons (transferor) are in "*control*" of each of two corporations and in return for assets (such as cash), one of the corporations (acquirer) acquires stock in the other corporation (target) from the person so in control – then such property will be treated as a distribution in redemption of the stock. In essence, these rules treat "*stock sales*" as "*deemed redemption*" transactions with the effect that the sale consideration paid by the acquirer to the transferor is re-characterized as dividends paid by the acquirer to the transferor. The deemed redemption takes place by construing two fictional steps. Firstly, it is assumed that the transferor is deemed to contribute the stock of the target to the acquirer in exchange for fictional stock of the acquirer. Secondly, the acquirer is deemed to redeem the fictional shares from the transferor in exchange for cash proceeds. The latter transaction is considered to give rise to the dividends[315].

86. Dutch tax law also provides for an anti-avoidance rules. These provisions, which are broad in scope, contain a negative definition of the term "*beneficial owner*". This implies that if the recipient of the dividend does not qualify as the beneficial owner then the Dutch dividend withholding tax (15%) will apply. The provisions state that the recipient of dividends will not be considered to be the beneficial owner if "*as a consequence of a combination of transactions, a person other than a recipient wholly or partly benefits from the dividends, whereby such person retains, whether directly or indirectly, an interest in the shares on which the dividends were paid and such person is entitled to a credit, reduction, or refund of the dividend withholding tax that is less than to which the recipient is entitled"* [316] too. The effect of this statement is a denial of treaty benefits as opposed to the transaction being re-characterized.

3.4.2.2. Measures to counteract base eroding payments

3.4.2.2.1. Rules restricting interest deductions

87. Typically, source States implement thin capitalization or similar regimes to reduce base erosion through excessive interest deductions. Thin capitalization rules vary from country to country. Nevertheless, the

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[315] HOOSE, Dividends, p. 1004; The origin of these rules can be traced back to the year 1954 and previous versions of the US IRC. For a historical overview of these rules see TERRY, Section 304, pp. 457-482.

[316] DE BOER, BOULONGE, Dividends, p. 796; WILDE, WISMAN, Avoidance, p. 34.

approaches followed by countries can broadly be divided between those that are based on the application of i) fixed ratios ii) rules based on the arm's length principle iii) rules that disallow a percentage of an interest expense payment[317] and iv) rules that compare the level of debt in an entity by reference to the overall position of the group it belongs to[318].

88. Under the fixed ratio approach, countries compare the debtor company's total debt to its equity capital and if the debt exceeds the equity by a certain proportion then the interest payment attributable to the excess debt is disallowed for tax purposes[319]. As an alternate to debt – equity ratios, States could also limit interest expenses by reference to interest/earnings or interest/total assets[320]. However, this focuses on debt-to-equity ratios.

89. For instance, the Canadian thin capitalization rules that were introduced in 1972 are designed to discourage a non-resident from capitalizing a Canadian corporation with excess debt and repatriating profits in the form of interest. Specifically, the Canadian tax law denies a Canadian corporation the right to deduct a portion on interest (non-resident interest) paid to specified non-residents if the specified non-residents debt in the Canadian corporation exceeds a debt-to-equity ratio of 2:1. The portion of non-deductible interest is calculated by multiplying yearly interest expense on outstanding debt owed to specified non-residents by the result obtained from dividing the monthly average of greatest amount of debt owed to specified non-residents in that year minus two times the equity with the monthly average of greatest amount of debt owed to specified non-residents in the year. The interest that is disallowed in computing the Canadian corporation's taxable income retains its character as interest for domestic law purpose and is not classified as dividends. Accordingly, withholding taxes applicable on interest will also apply to such payments[321].

90. Likewise, the US thin capitalization rules that were introduced in 1989 also follow such an approach. These rules also known as the earning stripping rules, prevent deduction of excessive interest payments by US

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317 OECD, Discussion Draft on Financial Payments, Para. 15.
318 OECD, Discussion Draft on Financial Payments, Para. 58-Para. 146.
319 OECD, Discussion Draft on Financial Payments, Para. 16.
320 2015 OECD, Final Report on Interest Deductions, Para. 11.
321 Section 18(4) to 18(8), CITA; EDGAR Thin Cap, p.10; SWEENEY, ROHDE, Thin Cap, p. 387; EDGAR, Report, p. 20.

companies. In essence, if a domestic or foreign related lender thinly capitalizes a US corporation, the provisions limit the deductibility of interest payments by such companies. The limitation is determined by the following a five step analysis. Firstly, in order for the rules to be applicable, the debt-to-equity ratio of the US corporation should exceed 1.5:1. Secondly, the US corporation should have a net interest expense ie its total interest expense should exceed its total interest income. Thirdly, the US corporation should have an excess interest expense (EIE). The EIE is the excess of the US corporations net interest expense (calculated in the second step) over 50% of the US corporations adjusted taxable income plus excess limitation carry forward. Fourthly, the exempt related person interest expense (ERPIE) needs to be determined. The ERPIE is the interest paid or accrued by the US corporation on related person debt or unrelated debt guaranteed by a related person which is not subject to US income tax. In this regard, it should be noted that for the purpose of both related and unrelated guaranteed debt, if a tax treaty provides for a lower withholding tax on the interest income, the difference between the domestic income tax rate and treaty rate, is considered to be exempt i.e. not subject to US tax. Lastly, a comparison has to be made between EIE (calculated in the third step) and ERPIE (calculated in the fourth step) to determine which amount is lower. The lower amount is then not allowed as a deduction for tax purposes. The interest which is disallowed as a tax deduction can be carried forward indefinitely and can be deducted in a subsequent taxable year when the taxpayer has an excess limitation. An excess limitation exists in a situation where the net interest expense is less than 50% of the adjusted taxable income. This disallowed interest retains the character of interest for the purpose of domestic law and is not treated as dividend. Further this interest is eligible for reduced rates of withholding taxes for the purpose of US tax treaties[322].

91. Similarly, the erstwhile French domestic thin capitalization rules provided that interest on loans granted by associated enterprises was not allowed as a deduction (the excess interest) if the loan exceeded a debt-to-equity ratio of 1.5:1. An exception was provided for parent companies of the payer that were subject to French corporate tax. Accordingly, if the parent company was a tax resident in France or it operated through a PE in France and was subject to the French corporate tax, then the thin capitalization rules

[322] Section 163(j), US IRC; MISEY, SCHADEWALD, US Tax, p. 353; DOERNBERG, International Tax, p. 67; ENGLE, RAINERI, Thin Cap, p. 788; EY, Thin Cap, p. 42.

did not apply[323]. The rules were modified and from January 2007 they have also applied to loans granted from French companies[324].

92. As an alternative, the fixed ratio approach could be used as a safe haven measure and, if breached, the taxpayer could be given the option of showing that the relevant company's debt/equity ratio is at arm's length or is otherwise acceptable. For instance the Swiss thin capitalization rules follow this approach. The rules provide that interest paid on loans which can be considered as equity is not deductible for corporate tax purposes i.e. in determining the taxable income of corporations and cooperatives. To determine the circumstances in which debt can be considered as equity (hidden equity) the Swiss tax authorities have issued administrative guidance. In essence, the guidance provides three steps to reclassify debt to equity for tax purpose. Firstly, a determination has to be made as to who has provided the debt. If the debt has been provided by a shareholder or closely related persons (domestic or foreign) the debt can be considered as hidden equity subject to steps two and three. If the loan is not provided by the shareholder or closely related person i.e. it is provided by an independent third party and as long as neither the shareholder nor closely related person has guaranteed the loan, the debt would be outside the scope of the thin capitalization provisions. Secondly, the guidance provides debt to equity ratios and percentages. For financial companies, the guidance provides that the debt to equity ratio should not exceed 6:1. For all other companies, the guidance provides that debt should not exceed a certain percentage of the market value of the assets. These ratios can be considered as safe haven measures which means that if the company does not have debt exceeding the ratios/percentages it can rely on the fact that debt will not be reclassified as hidden equity. However, where the ratio/percentages are exceeded, a reclassification from debt to equity could take place (subject to step 3). Lastly, if the taxpayer breaches the debt equity ratio or the specified percentages, the last step raises the question of whether such a loan adheres to the arm's length principle. A debt is considered as being at arm's length if an independent third party would have granted it under the same or similar conditions. Therefore, if an independent third party would have granted the loan under the same conditions, the debt provided by the related party will not be considered as hidden equity. To summarize, a related party debt is

[323] MESSAGE, Abuse, p. 223.
[324] JACQUOT, Passive income, p. 307.

considered as hidden equity if three cumulative conditions are met: i) it has been provided by the shareholders or by closely related persons ii) the debt to equity ratio or the percentages mentioned are exceeded and iii) the arm's length principle has been violated. The disallowed interest is treated as a hidden profit distribution for domestic tax law purpose. Accordingly, withholding taxes applicable on dividends apply to such payments[325].

93. Under the arm's length approach, a comparison is made between the level of debt and interest in an entity with the position that would have existed if that entity had been dealing with third parties[326]. For instance, prior to the 2004, broadly speaking the UK tax law dealt with the issue of thin capitalization in two ways. Firstly, the law combated the erosion of the UK tax base through excessive interest deductions pursuant to its TP rules. Secondly, specific rules existed that addressed the issue of thin capitalization. Specifically, these rules applied mostly to cross-border situations (foreign lender/UK borrower) and reclassified an interest payment as a dividend distribution if the interest paid by the borrower to the lender exceeded the arm's length amount. In 2004, changes were made to the UK tax law and the thin capitalization rules were incorporated into the rules dealing with TP. In addition, the TP rules were extended to domestic situations with the effect that the thin capitalization rules are now also applicable in domestic transactions too i.e. for loans between a UK lender and a UK borrower. Consequently, the current thin capitalization rules in the UK are based purely on the arm's length principle. No safe harbour rules such as debt to equity ratios are prescribed[327].

94. Moreover, certain States have also enacted rules that disallow a percentage of an interest expense payment. For instance, in 2008, Germany introduced interest barrier rules to replace its old rules that were based on the fixed ratio approach, as they were contrary to German tax treaties and the EU rules on Freedom of Establishment (*see section 16.4.6*). The new rules disallow a percentage of the interest expense irrespective of the nature of the payment and the recipient of the income. Consequently, the rules apply to intra group interest as well as interest paid to unrelated parties. Interestingly, the rules limit the interest deduction for the borrower without taking into

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[325] Art. 65, SDTL; UNTERSANDER, Interest, p. 720.

[326] OECD, Discussion Draft on Financial Payments, Para. 22.

[327] GREEN, Thin Cap, p. 3; KNÖLLER, Thin Cap, p. 330; HMRC, Thin Cap, 542220; The current TP rules are found in Part 4, TIOPA.

consideration the taxation of the income at the level of the lender. This gives rise to economic double taxation unless the excess interest is carried forward[328]. The rules provide that the net interest expense (the amount of interest exceeding the interest income) is not deductible if it exceeds 30% of the taxable earnings before interest, taxes, depreciation and amortization[329]. These rules also contain some exceptions[330].

95. Also, some States have adopted group wide ratios. Such rules limit the debt or interest expenses in an entity taking into consideration the multinational group's overall interest position. For instance, in the UK, tax deductions for interest payments (or similar finance costs) made by UK members of a UK or non-UK group is restricted with reference to the entire groups total external finance costs. The rules apply by comparing the net borrowing costs of the UK members of the group and the gross borrowing costs of the entire group. Broadly, if the net UK debt of the group exceeds 75% of the worldwide gross debt then the rules are triggered[331].

3.4.2.2.2. Rules restricting deductions for other payments

96. Several States have also introduced rules that deny deduction for payments made to non-residents in low tax jurisdictions. Although not a part of the comparative analysis in this thesis, for instance, Peru and Spain impose such restrictions. Similarly, in Belgium, interest, royalties and service fees are not deductible if they are paid to non-residents (including branches) that fail the subject to tax requirement[332].

328 KNÖLLER, Thin Cap, p. 324; FROSS, Thin Cap, p. 509.
329 LINN, Tax Avoidance, p. 338; REIMER, Avoidance, p. 25.
330 KNÖLLER, Thin Cap, pp. 325-326.
331 ANDERSON, JUPP, Passive income, p. 765. Also see 2015 OECD, Final Report on Interest Deductions, Chapter 7.
332 DAHLBERG, WIMAN, Passive income, pp. 52-53.

3.4.3. Residence State measures

3.4.3.1. Measures to counteract deferral/exemption of residence State taxes

3.4.3.1.1. CFC and similar regimes

97. Typically, residence States[333] implement CFC or similar regimes to prevent tax deferral through intermediary entities[334]. The deferral is avoided by the residence State, pursuant to its CFC legislation, by subjecting the income derived by the intermediary company to immediate taxation in the residence State[335]. Specifically, the undistributed income of the CFC is attributed to the shareholder (individual or company) and he is taxed on it in proportion to his pro rata share in the CFC. The effect is that the shareholder pays tax on the undistributed profits of the CFC. It is pertinent to note that the underlying rationale for implementing CFC rules is to uphold the principle of capital export neutrality (the principle requires equal tax treatment in relation to investments made by the taxpayer in his home State or investments made abroad). To elaborate, by attributing the income of the CFC to the shareholder and taxing it on a current basis, the shareholders residence State treats income from domestic and outbound investments equally from a tax perspective. Thus, from a tax viewpoint, it makes no difference whether the taxpayer invests in the domestic or overseas market. Almost all the countries that are covered in this comparative analysis have CFC rules. They have been introduced by the US (1962[336]), UK (1984[337]), Canada (1976[338]), Germany (1972[339]) and France (1980[340]). There are proposals for CFC rules in India[341]. Switzerland[342] and the Netherlands do not have CFC regimes in place although the latter State has provisions that operate in a similar way[343].

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333 DAHLBERG, WIMAN, Passive income, p. 25.
334 AIGNER, CFC, pp. 15-17; AULT, ARNOLD, CT, p. 477.
335 2014 OECD, Discussion Draft on CFC, Para. 7.
336 BRAUNER, HERZFELD, Passive income, p. 791.
337 ANDERSON, JUPP, Passive income, p. 791.
338 SLAATS, WORNDL, Passive income, p. 185.
339 SCHÖNFELD, Passive income, p. 331; REIMER, Avoidance, pp. 26-27.
340 JACQUOT, Passive income, p. 309.
341 AGARWAL, SHAH, Passive income, p. 367.
342 LINDER, SCHREIBER, Passive income, p. 739.
343 BOTERMAN, GULIK, Passive income, pp. 513-514; WILDE, WISMAN, Avoidance, p. 26.

98. Different approaches can be followed by the residence State to tax the undistributed income of the CFC in the hands of its shareholder. Firstly, the residence State might follow the piercing the veil/look through approach. Under this system, the residence State disregards the CFC and attributes the income of the CFC directly to the shareholder[344]. Secondly, the residence State may tax the shareholder under a fictitious dividend approach (for instance under the US[345] or German CFC[346] rules). Under this system, the residence State imputes a deemed dividend to the shareholder, regardless of an actual distribution from the CFC. Thirdly, the residence State could follow the notional income approach (for instance the UK[347] or proposed Indian[348] CFC rules). Under this approach, the shareholder of a CFC is taxed on a fictional income basis, which is often calculated on the basis of the CFC's income[349].

99. In determining the application of CFC rules to foreign corporations, countries follow two fundamental approaches. The first group of countries apply the *global approach*. Under this approach, CFC rules are applicable to all foreign corporations, irrespective of where they are a resident and the amount of tax that they pay in the country in which they are resident. Countries following this approach only attribute the tainted income of the CFC to the resident shareholder. This attribution methodology, also known as the *transactional* approach, focuses on the income derived by the CFC and differentiates between passive and active income. Specifically, under this approach, passive income streams (such as dividends, interest, royalty and capital gains) or base company income (income derived from transacting with related parties established outside the CFC resident jurisdiction) is attributed to the resident shareholder. Active business income is usually excluded. In contrast, a second group of countries apply the *jurisdictional approach*. Under this approach, CFC rules are applicable only to foreign corporations that are resident in low-tax countries or countries providing a preferential tax regime. The countries following this approach attribute all

344 None of the countries covered in the comparative study adopt this approach. However, it has been opined that this approach is followed Mexico, Italy and New Zealand. See GARFUNKEL, CFC, p. 66.
345 Section 951(a)(1), US IRC; MISEY, SCHADEWALD, US Tax, p. 143.
346 DAHLBERG, WIMAN, Passive income, p. 39.
347 HMRC, CFC 210010.
348 Clause 58(2)(u), IDTC read with Schedule 20, IDTC.
349 DE BROE, Thesis, p. 126; AIGNER, CFC, p. 23; FONTANA, CFC, p. 261.

the income of the CFC to the shareholder subject to certain exceptions. This method is also referred to as the *entity method* as all income of the entity qualifying as a CFC – regardless of its nature – is attributed to the shareholder. As in the first approach, active business income is usually excluded from the CFC rules[350]. Nevertheless, it has been opined that in practice, CFC legislation tend to be a mixture of both approaches[351].

100. In addition to CFC regimes, countries could also introduce rules that operate similarly to CFC regimes. For instance, the UK tax law contains attribution of gains rules under which capital gains derived by non-resident companies/trusts is attributed to UK residents that hold interests in such non resident companies/trusts[352]. Similarly, under Canadian law, the income of a non-resident trust will be attributed to a Canadian resident if the latter controls the trust (*see section 18.4.9*).

3.4.3.1.2. Switch over clauses

101. Countries that follow the principle of capital import neutrality, (the principle requires that investors in a country face the same tax rate in that State) usually exempt income from foreign sources, especially, income attributable to foreign PEs. These States do not have CFC rules, as foreign income is usually exempt. Thus, it is relatively easy for resident taxpayers to set up offshore PE's in low tax jurisdictions and attribute income to them in order claim an exemption from residence State taxes – by also relying on Art. 23(A). As a tool to counteract this, some States introduce domestic switch-over clauses. The rules typically provide that the exemption from income attributable to foreign PEs is not available when the State of the PE applies a low rate of taxation[353]. In such regimes, the domestic anti-avoidance rule disregards the exemption method and applies the credit method[354]. For instance, the Netherlands, in order to combat taxpayers from moving highly mobile capital to PEs established in low tax jurisdictions, applies a switch over clause. The provisions, which came into force in 2012, apply when the PE carries out passive activities (such as deriving more than 50% of its revenues from intra group financing activities) and is not subject

[350] DE BROE, Thesis, pp. 125-126; FONTANA, CFC, pp. 260-261; AIGNER, CFC, pp. 19-21; ARNOLD, DIBOUT, Low tax regimes, p. 44.
[351] DAHLBERG, WIMAN, Passive income, p. 34.
[352] MORTON, SKYES, Tax Avoidance, p. 813.
[353] DAHLBERG, WIMAN, Passive income, p. 49.
[354] VAN WEEGHEL, Tax Avoidance, p. 24.

to a minimum level of taxation as determined by Dutch standards. It should be noted, that prior to the introduction of the switch over clause, it had been a long-standing practice of the Netherlands to apply a switch over clause to passive PEs. The rule was introduced, as from 1989, in the Dutch Unilateral Decree for avoiding double taxation[355]. Similarly, Germany (although it cannot be considered to be a capital import country) applies a switch over clause to deny to passively low taxed income, the exemption for foreign income that is available in German tax treaties for passively low taxed income[356].

3.4.3.2. Measures to counteract transfer of residence[357]

3.4.3.2.1. Immediate exit taxes

102. In order to counter tax driven migrations countries apply exit charge regimes. Typically, for individuals, exit charge regimes take the form of immediate exit taxes or extended tax liabilities, whereas for companies that transfer their legal seat or POEM, countries implement immediate exit tax regimes[358].

103. Immediate exit taxes can be defined as taxes that are levied on the appreciated value of the taxpayer's properties immediately before emigration. This type of exit tax may be further divided in the following two categories for individuals: i) general; or ii) limited, based on the type of assets involved.

104. Typically, under a general exit tax regime, all of the assets of a taxpayer are deemed to be alienated. For instance, resident individuals who expatriate from the USA on or after June 2008 are subject to an exit tax under a mark-to-market regime, that is, such individuals are treated as if they sold all their worldwide property for its FMV on the day before loss of US citizenship or termination of long-term US residence status and the notional

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355 BOTERMAN, GULIK, Passive income, pp. 510-511; WILDE, WISMAN, Avoidance, pp. 26-27.

356 SCHÖNFELD, Passive Income, p. 328; REIMER, Avoidance, p. 24.

357 The author has published the content of this section in the Bulletin for International Taxation. The author has explicitly agreed with the editor of the Bulletin for International Taxation that this analysis can be used for the purpose of his doctoral thesis. See CHAND, Exit charges, Section 4.

358 CHAND, Exit charges, Section 2 & 3.

amount of the sale is reduced by the acquisition price[359]. Any gain on the deemed sale must be recognized to the extent it exceeds an exemption amount[360]. Certain exceptions are made from the exit tax rules[361]. It is possible to elect to defer the tax payment[362] subject to the condition that the taxpayer provides a bond or other security for payment of the tax[363]. Also, interest accrues during the deferral[364].

105. Likewise, in Canada, the general exit tax, which was introduced in 1972, applies when a Canadian tax resident becomes a resident of another country either for the purpose of the Canadian income tax law or for the purpose of a Canadian tax treaty[365]. Upon terminating Canadian residence the migrating individual is deemed to have disposed of each item of property and is taxed on the difference between the FMV of the assets less the cost of acquisition[366]. The time of disposition is immediately before emigration and the property that has been deemed to have been disposed of is once again deemed to have been re-acquired by the individual at a cost which is equal to the proceeds of disposition of the property. The exit tax does not apply to assets that remain in Canada's tax jurisdiction. Therefore, several assets are excluded. Specifically, real property located in Canada[367], property attributable to a PE[368] in Canada and certain taxpayer's rights[369] are excluded from the deemed disposition rule. Further, the deemed disposition rule applies only to property owned by long term Canadian residents, that is, residents who have been tax residents of Canada for a period of more than five years in the last ten years preceding emigration[370]. Also, as the tax is imposed on unrealized gains, an interest-free deferral of the payment of the

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359 Section 877A(a)(1), US IRC; KWONG, Exit tax, pp. 429-430; ARSENAULT, Exit tax, pp. 52-53.

360 Section 877A(a)(3)(A), US IRC; The exemption amount for 2012 is USD 651,000.

361 Section 877A(c), US IRC; ARSENAULT, Exit tax, pp. 53-56. Note that even though the assets are excluded from the expatriation tax they continue to be subject to US taxes.

362 Section 877A(b)(1), US IRC; RUBIN, Exit tax, p.6.

363 Section 877A(b)(4), US IRC; RUBIN, Exit tax, p.6.

364 Section 877A(b)(5), US IRC; RUBIN, Exit tax, p.6.

365 BROOKS, Residence, p. 314; DYER, YAGER, Exit charge, p. 194.

366 Section 128.1(4)(b), CITA; CAMPBELL, Exit charge, pp. 26-29; DYER, YAGER, Exit charge, p. 194.

367 Section 128.1(4)(b)(i), CITA.

368 Section 128.1(4)(b)(ii), CITA.

369 Section 128.1(4)(b)(iii), CITA; Section 128.1(10).

370 Section 128.1(4)(b)(iv), CITA; DYER, YAGER, Exit charge, p. 195.

exit tax until the actual alienation of the taxable assets is available provided that adequate security is posted with the Canadian tax authorities[371].

106. On the other hand, under a limited exit tax regime, only specific assets, such as substantial shareholdings are taxable. The Netherlands has, since 1997, imposed a limited exit tax on its departing residents if they have substantial shareholdings in companies[372]. A substantial shareholder is a person who holds (alone or with his or her partner), directly or indirectly, more than five percent of the shares of a company. Upon emigration[373] of a substantial shareholder a fictitious alienation occurs which is computed as the FMV less the acquisition price of the shares. This fictitious alienation occurs at the point in time immediately preceding the emigration[374]. Further, as the tax is imposed on unrealized gains, the Netherlands imposes a preserving assessment under which a deferral of payment is granted for a period of ten years. This deferral ends if the relevant shares are alienated within ten years or the company distributes its reserves in full (or almost in full). If these transactions do not occur within this ten-year period then the preserving tax assessment is waived (*kindly note that the Dutch Tax Law was amended in 2016 pursuant to which the waiver of exit tax has been abolished*). Generally, security must be provided in order to be eligible for a deferral of payment under a preserving tax assessment. Also, interest is not charged on the deferred payment[375]. However, the provision of a security may be waived if the taxpayer moves to Member State of the EU or EFTA[376]. Similar exit taxes are levied in France[377] and Germany[378].

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371 Section 220(4.5), CITA; CAMPBELL, Exit charge, p. 32; DYER, YAGER, Exit charge, p. 195.

372 It should be noted that temporarily resident taxpayers, i.e. taxpayers who reside less than eight years and less than a total of ten years in the twenty five years preceding to emigration in the Netherlands are not subject to the exit tax regarding substantial shareholdings in companies that are not resident in the Netherlands; BETTEN, Exit charge, pp. 412; It should also be noted that the Netherlands also imposes an exit tax for Dutch individual entrepreneurs who migrate outside Netherlands. The rules are similar to the exit charges applicable to Dutch companies. PETERS, ROELOFSEN, Tax Avoidance, p. 554.

373 Emigration is considered to occur if the taxpayer loses his or her status as a resident taxpayer in the Netherlands or becomes a treaty resident of another state pursuant to a tax treaty. BETTEN, Exit charge, p. 412.

374 BETTEN, Exit charge, pp. 411-412.

375 BETTEN, Exit charge, p. 413.

376 POTGENS, Assessments, p. 184.

377 GOUTHIERE, Exit tax, pp. 42-45.

378 RUST, Residence, pp. 370-372.

107. For companies, the exit tax, usually takes the form of an immediate exit tax rule[379]. For instance it is possible for a UK incorporated and managed company to migrate to another country by moving its POEM pursuant to treaty tiebreaker rules[380]. In such situations, the UK tax law imposes an exit charge on the un-realized gains of a company that ceases to be resident in the UK. The charge occurs immediately before the time when the company ceases to be resident in the UK. The company is deemed to have disposed of all its assets at their FMV. Certain assets are excluded from the charge. If the migrating company continues to trade in the UK through a PE to which the assets can be attributed the exit charge will not apply[381]. If this is not the case, the exit tax becomes payable immediately. However, the exit charge may be deferred[382] (again, if the move is within the EU).

108. Likewise, in Canada, when a corporation ceases to be resident either for the purposes of Canadian tax law or a tax treaty, the corporation is deemed to have disposed of all its property at FMV[383]. The time of disposition is the time immediately before emigration and each item of property disposed of is deemed to have been reacquired at a cost equal to the proceeds of disposition[384]. All assets are considered to be disposed of and no assets are excluded from this exit tax unless they are assets are attributed to a Canadian PE[385].

109. Similarly in the Netherlands, it is indeed possible for a Dutch incorporated and managed company to migrate to another jurisdiction by moving its POEM to the latter State pursuant to treaty tiebreaker rules[386]. In this case, an exit tax rule is triggered which provides for a deemed disposal of assets at FMV. The disposal is deemed to take place immediately before

379. CHAND, Exit charges, Section 3.

380 Most UK tax treaties contain a tie-breaker clause which follows the OECD Model. PANAYI, Corporate Residence, p. 844.

381 Section 185(2), UK TCGA; PANAYI, Corporate Residence, p. 850; HMRC, CGM, Para. 42370.

382 HMRC, CGM, Para. 42390. For migrations within the EU the exit charge may be deferred pursuant to the National Grid case. See ECJ: National Grid Indus, C-371/10, November 29th 2011.

383 Section 128.1(4)(b), CITA; CAMPBELL, Exit charge, p. 77.

384 Section 128.1(4)(c), CITA; CAMPBELL, Exit charge, p. 77.

385 AULT, ARNOLD, CT, p. 441.

386 The majority of Dutch tax treaties use tie-breaker rules that follow the OECD Model. DE BOER, Corporate residence, pp. 593-594.

the time at which the taxpayer ceases to be a Dutch tax resident or subject to corporate tax in the Netherlands, and it relates only to the assets which will no longer be subject to Dutch taxation. Thus, if a corporate taxpayer migrates to another State but retains a PE in the Netherlands to which its Dutch assets can be allocated the exit tax will not be levied. Further, no deferral is granted for the tax that becomes payable (unless the migration is within the EU) [387].

110. Furthermore, in Switzerland, it is also possible for a Swiss incorporated and managed company to move its POEM to another country[388]. If this happens, a deemed sale (fictitious liquidation) takes place in a situation where the POEM of a company is transferred from Switzerland. However, if the migrating company continues to operate in Switzerland through a PE to which the assets can be attributed the exit charge will not apply[389].

3.4.3.2.2. Extended tax liability

111. On the other hand, extended tax liabilities, i.e. "*trailing taxes*" or "*capital gains taxes on former residents*", can be defined as taxes that are levied on realized gains from the alienation of property by former resident taxpayers after emigration. These types of exit charges can be divided into unlimited or limited extended tax liabilities[390]. Under the unlimited extended tax liability regime, it is assumed that the migrating taxpayer continues to qualify as a deemed resident of the former residence state, irrespective of the fact that he is resident in another state. Accordingly, the migrating taxpayer is subject to tax on his worldwide income in the former residence state, i.e. on income derived from assets owned at the time of emigration and on income from assets acquired thereafter. None of the States covered in this comparative analysis apply an unlimited extended tax liability regime. However, in Finland – a Finnish citizen who leaves Finland to live in a foreign country is still regarded as a Finnish tax resident during the year of relocation and for the three following years and is subject to comprehensive tax liability. In contrast, under the limited extended tax liability regime, the

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387 DE BOER, Corporate residence, p. 596; See ECJ: National Grid Indus, C-371/10, November 29th 2011.

388 Many Swiss tax treaties also follow tie-breaker rules patterned along the OECD Model. MARAIA, Corporate Residence, p. 812.

389 2nd sentence , Art. 58 (1)(c), SDTL.

390 CHAND, Exit charges, Section 2.3.1.

tax liability of the former resident is restricted to income from sources in the country of emigration. Emigrants are treated as non-residents by this country, but are taxed for a number of years in a more burdensome manner than normal non-residents would face. Limited extended tax liability amounts to an extension of the territoriality concept (for instance, Germany imposes a limited extended tax liability when a resident citizen migrates to a tax haven)[391]. The interaction of limited extended tax liability regimes with tax treaties is not analyzed in this thesis.

3.5. Summary: The effect of applying domestic anti-avoidance measures in cross border situations as examined in this thesis

112. Based on the foregoing analysis, the author considers that in cross-border situations, the application of judicial doctrines, statutory GAARs and SAARs can have several effects. For the purpose of this thesis, the author restricts himself to analysing the following effects of domestic anti-avoidance rules and their interaction with tax treaties (*see chapters 12-20*).

a. applying from a residence or source State's perspective: the transaction is a sham or is simulated;

b. *applying from a source State's perspective:* domestic anti-avoidance rules which i) re-determine the taxpayer to whom an item of income is attributed for tax purposes; ii) re-characterize an item of income for tax purposes; iii) deny tax (treaty) benefits to a taxpayer; and iv) deny deductions for payments made to non-resident associated enterprises;

c. *applying from a residence State's perspective*: domestic anti-avoidance rules which i) deem non-residents to be residents of that jurisdiction so as to impose worldwide taxation; ii) impute income derived by an offshore taxpayer to a resident taxpayer; iii) deem a taxpayer to dispose of his assets prior to his migration; and iv) deny relief from double taxation to a taxpayer, in particular, the exemption method as provided in the tax treaty.

[391] CHAND, Exit charges, Section 2.3.3.

PART III: TAX TREATIES AND DOMESTIC LAW

4. Tax treaties and domestic law

4.1. Preliminary remarks

113. Prior to discussing the tax treaty interpretation process, the author would like to comment on the relationship between tax treaties and domestic law. This analysis will lay down the foundation for understanding the way tax treaties are implemented in the national legal order, the conflict resolution rules that States adopt to address conflicts between domestic law and tax treaties and the issue of treaty override. This is necessary because later in this thesis the author discusses his view on whether or not a domestic anti-avoidance rule, that is introduced or applied after the conclusion of a tax treaty, constitutes a treaty override.

4.2. Implementation of tax treaties in national legal order

4.2.1. Introductory comments

114. Tax treaties, which are instruments of international law[392], cannot be applied unless they come into force domestically. Thus, in order to give tax treaties their intended effect they have to be implemented in the domestic law[393]. The manner in which tax treaties are incorporated into the domestic law of States so as to apply to the taxpayer and tax authorities is different. It largely depends on the each States constitutional rules (or tax law practice). Broadly, countries can either follow the "*monistic*" or "*dualistic*" theories for transforming treaties into the national legal order[394].

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[392] VOGEL, Abuse, p. 3; GERZOVA, POPA, Anti Avoidance, p. 423.

[393] VOGEL, Abuse, p. 3; SASSEVILLE, Abuse, p. 39; SACHDEVA, Treaty Override, p. 180; SACHDEVA, Implementation, p. 313; WOUTERS, VIDAL, Abuse, p. 19; OECD, Treaty Override report, Para. 13.

[394] VOGEL, Commentary, p. 21; SACHDEVA, Treaty Override, p. 180; SACHDEVA, Implementation, p. 313.

4.2.2. Monistic doctrine

115. Under the monistic theory, national and international law (treaties) are two parts of a single legal system. In such systems, as soon as international law becomes valid, it is automatically considered to be valid domestically[395]. Put differently, after a treaty enters into effect at the international level, it spontaneously takes legal effect in a State. Thus, tax treaties in monistic States, are self-executing and directly become a part of the domestic law when they are ratified. This is the case, for instance, in the Netherlands[396], Switzerland[397], France[398] and the USA[399].

4.2.3. Dualistic doctrine

116. In contrast, under the dualistic theory, the national and international law (treaties) are considered to be separate. Consequently, in such systems, a specific instrument of domestic legislation is required to transform international law (treaties) into national law[400]. It is for this reason that treaties cannot be implemented directly within the legal system of such a State. Thus, treaties (including tax treaties) in dualistic States are given an indirect effect i.e. specific legislative steps are required to enact treaty provisions in domestic law[401]. The UK[402], India[403], Canada[404] and Germany[405] are some of the States which have a dualistic system.

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395 PIETRO, Override, p. 31; SACHDEVA, Treaty Override, p. 181; SACHDEVA, Implementation, p. 314; WOUTERS, VIDAL, Abuse, p. 19.

396 PIJL, Abuse, p. 281; SACHDEVA, Treaty Override, pp. 190-192.

397 OBERSON, HULL, Switzerland, p. 99.

398 SACHDEVA, Treaty Override, p. 185.

399 INFANTI, Abuse, pp. 355-356; SACHDEVA, Treaty Override, p. 195.

400 PIETRO, Override, p. 32; SACHDEVA, Treaty Override, p. 181; SACHDEVA, Implementation, p. 314; WOUTERS, VIDAL, Abuse, p. 20.

401 PIETRO, Override, p. 32; SACHDEVA, Treaty Override, p. 181; SACHDEVA, Implementation, p. 314; AVERY JONES, Court Interpretation, pp. 55-62; ARNOLD, VAN WEEGHEL, Abuse, p. 114.

402 ROXAN, Abuse, pp. 316-319; AVERY JONES, Court Interpretation, pp. 55-62; SACHDEVA, Treaty Override, p. 203.

403 SACHDEVA, Treaty Override, p. 188.

404 ARNOLD, VAN WEEGHEL, Abuse, p. 114; SACHDEVA, Treaty Override, pp. 182-183.

405 VOGEL, Commentary, pp. 24-25; PERDELWITZ, Override, p. 445; ARNOLD, VAN WEEGHEL, Abuse, p. 114.

4.3. Conflict resolution rules for discrepancies between domestic law and tax treaties

4.3.1. Introductory comments

117. The manner in which States resolve conflicts between domestic law and tax treaty law differs. In other words, the hierarchy allocated to tax treaties vis-à-vis domestic tax law at the domestic law level varies. The conflict rules could possibly be addressed in the State's constitution, the domestic tax law/domestic legislation that gives effect to the tax treaty or through the principle of statutory interpretation[406].

4.3.2. Conflict rules addressed in a States constitution

118. Art. 94 of the Dutch constitution expressly provides that domestic law cannot be applied to the extent it conflicts with tax treaties[407]. This implies that even if the legislature (intentionally or unintentionally) introduces subsequent legislation which conflicts with treaty terms – the latter will prevail[408]. Similarly, in Switzerland, where there is a conflict between current/subsequent domestic law and treaty law and if that conflict cannot be solved by interpretation, the treaty prevails. The principle of superiority of international law over domestic law is reflected in Art. 5(4) of the Swiss Federal Constitution[409]. Likewise, Art. 55 of the French Constitution provides that treaties must prevail over other laws and thus they enjoy preferential status[410]. Consequently, a posterior domestic law cannot trump the provisions of a treaty[411].

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406 SASSEVILLE, Abuse, pp. 41-42.

407 ARNOLD, VAN WEEGHEL, Abuse, p. 107; SACHDEVA, Treaty Override, p. 191.

408 PIJL, Abuse, pp 302-303; VOGEL, Abuse, p. 6; AULT, ARNOLD, CT, p. 542.

409 OBERSON, HULL, Switzerland, p. 99. Vogel states that on several occasions the SFSC has ruled that tax treaties prevail over domestic law in Switzerland. However, in older case law the SFSC deviated from this position in situations wherein the legislature had passed a law and that law clearly provided that it was to trump a treaty. Nevertheless, the position in the current Swiss tax literature and the SFSC is that treaties always trump domestic law. VOGEL, Abuse, pp. 8-10.

410 PIJL, Abuse, pp 302-303; VOGEL, Abuse, p. 6; AULT, ARNOLD, CT, p. 542; SACHDEVA, Treaty Override, p. 185.

411 SACHDEVA, Treaty Override, p. 186.

4.3.3. Conflict rules addressed in a State's tax legislation

119. The provisions of the UK tax law[412] that give effect to tax treaties provide that in case of a conflict between a treaty rule and domestic law the former prevails[413]. This does not mean that tax treaties prevail over domestic tax law in all circumstances. The principle of parliamentary sovereignty that applies in the UK implies that, if the legislature clearly intends to do so, it can enact subsequent domestic legislation that can prevail over treaty law[414]. Similarly in India, the current tax law provides that in the event of a conflict, the provisions that are more beneficial to the taxpayer prevail[415]. Consequently, the taxpayer may choose to apply the provisions of a tax treaty if its application is more beneficial than the domestic tax law. Nevertheless, as in the UK, if the legislature clearly intends to do so, it can enact subsequent domestic legislation that can prevail over treaty law[416]. However, this position is not crystal clear at the time of writing this thesis[417]. In Canada, the implementation Act that enacts Canadian tax treaties into law provides that in case of a conflict between the tax treaty and domestic law, the provisions of the former prevail[418]. Despite this general proposition, as Canada is a parliamentary democracy, the legislator can override tax treaties if it clearly intends to do so by passing subsequent legislation[419].

4.3.4. Conflict rules addressed through rules of interpretation

120. This approach is followed in the US and Germany. In the US, the supremacy clause of the US constitution[420] provides that federal statutes and treaties (including tax treaties) are considered to be the supreme law of the land. This means that federal statutes and treaties are considered to rank on an equal footing. Based on this premise, Courts in the US have generally provided that in case of a conflict between a federal statute and a treaty,

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412 Section 788, UK ICTA.
413 Section 788(3), UK ICTA; MORTON, SKYES, Tax Avoidance, p. 807.
414 ROXAN, Abuse, pp. 313-339; MORTON, SKYES, Tax Avoidance, p. 807; AULT, ARNOLD, CT, p. 542.
415 Section 90(2), IITA.
416 SANDLER, CFC, p. 51.
417 SACHDEVA, Treaty Override, p. 188.
418 ARNOLD, VAN WEEGHEL, Abuse, p. 114; SANDLER, CFC, p. 42; AULT, ARNOLD, CT, p. 540.
419 SACHDEVA, Treaty Override, p. 183.
420 Art. 6(2), US Constitution.

whichever is "*later in time*" will prevail[421]. This rule has been codified with respect to tax treaties in the US tax law provisions[422]. In Germany, where there is a conflict between the domestic law and a treaty provision, the latter prevails. However, a conflict between posterior domestic legislation and tax treaties is resolved by resorting to the *lex specialis* and the *lex posterior* rules[423].

4.4. Treaty overrides

4.4.1. The concept

121. In the 1989 Tax Treaty Override report (hereafter "1989 TTO report"), the OECD refers to a treaty override as "*a situation where the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that State*"[424]. Such domestic legislation may be implemented explicitly by stating that treaty provisions are to be disregarded in certain circumstances (such as in case of treaty shopping or other forms of abuse) or implicitly, that is, even if no direct reference is made to the disregard of tax treaties the domestic interpretation of the effect of the legislation with respect to treaty provisions has the same result in practice[425].

122. Essentially, in the 1989 TTO report, the OECD focuses on the kind of treaty override that occurs when the legislature of a State enacts a piece of domestic legislation that is clearly intended to conflict with an international treaty obligation of that State[426]. The treaty override not discussed in the

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421 INFANTI, Abuse, pp. 355-369; DOERNBERG, International Tax, pp. 123-124; VARMA, WEST, Tax Avoidance, pp. 838-839; MISEY, SCHADEWALD, US Tax, p. 451; SASSEVILLE, Abuse, p. 42; SANDLER, CFC, p. 52; AULT, ARNOLD, CT, p. 540.

422 Section 7852(d), US IRC read in conjunction with Section 894(a), US IRC; AULT, ARNOLD, CT, p. 540.

423 VOGEL, Commentary, p. 71; PERDELWITZ, Override, p. 445.

424 OECD, Treaty Override report, Para. 2.

425 OECD, Treaty Override report, Para. 2.

426 OECD, Treaty Override report, Para. 5. A question arises as to when does a treaty override actually occur? The OECD, in the context of intentional legislative overrides, provides that a treaty override occurs as soon as the legislator passes the overriding legislation even though the legislation is applied at the later point in time. The author agrees with this position. OECD, Treaty Override report, Para. 7. Similarly, for judicial overrides the author's submits that an override occurs when the Supreme Court of a State

report are i) override that occurs when the judiciary of a State interprets the legislation in such a manner that the interpretation "*deviates from the common interpretation explicitly accepted or tacitly implied by the treaty partners*" and as a consequence of the interpretation a State legislates a rule to reverse the court's decision [427] (the Court's decision could be considered as an override but these types of override are not discussed in the report); ii) override that can occur pursuant to Art. 3(2) of the OECD Model (*see chapter 7*). To elaborate, the 1989 TTO Report provides that treaties contain undefined terms. Pursuant to Art. 3(2) of the OECD or UN Models, the meanings of these terms have to be understood as per the domestic law of the State applying the tax treaty. It is well accepted that an "*ambulatory*" reference should be made to the domestic law. Thus, subsequent changes to the domestic law can be incorporated in the treaty text. Accordingly, a treaty override cannot occur provided such changes are compatible with the context of the tax treaty [428] ;and iii) when the legislature adopts new legislation and is not aware about it being a treaty override[429].

123. For the purpose of this thesis, in the author's opinion, treaty override can result from the act of the judiciary or the legislator. A judicial override occurs when the Supreme Court of a State interprets the domestic legislation in such a manner that the interpretation conflicts with the international understanding/interpretation of a previously concluded tax treaty [430] . Similarly, a legislative override occurs when the legislature enacts a domestic law (intentionally or unintentionally) that contradicts the provisions of a previously concluded treaty[431]. Notably, overrides can also occur pursuant to Art. 3(2) of the OECD or UN Models if the domestic law definition is not compatible with the treaty context[432] (*see section 7.2.6.2*). Whether or not a treaty override occurs depends on the facts and circumstances of each case, in particular, the scope of the posterior action adopted by the judiciary or legislator and the object and purpose of the relevant treaty provisions. The relationship between domestic and

passes a decision that clearly conflicts with the treaty provisions. In such situations, it could be argued that the override occurs when the Court interprets (applies) the legislation.

427 OECD, Treaty Override report, Para. 4a).
428 OECD, Treaty Override report, Para. 4b).
429 OECD, Treaty Override report, Para. 4c).
430 SACHDEVA, Solution, p. 469.
431 SACHDEVA, Solution, p. 469.
432 PIETRO, Override, pp. 81-130.

international law as applicable in a State also needs to be taken into consideration. With respect to the latter point, it should be noted that it might not be possible for a State to override a treaty if the Constitution of a State places treaties on a higher pedestal than domestic law. This is typically the case in States such as the Netherlands and France[433] (*see section 4.3.2*). Treaty override may, nevertheless, be possible in States where treaties rank at an equal footing with domestic law and are subject to the rule of "*lex posterior derogat legi priori*" or where the principle of parliamentary sovereignty applies (the legislature passes legislation that clearly intends to override treaties (for instance *see section 3.3*). This is typically the case in States such as US[434], UK, Canada and Germany[435] (*see section 4.3.3* and *section 4.3.4*)[436].

4.4.2. Conflict with international law provisions

124. It is generally accepted that domestic and international law are two spheres that exist independently of each other[437]. While, treaty override may be possible at the domestic law level, such override conflicts with international law provisions, in particular, the provisions of the VCLT that govern the law of treaties (*see chapter 5*)[438]. Art. 26 of the VCLT, which contains the "*pacta sunt servanda*" [439] principle, provides that "*every treaty in force is binding upon the parties to it and must be performed by them in good faith*". This implies that once a treaty comes into force it is binding on the parties (the contracting States) to the agreement and the provisions of the treaty have to be performed in good faith[440]. As discussed later on in this thesis (*see section 5.2.2*), the principle of "*good faith"* requires contracting States (the legislature and the judiciary) to mutually respect and apply treaty

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433 OECD, Treaty Override report, Para. 7.

434 VOGEL, Commentary, p. 68.

435 It should be noted that, in Germany, there was an ongoing debate concerning the constitutionality of treaty overrides. See PERDELWITZ, Override, pp. 445-450; KAHLENBERG, Override, p. 487. In a case involving German partnerships, the German Federal Tax Court held that treaty overrides were unconstitutional. See CLOER, HAGEMANN, Override, pp. 510-516. However, the German Federal Constitutional Court has recently held that treaty overrides do not conflict with German constitutional principles.

436 OECD, Treaty Override report, Para. 15; PIETRO, Coordination, Section 1.

437 VOGEL, Abuse, p. 3.

438 WOUTERS, VIDAL, Abuse, p. 19.

439 PIETRO, Override, pp. 225-227.

440 WOUTERS, VIDAL, Abuse, p. 21; GERZOVA, POPA, Anti Avoidance, p. 423.

provisions in a reasonable way and in such a manner that their purpose is realized[441]. Thus, passing a domestic legislation or interpreting domestic legislation such that it contravenes a State's treaty obligations, conflicts with the "*pacta sunt servanda*" principle as that State gives preference to domestic and not international law[442]. This conclusion is overtly reflected in Art. 27 VCLT which, under the heading of "*internal law and observances of tax treaties*", provides that a "*party may not invoke the provisions of its internal law as justification for its failure to perform a treaty."* While this provision of the VCLT precludes a State from disrupting its treaty obligations at the international law level it does not solve the situation at the domestic law level. Thus, more often than not, States contravene their treaty obligations even though a conflict can arise with the provisions of international law[443].

4.4.3. Material breaches of tax treaties

4.4.3.1. Introductory comments

125. Art. 60(1) of the VCLT provides "*a material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part"*. This implies that the injured State (the State that is impacted by the breach) can, as a remedy for non-compliance, terminate the treaty or suspend it completely or partially. The provision provides that this is possible only in situations of a "*material breach*". Art. 60(3)(b) of the VCLT provides that "*material breach*" arises when a "*provision essential to the accomplishment of the object or purpose of the treaty*" is violated. The OECD, to discuss "*material breach*" situations, provides two examples.

4.4.3.2. The OECD's examples on material breach of tax treaties

126. The first example deals with a situation where the State of source (State S) does not levy withholding taxes on royalties and interest. Further, treaties concluded by State S allocate taxing rights on these items of income

441 GERZOVA, POPA, Anti Avoidance, p. 423; MICHEL, Anti Avoidance, p. 418.
442 OECD, Treaty Override report, Para 7; GERZOVA, POPA, Anti Avoidance, p. 423; AVI YONAH, Abuse, pp. 66-67.
443 WOUTERS, VIDAL, Abuse, p. 21.

to the State of residence. Nevertheless, State S introduces legislation that applies a withholding tax on royalties and interest, irrespective, of the treaties concluded by that State[444]. In response, the 1989 TTO report provides that the enactment of new legislation by State S is an outright "*material breach*"[445] as it erodes the confidence of State S's treaty partners even though the reasons for the override are not provided[446].

127. The second example discusses a situation where a State (State S) that taxes capital gains derived from the sale of immovable property, decides to enact legislation deeming the sale of shares in any real estate company as a sale of immovable property for the purpose of the application of its tax treaties. By doing this, State S intends to avoid this scenario where a taxpayer resident in another State (State R) makes use of intermediary companies to acquire immovable property situated in State S and at the time of alienation take advantage of the provisions of Art. 13(4) of the 1977 OECD Model i.e. to prevent the State in which the immoveable properties are situated from taxing the capital gain derived from the sale of the shares of a real estate company[447]. In response, the 1989 TTO report provides that the enactment of new legislation by the State in which the immoveable properties are situated can be considered as a treaty override even though the measure is clearly designed to put an end to an improper use of tax treaties[448]. Clearly, this example reflects the amendment made by the US (State S) in its domestic tax law that deemed the sale of shares of US Property Holding Companies to be a direct sale of US real estate[449].

128. It should also be noted that in both examples, the enactment of the new legislation by one of the contracting States immediately affects persons who are residents of the other contracting State i.e. persons who could claim the application of the relevant distributive rule before the enactment of the new legislation. Put differently the enactment of the new legislation by the State was sufficient to convert an *exclusive right* to tax (attributed to the State of residence) into a *shared right to tax* (with the State of source). Thus, for the purpose of this thesis, the author provides that a "*material breach*"

444 OECD, Treaty Override report, Para. 28.
445 OECD, Treaty Override report, Para. 29.
446 MICHEL, Anti Avoidance, p. 417.
447 OECD, Treaty Override report, Para. 31.
448 OECD, Treaty Override report, Para. 32; GERZOVA, POPA, Anti Avoidance, p. 421; MICHEL, Anti Avoidance, p. 417.
449 AVI YONAH, Abuse, pp. 68.

arises when one State (either through its legislature or the judiciary) disturbs the treaty's object and purpose namely, the "*allocation of taxing rights*". Similarly, a "*material breach*" arises when one State (either through the legislature or the judiciary), applies a rule that leads to unresolved double taxation – especially juridical double taxation (*see section 9.2.1*).

4.4.3.3. The need to curb tax avoidance – Is it a justification for a material breach?

129. It can be inferred from the OECD's second example that if a State introduces posterior domestic legislation to curb an improper use of its tax treaties and if that legislation contradicts its treaty obligations then that legislation will be considered as an unjustifiable treaty override. However, one commentator, by referring to the US practice, is of the opinion that the need to curb tax avoidance or evasion can serve as a justification for treaty overrides. He argues that treaty override is justified because "*the purpose of tax treaties is to prevent double taxation and not enable double non taxation*" [450].

130. The author does not agree with this commentator's opinion. As discussed in this thesis (*see section 9.2*), the main "*object and purpose*" of a tax treaty based on the OECD Model is to avoid international double taxation (especially juridical double taxation) in order to facilitate the international exchange of goods, services, capital and persons. This objective, in the author's opinion, is interlinked with the objective of allocating taxing rights between contracting States. Additionally, the position is taken that tax treaties also prevent tax evasion as more often than not the text of a treaty (preamble) indicates such an objective. Furthermore, the author takes a position that the prevention of tax avoidance is not a primary objective of a tax treaty. At most it can be considered to be an ancillary objective which implies that in case of a conflict between the primary objective and ancillary objective the former prevails (*see section 9.2.5*). Also, prevention of double non-taxation is not the object and purpose of a tax treaty unless expressly stated in the treaty provisions. Therefore, if the text of the treaty does not support the prevention of tax avoidance or prevention of double non-taxation as being the treaty's object and purpose

[450] AVI YONAH, Abuse, pp. 78. Similarly, another commentator provides that treaty overrides may be justifiable with a view to prevent tax avoidance or double non-taxation. PERDELWITZ, Override, p. 445.

then a strong argument can be made that the introduction of posterior legislation that contradicts treaty obligations amounts to a treaty override even though the legislation has been introduced with the aim to curb tax avoidance[451]. However, in the author's opinion, if the text of the treaty supports the prevention of tax avoidance or prevention of double non-taxation as being the treaty's object and purpose, as suggest by the 2015 TTA Report (*see section no. 9.2.3*), then an argument can be made that the introduction of posterior domestic legislation, that has been introduced to curb tax avoidance (such as treaty or rule shopping), does not amount to a treaty override.

4.4.3.4. The OECD's solution to material breach of tax treaties – Treaty renegotiation

131. The OECD's view, in both examples (*see section 4.4.3.2*), is that the introduction of posterior domestic legislation's by State X is a "*material breach*" and the treaty partners of State X can terminate the treaty or suspend it (wholly or partially), pursuant to Art. 60(1) of the VCLT[452]. In both examples, it is stated that termination can do more "*harm than good*". It is suggested that States should consider renegotiation of tax treaties[453]. Specifically, the OECD recommends that State incorporate their domestic provisions into tax treaties to the extent that a treaty override occurs even though this is a time consuming process[454].

4.5. Conclusion

132. The answer to the question of whether the introduction or application of a posterior domestic anti-avoidance rule is a treaty override or not depends on the circumstances of each case, in particular, the scope of the action adopted by the judiciary or legislature and the object and purpose of the relevant treaty provisions. The relationship between domestic and international law as applicable in a State is also important. Whether or not the introduction or application of a posterior domestic anti-avoidance rule

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451 WOUTERS, VIDAL, Abuse, p. 25; GERZOVA, POPA, Anti Avoidance, p. 424; MICHEL, Anti Avoidance, p. 419.
452 GERZOVA, POPA, Anti Avoidance, p. 424.
453 OECD, Treaty Override report, Para. 33.
454 OECD, Treaty Override report, Para. 36.

amounts to a treaty override is further examined in *chapters 13 - 20* of this thesis.

PART IV: TAX TREATY

INTERPRETATION

5. The rules of the VCLT

5.1. Preliminary remarks

133. The VCLT entered into force on January 27th 1980[455]. It regulates "*treaties*" concluded between States[456]. Art. 2(1)(a) of the VCLT defines a "*treaty*" as, "*an international agreement concluded between States in written form and governed by international law…"*[457]. Tax treaties are international agreements concluded between States. Accordingly, it is clear that they fall within the meaning of the term "*treaty*" and are subject to the regulations of the VCLT[458]. This implies that the rules of interpretation as put forward in Art. 31 VCLT (the general rule of interpretation) and Art. 32 VCLT (which governs the circumstances in which a reference can be made to supplementary means of interpretation) are applicable to tax treaties[459]. Consequently, the author discusses his view on these interpretation rules as they lay down the foundation for tax treaty interpretation.

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455 FITZMAURICE, VCLT, pp. 166-176. The VCLT applies to States that have signed and ratified the agreement. The question arises as to how the VCLT applies to States that have signed it but not ratified it or have not signed it at all. The author takes the position that for such States, the VCLT could be regarded as customary international law. OECD, Treaty Override report, Para. 8; VOGEL, Commentary, p. 22; VOGEL, 2015 Commentary, p. 26. For instance, this is the practice followed in the US.

456 FITZM0AURICE, VCLT, pp. 166-176.

457 Art. 2(1)(a), VCLT.

458 DE BROE, Thesis, p. 236; ENGELEN, Thesis, p. 425; VOGEL, Commentary, p. 35; BRANDSTETTER, Art. 2, p. 7; LANG, BRUGGER, Interpretation, p. 97.

459 It is certain that the provisions of the VCLT apply to treaties concluded after its entry into force. However, there was doubt as to whether the provisions of the VCLT were applicable to pre-existing treaties i.e. treaties concluded before the entry into force of the VCLT. In this respect, it should be noted that International Court's have held that pre-existing treaties have to be interpreted in light of the principles of the VCLT. For example: In the *Gabcikovo-Nagymaros case*, the ICJ applied the provisions of the VCLT to a treaty concluded before the VCLT came into force. See ICJ: Gabcikovo-Nagymaros Project (Hungary/Slovakia), ICJ Reports, September 25th 1997; Also, the ECHR followed the similar approach in the *Golder case.* See ECHR: Golder, Application No 4451/70, February 21st 1975. For a detailed discussion on this issue refer ENGELEN, Thesis, pp. 48-58.

5.2. The general rule on interpretation

5.2.1. Introductory comments

134. Commentators voiced different approaches to the interpretation of treaties during the preparation of the VCLT. Essentially, three approaches were advocated. Firstly, some favoured the "*teleological*" approach under which the foremost responsibility of the interpreter was to interpret the terms of the treaty in light of the treaties object and purpose, even if, such interpretation would deviate from the actual terms expressed in the text of the treaty. Secondly, some favoured the "*subjective*" approach under which it was maintained that the primary objective of interpretation was to ascertain the common intention of the parties by using all possible means. Under this approach, scholars suggested a liberal recourse to the preparatory material and extrinsic evidence to a treaty in order to ascertain the common intentions of the parties. Lastly, other scholars favoured the "*textual*" approach which advocated that the common intention of the parties is to be ascertained from the text of the treaty itself. Under this approach preparatory materials played a secondary role in the interpretation process and were to be referred to only if the text of the treaty was unclear or to explicitly confirm a finding in a treaty[460].

135. The drafters of the VCLT took these three approaches into consideration and ultimately adopted the "*textual approach*". The draft Commentary to the VCLT provides that "*The article as already indicated is based on the view that the text must be presumed to be the authentic expression of the intentions of the parties; and that, in consequence, the starting point of interpretation is the elucidation of the meaning of the text, not an investigation ab initio into the intentions of the parties. The Institute of International Law adopted this—the textual—approach to treaty interpretation. The objections to giving too large a place to the intentions of the parties as an independent basis of interpretation find expression in the proceedings of the Institute"*[461].

136. The draft Commentary to the VCLT, thus, provides that the general rule of interpretation as laid out in Art. 31(1), ie a "*treaty shall be*

[460] ENGELEN, Thesis, pp. 83-84; DE BROE, Thesis, p. 237; VCLT, Draft Commentary, Section 3, Introduction, Para. 2.

[461] VCLT, Draft Commentary, Section 3, Commentary on Art. 27, Para. 11.

interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose", includes three separate principles which concretize the application of the textual approach to treaty interpretation[462]. The first principle is that treaties should be interpreted in "*good faith*". The second principle is that the intention of the parties to a treaty should be derived from the ordinary meaning of the words used in the treaty. This principle is subject to an exception if, as provided in Art. 31(4) VCLT, it can be established that the parties to the treaty intended to give a special meaning to a term in the treaty. The third principle is that the ordinary meaning of a treaty term should not be interpreted in isolation but should be determined in the context (determined pursuant to Art. 31(2) of the VCLT) of the treaty and in the light of its object and purpose[463]. These principles are discussed in the following sections.

5.2.2. Interpretation in "*good faith*"

137. The principle of "*good faith*" [464] plays an important role in treaty interpretation[465]. This is confirmed by the fact that the most important indicator of the principle of "*good faith*" i.e. the rule of "*pacta sunt servanda*", as found in Art. 26 of the VCLT[466], states that that every treaty in force must be performed by the parties in "*good faith"*. One commentator has convincingly provided that the term "*good faith"* relates to the moral elements of honesty, fairness and reasonableness[467]. In the context of treaty interpretation he states that the principle of "*good faith"* requires a treaty to be interpreted in an honest, fair and reasonable manner and in accordance with the "*common intentions*" of the parties as expressed in the terms of the treaty[468]. With respect to the latter point, the ICJ in the 1997 *Gabcikovo-Nagymaros case,* also stated that the principle of "*good faith"* warrants the

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462 ENGELEN, Thesis, p. 111; DE BROE, Thesis, p. 238; KANDEV, Interpretation, p. 36.

463 VCLT, Draft Commentary, Section 3, Commentary on Art. 27, Para. 12; ENGELEN, Thesis, p. 111; DE BROE, Thesis, p. 238.

464 The term is used in i) The 3rd paragraph of the preamble of the VCLT ii) In Art. 26 which provides for the "*Pacta Sunt Servanda*" principle iii) Art. 31(1) which deals with the general rule of interpretation iv) Art. 46(2) which provides for invalidation of consent to be bound and v) Art. 69(2)(b) which deals with consequences of invalidation of the treaty. ENGELEN, Thesis, pp. 124-125.

465 DE BROE, Thesis, p. 240; VAN DER BRUGGEN, Interpretation, p. 145.

466 DE BROE, Thesis, p. 241.

467 ENGELEN, Thesis, pp. 123-125.

468 ENGELEN, Thesis, pp. 130-131.

interpreter to take into consideration the "*common intentions*" of the parties to interpret a treaty[469]. Accordingly, the position adopted in this thesis is that the principle of "*good faith*" requires that a treaty should be interpreted in a fair, honest and reasonable manner and in accordance with the legitimate expectations of the parties to the treaty[470]. This also implies that the legal rights conferred upon the parties to the treaty must not be exercised by them arbitrarily or maliciously i.e. in an abusive manner[471].

5.2.3. Interpretation in accordance with the "ordinary meaning"

138. Art. 31(1) provides that the "*ordinary meaning of a treaty term*" is to be ascertained from the "*context*" of the treaty and in the light of the treaty's "*object and purpose*"[472]. In this respect, the author submits that ascertaining the "*ordinary meaning of a treaty term*" does not entail that the words and phrases used in the treaty are to be interpreted in a literal way. Nor does it imply that the meaning of a treaty term should be interpreted in a pure grammatical manner[473]. On the contrary, it is submitted that the grammatical meaning may be considered as a useful starting point[474], but nevertheless, the terms have to interpreted in the "*context*" of the treaty and its "*object and purpose*". Art. 31(2) VCLT defines the term "*context*" to be comprised of, on the one hand, the text of the treaty including its preamble and annexes, and, on the other hand, contemporaneous interpretative agreements and instruments made and accepted by the parties to the treaty[475]. Further, Art. 31(3) provides that in addition to the "*context*", an interpreter should also take into consideration, subsequent interpretative agreements between treaty partners[476], agreed States practices vis-à-vis the interpretation of a treaty between treaty partners[477] and any relevant rules of international law applicable in relations between treaty partners[478]. Thus, the "*ordinary*

[469] ICJ: Gabcikovo-Nagymaros case, Para 142.
[470] For a list of other author's who support this position kindly refer to the footnotes in ENGELEN, Thesis, pp. 122-137.
[471] ENGELEN, Thesis, pp. 127-128.
[472] DE BROE, Thesis, p. 244.
[473] ENGELEN, Thesis, pp. 140-146; DE BROE, Thesis, p. 244; VOGEL, Commentary, pp. 37-38; VOGEL, 2015 Commentary, pp. 39-41.
[474] VOGEL, PROKISCH, Interpretation, p. 68.
[475] VCLT, Draft Commentary, Section 3, Commentary on Art. 27, Para. 13.
[476] VCLT, Draft Commentary, Section 3, Commentary on Art. 27, Para. 14.
[477] VCLT, Draft Commentary, Section 3, Commentary on Art. 27, Para. 15.
[478] VCLT, Draft Commentary, Section 3, Commentary on Art. 27, Para. 16.

meaning of a treaty term", should not be taken to mean that one can "*simply concentrate on the sentence, paragraph, article, section, chapter or part of the treaty in which the term to be interpreted appears*"[479], but rather, the treaty should be interpreted by referring to all the interpretative instruments to which Art. 31 VCLT refers and the object and purpose of the treaty[480].

5.2.4. Interpretation in accordance with the treaties "object and purpose"

139. Art. 31(1) prescribes that the "*object and purpose*" of the treaty has to be taken into consideration to interpret a treaty term. At the outset, the author submits that the reference to the treaty's "*object and purpose*" does not imply that a "*teleological*" approach[481] to treaty interpretation should be followed. This is because of the following two reasons. Firstly, as stated earlier the draft Commentary to the VLCT rejects the "*teleological*" approach to treaty interpretation[482]. Secondly, one commentator, by referring to the preparatory works to the VCLT and case law of the ICJ & ECHR has convincingly demonstrated that, Art. 31(1) does not provide for the "*teleological*" interpretation method[483]. He states that "*it is clear that an interpretation going beyond what is expressed or necessarily implied in the actual terms of the treaty so as to give effect to its object and purpose is not in accordance with the textual approach to treaty interpretation underlying Article 31 VCLT…The object and purpose of the treaty are among the elements to be thrown into the crucible when giving the terms of the treaty their ordinary meaning in the application of the general rule interpretation enshrined in Article 31 VCLT*"[484]. Thus, the "*object and purpose*" of a treaty is not to be considered as an independent means of interpretation[485].

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479 ENGELEN, Thesis, p. 146.

480 DE BROE, Thesis, p. 244.

481 De Broe provides that "*under the teleological interpretation, the task of the interpreter is to ascertain the object and purpose of the treaty and to interpret the treaty so as to give effect to the treaties objective, even if that result is not supported by the terms of the treaty. Thus the purpose of the treaty is not just one factor in the interpretative process, along with the ordinary meaning and the context in which the treaty's terms are used – as set forth in the Article 31 VC – but the treaty's object and purpose becomes the determinative factor*". DE BROE, Thesis, p. 248.

482 VCLT, Draft Commentary, Section 3, Introduction, Para. 2.

483 ENGELEN, Thesis, pp. 166-179.

484 ENGELEN, Thesis, p. 172. Similar view has been adopted by De Broe. See DE BROE, Thesis, p. 250.

485 VOGEL, PROKISCH, Interpretation, p. 72.

Consequently, it follows that an interpreter is not allowed to investigate the intentions of the parties to ascertain an "*object and purpose*" if that "*object and purpose*" is not supported by the text of the treaty since such a method of interpretation would be in conflict with the "*textual*" approach to treaty interpretation[486].

5.3. Supplementary means of interpretation

140. At the outset, it is submitted that the separation of Art. 31 VCLT from Art. 32 VCLT does not imply that there are two distinct phases in the interpretation process. On the contrary it is submitted that the interpretative process is a unity and all available material should be consulted simultaneously. The reason for separating the instruments mentioned in Art. 31 from those mentioned in Art. 32 is to denote the relative weight to be assigned to the interpretative instruments. This means that the interpretative instruments as provided in Art. 31 (which are authentic and binding) carry more weight than the supplementary means (which throw light on the parties intentions) provided in Art. 32[487].

141. Art. 32 provides that recourse can be made to supplementary means of interpretation in two situations. Firstly, an interpreter can refer to supplementary means in order to confirm the meaning of a treaty term as derived from the application of Art. 31. Secondly, a reference can be made to supplementary means to ascertain the meaning of a treaty term if the general rule of interpretation (Art. 31) leaves the meaning of that treaty term ambiguous or obscure or leads to a result that is manifestly absurd or unreasonable. In this respect it should be noted that, under both situations, recourse may be had to supplementary means in order to throw light on the meaning of a treaty term as opposed to independently ascertaining the meaning of the treaty term. The draft Commentary to the VCLT confirms this position by stating that Art. 32 "*does not provide for alternative, autonomous, means of interpretation but only for means to aid an interpretation governed by the principles*" [488] contained in Art. 31. Therefore, recourse can be made to supplementary means of interpretation only in cases where ambiguity and obscurity cannot be resolved by the

[486] DE BROE, Thesis, pp. 250-251.
[487] ENGELEN, Thesis, p. 329; DE BROE, Thesis, p. 255.
[488] VCLT, Draft Commentary, Section 3, Commentary on Art. 28, Para. 19.

interpretation principles enshrined in Art. 31[489]. One commentator raises an interesting question as to what happens if a study of the supplementary means in Art. 32 provides conclusive evidence that the meaning ascertained by applying Art. 31 is not what the parties to the treaty intended[490]. In this regard, it is submitted that if the meaning of a treaty term is ascertained by applying the principles of Art. 31, then reference should not be made to supplementary means. This is because the "*textual*" approach warrants that the text of the treaty should prevail as it truly represents the intentions of the parties to the treaty[491].

142. Art. 32 does not provide for an exhaustive definition of "*supplementary means*". Nevertheless, it states that the "*preparatory work*" to the treaty and the "*circumstances of its conclusion*" can be considered as supplementary means. These terms are not defined. Some commentators state that "*preparatory works*" are extrinsic materials which have a formative effect on the final draft of the treaty and which assist in disclosure of the party's intentions. Likewise, "*circumstances of a treaties conclusion*" refers to documents that indicate the historical and contemporaneous background against which a treaty is concluded. Therefore, a position is taken that "*preparatory works*" and "*circumstances of its conclusion*" should be considered in the treaty interpretation process. This view is of course subject to the caveat that recourse to such material must be exercised with great caution as such material is not the authentic expression of the party's intentions to a treaty[492].

5.4. Applicability of the VCLT interpretation principles to tax treaties

143. In light of Art. 31 VCLT, the author firstly submits that tax treaties have to be interpreted in "*good faith*". This implies that a tax treaty should be interpreted honestly, fairly and reasonably and in accordance with the common intentions[493] of the parties as expressed in the terms of the treaty.

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489 ENGELEN, Thesis, p. 331; DE BROE, Thesis, p. 256.
490 ENGELEN, Thesis, p. 333.
491 ENGELEN, Thesis, p. 333; DE BROE, Thesis, p. 256.
492 ENGELEN, Thesis, pp. 335-338; DE BROE, Thesis, pp. 257-259.
493 The OECD Commentary, since 1992, also states that tax treaties should be interpreted in accordance with the principle of reciprocity. Refer 1992 OECD Comm. Art. 3, Para. 12.

This also implies that a tax treaty must not be interpreted in an abusive manner.

144. Secondly, the author submits that the ordinary meaning of the terms used in tax treaties should not be interpreted literally but should be interpreted in light of the tax treaties "*context*" and "*object and purpose*". In accordance with Art. 31(2), the "*context*" of a tax treaty means the entire text of the tax treaty (including its preamble and annexes), any agreements made ancillary to the tax treaty that were mutually agreed upon by the parties to the treaty and any instruments made by one party and accepted by the other party in relation to the conclusion of a tax treaty. The documents falling into the latter two categories would typically include mutually agreed protocols, memorandums of understanding and notes and letters exchanged during the conclusion of a tax treaty[494]. Also, in accordance with Art. 31(3), in addition to the "*context*", subsequent agreements which assist in application and interpretation of a tax treaty (such as interpretative MAPs concluded pursuant to Art. 25(3) of the OECD Model) [495], subsequent state treaty practice that establishes the agreement of the parties regarding the interpretation of the provisions of a tax treaty (such as the practice mutually followed by the tax authorities of two states) [496] and relevant rules of international law (rules which constitute the legal background against which the provisions of a tax treaty have to be interpreted and applied)[497] should be taken into consideration in the tax treaty interpretation process. It should be noted Art. 31(2) and Art. 31(3) require that the all the material listed therein is in accordance with the "*common intentions*" between the parties to a tax treaty. It follows from this that unilateral explanations issued by one party that have not been expressly confirmed and accepted by another party to a tax treaty cannot be included with the ambit of Art. 31 (for example unilateral technical explanations issued by the US as long as such technical explanations have not been accepted by its treaty partners)[498].

494 VOGEL, PROKISCH, Interpretation, p. 69; ENGELEN, Thesis, p. 429.

495 For a discussion on the legal status of mutual agreements in international law refer to ENGELEN, Thesis, pp. 431-434; VOGEL, PROKISCH, Interpretation, pp. 70-71.

496 ENGELEN, Thesis, p. 435.

497 ENGELEN, Thesis, p. 436.

498 VOGEL, PROKISCH, Interpretation, p. 69; VOGEL, Commentary, p. 38; VOGEL, 2015 Commentary, p. 40.

145. Thirdly, the author submits that even though Art. 31(1) requires a treaty to be interpreted in accordance with its "*object and purpose*", it does not mean that Art. 31(1) favours the "*teleological*" approach to treaty interpretation. This means that the interpretation of a tax treaty whereby the achievement of the tax treaty's object and purpose is the main factor over and above what is expressed in the actual terms of the tax treaty i.e. the "*teleological*" approach is not in accordance with the principles of the Art. 31(1). The question then arises as to what is a tax treaty's "*object and purpose*". In line with the "*textual*" approach to treaty interpretation, the author suggests that the "*object and purpose*" of a tax treaty is to be ascertained from the text of the treaty itself. This is indicated in the title and preamble of a tax treaties. As discussed later in this thesis (*see section 9.2*), the main "*object and purpose*" of a tax treaty based on the OECD Model is to avoid international double taxation (especially juridical double taxation) in order to facilitate the international exchange of goods, services, capital and persons. This objective, in the author's opinion, is interlinked with the objective of allocating taxing rights between contracting States. Additionally, the position is taken that tax treaties also prevent tax evasion as more often than not the text of a treaty (preamble) sets out such an objective. Furthermore, the author takes a position that the prevention of tax avoidance is not a primary objective of a tax treaty. At most it can be considered to be an ancillary objective which implies that in case of a conflict between the primary objective and ancillary objective the former prevails. Also, prevention of double non-taxation is not the object and purpose of a tax treaty unless expressly stated in the treaty provisions. Moreover, the author considers that a tax treaty has several other objectives such as the prevention of tax discrimination, MAP, exchange of information etc.[499]. Therefore, it is reasonable to state that the object and purposes of tax treaties are multifold.

146. Art. 32 VCLT provides that "*supplementary means of interpretation*" can be considered in the treaty interpretation process to confirm a result but not to correct it or to explain a doubtful term under specific circumstances [500]. The term "*supplementary means"* is not exhaustively defined but the VCLT provides that "*preparatory work*" and "*circumstances of a conclusion*" of a treaty can be considered in the interpretation process. "*Preparatory work*" is understood to include written

[499] ENGELEN, Thesis, p. 428; VOGEL, PROKISCH, Interpretation, p. 72.
[500] VOGEL, PROKISCH, Interpretation, p. 74.

material such as successive drafts, conference records, exchange of letters or notes etc between parties during the treaty negotiation process. However, given the fact that such material is not easily accessible - references to such preparatory work are seldom possible[501]. "*Circumstances of its conclusions"* refers to the historical background against which a tax treaty is concluded. This means that the domestic tax law, the existing treaty network and the practices adopted by the states that enter into a tax treaty need to be taken into consideration[502]. However, "*supplementary means*" should be referred to only if the common intentions of the parties to a tax treaty are discernible from them. Material, which represents the object and purpose of only one party to the tax treaty, is thus not considered as "*supplementary means*"[503]. This would once again include unilateral explanations issued by one party that have not been expressly confirmed and accepted by another party to a tax treaty[504].

147. The draft Commentary to the VCLT provides that "*any attempt to codify the conditions of the application of those principles of interpretation whose appropriateness in any given case depends on the particular context and on a subjective appreciation of varying circumstances would clearly be inadvisable. Accordingly the Commission confined itself to trying to isolate and codify the comparatively few general principles which appear to constitute general rules for the interpretation of treaties"*[505]. Accordingly, it has been opined that Art. 31 and 32 do not constitute a complete codification of interpretation rules that can be applied to tax treaties[506]. Therefore, a position is taken in this thesis that, in addition to the interpretative instruments mentioned in Art. 31 and 32, an interpreter can resort to interpretation material that can be useful to establish the meaning of a treaty term that would ideally reflect the common intentions of the parties[507].

501 DE BROE, Thesis, p. 257.
502 DE BROE, Thesis, p. 258.
503 VOGEL, PROKISCH, Interpretation, p. 74.
504 DE BROE, Thesis, p. 259.
505 VCLT, Draft Commentary, Section 3, Introduction, Para 5.
506 ELLIFFE, 2003 Commentary, p. 319.
507 DE BROE, Thesis, p. 259.

6. The role of the Commentary of international organizations in tax treaty interpretation

6.1. Preliminary remarks

148. It is widely accepted that the OECD Commentary plays an important role in the interpretation and application of a tax treaty based on the OECD Model[508]. Nevertheless, the extent to which the OECD Commentary can be used in the interpretation of tax treaties has been the subject matter of extensive debate and there seems to be no consensus regarding its legal status[509]. Specifically, the issue arises as regards the relationship between the interpretation rules of the VCLT and the OECD Commentary i.e. is the practice of considering the OECD Commentary permitted by the rules of the VCLT?

149. Commentators and Courts from different jurisdictions are divided in their opinion and consider that the OECD Commentary which is current at the time a tax treaty is concluded fits in either i) Art. 31(1) VCLT as providing the "*ordinary meaning*" of a treaty term[510] ii) Art. 31(2) VCLT as a part of the "*context*" which has to be taken into account to determine the "*ordinary meaning*" of a treaty term[511] iii) Article 31(4) VCLT as providing

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[508] VOGEL, Commentary, p. 43; VOGEL, 2015 Commentary, p. 45; DE BROE, Thesis, p. 293; ELLIFFE, 2003 Commentary, p. 310.

[509] Non exhaustive list: ENGELEN, Thesis, pp. 439-473; DE BROE, Thesis, pp. 290-300; VOGEL, Commentary, pp. 43-47; VOGEL, PROKISCH, Interpretation, pp. 64-66; ERASMUS, DOUMA, OECD, pp. 339-352; AVERY JONES, OECD, pp. 102-109; WARD, OECD, pp. 97-102; WATTEL, MARRES, OECD Commentary, pp. 222-235; LI, SANDLER, Abuse, pp. 902-904; ENGELEN, OECD, pp. 105-109; ELLIFFE, 2003 Commentary, pp. 313-327; LANG, BRUGGER, Interpretation, pp. 95-108; DANON, Thesis, pp. 263-267; MARTIN JIMENEZ, 2003 changes, pp. 27-30; AVERY JONES, Interpretation II, p. 90; AULT, OECD, pp. 144-148; INNAMORATO, OECD, pp. 98-124; LANG, OECD, pp. 7-9; ROMYN, OECD, pp. 470-472.

[510] Vogel argues that – for tax treaties concluded between OECD Member States – the OECD Commentary can be used to determine the "*ordinary meaning*" of the terms and therefore fits in Art. 31(1) VCLT. VOGEL, Commentary, p. 43; A similar view seems to be advocated by Lang and Brugger. LANG, BRUGGER, Interpretation, pp. 99-100.

[511] Vogel and Prokisch generally argue that – for tax treaties concluded between OECD Member States – the OECD Commentary forms part of the "*context*" for the purpose of Art. 31(2). See VOGEL, PROKISCH, Interpretation, p. 65. Similarly, Ward argues that the OECD Commentaries that exist at the time of conclusion of a tax treaty could form part of the "*context*" of the treaty. See WARD, OECD, p. 99. Likewise, Wattel and

a "*special meaning*" to a treaty term[512] iv) Art. 32 VCLT as "*supplementary means of interpretation*"[513] or v) does not fit into either Art. 31 or Art. 32 of the VCLT but nonetheless is useful in the tax treaty interpretation process[514].

Marres argue that the Commentary that was current at the time a treaty was concluded can be subsumed under the "*context*" as provided in Art. 31(2). See WATTEL, MARRES, OECD Commentary, p. 228. Avery Jones argues that the OECD Commentary may form a part of the "*context*" in Art. 31(2). See AVERY JONES, Interpretation II, pp. 90-108; AVERY JONES, OECD, pp. 102-104. Engelen is more specific and argues that – for tax treaties concluded between OECD Member States – the OECD Commentary fits in Art. 31(2)(a) of the VCLT as it is a "*tacit agreement*" to which both parties to a treaty formally agree and accept. See ENGELEN, Thesis, p. 466; ENGELEN, OECD, p. 109. The CSC seems to have held that the OECD Commentary forms a part of the legal "*context*" as provided in Art. 31 VCLT. See CSC: Crown Forest Industries Ltd. v. Canada, 2 SCR 802, June 22nd, 1995, Para. 46. ELLIFFE, 2003 Commentary, p. 318; VINCENT, Crown, pp. 49-55.

512 Ault takes the view that the OECD Commentary gives a "*special meaning*" to a treaty term. He argues that Art. 31(4) creates a bridge between Art. 31 and Art. 32 and thereby allows a meaning to be incorporated from the OECD Commentary in circumstances where the ordinary meaning of the term is clear but, in the context of the supplementary material provided by the Commentary, incorrect. AULT, OECD, pp. 146-147. Vogel supports this position as an alternate argument. VOGEL, Commentary, p. 43. Avery Jones also supports this position as an alternate argument. AVERY JONES, OECD, pp. 102-104. Courts in the UK provide that the OECD Commentary may fit into Art. 31(4) (though they are not conclusive about it). See for example the decision of the UK SC: Smallwood and another v Revenue and Customs Commissioners, 10 ITLR 574, February 19th, 2008, Paras. 98-99.

513 LI and Sandler consider the OECD Commentary to fit into Art. 32. LI, SANDLER, Abuse, p. 904. De Broe also argues that, at most, the Commentary can be classified under Art. 32 of the VCLT as it can be said to be a part of the "*circumstances of conclusion*" of a tax treaty. DE BROE, Thesis, p. 293. The AHC seems to have held that the OECD Commentary fits in Art. 32 VCLT. See AHC: Thiel v. Federal Commissioner of Taxation, (1990) 21 ATR 531, August 22nd, 1990, Ruling by Dawson J, Paras. 9-10. Similarily, the JSC has ruled that the OECD Commentary fits in Art. 32. See JSC: Glaxo Kabushiki Kaisha vs Director of Kojimachi Tax Office, Case No. 2008 (Gyou Hi), 12 ITLR 644, October 29th 2009, pp. 644-657. Also see SACR: AAA v Financial Directorate, (269) j 2Afs 108/2004-106, 8 ITLR 178, pp. 178-205, February 10th 2005.

514 De Broe also argues that the exercise of fitting the OECD Commentary within the VCLT is a fruitless exercise. DE BROE, Thesis, p. 293. Elliffe concludes that the OECD Commentary is not legal binding but should be applied as an aid to interpretation. ELLIFFE, 2003 Commentary, pp. 322-323; The FSAC in the *2002 Oyj Abp case* held that "*the Commentary to the Model Tax Convention is not a formally binding source of interpretation, it is relevant as an auxiliary source of interpretation, in particular where the tax treaty in question conforms to the design of the OECD Model Tax Convention*". See FSAC: Re A Oyj Abp, KHO: 2002.26, 4 ITLR 1009, March 20th 2002, pp. 1009-1076.

150. Similarly, for the subsequent versions of the OECD Commentary, commentators and Courts have argued that such versions fits into either i) Art. 31(3)(a) VCLT as a "*subsequent agreement*" between the parties regarding the interpretation and application of a tax treaty[515] ii) Art. 31(3)(b) VCLT as a "*subsequent practice*" between the parties regarding the interpretation and application of a tax treaty [516] iii) Art. 32 VCLT as "*supplementary means of interpretation"*[517] or iv) do not fit into the VCLT but are an interpretative aid in the tax treaty interpretation process[518].

6.2. Role of current OECD Commentary

151. In the author's view, the attempt to classify the OECD Commentary under one provision or another of the VCLT is not a gainful exercise. This is because the interpretation provisions contained in the VCLT are a "*means to an end and not as an end in themselves*"[519]. The draft Commentary to the VCLT makes this clear and states that the drafters, in drafting the interpretation rules of the VCLT, never intended Art. 31 and Art. 32 of the VCLT to be a complete codification of all principles and maxims that has to be adopted in interpreting treaties[520] (*see margin no. 147*). Therefore, even if the OECD Commentary cannot be considered to fit in Art. 31 and Art. 32 VCLT – it is submitted that it should be considered relevant in the tax treaty

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[515] Engelen argues that – for tax treaties concluded between OECD Member States – subsequent versions of the OECD Commentary fit into Art. 31(3)(a) of the VCLT. See ENGELEN, Thesis, p. 468.

[516] Lang and Brugger discuss the arguments for and against fitting subsequent versions of the OECD Commentaries in Art. 31(3)(b) VCLT. See LANG, BRUGGER, Interpretation, pp. 103-104. Also see LANG, OECD, pp. 7-8.

[517] Vogel argues that in certain circumstances the Commentary can fit in Art. 32. See VOGEL, OECD, p. 614. Wattel and Marres also argue that the subsequent OECD Commentary can fit in Art. 32. See WATTEL, MARRES, OECD Commentary, p. 229.

[518] Avery Jones argues that subsequent versions of the OECD Commentary cannot fall within Art. 31 or Art. 32 VCLT. Neverthless, he suggests that the relevance of such Commentary would depend mostly on how much weight should be given to them in any particular circumstances. AVERY JONES, OECD, pp. 102-104; The FSAC in the *2002 Oyj Abp case* held that "*the amendments later made to the Commentary also have significance as an aid to interpretation"*. See FSAC: Re A Oyj Abp, KHO: 2002.26, 4 ITLR 1009, March 20th 2002, pp. 1009-1076; Also see Conselho de Contribuintes (Council of Taxpayers): Eagle Distribuidora de Bebidas SA v Second group of the Revenue Department in Brasilia, Case no. 148.709, 9 ITLR 627, October 19th 2006, pp. 627-661.

[519] BRANDSTETTER, Art. 2, p. 10.

[520] VCLT, Draft Commentary, Section 3, Introduction, Paras. 4-5; BRANDSTETTER, Art. 2, p. 11; WARD, OECD, p. 98; DE BROE, Thesis, p. 294.

interpretation process because Art. 31 and Art. 32 VCLT "*were never intended to be exhaustive either in the description of materials that could be examined by, or the principles of interpretation that could be followed*" in interpretation of an international treaty[521]. Therefore, the position adopted in this thesis is that the OECD Commentary, existing at the time of conclusion of a tax treaty, is not a legally binding instrument but nevertheless plays an important role in the tax treaty interpretation process[522]. This conclusion is in line with the position expressed in the OECD Commentary which provides that "a*lthough the Commentaries are not designed to be annexed in any manner to the conventions signed by member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes"*[523]. Thus the OECD Commentary plays an important role in the interpretation of tax treaties by tax officials[524], taxpayers[525] and Courts[526] around the world. With respect to the judicial use of the OECD Commentaries, it should be noted that the Courts in the OECD countries covered (such as the USA[527], UK[528], Canada[529], Netherlands[530] and Switzerland[531]), have time and again referred

[521] ELLIFFE, 2003 Commentary, p. 319.

[522] WARD, OECD Commentary, p. 92; AVERY JONES, OECD Commentary, p. 157; INNAMORATO, OECD, pp. 109-110; ELLIFFE, 2003 Commentary, pp. 322-323.

[523] 2014 OECD Comm. Introduction, Para. 29.

[524] 2014 OECD Comm. Introduction, Para. 29.1.

[525] 2014 OECD Comm. Introduction, Para. 29.2.

[526] 2014 OECD Comm. Introduction, Para. 29.3.

[527] For example, the US TC has held that the OECD Commentary offers "*helpful guidance*" in the interpretation of a tax treaty. See US TC: The North West Life Assurance Company of Canada, v. Commissioner of Internal Revenue, Docket No. 4694-94, December 12th 1996.

[528] For example, the UK SC consider the OECD Commentary to be an "*important means of interpretation"*. See the UK SC: Smallwood and another v Revenue and Customs Commissioners, 10 ITLR 574, February 19th, 2008, Para. 98; AVERY JONES, Court Interpretation, pp. 69-70.

[529] For example, the CSC considers that the OECD Commentary is of "*high persuasive value*" in interpreting a tax treaty. See CSC: Crown Forest Industries Ltd. v. Canada, 2 SCR 802, June 22nd, 1995, Para. 55.

[530] For example, the DSC has held that the OECD Commentary is "*of great importance*". See DSC (Dutch Hoge Raad): BNB 1992/379, September 2nd, 1992. MARRES, Court Interpretation, pp. 318-319.

[531] For example, the SFSC held that OECD Member Countries "*are in principle obliged to take into account the model conventions and the relating commentaries of the OECD"* to interpret a tax treaty. See SFSC: A Holding ApS v Federal Tax Administration, 8 ITLR 536, November 28th 2005, pp. 536-562 at p. 558.

to the OECD Commentary to interpret a tax treaty[532]. Even Courts in non-OECD countries (such as India[533]) refer to the OECD Commentary.

6.3. Role of later OECD Commentary

152. Having established that the OECD Commentary plays an important role in the interpretation of tax treaties, even though it is not legally binding, the issue arises as to which version of the Commentary should be used to interpret a tax treaty i.e. is it the Commentary that exists at the time a treaty is concluded or are subsequent commentaries also relevant? In this regard, it should be noted that the OECD Commentary, itself, advocates the ambulatory approach by stating that *"existing conventions should, as far as possible, be interpreted in the spirit of the revised Commentaries"* [534]. Nevertheless the OECD seems to provide a limit to the ambulatory approach by differentiating between i) commentaries which substantially modify previous versions of the commentary i.e. they lead to a *"contrario"* interpretation and ii) commentaries that clarify previous versions of the Commentary[535]. In relation to the former, the OECD's view is that such commentary should be disregarded whereas in the case of the latter, the OECD's view is that such Commentary should be considered to be relevant in the tax treaty interpretation process.

153. A similar trend emerges in the views of many commentators[536] i.e. commentators generally distinguish between changes to the OECD Commentary that i) amplify or clarify the content of the OECD commentaries (for example by adding new examples and arguments) ii) fill gaps in the existing commentary (commentary that fills gaps in the OECD Model by covering matters not previously discussed) iii) reverse/contradict earlier positions and iv) records what States have actually been doing in practice. For commentaries that fall into (i) above i.e. they amplify or clarify previous versions, commentators generally agree that such Commentary

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532 PISTONE, Commentary, pp. 4-8.

533 See Pune ITAT: Automated Securities Clearance Inc v Income Tax Officer, 11 ITLR 201, September 10th, 2008; Also See Ahmedabad ITAT: Shri Rajeev Sureshbhai Gajwani, Prop Amtel Exports India v Assistant CIT, 13 ITLR 537, March 4th 2011.

534 2014 OECD Comm. Introduction, Para. 33.

535 2014 OECD Comm. Introduction, Para. 36.

536 ELLIFFE, 2003 Commentary, p. 327; WARD, OECD, p. 101; DE BROE, Thesis, p. 297.

could be considered in the tax treaty interpretation process [537]. For commentaries that fall into (ii) i.e. they fill gaps in the existing commentary with a view to fill a gap in the text of the OECD Model, commentators argue that such Commentary should be *"viewed with great care by treaty interpreters, particularly by domestic courts, to determine whether it has any legitimate role in the interpretive process"*[538]. For commentaries that fall into (iii) i.e. they reverse/contradict earlier positions, commentators argue that such Commentary should not be considered in the treaty interpretation process[539]. Lastly, for commentaries that fall in (iv) i.e. they record State practice it has been opined that the weight attributed to such Commentary depends on whether it is genuinely clarificatory or merely gap filling[540].

154. Courts, in several jurisdictions, seem to have no unanimous approach to the issue at stake. The extent to which subsequent versions of the OECD Commentary are considered to be relevant in the tax treaty interpretation process varies. For instance, the position seems to be mixed in the US. To elaborate, the US TC in the *Taisei Fire* case[541] used the 1977 OECD Commentary to interpret a tax treaty concluded in 1971 [542]. An analysis of this case indicates that the Court took into consideration subsequent versions of the OECD commentary that were in conflict with previous versions[543]. Canadian case law on the ambulatory role of the OECD Commentary also shows a conflicting trend. The CFCA in the *Cudd Pressure Control* case[544] held that the 1977 OECD Commentary could be of

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537 WARD, OECD, p. 101; DE BROE, Thesis, p. 297; WATTEL, MARRES, OECD Commentary, p. 229; AULT, OECD, p. 148.

538 WARD, OECD, pp. 101-102.

539 WARD, OECD, p. 102; DE BROE, Thesis, p. 298; WATTEL, MARRES, OECD Commentary, p. 229; AULT, OECD, p. 148.

540 WARD, OECD, p. 102.

541 US TC: The Taisei Fire and Marine Insurance Co Ltd. et al. v. Commissioner of Internal Revenue, Docket Nos. 14296-92, 14297-92, 14298-92, 14299-92, 104 T.C. 535, May 2nd 1995.

542 The Court held that *"generally, we would have reservations about interpreting a convention, ratified in 1971, on the basis of a commentary, adopted in 1977, that contradicts the literal language of the commentary in effect at the time of ratification. However, in light of the extensive analysis by the previously cited commentators and the confirmation of such analysis by our own research, we are persuaded that the criteria in the later commentary reflects the original intention of the commentary to the 1963 model and that the 1963 model should be interpreted as having a disjunctive ("or") meaning"*.

543 WATTEL, MARRES, OECD Commentary, p. 230.

544 CFCA: Cudd Pressure Control Inc. v. The Queen, 98 DTC 6630, October 19th 1998.

"*some assistance*" to interpret a tax treaty concluded in 1942[545]. However, in the *MIL Investment* case (*see section 15.4.3*), the CTC refused to interpret a tax treaty concluded in 1989 in light of the 2003 version of the OECD Commentary[546]. The trend changed once again in the *Prevost*[547] and *Sommerer*[548] cases wherein the CFCA and the CTC respectively ruled that subsequent versions of the OECD Commentary can be taken into consideration as long as they do not conflict with previous versions. In light of the aforementioned case law, it has been opined that in Canada, ambulatory OECD Commentary may be considered only to the extent that it is elaborative in nature and does not conflict with prior versions[549]. The position in the UK shows a consistent trend. Lord Diplock in the *Fothergill case*[550], though not in the context of the OECD Commentary, held that "*subsequent commentaries can have persuasive value only*". This approach

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[545] The Court held that "*The relevant commentaries on the OECD Convention were drafted after the 1942 Convention and therefore their relevance becomes somewhat suspect. In particular, they cannot be used to determine the intent of the drafters of the 1942 Convention. However, although the wording and arrangement of the provisions are significantly different in the two conventions, the 1942 Convention follows the same general principles as the OECD model. The OECD Commentaries, therefore, can provide some assistance in discerning the "legal context" surrounding double taxation conventions at international law, and in particular in ascertaining when it is appropriate to allow a deduction for a notional expense*". See *Ibid*, Para. 23.

[546] The Court held that "*The respondent presented the 2003 revisions to the OECD commentary as support for the existence of an inherent anti-abuse rule in tax treaties. Article 31(1)(c) of the Vienna Convention states 'there shall be taken into account, together with the context, any relevant rules of international law applicable in the relations between the parties.' I interpret that to mean that one can only consult the OECD commentary in existence at the time the treaty was negotiated without reference to subsequent revisions*". CTC: MIL (Investments) SA v Canada, 9 ITLR 25, August 18th, 2006, pp. 25-88, Para. 87.

[547] CFCA: Prevost Car Inc. v. Canada, 2009 FCA 57, February 26th 2009. The Court held that "*The worldwide recognition of the provisions of the Model Convention and their incorporation into a majority of bilateral conventions have made the Commentaries on the provisions of the OECD Model Convention a widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions…The same may be said with respect to later Commentaries, when they represent a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time a specific treaty was entered and when, of course, neither treaty partner has registered an objection to the new Commentaries.*" See Paras. 10-11.

[548] CTC: Peter Sommerer v. The Queen, 2011 TCC 212, May 13th 2011. The Court held that "a *later OECD Commentary should only be of assistance if not in conflict with the Commentary in existence at the time of the Convention*". See Para. 119.

[549] BAUM, WATSON, Beneficial Ownership, p. 159.

[550] UK HOL: Fothergill v Monarch Airlines Ltd - [1980] 2 All ER 696, July 10th 1980.

was followed in the *Smallwood case*[551]. An analysis of the case law of a non-OECD Member State such as India indicates that the courts have not discussed the issue at stake in a comprehensive manner but nevertheless seem to state that the OECD Commentary is an "*ambulatory document*"[552]. This may imply that the Indian courts consider subsequent versions of the OECD Commentary to be relevant in tax treaty interpretation. Dutch case law indicates that the DSC has also referred to subsequent versions of the OECD Commentary in a negative as well as in a positive manner[553]. Swiss case law i.e. the decision of the SFSC in the *A Holding Aps* case also indicates that the ambulatory OECD Commentary needs to be adopted in treaty interpretation even if subsequent commentaries conflict with previous versions[554].

156. In light of the above discussion, the position taken in this thesis is that the subsequent versions of the OECD Commentary can be considered, only if, the revised Commentary is in the nature of a clarification. Consequently, if the revised Commentary represents a fundamental change or if the Commentary reverses or contradicts previous versions then that Commentary should be disregarded and should not be taken into the tax treaty interpretation process.

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551 The UK SC held that "*The relevance of commentaries adopted later than the treaty is more problematic because the parties cannot have intended the new commentary to apply at the time of making the treaty. However, to ignore them means that one would be shutting one's eyes to advances in international tax thinking, such as how to apply the treaty to payments for software that had not been considered when the treaty was made. The safer option is to read the later commentary and then decide in the light of its content what weight should be given to it*". See UK SC: Smallwood and another v Revenue and Customs Commissioners, 10 ITLR 574, February 19th, 2008, Para. 99.

552 See Pune ITAT: Automated Securities Clearance Inc v Income Tax Officer, 11 ITLR 201, September 10th, 2008, Paras. 28-33; Also See Ahmedabad ITAT: Shri Rajeev Sureshbhai Gajwani, Prop Amtel Exports India v Assistant CIT, 13 ITLR 537, March 4th 2011, Paras. 8.2-8.3.

553 MARRES, Court Interpretation, pp. 318-319.

554 SFSC: A Holding ApS v Federal Tax Administration, 8 ITLR 536, November 28th 2005, pp. 558-559.

6.4. Role of UN Commentary

157. Similar to the OECD Model, the UN Model (last updated in 2011) is accompanied by detailed commentary. This Model has a profound impact on the international tax treaty practice of developing States although, at the time of writing this thesis, it is quite clear that influence of the OECD Model is significantly higher[555]. It should be noted that the UN commentary is not prepared by the UN member States but by a group of experts. Accordingly, it could be argued that the UN commentary does not represent the position of UN Member States (which also comprises of OECD member States). In the author's opinion, UN member States appoint the experts. The proposals put forward by the experts could be accepted or rejected by the UN member States. Therefore, the UN commentary, when accepted, does express the view of UN member States (unless some States oppose the Commentary).

158. It is fair to mention that the commentary to the UN Model is highly influenced by the Commentary to the OECD Model. This is because the 2011 UN Commentary, on several occasions, refers to the OECD Commentary while discussing the UN Model treaty provisions [556]. Accordingly, in line with the position taken in relation to the OECD Commentary, the view can be taken that the UN Commentary is not a legally binding instrument but nevertheless can be referred to in order to interpret a tax treaty even if it is based on the OECD Model. Likewise, subsequent versions of the UN Commentary can be considered, only if, the revised Commentary is in the nature of a clarification.

[555] PISTONE, Commentary, p. 2.
[556] 2011 UN Comm. Introduction, Paras. 20-23.

7. The interpretation of undefined treaty terms

7.1. Preliminary remarks

159. A tax treaty cannot be interpreted in isolation from the relevant domestic law[557]. This is because several provisions of tax treaties provide that treaty terms have to be interpreted in light of the domestic law. For example, Art. 6(2) of the OECD Model [558] provides that the term "*immoveable property*" should be interpreted as per the law of the State in which the property is situated. Likewise, the last sentence of Art. 10(3) of the OECD Model[559] provides that a reference can be made to the domestic law of the state of residence of the distributing company to ascertain the meaning of "*dividends*".

160. In addition to the above specific references, Art. 3(2) of the OECD (or UN) Model provides, in a general way, that "*as regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State*"[560].

161. Consequently, by applying Art. 3(2), domestic law meanings can be incorporated into a tax treaty. It should be noted that a discussion on Art. 3(2) is essential for this thesis. This is because the application of domestic anti-avoidance rules can be incorporated into a tax treaty pursuant to Art. 3(2). To elaborate, a tax treaty contains many undefined terms. Thus, pursuant to Art. 3(2), a reference has to be made to the domestic law of the

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557 ENGELEN, Thesis, p. 473.

558 2014 OECD Model. Art. 6, Para. 2, 1st sentence.

559 2014 OECD Model. Art. 10, Para. 3, last sentence.

560 2014 OECD Model. Art. 3, Para. 2. It should be noted that Art. 3(2) is one of the most controversial provisions of the OECD Model and its interpretation and application has been extensively debated in international tax literature. Refer to footnote no. 1381 in ENGELEN, Thesis, p. 474; footnote no. 2 in KANDEV, Interpretation, p. 33; footnote no. 1 in VAN DER BRUGGEN, Interpretation, p. 142; for a list of author's who have debated extensively on the interpretation and application of Art. 3(2).

State applying the treaty, unless the context otherwise requires, to ascertain the meaning of such a treaty term. As domestic anti-avoidance rules (judicial doctrine, statutory GAARs or SAARs) are part of the domestic law they may be called into play to give an undefined treaty term a particular meaning. Therefore, it is essential to determine the extent to which such domestic anti-avoidance rules can be incorporated into a tax treaty as a consequence of Art. 3(2)[561]. Accordingly, in the following sections, the author briefly discusses the provision of Art. 3(2). Thereafter, in a separate chapter (*see chapter 11*), the author discusses its relationship with domestic anti-avoidance rules.

7.2. Art. 3(2) of the OECD Model

7.2.1. Relationship with the VCLT

162. At the outset, the author submits that Art. 3(2) is a "*lex specialis"* in relation to the interpretation principles provided by the VCLT[562]. This is because Art. 3(2), by making reference to the domestic law, deviates from the interpretation principles of the VCLT, which state that a treaty term should be interpreted in accordance with the "*common intentions*" of the treaty partners[563]. In tax treaty interpretation, this means that Art. 3(2) governs the interpretation of any term not defined in a tax treaty. However, this does not mean that the VCLT interpretation rules are irrelevant. As Art. 3(2) is a treaty provision, it is, itself, subject to the provisions of the VCLT i.e. Art. 3(2) must be interpreted in "*good faith*" and in accordance with the "*ordinary meaning*" to be given to its terms in their "*context*" and in light of the "*object and purpose*" of the tax treaty[564].

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561 DE BROE, Thesis, p. 264; LI, SANDLER, Abuse, p. 905.

562 ENGELEN, Thesis, p. 477; DE BROE, Thesis, p. 264; VOGEL, PROKISCH, Interpretation, p. 77; VOGEL, Commentary, p. 209; WATTEL, MARRES, Fictitious income, p. 70; KANDEV, Interpretation, p. 39; VAN DER BRUGGEN, Interpretation, p. 142; BRANDSTETTER, Art. 2, p. 17.

563 DE BROE, Thesis, p. 263.

564 ENGELEN, Thesis, pp. 478-481; DE BROE, Thesis, p. 264; VOGEL, PROKISCH, Interpretation, p. 77; WATTEL, MARRES, Fictitious income, p. 70.

7.2.2. The meaning of "term"

163. Art. 3(2) provides that the meaning of any undefined tax treaty "*term*" should be derived from the State applying the tax treaty. The position taken in this thesis is that the word "*term*" should be interpreted broadly. This means that the word "*term*" not only refers to single words (such as "*derived*", "*alienation*", "*paid*", "*employment*" etc), but also extends to groups of words i.e. parts of phrases or a phrase itself (such as "*profits of an enterprise"* in the sentence "*profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein")*[565].

7.2.3. "Application of the convention" by a State

164. Art. 3(2) makes reference to the domestic law of the State applying the tax treaty to ascertain the meaning of undefined terms. Accordingly, the question that arises in a cross border residence-source situation is whether each contracting State is entitled to apply its own domestic law definitions or is the domestic law definition of one of the two States to be preferred to give a meaning to undefined treaty term? In this respect, it should be noted that the commentators have put forward different views vis-à-vis the expression *"application of the convention...by a Contracting State"* [566]. Some commentators suggest a broad view that a State applies a tax treaty whenever that State reads it to check whether or not it is entitled to tax a particular income stream. This would take place in any residence-source situation. Therefore, each contracting State is entitled to apply its domestic law definitions to undefined tax treaty terms [567]. In contrast, another

[565] DE BROE, Thesis, p. 265; VOGEL, PROKISCH, Interpretation, p. 79; LI, SANDLER, Abuse, p. 908.

[566] The 1963, 1977, 1992 and 2014 OECD Model's uses this expression. LI, SANDLER, Abuse, p. 909.

[567] ENGELEN, Thesis, pp. 484; VOGEL, Commentary, p. 211; VOGEL, PROKISCH, Interpretation, p. 77. This view propagates the idea that the residence State is not bound by the source States qualification pursuant to Art. 3(2). Accordingly, double taxation may exist i.e. the residence State may not provide relief from double taxation if it considers that the domestic law qualification applied by the source State is not in accordance with its own domestic law qualification for a particular item of income. Li and Sandler provide that "*For example, if the residence state characterizes the income in a manner that gives it exclusive jurisdiction to tax the income, it need not provide any relief for the tax levied by the source state. Given this interpretation, there remains a potential for double*

commentator convincingly provides an alternate view. He states that, in a cross-border residence-source situation, a tax treaty is only applied where it limits a State from applying its domestic law and not when a State simply reads a tax treaty[568]. This view provides that the domestic law of the source State is to be preferred i.e. undefined treaty terms should be interpreted pursuant to the domestic law of the source State and the residence State should accept the domestic law qualification of the source State[569]. The position taken in this thesis is that in a residence-source situation, the domestic law of the state of source is to be preferred to give a meaning to an undefined treaty term if a reference is made pursuant to Art. 3(2) (unless the treaty context requires otherwise).

7.2.4. Meaning under the "law" of the applying State

165. Art. 3(2) of the draft 1963 OECD Model provided that the meaning of an undefined term should be derived from the "*laws*" of the State applying the treaty[570]. The 1977 OECD Model and the versions thereafter have provided that the meaning of an undefined term should be derived from the "*law*" of the State applying the treaty. The question arises as to whether the expressions "*laws*" or "*law*" include references not only the domestic tax legislation (such as tax statutes) but also authoritative jurisprudence (such as the decision of a Supreme Court). In this respect, it is submitted that to the extent such authoritative case law assists in providing a meaning to for an undefined treaty term, a reference can be made to it pursuant to Art. 3(2). This is because the principles of the Art. 31 VCLT mandate that the expressions "*laws*" or "*law*" should not be interpreted literally so as to

taxation or no taxation depending on the manner in which each country characterizes the particular item of income". LI, SANDLER, Abuse, p. 909.

568 AVERY JONES, Qualification conflicts, pp. 43-62; For an explanation of this view also refer to DE BROE, Thesis, pp. 268-270; VOGEL, PROKISCH, Interpretation, p. 78.

569 The view propogates that the residence State should accept the source State's qualification of income and give relief pursuant to Art. 23 even if the residence State classifies the income differently due to it's domestic law. Li and Sandler provide that " *the word application" should be construed narrowly and should give priority to the source country's internal law definition of the particular type of income. The residence country should then follow this application in determining whether to provide an exemption for the income or a credit for the tax levied by the source country. Under this interpretation of article 3(2), the problem of double taxation or no taxation does not arise"*. LI, SANDLER, Abuse, p. 909. Other commentators also share this view. See DE BROE, Thesis, p. 269; The view has also been proposed by the OECD since 2000. Refer 2014 OECD Comm. Art. 23, Para. 32.1-32.4.

570 1963 OECD Model. Art. 3, Para. 2.

include only tax statutes. Consequently, judicial doctrines can be referred to, to ascertain the meaning of undefined tax treaty terms[571]. Art. 3(2) further provides that the meaning of an undefined treaty term should be derived from law *"the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State"*. This implies that the meaning of an undefined term should be ascertained, *prima facie*, from the tax legislation (including authoritative case law). If a definition does not exist under the tax legislation then the meaning of the undefined treaty term can be ascertained from the provisions of general law. Also, it implies that if both the tax law and the general law define an undefined term differently then the tax law definition prevails over the definition provided in general law[572].

7.2.5. The words "at any time...at that time": Dynamic vs Static interpretation

166. An interpretation issue triggered by Art. 3(2) is whether a State applies a tax treaty in a static or dynamic manner i.e. whether one applies to the undefined treaty term the domestic law meaning when the treaty was signed (static approach) or the domestic law meaning as amended from time to time (dynamic approach). The prevailing view among commentators is that the dynamic approach should be followed[573]. The OECD also shares this view. The 1992 OECD Commentary provides that *"the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the Convention was signed or that in force when the*

[571] DE BROE, Thesis, pp. 266-267; AVERY JONES, Interpretation I, p. 19 ; KANDEV, Interpretation, pp. 41-42: IFA, Abuse, pp. 11-15. However, other commentators disagree with this view. They provide that the term "*law*" does not include general principles (case law) of domestic law. This is because Art. 3(2) is found under the heading of Art. 3 which provides "*General Definitions*" ie it implies that Art. 3(2) is concerned only with definition of undefined treaty terms and does not refer to general principles of domestic law. VOGEL, Commentary, p. 210; VOGEL, PROKISCH, Interpretation, p. 79; WATTEL, MARRES, Fictitious income, p. 71.

[572] ENGELEN, Thesis, p. 486; The view has also been expressed by the OECD since 1995. Refer 2014 OECD Comm. Art. 3, Para. 13.1.

[573] Non exhaustive list: ENGELEN, Thesis, p. 490; DE BROE, Thesis, p. 271; VOGEL, PROKISCH, Interpretation, p. 80; VOGEL, Commentary, p. 64 and p. 213; WATTEL, MARRES, Fictitious income, p. 71; KANDEV, Interpretation, p. 54; AVERY JONES, Qualification conflicts, pp. 43-62; WATTEL, MARRES, OECD Commentary, p. 223; RIBES, Interpretation, p. 22.

Convention is being applied, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the latter interpretation should prevail"[574]. Further, the OECD also amended the text of Art. 3(2) in 1995 to reflect its view. The terms "*at any time*" and "*at that time*" were added to make it clear that the meaning of terms not defined in a tax treaty should be established by reference to the legislation in force when the treaty is applied[575].

167. The question arises as to whether the view expressed by the OECD holds good for tax treaties concluded before 1992 or tax treaties that do not include the terms "*at any time*" and "*at that time*". In the author's opinion, the changes made by the OECD were clarificatory in nature. Accordingly, the view of the OECD should also be applicable to treaties concluded prior to the amendments to the OECD Model (in 1995) and Commentary (in 1992). This is because of the following reason: Art. 3(2) of the draft 1963 OECD Model provided that an undefined term should have the meaning under the law "*relating to the taxes which are the subject of the Convention"*[576]. Similarly, Art. 3(2) of the 1977 OECD Model provided that an undefined term should have the meaning under the law "*concerning the taxes to which the Convention applies"*. Likewise, since 1995, the OECD Model has provided that an undefined term shall have the meaning under the law of the contracting State seeking to apply the treaty, for the "*purposes of the taxes to which the Convention applies*"[577]. In all the versions discussed previously, Art. 3(2) applies to "*taxes*" covered by a tax treaty. Art. 2(4) of the draft 1963, 1997 and subsequent OECD Models provides that the tax treaty applies to similar taxes that are subsequently imposed in addition to or in place of the existing taxes. Therefore, if Art. 3(2) is interpreted in light of Art. 2(4), there can be no doubt that Art. 3(2) applies to taxes that are imposed after the conclusion of a tax treaty[578]. Thus, the ambulatory approach should be adopted as it leads to a practical and effective application of the tax treaty[579]. This position is, of course, subject to the limitations discussed in the next section.

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574 1992 OECD Comm. Art. 3, Para. 11.
575 ENGELEN, Thesis, p. 489; DE BROE, Thesis, p. 271.
576 1963 OECD Model. Art. 3, Para 2.
577 2014 OECD Model. Art. 3, Para 2.
578 ENGELEN, Thesis, p. 489; AVERY JONES, Interpretation I, pp. 25-48.
579 ENGELEN, Thesis, p. 490; DE BROE, Thesis, p. 271; VOGEL, PROKISCH, Interpretation, p. 80; VOGEL, Commentary, p. 213; WATTEL, MARRES, Fictitious income, p. 71; RIBES, Interpretation, pp. 22-23; VAN RAAD, 1992 changes, p. 12.

7.2.6. The issue and limits to ambulatory interpretation

7.2.6.1. The issue with ambulatory interpretation

168. A reference to the domestic law carries the inherent risk that a State could, after the conclusion of a tax treaty, change its domestic law in such a way that the tax treaty equilibrium is distorted. This would typically happen in a situation when a State recovers taxing rights over items of income that have been allocated to another State. To illustrate, a State could change and incorporate its domestic law definition into a tax treaty is such a way that income which formerly fell under a certain specific distributive rule would be re-characterized under the domestic law in such a way that it falls under another distributive rule that is more advantageous for the State that re-characterized it[580]. In other words, as one commentator puts it: "*a State could manipulate the effect of a treaty in its own favour by defining in its domestic law any types of income over which it has full or limited taxing rights under the treaty, but that is undefined in a treaty*"[581]. Thus, ambulatory references to the domestic law could make a tax treaty partially inoperative[582] (such changes could also result in treaty overrides – *see section 4.4*). Nevertheless, in the author's opinion, the expression "*unless the context otherwise requires"* as provided in Art. 3(2) and the provisions of the VCLT – Art. 31 (especially interpretation in "*good faith*" and in accordance with the "*object and purpose*") set limits to such post tax treaty changes to the domestic law. These limitations are discussed in the following paragraphs.

7.2.6.2. *"Unless the context otherwise requires"*

169. The text of Art. 3(2) clearly provides that the domestic law should not be referred to if the "*context*" of the treaty requires an alternative meaning. In this regard question arises as to what constitutes the "*context*" of the tax treaty? It is submitted that the term "*context*" as used in Art. 3(2) should be interpreted as broadly as possible and a narrow interpretation of

[580] WATTEL, MARRES, Fictitious income, p. 72.
[581] DE BROE, Thesis, p. 272.
[582] 1992 OECD Comm. Art. 3, Para. 13.

the term should be rejected[583]. In the author's view, the "*context*" comprises of all of the items which may be taken into account, or to which one may have recourse, in interpreting treaties generally.

170. A group of commentators[584] provide that the term "*context*" as provided in Art. 3(2) includes, on the one hand, the "*internal context*" and on the other hand the "*external context*". The "*internal context*" includes all the material listed in Art. 31(2) of the VCLT (*see section 5.2.3*). This includes on the one hand, the text of the treaty including its preamble and annexes, and, on the other hand, contemporaneous interpretative agreements and instruments made and accepted by the parties to the treaty. The "*external context*" of the tax treaty includes all the material that could fit into Art. 31(3) of the VCLT such as subsequent agreements which assist in the application and interpretation of a tax treaty (such as MAP's concluded pursuant to Art. 25(3) of the OECD Model), subsequent State treaty practice that establishes the agreement of the parties regarding the interpretation of the provisions of a tax treaty (such as the practice mutually followed by the tax authorities of two states) and relevant rules of international law (rules which constitute the legal background against which the provisions of a tax treaty have to be interpreted and applied). It also includes material that fits into Art. 32 VCLT up to the extent that such material establishes the common intentions of the treaty partners. Furthermore, the external "*context*" also includes the OECD Commentary (or UN Commentary) at the time of the conclusion of the treaty, especially between two OECD Member States, (later versions of the OECD or UN Commentary are considered only to the extent they are clarificatory in nature)[585]; the status of domestic law of

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583 VOGEL, Commentary, p. 214; ENGELEN, Thesis, p. 482; DE BROE, Thesis, p. 273; VAN DER BRUGGEN, Interpretation, pp. 143-144; WATTEL, MARRES, Fictitious income, p. 72; BRANDSTETTER, Art. 2, pp. 18-19; Kandev also agrees that the word "context" should be interpreted broadly. He states "*The word "context" is not defined in the oecd model. Although "context" is certainly a term of law, it is not found in tax jargon. Conceivably, "context" may be given a meaning under the law of the state applying the treaty; however, it cannot be desirable that such a fundamental term of a tax treaty may have different meanings, depending on which state is applying the treaty. Accordingly, "context" for the purposes of article 3(2) should be a term of general tax treaty law*". KANDEV, Interpretation, p. 68.

584 AVERY JONES, Interpretation II, pp. 90-104; Another commentator agrees with this position. See DE BROE, Thesis, pp. 273-274.

585 WATTEL, MARRES, Fictitious income, p. 71.

the States when entering into the tax treaty[586]; the history and background of the undefined term at stake[587]; other tax treaties entered into by the States[588]; decision of Courts in other States [589], etc. Accordingly, for the purpose of this thesis, the position is taken that the term "*context*" as used in Art. 3(2) includes all material that can be classified under the "*internal*" and "*external*" context of the tax treaty.

171. Another question that arises is when does the "*context*" of the tax treaty otherwise "*require*" that an alternate meaning is adopted? Commentators suggest that the word "*requires*" is a word of "*some force*" and the "*context*" of a tax treaty must therefore be reasonably strong for the domestic law meaning to be disregarded[590]. The author agrees with this position. Accordingly, it is submitted that the domestic law meaning of a treaty term should be adopted unless relatively strong arguments – by utilizing the tax treaty "*context*" – are available to disregard the reference to the domestic law. A clear-cut line cannot be drawn as to when the tax treaty context does or does not "*require"* an alternate meaning. Thus, whether the context suggests an alternative interpretation that is sufficiently persuasive to disregard the domestic meaning of the treaty term at issue is a matter that can be decided only on the facts in relation to each individual case[591]. In light of the Dutch case law examined in this thesis (see *section 14.5.4*, *section 19.4.3* and *section 19.4.4*) in the author's view, the domestic law meaning of an undefined treaty term must be disregarded if the "*context*" of the treaty provides strong reasons for avoiding such domestic law references[592]. This would be the case where, for example, a State introduces a domestic law provision with a view to recapturing a taxing right that has

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586 WATTEL, MARRES, Fictitious income, p. 72; VAN RAAD, 1992 changes, p. 13. The OECD Commentary, since 1992, has provided that the term "*context*" is determined by i) the intention of the Contracting States when signing the tax treaty and ii) the meaning given to the term in question in the legislation of the other Contracting State (which implicitly refers to the principle of reciprocity). 1992 OECD Comm. Art. 3, Para. 12.

587 BRANDSTETTER, Art. 2, pp. 12-15; IFA, Abuse, p. 12.

588 DE BROE, Thesis, p. 274.

589 AVERY JONES, Interpretation II, pp. 100-101.

590 VOGEL, Commentary, p. 214; DE BROE, Thesis, p. 277; LI, SANDLER, Abuse, p. 908; KANDEV, Interpretation, p. 68; AVERY JONES, Interpretation II, p. 108; VOGEL, PROKISCH, Interpretation, pp. 81-82.

591 KANDEV, Interpretation, p. 69.

592 VOGEL, Commentary, p. 214; DE BROE, Thesis, p. 277; LI, SANDLER, Abuse, p. 908; KANDEV, Interpretation, p. 68; AVERY JONES, Interpretation II, p. 108; VOGEL, PROKISCH, Interpretation, pp. 81-82.

been allocated to another State i.e. the domestic law provision leads to a shift in the allocation of taxing rights. An exception can be made to this when the domestic law of the other treaty partner, at the moment of concluding the tax treaty, already had a similar domestic anti-avoidance rule in place (*see section 14.5.4)*. Furthermore, the context of the treaty would prevent the application of the domestic anti-avoidance rule if that rule were to lead to potentially unresolved juridical double taxation[593].

172. The OECD Commentary supports this view by providing that " *Consequently, the wording of paragraph 2 provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided)*" [594]. This implies that even though States can amend their domestic laws and incorporate new definitions in the tax treaty, there are limits to such amendments i.e. the amendments should not make the treaty "*partially inoperative*". In the author's opinion, a treaty becomes partially inoperative when the posterior domestic law provision leads to a shift in the allocation of taxing rights beyond what the treaty partners could have foreseen at the time when the treaty was concluded. This would also be the case where the application of the posterior domestic anti-avoidance rule leads to potentially unresolved double taxation (especially juridical double taxation).

7.2.6.3. The interpretation principles of the VCLT

173. Art. 31 of the VCLT provides that treaties should be interpreted and applied in "*good faith*". The principle of good faith (*see section 5.2.2)* requires that a tax treaty should be interpreted honestly, fairly and reasonably and in accordance with the "*common intentions*" of the parties as expressed in the terms of the treaty. Consequently, it implies that the right of a State to refer to its domestic law pursuant to Art. 3(2), as amended from time to time, for the interpretation of undefined treaty terms must be exercised by that State in an honest, fair and reasonable manner. It follows

[593] DE BROE, Thesis, pp. 282.
[594] 2014 OECD Comm. Art. 3, Para. 13.

that a State is not allowed to amend its domestic law and incorporate that change in a tax treaty if that domestic law meaning leads to a result that is unfair[595]. This would be the case where the State makes the tax treaty inoperative by amending the domestic law meaning in such a way that it upsets the treaty balance (allocation of taxing rights) i.e. a State intentionally recovers taxing rights that it had surrendered to the other treaty partner when signing the tax treaty. By doing so, the State also breaches Art. 26 VCLT and Art. 27 VCLT (*see section 4.4.2*) [596]. This would also be the case when a State amends its domestic law in such a way that the taxpayer is subject to unresolved double taxation[597].

174. One commentator, after analysing several Dutch Court cases[598], convincingly concludes that the "*principle of good faith puts a limit on the reference to domestic law for the purpose of interpretation and application of a tax treaty and prevents a contracting State from eroding or evading its obligation under the treaty by subsequently amending in its domestic law the scope of terms not defined in the treaty, either by means of legal definition or otherwise. Such an erosion or evasion of treaty obligations under a guise of an interpretation in accordance with Article 3(2) is clearly dishonest, unfair and un reasonable and, therefore, contrary to the principle of good faith to be observed by the contracting States in the interpretation and application of the provisions of a tax treaty*"[599]. Another commentator classifies such posterior changes as a State abuse of tax treaty. He provides that "*State abuse of a tax treaty refers to situations in which one of the contracting States, through the subsequent exercise of its domestic powers of taxation, modifies the obligations previously assumed by that State with other States and upsets the balance in the division of taxing powers expressed in the*

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595 ENGELEN, Thesis, p. 490; DE BROE, Thesis, pp. 272-273; VAN DER BRUGGEN, Interpretation, pp. 145-146.

596 DE BROE, Thesis, pp. 272-273; WOUTERS, VIDAL, Abuse, p. 16.

597 VAN DER BRUGGEN, Interpretation, pp. 148-149. However, Vogel provides a dissenting view that "e*ven if reference to domestic law were to lead to double taxation or double non taxation, that fact alone cannot be taken as an argument in support of an interpretation which deviates from domestic law, though it is true that the treaty seeks to avoid double taxation and that interpretation avoiding double taxation should be preferred. But apart from the consideration that often several different interpretations can avoid double taxation – to the detriment of one or the other State – The OECD Member States, by adopting Art. 3(2) MC, accepted double taxation as a – possible – result subject to the mutual agreement procedure*". VOGEL, Commentary, p. 214.

598 ENGELEN, Thesis, pp. 491-502.

599 ENGELEN, Thesis, p. 501.

concluded tax treaty. By so doing, it fosters the development of abusive situations involving from the improper use of the double taxation treaties signed by that State and causing significant injury to the legitimate financial interests of the other contracting State"[600]. In his view such State abuses conflict with the "*pacta sunt servanda*" principle contained in Art. 26 VCLT. Moreover, such State abuses also conflict with Art. 27 VCLT[601]. The author agrees with this conclusion. A subsequent domestic law that distorts the tax treaty equilibrium can be acceptable at the domestic law level. However, such a distortion cannot be acceptable at an international law level as it conflicts with Art. 26/27 VCLT. Accordingly, the position adopted in this thesis that a State does not exercise its obligation in "*good faith*" when that State recaptures a taxing right that it had allocated to another State through a subsequent change in its domestic law. This would also be the case where a State amends its domestic law in such a way that the domestic provision leads to unresolved double taxation (especially juridical double taxation) which thereby defeats the "*object and purpose*" of a tax treaty[602].

[600] See the comments of Prof. Garcia in Document No. ST/SG/AC.8/2003/L.3, Para. 12.
[601] See Document No. ST/SG/AC.8/2003/L.3, Para. 24.
[602] VOGEL, Commentary, pp. 65-67.

PART V: THE INTERACTION OF DOMESTIC ANTI-AVOIDANCE RULES WITH TAX TREATIES

8. The view of international organizations on the interaction of domestic anti- avoidance rules with tax treaties

8.1. Preliminary remarks

175. Typically, a domestic anti-avoidance rule is applicable when a taxpayer enters into a transaction or arrangement that constitutes an abuse of domestic law or tax treaty provisions. To counteract the abuse, the tax authorities apply a judicial anti-avoidance doctrine, statutory GAAR or SAAR to the transaction. Thereafter, a taxpayer may invoke the treaty provisions (typically in litigation) to argue that a conflict arises with the domestic anti-avoidance rule and thus the latter should not be applicable. This approach respects the "*pacta sunt servanda*" principle. In the following sections, the approach of international organisations will be examined with respect to their position on whether a conflict arises between a domestic anti-avoidance rule and tax treaty.

8.2. The view of the international organizations

8.2.1. The OECD position: 1961 – 2003

8.2.1.1. Historical development of the 1977 OECD Commentary

176. In November 1961, the US delegation issued a note on tax avoidance achieved through tax treaties [603]. In this note, it was indicated that the avoidance of double taxation and prevention of tax avoidance/evasion are the main objectives of tax treaties. The note outlined the problem of international tax avoidance [604] and stated that such international tax

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[603] Document No. TFD/FC/135.

[604] The note provided the following two examples of international tax avoidance schemes "*For example, an enterprise of one contracting country may establish a corporate subsidiary in the other contracting country principally for the purpose of taking advantage of the interaction of domestic tax statutes and an income tax convention between the two countries in such a way as to reduce the aggregate of taxes paid to a level below that which would prevail if the activities were conducted entirely in either one*

arrangements provided unintended benefits to taxpayers. The US put forward its view that "*income tax conventions should be so constructed that they cannot be availed of to avoid legitimate tax burdens, that artificial transactions and business structures entered into or established to avoid legitimate tax burdens should be discouraged and prevented, and that international co-operation to this end is possible and necessary"* [605]. Thereafter, the US suggested that the FC create a WP, which would analyse the different types of international tax avoidance schemes and suggest treaty provisions that could be inserted into the OECD Model to curtail international tax avoidance. Similarly, in January 1962, the US delegation issued another note[606], which stated that in addition to suggesting provisions to tackle tax evasion (such as exchange of information); the proposed OECD Model should also deal with the problem of legal avoidance of tax achieved through abuse of tax treaties. Towards this end, the note recognized the problems governments faced with tax avoidance and recommended the FC "*consider provisions for inclusion in income tax conventions so as to prevent the use of such conventions for avoidance of tax burdens (even though no violation of law may be involved), and to discourage the use of artificial transactions and corporate structures"* [607].

177. Once again, the US urged the FC to set up a WP which would analyse the different types of international tax avoidance schemes and suggest treaty provisions which could be inserted into the upcoming OECD Model to curtail international tax avoidance. In light of these two notes, the FC constituted WP 21, which comprised of the US and Denmark, to "*consider whether, and to what extent, tax avoidance problems have developed through the abuse of tax conventions between Member States and whether the benefits of a Convention should and can be denied to certain entities situated in the territories of the signatories to a convention or in the territories of third countries in order to prevent such abuse"* [608]. Soon afterwards, WP 21 indicated to the FC that they would prepare a report and

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of the countries party to the convention. A further example is the establishment of a similar subsidiary by an enterprise of a third state in order to take advantage of the treaty between the two contracting states". *Ibid*., pp.1-2.

605 *Ibid*., p.2.

606 Document No. TFD/FC/136.

607 *Ibid*., p.2.

608 Document No. TFD/FC/141.

questionnaire on tax avoidance which would be circulated to all the member countries[609].

178. In January 1963, WP 21 came out with its 1st preliminary report[610] on tax avoidance. This note discussed the different types of international tax avoidance structures employed by taxpayers using tax treaties. Specifically, the report highlighted the problem of legitimate tax avoidance using tax treaties[611] through PEs, base companies and transfer mispricing. The report also offered tentative solutions to the issue at stake. The FC discussed this report during two sessions i.e. one in the same month[612] and one in March 1963[613]. The main focus of the discussions seems to have been on the issue of defining abuse and counteracting base companies.

179. Nevertheless, the question of the interaction of domestic anti-avoidance rules with tax treaties was discussed too. In this respect, the Swiss delegate discussed the 1962 Abuse Decree[614] – and stated that this unilateral measure could strike down legitimate tax treaty abuse. In contrast, the German delegate raised the question as to whether it was necessary to insert a specific clause in a tax treaty to the effect that none of its articles prevented a State from applying domestic anti-avoidance measures (such as the 1962 Abuse Decree) to counteract tax treaty abuse. On a more generic basis, the Austrian delegate queried the extent to which the domestic law could set aside the provisions of existing tax treaties and what position was to be taken in such a case by the other Contracting State. The US delegate thought that a bilateral solution was necessary and proposed to devise a treaty article which would target abuse. The chairman of the FC, however, pointed out that it was too late to have such an article included in the upcoming draft 1963 OECD model and thus directed WP 21 to consider these issues in the next version of its preliminary report. This conclusion was reflected in the

609 See the minutes of the 4th & 6th session of the FC in Document No. FC/M (62) 3A and FC/M (62) 3B.

610 Document No. FC/WP 21 (63) 1.

611 *Ibid*., Paras. 5-12.

612 Document No. FC/M (63) 2.

613 Document No. FC/M (63) 3.

614 The 1962 Abuse Decree was enacted by Switzerland to tackle improper use of Swiss tax treaties by foreign taxpayers which utilized Swiss interposed companies to derive certain types of foreign income. It aims to safeguard the interest of Switzerland's treaty partners when they are the source State of the income and Switzerland the residence State of the person claiming treaty relief. JUNG, Tax Avoidance, p. 777.

commentary to the draft 1963 OECD Model which provides that the FC "*has recently brought under study the question of the improper use of double taxation Conventions and of the fiscal evasion which can result from the interaction of the Conventions and the domestic laws. The problems which may arise in this respect between two countries often involve third countries. Consequently the Fiscal Committee wishes to see how far it would be necessary to provide bilateral or multilateral solutions to this question*"[615].

180. In February 1965, WP 21 came out with its 2nd report on tax avoidance[616]. The 2nd report seems to be substantially similar to the 1st report. The FC discussed this report during its session in March 1965[617]. From an analysis of the minutes, it can be ascertained that the delegates for Austria and Spain raised the issue on the interaction of domestic anti-avoidance measures with tax treaties. However, these two delegates seem to have equated tax evasion to tax avoidance. They stated that the tax evasion was a matter to be dealt with under domestic law but nonetheless WP 21 should undertake a detailed analysis of the domestic anti-avoidance measures available to counter tax evasion. The US delegate picked up this discussion and highlighted that WP 21 needed to ascertain more information regarding domestic anti-avoidance measures targeting base companies and tax abuses. Thereafter, in the same year, WP 21 came out with its questionnaire titled "*Suggested Questions to Facilitate Summary of National Legislation Dealing with Tax Abuse Cases*" [618]. The purpose of this questionnaire was to gather information on the various domestic anti-avoidance measures[619] applied in the member countries of the FC to counter profit shifting[620] through base companies. The member countries of the FC gave their responses to this questionnaire during the period April 1965 to September 1966[621].

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615 1963 OECD Comm. Implementation of the Draft Convention, Para. 54.

616 Document No. FC/WP 21 (65) 1. This document is not publicly available. The author would like to thank Prof Richard Vann who passed on this document to the author via Angelo Nikolakakis.

617 Document No. FC/M (65) 1, 1965. This document is not publically available. The author would like to thank Prof Richard Vann who passed on this document to the author via Angelo Nikolakakis.

618 Document No. TFD/FC/183.

619 *Ibid*., Paras. 1-2.

620 *Ibid*., Para. 3.

621 The responses of the member countries can be found in the ten addendums to the Document No. TFD/FC/184.

181. Subsequently, in 1967, WP 21 came out with its 3rd report[622] on tax avoidance through the improper use of tax treaties and an annexure to it, which summarized the responses of the Member States to the previously issued questionnaire (in 1965). At the outset, the report discusses international tax avoidance techniques through the transfer of fiscal domicile (residence)[623]. Then, the report focused on international tax avoidance techniques achieved via tax treaties. Specifically, the report explained tax avoidance achieved through the creation of PEs in low tax countries by residents of high tax countries (particularly those which operate exemption systems)[624]. Afterwards, the report focused on tax advantages achieved through foreign subsidiaries i.e. base company income vis-à-vis interest, royalties, dividend and personal services income[625]. The report also addressed the issue of tax treaty exploitation by residents of third countries[626]. Finally the report provided possible solutions to counteract international tax avoidance techniques. With respect to base companies, the report suggested that base companies should be excluded from tax treaty benefits either i) by modifying the definition of the term "*company*" as found in Art. 3 of the 1963 OECD Model so as to exclude base companies and preserve source State taxation or ii) by the residence State which is adversely affected by the foreign base company modifying its internal law (and tax treaty) in order to treat the foreign base company as branch so that the affected state can immediately tax the income sheltered overseas[627]. However, these two solutions were criticized on several technical[628] and administrative grounds[629].

182. As stated earlier, the annexure to this report summarized the responses of the member states to the previously issued questionnaire. In this respect, four countries (out of the twenty) i.e. Belgium, Sweden, the UK and the US had submitted that a SAAR existed in the domestic tax law, which is aimed at tackling base companies[630]. Additionally, it was submitted by all countries (except Ireland) that the issue of base companies could be tackled by

622 Document No. FC/WP 21 (67) 1.
623 *Ibid*., Paras. 6-13.
624 *Ibid*., Paras. 16-21.
625 *Ibid*., Paras. 22-28.
626 *Ibid*., Paras. 29-30.
627 *Ibid*., Paras. 31-40.
628 *Ibid*., Paras. 41-42.
629 *Ibid*., Paras. 43-44.
630 *Ibid*., Annex, Paras. 1-6.

statutory GAARs under which the "*real, not technical, legal, relationships are relevant for tax purposes*" or specific TP type rules[631]. An analysis of this report indicates that, even though there was considerable information on the various domestic anti-avoidance measures that could be used to counteract tax avoidance via base companies, WP 21 was searching for a solution at the treaty level that could be inserted into the 1977 OECD Model. The WP wished to draft a treaty provision that would deny treaty benefits in abusive situations but thought that it was preferable to await the FC's discussion of the 3rd report"[632].

183. The FC discussed the 3rd report during its two sessions in 1969. During the February session[633], the delegate for the UK proposed a solution at the tax treaty level by providing that "*the attempt to define "base companies" and placing them outside the scope of the benefits of double taxation Conventions should be supplemented by other provisions such as: (i) Having a provision in Conventions to enable a country to tax where it considered its residents were setting up companies with the sole purpose of avoiding the tax of that country"* [634]. In contrast, the delegate for France raised the question of whether it was the tax treaties or the domestic law, which should be amended to obviate abuse[635]. During the October session[636], the UK delegate, once again, indicated that the draft 1963 OECD Model should be modified to include an anti-avoidance provision "*so that a country was not compelled to give up its taxing rights in cases where abuse"*[637] of tax treaties had occurred. The delegate for Switzerland indicated that "*his country was also in favor of acting against genuine abuse, both unilaterally and in bilateral conventions"*[638]. In a nutshell, the discussion by the UK delegate shows that he favoured the inclusion of an "*abuse*" provision in the tax treaty to counter tax avoidance schemes. The question from the French delegate clearly shows that there was confusion as to whether a treaty provision or domestic provision could be used to tackle cases of tax treaty abuse. Finally, the Swiss delegates comment implies that Switzerland was in favour of

631 *Ibid*., Annex, Paras. 7-9.
632 *Ibid*., Para. 45.
633 Document No. DAF/FC/ 69.5.
634 *Ibid*., p. 3.
635 *Ibid*., p. 4.
636 Document No. DAF/FC/ 69.13.
637 *Ibid*., p. 6.
638 *Ibid*., p. 6.

countering treaty abuse via domestic anti-avoidance measures or by inserting specific provisions in tax treaties.

184. Silence then followed for a number of years and WP 21 (with the addition of Germany) resurfaced in 1975 with its 4th report[639] on tax avoidance through the improper use of tax treaties. In light of the previous reports, WP 21 submitted that tax avoidance through PEs no longer poses a serious problem of treaty abuse as opposed to foreign subsidiaries[640]. Thus, the focus of this report was once again the issue of base companies. The report suggested that the issue of base companies could be solved by ensuring that the source States should not reduce withholding rates on dividend, interest or royalty payments made to a base companies residing in a treaty state that imposes a tax below some acceptable norm[641]. Once again, WP 21 proposed to find a solution at the treaty level i.e. inserting a specific provision in the tax treaty instead of finding a solution at the domestic level. A detailed discussion of this report is not available[642]. Finally, the draft commentary on Art. 1 to the 1977 OECD Model[643] indicated that the commentary on abuse of tax conventions would be circulated separately.

185. Based on an analysis of the aforementioned documents the following conclusions can be drawn. Firstly, it is apparent that the OECD attempted to carry out detailed research in relation to international tax avoidance via tax treaties. On several occasions it was stated that the objective of a tax treaty is not only to prevent tax evasion but that it also objective also extends to combat tax avoidance. Secondly, WP 21 did conduct a survey of the domestic anti-avoidance measures that were available in the Member States to counteract abusive situations – particularly those involving the creation of foreign base companies. However, WP 21 never undertook an analysis of whether the domestic anti-avoidance measures were in harmony or lead to a conflict with tax treaties. The delegates in the FC seem to have raised this issue but it was never analyzed by the working party. Instead, WP 21 seemed to have searched for common solution at the treaty level. An analysis of the reports on tax avoidance shows that WP 21 wanted to suggest a draft

639 Document No. CFA/WP1 (75) 3.
640 *Ibid*., Paras. 14-20.
641 *Ibid*., Paras. 21-26.
642 Document No. DAF/CFA/WP1/ 76.1 only provides that WP had only "*a general discussion on the areas covered in the report*".
643 Document No. DAF/CFA/WP1/ 76.19.

provision that could be inserted into a tax treaty or that it wanted to suggest certain amendments to draft 1963 OECD model to combat tax avoidance, that primarily arises through base companies. Thirdly, as the drafters did not come out with any concrete discussion on the interaction with domestic anti-avoidance measures with tax treaties, it can be concluded that the OECD did not take a position with respect to the issue at stake. To summarize, in the author's view, the drafters to the 1977 OECD Model analysed the issue of tax avoidance through tax treaties in a sporadic manner and there was a clear lack of in-depth research.

8.2.1.2. The 1977 OECD Commentary on Art. 1

186. The conclusion in the aforementioned section is appropriately reflected in the Commentary to the 1977 OECD Model which states that "*The Committee on Fiscal Affairs has examined the question of the improper use of double taxation conventions but, in view of the complexity of the problem, it has limited itself, for the time being, to discussing the problem briefly in the Commentary on Article 1 and to settling a certain number of special cases…The Committee intends to make an in-depth study of such problems and of other ways of dealing with them*"[644]. Accordingly, the 1977 OECD Commentary on Art. 1, under the section improper use of double tax conventions, reflected the indeterminate conclusions of the WP 21.

187. In Para 7, the Commentary stated that the purpose of tax treaties is "*to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons"*[645]. It was also stated "*they should not, however, help tax avoidance or evasion"* [646]. The Commentary also provided that, double taxation conventions left aside, taxpayers "*have the possibility… to exploit the differences in tax levels as between States and the tax advantages provided by various countries' taxation laws, but it is for the States concerned to adopt provisions in their domestic laws to counter possible manoeuvres"* [647]. Moreover, the Commentary, then, provided that "*Such States will then wish, in their*

644 1977 OECD Comm. Introduction, Para. 31.
645 1977 OECD Comm. Art. 1, Para. 7 – 1st sentence.
646 1977 OECD Comm. Art. 1, Para. 7 – 1st sentence.
647 1977 OECD Comm. Art. 1, Para. 7 – 2nd sentence.

bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws"[648].

188. In Para 8, the Commentary provided that taxpayer's can exploit tax treaties "*through the creation of usually artificial legal constructions, to benefit both from the tax advantages available under certain domestic laws and the reliefs from tax provided for in double taxation conventions"*[649]. To illustrate the mechanism through which taxpayers exploit tax treaties, the Commentary provided two examples in Para 9 viz., "*a person (whether or not a resident of a Contracting State), acted through a legal entity created in a State essentially to obtain treaty benefits which would not be available directly to such person. Another case would be one of an individual having in a Contracting State both his permanent home and all his economic interests, including a substantial participation in a company of that State, and who, essentially in order to sell the participation and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 4 of Article 13), transferred his permanent home to the other Contracting State, where such gains were subject to little or no tax"*[650]. Finally, the Commentary, after discussing the various measures available in a tax treaty to combat tax treaty exploitation by taxpayers (such as the beneficial ownership clause in Art. 10, Art. 11 & Art. 12 and Art. 17(2) for Artist Companies), reinstates in Para 10 that "*It may be appropriate for Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention"*[651]. Consequently, the Commentary, once again, suggested that states adopt specific provisions in tax treaties for applying domestic anti-avoidance rules.

189. Some commentators[652] have considered the statements made in Para 7 and Para 10 of the OECD Commentary to mean that domestic anti-avoidance rules can be given effect at the tax treaty level only if a specific provision allowing the use of such rules is incorporated in tax treaties. The author

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[648] 1977 OECD Comm. Art. 1, Para. 7 – 3rd sentence.
[649] 1977 OECD Comm. Art. 1, Para. 8.
[650] 1977 OECD Comm. Art. 1, Para. 9.
[651] 1977 OECD Comm. Art. 1, Para. 10.
[652] ARNOLD, 2003 changes, pp. 245-246; WARD, OECD, p. 101; MATTEOTTI, 2003 changes, pp. 340-341; DE BROE, Thesis, p. 401.

agrees that a plain reading of Para 7 and 10 would lead to such a conclusion. However, when the OECD Commentary on Art. 1 is read in light of the drafting period of the 1977 OECD Commentary, it is submitted that the OECD did not strongly imply that if a tax treaty lacks a specific provision on a domestic anti-avoidance rule then that domestic anti-avoidance rule cannot be applied to the tax treaty. From an analysis of the historical documents, it is clear that the OECD never made any firm statement on the interaction of domestic anti-avoidance measures with tax treaties. Accordingly, in the author's view, the OECD's suggestion should not be read in a literal manner as such a position is not correct[653].

8.2.1.3. The 1986 Base Companies Report

190. In the 1986 Base Companies Report (hereafter "1986 BC Report"), the OECD dealt with the issue of base companies from the perspective of the State of the shareholder of the base company (the base company being located in another State). At the outset, in the report, the OECD stated "*The main issue dealt with in this report is the compatibility of domestic anti-abuse measures with, and their consequences for, the existing system of international tax relations"*[654]. Accordingly, it can be ascertained that this report was the first time that the OECD had discussed the issue at stake and the issues discussed by the OECD, even though discussed in the context of base companies, were not strictly confined to such companies as is suggested by some commentators[655]. The report provided that the State of residence of the shareholder could counteract tax avoidance through base companies by general surveillance measures viz., TP and procedural rules[656], *substance over form provisions*[657] and specific Sub Part F type provision i.e. CFC legislation[658].

191. With respect to the "*substance over form*" provisions, the OECD, indeed, recognizes that States combat tax avoidance transactions via base companies through the application of "*general legal provisions and/or case*

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653 MARTIN JIMENEZ, Anti Abuse – I, p. 550; MARTIN JIMENEZ, 2003 changes, p. 18.
654 OECD, Base Companies report, Para. 4.
655 DE BROE, Thesis, p. 380; MARTIN JIMENEZ, Anti Abuse – I, p. 548.
656 OECD, Base Companies report, Para. 20.
657 OECD, Base Companies report, Paras. 21-22. For a discussion on "*substance over form provisions*" see OECD, Tax Havens Report, Paras. 52-54 & Paras. 81-85.
658 OECD, Base Companies report, Paras. 23-26.

law which permit the application of substance over form" [659] principles. The report states that, firstly, such rules may disregard the legal personality of the base company by not treating it as a "*person*" for the purpose of Article 3(1)(a) of the 1977 OECD Model. However it is then provided that a base company cannot be disregarded as a "*person*" for the purpose of a tax treaty if it is legally constituted[660]. Secondly, domestic general anti-avoidance rules could deem the base company to be a "*resident*" of the State of the shareholder by arguing that the POEM is located in the latter State for the purposes of Art. 4(1) of the 1977 OECD Model. However, if it is proved that the POEM of the base company is located outside the State of the shareholder (i.e. State of the base company) then such a deeming provision would not apply, as the provisions of the treaty would prevail[661]. Thirdly, even though the POEM is situated in the country of the base company, such rules may contend that the base company has a PE in the State of the shareholder by arguing that a place of management exists for the purpose of Art. 5(2) of the 1977 OECD Model. In response, it is argued that it is difficult to prove the existence of a PE if the conditions to trigger it are not satisfied (the list of conditions under Article 5(1)[662]. Lastly, it is argued that domestic general anti-abuse measures could attribute the activities/income of the base company to the shareholder even though the base company is legally constituted; it has its POEM in the country of the base company; and does not maintain a PE in the State of the shareholder[663]. With respect to the treaty implications of this outcome, the report raises the question "*as to whether, quite generally, domestic rules as to who is regarded as the recipient of specific income for tax purposes are compatible with treaties. This question especially arises in the case of "antiabuse" or "substance-over-form" rules according to which it is not the base company itself but its shareholder, who is regarded as the true recipient of the income shifted to the base company"*[664].

192. In response, the OECD expresses the view that "*The large majority of OECD Member countries consider that rules of this kind are part of the basic domestic rules set by national tax law for determining which facts give*

[659] OECD, Base Companies report, Para 22.
[660] OECD, Base Companies report, Para. 34.
[661] OECD, Base Companies report, Paras. 35-36.
[662] OECD, Base Companies report, Para. 37.
[663] OECD, Base Companies report, Paras. 34-40.
[664] OECD, Base Companies report, Para. 38.

rise to a tax liability. These rules are not addressed in tax treaties and are therefore not affected by them. One could invoke the spirit of the Convention, which would be violated only if a company, which is a person within the meaning of the Convention, ended up with no or almost no activity and/or income being attributed to it, and the Contracting States took divergent views on the subject, with economic double taxation resulting therefrom, the same income being taxed twice in the hands of two different taxpayers (cf. Article 9, paragraph 2). A dissenting view, on the other hand, holds that such rules are subject to the general provisions of tax treaties against double taxation, especially where the treaty itself contains provisions aimed at counteracting its improper use"[665].

193. Further, the report states, "*It is not easy to reconcile these divergent opinions in theory, nor in mutual agreement procedures on specific cases. The main problem seems to be whether or not general principles such as "substance-over-form" are inherent in treaty provisions, i.e. whether they can be applied in any case, or only to the extent they are expressly mentioned in bilateral conventions. On the dissenting view, to give domestic rules precedence over treaty rules as to whom, for tax purposes, is regarded as the recipient would erode the protection of taxpayers against double taxation (e.g. where by applying these rules, base company income is taxed in the country of the shareholders even though there is no permanent establishment of the base company there). However, it is the view of the wide majority that such rules, and the underlying principles, do not have to be confirmed in the text of the convention to be applicable"*[666]. In essence, the OECD provides that as the majority of the OECD member countries consider that domestic "*substance over form*" provisions (to the extent that they determine which facts give rise to a tax liability eg. who is the recipient of income) do not conflict with tax treaties. Further, such rules need not be preserved in tax treaties to be applicable. However, at the same time the OECD also expresses the view of the minority [667]. By using the aforementioned argument (and technical and policy related arguments), it is also clarified that domestic CFC legislation does not conflict with tax treaties (*see section 18.3*).

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[665] OECD, Base Companies report, Para. 39.

[666] OECD, Base Companies report, Para. 40.

[667] DE BROE, Thesis, p. 378; MARTIN JIMENEZ, Anti Abuse – I, p. 548; ARNOLD, 2003 changes, p. 246; MATTEOTTI, 2003 changes, p. 340.

194. Thereafter, the OECD concludes the discussion by providing that "*Tax treaties set limitations to technical rules though these limits are not very well defined. Furthermore, there are certain doubts as to their implications for the "substance-over-form" provisions. This adds to the well-known practical difficulties of implementing national provisions of this type. Further clarification therefore seems to be necessary. In any case, where States feel that difficulties might arise in this area, they would try to settle them by inserting specific safeguards in their bilateral treaties…A certain danger remains that technical and "substance-over-form" provisions could lead to double taxation even where a convention exists. Therefore, States applying provisions of this type should endeavour to alleviate any such double taxation in accordance with the letter and if possible with the spirit of their double taxation treaties"*[668]. Switzerland was the only country that made an observation to the OECD's statements by disagreeing with the conclusion of the OECD. It was observed that "a*s divergences of view exist as to what extent some provisions…are contrary to the 1977 OECD Model Convention…legal provisions of that kind should not be implemented without prior consultation of partner countries; the latter's interests should then be taken into consideration"*[669].

195. In the author's view, even though the OECD expresses the view of the majority and minority, the aforementioned statements indicate that it did not take a firm stance with respect to the compatibility issue[670]. Nonetheless, it is submitted that by 1986, a large majority of OECD member countries clearly believed that the provisions of a tax treaty could not prevent the application of judicial doctrines or statutory GAARs to the extent that such rules determined the facts which gave rise to a tax liability (e.g. determined the recipient of income for tax purposes)[671] as such decisions are not taken by tax treaties.

8.2.1.4. The 1986 Conduit Companies Report

196. In the 1986 Conduit Companies Report (hereafter the "1986 CC Report"), the OECD deals with the issue of conduit companies from the perspective of the source State i.e. the State from which the conduit

668 OECD, Base Companies report, Paras. 41-42.
669 OECD, Base Companies report, Para. 96.
670 OECD, Base Companies report, Paras. 92-93.
671 ELLIFFE, 2003 Commentary, p. 330.

company receives its income (the conduit company being located in another state). One commentator has suggested that the OECD took a different position in its report than the one it expressed in the 1986 BC report in relation to the interaction of domestic anti-avoidance rules with tax treaties[672]. He quotes the following passage from the 1986 CC report "*Existing conventions may have clauses with safeguards against the improper use of their provisions. Where no such provisions exist, treaty benefits will have to be granted under the principle of "pacta sunt servanda" even if considered to be improper"*[673] in support of his conclusion that the OECD view was that specific provisions had to be inserted in tax treaties to allow the application of domestic anti-avoidance rules.

197. However, in the author's opinion that view is not correct, as that commentator did not take into consideration the subsequent paragraphs of the report, which dealt with handling artificial tax avoidance. The 1986 CC report provided that "*A State may wish to protect itself against "abuse of law" by applying the general provisions in its domestic laws: it will then deny the benefits of the convention to income paid by a resident of that State to a company situated in the other State when it has reasons to suspect an improper use of the convention"*[674]. The case in the quoted paragraph pertains to a situation where the source State uses its domestic general anti abuse rule (e.g. abuse of law) to deny treaty access to a taxpayer even though the taxpayer qualifies as a "*person*", "*resident*" and "*beneficial owner*" of the income as it suspects improper use. This case is different from the case discussed previously (*see section 8.2.1.3*), in the sense that, the source State simply denies treaty benefits after ascertaining all the facts as opposed to determining the facts which give rise to a tax liability (the source State does not determine the recipient of the income for tax purposes pursuant to its domestic general anti-abuse rules). Accordingly, the OECD did not reverse its position, rather it analysed another outcome/effect of the domestic general anti-abuse rule.

198. The report went on to debate "th*e question arises as to whether the denial of treaty benefits in such cases is compatible with treaty obligations. This relates to the issue of the priority accorded to international law in relation to domestic law, a matter on which opinions differ among States,*

672 DE BROE, Thesis, p. 378.
673 OECD, Conduit Companies report, Para. 43.
674 OECD, Conduit Companies report, Para. 44 a).

some taking the view that where the beneficiary of the income fulfils the conditions set in the convention (beneficial ownership, residence), the provisions of the convention should apply, notwithstanding the domestic provisions of the State of source…others taking the contrary view"[675]. In the author's opinion, the OECD, once again, expresses different views without reaching a conclusion as to which view is correct. Nevertheless, in the context of stepping stone structures[676], the OECD provides that such complex arrangements may be countered by recourse to the principle of *"substance over form"*[677]. This implies that the source State can counteract stepping stone structures by re-determining the taxpayer to whom the income is allocated (as the facts pursuant to the application of the domestic general anti-abuse rules will suggest that the taxpayer in the State of the shareholder is the true recipient of income as opposed to the conduit companies) and not by denying treaty benefits.

8.2.1.5. The 1992 OECD Commentary on Art. 1

199. Changes were made to the 1992 OECD Commentary to reflect the conclusions in the aforementioned reports. The Commentary on Para 7-10 of the 1977 OECD Commentary was retained verbatim in the 1992 version. Para 7 continued to provide that domestic anti-avoidance measures had to be preserved in the text of a tax treaty in order to give them effect at the treaty level[678]. On the other hand, the ideas expressed by the OECD in the 1986 BC and 1986 CC Reports were added to the Commentary via Paras 11-26. In Para 11, the OECD stated that as a means to counter tax avoidance via conduit companies *"increasing number of Member countries implement treaty provisions (both general and specific) to counter abuse and to preserve anti-avoidance legislation in their domestic laws"*[679]. Further, Para 12-21 reproduced the conclusions of the 1986 CC Report[680].

200. Paras 22-26 reinstate the conclusions provided in the 1986 BC report. Para 22 provides that *"Other forms of abuse of tax treaties (e.g. the use of a base company) and of possible ways to deal with them such as "substance-over-form" rules and "sub-part F type" provisions have also been*

675 OECD, Conduit Companies report, Para. 44 a).
676 OECD, Conduit Companies report, Para. 4.
677 OECD, Conduit Companies report, Para. 45.
678 1992 OECD Comm. Art. 1, Para. 7.
679 1992 OECD Comm. Art. 1, Para. 11.
680 1992 OECD Comm. Art. 1, Para. 12-21.

analysed"[681]. Paras 23-24 reproduced the view of the majority and minority OECD Member States on the issue [682]. Para 25 provided that the counteracting measures discussed in the 1986 BC report and 1986 CC report do not violate the spirit of tax treaties. Further, it provided that if such measures lead to double taxation then a Member State should comply with the spirit of tax treaties and alleviate double taxation unless it suspects abuse[683]. Finally, Para 26 provided that domestic anti-abuse measures should not apply to taxpayers who were carrying out *bonafide business activities* (taxpayers undertaking proper business activities linked to the economic environment of the State in which the base/conduit company was set up) or who satisfied the comparable tax test (the taxes paid in the State of the base/conduit company were comparable to the State enforcing its domestic anti-abuse rule)[684].

201. The author makes the following comments on the OECD's approach from 1977 to 1992. Firstly, it has already been submitted that the view expressed by the OECD in Paras 7 and 10 of the 1977 OECD Commentary should not be read in a literal manner (see *section 8.2.1.2*). Secondly, the author submits that the first time that the OECD had a chance to discuss the interaction of domestic general anti-abuse measures with tax treaties was in the 1986 BC Report and 1986 CC Report. Two of the outcomes of such measures were tested against the provisions of tax treaties viz., redetermination of the taxpayer to whom the income is allocated for tax purposes and denial of treaty benefits after identifying the taxpayer to whom the income is allocated for tax purposes. However, the findings of the reports were inconclusive as divergent views were expressed. The inadequate conclusions of these 1986 Reports were directly incorporated in the 1992 OECD Commentary. On the one hand, the 1992 OECD Commentary provided that specific provisions had to be inserted in tax treaties to give effect to domestic anti-avoidance rules at the treaty level whereas on the other hand it provided that domestic judicial doctrines or statutory GAARs (even specific SAARs such as CFC rules), to the extent that they determined the facts which could give rise to a tax liability, could be applied to treaty situations irrespective of specific clauses being inserted in tax treaties. As no definitive position was not adopted, no countries entered an observation to

681 1992 OECD Comm. Art. 1, Para. 22.
682 1992 OECD Comm. Art. 1, Para. 23-24.
683 1992 OECD Comm. Art. 1, Para. 25.
684 1992 OECD Comm. Art. 1, Para. 26.

the Commentary[685]. Consequently, several commentators expressed the opinion that the 1992 OECD Commentary was rather confusing and unsatisfactory[686]. The author subscribes to that position.

8.2.1.6. The 1998 Harmful Tax Competition Report

202. The 1998 Harmful Tax Competition report (hereafter "1998 HTC report") also confirmed that there was ambiguity in the position adopted in the 1992 OECD Commentary. Among various recommendations, the 1998 HTC Report recommended that the 1992 OECD Commentary be clarified to remove any uncertainty or ambiguity regarding the compatibility of domestic anti-abuse measures with the provisions of the tax treaties[687]. To elaborate, the report provided that the domestic law of several countries contains domestic anti-abuse rules such as CFCs and judicial doctrines such as sham, alter ego and business purpose doctrines. Further, the report raised the question as to whether such "*domestic anti-abuse rules and judicial doctrines are compatible with tax treaties. For instance, where a transaction is ignored or re-characterised under domestic anti-avoidance rules or doctrines, the issue is whether such re-characterisation can be applied for purposes of the provisions of a tax treaty without resulting in a treaty override*"[688]. Once again, the OECD discussed the compatibility of domestic anti-avoidance rules, which re-characterize a transaction with tax treaties. In response, the report expresses the view that such domestic measures are generally compatible with tax treaties[689]. However, the report stressed that a clarification was necessary, as it would help ensure that this outcome is achieved[690]. Surprisingly, even after the recommendation in the 1998 HTC report, the 2000 update to the OECD Commentary did not clarify the relationship between domestic anti-abuse rules and tax treaties[691]. Likewise, the 2002 Restricting Entitlement to Treaty Benefits report (hereafter the "2002 RETB report") did not comment on this issue either, though it,

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685 DE BROE, Thesis, p. 378; ARNOLD, VAN WEEGHEL, Abuse, p. 90; ARNOLD, 2003 changes, p. 246; MATTEOTTI, 2003 changes, p. 341.

686 DE BROE, Thesis, p. 379; ARNOLD, VAN WEEGHEL, Abuse, p. 90; ARNOLD, 2003 changes, p. 246; MARTIN JIMENEZ, Anti Abuse – II, p. 625; AIGNER, CFC, p. 29; LI, SANDLER, Abuse, p. 955.

687 OECD Competition report, Recommendation No. 10.

688 OECD Competition report, Para. 122.

689 OECD Competition report, Para. 123.

690 OECD Competition report, Para. 125.

691 MARTIN JIMENEZ, Anti Abuse – I, p. 549.

nevertheless proposed the inclusion and deletion of several paragraphs in the Commentary to Art. 1[692].

8.2.1.7. The 2003 OECD Commentary on Art. 1 (January 28th, 2003)

203. At the outset, Para 7 of the 2003 OECD Commentary was changed. The 2003 OECD Commentary provided that the principal purpose of tax treaties is "*to promote – by eliminating international double taxation – exchanges of goods and services and the movement of capital and persons*". It was further stated that the purpose of tax treaties is also to "*prevent tax avoidance and evasion*"[693]. In this context, it should be noted that the 1977/1992 OECD Commentary which prescribed that States should insert specific provisions in tax treaties to give effect to domestic anti-avoidance rules in treaty situations was deleted. Para 7.1 was added which noted that taxpayers may abuse the tax law of a State by exploiting differences between various countries laws. As a solution, the Commentary states that such abuses can be countered through domestic anti-avoidance rules. It is also stated that such States would not agree to enter into treaty provisions that foster abuse that would otherwise by prevented by domestic anti-avoidance rules[694]. Para 8-9 remained the same, even though minor drafting changes were made to them. Significant additions were made subsequently. Para 9.1 raised two fundamental questions. The first question is whether tax treaty benefits must be granted when transactions entered into by taxpayer's abuse the provisions of tax treaties and the second question is whether specific provisions or judicial doctrines of domestic law, that are intended to prevent abuse, conflict with tax treaties[695].

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[692] DE BROE, Thesis, p. 379; The report discusses issues only regarding "*a) using the concepts of place of effective management and permanent establishment to reduce benefits obtained under a tax convention b) the possible inclusion in the Model of various types of provisions aimed at ensuring that income sheltered from taxation through regimes constituting harmful tax competition do not inappropriately get the benefits of tax conventions c) possible ways of ensuring that, where a country that is a party to a tax convention introduces measures resulting in harmful tax competition after the conclusion of the tax convention, benefits of the convention are not inappropriately granted with respect to income covered by such measures; d) the clarification of the concept of beneficial ownership*". OECD, Treaty Entitlement report, Para. 24.

[693] 2003 OECD Comm. Art. 1, Para. 7.

[694] 2003 OECD Comm. Art. 1, Para. 7.1.

[695] 2003 OECD Comm. Art. 1, Para. 9.1.

204. In relation to the second question, the 2003 Commentary made a reference to Para 22 which stated "*other forms of abuse of tax treaties (e.g. the use of base company) and of possible ways to deal with them, including "substance-over-form", "economic substance" and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties, which is the second question mentioned in paragraph 9.1 above*". In response, it is stated in Para 22.1 "*Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict. For example, to the extent that the application of the rules referred to in paragraph 22 results in a recharacterisation of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes"*[696]. It was also stated in Para 22.2 "*Whilst these rules do not conflict with tax conventions, there is agreement that member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused".*

205. With respect to the first question, Para 9.2 provided that for many States the answer to the first question depends on the answer to the second question. Several States consider that taxes are ultimately levied through domestic law as restricted by tax treaties – as such an abuse of a tax treaty can be considered as an abuse of domestic law. Accordingly, for these States the issue then becomes whether the provisions of tax treaties may prevent the application of domestic anti-avoidance rules. In this regard the Commentary, by referring to the fact finding approach in Para 22.1 (*see margin no. 0*), provided that domestic anti-avoidance rules, in general, do not conflict with tax treaties"[697]. Thus, if a domestic anti-avoidance measure such as a substance-over-form, economic substance or general anti-abuse rule determines which facts give rise to a tax liability then to the extent that such a rule results in a re-characterization of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the tax treaty will be applied taking into account these changes[698].

696 2003 OECD Comm. Art. 1, Para. 22.1.
697 2003 OECD Comm. Art. 1, Para. 9.2.
698 2003 OECD Comm. Art. 1, Para. 23.

206. Furthermore, with respect to the first question, Para 9.3 provides that other States tackle abuse by considering tax treaty abuse to be independent of domestic law abuse. Such States "*consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties)"*[699].

207. The Commentary then concluded in Para 9.4 that the benefit of tax treaties should not be granted to arrangements that constitute an abuse of the treaty provisions[700]. The Commentary did not elaborate on what is an abusive arrangement. Nevertheless, in Para 9.5 it was stated it should not be "*lightly assumed*" that a taxpayer is entering into an abusive arrangement. The Commentary introduced a guiding principle, which provides for a conjunctive test to be satisfied. It was stated, "*A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements* (subjective element) *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"* (objective element)[701].

208. Para 9.6 then provides that "*the potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance"*[702]. It is also stated "*Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy. Also, this will be necessary where a State which adopts the view described in paragraph 9.2 above believes that its domestic law lacks the anti- avoidance rules or principles necessary to properly address such strategy*". This paragraph implicitly

699 2003 OECD Comm. Art. 1, Para. 9.3.
700 2003 OECD Comm. Art. 1, Para. 9.4.
701 2003 OECD Comm. Art. 1, Para. 9.5.
702 2003 OECD Comm. Art. 1, Para. 9.6.

introduces the OECD position on the relationship between domestic GAARs and treaty SAARs. It can be deducted that domestic GAARs and treaty SAARs can apply concurrently.

209. Six countries viz., Belgium, Ireland, Luxembourg, the Netherlands, Portugal and Switzerland recorded observations to the 2003 Commentary (four countries also made observation in regard to the CFC rules – *see section 18.3)*. These countries – with the exception of Belgium and Portugal – made observations more generally on the compatibility of domestic anti-avoidance rules with tax treaties. Ireland observed that the answer to the compatibility issue depends on the nature of the domestic law provision and the legal and constitutional relationship between domestic law and international law as applicable in the country[703]. Similarly, the Netherlands observed that the answer to the issue at stake would depend on the wording of the specific tax law provision, the wording and purpose of the relevant treaty article and the relationship between international and domestic law as applicable in a State[704]. Luxembourg rejected the application of Para 9.2 and 22.1 and observed that in the absence of any express provision in a tax treaty, domestic anti-abuse rules can only be applied by a State after recourse to the MAP[705]. Switzerland was the only country to record an observation on Para 7. The Swiss observed that they did not agree with the change that the purpose of tax treaties is to prevent tax avoidance and evasion and they considered that this purpose also conflicts with the title of the OECD Model. They further observed in relation to Para 22.1 that domestic tax rules must conform to the general provisions of tax conventions, especially when the treaty in question contains measures to prevent abuse.

8.2.2. The UN position: 1980 – 2011

8.2.2.1. The 1980 UN Commentary

210. The 1980 UN Commentary follows the same course as the 1977 OECD Commentary. This position is confirmed as the 1980 UN Commentary on Art. 1 provides that "*To limit the possible use of artificial legal manoeuvres designed to obtain the benefit of tax advantages which may be available under domestic laws and the tax reliefs provided for in*

[703] 2003 OECD Comm. Art. 1, Para. 27.5.
[704] 2003 OECD Comm. Art. 1, Para. 27.7.
[705] 2003 OECD Comm. Art. 1, Para. 27.6.

bilateral double taxation conventions, the United Nations Model Convention follows the same course as the OECD Model Convention. It introduces in its articles certain concepts such as that of "beneficial owner" (in Articles 10, 11 and 12) and special provisions, such as those for so-called artiste-companies (article 17, paragraph 2), which are also mentioned in the commentaries".

211. Further the Commentary states that "*It may be appropriate for potential Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention*". This means that the Commentary suggested that the UN member States negotiate and agree in tax treaties that their domestic anti-avoidance rules can be applied to treaty situations. Like the 1977 OECD Commentary, the 1980 UN Commentary seems to make a suggestion to the UN member States as opposed to strongly implying that if a tax treaty lacks a specific provision on a domestic anti-abuse rule then that domestic anti-abuse rule cannot be applied to a tax treaty.

8.2.2.2. The 2001-2011 work by the UN on improper use of treaties

212. The 2001 UN Commentary on Art. 1 followed the 1992 OECD Commentary verbatim[706]. This shows that prior to 2001, the UN had not undertaken any considerable work on the improper use of tax treaties. Subsequently, in June 2003, an eminent professor prepared a report on abuse of tax treaties and treaty shopping on behalf of the UN Secretariat[707]. His report only briefly discusses the issue on the interaction of domestic anti-abuse measures with tax treaties[708]. Nevertheless, it urged the Ad Hoc Group of Experts on International Cooperation in Tax Matters[709] (Group of Experts) to elaborate and discuss the amendments made to the 2003 OECD Commentary. Specifically, the report considered whether Paras 9.2-9.6 read

[706] 2001 UN Comm. Art. 1, Paras. 8-11.

[707] Document No. ST/SG/AC.8/2003/L.3.

[708] *Ibid*, Paras. 26-34.

[709] The Group was composed of tax officials and experts from both developing and developed countries, appointed in their personal capacity. It was created in 1968 and was called the "*Ad Hoc Group of Experts on Tax Treaties*". Subsequently, in 1980, the group was renamed to the "*Ad Hoc Group of Experts on International Cooperation in Tax Matters*". 2011 UN Comm. Introduction, Paras. 7-8.

in conjunction with Paras 22-26 of the 2003 OECD Commentary on Art. 1 should be introduced in the next version of UN Commentary[710].

213. This report was discussed during the 11th meeting of the Group of Experts[711]. During that meeting, some participants contended that there was no need to establish specific rules in a treaty and there was general consensus that domestic anti-abuse measures could be used to counter treaty abuse. However, other participants opposed this view and were concerned about the uncertainties that such a position might produce[712]. Thereafter, in November 2005, the Group of Experts (by then renamed as the Committee of Experts[713]) met again to discuss the issue of treaty abuse/treaty shopping and in particular the amendments made to the 2003 OECD Commentary on Art. 1[714]. In a nutshell, the Committee of Experts discussed the work of the OECD and tentatively concluded that the OECD's guiding principle applied mainly to judicial doctrines and statutory GAARs[715] and inserting specific SAARs in tax treaties might not be a satisfactory measure to counter treaty abuse[716].

214. Soon afterwards, pursuant to a meeting of the Committee of Experts[717], a subcommittee on improper use of tax treaties was appointed[718]. In October 2006, the subcommittee came out with its report on treaty abuse and treaty shopping[719]. The report discussed *i) the concept of treaty abuse and treaty shopping ii) various fact patterns of the abuse of tax treaties iii) applicability of domestic anti-abuse measures to treaty abuse cases and iv) treaty measures for preventing tax treaty abuse*[720]. With respect to point iii) the report acknowledges that tax treaty abuse can be counteracted by

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710 Document No. ST/SG/AC.8/2003/L.3, Paras. 31-32.
711 Document No. ST/SG/AC.8/2003/L.11, Paras. 21-29.
712 *Ibid*, Para. 27.
713 In 2005, the Ad Hoc Group of Experts was upgraded by conversion into a Committee structure. The Committee of Experts on International Cooperation in Tax Matters consist of 25 members nominated by UN countries and chosen by the Secretary-General of the UN to act in their personal capacities for a period of 4 years. 2011 UN Comm. Introduction, Para. 10.
714 Document No. E/C.18/2005/2.
715 *Ibid*, Para. 31.
716 *Ibid*, Paras. 18-22.
717 Document No. E/C.18/2005/11.
718 *Ibid*, Para. 37.
719 Document No. E/C.18/2006/2.
720 *Ibid*, Para. 7.

SAARs, statutory GAARs and judicial doctrines found in domestic tax law[721]. Then, the subcommittee provides that two schools of thought exist with respect to the issue of whether a domestic anti-abuse measures are applicable to a treaty abuse case[722].

215. The first school considers that if a domestic anti-avoidance rule leads to the reconsideration of the facts to which the domestic tax rule and the treaty rule applies then it is difficult to argue that the domestic rule is incompatible with tax treaties. This group, nevertheless, believes that if a domestic anti-abuse rule "*leads to a legal recharacterization of the situation or arrangement devised in order to commit treaty abuse, whether or not there is a unilateral breach of treaty obligations — with reference to the beneficiaries of the treaty — will depend on the impact of the recharacterization on the conditions governing the application and interpretation of the treaty. If the exemptions issue relates to the domestic tax rule then it cannot be argued that there are insuperable obstacles to the application of the recharacterizing domestic tax rule. However, if the recharacterization occurs first and gives rise to the application of a different treaty rule with different effects, the increased tax liability of the individual could be seen as a unilateral modification of the conditions governing the application of the treaty, thus contravening the pacta sunt servanda principle. In that event, the attempt by States to make domestic anti-abuse rule prevail over particular treaty obligations might succeed through the inclusion in the tax treaty itself of a safeguard clause authorizing the application of domestic tax rules*"[723].

216. The second group, on the other hand, follows the comments of the OECD in Paras 22, 22.1, 9.2 and 9.5 of the OECD Commentary. This group believes that the provisions of tax treaties will be applied only after taking into consideration the effects of the domestic anti-abuse rule. Thus, to the extent that the application of domestic GAARs results in a re-characterization of income or a redetermination of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes. Of course, this group will take into consideration the guiding principle to determine if abuse exists[724].

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721 *Ibid*, Paras. 79-87.
722 *Ibid*, Paras. 90-92.
723 *Ibid*, Para. 91.
724 *Ibid*, Para. 92.

Nevertheless, the subcommittee decided to discuss this issue comprehensively in its later reports[725]. The subcommittee came out with subsequent reports on improper use of tax treaties in October 2007[726] & October 2008[727]. These reports were finalized in June 2009. Thereafter, the conclusions reached in the various reports were inserted in the 2011 UN Commentary.

8.2.2.3. The 2011 UN Commentary

8.2.2.3.1. Domestic SAARs

217. In relation to the interaction of domestic SAARs with tax treaties it is stated that if a conflict arises then the provisions of the tax treaty prevail pursuant to Art. 26 of the VCLT. However, the Commentary notes that such a conflict will not arise if the treaty itself contains an express provision which authorizes the use of the domestic SAAR; if the treaty contains an undefined term and that term is then defined pursuant to a domestic SAAR as a result of Art. 3(2) or a provision which refers to the domestic law; or if treaty benefits are denied pursuant to the domestic SAAR and the proper interpretation of treaty approach[728]. With respect to the interpretation approach, the 2011 UN Commentary adopts the view expressed in the 2003 OECD Commentary on Para 9.3[729]. The UN Commentary also states that the guiding principle has to be satisfied to determine if abuse arises under this approach[730].

8.2.2.3.2. Domestic statutory GAARs

218. In relation to the interaction of domestic statutory GAAR's with tax treaties, the 2011 UN Commentary adopts the view expressed in the 2003 OECD Commentary[731]. The UN Commentary does not discuss the question of what constitutes an abuse of a tax treaty but accepts the OECD guiding principle[732] to determine if tax treaty abuse exists. Furthermore, it seems that

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[725] *Ibid*, Para. 93.
[726] Document No. E/C.18/2007/CRP. 2.
[727] Document No. E/C.18/2008/CRP. 2.
[728] 2011 UN Comm. Art. 1, Paras. 16-19.
[729] 2011 UN Comm. Art. 1, Para. 38
[730] 2011 UN Comm. Art. 1, Para. 39.
[731] 2011 UN Comm. Art. 1, Para. 21.
[732] 2011 UN Comm. Art. 1, Paras. 22-24.

the UN Commentary provides certain guidance to check if the first element of the guiding principle (a main purpose test) is satisfied or not. The Commentary states that "*the determination of whether a main purpose for entering into transactions or arrangements is to obtain tax advantages should be based on an objective determination, based on all the relevant facts and circumstances, of whether, without these tax advantages, a reasonable taxpayer would have entered into the same transactions or arrangements*"[733]. Thus, in order for this test to be satisfied, it has to be checked if a reasonable taxpayer would have entered into a similar arrangement absent such tax advantages. No such guidance is provided for the second element of the guiding principle.

8.2.2.3.3. Domestic judicial doctrines

219. In relation to the interaction of domestic judicial doctrines (business purpose, substance over form, economic substance, step transaction, abuse of law and fraus legis approaches) with tax treaties, the 2011 UN Commentary notes that such judicial doctrines vary from country to country[734]. Further, it is stated that "*while the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the Vienna Convention on the Law of Treaties, nothing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties*". As an example, the Commentary provides that if "*the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach to be adopted with respect to the application of the provisions of a tax treaty to similar transactions*"[735]. Accordingly, the Commentary takes the view that judicial doctrines (which are interpretational principles) do not conflict with tax treaties.

8.2.2.3.4. Proper interpretation of tax treaty provisions

220. With respect to combating treaty abuse via a proper interpretation of the treaty provisions, the 2011 UN Commentary states that "*Another approach that has been used to counter improper uses of treaties has been to*

[733] 2011 UN Comm. Art. 1, Para. 27.
[734] 2011 UN Comm. Art. 1, Para. 28.
[735] 2011 UN Comm. Art. 1, Para. 30.

consider that there can be abuses of the treaty itself and to disregard abusive transactions under a proper interpretation of the relevant treaty provisions that takes account of their context, the treaty's object and purpose as well as the obligation to interpret these provisions in good faith". The Commentary once more, adopts the view expressed in the 2003 OECD Commentary on Para 9.3[736]. The Commentary also states that the guiding principle is relevant for the purposes of the application of this approach[737].

221. It should be noted that as per the 2011 UN Commentary, the outcome arrived at after applying the statutory GAAR or the outcome arrived at after a proper interpretation of a tax treaty needs to be tested with the guiding principle. The outcome arrived at after applying domestic judicial doctrines need not be tested with the guiding principle. This clearly contrasts with the view of the OECD that provides that judicial doctrines have to be applied having regard to the guiding principle.

8.2.3. The OECD BEPS Project and Action 6 of the BEPS plan

8.2.3.1. Preliminary remarks

222. In February 2013, the OECD released its report on Addressing BEPS[738]. Subsequently, in July 2013, the OECD released its 15-point Action Plan to address BEPS[739]. In this plan, treaty abuse (among other action), in particular, treaty shopping was considered to be one of the most important sources of BEPS concerns. Accordingly, Action 6 was dedicated to prevent treaty abuse. Thereafter, in March 2014, the OECD released its discussion draft on Action 6[740]. Following a two-day public consultation in April the OECD released its report on treaty abuse as part of its seven deliverables due in September 2014[741]. It is clearly indicated that the recommendations made in the report are at a draft stage and further refinement is necessary[742]. Moreover, in November 2014, the OECD released a follow up report to

736 2011 UN Comm. Art. 1, Para. 38.
737 2011 UN Comm. Art. 1, Para. 39.
738 2013 OECD, Addressing BEPS.
739 2013 OECD, BEPS Action Plan, pp. 18-19.
740 2014 OECD, Discussion Draft on Treaty Abuse.
741 2014 OECD, Report on Treaty Abuse.
742 *Ibid*., Para. 5.

address issues, primarily, those dealing with the LOB clause and the PPT rule [743]. The final deliverable was then released in October 2015[744].

223. In order to determine the best way to prevent the granting of treaty benefits in inappropriate circumstances, the reports (the 2014 TTA report and 2015 Final TTA report – hereafter references will be made to both reports as "reports") distinguishes between two types of situations. The first situation deals with cases where a taxpayer tries to avoid restrictions provided by the treaty itself, for example, by engaging in treaty shopping or rule shopping[745]. The second situation deals with cases where a person tries to avoid the provisions of domestic tax law[746] using treaty benefits, for example, by arguing that the provisions of tax treaties preclude the application of domestic anti-avoidance rules[747] (the two situations resemble the two questions raised in the 2003 OECD Commentary on Art. 1 – Para. 9.1). For the former the report mainly suggests treaty anti-abuse rules whereas for the latter clarificatory comments are provided.

8.2.3.2. Treaty measures (LOB clause, PPT rule and other SAARs)

224. At the outset, the reports suggest a three-prong approach to counter abuse of treaty provisions, in particular, treaty shopping[748]. Firstly, the title and preamble of tax treaties is modified to clearly include a statement to the effect that when States enter into tax treaties their intention is not to create opportunity for tax avoidance or evasion including treaty-shopping arrangements (*see section 9.2.3*). Secondly, the report proposes the inclusion of a treaty SAAR in line with the US style LOB clause in tax treaties. Thirdly, a treaty GAAR in the form of a principal purpose test (PPT), which resembles the guiding principle, is proposed.

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[743] 2014 OECD, Follow up work on BEPS Action 6.

[744] 2015 OECD, Final Report on Treaty Abuse.

[745] The object of abuse in these situations is the provisions of the tax treaty. See DE BROE, LUTS, BEPS, p. 125.

[746] The object of abuse in these situations are the provisions of the domestic law. The treaty is used subsequently to neutralize the application of the domestic anti-avoidance rule. See DE BROE, LUTS, BEPS, p. 125.

[747] 2014 OECD, Report on Treaty Abuse, Para. 7; 2015 OECD, Final Report on Treaty Abuse, Para. 15.

[748] 2014 OECD, Report on Treaty Abuse, Para. 11; 2015 OECD, Final Report on Treaty Abuse, Para. 19.

225. The objective of the proposed LOB clause is to ensure that treaty protection is granted to resident taxpayers that i) carry out genuine business activities ii) have sufficient nexus to their State of residence and iii) have genuine motives[749]. Art. X, in the 2015 Final TTA Report, contains six paragraphs (the last providing "*definitions*")[750]. These paragraphs provide a series of alternative tests. Resident taxpayers need to satisfy at least one of these tests in order to be entitled to treaty benefits.

226. To elaborate, Art. X(1) (*detailed version*) provides that treaty benefits will be denied to a resident taxpayer who does not fall within the definition of a "*qualified person*"[751] unless the benefits are granted under Art. X(3), Art. X(4) or Art. X(5). Art. X(2) (*detailed version*) discusses the situations in which a resident taxpayer is deemed to be a "*qualified person*"[752]. Essentially, a "*qualified person*" for the purposes of Art. X(2) is i) an individual[753]; ii) a Contracting State or its political subdivision or local authority or an entity that the State owns[754]; iii) a publicly listed entity[755]; iv) a charity or pension fund[756]; v) an entity that meets the ownership (and base erosion test)[757] or; vi) collective investment vehicle[758]. It the taxpayer does not fall within the definition of a "*qualified person*" then the subsequent provisions of the LOB clause need to be looked into.

227. Art. X(3)(a) (*detailed version*) provides that treaty benefits will be granted to a resident if that resident is engaged in "*the active conduct of a business in the first-mentioned Contracting State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank or [list financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer respectively), and the income derived from the other Contracting*

[749] DE BROE, LUTS, BEPS, p. 128 ; VAN WEEGHEL, Tax Avoidance, p. 49.
[750] 2015 OECD, Final Report on Treaty Abuse, Para. 25.
[751] 2015 OECD, Final Report on Treaty Abuse, p. 21.
[752] 2015 OECD, Final Report on Treaty Abuse, p. 24.
[753] 2015 OECD, Final Report on Treaty Abuse, p. 25.
[754] 2015 OECD, Final Report on Treaty Abuse, p. 25.
[755] 2015 OECD, Final Report on Treaty Abuse, pp. 26-28.
[756] 2015 OECD, Final Report on Treaty Abuse, pp. 28-30.
[757] 2015 OECD, Final Report on Treaty Abuse, pp. 30-32.
[758] 2015 OECD, Final Report on Treaty Abuse, pp. 32-35.

State is derived in connection with, or is incidental to, that business". Essentially, the provision provides that a resident taxpayer is entitled to treaty benefits if it satisfies the requirement of two prongs i.e. i) it actively conducts business in its State of residence and ii) the payments for which treaty benefits are sought are derived in connection with or are incidental to that business[759]. With respect to the first prong, the Commentary to the provision provides that "*An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting (such as officers or employees of a company) conduct substantial managerial and operational activities"*[760]. Importantly, it should be noted that the first prong provides that the business of making or managing investments for the resident's own account will not be considered to be an active business unless the relevant activities are part of banking, insurance, or securities activities conducted by an insurance enterprise. With respect to the second prong, the issue is whether the income derived from the other Contracting State is "*derived in connection with*", or is "*incidental*" to that business. The Commentary to the provision provides that an item of income *"is derived in connection with"* a business if the income generating activity in the State of source is a line of business that *"forms a part of"* or is *"complementary to"* the business conducted in the State of residence by the income recipient[761]. Furthermore, the Commentary provides that an item of income derived from the State of source is *"incidental to"* the business carried on in the State of residence "*if production of the item facilitates the conduct of the business in the State of residence"*[762]. Accordingly, depending on the facts of each case, a taxpayer may satisfy the conditions under Art. X(3)(a).

228. Furthermore, it needs to be checked whether the conditions of Art. X(3)(b) (*detailed version*) are satisfied. The provision provides that "*If a resident of a Contracting State derives an item of income from a business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from an associated enterprise, the conditions described in subparagraph a) shall be considered to be satisfied with respect to such item only if the business activity carried on by the resident in the firstmentioned Contracting State is substantial in*

[759] 2015 OECD, Final Report on Treaty Abuse, p. 37.
[760] 2015 OECD, Final Report on Treaty Abuse, p. 38.
[761] 2015 OECD, Final Report on Treaty Abuse, pp. 38-40.
[762] 2015 OECD, Final Report on Treaty Abuse, p. 40.

relation to the business activity carried on by the resident or associated enterprise in the other Contracting State. Whether a business activity is substantial for the purposes of this paragraph will be determined based on all the facts and circumstances"[763]. Essentially, Art. X(3)(b) provides that the conditions of Art. X(3)(a) are satisfied when substantial activities are carried out in the State of residence. The Commentary to the provision provides that the idea of introducing the substantiality requirement is to "*prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty State of which it is resident (i.e. activities that have little economic cost or effect with respect to the company's business as a whole)"* [764].

229. Art. X(4) (*detailed version*) provides for a derivative benefits clause. Essentially, the provision provides that resident companies can enjoy treaty benefits if the owner would have been entitled to at least the same benefit had that owner received the income directly. The principle underlying the provision is that taxpayers will not engage in treaty shopping transactions if the income is remitted directly to them. The company should satisfy an ownership and base erosion test. Accordingly, if the taxpayer satisfies this test, treaty benefits may be extended to it[765].

230. If the taxpayer does not satisfy the condition of Art. X(3) or Art. X(4), it may, nevertheless be entitled to discretionary relief under Art. X(5) (*detailed version*). Essentially, the taxpayer may approach and file a request with the competent authority to be granted treaty benefits. The competent authority may grant the benefits if, after taking into consideration all the facts and circumstances, it determines that "*neither the establishment, acquisition, or maintenance of the resident, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under the Convention*". In the author's opinion, several non-tax reasons for establishing the taxpayers business need to be demonstrated if discretionary relief is sought from the competent authorities[766].

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[763] 2015 OECD, Final Report on Treaty Abuse, pp. 40-41.
[764] 2015 OECD, Final Report on Treaty Abuse, pp. 40-41.
[765] 2015 OECD, Final Report on Treaty Abuse, p. 42.
[766] 2015 OECD, Final Report on Treaty Abuse, pp. 43-46.

231. On the other hand, the treaty GAAR i.e. the PPT rule provides that "*Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes* (subjective element) *of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention* (objective element)" (for a detailed analysis of the elements of the PPT rule *see section 9.3*).

232. The reports acknowledges that all countries may not find it necessary to adopt the three measures. Thus, a minimum standard (MS) is recommended wherein it is suggested that countries should change the title and preamble of the tax treaties and include either:

a. the LOB clause and PPT rule;

b. the PPT rule only;

c. the LOB clause with an inbuilt narrow PPT rule or domestic anti abuse measures[767].

233. After an extensive discussion on the LOB clause[768], the PPT rule[769] and other treaty SAARs (for example to curb rule shopping with respect to dividends in Art. 10 and capital gains on the sale of real estate companies in Art. 13)[770], the report analyses the issue on the interaction of domestic anti-abuse measures with tax treaties.

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[767] 2014 OECD, Report on Treaty Abuse, Paras. 13-14; 2015 OECD, Final Report on Treaty Abuse, Para. 22.

[768] 2014 OECD, Report on Treaty Abuse, Paras. 15-16; 2015 OECD, Final Report on Treaty Abuse, Para. 25.

[769] 2014 OECD, Report on Treaty Abuse, Para. 17; 2015 OECD, Final Report on Treaty Abuse, Para. 26.

[770] 2014 OECD, Report on Treaty Abuse, Paras. 18-42; 2015 OECD, Final Report on Treaty Abuse, Paras. 27-52; DE BROE, LUTS, BEPS, pp. 134-135.

8.2.3.3. Domestic anti-avoidance rules and tax treaties

8.2.3.3.1. Introductory comments

234. States apply domestic GAARs and SAARs to avoid domestic BEPS concerns. In many situations, taxpayers argue that such measures conflict with tax treaties as treaties rank highly than domestic law. For example, taxpayers argue that tax treaties prevail over domestic GAARs, thin capitalization rules conflict with the non-discrimination provisions etc[771]. The report provides that a conflict does not arise between domestic anti-abuse rules and tax treaties by referring to the comments made in Paras 22, 22.1 and 9.5 to the 2003/2014 Commentary to Art. 1[772]. The report also provides that the conclusions already reflected in the Commentary on Art. 1 on the interaction between treaties and domestic anti-abuse measures remain applicable even if tax treaties do not incorporate the PPT rule[773]. Thereafter, "*clarificatory*" draft commentary is provided which recognizes that domestic SAARs, statutory GAARs and judicial doctrines can be used to counter treaty abuse as well as domestic law abuse (for the latter case the issue is whether treaties can prevent the application of rules that target avoidance of domestic law). With respect to the interaction of domestic anti-abuse rules with tax treaties – it is quite obvious that the draft commentary follows the 2011 UN Commentary and elaborates on it.

8.2.3.3.2. Domestic SAARs

235. With respect to SAARs, it provides that if a conflict arises between a domestic SAAR and tax treaty the latter will prevail pursuant to Art. 26 VCLT[774]. However, such conflicts can be avoided if:

a. firstly, the treaty contains an express provision which allows the application of a domestic SAAR[775] (*see chapter 10*);

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[771] 2014 OECD, Report on Treaty Abuse, Para. 45; 2015 OECD, Final Report on Treaty Abuse, Para. 54.

[772] 2014 OECD, Report on Treaty Abuse, Paras. 47-48; 2015 OECD, Final Report on Treaty Abuse, Paras. 56-57.

[773] 2014 OECD, Report on Treaty Abuse, Para. 49; 2015 OECD, Final Report on Treaty Abuse, Para. 58.

[774] 2014 OECD, Report on Treaty Abuse, Para. 49 (Commentary in Para 5); 2015 OECD, Final Report on Treaty Abuse, Para. 59 (Commentary in Para. 23).

[775] 2014 OECD, Report on Treaty Abuse, Para. 49 (Commentary in Para 7); 2015 OECD, Final Report on Treaty Abuse, Para. 59 (Commentary in Para. 25).

b. secondly, if the domestic SAAR gives a meaning to a term and that term is incorporated in a tax treaty because a reference is made to the domestic law to understand the treaty meaning of that term[776] (*see chapter 11*);

c. thirdly, it is stated that a conflict does not arise if treaty benefits are denied both under the domestic SAAR and the guiding principle or PPT rule (a slight deviation from the 2011 UN Commentary which provided for denial of treaty benefits under a proper interpretation of the treaty approach). In other words, the draft commentary provides that even though a tax treaty prevents the application of a domestic SAAR that domestic SAAR can, nevertheless, apply if the taxpayer does not satisfy the tests of the guiding principle or PPT rule. This is illustrated through an example on trailing tax/extended tax liability[777] (*see section 17.5.1.2*);

d. Lastly, (a new position is introduced) a conflict does not arise if the benefits of tax treaties are denied under both domestic judicial doctrines and principles applicable to treaty interpretation coupled with domestic SAARs. This is illustrated through an example in which the artificial facts of a transaction are substituted pursuant to the application of the sham transaction doctrine and the domestic law (including the domestic SAAR) and treaty is applied to the real facts[778] (*see section 12.2*).

8.2.3.3.3. Domestic GAARs

236. With respect to the interaction of domestic statutory GAARs with tax treaties, the draft commentary states that a conflict will not arise if: the treaty includes a specific provision for its application; or if the domestic statutory GAAR gives a meaning to a term and that term in incorporated in a tax treaty because a reference is made to the domestic law to understand the treaty meaning of that term; or if the domestic rule is in conformity with the guiding principle[779].

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[776] 2014 OECD, Report on Treaty Abuse, Para. 49 (Commentary in Para. 8); 2015 OECD, Final Report on Treaty Abuse, Para. 59 (Commentary in Para. 26).

[777] 2014 OECD, Report on Treaty Abuse, Para. 49 (Commentary in Para. 9); 2015 OECD, Final Report on Treaty Abuse, Para. 59 (Commentary in Para. 26.1).

[778] 2014 OECD, Report on Treaty Abuse, Para. 49 (Commentary in Para. 10); 2015 OECD, Final Report on Treaty Abuse, Para. 59 (Commentary in Para. 26.2).

[779] 2014 OECD, Report on Treaty Abuse, Para. 49 (Commentary in Paras. 11-12); 2015 OECD, Final Report on Treaty Abuse, Para. 59 (Commentary in Paras. 26.3-26.4).

8.2.3.3.4. Domestic judicial doctrines

237. Further, with respect to judicial doctrines (substance over form, economic substance, sham, business purpose, step transaction, abuse of law and *fraus legis*) the approach is similar to the one mentioned in the 2011 UN Commentary[780] (*see section 8.2.2.3.3*).

8.2.3.4. Other measures (saving clause)

238. The reports also clarify that counteracting measures introduced by the residence State (in particular CFC rules) do not conflict with treaty provisions. This position is justified by:

a. Referring to the principles expressed in Para 6.1 of the Commentary on Art. 1 vis-à-vis taxation of partners and partnerships[781] which are derived from the 1999 OECD report on taxation of partnerships (hereafter "*1999 OECD Partnership report*").

b. The introduction of a US type Saving clause (which then negates the argument of a treaty restricting a residence State's domestic anti-abuse measure)[782]. The clause reads as follows "*This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23, 24 and 25 and 28*".

c. By referring to the Saving clause it is also clarified that immediate exit taxes do not conflict with tax treaties[783].

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[780] 2014 OECD, Report on Treaty Abuse, Para. 49 (Commentary in Para. 13); 2015 OECD, Final Report on Treaty Abuse, Para. 59 (Commentary in Paras. 26.5-26.7).

[781] 2014 OECD, Report on Treaty Abuse, Para. 51; 2015 OECD, Final Report on Treaty Abuse, Para. 61.

[782] 2014 OECD, Report on Treaty Abuse, Para. 52; 2015 OECD, Final Report on Treaty Abuse, Para. 63.

[783] 2014 OECD, Report on Treaty Abuse, Paras. 54-57; 2015 OECD, Final Report on Treaty Abuse, Paras. 65-66.

9. Analysis of the view of international organizations – Selected issues

9.1. The role of the 2003 OECD and 2011 UN Commentary in interpreting pre-existing tax treaties

239. The position adopted in this thesis vis-à-vis the use of later commentaries is that subsequent versions of the OECD Commentary can be considered, only if, the revised Commentary is in the nature of a clarification (*see section 6.3*). The question analysed in this section is whether the 2003 amendments made to the OECD Commentary are clarifying in nature. The question arises because if the Commentary is considered not to be clarificatory in nature then the 2003 amendments cannot be used to interpret tax treaties concluded before 2003. In other words, can the taxpayers argue that (for tax treaties concluded before 2003) domestic anti-avoidance rules cannot be applied to tax treaties unless a specific provision, which preserves the application of such anti-abuse rules, is inserted in tax treaties.

240. Commentators are divided in their opinion on the issue. Some have described the 2003 changes as i) taking a "*fundamentally different approach"* [784] *ii*) reversing *"prior commentary*" [785] or iii) representing a "*fundamental change in position*"[786] which means that the 2003 changes are not clarificatory in nature. On the other hand, other commentators have suggested that the 2003 changes to i) have "*retroactive effect*" [787] or ii) represent "*matters of clarification*" [788] which means that they are clarificatory.

241. The author agrees that when the 2003 changes are read in isolation with the 1977 OECD Commentary they seem to be radical. However, in the author's view the changes made to the 2003 OECD Commentary represent a clarification (with respect to the guiding principle see below). The reasons are as follows: The work of the OEEC-OECD during 1961 to 1977 indicates

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[784] ARNOLD, 2003 changes, p. 245.
[785] WARD, OECD, p. 102.
[786] DE BROE, Thesis, p. 385.
[787] MARTIN JIMENEZ, 2003 changes, p. 28.
[788] ELLIFFE, 2003 Commentary, p. 332.

that the question of whether domestic anti-abuse measures are in harmony or lead to a conflict with tax treaties was never analysed (*see section 8.2.1*). The issue was on the OECD's agenda and it had to be analysed in the subsequent years. This position was appropriately reflected in the Introduction to the 1977 OECD Commentary. Nevertheless, in light of its work during 1961 to 1977, the OECD made a suggestion that its member States might wish to include specific provisions in their tax treaties to preserve the application of their domestic anti-avoidance rules. This definitely does not mean that the OECD has concretely implied that if a tax treaty lacks a specific provision on a domestic anti-abuse rule then that domestic anti-abuse rule cannot be applied to a tax treaty. Accordingly, the OECD's position should not be read in a literal manner (*see section 8.2.1.2*). The issue at stake was analysed by the OECD for the first time in the 1986 BC report. In that report the OECD provided the view of the majority and minority without providing its own view. Nonetheless, by 1986 the OECD did indicate that a large majority of OECD member countries considered that the effects of domestic anti-avoidance rules could be applied at the level of the tax treaty even if those rules were not preserved in them (*see section 8.2.1.3*). This view seems to be implicitly reflected in the 1986 CC report (*see section 8.2.1.4*) whereas it was explicitly reflected in the 1992 OECD Commentary (*see section 8.2.1.5*). Subsequently, in light of the recommendation made in the 1998 HTC report, the 2003 OECD Commentary deleted its statements to the effect that domestic anti-avoidance had to be preserved in tax treaties in order to be applicable. This was done primarily to clarify the confusion created by the previous versions of the OECD Commentary (*see sections 8.2.1.6 & 8.2.1.7*)[789].

242. Thus, in the author's opinion, the "*effect*" of domestic anti-avoidance rules can be applied to tax treaties concluded prior to/or after the 2003 changes. Whether or not such "*effects*" domestic anti-abuse rule conflicts with a tax treaty depends on the nature of the domestic law anti-avoidance rule (its scope and effect) and the wording and purpose of the relevant treaty provision. If a conflict arises i.e. the domestic law rule does not square with the terms of the tax treaty then the latter will prevail pursuant to Art. 26 of the VCLT which contains the "*pacta sunt servanda*" principle.

[789] ELLIFFE, 2003 Commentary, p. 332.

243. With respect to the guiding principle, the author considers that this principle should not be applied to treaties concluded before January 28th 2003 (especially between OECD Member States) to determine if a transaction undertaken by the taxpayer is abusive. This is because the principle was never discussed before the 2003 update to the OECD Commentary. Therefore, it represents a "*fundamental addition*" to the Commentary. Furthermore, for treaties concluded by UN Member States that are patterned on the UN Model, it is clear that this principle should not be applied to treaties concluded before June 2003. The guiding principle was added to the 2011 update to the UN Commentary. Accordingly, the question arises as to whether the guiding principle applies to tax treaties concluded during the period 2003-2011? In the author's opinion, the development of the 2011 UN Commentary indicates that the principle was discussed and deliberated by the Group of Experts in several sessions since June 2003 (*see section 8.2.2.2*). Accordingly, a position is taken that the principle applies to treaties concluded by UN Member States (that are based on the UN Model) post June 2003 (this principle is further discussed in *section 9.3).*

9.2. A tax treaty's object and purpose(s)

9.2.1. Allocation of taxing rights and eliminating double taxation

244. Ideally, the first place to look at a tax treaty's object and purpose is in its title and preamble. The title to the draft 1963 OECD Model and the 1977 OECD Model included a reference to "*avoidance of double taxation*". However, as the OECD Model did not exclusively deal with the elimination of double taxation but also addressed other issues the title was modified in the 1992 OECD Model[790]. The title was narrowed and provided that the tax treaty is applicable between two States with respect to "*taxes on capital and income*". Nevertheless, the note to the title provided that states may adopt the "*practice of including in the title a reference to either the elimination of double taxation or to both the elimination of double taxation and the prevention of fiscal evasion"*. On the other hand, the preambles of the various OECD Model do not shed any light on the object and purpose of a tax treaty. They only provide that the "*preamble of the Convention shall be*

[790] 1992 OECD Comm. Introduction, Para. 16.

drafted in accordance with the constitutional procedure of both Contracting States".

245. Accordingly, the view can be taken that even though the preamble is not helpful in determining a tax treaty's object and purpose, the titles to the 1963, 1977 and 1992 OECD Models (in the note) indicate that a tax treaty's main objective is to eliminate juridical double taxation. This position is explicitly confirmed in the 1977[791], 1992[792], 2003[793] OECD Commentary. Moreover, in the author's opinion, the objective of eliminating juridical double taxation is interlinked with the objective of allocating taxing rights. This is because double taxation is eliminated as a consequence of, firstly, allocating taxing rights (distributive rules contained in Arts. 6-22) among contracting States and then, secondly, applying the relief provisions (Art. 23). Thus, the position adopted in the thesis is that the primary purpose of a tax treaty is to allocate taxing rights among contracting States over items of income/capital with the purpose of eliminating juridical double taxation so that cross border international trade is fostered[794]. This position is confirmed by the fact that majority of the operative provisions of a tax treaty support such a purpose (Art. 6-23 of the OECD Model).

9.2.2. Prevention of tax evasion

246. Further, in the author's opinion the object and purpose of a tax treaty also extends to prevention of tax evasion. This is because of the fact that even though neither the title nor the preamble to the various OECD Models provides that the purpose of tax treaties is to prevent tax evasion; States in their treaty practice, more often than not, include the prevention of tax evasion in the title/preamble of tax treaties in addition to the objective of eliminating double taxation. Moreover, there seems to be consensus among commentators on this position[795]. It can be argued that, prevention of tax evasion, is an ancillary objective as only a few provisions of the OECD

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791 1977 OECD Comm. Art. 1, Para. 7 – 1st sentence.

792 1992 OECD Comm. Art. 1, Para. 7 – 1st sentence.

793 2003 OECD Comm. Art. 1, Para. 7.

794 DE BROE, Thesis, p. 328; ELLIFFE, Tax Avoidance, p. 1; ENGELEN, Thesis, pp. 428-429; On the contrary, it has been argued that the main objective and purpose of a tax treaty is to allocate and limit taxing powers of the two states as double taxation is eliminated through internal tax law and not tax treaties as such. WARD, Abuse, p. 3.

795 VAN WEEGHEL, Thesis, pp. 34-35; DE BROE, Thesis, p. 330-331; ENGELEN, Thesis, pp. 428-429.

Model support this conclusion (such as Art. 26 of the OECD Model wherein competent authorities may exchange information related to tax evasion schemes[796]; Art. 27 of the OECD Model wherein states can be obliged to provide assistance in collection of each other's tax claims for tax evasive schemes)[797]. However, in the author's view such an argument should be rejected as the title and preamble to several tax treaties includes the prevention of fiscal evasion. Needless, to say, if the title and preamble does not contain prevention of fiscal or tax evasion, then such an objective will at most qualify as an ancillary objective.

9.2.3. Prevention of tax avoidance and double non taxation

247. Furthermore, in the author's opinion, the question of whether the purpose of tax treaties is to prevent tax avoidance is highly debatable. The OECD's view is that the purpose of tax treaties is to prevent tax avoidance. This is because the historical development of the 1977 Commentary (*see section 8.2.1.1*), the 1977 OECD Commentary (see *section 8.2.1.2*) and the 1992 OECD Commentary (see *section 8.2.1.5*) on Art. 1 reflects this conclusion. In 2003, the OECD made this explicit by providing that, in addition to the "*principal purpose*" of tax treaties which is to avoid international double taxation, it is also "*a purpose*" of tax treaties to prevent tax avoidance. Accordingly, the OECD's view is that tax treaties can be used to counteract tax avoidance schemes although such an objective seems ancillary to the principal purpose[798].

248. Moreover, a few provisions[799] of the 2014 OECD Model that support such conclusions are: Art. 13(4) which was added to prevent tax avoidance through real estate companies; Art. 17(2) which was added to prevent tax avoidance through rent a star companies; Art. 10-12 which contain the beneficial owner requirement; Art. 9(1) which provides for arm's length adjustments (which may be considered as an anti-avoidance provision combating profit shifting); Art. 11(6) and Art. 12(4) which provide rules for "*special relationship*" between a payor and payee (although it is arguable

796 2014 OECD Comm. Introduction, Para. 41; 2014 OECD Comm. Art. 26, Para. 5.1.
797 DE BROE, Thesis, p. 331; ARNOLD, 2003 changes, p. 247.
798 DE BROE, LUTS, BEPS, p. 123.
799 ARNOLD, VAN WEEGHEL, Abuse, p. 90.

whether they are aimed at preventing tax avoidance)[800]; and Art. 26, which can also be used to exchange information related to tax avoidance schemes[801]. Thus, a reasonable argument can be made that the purpose of a tax treaty is to prevent tax avoidance.

249. While, in principle, the author agrees with the fact that tax treaties should not be used to foster tax avoidance, such a position is subject to the following criticism. Firstly, in contrast to the prevention of tax evasion, States do not include the "*prevention of tax avoidance*" in the preamble to a tax treaty[802]. Accordingly, if a Court refers to the preamble to interpret a tax treaty pursuant to Art. 31(2) VCLT, then a Court will most likely conclude that a tax treaty does not prevent tax avoidance as the preamble will not reflect it. Furthermore, it should be noted that Art. 31(1) VCLT provides for a textual approach to treaty interpretation. This means that the object and purpose can be given effect only if the text of a treaty supports their inclusion. Put differently, if the "*object and purpose*" of a treaty is not supported by the terms of a treaty then that "*object and purpose*" cannot be considered in the treaty interpretation process as it would undermine the primacy of the textual approach[803]. Therefore, if the "*prevention of tax avoidance*" is not stated in the text of a treaty then that objective should not be considered in the treaty interpretation process. Secondly, it can be argued that the operative provisions that support prevention of tax avoidance are few in number when compared to the operative provisions that deal with allocation of taxing rights and elimination of double taxation. Accordingly, the latter objectives should be given more weight. This conclusion is also supported by the findings in the 1989 TTO report that "*First, Article 31 requires States to interpret treaties in the light of their object and purpose. Tax treaties aim primarily at the avoidance of double taxation and the prevention of fiscal evasion but also have the objective of allocating tax revenues equitably between the two Contracting States. Thus, any interpretation achieving these objectives would be preferable to one leading to double taxation or to an inappropriate double exemption*"[804]. Thirdly, the OECD's view that tax treaties prevent tax avoidance stems from the

[800] DE BROE, Thesis, p. 332; ARNOLD, 2003 changes, p. 248.
[801] 2014 OECD Comm. Introduction, Para. 41; 2014 OECD Comm. Art. 26, Para. 5.1.
[802] For example, Canada usually does not include "*prevention of tax avoidance*" in the preamble to Canadian tax treaties. GOYETTE, Treaty Abuse, p. 766.
[803] DE BROE, Thesis, p. 336; ENGELEN, Thesis, p. 429; ARNOLD, VAN WEEGHEL, Abuse, p. 90.
[804] OECD, Treaty Override report, Para. 19a).

historical work of the OECD Model and the OECD Commentary. The author wonders why the OECD did not reflect this conclusion in the text of the OECD Model itself. Probably, the OECD considered that such an objective couldn't be elevated to being the primary objective of a tax treaty. Thus, the author takes the view in this thesis that the prevention of tax avoidance can be considered; at most, an ancillary objective of a tax treaty as the text of the OECD Model has never reflected this conclusion[805].

250. With respect to the prevention of double non-taxation, the work of the OECD, since late 1990's, indicates that such an objective is a tax treaty's object and purpose. Specifically, the 1999 Partnership Report clearly suggested that the basic purpose of tax treaties is "*to prevent double non-taxation*" [806] . The view was subsequently reflected in the OECD Commentary on Art. 23A(1)[807] and the new Art. 23A(4)[808] (inserted in the OECD Model in 2000). Commentators have divergent opinions on this issue. Some argue that tax treaties do not prevent double non-taxation[809]. It is argued that neither the title nor the preamble of a tax treaty refers to such an objective[810]; the distributive rules of tax treaties allocate taxing rights among States and do not force a State to effectively exercise the right and tax the allocated income[811] ; the provisions of Art. 23(A)(1) which provides for the exemption method (the application of which is more likely to create double non taxation as opposed to the application of the credit method) states that the residence State is to provide an exemption from taxes on income which "*may be taxed*" by the source State even though the latter State does not effectively tax the income due to its domestic law provisions[812] and; specific provisions such as tax sparing credits are intentionally inserted in tax treaties to achieve double non-taxation in light of economic reasons [813] . Other commentators argue that States conclude tax treaties with the expectation that an item of income will be subject to tax at least once[814] and double non-

[805] ARNOLD, VAN WEEGHEL, Abuse, p. 90.
[806] OECD Partnership report, Para. 52.
[807] 2014 OECD Comm. Art 23, Paras. 32.5-32.7.
[808] 2014 OECD Comm. Art 23, Paras. 56.1-56.3. The 2011 UN Commentary also encourages States which follow the exemption method to insert a clause equivalent to Art. 23A(4) to tackle the issue of double non-taxation. See 2011 UN Comm. Art. 23, Para. 19.
[809] DE BROE, Thesis, p. 357; LANG, Double non taxation, pp. 81-86.
[810] LANG, Double non taxation, p. 86.
[811] DE BROE, Thesis, pp. 358-360.
[812] DE BROE, Thesis, pp. 361-362.
[813] DE BROE, Thesis, pp. 362-363.
[814] WATERS, Double non taxation, pp. 704-705.

taxation violates the objective of a tax treaty which is to prevent fiscal evasion[815].

251. While the author agrees that States expect that taxes should be levied at least once, such an expectation should be derived from the text of a tax treaty. If not, the application of such an objective would be contrary to the textual approach to treaty interpretation (*see section 5.4*). Further, the argument that double non-taxation violates a treaties primary objective of preventing fiscal evasion is not tenable. This is because double non-taxation, does not necessarily imply, that a taxpayer has engaged in tax fraud although such a result can be achieved pursuant to a tax avoidance scheme. Accordingly, for the purpose of this thesis the author takes a position that prevention of double non-taxation is not an object and purpose of a tax treaty unless explicitly stated[816].

252. To overcome the aforementioned limitation in the tax treaty interpretation process, the 2014 TTA report and 2015 Final TTA Report propose to change the preamble to the OECD Model so as to read that States "*Desiring to further develop their economic relationship and to enhance their cooperation in tax matters, Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)"*[817]. Art. 31(2) of the VCLT requires a treaty interpreter to refer to the title and preamble of the tax treaty. Accordingly, by changing the preamble, the drafters of the BEPS reports clearly intend that treaties (including their operative provisions) should be interpreted in such a manner so as to prevent tax avoidance and double non-taxation[818]. If this change is reflected in the preamble of tax treaties then the

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[815] WATERS, Double non taxation, pp. 706-707.

[816] BEAULNE, NIKOLAKAKIS, Double non taxation, p. 252; LANG, Double non taxation, p. 86; DE BROE, Thesis, p. 363.

[817] 2014 OECD, Report on Treaty Abuse, Para 62; 2015 OECD, Final Report on Treaty Abuse, Para 72.

[818] 2014 OECD, Report on Treaty Abuse, Para. 64; 2015 OECD, Final Report on Treaty Abuse, Para 73. The Commentary provides that the "*Committee decided to amend the title of the Convention and to include a preamble. The changes made expressly recognise that the purposes of the Convention are not limited to the elimination of double taxation and that the Contracting States do not intend the provisions of the Convention to create*

author submits that the objectives of i) allocating taxing rights and eliminating double taxation; ii) the prevention of tax evasion and iii) prevention of tax avoidance and double non taxation can be considered to be on an equal footing (this strengthened by the fact that several treaty anti abuse rules with be introduced pursuant to Action 6) [819].

9.2.4. Other objectives of a tax treaty

253. In addition to the aforementioned objectives, a tax treaty (especially a tax treaty following the 2014 OECD Model and its previous versions) has several other supplementary purposes. As indicated in the OECD Commentary, these include, amongst others, the elimination of tax discrimination as provided in Art. 24 and the establishment of a MAP as per Art. 25 [820]. If all these object and purposes have to be taken into consideration it is reasonable to conclude that the objectives and purposes of the OECD Model are multifold [821].

9.2.5. Relationship between primary and ancillary objectives

254. An interesting issue arises on the relationship between the primary objective and ancillary objectives in the tax treaty interpretation process. Suppose it is established that a treaty's main object and purpose is allocation of taxing rights/elimination of juridical double taxation. It is also established

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opportunities for non-taxation or reduced taxation through tax evasion and avoidance. Given the particular base erosion and profit shifting concerns arising from treaty-shopping arrangements, it was also decided to refer expressly to such arrangements as one example of tax avoidance that should not result from tax treaties, it being understood that this was only one example of tax avoidance that the Contracting States intend to prevent". 2015 OECD, Final Report on Treaty Abuse, p. 93.

819 DE BROE, LUTS, BEPS, pp. 142-144.

820 2014 OECD Comm. Introduction, Para. 26; DE BROE, Thesis, p. 326.

821 The Commentary to the 2011 UN Model also considers tax treaties to have multifold objectives and purposes. The Commentary provides that "*Broadly, the general objectives of bilateral tax treaties therefore include the protection of taxpayers against double taxation with a view to improving the flow of international trade and investment and the transfer of technology. They also aim to prevent certain types of discrimination as between foreign investors and local taxpayers, and to provide a reasonable element of legal and fiscal certainty as a framework within which international operations can confidently be carried on...In addition, the treaties seek to improve cooperation between taxing authorities in carrying out their functions, including by the exchange of information with a view to preventing avoidance or evasion of taxes and by assistance in the collection of taxes*". 2011 UN Comm. Introduction, Para. 6.

that a treaty's ancillary object and purpose is the prevention of tax avoidance (based on the OECD/UN Commentary). Thus, the question arises as to which interpretation prevails i.e. should the interpretation which gives weight to the primary objective prevail over an interpretation which gives weight to the ancillary objective. To illustrate, let us assume that a taxpayer enters in a tax avoidance scheme using a tax treaty. In this situation, can the tax avoidance scheme be tackled by arguing that the purpose of a tax treaty is to prevent tax avoidance even if such an argument leads to unresolved international juridical double taxation? In such a situation, the author submits that when a tax treaty is open to two interpretations i.e. one of which does and one of which does not eliminate double taxation, the object and purpose of a treaty demand that the former interpretation be adopted[822].

9.3. The guiding principle (or PPT rule)[823]

9.3.1. Introductory comments

255. The 2003/2014 OECD Commentary provides that tax treaty benefits need not be granted to a taxpayer when that taxpayer's arrangements constitute an abuse of the tax treaty's provisions. Toward this end, the OECD Commentary does not define as to what constitutes abuse[824]. Nevertheless, the OECD Commentary provides for a "*guiding principle*" which can be used to determine if an abuse exists or does not exist. Under the guiding principle the following two elements must concurrently be present for certain transactions or arrangements to constitute an abuse of the provisions of a tax treaty. They are i) a main purpose for entering into a transaction or arrangement was to secure a more favorable tax position and ii) obtaining that more favourable tax position would be contrary to the object and purpose of the relevant tax treaty provisions.

256. In this respect, it should be noted that these two elements are also found in the domestic statutory GAARs or judicial doctrines of several

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[822] DE BROE, Thesis, p. 329; ENGELEN, Thesis, p. 429.

[823] The author has published the analysis in this section in a summarized form in Taxmann's International Taxation Journal. The author has explicitly agreed with the editor of Taxmann that this analysis can be used for the purpose of his doctoral thesis. See CHAND, PPT, pp. 484-490.

[824] SASSEVILLE, Abuse, p. 56.

States. For example, the UK tax law provides that the UK GAAR gets triggered if the main purpose or one of the main purposes, of the arrangement is to seek a tax advantage and granting that tax advantage would run afoul of the UK tax/treaty provisions. Further, the Canadian tax law provides that the Canadian GAAR applies to transaction(s)/arrangement(s) which result in a tax benefit and were undertaken primarily (and not for bonafide purposes) for obtaining that tax benefit. If it proved that the transaction(s)/arrangement(s) undertaken by the taxpayer run against the object, spirit or the purpose of the legislation then the GAAR provisions apply. Similarly, the Indian tax law provides that the Indian GAAR gets triggered if the main purpose of entering into an arrangement is to obtain a tax benefit and that tax benefit is contrary to the object and purpose of the Indian income tax/treaty provisions. Also, the Dutch Fraus Legis doctrine gets triggered when tax avoidance is the predominant motive of the taxpayer for concluding legal transactions and the tax effect emanating from the transactions is contrary to the purpose and intent of the law. Moreover, under the French tax law rules, abuse arises when the transaction undertaken by the taxpayer is "*purely*" tax motivated and results in a tax advantage the grant of which would be contrary to "*purpose*" of the relevant provisions (*see section 3.3*). Accordingly, the guiding principle establishes a treaty anti-avoidance rule [825]. This is confirmed by the 2014 TTA and 2015 Final TTA reports which introduce a treaty GAAR in the form of the PPT rule that mirrors the guiding principle.

257. The 2003/2014 OECD Commentary suggests that domestic anti-avoidance rules should be applied having regard to the guiding principle (*see section 8.2.1.7*). The 2011 UN Commentary also states that the domestic GAARs should be applied having regard to the guiding principle (*see section 8.2.2.3.2*). Likewise, the 2014 TTA report and 2015 TTA report provides at several occasions that domestic anti-avoidance rules which deny treaty benefits have to be applied in conformity with the guiding principle (or the PPT rule). Accordingly, the guiding principle acts as a restriction to the application of domestic anti-avoidance rules that are used to deny treaty benefits. In other words, even if the application of the domestic anti-avoidance rule conflicts with treaty provisions, the outcome of applying that domestic anti-avoidance rule (denial of treaty benefit) may still be upheld if

[825] ARNOLD, VAN WEEGHEL, Abuse, p. 93; ARNOLD, 2003 changes, p. 250.

the various elements of the guiding principle or PPT rule are satisfied. The elements of the principle (or PPT rule) will be discussed hereafter.

9.3.2. Benefit under the tax treaty

258. At the outset, an issue arises as to whether the commentary to the PPT rule (as expressed in the 2014 TTA and 2015 Final TTA reports) can be used to interpret the OECD's guiding principle? In the author's opinion, the PPT rule resembles the guiding principle although they are worded differently. Accordingly, the commentary to the PPT rule can be used (up to the extent that it clarifies the application of the guiding principle).

259. The guiding principle (as well as the PPT rule) provides that a benefit under the tax treaty should not be given if the subjective and objective elements are satisfied. However, the term "*benefit*" is not defined in the OECD Commentary. In contrast, the commentary to the PPT rule states that the term "*benefit*" includes "*all limitations (e.g. a tax reduction, exemption, deferral or refund) on taxation imposed on the State of source under Articles 6 through 22 of the Convention, the relief from double taxation provided by Article 23, and the protection afforded to residents and nationals of a Contracting State under Article 24 or any other similar limitations"* [826]. Thus, it is clear that the guiding principle/PPT rule covers benefits in respect of income and capital as well as the benefits sought under the non-discrimination provisions. The issue arises as to whether a procedural benefit available to a taxpayer, such as access to a MAP or arbitration under Art. 25, can be denied under the guiding principle/PPT rule? In the author's opinion, this should not be the case, as such a benefit cannot be considered as "*any other similar limitations"* as provided in the commentary to this rule[827]. Furthermore, the author states that only benefits covered under the tax treaty will fall within the scope of the guiding principle/PPT rule. Benefits arising to a taxpayer under the domestic law or EU law or another tax treaty will not fall under the scope of this rule[828].

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[826] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 7); 2015 OECD, Final Report on Treaty Abuse, Para. 26 (Commentary in Para. 7).

[827] LANG, PPT rule, p. 657.

[828] LANG, PPT rule, p. 656; DE BROE, LUTS, BEPS, p. 131.

9.3.3. The subjective element

260. Treaty benefits will be denied under the guiding principle/PPT rule if it is proved that that "*a main purpose*"/"*one of the principal purposes*" for entering into the transaction/arrangement (respectively) was to obtain a tax benefit. The OECD uses this terminology as opposed to "*the main purpose*" test or "*the sole purpose*" or "*the predominant purpose*". This implies that, even if an arrangement has many main purposes and to obtain a tax benefit was one of the main purposes, the arrangement undertaken by the taxpayer will satisfy this test[829]. Thus, by advocating "*a main purpose*" test the OECD is setting a low threshold for upholding the abuse of a tax treaty[830]. Accordingly, commentators have criticized this test as transactions with sufficient business purpose or economic substance may come under its scope[831]. The commentary to the PPT rule also states that an objective analysis of all facts and circumstances surrounding the transaction/arrangement needs to be carried out in order to ascertain what the main purposes of the arrangement are. However, the OECD does not provide any guidance on how to distinguish between several "*main purposes*" on the one hand and several "*main purposes*" with "*ancillary purposes*" on the other hand[832]. Therefore, it seems that tax authorities have tremendous amount of discretion when applying this rule. In the author's opinion, the low threshold test as provided by the OECD should be replaced by "*the main purpose*" or "*the principal purpose*" or "*the essential purpose*" tests so that transactions which pursue genuine economic objectives come out of the purview of the guiding principle/PPT rule[833]. This change would also be in line with the ECJ's case law on determining abuse as discussed in the *Emsland Stärke*[834] and *Halifax*[835] cases (*see section 22.1.2.2*).

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[829] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 12); DE BROE, LUTS, BEPS, p. 131.

[830] 2011 UN Comm. Art. 1, Para. 36.

[831] DE BROE, Thesis, pp. 319-320; ARNOLD, VAN WEEGHEL, Abuse, pp. 93-95; PEREZ, BAEZ, 2003 changes, p. 153; MARTIN JIMENEZ, 2003 changes, p. 19.

[832] LANG, PPT rule, p. 659; DE BROE, LUTS, BEPS, p. 132.

[833] A commentator convincingly demonstates that "*the main purpose*" test should be used. DE BROE, Thesis, pp. 319-325; DE BROE, LUTS, BEPS, p. 132.

[834] ECJ: Emsland-Stärke GmbH v Hauptzollamt Hamburg-Jonas, Case No: C-110/99, December 14st 2000.

[835] ECJ: Halifax plc and others v Customs and Excise Commissioners, Case No: C-255/02, February 21st 2006.

261. An interesting issue arises with respect to the relationship between the first element and domestic statutory GAARs. The question arises as to what happens if a domestic GAAR provides for a test that is the same ("*a main purpose*" test) or is more stringent ("*the main purpose*" test) than the test put forth in the guiding principle. In this respect, the author submits that (if one follows the OECD reasoning) there will be no conflict between the tax treaty and domestic GAAR if the latter provides for "*a main purpose"* test or a more stringent "*the main purpose"* test. This is because each time the domestic test is satisfied the treaty test is also met. However, on the other hand, if the domestic GAAR contains a more lenient test then it has to be established if the treaty test is still satisfied or not. If not, the domestic GAAR does not apply and there may not be any treaty abuse[836]. In this author's opinion this analysis shows that the statements made in Para 9.5 conflict with the general conclusion of the OECD in Para 9.2 that the domestic anti-avoidance rules do not conflict with tax treaties[837].

9.3.4. The objective element

262. Under this element it needs be ascertained whether obtaining the "*favourable tax position*"/ "*granting that benefit*" defeats the "*object and purpose of the relevant provisions*" of a tax treaty. The issue arises as to whether the tax treaty's overall object and purpose should only be taken into consideration or only the object and purpose of the relevant tax treaty provisions to determine if a taxpayer's transaction is abusive. In this respect, the author submits that it has to be proved that the taxpayer's transactions both defeat the object and purpose of the tax treaty and well as the object and purpose of relevant tax treaty provisions. This is because of the following reason: As discussed before, the OECD Commentary (since 1977) provides that one of the purposes of tax treaties is to prevent tax avoidance. Accordingly, tax authorities can easily argue that since the prevention of tax avoidance is a tax treaties purpose, treaty benefits should be denied to a taxpayer who undertakes a tax avoidance transaction. Thus, this element of the guiding principle/PPT rule gets satisfied if one only takes into consideration the object and purpose of preventing tax avoidance. Consequently, in order to avoid this simplistic argument, in the author's opinion, it is necessary that the transaction undertaken by the taxpayer also

836 DE BROE, Thesis, p. 394.
837 ARNOLD, 2003 changes, p. 250; ARNOLD, VAN WEEGHEL, Abuse, p. 95.

defeats/frustrates the object and purpose of the relevant tax treaty provisions[838].

263. This being established the author states that tax avoidance structures (such as treaty shopping or rule shopping) aim to exploit the distributive rules (Art. 6-22) often in combination with the double taxation relief provisions (Art. 23) and/or with the provisions of the domestic law. Accordingly, the object and purpose of the relevant distributive rules needs to be ascertained before it can be established that a taxpayer's transaction is an abuse of (defeats) the objective of the relevant distributive rules[839]. To ascertain the objective and purpose of the relevant distributive rules reference can be made to the approach adopted by the Canadian Courts when interpreting the Canadian GAAR, especially when determining whether "*abusive tax avoidance*" exists (*see section 3.3.1*). As discussed subsequently – from the *MIL Investment* case (*see section 15.4.3*) it can be ascertained that the object and purpose of a distributive rule is to allocate taxing rights and it is difficult to read/identify an object and purpose, such as prevention of tax avoidance that is not supported by the treaty text. Also, the *Garron* judgment indicates that the objective of preventing tax avoidance cannot be read into a treaty if that objective is not reflected by the treaty text. It could also be implied from *Garron*, that the object and purpose of the relevant treaty provisions (distributive rules) is restricted to the allocation of taxing rights (*see section 15.4.6*). Nonetheless, from the *Antle case (see section 15.4.5)*, it could be ascertained that even though a tax treaty does not include prevention of tax avoidance, courts may nevertheless refer to the OECD Commentary and read such an objective in the treaty provisions which in turn has an influence on how a distributive rule is interpreted.

264. In summary, the author submits that to ascertain the object and purpose of a distributive rule would entail a two-stage analysis. Under the first stage, an analysis of the provisions conferring the favourable tax position has to be carried out in order to determine the object and purpose of the relevant distributive rules (or relief rules) at stake. Thereafter, under the second stage, it has to be determined whether the transactions respect or defeat the object and purpose of the relevant distributive rules at stake. However, the author states that determining the object and purpose of the

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838 ARNOLD, VAN WEEGHEL, Abuse, p. 93; PEREZ, BAEZ, 2003 changes, p. 153.
839 DE BROE, Thesis, p. 344.

distributive rules is not a simple task. Arguably, based on the case law (*MIL Investments and Garron*), the object and purpose of the distributive rules are to fairly allocate taxing rights over the various items of income and capital between two contracting States. However, this objective is not of great help to ascertain whether a particular arrangement defeats the object and purpose of the relevant treaty provisions. This is because under a treaty or rule shopping arrangement or any other form of tax avoidance transaction – a taxpayer formally respects the conditions imposed by the relevant distributive rule but usually acts against the underlying spirit or intentions of the treaty[840]. This is a serious limitation of the guiding principle/PPT rule since it is impossible to look behind the text of the distributive rules and find an object or purpose the abuse of which would justify a departure from the plain words of the treaty text. However, if one starts reading the distributive rules in light of the *Antle case* or the OECD Commentary (which states that treaties prevent tax avoidance) then the author does not rule out the harsh application of the guiding principle. This could thus lead to a tremendous amount of uncertainty among taxpayers. As stated earlier, in the author's opinion, the object and purpose of tax treaties are multifold. The treaty has primary as well as ancillary objectives. The primary objectives should always prevail over the ancillary objectives. Therefore, even when the guiding principle is applied, the objectives of allocating taxing rights and eliminating double taxation should be given more importance that the prevention of tax avoidance. Of course, if an amendment is made to the title of the OECD Model pursuant to the 2014 TTA report or 2015 Final TTA report, the PPT rule[841] should be interpreted in light of allocating taxing rights and eliminating double taxation coupled with the prevention of tax avoidance.

9.3.5. Burden of Proof

265. With respect to the guiding principle, the 2003/2014 OECD Commentary does not discuss which party is required to demonstrate that these two elements are satisfied. In this respect, the author submits that the tax authorities assume the burden of proof and they have to prove that the impugned transaction undertaken by the taxpayer satisfies both elements[842].

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840 DE BROE, Thesis, pp. 344-355.
841 2014 OECD, Report on Treaty Abuse, Paras. 58-64.
842 DE BROE, Thesis, p. 319; DE BROE, LUTS, BEPS, p. 132.

However this conclusion is different with respect to the PPT rule. Even though the tax authorities will be required to undertake an objective analysis of the facts of the transaction they only have to "*reasonably*" (and not convincingly) conclude that the subjective element is satisfied[843]. This threshold seems to be low in comparison to the burden assumed by the taxpayer wherein it is required to "*establish*" (convincingly) that granting the benefit is in accordance with the object and purpose of the relevant provisions of the tax treaty. Thus the burden of proof is unbalanced and unreasonable[844].

9.3.6. Outcome of denial of treaty benefits

266. The guiding principle/PPT rule provides that a benefit should not be granted if the subjective and objective elements are satisfied. Imagine a rule-shopping scheme (*see section 14.2.2*) wherein a taxpayer enters into an arrangement to transform taxable dividends (taxable at source under Art. 10(2)) to treaty exempt capital gains on shares (exempt from tax at source under Art. 13(5)). If the guiding principle/PPT rule applies to this transaction then treaty benefits (the benefit of exempting from source taxation) shall not be granted. Does this mean that the item of income will be taxable as per the domestic law of the source State (for instance @ 35%) or can the taxpayer still invoke the provisions of Art. 10(2) (for instance @ 15%) and request for treaty relief?

267. In such a situation, if treaty benefits are denied pursuant to the guding principle then the author's view is that the lower rate of 15% should apply automatically. However, the OECD's view, in the context of the PPT rule, was that the item of income should then be taxed as per the domestic law of the source State[845]. Nevertheless, in light of the public comments it received pursuant to its follow up work in November 2014, the 2015 Final TTA report suggested that States incorporate an alternate treaty provision which would enable the competent authorities (tax authorities) to provide discretionary relief[846]. The provision states that "*Where a benefit under this Convention is denied to a person under (the PPT rule), the competent authority of the Contracting State that would otherwise have granted this*

843 DE BROE, LUTS, BEPS, p. 132; LANG, PPT rule, p. 659.
844 DE BROE, LUTS, BEPS, p. 132; LANG, PPT rule, p. 660.
845 2014 OECD, Follow up work on BEPS Action 6: Preventing Treaty Abuse, pp. 10-11.
846 2015 OECD, Final Report on Treaty Abuse, Para. 26 (Commentary in Paras. 16-18).

benefit shall nevertheless treat that person as being entitled to this benefit, or to different benefits with respect to a specific item of income or capital, if such competent authority, upon equest from that person and after consideration of the relevant facts and circumstances, determines that such benefits would have been granted to that person in the absence of the transaction or arrangement referred to in paragraph 7. The competent authority of the Contracting State to which the request has been made will consult with the competent authority of the other State before rejecting a request made under this paragraph by a resident of that other State" [847]. This implies that treaty benefits under Article 10(2) are granted after obtaining the approval of the competent authority (authorities). In the author's opinion, treaty benefits should be granted to the taxpayer automatically rather than referring to a discretionary relief clause as it could be more burdensome for the taxpayer to seek relief under an administrative mechanism[848].

268. An interesting question also arises from the perspective of the residence State. Should the residence State provide relief (credit under Art. 23) for the 15% tax levied by the source State (under Art. 10(2)) even though from its perspective the item of income is taxable under its own jurisdiction only (under Art. 13(5)). The wording of the guiding principle (or the PPT rule) does not provide any guidance on this issue. The OECD Commentary states that when conflicts of qualification arise from differences in domestic law then the residence State should provide relief from double taxation[849]. However, for qualification conflicts that arise due to differences in treaty interpretation, the OECD is of the view that the residence State should not provide relief automatically but through the MAP[850]. It could be argued that the source State is denying treaty benefits by interpreting the guiding principle (a principle derived from the OECD Commentary) or the PPT rule (derived from the text of the treaty). Thus, the conflict arises from a difference in treaty interpretation as opposed to differences in domestic law. Accordingly, relief would not be provided to the taxpayer directly but would be available through the MAP. In the author's opinion, this conclusion would be unreasonable. The wording of Art. 23 does not differentiate between such conflicts. The provision simply states that relief shall be

847 2015 OECD, Final Report on Treaty Abuse, pp. 64-65.
848 LANG, PPT rule, p. 662.
849 2003/2014 OECD Comm. Art. 23, Para. 32.1-32.4.
850 2003/2014 OECD Comm. Art. 23, Para. 32.5.

provided for income, which "*in accordance with the provisions of this convention*" is taxable in the other State. Therefore, as long as the source State taxes an item of income in accordance with the treaty, the residence State has to fulfil its obligations under Art. 23[851] automatically although this position is disputable. Therefore, the legal consequences of the guiding principle (or PPT rule) are unclear.

9.3.7. Summary

269. Several issues arise with respect to the interpretation of the guiding principle or the PPT rule. Whether or not the conditions for the application of the principle i.e. the subjective and objective elements are satisfied depends on the facts and circumstances of each case. The application of this principle to various fact patterns is examined in the following chapters (*see chapters 13-20*).

9.4. Observations to the OECD Commentary

270. An OECD member country is entitled to make an observation if it is unable to concur with the interpretation put forth in the OECD Commentary. The OECD Commentary provides that "*These observations…usefully indicate the way in which those countries will apply the provisions of the Article in question*"[852]. Interesting issues arises with respect to observations made to the OECD Commentary. Firstly, the question arises as to what the legal status of such observations is. Secondly, the question arises as to whether the State making the observation (observing State) is bound to interpret a tax treaty in accordance with its observation to the OECD Commentary. Lastly, the question arises as to whether the non-observing State is bound by the interpretation advocated by the observing State. An answer to these questions is essential, as it would assess the impact of the observations made on the 2003 OECD Commentary on Art. 1.

271. At the outset, the author submits that observations cannot be considered to be unilateral interpretative declarations under general international law. This is because they are made in response to an

[851] LANG, PPT rule, p. 662.
[852] 2014 OECD Comm. Introduction, Para. 30.

international recommendation by the OECD i.e. to the OECD Commentary and are not formulated in connection with a concluded tax treaty[853]. In the author's opinion, the legal status of observations to the OECD Commentary depends on the legal status attributed to the OECD Commentary itself[854]. The position adopted in the thesis is that the OECD Commentary is not a legally binding instrument (*see section 6.2*). Logically, observations as such should not be legally binding statements. However, this does not mean that a State entering an observation can interpret its treaties differently from what it has proposed in the observation. By making an observation, the observing State has given a clear indication about the way in which it will interpret the OECD Commentary. The OECD Commentary also provides that "*member countries…should follow these Commentaries…as modified from time to time and subject to their observations thereon, when applying and interpreting the provisions of their bilateral tax convention*"[855]. Thus, even if observations are not legally binding statements, it is submitted that the observing State should interpret a tax treaty in accordance with its observation to the OECD Commentary[856]. This is because the observation creates a legitimate expectation as to how a tax administration interprets and applies tax treaties (*see section 5.2* on principles of tax treaty interpretation). This conclusion, of course, does not imply that the non-observing State has to interpret a tax treaty in accordance with the observing States observation. This is because observations, as stated previously, are not legally binding. Accordingly, the non-observing State (if it resorts to the OECD Commentary) will interpret a tax treaty in accordance with the interpretation laid down in the OECD Commentary[857]. This being established the author would like to comment on the observations made to the 2003 OECD Commentary on Article 1.

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853 MAISTO, Observations, p. 17.

854 MAISTO, Observations, pp. 17-18.

855 2014 OECD Comm. Introduction, Para. 3.

856 One commentator reaches a similar conclusion but argues that observations to the OECD Commentaries may constitute unilateral interpretative declarations under general international law. Nevertheless, the commentator provides that there may be departures from this general conclusion given the nature of the observation eg if a State reserves its right to propose an alternate interpretation in the course of negotiating/concluding tax treaties with other OECD member States rather than making a clear and conclusive observation. MAISTO, Observations, p. 18.

857 A commentator reaches a similar conclusion. MAISTO, Observations, p. 18.

272. The Luxembourg and Swiss observations indicate that domestic anti-abuse rules cannot be applied in a treaty context unless a specific provision is inserted in a tax treaty. Do these observations mean that Luxembourg and Switzerland cannot apply its domestic anti-abuse rules to treaty situations unless a specific provision towards that extent is present in a tax treaty? In the author's opinion the answer to the question is in the affirmative. Accordingly, the tax authorities of Switzerland and Luxembourg are required to interpret tax treaties in such a way that absent a specific provision in a treaty, Switzerland and Luxembourg cannot apply their domestic anti-avoidance rules to tax treaties. This is because the observations reflect Luxembourg's and Switzerland's intention towards treaty interpretation. The conclusion applies to tax treaties entered into by these countries prior to and following the 2003 amendments[858]

273. The next question arises as to whether the treaty partners (non-observing States) of Luxembourg and Switzerland are obliged to accept the latter States position. In other words, can taxpayers in Switzerland and Luxembourg argue that absent specific provisions in tax treaties, the non-observing States cannot apply their domestic anti-avoidance rules to treaty situations? In the author's opinion the answer to the question is in the negative. It can be argued that as the non-observing State had knowledge about the observing States observation, the former country should abide by the position of the latter country[859]. It can also be argued that as the principle of common interpretation requires that a treaty should be interpreted in the same way, domestic anti-abuse rules cannot be applied to treaty situation absent a specific provision in the treaty[860]. However, as stated earlier, observations are not legally binding statements. They express the way in which one State approaches the issue of treaty interpretation and that approach is not binding on another State. Therefore, the treaty partners of Luxembourg and Switzerland are not bound by the latter States observations[861].

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858 ARNOLD, 2003 changes, p. 259; DE BROE, Thesis, p. 402.
859 DE BROE, Thesis, p. 402.
860 ARNOLD, 2003 changes, p. 259
861 Concurring: ARNOLD, 2003 changes, p. 259; Dissenting: DE BROE, Thesis, pp. 402-403; WARD, OECD, p. 101.

9.5. The Saving Clause

274. The *saving clause* is a standard feature of the US Treaty Policy. The clause, that is found in Art. 1(4) of the US Model, provides that "…*this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens*"[862]. This implies that the treaty partners can tax their residents or citizens in accordance with their internal laws irrespective of whether the treaty is in effect[863]. Accordingly, from a US perspective, the clause saves the ability of the US to tax its residents and citizens on a worldwide income basis[864]. However, Art. 1(5) of the US Model provide certain exceptions to the *saving clause*[865]. These exceptions ensure that treaty benefits are available to residents or citizens. In other words, the exceptions restrict the domestic taxing right of residents or citizens[866]. Again from a US perspective, this implies that the US would be restricted from applying its domestic law and would have to provide treaty benefits if the situation of the resident or citizen falls within specific provisions of the US Model such as Art. 9(2) that deals with corresponding adjustments; Art. 17(1)(b) or Art. 17(2) or 17(5) that deal with pensions, social security, annuities, alimony and child support; Art. 18(1) that deals with pension funds; Art. 23 that deals with the relief from double taxation provisions; Art. 24 that deals with non-discrimination; and Art. 25 that deals with the mutual agreement procedure. Moreover, exceptions are also extended for situations of the resident or citizen that falls within Art. 18(2) that deals with pension; Art. 19 that deals with Government Service; Art. 20 that deals with students and Art. 27 that deals with members of diplomatic missions or consular posts[867].

275. In the 2015 TTA report, the OECD introduces the US type *saving clause* in the OECD Model[868]. The provision provides that "*This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 A [23 B], 24 and 25 and*

[862] 2006 US Model, Art. 1(4).
[863] DE BROE/LUTS, BEPS, pp. 137-139.
[864] 2006 US Technical Explanation, Art. 1(4).
[865] 2006 US Model, Art. 1(5).
[866] DE BROE/LUTS, BEPS, pp. 137-139.
[867] 2006 US Technical Explanation, Art. 1(5).
[868] DE BROE/LUTS, BEPS, pp. 137-139.

28". The idea behind introducing the saving clause is to concretize the idea that treaty provision should not limit a State's right to tax its own residents, in particular, when that State applies its domestic anti-avoidance rules to its own residents (such as a CFC rules or exit taxes)[869]. Whether or not the application of a domestic anti-avoidance rule, targeted by a State towards its own residents, is preserved by the saving clause is discussed in the following chapters (*see chapters 16-20*).

[869] DE BROE/LUTS, BEPS, pp. 137-139.

10. Treaties permitting the application of domestic anti-avoidance rules

10.1. Preliminary remarks

276. The 2011 UN Commentary (*see section 8.2.2.3.1*) provides that a conflict does not arise between a domestic SAAR and a tax treaty if the latter contains an express provision that authorizes the use of the domestic SAAR ("*safeguard clause*"). Similarly, the 2014 TTA and 2015 Final TTA reports (*see section 8.2.3.3.2* and *section 8.2.3.3.3*) provide that a conflict does not arise between a statutory GAAR/ domestic SAAR and a tax treaty if the latter contains a safeguard clause. The questions analysed in this chapter are i) whether the statements made by the UN and OECD are correct and ii) the implications for treaties concluded by States that contain a safeguard clause for treaties concluded by that same State that do not contain a safeguard clause.

10.2. Treaties preserving the application of domestic anti-avoidance rules

10.2.1. Scope of the safeguard clause

277. Several States[870] negotiate a safeguard clause in their tax treaties to allow the application of domestic anti-avoidance rules without making reference to a particular anti-avoidance measure. For example, reference can be made to the German tax treaty policy. Germany, in several of its tax treaties, includes a safeguard clause that reads as follows "*this agreement shall not be interpreted to mean that a Contracting State is prevented from applying its domestic legal provisions on the prevention of tax evasion or tax avoidance*" [871]. Accordingly, the application of domestic anti-avoidance rules that curb tax avoidance is preserved in tax treaties. The question then arises as to which provisions of the domestic law curb tax avoidance? In the author's opinion, the answer to this depends on the intention with which the

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[870] EY, GAAR, pp. 18-19.

[871] For instance, see Art. 27, 2011 Germany – Cyprus tax treaty; Art. 29, 2011 Germany – Mauritius tax treaty; Art. 27, 2011 Germany – Taiwan tax treaty; Art. 28, 2011 Germany – Spain tax treaty; Art. 28, 1997 Germany – Kazakhstan tax treaty; Art. 27, 2001 Germany – Malta tax treaty; Art. 3, Protocol, 2005 Germany – Kyrgyzstan tax treaty.

domestic legislation was introduced by the legislature. If the domestic legislation was introduced with the clear intention to curb tax avoidance then an argument can be made that such legislation could apply even though it conflicts with treaty provisions. Examples of this are statutory GAARs that States introduce specifically to tackle tax avoidance (*see section 3.3*). The same question also arises with respect to the term "*legal provisions*". It could be argued that the reference to the term "*legal provisions*", in the above safeguard clause, implies that treaties containing this reference only preserve the application of statutory GAARs or SAARs and that judicial doctrines fall outside the scope of the clause. The author agrees with such a conclusion as the term "*legal provisions*" refers to a provision codified in the law and does not include judicial doctrines[872].

278. Furthermore, in some of its tax treaties, Germany incorporates the OECD's comments on the interaction of domestic anti-avoidance rules with tax treaties as expressed in the 2003 OECD Commentary on Art. 1 (*see section 8.2.1.7*). Typically, this view is expressed in Joint declarations between Germany and its treaty partners. These declarations provide that "*Having regard to…the Commentary to Article 1 of the OECD model tax convention, it is understood that this Agreement shall not be interpreted to mean that a Contracting State is prevented from applying its domestic legal provisions on the prevention of tax evasion or tax avoidance where those provisions are used to challenge arrangements which constitute an abuse of the Agreement. It is further understood that an abuse of the Agreement takes place where a main purpose for entering into certain transactions or arrangements is 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 of the Agreement"* [873]. Consequently, the application of domestic anti-avoidance provisions to curb tax avoidance is preserved having regard to the OECD's guiding principle. Accordingly, if the domestic anti-avoidance rule is broader in scope in comparison to the guiding principle, then the latter will restrict the former.

279. Even though the aforesaid safeguard clauses preserve the application of domestic anti-avoidance rules, the author submits that the application of such rules leads to double taxation (especially economic double taxation –

[872] DE BROE, Thesis, p. 463.

[873] Joint Declaration, Improper use of the Agreement, 2012 Germany – Ireland tax treaty; Joint Declaration, Improper use of the Agreement, 2010 Germany – UK tax treaty.

for instance see chapter 18). Accordingly, in several of its tax treaties Germany clearly provides that if the application of such rules leads to double taxation then the competent authorities shall consult with each other on the mechanics to avoid double taxation. The clause would typically provide that "*If the foregoing provision results in double taxation, the competent authorities shall consult each other pursuant to (MAP) on how to avoid double taxation*[874].

280. A few treaties entered into by some other States[875] contain safeguard clauses that preserve the application of judicial doctrines and/or statutory GAARs. For instance, Switzerland's tax treaty with Israel provides that "*the Contracting States declare that their domestic rules and procedures with respect to the abuses of law (including tax treaties) may be applied to the treatment of such abuses notwithstanding the provisions of any treaty or convention for the avoidance of double taxation*" [876].

281. Canada's tax treaty with the US provides that the treaty "*shall not be construed as restricting in any manner the right of a Contracting State to deny benefits under the Convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Convention"* [877]. The technical explanation issued by the US on the interpretation of this Article outlines that the "*paragraph…clarifies the application of general anti-abuse provisions…This provision permits a Contracting State to rely on general anti-avoidance rules to counter arrangements involving treaty shopping through the other Contracting State. Thus, Canada may apply its domestic law rules to counter abusive arrangements involving "treaty shopping" through the United States, and the United States may apply its substance-over-form and anti-conduit rules, for example, in relation to Canadian residents".* Accordingly, it has been opined that conflicts should not arise between Canadian domestic anti-avoidance

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[874] For instance, see Art. 29, 2011 Germany – Mauritius tax treaty; Art. 27, 2011 Germany – Taiwan tax treaty; Art. 28, 2011 Germany – Spain tax treaty; Art. 28, 1997 Germany – Kazakhstan tax treaty; Art. 3, Protocol, 2005 Germany – Kyrgyzstan tax treaty.

[875] VAN WEEGHEL, Tax Avoidance, p. 43.

[876] Art. 8, 2003 Protocol, 2003 Switzerland – Israel tax treaty. Similar clauses are also included by Israel in its tax treaties with several other countries. See KATZ, Tax Avoidance, pp. 422-423. Also, see Para. I, 2006 Protocol, 1996 Switzerland – Spain tax treaty.

[877] Art. XXIXA(7), 1980 Canada – USA tax treaty (updated via protocol in 2007). A similar clause is also included in Art. 29(6), 2001 Germany – Canada tax treaty.

rules and the treaty as its application is preserved[878]. Interestingly, it is also stated "*This principle is recognized by the OECD in the Commentaries to its Model Tax Convention on Income and on Capital, and the United States and Canada agree that it is inherent in the Convention. The statement of this principle explicitly in the Protocol is not intended to suggest that the principle is not also inherent in other tax conventions concluded by the United States or Canada*".

282. It was previously established that unilateral explanations issued by the US (*see section 5.4*) could not be included within the ambit of Art. 31 VCLT to interpret a tax treaty. The starting point is the text of the treaty. From the text of the treaty the author cannot clearly ascertain if the clause preserves the application of all domestic anti-avoidance rules. The provision only provides that the provisions of the convention shall not restrict the "*right*" of a Contracting State to deny benefits. The "*right*" may include the application of domestic anti-avoidance rules. However, domestic anti-avoidance rules that cannot establish treaty abuse fall outside the scope of this provision (for instance a thin capitalization rule – *see chapter 16*). Accordingly, it should not be assumed that this treaty preserves the application of all domestic anti-avoidance rules.

283. On the other hand, several treaties concluded by several States preserve the application of domestic SAARs[879]. France in at least fifty of its tax treaties includes a provision that preserves the application of its thin capitalization rules[880]. A typical clause would provide that "*The provisions of this Convention shall not prevent…France from applying the provisions of Articles …212*" or any other similar provisions of the FTC. Art. 212 deals with the French thin capitalization rules [881]. Further, it has been contended that Canada in almost all of its tax treaties (barring four) has inserted a clause that preserves the application of the Canadian deemed income attribution rules such as CFC rules[882]. A typical clause (which extends to several deemed attribution rules) would provide that "*Nothing in the Convention shall be construed as preventing a Contracting State from imposing a tax on amounts included in the income of a resident of that State*

878 GOYETTE, HALVORSON, Tax Avoidance, p. 183.
879 VAN WEEGHEL, Tax Avoidance, p. 44.
880 AUSTRY, COLLET, Tax Avoidance, pp. 326-327.
881 For instance, see Para. 8, Protocol, 1995 France – Austria tax treaty.
882 GOYETTE, HALVORSON, Tax Avoidance, p. 189.

with respect to a partnership, trust, or controlled foreign affiliate, in which the resident has an interest" [883].

284. To summarize, in the author's opinion, if the tax treaty contains a clause that preserves the application of domestic anti-avoidance rules then the scope of that clause needs to be ascertained as to whether it applies to a judicial doctrine, statutory GAAR or to a SAAR. Once it is established that the provision applies to a particular domestic anti-avoidance rule then an argument cannot be made that the application of that domestic anti-avoidance rule is contrary to a States treaty obligation. This is because such clauses express the common intention of the treaty partners to apply that domestic anti-avoidance rule to that tax treaty[884] (even though such rules conflict with treaty provisions). Towards this end, the author agrees with the comments of the OECD and UN that a conflict can be avoided between a domestic anti-avoidance rule and a tax treaty if the treaty contains an express provision which allows the application of the domestic anti-avoidance rule. For instance, in the *Garron case* (*see section 18.4.9*), the CTC held that if a treaty preserves the application of the CFC rules then those rules could be applied notwithstanding the fact that such a rule could conflict with the provisions of the tax treaty. At the same time, the Court held that the fact that the treaty preserves the application of the CFC rules does not imply that other deemed attribution rules are covered by the scope of that provision. Moreover, in the author's opinion, for tax treaties concluded after 2003, domestic anti-avoidance rules that deny treaty benefits can be applied having regard to the guiding principle (*see section 9.3*) [885]. This means that if the scope of the domestic anti-avoidance rule that is used to deny treaty benefits is broader than the guiding principle then the application of the former should be restricted.

10.2.2. Static or ambulatory interpretation of the safeguard clause

285. Another issue arises as to whether a safeguard clause needs to be interpreted in a static or ambulatory manner. For example, assume that State R and State S have the following clause in their tax treaty concluded in the

[883] For instance, see Art. 26(2), 2006 Canada – Mexico tax treaty.
[884] DE BROE, Thesis, p. 463; VOGEL, 2015 Commentary, p. 128.
[885] This will also depend on the legal status attributed to the work of the international organisations: s*ee Chapter 6*.

year 2000: "*this agreement shall not be interpreted to mean that a Contracting State is prevented from applying its domestic legal provisions on the prevention of…tax avoidance*" [886]. The question arises as to whether this provision preserves the application of domestic anti-avoidance rules (to curb tax avoidance) that existed in State R and State S in the year when the treaty was signed (year 2000) or even domestic anti-avoidance rules (to curb tax avoidance) that State R or State S have enacted after the conclusion of the tax treaty (2005). In the author's opinion, the treaty terms ("*domestic legal provisions*") should be interpreted in an ambulatory manner. Thus, subsequently enacted domestic anti-avoidance rules fall within the scope of this provision subject to the limits of ambulatory interpretation (*see section 7.2.6* and *chapter 11*). For instance, if State R had a rule such as the Dutch fictitious wage rule (*see section 14.5.4*) when the treaty was signed, it cannot be argued that such a rule conflicts with the treaty provisions when applied by State R. Likewise, if in the year 2005, State S introduces a similar rule, it cannot be argued that State S is violating the treaty provisions. This is because State S does not impair the treaty balance. However, if neither State had a fictitious wage provision when the treaty was signed, and one of the States introduces such a provision in its domestic tax law to counteract tax avoidance schemes then a reasonable argument can be made that such a rule falls outside the scope of the safeguard clause. The safeguard clause, itself, has to be interpreted in light of Art. 31 VCLT. Accordingly, if the posterior rule leads to a recapture of a taxing right allocated to another State by interpreting undefined terms then the treaty will prohibit the application of such a rule. Moreover, if the domestic rule leads to unresolved double taxation (especially juridical double taxation), it could be argued that the "*object and purpose*" of the treaty is being violated. Even if applied in an ambulatory manner the domestic rule needs to be applied having regard to the OECD's guiding principle (for treaties post the 2003 amendment). This means that if the scope of the domestic anti-avoidance rule that is used to deny treaty benefits is broader than the guiding principle then the application of the former should be restricted. However, one commentator has suggested that the limits of ambulatory interpretation do not apply to such safeguard clauses[887].

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[886] For instance, see Art. 27, 2011 Germany – Cyprus tax treaty; Art. 29, 2011 Germany – Mauritius tax treaty; Art. 27, 2011 Germany – Taiwan tax treaty; Art. 28, 2011 Germany – Spain tax treaty; Art. 28, 1997 Germany – Kazakhstan tax treaty; Art. 27, 2001 Germany – Malta tax treaty; Art. 3, Protocol, 2005 Germany – Kyrgyzstan tax treaty.

[887] DE BROE, Thesis, p. 466.

10.3. The issue of negative inference: Some treaties that do preserve the application of domestic anti-avoidance rules while others do not

286. The aforementioned analysis indicates that States do not have a homogeneous practice of including safeguard clauses in their tax treaty network that preserves the application of domestic anti-avoidance rules. Some treaties contain such a clause whereas others do not. The question analysed here is as follows: suppose a treaty entered into between State R and State S contains a safeguard clause that preserves the application of a domestic anti-avoidance rule. What is the impact of this clause on a treaty entered into by State S with State T that does not contain a safeguard clause to preserve the application of that same domestic anti-avoidance rule? In other words, can it be argued that as the R-S tax treaty allows the application of the domestic anti-avoidance rule, the T-S tax treaty should also apply that rule notwithstanding the fact that the rule may conflict with treaty provisions? Prior to answering this question, it needs to be ascertained what the interpretative value of the R-S tax treaty on the T-S tax treaty is.

287. Tax treaties, in general, are bilateral in nature. Therefore, by applying the interpretation principles of the VCLT, in particular Art. 31 VCLT, an argument can be made that the R-S tax treaty does not have any impact on the T-S tax treaty. This is because Art. 31(2) VCLT provides that the "*context*" of the T-S tax treaty includes the text of the treaty and the agreements, as entered into by State T and State S, in relation to the treaty. Accordingly, the text of the R-S tax treaty cannot be read into the T-S tax treaty as it does not fall within the definition of the "*context*". Also, the text of the R-S tax treaty cannot fit into Art. 31(3) VCLT as it is not a subsequent agreement which assists in the application and interpretation of a tax treaty, nor is it a subsequent State treaty practice that establishes the agreement of the parties regarding the interpretation of the provisions of the T-S tax treaty or a relevant rule of international law as applicable between State T and State S. It could be argued that the R-S tax treaty can be used to interpret the T-S tax treaty as the former fits into Art. 32 VCLT, which provides for supplementary rules of interpretation. However, "*supplementary means*"

should be referred to only to confirm the meaning of a treaty term as derived from the application of Art. 31 VCLT (which is not the case here as the R-S treaty falls outside the scope of Art. 31 VCLT). Alternatively, a reference can be made to supplementary means to ascertain the meaning of a treaty term if the general rule of interpretation (Art. 31 VCLT) leaves the meaning of that treaty term ambiguous or obscure or leads to a result that is manifestly absurd or unreasonable (which is also not the case here). In the author's opinion, the R-S tax treaty will not fit into Art. 32 VCLT as it does not shed any light on the established treaty terms of the T-S tax treaty. Thus, reading a safeguard clause in the T-S tax treaty does not make sense as the text of the treaty does not support such an inclusion[888] (*see section 5.4*). It could be argued that the use of the interpretation provisions contained in the VCLT are not a complete codification of all principles and maxims that have to be adopted in interpreting treaties. Therefore, even though the R-S tax treaty does not fit into either Art. 31 VCLT or Art 32 VCLT it should be considered relevant in the tax treaty interpretation process. However, in the author's opinion, material that represents the common intentions of the parties should only be referred to. The intention (policy reasons) behind State S entering into a tax treaty could be different from the reasons behind the treaty between State R and State T. Accordingly; the R-S tax treaty should not have any impact on the T-S tax treaty.

288. Commentators are divided in their opinion on the impact of a treaty that contains a safeguard clause on a treaty concluded by a State that does not contain such a clause. As indicated earlier, Canada in majority of its tax treaties includes a safeguard clause for applying its domestic income attribution rules, in particular its CFC rules. However, such a clause is absent in a few tax treaties. Consequently, it has been argued that this practise means that Canadian CFC rules cannot be applied to these other treaties[889]. However, at the same time it is argued that Canadian CFC rules can be applied to tax treaties[890] as Canadian Courts refer to the OECD Commentary and the Commentary (*see chapter 6*) provides that such rules do not conflict with tax treaties[891].

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888 DE BROE, Thesis, p. 463.
889 DE BROE, Thesis, p. 469.
890 GOYETTE, HALVORSON, Tax Avoidance, p. 189.
891 SLAATS, WORNDL, Passive income, pp. 199-200.

289. Interestingly, the technical explanation to the 1980 Canada – US tax treaty [892] provides that (*see section 10.2*), even though Art. XXIXA(7) preserves the application of domestic anti-avoidance rules, it does not mean that the clause suggests that other tax treaties have to be interpreted in a manner that absent such a clause the domestic anti- avoidance rule is not applicable to treaty situations. Thus, by referring to the OECD Commentary (probably Para. 9.6 of the 2003 OECD Commentary on Art. 1 – *see section 8.2.1.7*), the US is of the view that treaties (based on the US Model) always allow the application of domestic anti-avoidance rules and (probably) such rules do not conflict with tax treaties.

290. In the author's opinion, if a treaty does not contain a safeguard clause (T-S tax treaty) then a negative inference cannot be drawn from another tax treaty (R-S tax treaty) that the former treaty contains a safeguard clause. This is because the text of the latter treaty cannot be read into the T-S tax treaty. Indeed, if the T-S tax treaty does not include such a clause then whether or not a domestic anti-avoidance provision conflicts with a treaty provision depends on the effects of the domestic provision and the wording and purpose of the relevant tax treaty[893].

10.4. The following chapters in the thesis

291. In the following chapters, the author discusses the interaction of domestic anti-avoidance measures with tax treaties that do not incorporate a safeguard clause. Prior to that the author discusses the relationship between Art. 3(2) of the OECD Model and domestic anti-avoidance rules.

[892] 1980 Canada – USA tax treaty (updated via protocol in 2007).
[893] DE BROE, Thesis, p. 471.

11. Art. 3(2) and the application of domestic anti-avoidance rules

11.1. Domestic law has supremacy in ascertaining the meaning of undefined treaty terms

292. As discussed previously (*see chapter 3*), domestic anti-avoidance rules (judicial doctrines, statutory GAARs or SAARs) may be called into play to give undefined treaty terms a particular meaning. To elaborate, a tax treaty contains many undefined terms such as "*income*", "*profits*", "*gains*", "*paid to*", "*derived by*", "*alienation*", "*arising*" etc. Domestic anti-avoidance rules could be applicable in such a way that they provide meanings for these undefined treaty terms. The question which then arises is the extent to which these rules can be incorporated into a tax treaty if a reference is made to the domestic law pursuant to Art. 3(2). In this regard, the author observes that the commentators are divided in their opinion. One commentator suggests that Art. 3(2) prescribes a broad application of domestic anti- avoidance provisions to tax treaties. He argues that domestic anti-avoidance rules can be referred to pursuant to Art. 3(2) as such rules preserve the coherence and autonomy of domestic law[894]. On the other hand, another commentator suggests applying narrow view and provides that Art. 3(2) does not envisage the application of domestic anti-avoidance rules to tax treaties. It is argued that Art. 3(2) falls under the heading of Art. 3 i.e. "*General Definitions*" which indicates that it is concerned with the definition of simple terms in the domestic law as opposed to definition of terms derived from the substantive provisions of domestic law (such a domestic anti-avoidance rules)[895]. The broad and the narrow view have been criticized in academic literature[896]. In the author's view domestic anti-avoidance rules

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[894] Katz argues that the US judicially developed substance over form doctrine can be applied to a tax treaty. He states that a "*treaty has to operate through local law, which has to remain coherent, and it is reinforced by explicit or implicit intent to retain the full applicability of the domestic law to the extent consistent with the treaty. To some extent – I think to a great extent – that general provenance for applying domestic substance over form rules can be read as being embodied in Article 3(2) of the typical DTC*". IFA, Abuse, p. 12 and p. 42.

[895] GOYETTE, Treaty Abuse, pp. 779-780. Also see VOGEL, PROKISCH, Interpretation, pp. 79-80.

[896] For critical remarks regarding the broad and narrow view refer to DE BROE, Thesis, pp. 284-288.

can be used to interpret undefined treaty terms. This is because Art. 3(2) makes a reference to the domestic law of the State applying the treaty. As domestic anti-avoidance rules form part of the domestic tax law of the State applying the treaty such rules can be called into play to give a meaning to an undefined treaty term[897]. Consequently, if a domestic judicial doctrine, statutory GAAR or even a SAAR is applied to give a meaning to an undefined treaty term then that meaning will take precedence[898]. This is confirmed by the 2011 UN Commentary (*see section 8.2.2.3*) and the 2014 TTA and 2015 Final TTA report (*see section 8.2.3.3.2*). Although the 2011 UN Commentary, the 2014 TTA report and 2015 Final TTA report do not discuss this, this position is of course subject to the limitation that the "*context*" (internal and external) of the tax treaty and the interpretation principles of the VCLT may not require a reference to a domestic law provision.

11.2. The limits towards incorporating domestic law meanings

11.2.1. Unless the context otherwise requires

293. In the author's view (*see chapter 21* for a detailed analysis), the internal context of a tax treaty would prohibit a reference to a domestic anti-avoidance rule if the tax treaty contains an anti-avoidance rule and both anti-avoidance rules apply to a similar fact pattern. For example, if the domestic law of a State contains a statutory GAAR (*see section 3.3*) that can be used to counteract treaty shopping and the treaty contains a PPT rule (*see section 8.2.3.2*), the latter will restrict the former (if it is broader) as it is a "*lex specialis*" which expresses the common intentions of the parties. Moreover, if a specific anti-avoidance strategy, such as treaty shopping, has been identified by States and if a provision towards that effect has been inserted in a tax treaty (this would be the case if the tax treaty contains a LOB clause) then a reference to a domestic anti-avoidance rule to thwart that impugned tax avoidance transaction (such as the German anti treaty shopping or the US

[897] VOGEL, Commentary, p. 123; DE BROE, Thesis, p. 285; KANDEV, Interpretation, pp. 53-55.

[898] This view is supported by Dutch case law on the compatability of the deemed notional employment income provision with tax treaties. *See section 14.5.4*.

Conduit financing rules – *see section 3.4.2.1*) should not be made[899]. The external context of a tax treaty would prohibit a reference to the domestic law if the material which can be classified under it (the OECD or UN Commentary till the extent it is clarificatory in nature) indicates that the domestic law meaning of an undefined treaty term ascertained pursuant to a domestic anti- avoidance rule is far reaching and unreasonable[900]. For instance, this would be the case where the domestic anti-avoidance rule is broader in scope than the guiding principle (for treaties post 2003) as far as counteracting rule shopping schemes is concerned.

11.2.2. The interpretation principles of the VCLT

294. The interpretation principles of the VCLT which warrant that the meaning of an undefined treaty term ascertained pursuant to a domestic anti-avoidance rule, subsequent to the conclusion of a tax treaty, be disregarded when that rule is contrary to the "*good faith"* requirement and the "*object and purpose*" of tax treaties. This would be the case when a State recaptures a taxing right that has been allocated to another treaty partner at the time of concluding a tax treaty as it is against the "*good faith*" requirement[901] (see for instance the DSC case on fictitious wages – *see section 14.5.4*) – an exception can be made to this conclusion if the other State had a similar domestic anti-avoidance rule in place when the treaty was concluded. This will also be the case when that subsequent rule leads to unresolved juridical double taxation as it is against the primary "*object and purpose*" of the tax treaty[902].

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[899] The 2006 US Technical Explanation, Art. 22(1) states a contrary view, namely that "*Article 22 and the anti-abuse provisions of domestic law complement each other, as Article 22 effectively determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (e.g., business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source Contracting State may be applied to identify the beneficial owner of an item of income, and Article 22 then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income"*.

[900] DE BROE, Thesis, p. 288.

[901] DE BROE, Thesis, p. 289.

[902] DE BROE, Thesis, p. 289; PERROU, JAAR, p. 110.

12. Domestic rules that determine real facts: Sham or simulated transactions

12.1. Preliminary remarks

295. The application of tax law involves the ascertainment of facts and the interpretation of law. In this section, the author discusses the treaty compatibility of a domestic law rule that determines the real facts of a transaction to which the domestic law and tax treaties apply.

12.2. The OECD view: The factual vs interpretation approach

296. Para 22 of the 2003/2014 OECD Commentary (*see section 8.2.1.7*) states that "*other forms of abuse of tax treaties (e.g. the use of base company) and of possible ways to deal with them, including "substance-over-form", "economic substance" and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties"*. In response, Para 22.1 of the 2003/2014 OECD Commentary provides that such domestic anti-avoidance rules are rules that determine the "*facts*" that give rise to a tax liability. This fact-based approach can be traced back to the 1986 BC report. In that report, the OECD supported the view of the majority which clearly stated that the provisions of the treaty would apply only after the facts are determined. The conclusions were reached to counteract base companies. The analysis, after being incorporated in the 1992 OECD Commentary, was then transported generally to the 2003 OECD Commentary and is present in the 2014 update to the Commentary.

297. Some commentators have questioned the statements of whether a domestic anti-avoidance rule determines facts that gives rise to a tax liability?[903]. In this respect, a distinction is to be made between domestic anti-avoidance rules (or general doctrines) that determine the facts

[903] DE BROE, Thesis, p. 389; ARNOLD, 2003 changes, p. 250; ARNOLD, VAN WEEGHEL, Abuse, p. 91; MARTIN JIMENEZ, 2003 changes, p. 19; PEREZ, BAEZ, 2003 changes, p. 132.

undertaken by the taxpayer; domestic anti-avoidance rules that re-classify an established fact pattern and substitute it with another fact pattern (redetermination of taxpayer or re-characterization of income); and domestic anti-avoidance rules that deny tax benefits to a transaction undertaken by the taxpayer.

298. One commentator, in the context of analysing whether judicial doctrines lay down rules of law or determine questions of facts, states that in an anatomy of a tax case a Court is required to "*determine the facts, interpret the law and apply that interpretation to the facts*"[904]. In the commentators opinion, the sham doctrine (as applied in the UK context – *see section no. 3.2.1*) is relevant in determining the facts of a tax case because this doctrine assists in determining whether the facts stated by the taxpayer should be given the appropriate private law classification or not[905]. However, in this commentators opinion, the business purpose test as applied in the US, is relevant in interpreting the law as it reads into the tax law a requirement that the particular provision should apply only where there is some business (or other non-tax) purpose[906]. Similarly, the commentator also suggests that the US economic substance doctrine (*see section no. 3.2.2*) assists in interpreting the law and applying that interpretation to the facts[907]. Other commentators have also identified this issue. They comment that domestic judicial doctrines (with the exception of the narrow sham or simulation doctrine) are interpretive principles under which the domestic tax law applies only to transactions with economic substance or business purpose and such doctrines are not fact-finding rules[908].

299. In the author's opinion, at one end of the spectrum, the sham doctrine which originated in the UK *Snook case* and is followed by other common law countries or the simulation doctrines as applied in civil law countries can be classified as doctrines which determines the facts that give rise to a tax liability. Thus, if such doctrines lead to establishing the real facts to which the domestic tax rule and the treaty rule applies, it is impossible to argue that tax treaties preclude the application of a rule that ascertains the real facts of a transaction (*see section no. 8.2.2.2*).

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904 TILEY, Jaar, 1, pp. 190-196.
905 TILEY, Jaar 1, pp. 190-196.
906 TILEY, Jaar 1, pp. 190-196.
907 TILEY, Jaar 1, pp. 190-196.
908 ARNOLD, 2003 changes, p. 251.

300. The 2014 TTA and 2015 Final TTA reports provide an example of such a situation where the sham transaction doctrine is used to ascertain the true facts of a transaction to which the domestic and treaty rule applies. The following example is discussed "*assume, for example, that the domestic law of State A provides for the taxation of gains derived from the alienation of shares of a domestic company in which the alienator holds more than 25 per cent of the capital if that alienator was a resident of State A for at least seven of the 10 years preceding the alienation. In year 2, an individual who was a resident of State A for the previous 10 years becomes a resident of State B. Shortly after becoming a resident of State B, the individual sells the totality of the shares of a small company that he previously established in State A. The facts reveal, however, that all the elements of the sale were finalised in year 1, that an interest-free "loan" corresponding to the sale price was made by the purchaser to the seller at that time, that the purchaser cancelled the loan when the shares were sold to the purchaser in year 2 and that the purchaser exercised de facto control of the company from year 1. Although the gain from the sale of the shares might otherwise fall under paragraph 5 of Article 13 of the State A-State B treaty, the circumstances of the transfer of the shares are such that the alienation in year 2 constitutes a sham within the meaning given to that term by the courts of State A. In that case, to the extent that the sham transaction doctrine developed by the courts of State A does not conflict with the rules of interpretation of treaties, it will be possible to apply that doctrine when interpreting paragraph 5 of Article 13 of the State A State B treaty, which will allow State A to tax the relevant gain under its domestic law rule*"[909]. In the example, the facts reveal that the taxpayer made the gain on sale of shares in year 1 as opposed to year 2. In year 1, the taxpayer was still a resident of State A. Therefore, applying the treaty from State A's perspective, the provisions of Art. 13(5) will not prevent State A from levying its tax. The author cannot disagree with these statements as the sham transaction doctrine ascertains the real facts to which a domestic and treaty rule will both apply.

301. At the other end of the spectrum, the business purpose and economic substance doctrines as applied under the US tax law provisions can be classified as doctrines that assist in the proper interpretation of law (or

[909] 2014 OECD, Report on Treaty Abuse, Para. 49 (Commentary in Para. 10); 2015 OECD, Final Report on Treaty Abuse, Para. 59 (Commentary in Para 26.2).

statutory GAARs or SAARs up to the extent they deny tax benefits). The former are covered by Para 22.1 whereas the latter are not.

302. The question arises as to whether re-characterization doctrines such as the US step transaction *(see section 3.2.3)* or the Dutch Fraus Legis (*see section 3.2.6*) (or statutory GAARs or SAARs up to the extent that they re-characterize transactions - (*see section 3.3 & 3.4*) are fact finding rules or rules that assist in the interpretation of the law. In the structure of a tax case, on one side it can be argued that such rules are fact-finding rules as they seek to apply tax law to the actual transactions undertaken by the taxpayer. Thus, tax law/tax treaties will be applied only to the re-characterized (substituted) transactions. At the same time it can be argued that such rules assist in interpreting the law and applying that interpretation to the facts. The facts of a transaction will be re-characterized (substituted) only after the law is interpreted and it can be established that the taxpayer has acted against the object or purpose or intention of the law[910]. Thus, such rules assist to interpret tax law and are not fact-finding rules[911]. The author subscribes to this view. Accordingly, an argument can be made that the OECD's comments in Para 22.1 should be applicable only to limited situations (narrow sham/simulation doctrine) although the OECD believes otherwise. Consequently, the OECD should consider redrafting its statements in the Commentary for the sake of clarity.

303. It is because of this conclusion the author believes that the 2011 UN Commentary and the 2014 TTA and 2015 Final TTA reports contain a separate section on the interaction of judicial doctrines with tax treaties. However, the author would question the position adopted on the interaction of judicial doctrines with tax treaties as put forward in the 2011 UN Commentary, 2014 TTA and 2015 Final TTA reports? In the author's opinion, the effect of applying domestic statutory GAARs and judicial doctrines (except the sham doctrine) is quite similar. Consequently, the general conclusion proposed by the OECD/UN that the provisions of the VCLT do not prevent the application of judicial doctrines to tax treaties can therefore be qualified because if a conflict arises between a domestic law provision and tax treaty the latter should prevail. This is implicitly stated in

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910 ARNOLD, 2003 changes, p. 251, ARNOLD, Tax Avoidance, p. 30; DE BROE, Thesis, p. 389.

911 PEREZ, BAEZ, 2003 changes, p. 138; MARTIN JIMENEZ, 2003 changes, p. 19; DE BROE, Thesis, p. 389.

the 2014 TTA and 2015 Final TTA reports which outlines that "*in that case, to the extent that the sham transaction doctrine developed by the courts of State A does not conflict with the rules of interpretation of treaties, it will be possible to apply that doctrine when interpreting paragraph 5 of Article 13 of the State A State B treaty, which will allow State A to tax the relevant gain under its domestic law rule"*. Accordingly, if the sham transaction doctrine (or other doctrines) conflict with the treaty interpretation rules then that doctrine may not apply.

12.3. The view expressed in International case law

12.3.1. 2003: Azadi Bachao Andolan – India[912]

304. This case dealt with foreign investors benefiting from the 1982 India-Mauritius tax treaty ("1982 tax treaty"). The domestic tax law of India provides that capital gains derived by non-residents from alienation of shares in Indian companies are taxable in India[913]. The domestic law also provides that, in assessing the final tax impact, a taxpayer can choose between the domestic law or a tax treaty – whichever is more beneficial to the taxpayer[914]. Thus, in order to avoid this domestic capital gains tax, many non-residents (in particular foreign institutional investors) started investing in India via entities incorporated in Mauritius. The main reason for investing through Mauritius is that Art. 13(4) of the 1982 tax treaty[915] provides that gains derived from the alienation of shares in Indian companies is taxable only in Mauritius. Further, Mauritius under its domestic law did not tax these gains. Accordingly, this resulted in double non-taxation. The Indian tax authorities (at the lower level) attacked the Mauritian structures adopted by taxpayers by contending that these were cases of treaty shopping and therefore abusive. This was mainly because residents of third countries were setting up shell companies[916] in Mauritius to route investments in India. As the tax authorities had become fairly aggressive in their approach, the

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912 ISC: Union of India and another v Azadi Bachao Andolan and another, 132 Taxman 373 (SC), October 7th 2003, pp. 233-291.

913 Section 9, IITA.

914 Section 90(2), IITA.

915 Art. 13(4) of the tax treaty provided that "*Gains derived by a resident of a Contracting State from the alienation of any property other than those mentioned in paragraphs (1), (2) and (3) of this article shall be taxable only in that State*".

916 ISC: Para. 9, Azadi case.

Central Board of Direct Taxes issued a circular (which was binding on tax authorities). This circular directed the tax authorities to grant treaty benefits to Mauritius resident taxpayers only if they could provide valid tax residence certificates. Thereafter, a public interest litigation was filed before the Delhi High Court which challenged the validity of this circular. The reason for challenging the circular was that it was relatively simple for Mauritius resident taxpayers to produce tax residence certificates to claim tax treaty benefits. This meant that the tax authorities could not challenge Mauritius resident taxpayers.

305. The Delhi High Court quashed the circular as it regarded it to be unconstitutional. In its findings, the Delhi High Court held that tax authorities are "*entitled to lift the corporate veil in order to see whether a company is actually a resident of Mauritius or not and whether the company is paying income-tax in Mauritius or not*" [917]. This meant that the tax authorities could look into the substance of the transaction as opposed to its form. It was also held that "*Treaty Shopping, by which the resident of a third country takes advantage of the provisions of the Agreement, is illegal and thus necessarily forbidden*"[918]. The case went for trial before the ISC.

306. The ISC held that the form of a transaction should be respected. This meant that the tax authorities could not challenge a Mauritius investment structure by looking into the underlying motives of a taxpayer[919]. Therefore, as long as a structure contained legal substance i.e. the structure was legally effective – the underlying economic substance could not be considered. Also, the ISC analysed whether the doctrine of piercing/lifting the corporate veil could be applied. In this regard, the Court seems to have provided that such a doctrine can be invoked only in cases of fraud (sham) and not tax avoidance transactions[920]. In relation to the issue of whether treaty shopping is legal the ISC ruled that "*It is urged by the learned counsel for the appellants, and rightly in our view, that if it was intended that a national of a third State should be precluded from the benefits of the DTAC, then a suitable term of limitation to that effect should have been incorporated therein*"[921]. Accordingly, in the absence of a LOB clause in the 1982 tax

[917] ISC: Para. 11(c), Azadi case.
[918] ISC: Para. 11(c), Azadi case.
[919] ISC: Para. 144, Azadi case.
[920] ISC: Para. 105, Azadi case.
[921] ISC: Para. 104, Azadi case.

treaty, the ISC opined that tax treaty benefits had to be conferred upon the taxpayer.

307. The author agrees with the decision as it is applied in the Indian tax law sphere. The jurisprudence in India indicates that the form of a transaction is respected as long as it contains legal substance. Only, in cases where the transaction does not contain legal substance i.e. where it is not legally effective or if the sham doctrine applies, can one look at the underlying substance of the transaction or pierce the corporate veil. In the case at hand, investors of third countries invested in India through entities incorporated in Mauritius. These entities were properly created and prima facie, were not "*shams*". Accordingly, the Court could not look into the underlying motive of the structure created by the taxpayer.

12.3.2. 2009: Antle – Canada [922]

308. This case dealt with a structure that was implemented to exploit the beneficial provisions of the 1980 Canada-Barbados tax treaty ("1980 tax treaty"). In the case, the taxpayer viz., Mr Antle wished to sell shares in certain Canadian resident companies to an independent third party purchaser. In order to shelter the capital gain that would arise on the sale, he employed a scheme known as a "*capital property step-up strategy*". Pursuant to this scheme, Mr. Antle transferred his shares to a newly settled discretionary Barbados trust ("trust") in which his wife i.e. Mrs Antle (a Canadian tax resident) was the sole beneficiary. This transfer was effected on a tax deferred "*rollover basis*" which meant that there was no immediate payment of the tax. Shortly afterwards, the trust sold the shares at FMV to Mrs. Antle in exchange for a promissory note. This sale was tax neutral for Canadian tax purposes as Art. 14(4) of the 1980 tax treaty provided that the gains were only taxable in the residence State of the alienator. As the trust was a resident of Barbados (as the trustees were also tax resident therein), the gain was taxable only in Barbados. Thereafter, Mrs Antle sold the shares to the Canadian arm's length purchaser. The sale proceeds that were received by Mrs Antle were used to repay the note that was due to the trust. After the trust received the funds, it made a capital distribution of those proceeds to

[922] CTC: Antle v R; Marquis-Antle Spousal Trust v R; Antle and another v R, 12 ITLR 359, September 18th 2009, pp. 359-408. Followed by CFCA: Antle v Her Majesty the Queen; Marquis-Antle Spousal Trust v Her Majesty the Queen; 13 ITELR 591, October 21st 2010, pp. 591-598.

Mrs Antle. This distribution was exempt from Canadian tax pursuant to the domestic tax law. As a result of undertaking these steps the cost base of the shares was stepped-up to FMV prior to the sale to the independent purchaser. The key to the scheme was that the gain on the sale of the shares that was realized by the trust was exempt from Canadian capital gains tax under the 1980 tax treaty.

309. The CTC summarizes the scheme appropriately by stating that "*this strategy involves a shifting of capital property (with an accumulated gain) from husband to a Barbados spousal trust, and in this case, the trust then selling the property to the beneficiary wife, the wife selling the property to a third party purchaser using the proceeds to pay off the trust, the trust then distributing the funds to the wife as beneficiary and the trust then dissolving. Result--no tax, as there is no capital gain taxable in Canada, as there would have been had the husband sold the capital property directly to the third party. The capital gain arises in the trust in Barbados where there is no tax on capital gains*". The Canadian tax authorities objected to this scheme on many grounds, two of them being the doctrine of sham and the legally ineffective transaction doctrine. Further, the tax authorities also argued that the Canadian GAAR applied as the scheme was an abusive tax avoidance scheme (*see section 15.4.5*).

310. After an in-depth analysis of the facts of the case, the CTC held that the Barbados trust was not validly constituted according to the relevant trust law and the shares were never transferred to the trust as the circumstances surrounding the case clearly indicated that Mr Antle had never intended to give the trustee any discretion or control over the trust property. Hence, the trust was legally invalid[923]. Further, the CTC concluded that the Trust was not a sham even though Mr. Antle never intended to settle a discretionary trust[924]. On appeal by the taxpayer, the CFCA also held in favor of the tax authorities. It was held that the trust was not validly constituted [925]. Furthermore, in contrast to the CTC's decision, the CFCA held that the trust was a sham. This was because an intentional element of deceit was present since the parties to the transaction presented the structure in a way that suggested that it was something different from what it actually was [926]. The

[923] CTC: Paras. 40-59, Antle case.
[924] CTC: Paras. 60-74, Antle case.
[925] CFCA: Para. 15, Antle case.
[926] CFCA: Para. 20, Antle case.

author agrees with the finding that if a transaction is considered to be sham or legally ineffective then that transaction should not be respected for domestic as well as tax treaty purposes. It would be extremely vague to argue that a transaction which is considered to be a sham or legally ineffective should be given effect for the purpose of the tax treaty. In this regard, the findings of the CTC may be referred to wherein the Court held that "*In short, if you are going to play the avoidance game, it is not enough to have brilliant strategy, you must have brilliant execution*" [927]. Accordingly, if the transactions are not executed appropriately in order to give them the necessary legal effect, then they should be disregarded for tax purposes.

12.3.3. 2012: Vodafone – India[928]

311. This case dealt with an indirect transfer of Indian assets. At the outset, it should be noted that this case was not a treaty shopping case but was more concerned with domestic anti-avoidance rules. Nevertheless, the ISC did discuss certain tax treaty issues vis-à-vis the 1982 India-Mauritius tax treaty (1982 tax treaty) which are relevant for other parts of this thesis. The facts are as follows.

312. Hutchinson Group, a Hong Kong based conglomerate, owned nearly two thirds of the share capital of Hutchinson India ("Hutch India"), a leading Indian telecommunications company. The share capital was held through a chain of offshore companies ie Hutchinson Hong Kong ("Hutch Hong Kong") owned Hutchinson Telecommunications International, a Cayman Islands corporation ("Hutch Cayman)", which in turn owned British Virgin Island entity ("Hutch BVI"), which in turn owned CGP investments ("CGP"), another Cayman Islands corporation, which in turn owned several entities in Mauritius. These Mauritius entities owned 67% of Hutchinson India. Thus, through CGP, the Hutch Group held a controlling interest in Hutchinson India. Subsequently, Vodafone NL, a Dutch entity acquired the controlling interest of Hutch India ie it bought CGP from Hutch BVI.

313. The tax authorities decided that the sale of shares of CGP by Hutch BVI to Vodafone NL was subject to tax in India. This was because the

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[927] CTC: Para. 58, Antle case.

[928] ISC: Vodafone International Holdings B.V. vs Union of India, Civil Appeal No.733 of 2012, January 20th 2012.

taxpayer alienated a "*controlling interest*" in an Indian entity. Essentially they argued that a "*look through*" approach needed to be adopted in this case with the effect that Hutch BVI had sold the assets of the Indian entity to Vodafone NL and not the shares of CGP. Therefore, the transaction was subject to tax in India and pursuant to the withholding tax provisions and Vodafone NL had to withhold taxes on the sale consideration paid to Hutch BVI[929]. As Vodafone NL did not withhold the taxes they were treated as "*Taxpayers in default*". The tax authorities adopted this position even though the seller (Hutch BVI), the object of sale (CGP) and the purchaser (Vodafone NL) were non-residents for Indian tax purposes. Being aggrieved, Vodafone NL filed a writ petition before the Mumbai High Court. In this regard, the Mumbai High Court also held that the transaction was subject to tax in India as Hutch BVI had alienated a "*controlling interest*" in an Indian entity. Finally, Vodafone NL appealed before the ISC to determine the taxability of the transaction. The ISC then ruled in favour of Vodafone and held that the transaction was not subject to tax in India. While doing so the ISC made the following observations which are relevant to the discussion here.

314. Firstly, among the various arguments that were made, the tax authorities in this case had argued that the judicial anti-avoidance doctrines (sham or lifting the corporate veil or even substance over form doctrines) could be applied to the transaction. Basically, the tax authorities contended that the structure utilized to hold the shares of Hutch India was an abuse of the domestic law as the structure was put in place only to avoid Indian capital gains taxes on exit. However, the ISC had previously held that judicial anti-avoidance doctrines could be invoked only if the transaction could be considered to be a sham or is tax evasive (*see section 12.3.1*) and since the holding structure in this case was neither a sham nor was used for tax evasion purposes, the Court held that it could not "*look through*" the intermediary entities. To elaborate, the ISC, in relation to cross-border holding company structures, specifically held that in a case where the tax authority "*finds that in a Holding Structure an entity which has no commercial/business substance has been interposed only to avoid tax then in such cases applying the test of fiscal nullity it would be open to the Revenue to discard such interpositioning of that entity. However, this has to be done*

[929] The IITA provides that a taxpayer is required to withhold taxes if the transaction is subject to tax in India. Section 195, IITA.

at the threshold. In this connection, we may reiterate the "look at" principle enunciated in Ramsay …in which it was held that the Revenue or the Court must look at a document or a transaction in a context to which it properly belongs to. It is the task of the Revenue/Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole and not to adopt a dissecting approach. The Revenue cannot start with the question as to whether the impugned transaction is a tax deferment/saving device but that it should apply the "look at" test to ascertain its true legal nature…which further observed that genuine strategic tax planning has not been abandoned by any decision of the English Courts till date. Applying the above tests, we are of the view that every strategic foreign direct investment coming to India, as an investment destination, should be seen in a holistic manner. While doing so, the Revenue/Courts should keep in mind the following factors: the concept of participation in investment, the duration of time during which the Holding Structure exists; the period of business operations in India; the generation of taxable revenues in India; the timing of the exit; the continuity of business on such exit. In short, the onus will be on the Revenue to identify the scheme and its dominant purpose. The corporate business purpose of a transaction is evidence of the fact that the impugned transaction is not undertaken as a colourable or artificial device. The stronger the evidence of a device, the stronger the corporate business purpose must exist to overcome the evidence of a device"[930].

315. Accordingly, when an investment in India is made by offshore companies, which are owned and controlled ultimately by non-residents, and if the investment can be classified as a "*strategic investment*" (based on the factors identified by the Supreme Court) the view could be taken that the tax authorities may not apply the judicial anti-avoidance doctrines. As the structure adopted by the taxpayer was a "*strategic investment*" structure (the holding structure was in place for a long period, Hutch India generated significant taxable revenues prior and after being sold) the ISC held that "*The said Offshore Transaction evidences participative investment and not a sham or tax avoidant preordained transaction"*[931].

[930] ISC: Para. 68, Ruling by Justice Kapadia, Vodafone case.
[931] ISC: Para. 90, Ruling by Justice Kapadia, Vodafone case.

316. The words "*tax avoidant preordained transaction*" from the case raises an interesting issue. The ISC at several places in the judgment provides that the tax authorities can apply the judicial anti-avoidance doctrines to a preordained transaction that is created for tax avoidance purposes. This view was essentially adopted from the *Ramsay case (see section 3.2.3)*. To ascertain whether a transaction is preordained, the Court provides that to "*find out whether a given transaction evidences a preordained transaction…one has to take into account the factors enumerated hereinabove, namely, duration of time during which the holding structure existed, the period of business operations in India, generation of taxable revenue in India during the period of business operations in India, the timing of the exit, the continuity of business on such exit"* [932]. In this respect, the ISC held that "*Sale of CGP share, for exiting from the Indian Telecommunication Sector, in our view, cannot be considered as pre-ordained transaction, with no commercial purpose, other than tax avoidance. Sale of CGP share, in our view, was a genuine business transaction, not a fraudulent or dubious method to avoid capital gains tax"*[933]. Accordingly, the author suggests that this judgment has the effect of creating a step transaction doctrine that is limited to the composite transaction doctrine (as seen in the UK approach) in the Indian tax law sphere. Thus, if a step in a transaction is created with the underlying purpose only of avoiding tax and if this step cannot be justified from a commercial or business perspective, the tax authorities may disregard it.

317. Secondly, the Court in line with the view it expressed in the *2003 Azadi case*, held that in the absence of a comprehensive LOB clause in the 1982 tax treaty, treaty benefits had to be conferred upon the taxpayer even if that taxpayer was owned and controlled by residents of third states. The Court held that "*We are, therefore, of the view that in the absence of LOB Clause…tax department cannot at the time of sale/disinvestment/exit from such FDI, deny benefits to such Mauritius companies of the Treaty by stating that (investment) was only routed through a Mauritius company, by a company/principal resident in a third country; or the Mauritius company had received all its funds from a foreign principal/company; or the Mauritius subsidiary is controlled/managed by the Foreign Principal; or the Mauritius company had no assets or business other than holding the*

[932] ISC: Para. 73, Ruling by Justice Kapadia, Vodafone case.
[933] ISC: Para. 126, Ruling by Justice Radhakrishnan, Vodafone case.

investment/shares in the Indian company; or the Foreign Principal/100% shareholder of Mauritius company had played a dominant role in deciding the time and price of the disinvestment/sale/transfer; or the sale proceeds received by the Mauritius company had ultimately been paid over by it to the Foreign Principal/ its 100% shareholder either by way of Special Dividend or by way of repayment of loans received; or the real owner/beneficial owner of the shares was the foreign Principal Company"[934]. This meant that in the absence of a LOB clause in a tax treaty, a taxpayer from a third state could indeed engage in treaty shopping.

318. Lastly, the ISC also discussed the issue of whether the 1982 tax treaty contains an inherent anti-abuse clause. In this regard, the Supreme Court held that "*we also find no reason to import the "abuse of rights doctrine" (abus de droit) to India. The above doctrine was seen applied by the Swiss Court in A Holding Aps…, unlike Courts following Common Law...That was a case where a Danish company was interposed to hold all the shares in a Swiss Company and there was a clear finding of fact that it was interposed for the sole purpose of benefiting from the Swiss- Denmark DTA which had the effect of reducing a normal 35% withholding tax on dividend out of Switzerland down to 0%. Court in that case held that the only reason for the existence of the Danish company was to benefit from the zero withholding tax under the tax treaty. On facts also, the above case will not apply to the case in hand"*[935]. Accordingly, the ISC rejected the existence of an inherent anti-abuse rule in a tax treaty (*see section 21.3.1.1*).

12.4. Conclusion

319. In the author's opinion, if a transaction is considered to be sham or simulated (or even legally ineffective) then that transaction should not be respected for domestic tax law purposes. Logically, such rules cannot be considered to violate the provisions of a tax treaty as such rules determine the true facts to which the taxing provisions apply.

[934] ISC: Para. 97, Ruling by Justice Radhakrishnan, Vodafone case.
[935] ISC: Para. 101, Ruling by Justice Radhakrishnan, Vodafone case.

13. Source State: domestic anti-avoidance rule that redetermines a taxpayer

13.1. The domestic anti-avoidance rule

320. In this section, the author discusses the treaty compatibility of a domestic anti-avoidance rule that is applied by the source State pursuant to which a re-determination of the taxpayer to whom a domestic income attribution rule applies. In other words, the income that originates from the source State is attributed to another taxpayer and not to the taxpayer that is legally entitled to receive the income.

13.2. The case study fact pattern

321. Consider the following situation: A resident investor, X, of State R wishes to invest in State S companies. The domestic tax law of State S imposes a capital gains tax on sale the of shares in domestic companies. The tax applies, irrespective, of the R-S tax treaty as the treaty deviates from Art. 13(5) of the OECD Model by allocating the taxing rights to State S. Thus, in order to invest in State S companies, X, legally sets up a wholly owned subsidiary – B Corp – in State T. B Corp qualifies as a resident for domestic as well as treaty rules (treaties concluded by this State do not contain the LOB clause or the PPT rule). State T does not levy taxes on capital gains. B Corp, in turn, invests in State S companies. B Corp, subsequently, sells the shares. The State S capital gains tax is not triggered as Art. 13(5) of the T-S treaty follows the OECD Model that allocates the taxing rights to the State of residence of the alienator (State T). Assume that State S applies its domestic anti-avoidance rule (as the conditions to apply it are triggered) and redetermines the taxpayer, in the sense that, capital gains are attributed to X and not B Corp. The question arises as to whether the application of the domestic anti-avoidance rule conflicts with the treaty provisions? The issue is important as from a State R and State T perspective the capital gains are derived by B Corp whereas from a State S perspective they are derived by X.

13.3. The OECD/UN view

Para 22.1 of the 2003/2014 OECD Commentary provides that the provisions of a tax treaty will be applied only after a domestic anti-avoidance rule redetermines a taxpayer. It is also stated that, as a general rule, a conflict does not arise between such domestic rules and tax treaties. The OECD Commentary to Art. 17(2) discusses this position. The Commentary, in the context of preventing rent a star arrangements, provides that "*the Convention would not prevent the application of general anti-avoidance rules of the domestic law of the State of source which would allow that State to tax either the entertainer/sportsperson or the star-company in abusive cases, as is recognised in paragraphs 22 and 22.1 of the Commentary on Article 1*" [936]. Accordingly, a conflict with treaty provisions does not arise if a domestic anti- avoidance rule re-allocates the income derived by an intermediary entity to the artist or sportsman. The development of the 2011 UN Commentary also indicates that the treaty will apply after taking into account the redetermination effect. Both the OECD (generally) and the UN (in the context of statutory GAARs) are of the view that the domestic anti-avoidance rule should be applied having regard to the guiding principle. Similarly, the 2014 TTA and 2015 Final TTA report also provides that the conclusions already reflected in the 2003/2014 OECD Commentary on Art. 1 with respect to domestic anti-avoidance rules remains applicable even with respect to treaties that do not incorporate the PPT rule. It is also stated that no conflict will arise if a domestic statutory GAAR is in conformity with the guiding principle. Essentially, the guiding principle is required to be seen as a treaty GAAR.

13.4. The view expressed in International case law

13.4.1. 1971: The Aiken Industries – USA[937]

322. This case dealt with a treaty shopping structure whereby a taxpayer attempted to exploit the beneficial provisions of the USA-Honduras tax treaty that was in force during the years 1964-65. The issue was whether the taxpayer could obtain the treaty benefits vis-à-vis interest payments made by

[936] 2014 OECD Comm. Art. 17, Para. 11.2.

[937] US TC: Aiken Industries, Inc vs Commissioner of Internal Revenue, 56 TC 925, August 5th 1971.

a US corporation to a Honduran corporation. The facts of the case are as follows. A Bahamas resident corporation viz., ECL had initially given a loan to its indirect subsidiary viz., MPI, a US resident corporation. As a tax treaty did not exist between the Bahamas and the US, the interest payments made by MPI to ECL were subject to a 30 percent withholding tax in the US. In order to avoid this withholding tax, ECL assigned the loan to its newly incorporated indirect subsidiary viz., Industrias, a corporation resident in Honduras in exchange for several promissory notes (these notes, in principle, contained the same features of the loan that now existed between Industrias and MPL). By doing this, the taxpayer sought to take advantage of Art. 9 of the 1964 tax treaty[938], which provided that the US source interest, was exempt from the 30 percent withholding tax. In essence, the structure was a back to back loan arrangement pursuant to which the interest received by Industrias was passed on to ECL. As the structure was set up solely to avoid the US withholding tax, the US tax authorities denied the treaty benefits to Industrias. They argued that Industrias should be disregarded for tax purposes and ECL should be deemed the true owner and recipient of the interest income.

323. The US TC disagreed with the first argument advanced by the tax authorities. In the Courts opinion, Industrias was a corporation for the purpose of the 1964 tax treaty (it was not a factual sham). However, the US TC did agree with the tax authority's argument that the recipient of the interest income was not Industrias but ECL. To arrive at this conclusion – the Court adopted the following reasoning. The Court held that the term "*received by*" as provided in Art. 9 of the tax treaty was an undefined treaty term. Accordingly, pursuant to Art. 2(2) of the 1964 tax treaty[939] reference was made to the domestic tax law of the US to ascertain its meaning. Thereafter, the US TC, by referring to the domestic judicial anti-avoidance doctrines (as applied in the *Gregory v. Helvering case, Higgins vs Smith case* and the *Knetsch vs United States case - see section 3.2),* which were

[938] Art. 9 of the tax treaty provided that "*Interest on bonds, securities, notes or on any other form of indebtedness from sources within one of the contracting States received by a resident, corporation or other entity of the other contracting State not having a permanent establishment within the former State at any time during the taxable year in which such interest is received, shall be exempt from tax by such former State*".

[939] Art. 2(2) of the tax treaty provided that "*For purposes of application of the provisions of the present Convention by one of the contracting States, any term not otherwise defined shall, unless the context otherwise requires, have the meaning which such term has under the laws of such State relating to the taxes which are the subject of the present Convention".*

developed by the US Courts before the conclusion of the tax treaty, held that the interest income was "*received by*" MPI as opposed to Industrias since the latter did not have any economic substance or business purpose and was set up only for tax avoidance purposes.

324. The US TC provided that "*In effect, Industrias, while a valid Honduran corporation, was a collection agent with respect to the interest it received from MPI. Industrias was merely a conduit for the passage of interest payments from MPI to ECL, and it cannot be said to have received the interest as its own. Industrias had no actual beneficial interest in the interest payments it received, and in substance, MPI was paying the interest to ECL which "received" the interest within the meaning of article IX. Consequently, the interest in question must be viewed as having been "received by" an entity (ECL) which was not a "corporation or other entity" of one of the contracting States involved herein, and we therefore hold that the interest in question was not exempt from taxation by the United States under article IX of the convention*". Thus, as the Honduran corporation lacked dominion and control over the interest payments the income was considered to be "*received by*" ECL.

325. The outcome of the US TC's approach seems to be in line with the OECD Commentary that states that provisions of the tax treaty will then be applied after taking into account these changes. The US TC found that pursuant to the application of the domestic judicial anti-avoidance doctrines (which were in existence before the conclusion of the relevant tax treaty) the income was "*received by*" MPI as opposed to Industrias. Consequently, as the income was attributed to a Bahamas resident corporation ie ECL – the 1964 tax treaty did not apply to the facts of the case.

13.4.2. 1995: Teong Chan Gaw – USA [940]

326. This case dealt with a treaty shopping structure whereby a taxpayer attempted to exploit the beneficial provisions of the 1948 USA-Netherlands tax treaty. The issue was whether the taxpayer could obtain treaty benefits vis-à-vis interest payments made by a US corporation to a Dutch corporation. The facts[941] that are relevant to the case are as follows. A

[940] US TC: Anthony Teong-Chan Gaw v. Commissioner, TC Memo 1995-531 Anthony Teong-Chan Gaw as Transferee of Radcliffe Investment, November 9th 1995.

[941] The author has presented a simplified version of the facts.

corporation resident in Hong Kong viz., Pioneer wished to provide a loan to its indirectly held US subsidiary viz., BOT. Instead of providing the loan directly to BOT, Pioneer provided a loan to another indirectly held Netherland Antilles subsidiary viz., Asselwell which in turn provided a loan to its Dutch subsidiary viz., Horbury. Finally, Horbury provided the loan to BOT. In essence, the structure was a back to back loan arrangement pursuant to which the interest paid by BOT was ultimately passed on to Pioneer. The primary reason for routing the loan through Horbury was that interest payments made by US resident corporations to Dutch recipients were exempt from US withholding taxes pursuant to Art. 8(1) of the 1948 tax treaty[942] (this withholding tax exemption would not have been available if Pioneer had made the loan directly to BOT). As the loan was provided through a Dutch Company with the purpose of avoiding the US interest withholding tax, the US tax authorities denied the treaty benefits to Horbury. They argued that the interest on the loan was "*paid to*" Pioneer as compared to Horbury. To support this position, the tax authorities relied on the US TC's decision in the *1971 Aiken Industries case* (discussed previously) and invoked the domestic judicial anti-avoidance doctrines, which were developed by the US Courts before the conclusion of the tax treaty, to contend that in substance the interest was paid to a Hong Kong resident. Being aggrieved, the taxpayer appealed to the US TC.

327. The US TC decided against the taxpayer by providing that "*Turning to petitioner's contention that the interest at issue in the Horbury transaction is exempt from U.S. taxation under article VIII(1) because the express provisions of that article have been satisfied, we agree with respondent that, under substance over form and related principles, which we applied in Aiken Indus., Inc. v. Commissioner… the question whether a payment of interest is exempt from U.S. taxation under the provisions of a treaty is determined by the substance, rather than the form, of the transaction with respect to which such a payment is made…We therefore cannot conclude that the interest at issue in the Horbury transaction was, in substance, paid to Horbury, as petitioner contends"*.

[942] Art. 8(1) of the tax treaty provided that "*Interest on bonds, notes, debentures, securities, deposits or any other form of indebtedness (including interest from mortgages or bonds secured by real property) paid to a resident or corporation of one of the Contracting States shall be exempt from tax by the other Contracting State"*.

328. Although the US TC concludes that Horbury is not the income recipient for US domestic tax law purposes, it is not extremely clear from the judgment whether the US TC attributed the income to Pioneer. If this is the case then the comments which it makes in the judgment seem to be in line with the OECD Commentary in Para 22.1 on Art. 1; as a tax treaty did not exist between the US and Hong Kong, Pioneer was not entitled to treaty benefits.

13.4.3. 1995: Unknown Taxpayer – Netherlands[943]

329. This case dealt with the Dutch "*holding*" structure which is more or less a variant of the Dutch "*cash box*" structure (*see section 14.4.1*). Under the prior law in the Netherlands, dividends were taxable at a higher rate than capital gains. Thus, a Dutch resident taxpayer ("taxpayer"), who owned shares in a Dutch Operating Company ("Dutch Op Co"), tried to strip the profits of the Dutch Op Co by receiving a capital gain as opposed to dividends. To do this, firstly, the taxpayer created a new holding company ("Dutch Hold Co"). Secondly, he sold the shares in the Dutch Op Co to the Dutch Hold Co in return for a note. As a result he realized a capital gain. Thirdly, the Dutch Hold Co caused the Dutch Op Co to distribute a dividend (this dividend distributions was exempt pursuant to the Dutch participation exemption regime). Finally, the Dutch Hold Co used the dividends received from the Dutch Op Co to repay the note due to the taxpayer. Thus, by undertaking these steps the taxpayer converted dividends to capital gains.

330. In this case, a Belgian resident taxpayer ("Belgian taxpayer") who owned a Dutch Op Co implemented a complex version of the "*holding*" structure. The tax authorities applied the domestic *fraus legis* doctrine and argued that the dividend had been paid by the Dutch Op Co to the Belgian taxpayer as opposed to the newly created Dutch Hold Co. They had eliminated a transaction and taxpayer from the facts of the case. Accordingly, the question that arose in this case was whether the *fraus legis* doctrine could be used to attack the "*holding*" structure scheme when the taxpayer was a resident of Belgium. In other words, whether attributing the "*dividends*" [944] to the Belgian taxpayer was in accordance with the

[943] DSC: Case No. 29. 531, March 15th 1995. The author did not manage to get a translation of this case. Thus, reliance was made on the summary of the case as available on the IBFD Tax Treaty case law database. Also see DE BROE, Thesis, pp. 407-411.

[944] Art. 10 (3) of the tax treaty defined dividends to mean "Th*e term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights,*

provisions of the 1970 Netherlands-Belgium tax treaty ("1970 tax treaty"). The case went for trial and the DSC ruled in favour of the taxpayer. The Court held that even if the sole objective of the scheme was to frustrate the Dutch withholding tax provisions on dividends, Art. 10 of the treaty precluded the Netherlands from taxing that item of income. The Court arrived at this conclusion by stating that nothing in the text of the 1970 tax treaty or in the explanations of the treaty partners indicated that the Netherlands or Belgium had the common intention of applying the *fraus legis* at the treaty level[945]. Accordingly, the redetermination effect could not be given effect. This approach clearly contrasts with the OECD view on this issue, which provides that the provisions of a tax treaty apply after taking into account the redetermination effect. In the author's opinion, it can be implied that the *fraus legis* doctrine cannot be applied to a situation when a shift in allocation of taxing rights occurs. This doctrine, which was developed in the early 1980's, resulted in a shift of allocation of taxing rights with respect to a tax treaty concluded in 1970 (the Netherlands wanted to recapture a an exclusive right to tax that was vested in Belgium). Thus, the DSC precluded the Netherlands from taxing that item of income.

13.4.4. 1997: Northern Indiana Public Service – USA[946]

331. This case dealt with a structure that was set up to exploit the beneficial provisions of the 1948 USA-Netherlands tax treaty as extended to the Netherlands Antilles. The facts of the case are as follows. A US Corporation viz., NIPSCO wished to borrow money from the Eurobond market. To achieve this NIPSCO incorporated a Netherlands Antilles corporation viz., Finance. Finance issued loan notes worth Euro 70 million on the Eurobond market at an interest rate of 17.25%. Subsequently, Finance loaned the proceeds obtained from the Eurobond issue at an interest rate of 18.25% to NIPSCO. Thus, the main issue that arose in this case was whether the

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founders' shares or other rights, not being debt-claims, participating in profits, as well as income from corporate rights assimilated to income from shares by the taxation law of the State of which the company making the distribution is a resident".

945 In this respect, it should be noted that the DSC has reiterated its opinion in a case that had a similar fact pattern. Refer Dutch Hoge Raad: Case No. 36. 773, December 2002. The author did not manage to get a translation of this case. Thus, reliance was made on the summary of the case as available on the IBFD Tax Treaty case law database. Also, see DE BROE, Thesis, pp. 407-411.

946 US TC: Northern Indiana Public Service Co. v. Commissioner, 105 TC 341, November 6th 1995; Followed by US COA for Seventh Circuit: Northern Indiana Public Service Company v. Commissioner, 115 F3d 506, June 6th 1997.

interest payments made by NIPSCO to Finance were eligible for treaty benefits i.e. whether the interest paid was exempt from the 30 percent US withholding tax pursuant to Art. 8(1) of the 1948 tax treaty[947].

332. The US tax authorities argued that Finance should be disregarded, as it served no business purpose and was a mere conduit in the borrowing and lending process. Therefore, NIPSCO should be treated as making the interest payments to the bondholders as opposed to Finance. Accordingly, the withholding tax was applicable. In response the US TC held that Finance had sufficient business purpose ie it engaged in genuine borrowing and lending. In this regard the Court held that NIPSCO "*wanted to take advantage of favourable Eurobond interest rates. However, prospective lenders did not want to be liable for the 30-percent tax…Prospective lenders were willing to lend money to Finance because it was a Netherlands Antilles corporation whose notes would not be subject to tax…The business purpose of Finance was to borrow money in Europe at a favorable rate and lend money to petitioner. For its involvement, Finance would derive a profit equal to 1 percent of the amount lent to petitioner; i.e. the difference between 17-1/4 percent and 18-1/4 percent interest"*. This quote from the case seems to suggest that because Finance engaged in the business activity of borrowing and lending money at a profit, it had sufficient business purpose. Accordingly, Finance was the true recipient of the interest paid to it by NIPSCO. Further, the Court distinguished this case from the *1971 Aiken Industries case* on the following two grounds. The Court stated in the *Aiken case* that the transactions were between related parties and the intermediary corporation had paid out the same interest that it had received. These two elements were absent in the NIPSCO case as Finance dealt with unrelated parties and was set up with the valid business purpose of borrowing and lending. Thus, Finance was considered as the recipient of the income.

333. The tax authorities appealed the decision before the US COA (seventh circuit). However, the US COA decided the case in favor of the taxpayer by providing that "*Finance was set up to obtain capital at the lowest possible interest rates. Accessing the Eurobond market through a Netherlands Antilles subsidiary was not, at the time, an uncommon practice to accomplish this end. The record demonstrates that Finance "was managed*

[947] Art. 8(1) of the tax treaty provided that "*Interest on bonds, notes, debentures, securities, deposits or any other form of indebtedness paid to a resident or corporation of one of the Contracting States shall be exempt from tax by the other Contracting State*".

as a viable concern, and not as simply a lifeless facade."…Finance conducted recognizable business activity-- concededly minimal activity, but business activity nonetheless. Significantly, Finance derived a profit. It earned income on the spread between the interest rate it charged Taxpayer on the Note (18.25 percent) and the rate it paid to the Euronote holders (17.25 percent). The foreign corporation in Aiken Industries was held to lack dominion and control because, unlike Finance, it was literally a mere conduit, earning no profit on its borrowing and lending activities.…Finance netted an annual $700,000 from its borrowing and lending activities. That income stream had economic substance to both Taxpayer and Finance. Each time Taxpayer made an interest payment to Finance, Taxpayer's economic resources were diminished while Finance's economic position was enhanced. Finance also reinvested the annual $700,000 interest income in order to generate additional interest income. Taxpayer had no control over Finance's reinvestments. Finally, the transactions in Aiken Industries were entirely between related parties. Finance, on the other hand, borrowed funds from unrelated third parties, the Euronote holders".

334. The author would like to point out that the Courts in this case held that the domestic judicial anti-avoidance doctrines were not applicable as Finance had sufficient business activity and was transacting with unrelated parties. Accordingly, the Courts considered that the interest income was derived by Finance as opposed to the bondholders. As Finance was the recipient of the income, the 1948 tax treaty applied to the transaction.

13.4.5. 1997: Unknown taxpayer – Germany[948]

335. This case dealt with a structure that was implemented to seek treaty benefits under the 1959 German-Netherlands tax treaty. In this case, a Dutch pension fund advanced interest-bearing loans to two Dutch companies ("Dutch Co's") that it owned. The Dutch Co's used the loan proceeds to invest in real estate situated in Germany from which they derived real estate income. It should be noted that the Dutch Co's had no personnel, office space, or office equipment, and neither maintained a PE in Germany. While filing the German tax return, the Dutch Co's deducted the interest payments

[948] GFFC: Case IR 8/97, August 27th 1997; The original text of the case is in German and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported by in the IBFD Tax Treaty Case Law database was referred too. Also see ECKL, Treaty Shopping, p. 120.

against the rental income. The tax authorities, by invoking the German statutory GAAR (*see section 3.3.2*), argued that the Dutch companies should be ignored for tax purposes as they were letter boxes. Accordingly, the interest deduction against the real estate income should not be allowed. The taxpayer then appealed to the GFFC which ruled against it. In essence, the GFFC, by invoking the abuse of law provision (*see section 3.3.2*), held that the Dutch Co's could be disregarded. This meant that interest payments were not made between the Dutch Co's and the Dutch pension fund. Further, the GFFC held that the real estate income should be attributed directly to the Dutch pension fund. Thereafter, the tax treaty was applied. The article dealing with real estate income (similar to Art. 6 of the OECD Model) allowed Germany to tax the real estate income. The author is aware that in this case the taxpayer was not trying to obtain a benefit that flowed from the tax treaty. Rather the taxpayer was trying to obtain a benefit (interest deduction) that flowed from domestic tax law. Nevertheless, it is interesting to note that the GFFC applied the tax treaty after it was established that the recipient of income is the Dutch Pension Fund. The position is in line with the OECD's view[949].

13.4.6. 1997: Unknown Taxpayer – Austria

336. At the outset, it is pertinent to note that Austrian tax law has a statutory GAAR (Art. 22 of the Austrian Federal Tax Act) that provides that a tax liability cannot be avoided by abusing the law. An abuse of law exists whenever an inappropriate legal structure is chosen by the taxpayer solely to avoid taxes ie in other words an abuse of law is triggered when there is no economic reason except tax avoidance for a specific legal structure. If the tax authorities demonstrate that the taxpayer has abused the law then they are entitled to impose the taxes that would have been applicable if an appropriate legal structure had been chosen in relation to the facts of the relevant case and the economic intention of the parties. There is a debate in Austria as to whether this provision denies tax benefits under an appropriate (teleological) interpretation of the legislation or whether it is regarded as an attribution of income clause. The former seems to be the prevailing view

[949] It is contended that this judgement overruled the previous decision of the same Court in a treaty-shopping situation where treaty benefits were allowed to a taxpayer (*see section 15.4.1*). See KESSLER, EICKE, Tax Planning, p. 504.

among scholars whereas the latter seems to be the position of the Courts and tax administrations[950].

337. In this case[951], a UK company ("UK Co") initially owned the shares of an Austrian company ("Austrian Co"). After a while, the UK Co transferred the shares of the Austrian Co to its associated enterprise in the Netherlands ("Dutch Co" or "the taxpayer"). The domestic law of Austria provided a withholding tax of 25% on outbound dividends. However, Art. 10(3) of the 1970 Dutch – Austrian tax treaty [952] restricted the withholding tax on outbound dividends to zero percent subject to a certain shareholding percentage. The Austrian Co then declared the dividends. The taxpayer argued that Austria should be restricted from taxing the dividends. On the contrary, the Austrian tax authorities argued that the sole purpose for the transfer of the participation in the Austrian Co from the UK Co to the Dutch Co was to reduce Austrian source taxation by claiming the zero percent withholding tax available in the 1970 tax treaty. Specifically, it was argued that there was no economic reason for the transfer. Further, it was argued that the Dutch Co was a "*letter box*" company which was set up only for tax avoidance reasons. Therefore, the Austrian tax authorities invoked the domestic statutory GAAR and contended that there was an "*abuse of law*". Moreover, it was also contended by the tax authorities that the domestic GAAR could be applied to tax treaty situations. Reliance was placed on the reports issued by the OECD in 1986 to support this position. It should be noted that these arguments were not well founded by the tax authorities i.e. the tax authorities did not give the opportunity to the taxpayer to demonstrate the non-tax/economic reasons for the transfer of shares.

338. The case went to a hearing and the ASAC ruled in favor of the taxpayer. This was mainly because the Court observed that the taxpayer was

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950 For a discussion of the Austrian domestic GAARs refer KOFLER, Tax Avoidance, pp. 100-101; LOUKOTA, Treaty Shopping, pp. 347-357; OBERMAIR, WENINGER, Treaty shopping, p. 466; HOHENWARTER, Abuse, pp. 193-195; BERGMANN, Avoidance, pp. 2-5.

951 ASAC: Case No. 93/13/0185, December 10th 1997. The author did not manage to get a translation of this case. So reliance was made on the summary of the case as available on the IBFD Tax Treaty case law database.

952 Art. 10(2) of the tax treaty provided that "*Notwithstanding the provisions of paragraph 2, the State of which the company paying the dividends is a resident may not levy a tax on dividends paid by that company to a company the capital of which is wholly or partly divided into shares and which is a resident of the other State and holds directly or indirectly at least 25% of the capital of the company paying the dividends.*"

not given an appropriate opportunity to explain the non-tax/ economic reasons that could justify the non-applicability of the domestic statutory GAAR. Nevertheless, the Court held in an *obiter dictum* that the domestic statutory GAAR could be applied. In essence, the Court suggested that the income could be attributed to the UK Co, if it was found that the Dutch Co did not exercise real functions and was merely a conduit. Accordingly, the 1970 Dutch – Austrian tax treaty would not apply[953]. The *obiter dictum* is in line with the view expressed by the OECD.

13.4.7. 2000: N AG – Austria[954]

339. This case dealt with a treaty-shopping situation with Switzerland and Austria being the residence and source countries respectively. An Austrian Company ("Austrian Co") was owned by Swiss resident company ("Swiss Co") and two other shareholders. The Austrian Co declared dividends. On the dividends that were paid to the Swiss Co, the Austrian tax authorities applied the domestic Austrian withholding tax of 25%. Nevertheless, in order to apply the withholding tax rate of 5% as per Art. 10(2) 1974 Swiss-Austrian tax treaty ("1974 tax treaty")[955], the Austrian tax authorities issued several information requests to the Swiss Co. The reason behind issuing the requests was to find out if residents of third countries had interposed the Swiss Co to reduce Austrian taxes at source ie if residents of third counties engaged in "*Treaty shopping*". However, the Swiss Co could not furnish all the information requested – in particular complete details with respect to its ownership structure (the Swiss Co had only mentioned that it was owned by two Swiss lawyers and declined to answer the tax authorities question as to whether the Swiss lawyers were only nominees acting on behalf of residents of third states). Further, during the assessment proceedings it was found out that the Swiss Co was merely a "*letter box*" company as it did not carry out real economic activities and it did not have its own business premises or personnel. Moreover, the Austrian tax authorities indicated that the real owners of the Swiss Co were residents of Monaco and Austria in contrast to the Swiss Co's submission that two Swiss lawyers owned it.

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953 KOFLER, Attribution, p. 92.

954 ASAC: N AG v Regional Tax Office for Upper Austria, 2 ITLR 884, July 26th 2000, pp. 884-901.

955 Art. 10(2) provided that "*However, such dividends may be taxed in the first-mentioned Contracting State in which the company paying the dividends has its seat or place of management and according to the law of that State; but the tax so charged may not exceed 5% of the gross amount of the dividends*".

340. Based on these facts, the Austrian tax authorities invoked the domestic statutory GAAR and contended that the interposition of the Swiss Co was an "*abuse of law*" because there was no economic reason for doing so other than for tax avoidance. They argued that this was a "*treaty shopping*" case wherein residents of third countries wished to avoid Austrian source taxation through interposing a Swiss resident corporation which carried out no activities other than holding shares in the Austrian Co. These arguments were made notwithstanding the fact that the Swiss tax authorities had issued a tax residence certificate in favour of the Swiss Co, which could be used to claim treaty benefits.

341. The case went for trial and the ASAC ruled in favor of the tax authorities. The reasons for this was as follows. The Court noted that the Swiss Co did not provide all information regarding its ownership structure. Taking this fact into consideration the Court observed that there was considerable amount of suspicion as to whether or not residents of third States interposed the Swiss Co to claim treaty benefits. This lack of information led the Supreme Court to believe that the Swiss resident owners (lawyers) were only nominees who acted on behalf of residents of third states. In this respect, the Court provided that treaty benefits should not be extended to "*nominee arrangements"* or arrangements that abuse "*forms and institutions of civil law"*. Further it was stated that in abusive situations a country "*has the right to protect itself against an unjustified exploitation of the tax benefits provided for in the convention*". As the situation at stake was abusive, Austria could rely on its domestic statutory GAAR to protect itself against treaty abuse by attributing income to the shareholders[956].

342. To arrive at this conclusion, the Supreme Court referred to its previous judgments on treaty shopping which provided that "*the interposition of … entities constitutes an abuse of the treaty, if there are no commercial or other substantial reasons for their establishment or if the company does not undertake any independent economic activity"*. Further, the Court also referred to an Article published by representative of the Austrian ministry of Finance. In that Article, the representative had argued that the Austrian GAAR could be applied to tax treaty situations because it was "*international practice*" to do so (reference was made to the 1986 BC and 1986 CC reports

[956] KOFLER, Attribution, p. 92.

by this representative to arrive at this position)[957]. Accordingly, it can be deduced that the Supreme Court relied on the OECD's view from 1986 that domestic GAARs that determine the facts that give rise to a tax liability do not conflict with tax treaties.

343. In the author's view, the Swiss Co seems to have concealed facts about its real owners. It is true that the Swiss tax authorities did issue a certificate of residence and they also confirmed that owners of the Swiss Co were Swiss residents (lawyers). However, on further enquiry into the ownership structure, the taxpayer did not furnish additional information and seemed to have been uncooperative. This led the Court to conclude that the Swiss residents were nominees/agents of residents of third countries. As it was a treaty shopping case via a Swiss "*letter box*" company, the Court noticed that the conditions to invoke the statutory GAAR were satisfied. Thereafter, it applied the statutory GAAR to redetermine the taxpayer to whom income is attributed. Nevertheless, one point merits criticism. The Court held that it was "*international practice*" to apply domestic GAARs to tax treaties to arrive at the conclusion that domestic GAARs can be applied to tax treaties even if they are not preserved in them. Reference was made to the 1986 BC and 1986 CC reports to justify this position. In the author's opinion, the Court seems to have considered the "*majority position*" expressed in these reports and not the position of the "*minority*". As the practice of States on the issue vis-à-vis the interaction of domestic GAARs with tax treaties is not homogeneous, such a reference by the Court seems to be incorrect[958].

13.4.8. 2001: Del Commercial – USA[959]

344. This case dealt with a structure that was set up to exploit the beneficial provisions of the 1965 USA-Netherlands tax treaty ("1965 tax treaty"). The facts of the case are as follows. A US Corporation viz., Del Commercial wished to raise funds for its business. In this regard, its Canadian affiliate viz., Del Financial took a loan from an independent bank with the objective of on-lending the funds to Del Commercial. However, instead of providing the loan directly, Del Financial routed the loan to Del Commercial through certain affiliated intermediary entities. To elaborate, Del Canada provided

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957 LOUKOTA, Treaty Shopping, pp. 357-358.

958 DE BROE, Thesis, p. 453; OBERMAIR, WENINGER, Treaty shopping, p. 469.

959 US TC: Del Commercial Properties, Inc. v. Commissioner, TC Memo 1999-411, December 20th, 1999; Followed by US COA for District of Columbia Circuit: Del Commercial Properties, Inc. v. Commissioner, 251 F.3d 210, June 8th, 2001.

the loan to another Canadian company which in turn contributed the loan proceeds to its wholly owned Cayman Island subsidiary, which contributed the same proceeds to its Netherlands Antilles subsidiary, which then contributed the same proceeds to its Dutch subsidiary viz., Del NL (a company with minimal business activity). Finally, Del NL provided a loan to Del Commercial. Initially, Del Commercial made the interest payments on the loan to Del NL. Thereafter, Del NL transferred the funds to Del Financial which in turn used the funds to service the loan obtained from the bank. However, after a year and a half, Del Commercial started making the interest payments directly to Del Financial. The primary reason for routing the loan through the Netherlands was that interest payments made by US resident corporations to Dutch recipients were exempt from US withholding taxes pursuant to Art. 6 of the 1965 tax treaty[960]. In contrast, if the loan was given directly from Canada, interest payments made by US companies to Canadian residents were subject to a withholding tax of 15% pursuant to Art. 9 of the 1980 Canada - US tax treaty[961].

345. The US tax authorities argued that the structure was abusive and accordingly the interest on the loan should be attributed to Del Financial and not Del NL. To reach this conclusion they applied the step transaction doctrine to the case. The US TC agreed with the finding of the tax authorities and held that "*Regardless of which theory is used under the step-transaction doctrine, the facts in this case result in the same conclusion. The facts reflect a step transaction created simply to bypass U.S. withholding tax. Del Netherlands had minimal assets, and Del Netherlands had only transitory possession of and no control over the (…) loan proceeds as the proceeds were passed from Delcom Financial to Del Commercial. Apart from the purported (…) loan to Del Commercial, Del Netherlands engaged in minimal business activity"*. Thus, by applying the step transaction doctrine the Court held that the income was attributed to Del Financial rather than Del NL. The taxpayer appealed the decision before the US COA (District of Columbia). However, the US COA decided the case in favor of the tax authorities by upholding the effect of the step transaction doctrine to this

[960] Art. 6 of the tax treaty provided that "*Interest on bonds, notes, debentures, securities, deposits or any other form of indebtedness (including interest from mortgages or bonds secured by real property) paid to a resident or corporation of one of the Contracting States shall be exempt from tax by the other Contracting State*".

[961] Art. 9 of the tax treaty provided that the tax on interest payments "*shall not exceed 15 percent of the gross amount of the interest*" if the recipient of the payments is "*the beneficial owner of such interest*".

case. The Court held that "*If appellant had received the loan from Royal Bank or Delcom Financial directly, the interest payments would have been taxable under the U.S.-Canada Tax Treaty. Appellant has not shown that Del BV served any role with a "sufficient business or economic purpose to overcome the conduit nature of the transaction."*

346. The author would like to comment that the Courts in this case held that the step transaction doctrine was applicable, as routing the loan through intermediary entities had no business purpose. Accordingly, the Courts considered that Del Financial as opposed to Del NL derived the interest income. As Del Financial was the recipient of the income, the 1980 Canada – US tax treaty applied and not the 1965 tax treaty. This position is in line with the OECD Commentary on Art. 1.

13.4.9. 2001: V SA – Switzerland[962]

347. This case dealt with a treaty shopping structure that dealt with the 1993 Switzerland-Luxembourg tax treaty. In the case, UK companies ("UK Co's") owned a Luxembourg Company ("V SA") that in turn owned 100% of a Swiss Company ("I Co"). I Co declared and paid dividends to V SA. The dividends were subject to the Swiss withholding tax of 35%. However, V SA argued that the Swiss withholding tax should be refunded as Art. 10(2)(b) of the 1993 tax treaty provided that the source State could not tax dividends if the recipient "*beneficial owner*" owned more than 25% of the payer for an uninterrupted period of two years[963]. The tax authorities refused to apply the favorable provisions of the tax treaty. Essentially, they argued that the structure was "*abusive*" as VSA was not the "*beneficial owner*" of the dividend. This was because VSA passed on all the dividends it received to the UK Co's in the form of interest and other charges. Further, V SA did not supply all information vis-à-vis its ownership structure to the Swiss tax authorities. The case went for trial and the SFCA agreed with the tax

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962 SFCA: Re V SA, 4 ITLR 191, February 28th, 2001, pp.191-214.

963 Art. 10(2)(b) of the tax treaty provided that "*Notwithstanding the provisions of letter (i) of sub-paragraph a), the dividends are exempt in the Contracting State of which the company paying the dividends is a resident, if the beneficial owner is a company (other than a partnership) which is a resident of the other Contracting State and which holds, directly for an uninterrupted period of two years preceding the date of payment of such dividends, at least 25 percent of the capital of the company paying the dividends. The provision applies only to dividends from the fraction of the holding which has been the uninterrupted property of the company that is beneficial owner during said period of two years*".

authorities and ruled that the structure was abusive and VSA was not the "*beneficial owner*". The main issue that was analysed in the case was vis-à-vis "*beneficial ownership*". Nevertheless, it should be noted that the SFCA also discussed the applicability of the Swiss statutory GAAR on abusive tax refunds viz., Art. 21(2) of the SWTA (introduced in 1965) to the 1993 tax treaty.

348. In principle, the SFCA ruled that Art. 21(2) can be applied to treaty situations to counter treaty abuse. To arrive at this conclusion, the SFCA referred to the 1990 EU Parent-Subsidiary directive[964]. Reference was made to the directive because the SFCA believed that the context of Art. 10(2)(b) of the 1993 tax treaty was adopted from Art. 5(1) of the 1990 EU parent-subsidiary directive. Further, the SCFA referred to Art. 1(2) of the Directive which provided that "*This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse*". This meant that domestic anti-avoidance rules could be applied at the level of the directive. The SFCA used this conclusion to uphold that "*Switzerland may maintain the rules of its internal law aimed at combating abuse with regard to the application of double taxation conventions"*. In the SFCA's opinion treaty shopping is abusive. The Court provided that "*when the advantages of a double taxation convention benefit the nationals of third countries, there is an abuse of the convention, and Switzerland may adopt anti-abuse measures in a unilateral fashion to assure itself that the benefits of the convention do not profit nationals of states who have no such right"*[965]. Having ruled this, the SFCA stated that the three conditions to be met before application of the judicial anti-avoidance doctrine to Art. 21(2) of the Swiss WTA were satisfied. From the facts of the case it is not really clear as to whether the Court attributed the income to the UK companies pursuant to Art. 21(2) or not. However, the author believes that if the rule was considered to apply then the Court should have attributed the income to the UK Co's in order to deny treaty benefits to the taxpayer.

349. The judgement can be criticized on several grounds. Notably, the author does not think it was appropriate for the Court to refer to an EU directive to arrive at the conclusion that treaty shopping can be precluded by domestic anti-avoidance rules. The text of EU directives should not be used

964 Council Directive 90/435/EEC, July 23rd, 1990.
965 SFCA: V SA case, pp. 211-212.
965 SFCA: V SA case, pp. 211-212.

in the interpretation process as they do not fit into the interpretation rules of the VCLT (neither Art. 31 or Art. 32 VCLT). It could be argued that the interpretation principles of the VCLT were not intended to be exhaustive. However, referring to the text of the directive to interpret the text of bilateral tax treaty is far reaching. Moreover, in the author's view, the position of the Court contrasts with the Swiss observation to Para. 22.1 to the 2003/2014 OECD Commentary on Article 1[966] which provides that domestic anti-avoidance rules should not apply to treaty abuse situations where the treaty itself contains anti-avoidance rules (such as the beneficial ownership clause). Furthermore, the Swiss judicial doctrine, which is used to interpret Art. 21(2), is primarily a doctrine to combat tax avoidance. Switzerland has also observed that the purpose of tax treaties is not to prevent tax avoidance. Accordingly, this position makes the argument that Switzerland should not apply its domestic provisions to counter abuse to treaty situations much stronger (*see section 9.4*).

13.4.10. 2006: Bank of Scotland case – France[967]

350. This case dealt with a dividend stripping structure that sought to benefit from the provisions of the 1968 French-UK tax treaty. In the case, a US company ("US Co") owned 100% ordinary stock in its French subsidiary ("French Co"). Additionally, the US Co also owned preferred stock in the French Co. This preferred stock carried a right to receive a dividend (USD 270 million). If the French Co had made a dividend distribution on the preferred stock to the US Co then that distribution would have been subject to the withholding tax in France pursuant to the French-US tax treaty. However, in such a situation the US Co would not have been able to claim a refund from the French treasury for the dividend tax credit ie the "*avoir fiscal"* (USD 74.25 million) on the dividends because the French-US tax treaty did not contain a provision to that effect. Therefore, the US Co sold the usufruct (right to receive dividends) to the Bank of Scotland ("taxpayer"), a resident of the UK (for USD 267 million). This was essentially done because Art. 7 of the 1968 tax treaty provided that a UK resident could claim the "*avoir fiscal"* from the French treasury when a dividend distribution was made to it. It should be noted that the contract between the US Co and the taxpayer provided that if the French Co did not

966 JUNG, Treaty Shopping, pp. 238-240; JUNG, EC Directive, p. 116.

967 FSC: Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland, 9 ITLR 683, December 29th 2006, pp. 683-714.

distribute dividends to the taxpayer then the US Co would indemnify the taxpayer the extent of an amount equal to the dividends. Further, the US Co also guaranteed that if the French tax authorities did not repay the "*avoir fiscal"* then the US Co would also indemnify the taxpayer for that amount. Also, the contract provided that the US Co would take all necessary financial measures to ensure that the French Co distributed the dividends.

351. Subsequently, a dividend distribution was made. The French tax authorities denied treaty benefits to the taxpayer by arguing that the taxpayer was not the "*beneficial owner*" of the dividend. Further, a refund of the avoir fiscal was also denied on the same ground. To arrive at the conclusion that the taxpayer was not the "*beneficial owner*", the tax authorities also invoked the domestic "*abuse of law*" provision (*see section 3.2.5*) and argued that the transaction was a loan from the taxpayer to the US Co (USD 267 million) and the repayment of the loan was made through the French Co (the loan was repaid via dividends ie USD 270 million and the interest on the loan was repaid by the "*avoir fiscal" ie* USD 74.25 million). Therefore, pursuant to the domestic statutory GAAR the taxpayer could not be considered as the "*beneficial owner"*.

352. The case went for trial and the taxpayer lost before the Administrative tribunal of Paris but won before the Administrative Court of Appeal. The tax authorities then appealed to the FSC (Conseil d'Etat). The FSC ruled in favor of the tax authorities. The Court upheld the applicability of the domestic *"abuse of law"* provision and provided that pursuant to this provision the arrangement was a loan from the taxpayer to the US Co which was repayable by the dividends from the French Co and the "*avoir fiscal"* from the French treasury. In essence, the Court re-classified the transaction and upheld that the income recipient for tax purposes was the US Co[968]. By doing so, the provisions of the French-UK tax treaty were not applied. This ruling demonstrates that the FSC applies the redetermination effect of its domestic statutory GAAR to tax treaties. The approach resembles the one approach followed in the OECD Commentary on Art 1.

[968] AUSTRY, COLLET, Tax Avoidance, p. 316.

13.4.11. 2008: Aznavour – France[969]

353. In this case, a Swiss resident artist performed a concert in France via his personally owned UK company ("UK Co"). The payment for the service was made to the UK Co, which in turn, paid the performer. In order to counteract "*rent a star*" structures, the French Tax Code contained an anti-avoidance provision viz., Art. 155A (introduced in 1972). This provision disregarded personally owned artist companies and allocated the income directly to the service provider. Accordingly, the tax authorities applied this provision and disregarded the UK Co and allocated the service fee directly to the Swiss resident. They also argued that Art. 19(1) of the 1966 French-Swiss tax treaty, which is similar to Art. 17(1) of the OECD Model, applied to the service fee. Thus, France had a right to tax the income. However, the taxpayer argued that the provisions of the UK – French tax treaty applied to this case. It was claimed that the service fee was not taxable in France because Art. 6(1) of the UK-French tax treaty, which is similar to Art. 7(1) of the OECD Model, provided that the UK Co was not taxable in France unless and until it has a PE therein. The case went to hearing.

354. After hearing the arguments of both sides, the FSC decided against the taxpayer. The Court held that attribution of income is determined by domestic tax law (including anti- avoidance provisions). For domestic tax law purposes, the income recipient was the Swiss resident. Accordingly, the 1966 French-Swiss tax treaty applied to the facts of the case. The Court also observed that the UK Co did not play any role under the French domestic law and, thus, the UK-France treaty did not apply to the facts of the case.

13.4.12. 2012: Lone Star Fund III – Korea [970]

355. At the outset, it is pertinent to note that Korean tax law has a very broad codified statutory GAAR ie a "*substance over form*" provision that encompasses the business purpose, step transaction and economic substance doctrines. The provision is applicable to both domestic as well as cross-border transactions. With respect to cross-border transactions, the substance over form provisions were introduced in the Law for Coordination of

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969 FSC: Case No. 271366, March 28th 2008. The author did not manage to get a translation of this case. Thus, reliance was made on the summary of the case as available on the IBFD Tax Treaty case law database.

970 KSC: Lone Star Fund III (Bermuda) LP v Director of Yeok-sam Department of Revenue, 14 ITLR 953, January 27th 2012, pp. 953-966.

International tax affairs in 2006. Specifically, when the provision is triggered the provisions of tax treaties are applied only after determining who is the taxpayer in substance[971].

356. In this case[972], a US Limited Partnership ("US LP") invested in Korean real estate. The investment structure was as follows. The US LP invested in a Belgium Corporation ("Belgian Co"), which in turn invested in a Korean Corporation ("Korean Co"). The Korean Co acquired real estate in Korea. After a few years, the Belgian Co alienated the shares of the Korean Co and made a huge capital gain. The Belgian Co claimed that the capital gain was exempt from the Korean capital gains tax as Art. 13(3) of the 1977 Korean Belgium tax treaty ("1977 tax treaty") provided that capital gains from the sale of shares in Korean companies are taxable only in Belgium. However, the tax authorities invoked the domestic GAAR (substance over form provision) and claimed that the intermediary entities (including the Belgian Co) should be disregarded because they did not have any economic substance. Consequently, they attributed the gain to the US LP. Thus, from a Korean tax law perspective the taxpayer was the US LP.

357. Accordingly, the tax authorities applied the 1976 Korea-US tax treaty ("1976 tax treaty"). Art. 16 of the 1976 tax treaty[973] provides that when a US resident makes a gain from selling shares in a Korean company and if the Korean company derives its value from immoveable property in Korea, then that gain is taxable in Korea. Thus, by attributing the income to the US LP and applying the tax treaty thereafter, the Korean tax authorities argued that the gain was taxable in Korea. After, hearing the arguments of both sides, the KSC decided against the taxpayer. The Court ruled that as the Belgian Co did not engage in any ordinary business activities in Belgium and was inserted solely for tax avoidance purposes, the domestic "*substance over form*" provision could be used to disregard the Belgian Co and attribute the gains to the US LP. Thus, the 1976 tax treaty applied to the facts of this case.

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971 For a description of the Korean domestic GAARs refer LEE, Tax Avoidance, pp. 471-472.

972 LEE, Tax Avoidance, pp. 476-477.

973 Art. 16 of the tax treaty provided that "*Gains derived by a resident of a Contracting State from the alienation of shares a) other than shares quoted on an approved Stock Exchange, deriving their value or the greater part of their value directly or indirectly from immovable property situated in the other Contracting State…*".

13.4.13. 2012: La Salle Asia Recovery case – Korea[974]

358. In this case, two taxpayers viz., two UK limited partnerships ("UK LLPs") acquired Korean real estate. The investment structure was as follows. The UK LLP's invested in a Luxembourg companies ("Luxembourg Co's") which in turn invested in Belgium Corporations ("Belgian Cos"), which in turn acquired all the shares of a Korean Corporation ("Korean Co") that owned a building in Seoul. After a few years, the Belgian Cos alienated the shares of the Korean Co and made a huge capital gain. The Belgian Co claimed that the capital gain was exempt from the Korean capital gains tax as Art. 13(3) of the 1977 Korean Belgium tax treaty[975] ("1977 tax treaty") provided that capital gains from sale of shares in Korean companies were taxable only in Belgium. However, the tax authorities invoked the domestic GAAR (the domestic substance over form doctrine) and claimed that the intermediary entities (including the Belgian Co's) should be disregarded because they did not have any economic substance. Consequently, they attributed the gain to the UK LLPs. Thus, as the recipient of the income was a UK resident – the tax authorities applied the 1996 UK-Korean tax treaty ("1996 tax treaty"). Art. 13(2)(a) of the 1996 tax treaty[976] provided that when a UK resident makes a gain from selling shares in a Korean company and if the Korean company derives its value from immoveable property in Korea, then that gain is taxable in Korea. Accordingly, by attributing the income to the UK recipient and applying the tax treaty thereafter, the Korean tax authorities argued that the gain was taxable in Korea.

359. The case went for trial and the KSC ruled in favour of the tax authorities. The KSC held that the domestic substance over form provisions apply to the facts at stake. This is because i) the Belgian Co's were only established to take advantage of the capital gains Article of the 1977 tax

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974 KSC: La Salle Asia Recovery International LLP and another v Director of the Jongro District Tax Office, 15 ITLR 1, April 26th 2012, pp.1-17.

975 Art. 13(3) of the tax treaty provided that "*Gains from the alienation of any property other than those mentioned in paragraphs 1 and 2, shall be taxable only in the Contracting State of which the alienator is a resident.*"

976 Art. 13(2) of the tax treaty provided that "*Gains derived by a resident of a Contracting State from the alienation of shares a) other than shares quoted on an approved Stock Exchange, deriving their value or the greater part of their value directly or indirectly from immovable property situated in the other Contracting State…*".

treaty ii) the Belgian Co's did not play any role in the whole process of acquisition and alienation of the shares of the Korean Co (it was demonstrated that the UK LLP's performed this role) iii) there was no evidence to prove that the Belgian Co's engaged in economic activities in Belgium. Consequently, the KSC disregarded the intermediary entities and pursuant to the "*substance over form*" provision attributed the income to the UK LLP's for Korean domestic tax law purposes. The provisions of the 1996 tax treaty were applied after this attribution exercise.

13.5. Author's view on the case study

13.5.1. Implications under the T-S tax treaty

13.5.1.1. Attribution of income is governed by domestic law

360. The author believes that domestic tax law, including the use of domestic anti-avoidance rules, governs attribution of income to a taxpayer (see for instance the *Unknown Taxpayer (Germany)*, *Unknown Taxpayer (Austria)*, *N AG*, *Bank of Scotland*, *Aznavour*, *Lone Star Fund III* and *La Salle Asia Recovery* cases). A State can indeed decide as to what the taxable event is, what the taxable amount is and who the taxpayer is. Accordingly, in the case study, State S can attribute the capital gains to X of State R even if State R and State T consider B Corp to be the income recipient for tax purposes. Consequently, the attribution of income by each State should be seen independently as tax treaties do not interfere with such decisions. This being established, the author also believes that once the domestic law attributes income to a taxpayer – a tax treaty indeed applies. Therefore, income attribution decisions, once triggered by the domestic law, are indeed affected by tax treaties. If a State has entered into a tax treaty, then the provisions of that tax treaty have to be analysed in order to understand if the State imposing the tax can be restricted from taxing the income[977].

[977] DE BROE, Thesis, p. 605; WHEELER, Keystone, p. 254; SALOM, Attribution, pp. 394-399.

13.5.1.2. Treaty entitlement (including Action 2 Anti-Hybrid clause)

361. Art. 1 of the OECD Model (various versions) provides that the treaty applies to "*persons*" who are "*residents*" of one of the contracting States. Accordingly, once a taxpayer qualifies as a "*person*" in accordance with Art. 3(1)(a) and a "*resident*" as per Art. 4(1), primarily by reference to unlimited/full tax liability criteria[978], then – in principle – the tax treaty can be applied. The next condition, even though this has not been expressly provided in the tax treaty, is that the income should be attributed to the resident person in order to apply the distributive rules[979]. In other words, in order to claim treaty benefits, there has to be a connection between a tax subject (resident person) and the tax object (income or gains) [980]. This condition can be deduced from the distributive rules of tax treaties[981] that use different terms such as "*derived by*" [982], "*of*" [983], "*from*" [984], "*paid to*" [985] etc. Put differently, these terms represent a connection that is required between the resident person and the tax object so that the resident person can claim treaty benefits with respect to the tax object. Accordingly, in order to apply the distributive rules, the income/gain that originates in the State of source has to be received by a resident person of the other State. Therefore, it needs to be checked if there is a resident recipient of the income (the test of beneficial ownership [986] as provided in Art. 10-12 should be considered separately) [987]. In the case study at hand, from the perspective of State S, a State T resident does not receive the income (capital gains) whereas from the perspective of State T the income (capital gains) is indeed received by a State T resident. Thus, a conflict of income attribution arises. Accordingly, the question as to whether the source States income attribution criteria are controlling or the residence States income attribution criteria are controlling, in order to obtain treaty entitlement needs to be answered.

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978 2014 OECD Comm. Art. 4, Para. 8.
979 SALOM, Attribution, p. 399.
980 WHEELER, Attribution, p. 22; WHEELER, Keystone, p. 249.
981 DANON, Attribution conflicts, p. 211.
982 2014 OECD Model. Art. 6, Para. 1; Art. 13, Para. 1; Art. 13, Para. 4; Art. 15, Para. 1; Art. 16, Para. 1; Art. 17, Para. 1.
983 2014 OECD Model. Art. 7, Para. 1; 2014 OECD Model. Art. 21, Para. 1.
984 2014 OECD Model, Art. 13, Para 5.
985 2014 OECD Model. Art. 10, Para. 1; Art. 11, Para. 1; Art. 18, Para. 1; Art. 19, Para. 1.
986 For an analysis of this concept see DANON, Thesis, pp. 326-350.
987 WHEELER, Keystone, p. 249; SALOM, Attribution, p. 399.

362. The expressions used in the distributive rules such as "*derived by*", "*of*", "*from*", "*paid to" etc* are undefined treaty terms. Accordingly, reference should be made to the domestic tax law of the source State (*see section 7.2.3*) to understand the meaning of these terms subject to the "*context*" requiring otherwise. The State of source could argue that, from its perspective, a resident of the other State (State T) does not receive the income/gains. Thus, the T-S treaty should not apply and the R-S treaty should apply. The Courts, for instance, adopted this approach in the *Del Commercial, Bank of Scotland, Aznavour, Lone Star Fund III* and *La Salle Asia Recovery* cases wherein the attribution rules applicable in the intermediary State were not taken into consideration and the source States attribution was upheld. One commentator also supports the position that the source States attribution criteria are to be endorsed. This has the clear advantage of simplicity as the source States tax administration applies its own attribution rules and therefore its tax treaties[988].

363. Conversely, another commentator states that a "*contextual*" interpretation of the connecting terms in the distributive rules needs be undertaken[989]. In his opinion, reference can be made to the principles of the 1999 OECD Partnership Report to understand the contextual meaning of the connecting terms, especially, the expressions "*derived by*" and "*paid to"*. The general recommendation proposed by the report, to solve conflicts regarding attribution of income in the context of partnerships, is that the State of source should consider that an item of income is "*derived by*" / "*paid to"* a resident of the other State, if, the latter State attributes the income to that resident person for tax purposes[990]. The view has been incorporated in the OECD Commentary (2000 update) wherein it is stated that "*the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident"*[991].

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988 LANG, Partnership, p. 38.
989 DANON, Thesis, pp. 314-323.
990 DANON, Attribution conflicts, p. 217; Also see SALOM, Attribution, p. 401.
991 2014 OECD Comm. Art. 1, Para. 6.3.

364. Furthermore, illustration 8 of the 1999 OECD Partnership Report can be used to shed light on the case study at hand[992]. The example deals with a situation where two partners, residents of State R, own interests in a partnership (P) that is a resident in State P and the income source (dividend) emanates from State S. All States treat the partnership as a taxable entity. In such a situation, the report provides that State S should follow the residence State's attribution criteria to check the treaty entitlement of the partners or the partnership. The report concludes that the partners should not be entitled to treaty benefits as they are not "*liable to tax*" on the dividends for the purposes of applying Art. 4(1). On the other hand, the partnership should be entitled to treaty benefits as it is "*liable to tax*" on the dividends for the purposes of applying that provision. In summary, the report states that the attribution criteria of State S does not matter. If that logic is followed then the applicable treaty in the case study is the T-S treaty as opposed to the R-S treaty. Consequently, State S should be restricted from taxing the capital gains. Applying this logic, the redetermination effect of the domestic anti-avoidance rule will be curtailed as a conflict arises with the treaty provisions[993].

365. The argument becomes stronger if the T-S tax treaty has an anti-hybrid clause that is proposed in the context of BEPS Action Plan 2 to prevent hybrid mismatches. The clause which codifies the principles of the 1999 OECD Partnership Report states that "*For the purposes of this Convention, income derived by or through an entity or* ***arrangement (emphasis added)*** *that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State*"[994].

366. The commentary to this provision provides "*The reference to "income derived by or through an entity or arrangement" has a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each Contracting State as to who derives that*

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992 See OECD, Partnership Report, Paras. 71-72.

993 STEINDL, STIASTNY, Tax Avoidance, pp. 112-113.

994 See OECD, Hybrid Mismatch Arrangements, Chapter 9; 2015 OECD, Final Report on Hybrid Mismatches, Chapter 14.

income for domestic tax purposes"[995]. Thus, if State S, by applying its domestic anti-avoidance rule, treats the taxpayers "*arrangement*" as fiscally transparent (by allocating the income to X), it will still be restricted by the T-S tax treaty as State T would attribute the income to its own resident i.e. B Corp and would tax that company on it. Consequently, the application of the 1999 OECD Partnership Report principles leads to an effect which is contrary to that intended by the application of the domestic anti-avoidance rules.

367. It could be argued that the principles of the 1999 OECD Partnership Report should be restricted to partnerships and should not be extended to other situations. However, in the author's opinion, the principles should be extended to all situations that involve residence – source conflicts of income attribution (a residence – source conflict of income attribution arises when the residence State and source State attribute the same income to different taxpayers) as they represent a correct interpretation of the connecting terms used in the OECD Model[996], even though several States do not follow this opinion[997]. It could also be argued that these principles should be applied to tax treaties concluded by the OECD Member States, after the year 2000, as the findings of the report were inserted into the OECD commentary in 2000. The author does agree with this line of reasoning. Nevertheless, for treaties concluded prior to 2000, it is also the author's view that the recommendations inserted into the OECD Commentary correspond to the correct interpretation of the OECD Model[998] (*see section 6.2 & 6.3*). Applying this approach, to the facts of the case, would mean that the T-S treaty applies and Corp B should be entitled to treaty benefits. Therefore, the capital gains should not be taxable in State S[999]. If State S does not follow this approach an argument can be made that the taxation results in a tax treatment that is not in accordance with the provisions of a tax treaty. Thus,

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995 See OECD, Hybrid Mismatch Arrangements, Para. 131 (Commentary in Para. 26.8); 2015 OECD, Final Report on Hybrid Mismatches, Para. 435 (Commentary in Para. 26.8).

996 SALOM, Attribution, pp. 403-404; The 1999 OECD Partnership report also provides that the principles of the report can be applied to other entities. OECD, Partnership Report, Para. 1.

997 LANG, STARINGER, Taxable Entities, pp. 45-46. The author's provide that many States do not take into consideration the principles of the 1999 OECD Partnership Report to resolve residence – source conflicts of income attribution. In their view, it is doubtful whether State S should be restricted from taxing that item of income.

998 SALOM, Attribution, p. 403.

999 A commentator (Rust) argues to the contrary without any elaboration. See VOGEL, 2015 Commentary, p. 129.

the provisions of the treaty should prevail pursuant to the "*pacta sunt servanda*" principle as the application of this domestic anti-avoidance rule increases the tax liability of a taxpayer beyond what was allowed by the T-S tax treaty. If this approach is not followed and the source State applies its own income attribution criteria then the following double taxation issue arises.

13.5.1.3. The issue of double taxation

368. Should State T provide relief from double taxation even if State S taxes that item of income pursuant to its domestic anti-avoidance rule? Art. 23A or Art. 23B of the OECD Model provides that State T should provide relief from double taxation with respect to items of income which "*in accordance with the provisions of this convention*" is taxable in State S. If State S applies the 1999 OECD Partnership Report principles then it will be restricted from taxing the capital gains. However, if State S does not apply the 1999 OECD Partnership Report principles, the answer should be in the negative because State T would rightly argue that State S has not levied it taxes "*in accordance with the provisions of this Convention*" as provided in Art. 23. To elaborate, State T would argue that State S has imposed its taxing powers on the capital gains by applying the provisions of another convention (R-S tax treaty) and thus that State is not under any obligation to provide relief from double taxation as this conflict arises from differences in treaty interpretation with respect to the resident person that has derived the item of income [1000]. Essentially, the dispute could be over treaty terms such as "*derived*" or "*paid*". Accordingly, as the domestic anti-avoidance rule also leads to unresolved juridical double taxation (State T does not provide relief for taxes paid in State S), an argument can be made that the application of such a domestic anti-avoidance rule should be prevented. This is because such a rule defeats the primary object and purpose of the tax treaty that is to prevent double taxation.

13.5.1.4. Impact of the guiding principle (or PPT rule)

369. If the principles of the 1999 OECD Partnership report are applied then State S will be restricted from taxing the capital gains. The question analysed in this section is whether State S can deny treaty benefits by resorting to the guiding principle, which can be considered to be a treaty GAAR? The

[1000] 2003/2014 OECD Comm. Art. 23, Paras. 32.5.

position taken in this thesis is that the guiding principle applies for tax treaties concluded by OECD or UN member States after January and June 2003 respectively (*see section 9.1*). *The following analysis can also be extended to treaties that may incorporate the PPT rule in light of the BEPS Action Plan.*

370. The question arises as to whether the requirements of the guiding principle are satisfied. Firstly, it needs to be ascertained if there is a treaty benefit. The Commentary to the PPT rule provides that the term "*benefit*" includes "*all limitations… imposed on the State of source under Articles 6 through 22 of the Convention*" [1001]. Accordingly, a benefit does arise for the taxpayer under Art. 13, namely, the non-taxation of capital gains in the State of source.

371. Secondly, it needs to be ascertained as to whether a main purpose for creating B Corp was to secure a more favourable tax position. It could be argued that the creation of B Corp in State T (depending on the facts and circumstances) was mainly for non-tax reasons such as i) access to a politically stable environment ii) access to flexible corporate law iii) centralized location for doing business or access to a particular region (for instance, to the EU Market) iv) access to highly reliable and skilled labour, especially, a competent board of directors v) access to third party financing and financial markets, if required, in the near future or access to a sophisticated banking industry vi) low infrastructure and operational costs vii) a high degree of asset protection viii) a business friendly environment etc. Therefore, there are several business and commercial purposes for creating B Corp. Furthermore, the "*look at*" approach suggested by the ISC in the Vodafone case can be referred to in order to understand if a main purpose of the transaction was to obtain a tax benefit (*see section 12.3.3*). In that decision, the ISC held that the tax authorities have to identify the scheme and its dominant purpose. If the investment made by B Corp qualifies as "*strategic investment*" then it can be concluded that a main purpose of the transaction was not to obtain treaty benefits. This will be the case when i) B Corp holds the participation in State S companies for a long period of time ii) the business operations of State S companies continue for a long period of time iii) State S companies generate taxable revenues iv) the timing of the exit by B Corp from State S companies is after several years,

[1001] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 7).

and v) the continuity of the business of State S companies on such exit. Accordingly, if the conditions prescribed by the "*look at*" approach are satisfied, a tax benefit should not exist. However, at the same time the tax authorities could argue that one of the main purposes for inserting B Corp, into this series of transaction is to obtain a tax benefit under the T-S treaty. This is because B Corp i) does not employ operational personnel who could exercise essential economic functions ii) does not utilize significant assets and iii) does not control any risks. In fact, in Example G of the 2015 Final TTA report, the OECD does indicate that if the intermediary does not exercise substantive economic functions, using real assets and assuming real risks and if the intermediary does not carry out business through its own personnel located in its own State, then it could be reasonable to deny treaty benefits. Accordingly, the subjective test may be satisfied even though there are several business/commercial reasons for establishing an intermediary [1002].

372. Lastly, does the transaction that has been entered into by the taxpayer against the object and purpose of Art. 13(5)? As discussed in this thesis (*see section no. 9.3.4*), the purpose of such a distributive rule is to allocate taxing rights with respect to capital gains and not prevent tax avoidance transactions. Thus, the objective element should not be satisfied, as the taxpayer has not acted against that purpose. However, if the Courts read Art. 13(5) in order to prevent tax avoidance (based on the OECD/UN Commentary) then the author does not rule out the possibility of the objective test being satisfied. Therefore, the application of the guiding principle leads to uncertainty.

13.5.2. Implications under the R-S tax treaty

373. The question arises as to whether the R-S tax treaty applies to the facts of the case, even though, from the perspective of State R the income has been derived by a State T resident. According to international case law such as the *Unknown Taxpayer (Germany), Unknown Taxpayer (Austria), Del Commercial, Bank of Scotland, Aznavour, Lone Star Fund III and La Salle Asia Recovery* cases, the provisions of the R-S treaty should apply. From a source State perspective, the Courts in these cases, arrived at this conclusion even though the ultimate residence State did not attribute income to its taxpayer for tax purposes (X in the case study).

[1002] 2015 OECD, Final Report on Treaty Abuse, p. 62.

374. As discussed previously, the OECD view, in the context of illustration 8 of the 1999 OECD Partnership Report is that the partners should not be entitled to treaty benefits as they are not "*liable to tax*" on the dividends. Consequently, if State R does not attribute any income to X on which it has to pay taxes, the R-S tax treaty should not be applied. This approach contrasts the view of the Courts. The argument also becomes stronger if the R-S tax treaty has the anti-hybrid clause that is proposed in the BEPS Action Plan 2. The clause which codifies the principles of the partnership report states that "*For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State*"***(emphasis added)***[1003].

375. Thus, if State R, does not attribute any income to X then the provisions of the R-S tax treaty should not apply. Thus, if State S wishes to apply this treaty then from a technical perspective it is not correct. This is because X is not "*liable to tax*" (subject to a worldwide tax liability) on that item of income. As State R would not be taxing that item of income the question of relief from double taxation also does not arise.

13.5.3. Summary

376. In the author's opinion, the T-S tax treaty applies to the facts of this case, even though, State S attributes the income in the hands of X. This is because B Corp qualifies as a "*person*" (as it is an individual or body corporate) under Art. 3(1)(a) that is a "*resident*" under Art. 4(1) of State T (as it was incorporated in that State). In fact, it is B Corp that derives a "*gain from the alienation*" of property for the purpose of Art. 13(5). To summarize, State S should not apply the effect of its domestic anti-avoidance rule if one applies the general recommendation of the 1999 OECD Partnership Report and the anti-hybrid clause put forward by BEPS Action Plan 2. However, if it does then issues of reduction of taxes at the level of source State and relief from double taxation at the level of the residence State still remain open. A possible solution would be to invoke a MAP. Nevertheless, treaty benefits could be denied under the guiding principle (or

[1003] OECD, Hybrid Mismatch Arrangements, Chapter 9; 2015 OECD, Final Report on Hybrid Mismatches, Chapter 14.

PPT rule) even though the domestic anti-avoidance rule conflicts with treaty provisions. However, whether the objective element of the principle/rule is satisfied is highly questionable. This would depend on the facts and circumstances of each case.

13.5.4. The issue of treaty override

377. In the previous sections it was concluded that the domestic anti-avoidance rule, which redetermines a taxpayer, conflicts with the provisions of a tax treaty. Logically, even if the rule is introduced after the conclusion of a tax treaty, that rule should not be applicable as the provisions of the tax treaty take precedence. Accordingly, if the legislature (as a standalone SAAR or as part of a statutory GAAR) or the judiciary (typically by developing and applying a step transaction or a similar doctrine) introduces/applies a posterior domestic anti-avoidance rule, that notwithstanding the conflict, redetermines the taxpayer then a strong argument can me made that a treaty override occurs. This is because such a rule disturbs the allocation of taxing rights.

378. To elaborate on this position, reference is made to the OECD position to ascertain whether the introduction/application of such an anti-avoidance rule by a State after the conclusion of a tax treaty can constitute a treaty override. As discussed previously (*see section 4.4.3.2*), the OECD has provided two examples of treaty overrides. The second example is of relevance to the discussion here. In that example, the enactment of new legislation by the State to counteract tax avoidance through immoveable property companies was considered to be a treaty override. It should be noted that in the example provided by the OECD the enactment of the new legislation by one contracting State immediately affects persons who are residents of the other contracting State i.e. persons who can claim the application of Art. 13(4) of the 1977 OECD Model before the enactment of the new legislation. Put differently the enactment of the new legislation by the State in which the immovable property was situated was sufficient to convert an exclusive right to tax (attributed to the State of residence) into a shared right to tax (with the State of source). As a result, the State of residence was no longer granted the exclusive right to tax the income derived from the sale of shares.

379. If we transpose this example to the domestic anti-avoidance rule at stake, the conclusion will be that the introduction or application of a domestic anti-avoidance rule, by the legislator or judiciary, after the conclusion of a tax treaty amounts to a treaty override. This is because the State enforcing its domestic anti-avoidance legislation (State S) tampers with the allocation of taxing rights i.e. it recaptures an exclusive right to tax attributed to another State (State T) pursuant to Art. 13(5). The right is recaptured by applying the provisions of the R-S tax treaty as opposed to the T-S tax treaty. Also, if the rule leads to unresolved juridical double taxation it can be considered that a treaty override occurs. Thus, a material breach arises for the purposes of Art. 60(1) VCLT.

14. Source State: domestic anti-avoidance rules that re-characterize an item of income

14.1. The domestic anti-avoidance rule

380. In this section, the author discusses the treaty compatibility of a domestic anti-avoidance rule that is applied by the source State pursuant to which a re-characterization of income takes place. In other words, the taxpayer's classification of income that originates from the source State is re-characterized pursuant to a domestic anti-avoidance rule (for instance interest is re-characterized as dividends or capital gains are re-characterized as dividends).

14.2. The case study fact patterns

14.2.1. Interest is re-characterized as dividends

381. Consider the following thin capitalization situation: Corp R (an entity which carries out sufficient economic activity), a resident of State R, invests in Corp S (its wholly owned operating subsidiary), a resident of State S, by minimal equity and excess loans. This is because the domestic law of State S applies a withholding tax of 30% on outbound dividends and interest whereas the State R-S tax treaty (which deviates slightly from the OECD Model) does not provide for source taxation of interest whereas dividends are subject to tax at a rate of 15%. Corp S pays interest to Corp R. Assume the following situations where State S applies its domestic anti-avoidance rule and: i) re-characterizes the funding instrument from loan to equity for private law (commercial law) purposes by invoking a sham/simulation doctrine ii) re-characterizes the funding instrument from loan to equity for tax law purposes and iii) does not re-characterize the funding instruments but reclassifies interest as dividends for the purposes of the domestic tax law of State S. By doing so, State S seeks to apply a withholding tax of 15%. The question arises as to whether such re-characterized amount will be governed by the provisions of Art. 10 or Art. 11?

14.2.2. Capital gains re-characterized as dividends

382. Consider the following dividend stripping situation (the case has already been provided as an example while discussing rule shopping situations – *see section 2.2.1*). Corp R, a resident of State R, owns a subsidiary viz., Corp S (with significant reserves), a resident of State S. In term of taxes, State S levies a domestic withholding tax of 35% on dividends paid by its resident corporations to non-residents. Further, States R and S have concluded a tax treaty based on the OECD Model. If Corp S distributes a dividend then State S will apply its domestic withholding tax that can ultimately be reduced under the R-S tax treaty in accordance with Art. 10 (5% or 15% depending on the percentage of shareholding). To avoid the State S withholding tax on dividends, Corp R sells the shares of Corp S to a related corporation ABC, which is also a resident of State S, in exchange for a promissory/loan note. This sale is taxable only in State R pursuant to Art. 13(5) of the R-S tax treaty – even if State S taxes capital gains derived by non-residents pursuant to its domestic law. Thereafter, ABC instructs Corp S to distribute a dividend. The receipt of dividend by ABC is mostly tax exempt (pursuant to a domestic dividend exclusion system for intercorporate dividends or a domestic participation exemption regime). Soon afterwards, ABC uses those proceeds to pay off the promissory/loan note due to Corp R. Thus, by engaging in such a transaction, Corp R converts dividend income falling under Art. 10(2)(a) or 10(2)(b) of the R-S tax treaty into a capital gain falling under Art. 13(5). Assume that State S applies its domestic anti-avoidance rule and reclassifies the capital gains derived by Corp R as dividends for the purposes of the domestic tax law of State S. By doing so, State S seeks to apply a withholding tax. The question arises as to whether the re-characterized amount will be governed by the provisions of the Art. 10 or Art. 13?

14.3. The OECD/UN view

383. Para 22.1 of the 2003/2014 OECD Commentary provides that the provisions of a tax treaty will be applied only after a domestic anti-avoidance rule re-characterizes an item of income. It is also stated that as a general rule a conflict does not arise between such rules and tax treaties. The

development of the 2011 UN Commentary also indicates that the treaty will apply after taking into account the recharacterization effect. Both the OECD (generally) and UN (in the context of statutory GAAR's) are of the view that the domestic anti-avoidance rule should be applied having regard to the guiding principle. Similarly, the 2014 TTA and 2015 Final TTA report also provide that the conclusions already reflected in the 2003/2014 OECD Commentary on Art. 1 with respect to domestic anti-avoidance rules remains applicable even with respect to treaties that do not incorporate the PPT rule. It is also stated that no conflict will arise if a domestic statutory GAAR is in conformity with the guiding principle. Essentially, the guiding principle is required to be seen as a treaty GAAR.

14.4. The view expressed in International case law

14.4.1. 1993: Unknown Taxpayer[1004] – Netherlands

384. The case deals with the Dutch "*cash box*" tax planning scheme under which a taxpayer tried to convert dividends to capital gains as the latter were taxed more favourably. The following facts are a simplified version of the complex scheme. The taxpayer ("Mr X"), a resident of the US, owned shares in a Dutch Holding Company ("Dutch Hold Co") which in turn owned shares in a Dutch Operating Company ("Dutch Op Co"). If the Dutch Op Co had distributed dividends to the Dutch Hold Co then those dividends would have been exempt from Dutch taxation pursuant to the domestic participation exemption regime. However, had the Dutch Hold Co distributed its profits to Mr X, Netherlands would have applied its domestic withholding tax on dividends as restricted by the 1948 Netherlands-USA tax treaty ("1948 tax treaty"). Art. 7(1)(a) of the 1948 tax treaty[1005] provided that the source State (the Netherlands in this situation) could levy a tax up to 15% on the gross amount of the dividends. Thus, in order to avoid the withholding tax of 15%, Mr X resorted to the "*cash box*" structure. Firstly,

[1004] DSC (Dutch Hoge Raad): Case No. 29 296, December 15th 1993. The author did not manage to get a translation of this case so reliance was made on the summary of the case as available in the IBFD Tax Treaty case law database. Also see DE BROE, Thesis, pp. 407-411.

[1005] The tax treaty provided that "*Dividends paid by a corporation of one of the Contracting States to a resident or corporation of the other Contracting State shall be taxed as follows in the former State: a) at a rate not exceeding 15 percent of the gross amount actually distributed*".

Mr X instructed the Dutch Op Co to distribute a dividend to the Dutch Hold Co. This was a tax neutral transaction pursuant to the domestic participation exemption regime. Secondly, Mr X instructed the Dutch Hold Co sell the shares of the profit stripped Dutch Op Co to a newly created Dutch Holding Company ("New Dutch Hold Co"). Lastly, Mr X sold the shares of the Dutch Hold Co, a "*cash box*", to an accommodating party viz. a bank and made a capital gain. Under the Dutch domestic tax law, capital gains were taxable in the Netherlands. However, Art. 11(1) of the 1948 tax treaty provided that capital gains derived by US residents were taxable only in the US. It should be noted that the 1948 tax treaty deviated from the various versions of the OECD Model as it did not provide for a definition of the term "*dividends*".

385. The tax authorities challenged the transactions undertaken by the taxpayer under the *fraus legis* doctrine and re-characterized the capital gains earned by Mr X from selling the Dutch Hold Co as "*dividends*". Further, the tax authorities made the following alternate arguments. Firstly it was argued that the definition of "*dividends*" was not provided in the tax treaty. Thus, pursuant to Art. 2(2) of the 1948 tax treaty[1006] reference had to be made to the Dutch domestic tax law to ascertain the meaning of the term "*dividends*". Secondly, the tax authorities also referred to Para 39 of the 1963 draft OECD Commentary on Art. 10[1007] as well as Para 27[1008] and 28[1009] of the 1977 OECD Commentary on Art. 10 to argue that the word "*dividends*" should be interpreted as broadly as possible. Lastly, the tax authorities argued that the spirit and purpose of the 1948 tax treaty would be frustrated if the re-characterization were not permitted.

[1006] Art. 2(2) of the tax treaty provided that "*In the application of the provisions of the present convention by either of the Contracting States, any term which is not defined in the present Convention shall, unless the context otherwise requires, have the meaning which that term has under the laws of such Contracting State relating to the taxes which are the subject of the present Convention"*.

[1007] The Commentary provided that disguised distribution of profits is included in the meaning of the term "*dividends*" if the State of which the paying company is a resident taxes such benefits as dividends. 1963 OECD Comm. Art. 10, Para. 39.

[1008] The Commentary on this Para. is identical to the 1963 OECD Comm. Art. 10, Para. 39. Refer 1977 OECD Comm. Art. 10, Para. 27.

[1009] The Commentary provides that, in principle, dividends can arise only for direct shareholders. Nevertheless, the Commentary provides that in certain situations payments made to parties related to the shareholder may qualify as dividends even though that related party might not be a shareholder in the distributing company. 1977 OECD Comm. Art. 10, Para. 28.

386. The DSC (Dutch Hoge Raad) held that for domestic tax purposes the capital gain had to be reclassified as a dividend. However, for the purposes of the 1948 tax treaty, the reclassification would have not been permitted. This was because neither the "*text of the 1948 Tax Treaty*" nor the "*clarifications*" given by the US or the Netherlands supported the view that either of the States had the common intention when applying Art. 7(1)(a) to interpret the term "*dividends*" as including income which, for domestic tax purposes, is reclassified by applying the *fraus legis* doctrine and is taxed in the same way as dividends. Thus, in essence, the DSC concluded that the non-taxation of the capital gain would not frustrate the spirit and purpose of the 1948 tax treaty as it was not justified by the text of the treaty or by the clarifications given by the Contracting States.

387. The author does not agree with the final outcome of the decision because of the following reason. In the author's opinion, the DSC does not discuss the applicability of Art. 2(2) – which is similar to Art. 3(2) of the 2014 OECD Model. Art. 2(2) of the 1948 tax treaty provides that a reference should be made to the domestic law of the State applying the tax treaty to ascertain the meaning of undefined terms. The term "*dividends*" as used in Art. 7 of the 1948 tax treaty was an undefined term. Therefore, a reference to the Dutch domestic law, which also includes the Dutch *fraus legis* doctrine, should have been made to ascertain the meaning of the term "*dividends*". Thus, payments regarded as "*dividends*" pursuant to the *fraus legis* doctrine should have been regarded as "*dividends*" for the purpose of the 1948 tax treaty. Probably, the Supreme Court did not refer to the domestic law of the Netherlands because Art. 2(2) of the 1948 tax treaty provided that a reference to the domestic law is not required if the "*context*" of the tax treaty requires another meaning. The "*context*" would require another meaning if the domestic anti-avoidance rule leads to a shift in allocation of taxing rights. This doctrine, which was developed in the early 1980's (long after the treaty was concluded), resulted in a shift of allocation of taxing rights with respect to a tax treaty concluded in the 1948 (the Netherlands wanted to recapture an exclusive right to tax that was vested in the USA). Thus, this may be the reason as to why the DSC precluded Netherlands from taxing that item of income.

388. On the other hand, one commentator argues that in a reverse scenario i.e. the US and the Netherlands being the source and residence countries

respectively, the capital gains made by a Dutch resident would have been reclassified as "*dividends*" for both US domestic and tax treaty purpose. Therefore, if the US regarded the payments as "*dividends*" for the purpose of the 1948 tax treaty then the Netherlands should not be restricted from regarding the payment as "*dividends*" as the "*context*" of the tax treaty would not prohibit this meaning[1010]. It is true that the US would have applied its judicial doctrines as they were in force prior to the conclusion of the tax treaty. However, the Dutch *fraus legis,* was not applied in the Netherlands before the early 1980's which may also be a reason for the Court ruling in favour of the taxpayer.

14.4.2. 1997: RMM Enterprises – Canada [1011]

389. This case dealt with an earning stripping structure. In this case, a US Corporation viz., Equilease US ("EC") owned a Canadian subsidiary viz., Equilease Canada ("EL") which in turn owned assets. EC wanted to liquidate EL. If EL had been liquidated however, the transaction would have resulted in a taxable deemed dividend in the hands of EC under the Canadian domestic tax law. Further, under Art. 10 of the 1980 Canada-US tax treaty (1980 tax treaty) the liquidating distribution would have been considered to fall within the definition of "*dividends*"[1012], pursuant to which Canada could have taxed the distribution at a rate not exceeding 10%[1013]. In order to avoid this deemed dividend taxation, EC undertook the following steps. Firstly, EC incorporated a new Canadian subsidiary viz., RMM Enterprises ("RMM"). Secondly, EC sold EL to RMM for a consideration that was almost equal to EL's assets. RMM approached a bank to finance this acquisition. The bank provided a loan to RMM the proceeds of which were used to pay off EC. Thirdly, EL was liquidated and its assets were transferred to RMM. The funds received by RMM on this liquidation were then used to pay off the bank loan. Essentially, by undertaking these steps, taxable dividends were converted to tax free capital gains. This was because Art. 13(4) of the 1980 tax treaty provided that the sale of shares by the US residents in Canadian

[1010] See Katz's view in IFA, Abuse, pp. 34-36; DE BROE, Thesis, p. 411.

[1011] CTC: RMM Canadian Enterprises Inc v Canada, Case No. 94-1732(IT)G and 94-1753(IT)G, 97 DTC 302, April 10th, 1997.

[1012] Art. 10(3) of the tax treaty provided that "*The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income subjected to the same taxation treatment as income from shares by the taxation laws of the State of which the company making the distribution is a resident*".

[1013] Art. 10(2) of the tax treaty.

companies was not taxable in Canada[1014]. Therefore the main issue in this case was whether it was correct for a US taxpayer to claim that it had realized a capital gain rather than a dividend. The Canadian tax authorities attacked this structure under a SAAR i.e. section 84 and section 212 of the CITA. The CTC, after an in-depth analysis held that the transaction would be considered as a dividend pursuant to this specific SAAR that provided for deemed dividend rules. Accordingly, for the purpose of the tax treaty the transaction would be classified as a dividend with the effect that Canada has the right to tax the income to a limited extent[1015].

390. Even though the tax authorities did not challenge the structure under the Canadian GAAR, the CTC in an *obiter dictum*, analysed the issue as to whether the transactions could be considered to be a dividend if the Canadian GAAR provisions were invoked. In this respect, the Court held that the GAAR provisions were applicable as there was a "*tax benefit*" and an "*abusive*" tax "*avoidance transaction*" since the transaction undertaken by the taxpayer was devoid of any commercial objective and was carried out with the real purpose of extracting corporate surplus. The Canadian GAAR, introduced in 1987, is applicable to treaty situations (*see section 3.3.1*).

391. Thereafter, the CTC considered the implication of the transaction under the 1980 Canada-US tax treaty. In this regard, the Court made the following observations. Firstly, the Court held that "*It would be a surprising conclusion that Canada, or indeed any of the other countries with which it has tax treaties, including the United States, had intentionally or inadvertently bargained away its right to deal with tax avoidance or tax evasion by residents of treaty countries in its own domestic tax laws. It would be equally surprising if tax avoidance schemes that are susceptible of attack under either general anti-avoidance provisions or specific anti-avoidance rules, if carried out by Canadian residents, could be perpetrated with impunity by non-residents under the protection of a treaty*". Secondly, the Court held that the term "*alienation*" as used in Art. 13(4) reflects only a true alienation, and not one that is made to an accommodating party i.e. (RMM in the case). Accordingly, such a transaction could not be considered to be "*alienation*" for the purpose of the 1980 tax treaty. Thirdly, the Court

[1014] Art. 13(4) of the tax treaty provided that "*Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3 shall be taxable only in the Contracting State of which the alienator is a resident*".

[1015] GOYETTE, HALVORSON, Tax Avoidance, p. 188.

analysed the definition of the term "*dividends*". Surprisingly, the Court considered the definition as used in Art. 10(3) of the 1980 tax treaty to be exactly the same to the definition of "*dividends*" as found in Art. 10(3) of OECD Model, even though there were significant differences[1016]. The last part of the definition in the 1980 Canada-US tax treaty provides that dividends includes "*income subjected to the same taxation treatment as income from shares by the taxation laws of the State of which the company making the distribution is a resident"*. This signified that the definition of dividends was very broad as compared to the definition of dividends in the OECD Model. Nevertheless, the Court referred to the OECD Commentary on Art. 10[1017] and held that the distribution was a disguised distribution of profits. As neither Canada nor the USA has made a reservation on the Commentary to Art. 10, the transaction was a dividend distribution for tax purposes. Fourthly, the Court discussed whether the provision of the 1980 Canada-US tax treaty could be read in such a manner so that the purpose of the tax treaty at stake included preventing tax avoidance. With respect to this issue, the Court referred to Para 7 of the 1977 OECD Commentary on Article 1 and concluded that preventing tax avoidance was a treaty purpose. Also, the Court referred to Para 7 of Article XXIX A[1018] added pursuant to the 1995 protocol to the US-Canada tax treaty (*see section 10.2*). The US technical explanation to this Article provides that Canada can apply its domestic anti-avoidance measures (including GAAR's) to situations covered by the tax treaty. The Court concludes by providing that "*The conclusion that I draw from the above is that the parties to the U.S. Convention are in agreement that it cannot be construed in a manner that prohibits the application of domestic anti-abuse rules to residents of the other contracting state, whether they are applied in the context of domestic legislation alone, or in connection with an avoidance scheme that depends upon an abuse of provisions of the Income Tax Act coupled with the U.S. Convention"*.

392. In the author's opinion, the definition of dividends as provided in the 1980 tax treaty is broad enough to include the re-characterized gain under

[1016] DE BROE, Thesis, p. 432.

[1017] 2014 OECD Comm. Art. 10, Para. 28.

[1018] Art. 29(A)(7) of the tax treaty provided that "*It is understood that the fact that the preceding provisions or this Article apply only for the purposes of the application of the Convention by the United States shall not be construed as restricting it any manner the right of a Contracting State to deny benefits under the Convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Convention."*

Art. 10(3)[1019]. This is because the last part of the definition stated that dividends include "*income subjected to the same taxation treatment as income from shares by the taxation laws of the State of which the company making the distribution is a resident"*. Therefore, as long as the domestic law characterized an item of income as dividends the same classification would follow for the purpose of the tax treaty. Nevertheless, the other observations made by the CTC merit attention. The CTC found that the object and purpose of the tax treaty included prevention of tax avoidance. To ascertain this fact, the CTC referred to the OECD Commentary on Art. 1. The Court did not discuss the legal status of the OECD Commentary vis-à-vis tax treaty interpretation but referred to the CSC decision in the *1995 Crown Forest Industries case*[1020]. In that case, CSC considered the OECD Commentary to be part of the legal context and fit into Art. 31 VCLT (however this view is subject to debate[1021]). If this was the conclusion, then in the author's view, the CTC's reliance on the OECD Commentary to conclude that the purpose of tax treaties is to prevent tax avoidance seems reasonable (subject to the limits discussed in *section 9.2.3*). Moreover, the Court relied on Para 7 of Article XXIX A of the treaty which authorized Canada to apply its GAAR (even though this provisions was added into the tax treaty several years after the impugned transaction took place). However, the author does not agree with the CTC's finding that the term "*alienation*" reflects only true alienations and not alienations made to related parties. A textual interpretation of the treaty text does not justify such a conclusion. Furthermore, there are no indications in the OECD Commentary that "*alienation*" mean only genuine alienations. Probably, as the Court considered the purpose of tax treaties to include prevention of tax avoidance, it arrived at this conclusion.

14.4.3. 2004: AAA v Finance Directorate – Czech Republic[1022]

393. This case dealt with the interaction of the Czech Republic's domestic thin capitalization regime with Art. 10 (Dividends) and Art. 11 (Interest) of the tax treaties entered into by the Czech Republic with the Netherlands in

[1019] DE BROE, Thesis, p. 435.
[1020] CSC: Crown Forest Industries Ltd. v. Canada, 2 SCR 802, June 22nd, 1995, Para. 46.
[1021] VINCENT, Crown, pp. 49-55.
[1022] SACR: AAA v Financial Directorate, (269) j 2Afs 108/2004-106, 8 ITLR 178, pp. 178-205, February 10th 2005. The author relied on the unofficial translation to analyse this case. In the author's view the unofficial translation was not accurate.

1974 ("CZ-NL tax treaty") and with the US in 1993 ("CZ-US Tax Treaty"). The issue at stake was whether Art. 10 or Art. 11 of the tax treaties under consideration governed the interest that had been re-characterized as dividends under the Czech thin capitalization rules.

394. The domestic thin capitalization rules of the Czech Republic were based on a fixed debt equity ratio of 4:1. The tax law provided that that if the loan amount provided by associated enterprises exceeded this ratio then interest on the loans that exceed the ratio was considered as a participation in the profit of the payer with the effect that the excess interest payment was disallowed and was re-characterized as dividends. It is important to note that the domestic law regarded the excess interest as income from participation in the profit of the payer.

395. At the treaty level, the definition of "*Dividends*" and "*Interest*" and the rate at which the source country could tax the income in the tax treaties at stake differed from the provisions of the OECD Model. They treaty provisions were follows: Art. 10 of the CZ-US tax treaty allowed the state of residence of the company to impose a tax of 5% or 15% on dividends (depending on whether the recipient owned a certain percentage of the distributing company)[1023]. The definition of "*dividends*" provided that "*The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident. The term "dividends" also includes income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the law of the Contracting State in which the income arises"*[1024]. Art. 11 of the same tax treaty restricted the State of residence of the payer to impose any taxes on interest payments[1025]. The definition of "*interest*" in that tax treaty provided that "*The term "interest" as used in this Convention means income from debt-claims of every kind, whether or not secured by mortgage and, subject to paragraph 4 of Article 10 (Dividends), whether or not carrying a right to participate in the debtors profits, and in particular, income from government securities, and income from bonds or debentures, including premiums or*

[1023] Art. 10(2) of the CZ-US tax treaty.
[1024] Art. 10(4) of the CZ-US tax treaty.
[1025] Art. 11(1) of the CZ-US tax treaty.

prizes attaching to such securities, bonds, or debentures, as well as all other income that is treated as income from money lent by the taxation law of the Contracting State in which the income arises[1026]*."*

396. On the other hand, Art. 10 of the CZ-NL tax treaty allowed the state of residence of the company to impose a tax of 10% on dividends whereas for majority shareholdings in such companies the tax was reduced to nil[1027]. The definition of "*dividends*" in that treaty provided that "*The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights participating in profits, as well as income from debt-claims participating in profits and income from other corporate rights assimilated to income from shares by the taxation law of the State of which the company making the distribution is a resident"*[1028]. Art. 11 of this tax treaty restricted the right of the State of residence of the payer to impose any taxes on interest payments[1029]. The definition of "*interest*" provided that "*The term "interest" as used in this Article means income from Government securities, bonds or debentures, whether or not secured by mortgage but not carrying a right to participate in profits, and debt-claims of every kind not secured by mortgage as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises"*[1030].

397. The facts of the case are as follows. A domestic company of the Czech Republic ("Czech Co" or "taxpayer") obtained loans from its associated enterprises resident in the US and Netherlands respectively. The loan agreements provided that the repayment of the principal and interest on these loans was linked to the profits/cash flow of the taxpayer. As the loan amount exceeded the debt equity ratio of 4:1, the tax authorities reclassified the interest on these loans as dividends, for the purpose of domestic law and the tax treaties at stake. Consequently, the withholding tax rates provided for "*dividends*" under both tax treaties was applied. It should be noted that if the "*interest*" Article had been applicable the payment would have been made without any withholding taxes. Being aggrieved, the taxpayer appealed to the Regional Court. Its main contention was that Art. 11 applied. The

[1026] Art. 11(3) of the CZ-US tax treaty.
[1027] Art. 10(2) and 10(3) of the CZ-NL tax treaty.
[1028] Art. 10(6) of the CZ-NL tax treaty.
[1029] Art. 11(1) of the CZ-NL tax treaty.
[1030] Art. 11(2) of the CZ-NL tax treaty.

Regional Court, then, ruled in favor of the taxpayer and held that such income could not be classified under Art. 10. For Art. 10 to apply, in addition to this income being treated as dividends under domestic law, it should also be treated as income from "*participation rights"*. Further, the Regional Court considered the OECD Commentary as supplementary means of interpretation under Art. 32 VCLT. However, as it was of the opinion that supplementary means of interpretation should be referred to only in situations where the meaning of a treaty term is obscure and since nothing was obscure in this case, the Regional Court did not refer to the OECD Commentary.

398. The tax authorities then appealed the decision of the Regional Court before the Czech SC. The main arguments used by the tax authorities were as follows. Firstly, the tax authorities referred to the treaty definition of "*dividends*". To reiterate, the last part of the definition of "*dividends"* in the CZ-US tax treaty provided that the term included *"income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident. The term "dividends" also includes income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the law of the Contracting State in which the income arises"*. The last part of the definition of "*dividends"* in the in the CZ-NL tax treaty provided that it included "*income from debt-claims participating in profits and income from other corporate rights assimilated to income from shares by the taxation law of the State of which the company making the distribution is a resident"*. These definitions made reference to the domestic law and as the domestic thin capitalization rules treated the excess interest as profit participations ie rights to participate in profits (CZ-US tax treaty) or corporate rights (CZ-NL tax treaty), Art. 10 applied. The tax authorities argued that it should not matter whether or not such corporate rights actually allow the lender to participate in the control, profits or liquidation proceeds of the borrower. The characterization provided in the domestic law should be controlling. To bolster this argument, the tax authorities also provided that in accordance with Art. 3(2) of these treaties, reference should be made to the domestic law of the State applying the treaty to ascertain the meaning of undefined terms, unless the context otherwise requires. The terms "*other corporate rights*" or "*rights…to participate in profits*" are not defined in the tax treaties. Accordingly, reference should be made to Czech domestic law. As the domestic law re-

characterizes interest to profit participation rights ie dividends, Art. 10 applied. Secondly, the tax authorities referred to Art. 10 of the OECD Commentary that provided that dividends include reclassified interest to the extent that the lender effectively shares the risks in the borrower (Para 25) . In this case, as the repayment of loan and interest depended on the profits of the borrower, the tax authorities argued that such income falls under the definition of "*dividends*".

399. In response, the taxpayer argued that the word "*other corporate rights*" or "*rights… to participate in profits*" should not be interpreted as per the domestic law that provided that interest on loans, which exceeded the debt equity ratio, would be treated as profit participations. Such rights should allow the lender to participate in the control; profits or liquidation proceeds of the borrower. If this was not the case, the reclassified interest cannot be governed by the "*dividend*" Article. In the case at hand, the US and Dutch lenders did not hold such rights. Only the payment of the principal or interest was dependent on the borrower's profits. This did not mean that the lenders had any shareholder rights over the borrower. Accordingly, the taxpayer argued that the *"interest"* Article and not the *"dividend"* Article should be applied. Secondly, the taxpayer, argued that Art. 3(2) should not be invoked as the definition of "*interest*" in both tax treaties included income from "*debt claim of every kind"*. Accordingly, Art. 11 was applicable and there was no need to fall back on Art. 10. Lastly, the taxpayer followed the Regional Courts view and provided that the OECD Model and its Commentary are supplementary means of interpretation and can be referred to if the meaning of a treaty term is obscure. As the meaning of the text was not obscure, reference to the Commentary could not be made. In addition, it was argued that the OECD Commentary could not be referred to as the treaties at stake did not refer to them during the negotiation stage.

400. After taking into consideration the arguments of the taxpayer and tax authorities, the Czech SC ruled as follows. Firstly, the Czech SC provided that Art. 3(2) cannot be invoked as both treaties provided for the definition of "*Dividends*" and "*Interest*". After analyzing these definitions, the Czech SC, in line with the Regional Courts verdict, ruled that the excess interest will be classified under the "*Interest*" Article. The Czech SC provided that the terms "*other corporate rights*" or "*other rights to participate in profits*" cannot be interpreted in such a way that it includes payment of interest/principal that is dependent on the borrower's success. In the present

case, the lenders did not own any rights to participate in the profits of the borrower. Accordingly, the "*Interest*" Article is controlling. Secondly, the Czech SC held that the OECD Model and its Commentary can be used if the meaning of treaty terms is obscure. As the meaning is not obscure, reference cannot be made to the Commentary.

401. The Czech SC in this case accepted that the expressions "*corporate rights*" or "*rights to participate in profits*" should be interpreted in such a way that they included rights to participate in the profits, control and liquidation proceeds of the borrower. Also, it seems reasonable to agree with the view that Art. 3(2) should not be referred to in order to ascertain the meaning of the terms "*Dividends*" and "*Interest*". Nevertheless, reference can be made to the domestic law, to ascertain the meaning of terms such as "*corporate rights*" or "*rights to participate in profits*". This is subject to the context requiring otherwise and in this case the "*context*" indeed provided that reference to the domestic law should not be made.

14.4.4. 2007: Swedwood Tikhvin – Russia[1031]

402. This case dealt with the interaction of the Russian thin capitalization rules with the Russia – Netherlands tax treaty concluded in 1996 ("tax treaty"). The Russian domestic thin capitalization rules provided that interest on loans granted by foreign associated enterprises was not allowed as a deduction (the excess interest) if the loan exceeded a debt equity ratio of 3:1. Such excess interest would then be regarded as dividends for domestic tax law purposes. At the treaty level Art. 10 of the tax treaty was similar to Art. 10 of the OECD Model.

403. A Dutch Company ("Parent Co") held the entire share capital in its Russian subsidiary ("taxpayer"). As the Parent Co funded the taxpayer in addition to the prescribed debt equity ratio, the tax authorities disallowed the excess interest and re-characterized it as dividends for domestic tax law purposes. Furthermore, the tax authorities contended that the reclassified interest fell within the definition of dividends as provided under Art. 10. Accordingly, a withholding tax was applied (the article dealing with interest

[1031] Federal Arbitration Court North West District: Swedwood Tikhvin vs Inter-regional tax inspectorate, Case no. A56-19578/2006, April 9th 2007. The original text of the case is in Russian and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported by in the IBFD Tax Treaty Case Law database was referred too. Also see BRUK, Thin Cap, p. 507.

did not provide a withholding tax). However, the taxpayer did not agree with the findings of the tax authorities and brought the case before the Federal Arbitration Court. The Court, after taking into consideration, the provisions of Art.10 ruled that the definition of dividends should be interpreted autonomously and independently of Art. 11. An autonomous interpretation of Art. 10 warranted a definition of dividends that did not include re-characterized interest payments. The court did not provide concrete reasoning for its conclusion[1032].

14.5. Author's view on the case study

14.5.1. Interest is re-characterized as dividends

14.5.1.1. Conflict with the R-S treaty provisions

404. At the outset, the author states that if the sham/simulation doctrine is applied to the facts of this case and it is determined that the loan is actually equity for private law purposes (for example, because it is a loan with a duration for 1000 years) then it cannot be argued that the provisions of the domestic law or treaty are breached. This is because the doctrine establishes the true fact pattern to which the provisions of the domestic law and treaty apply (*see chapter 12*).

405. If the domestic anti-avoidance rule re-characterizes the instrument from loan to equity (not for private or commercial law but only for tax law purposes by using domestic anti-avoidance rules including the arm's length provisions – *see section 16.5.1.1.2*) then the answer is not straightforward. Art. 10(3) of the OECD Model defines "*dividends*". The definition is divided into three parts i.e. dividend includes i) income from shares, jouissance shares or jouissance rights, mining shares, founder's shares ii) income from other rights, not being debt claims, participating in profits and iii) income from other corporate rights which is subject to the same taxation treatment as income from shares by the laws of the State of residence of the distributing company. The wording of Art. 10(3) lays out a precise relationship between the three parts of the definition. Firstly, the use of the expression "*other rights, not being debt claims, participating in profits'* in ii) implies that the examples enumerated in i) cannot be debt claims participating in profits and

[1032] BRUK, Thin Cap, p. 508.

that such limitation is not applicable to iii). Secondly, the expression "*other corporate rights"* provided in iii) makes clear that all the rights covered by the three parts of the definition must be "*corporate rights"*. Lastly, recourse to domestic law applies only to iii)[1033].

406. Conversely, Art. 11(3) defines "*interest*" [1034] in an exhaustive manner to include income from debt-claims of every kind, whether or not secured by a mortgage and whether or not carrying a right to participate in profits[1035]. It should be noted that Art. 10(3) excludes "*debt claims*" from the definition of dividends (only in relation to the first and second parts) whereas Art. 11(3) includes "*debt claims whether or not they have a right to participate in the debtors profits"* within the definition of interest. However, Art. 10(3) (last part) could be interpreted to include income from "*debt claims*" as dividends only if the domestic law of the State of residence of the distributing company assimilates such income from debt claims as income from "*corporate rights*"[1036]. Consequently, the question arises as to what is a "*corporate right"?*

407. The term "*corporate rights*" is not defined in the OECD Model. Accordingly, reference has to be made to the domestic law of the State applying the treaty pursuant to Art. 3(2) in order to ascertain the meaning of this term, unless the context requires otherwise. The domestic law could

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[1033] VOGEL, Commentary, p. 649.

[1034] Art. 11(3) of the OECD Model provides that "*The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article*". 1977 OECD Model. Art. 10, Para. 3. The provision has not changed since then and it appears in the same format in the 2014 OECD Model.

[1035] VOGEL, Commentary, p. 732.

[1036] AVERY JONES, Translation, p. 27. In this contribution the author's conclude that the last part of the dividend definition does not include income from debt claims. However, they also provide that even if debt claims are excluded from the last part this does not necessarily mean that excessive debt in a thin capitalization case cannot fall under the last part of the dividend definition.

[1036] AVERY JONES, Translation, p. 27. In this contribution the author's conclude that the last part of the dividend definition does not include income from debt claims. However, they also provide that even if debt claims are excluded from the last part this does not necessarily mean that excessive debt in a thin capitalization case cannot fall under the last part of the dividend definition.

either be the tax law or non-tax law (the former should be given preference). Irrespective of the domestic law definition, in the author's view, the term "*corporate rights*" should be interpreted autonomously in its "*context*" in the way that the owner of the right bears risks which are similar to that of a shareholder i.e. the term should cover all those rights that carry title not only to a share in current profits but also to at least a share in the liquidation proceeds of the Company[1037]. This approach seems to have been accepted by the SACR in the *2004 AAA* case. The SACR did not accept the domestic law definition of dividends because the loans provided to the Czech borrower did not constitute corporate rights within the meaning of the "*Dividend*" Article. According to the Court the term "*corporate rights*" means rights to participate in profits, control and liquidation proceeds of the borrower.

408. In this situation the lender does not bear such shareholder risks because the re-characterization achieved through applying the domestic anti-avoidance rule does not entitle the lender to a return on corporate rights (as tax law does not give a right to the lender to participate in current or liquidation proceeds of the company making the distribution). Therefore, in the author's opinion, the reclassified amount will fall under the definition of "*interest*" in Art. 11(3) of the R-S tax treaty even though the domestic law treats it as dividends. Consequently, if State S applies its withholding tax it clearly breaches the "*pacta sunt servanda*" principle as the domestic rule conflicts with the treaty provision (it increases the tax liability of the taxpayer).

409. Continuing with the aforementioned argument, if the domestic law of State S re-characterizes interest as dividends (without re-characterizing the instrument) then the author submits that the domestic law re-characterization cannot be given effect at the treaty level. This is because the income would not stem from a "*corporate right*" but it would be from a "*debt claim*" (as provided by Art. 11) for the purpose of the tax treaty. Thus, the re-characterization effect of the domestic anti-avoidance rule will be curtailed i.e. the treaty provisions will prevail. Reference is made once again to the decision of the SACR wherein it was held that the term "*corporate rights*" includes rights to participate in the profits, in the control and in the liquidation proceeds of the borrower.

[1037] VOGEL, Commentary, p. 651.

14.5.1.2. The impact of the guiding principle (or PPT rule)

410. Even if a conflict arises between the domestic anti-avoidance rule and the tax treaties, the question arises as to whether treaty benefits can be denied under the guiding principle? The position taken in this thesis is that the guiding principle applies in relation to tax treaties concluded by OECD or UN member States after January and June 2003 respectively (*see section 9.1*). *The following analysis can also be extended to treaties that may incorporate the PPT rule in light of the BEPS Action Plan.*

411. The question arises as to whether the tests of the guiding principle are satisfied? Firstly, it needs to be ascertained if there is a treaty benefit. The Commentary to the PPT rule provides that the term "*benefit*" includes "*all limitations… imposed on the State of source under Articles 6 through 22 of the Convention*" [1038]. Accordingly, a benefit does arise for the taxpayer under Art. 11. By applying the provisions of Art. 11 the State of source is restricted from taxing the interest. Secondly, in the author's opinion, it would be quite difficult to prove that one of the main purposes, in the case study analysed, was to secure a more favourable tax position. Reference can be made to Example C as provided in the 2014 TTA and 2015 TTA report. In that example, R Co a resident of State R invests in State S in order to expand its business[1039]. Applying, that logic, it could be argued that the taxpayer has a choice to invest via equity or debt and exercising that choice in one way or another is related to the expansion of the subsidiaries business. Hence, "*given that a general objective of tax conventions is to encourage cross-border investment, obtaining the benefits of the State R-State S convention for the investment … in State S is in accordance with the object and purpose of the provisions of that convention*". Thus, the subjective element of the guiding principle will not be satisfied. Even if it is argued that the subjective test is satisfied the objective test needs to be met. The distributive rule that the taxpayer is trying to circumvent is Art. 10. Therefore, it must be considered whether the debt funding is against the object and purpose of Art. 10? In the author's opinion, the purpose of such a distributive rule is to allocate taxing rights with respect to dividends and not to prevent taxpayers from choosing to invest via debt or equity. Thus, the objective element should not be considered to be satisfied, as the taxpayer has not acted against

[1038] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 7).
[1039] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 14); 2015 OECD, Final Report on Treaty Abuse, p. 60.

that object and purpose. However, if the Courts read Art. 10 in order to prevent tax avoidance (based on the OECD/UN Commentary) then the author does not rule out the possibility of the objective test being satisfied. Therefore, the application of the guiding principle leads to uncertainty. Even if the guiding principle is used to deny the application of Art. 11, the author considers that the lower rates provided in Art. 10 shall apply to the facts of this case (*see section 9.3.6* and subject to the fact that the taxpayer qualifies as the "*beneficial owner*" of that income).

14.5.2. Capital gains re-characterized as dividends

14.5.2.1. Conflict with the R-S treaty provisions

412. As discussed previously, Art. 10(3) of the OECD Model defines "*dividends"* to mean i) "*income from shares, "jouissance shares" or "jouissance rights", mining shares, founder's shares"* ii) or "*other rights, not being debt claims, participating in profits*" and iii) "*as well as income from other corporate rights which is subject to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident"*. From a reading of the expression "*as well as income from other corporate rights"* provided in iii), it can be ascertained that all the rights covered by the three parts of the definition must be "*corporate rights"*. Therefore, a position could be taken that only income derived by a shareholder from "*corporate rights*" is covered by the definition of dividends. This position is also supported by the fact that the definition in Art. 10(3) uses the word "*from*" in connection with "*shares*", "*other rights*" and "*other corporate rights*". Therefore, in the present context, the question arises as to whether the capital gain derived by Corp R from the alienation of a "*corporate right*" can be considered to be income "*from a corporate right*" for the purposes of Art. 10(3). One commentator expressly provides that "*only income that flows to the recipient because of this position as a shareholder comes from a corporate right; thus proceeds from the alienation of corporate rights are not included"*[1040]. The author agrees with this reasoning and submits that Art. 13(5) covers capital gains arising from alienation of corporate rights and not Art. 10(3) as the latter concerns distributions by companies to their shareholders[1041]. Therefore, an

[1040] VOGEL, Commentary, pp. 649-651.
[1041] 2014 OECD Comm. Art. 10, Para. 24.

argument can be made that the terms of the R-S tax treaty do not permit to re-characterization of the capital gain as a dividend[1042].

413. The aforementioned conclusion could be challenged on several grounds. Firstly, in light of the *RMM case*, it could be argued that Art. 13(5) of the R-S treaty does not apply to the sale as Corp R did not engage in a "*definitive disposal*" of Corp S. This is because Corp R continues to hold Corp S through ABC and can enjoy the future appreciation in the value of Corp S shares[1043]. Secondly, it could be argued that the as the OECD Commentary provides for a broad construction of the term "*dividends*" the re-characterization under a domestic anti- avoidance rule has to be given effect for the purpose of the tax treaty[1044]. However, in the author's view, this section of the OECD Commentary applies to payments made by a company to a shareholder in his position of a shareholder and not as an alienator. Accordingly, this example shows that the re-characterization made pursuant to the domestic anti-avoidance rule may not be applicable in a tax treaty context due to the restrictive wording of the latter. Consequently, the OECD's general conclusion that domestic anti- avoidance rules do not conflict with tax treaties is not true as this case study shows a possible conflict.

14.5.2.2. The impact of the guiding principle (or PPT rule)

414. Even if a conflict arises between the domestic anti-avoidance rule and the tax treaties, the question arises as to whether treaty benefits can be denied under the guiding principle? The position taken in this thesis is that the guiding principle applies in relation to tax treaties concluded by OECD or UN member States after January and June 2003 respectively (*see section 9.1*). *The following analysis can also be extended to treaties that may incorporate the PPT rule in light of the BEPS Action Plan.*

415. The question then arises as to whether the tests under the guiding principle are satisfied? Firstly, it needs to be ascertained if there is a treaty benefit. The Commentary to the PPT rule provides that the term "*benefit*" includes "*all limitations… imposed on the State of source under Articles 6*

[1042] DE BROE, Thesis, pp. 481-486; LI, SANDLER, Abuse, p. 950.
[1043] DE BROE, Thesis, pp. 485-486.
[1044] 2014 OECD Comm. Art. 10, Paras. 28-29.

through 22 of the Convention" [1045]. Accordingly, a benefit does arise for the taxpayer under Art. 13. By applying the provisions of Art. 13, the State of source is restricted from taxing the capital gains. Secondly, in the author's opinion, it needs to be ascertained as to whether a main purpose for creating ABC was to secure a more favourable tax position. It could be argued that the creation of ABC in State S (depending on the facts and circumstances) was mainly due to non-tax reasons. However, at the same time the tax authorities could argue that one of the main purposes to insert ABC, into this series of transactions, is to obtain a tax benefit under the R-S treaty (*see section 13.5.1.4*). As one of the main purposes was to obtain a more favourable tax position, the subjective test is satisfied. Lastly, is the taxpayer acting against the object and purpose of Art. 10? The purpose of such a distributive rule is to allocate taxing rights with respect to dividends. Thus, the objective element should not be satisfied, as the taxpayer has not acted against that object and purpose. However, if the Courts read Art. 10 as aiming to prevent tax avoidance then the author does not rule out the possibility of the objective test being satisfied. Therefore, the application of the guiding principle leads to uncertainty. If the guiding principle is used to deny the application of Art. 13 the author considers that the lower rates provided in Art. 10 should apply to the facts of this case (*see section 9.3.6* and subject to the fact that the taxpayer qualifies as the "*beneficial owner*" of that income).

14.5.3. Summary

416. In general, if a conflict arises between a domestic anti-avoidance rule and the provisions of the tax treaty then the latter will prevail. This is a logical outcome of the *pact sunt servanda* principle. In order to avoid a conflict under both case studies, the author suggests that the treaty text needs to be modified. The reference to the term "*other corporate rights*" in Art. 10 of the OECD Model needs to be deleted. This proposal seems to be in line with the 2014 TTA report and 2015 TTA Report, which suggests amending the definition of the term "*dividends*" [1046]. The provision could be drafted in a manner that is similar to Art. 10 of the 1980 Canada-US tax treaty as discussed in the *RMM case*. Thus, if the State of source regards an item of income as dividends then that classification will also be upheld for the

[1045] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 7).
[1046] 2014 OECD, Report on Treaty Abuse, Para. 23; 2015 OECD, Final Report on Treaty Abuse, p. 69.

purpose of the tax treaty. However, double taxation could arise if the treaty text is not modified, and the State of source applies its domestic anti-avoidance rule. This is because the residence State may argue that the State of source has not levied its tax "*in accordance with the provisions of this convention*" for the purpose of applying Art. 23[1047]. This is because the treaty text, in particular, the treaty definitions dealing with "*dividends*" or "*interest*" have not been interpreted properly. Nevertheless, even if the treaty text is not modified, treaty benefits could be denied under the guiding principle (or the PPT rule subject to the fact that it is included in the treaty). However, whether the objective element of the principle/rule is satisfied is highly questionable. This would depend on the facts and circumstances of each case.

14.5.4. The issue of treaty override

417. In the previous sections it was concluded that a domestic anti-avoidance rule, which re-characterizes an item of income, conflicts with the provisions of a tax treaty, especially when the treaty itself provides for a definition of an item of income (such as "*dividends*" or "*interest*"). Logically, even if the rule is introduced/applied after the conclusion of a tax treaty, that rule should not be applicable as the provisions of the tax treaty take precedence. Accordingly, if the legislature (on a standalone basis or as a part of a statutory GAAR) or the judiciary (typically by developing and applying a step transaction or a similar doctrine) introduces/applies, notwithstanding the conflict, a posterior domestic anti-avoidance rule that re-characterizes an item of income then a strong argument can be made that a treaty override occurs.

418. Even if a tax treaty contains undefined terms and a domestic anti-avoidance rule (subsequent to the conclusion of a tax treaty) is used to provide a meaning to the terms in such a way that the item of income leads to the application of another distributive rule rather than the one which applied initially with the effect that an exclusive right to tax that is vested in one State becomes a shared right to tax, then an argument can be made that a treaty override occurs. In simple terms, this is because such a rule disturbs the allocation of taxing rights. Consequently, the "*context*" of the treaty (*see section 11.2.1*) would "*require*" another meaning and will thus prohibit State S from applying its domestic anti-avoidance rule. This is clearly illustrated

1047 2003/2014 OECD Comm. Art. 23, Paras. 32.5.

in the following DSC case on fictitious wages. The case[1048] dealt with the fictitious wage provision of the Dutch tax law and its interaction with the 1970 Belgium-Netherlands tax treaty. According to Article 12a DWTA, which was implemented on the 1st of January 1997, an individual (resident or non-resident) who owns a substantial shareholding in a Dutch resident company and performs personal activities for the company should earn a certain "*wage*" for individual income tax purposes. If such wage is not paid then the taxpayer will be deemed to have received a fictitious salary on the presumption that an employment relationship exists. It should be noted that prior to the introduction of this rule, the income from the company would have been taxable in the hands of the taxpayer as dividends or capital gains under the domestic law. Even under tax treaties the income was classified under Art. 10 as dividends or Art. 13 as capital gains (the State of source does not have a right to tax). However, after the introduction of the rule, the tax authorities classified the income under Art.15 that deals with employment income and Art. 16 that deals with director's fees (the State of source has an unlimited right to tax).

419. In this case, a Belgium resident was a substantial shareholder of a company resident in the Netherlands. The tax authorities applied Art. 12a DWTA and attributed a fictitious wage to him. The taxpayer took the case to the Dutch Supreme Court and argued that the provisions of the tax treaty precluded the application of the domestic anti-avoidance rule. The Supreme Court ruled that, in essence, the fictitious wage could be classified under Art. 15. This is because the terms "*salaries, wages and other similar remuneration*" are undefined treaty terms. Also, the fictitious wage could be classified under Art. 16. This is because the terms "*bonus schemes, attendance remunerations and other remuneration derived by*" are undefined treaty terms. Consequently, by resorting to Art. 3(2), the Dutch domestic law can be referred to understand the meaning of these terms. As the Dutch domestic law provides that "*salaries, wages and other similar remuneration*" include a fictitious wage – Art. 15 will also include this wage. However, the Court ruled that Art. 12a DWTA was incompatible with the treaty provisions. This was because a shift in the allocation of taxing rights occurred. Prior to the introduction of the rule, the Netherlands was restricted to taxing that item of income under Art.10 or Art. 13. However,

[1048] DSC (Dutch Hoge Raad): Case No. 37651 and 37670, September 5 2003. The author did not manage to get a translation of this case. See PETERS, ROELOFSEN, Tax Avoidance, p. 564; POTGENS, Carried Interest, p. 468; PIETRO, Override, p. 110.

after its introduction, the domestic anti-avoidance rule allowed the Netherlands to tax an item of income on an unlimited basis under Art. 15 or Art. 16. As the introduction of the rule allows the Netherlands to unilaterally expand its taxing rights such a rule breaches its treaty commitments. Thus, even though Art. 3(2) was applied to ascertain the meaning of a treaty term, that meaning could not be incorporated into the tax treaty as the Netherlands had unilaterally expanded its taxing rights. It seems that the Court referred to Para. 12 and Para. 13 of the OECD Commentary on Art. 3(2) (*see section 7.2.6.2*) and held that, even though, States can refer to the domestic law to ascertain the meaning of undefined treaty terms such references have to be used with caution so that tax treaties do not become partially inoperative.

420. In principle, the Court held that the "*context*" of a treaty will be violated if the principle of reciprocity (on which a tax treaty is built) is weakened (by the introduction of a rule that changes the allocation of taxing rights). Interestingly, the Court held that the effect of a domestic anti-avoidance rule after the conclusion of a tax treaty, which has no equivalent in the domestic law of the other State, could not be applied at the level of the treaty. This meant that if the other State had a measure comparable to the Netherlands, the fictitious wage provision would not violate the treaty[1049]. In such a case the treaty equilibrium would not be disturbed as the other State (Belgium) would also be able tax the item of income. To elaborate, assume the following situation. State R and State S enter into a tax treaty in the year 2000. At the time when the treaty was signed, the domestic law of State R had a provision such as the Dutch fictitious wage rule. In the year 2005, State S introduces a similar rule. Can State S apply this rule without breaching its treaty obligations?

421. If one applies the logic of the DSC, then the treaty "*context*" would not prohibit the application of such a rule as State S is not recapturing its taxing right that was allocated to State R. The author agrees with this position as the status of domestic law of both States forms part of the treaty context and the amendment made by State S is up to the extent that State R has the right to tax the income in a similar situation[1050]. Assume another situation: State R and State S enter into a tax treaty in the year 2000. At the time of signing, none of the States has a provision such as the Dutch fictitious wage rule. In

[1049] ENGELEN, Thesis, pp. 493-495.
[1050] DE BROE, Thesis, p. 282.

the year 2005, State S introduces the Dutch fictitious wage rule. Can State S apply this rule without breaching its treaty obligations? If one applies the logic of the DSC, then the treaty "*context*" prohibits the application of such a rule as State S is recapturing a taxing right that was allocated to State R. The author agrees with the view. Continuing with this example, assume that in 2010 State R introduces a similar rule. In that situation can it be argued that the treaty equilibrium is restored? The author does not think so as one treaty override cannot be justified by another treaty override [1051] .

[1051] DE BROE, Thesis, pp. 284-285.

15. Source State: domestic anti-avoidance rules that deny treaty benefits to a taxpayer

15.1. The domestic anti-avoidance rule

422. In this section, the author discusses the treaty compatibility of a domestic anti- avoidance rule that is applied by the source State pursuant to which tax authorities argue that treaty benefits should be denied to the taxpayer. In other words, the income that originates from the source State is neither allocated to another taxpayer (redetermination of the taxpayer) nor re-characterized, pursuant to a domestic anti-avoidance rule. However, it is argued that the treaty benefit should be denied to the taxpayer.

15.2. The case study fact pattern

423. Consider the following situation: A resident investor, X, of State R wishes to invest in State S companies with a view to deriving dividends. The domestic tax law of State S imposes a dividend withholding tax of 35%. As a tax treaty does not exist between States R-S, the withholding tax of 35% is the final tax. Thus, in order to invest in State S companies, X, legally sets up a wholly owned subsidiary – B Corp – in State T. B Corp qualifies as a "*person*", "*resident*" and "*beneficial owner*" for treaty rules (treaties concluded by this State do not contain the LOB clause or the PPT rule). State T also has a participation exemption regime. B Corp, in turn, invests in State S companies. B Corp, subsequently, receives dividends. The State S withholding tax is not triggered as Art. 10(2) of the T-S treaty, which slightly deviates from the 2014 OECD Model, provides for nil taxation of dividends at source and exclusive taxation in State R. Assume that State S applies its domestic anti-avoidance rule and denies the treaty benefit to the taxpayer, in the sense that, it is contended that exemption provided under Art. 10(2) should not apply. The question arises as to whether State S can use its domestic anti-avoidance rule to deny treaty benefits to the taxpayer?

15.3. The OECD/UN view

424. In the 1986 CC report, the OECD discusses a situation wherein the source State uses its domestic general anti-abuse rule (e.g. abuse of law) to deny treaty access to a taxpayer even though the taxpayer qualifies as a "*person*", "*resident*" and "*beneficial owner*" of the income as it suspects improper use. The report questions whether denial of treaty benefits is compatible with treaty obligations. In response, it is stated that this *"relates to the issue of the priority accorded to international law in relation to domestic law, a matter on which opinions differ among States, some taking the view that where the beneficiary of the income fulfils the conditions set in the convention (beneficial ownership, residence), the provisions of the convention should apply, notwithstanding the domestic provisions of the State of source…others taking the contrary view"* (*see section 8.2.1.4*).

425. However, Para 22.1 of the 2003/2014 OECD Commentary (*see section 8.2.1.7*) provides that the provisions of a tax treaty will be applied only after a domestic anti- avoidance rule redetermines the taxpayer or re-characterizes an item of income. It does not discuss the situation where a domestic anti-avoidance rule is used to deny a treaty benefit. Accordingly, the question arises as to whether such a rule is outside the scope of the OECD's comments. It was established earlier in this thesis that such rules should, indeed, fall outside the OECD's comments (*see section 12.2*). Accordingly, a possible conflict could arise with the treaty provisions. The development of the 2011 UN Commentary does not discuss the situation either. However, if it is argued that such rules are included within the OECD's general comments or UN comments (for statutory GAARs), then these rules have to be applied having regard to the guiding principle. Similarly, the 2014 TTA and 2015 Final TTA report also provide that the conclusions already reflected in the 2003/2014 OECD Commentary on Art. 1 with respect to domestic anti-avoidance rules remain applicable even with respect to treaties that do not incorporate the PPT rule. It is also stated that no conflict will arise if a domestic statutory GAAR is in conformity with the guiding principle. Essentially, the guiding principle is required to be seen as a treaty GAAR.

15.4. The view expressed in International case law

15.4.1. 1981: Unknown taxpayer – Germany[1052]

426. This case dealt with a structure that was implemented to seek treaty benefits under the 1931 German-Swiss tax treaty ("tax treaty") updated via protocol in 1959. In this case, a citizen of Monaco was a shareholder in a Swiss company (taxpayer). The taxpayer received dividends from a German company. The taxpayer claimed a reduction of German withholding taxes by invoking Art. 10(2) of the tax treaty. However, the tax authorities invoked the German statutory GAAR (*see section 3.3.2*) and contended that the transaction was abusive. The argument was that the citizen of Monaco had invested, via a taxpayer, in the German company only to receive treaty benefits that would have not been available if the investment had been made directly. Accordingly, as the transaction was abusive, treaty benefits should be denied to the taxpayer. The taxpayer then appealed to the GFFC. The GFFC ruled against the tax authorities. The Court ruled that the German statutory GAAR did not apply to non-resident companies with non-resident shareholders. This would have been the case even if the taxpayer had been a letter box company. Thus, treaty benefits should be given to the taxpayer.

15.4.2. 2005: A Holding APS – Switzerland[1053]

427. This case dealt with a treaty shopping structure whereby a taxpayer attempted to exploit the provisions of the 1973 Switzerland-Denmark tax treaty. The issue was whether a Danish resident taxpayer could obtain the tax treaty benefits vis-à-vis dividends paid by a Swiss resident corporation. At the outset, it should be mentioned that the applicability of Art. 21(2) of the SWTA (*see section 13.4.9*) also arose in this case. However, the SFSC refrained from answering the question[1054]. Nevertheless, the author believes that a discussion of this case is relevant because the issue of treaty abuse was addressed via propagating the idea that the tax treaty at stake included an inherent anti-abuse rule by referring to the 2003 OECD Commentary. This

[1052] GFFC: Case IR 89/80, October 29th 1981. The original text of the case is in German and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported by in the IBFD Tax Treaty Case Law database was referred to.

[1053] SFSC: A Holding ApS v Federal Tax Administration, 8 ITLR 536, November 28th 2005, pp.536-562.

[1054] JUNG, Tax Avoidance, p. 779.

inherent anti-abuse rule was developed on the basis of the domestic abuse of rights doctrine (*see section 3.2.5*).

428. The facts of the case are as follows. A Bermuda corporation owned a Guernsey corporation which in turn owned a Danish resident corporation viz., A Holding Aps ("Danish Co" or the "taxpayer"). The Danish Co acquired the shares of a Swiss company viz., F AG ("Swiss Co"). Thereafter, the Swiss Co made a dividend distribution to the Danish Co. The Swiss domestic law provides that dividend distribution payments to non-residents are subject to a final withholding tax of 35%. However, Art. 10 of the 1973 tax treaty which differed from the 1977 OECD Model, provided that dividend income was taxable exclusively in the residence State of the recipient. Furthermore, unlike the 1977 OECD Model, Art. 10 of the 1973 tax treaty did not include a "*beneficial ownership*" requirement. Thus, after receiving the dividends, the taxpayer contended that the Swiss withholding tax should be refunded. However, the tax authorities rejected the taxpayer's contention. They argued that the 1973 tax treaty contained an inherent anti-abuse principle and that principle could be used to combat treaty-shopping structures (*see section 21.3.1.1*). The tax authorities considered this case to be a treaty shopping case as residents of third countries had incorporated the Danish Co solely to exploit Art. 10 of the 1973 tax treaty for Swiss source dividends. They also strengthened this argument by factually finding that the entire dividend income received by the Danish Co was paid out to the Guernsey corporation and the Danish Co did not carry out any real economic activity i.e. it had no staff, offices or other assets. It should be noted that the Swiss tax authorities agreed that the Danish Co was the beneficial owner of the dividends (even though the treaty did not include the "*beneficial ownership*" requirement). Nevertheless, they considered the entire holding structure abusive. The case went for trial before the SFSC.

429. In this respect, the SFSC ruled the case in favour of the tax authorities. The Court essentially ruled that the principle of good faith enshrined in Art. 26 and Art. 31 of the VCLT includes the prohibition of abuse. The Court held that the principle of "*good faith, the aim and purpose of a convention are to be taken into account when an international convention is applied. Every contracting state can expect that the other contracting state acts in accordance with these principles…This includes the tackling of abuses. Because the prohibition of abuses is part of the principle of good faith...It prohibits the use of an institute of law against its purpose to realize interests*

which are not protected by it … Accordingly, the prohibition of an abuse of rights as regards conventions is not only recognised in Switzerland as a general principle of law but also on the European level without being necessary to adopt an explicit provision in the respective convention"[1055]. Furthermore, the SFSC referred to Paras 9.3 and 9.4 of the 2003 OECD Commentary (thus considering that it qualifies as supplementary means of interpretation i.e. it fits into Art. 32 of the VCLT) to conclude that the benefits of tax treaties should not be provided in abusive situations[1056]. To determine if abuse existed in the current case the Court referred to the fact pattern of the various solutions offered by the 2003 OECD Commentary (since 1992) to tackle Conduit Company issues i.e. the proposed clauses in Paras 13, 14, 19, 21 on the Commentary to Art. 1[1057]. Thereafter, the Court concluded that as the Danish Co did not have any economic substance (i.e. no office or staff) and it paid out the dividends it received; the structure adopted by the taxpayer was abusive.

430. The decision of the Court can be criticized on various grounds. Firstly, even though the Court referred to the 2003 OECD Commentary, the Court did not analyse the impact of the guiding principle as put forth in Para. 9.5 of the OECD Commentary on Art. 1 to ascertain if abuse exists. In the author's view, the first component of the guiding principle (a main purpose test) would have been satisfied in this case. This is because there was clearly a tax advantage. However, in the author's view the second component (the favorable tax advantage is contrary to the object and purpose of the relevant tax treaty provisions) would not have been satisfied. If one applies the VCLT principles to treaty interpretation (discussed previously), the object and purpose of Art. 10(1) of the 1973 tax treaty seems to be to allocate taxing rights vis-à-vis dividend income. Thus, as long as the Danish Co qualified as a resident for the purposes of the tax treaty and received the dividend in its capacity as a treaty resident – the object and purpose of Art. 10 does not seem to be frustrated. It could have been argued that the object and purpose of Art. 10(1) is to ensure that only "*beneficial owners*" of the dividend are entitled to relief from Swiss source taxation. However, this argument would have been inoperable because the tax authorities conceded that the Danish Co was the "*beneficial owner*". Furthermore, the Swiss tax authorities made

[1055] SFSC: Para. 3.4.3, A Holding ApS case, unofficial translation.
[1056] SFSC: Para. 3.4.5, A Holding ApS case, unofficial translation.
[1057] SFSC: Para. 3.6, A Holding ApS case, unofficial translation.

an observation to Para 7 of the 2003 OECD Commentary. The observation provided that Switzerland does not agree that the purpose of a double tax convention is to prevent tax avoidance. In the author's opinion, the holding structure in the current case is a tax avoidance structure. Therefore, if Switzerland considers that the purpose of the convention is not to prevent tax avoidance then the author believes that Switzerland should be restricted from arguing that the benefit of tax treaties should not be given in tax avoidance cases. Even the second limb of the guiding principle should not be interpreted in light of the objective of preventing tax avoidance. Secondly, the Court referred to the various proposed clauses found in the Commentary on Art. 1 to tackle conduit company cases in order to determine that the holding structure at stake was abusive. In the author's opinion, it was inappropriate for the Court to refer to these proposed clauses to determine if abuse exists. These clauses are provisions used to tackle conduit companies. Unless and until they are inserted into a tax treaty, no effect should be given to them. In summary, the author believes that the domestic abuse of rights doctrine found in Swiss law was given indirect effect in order to deny treaty benefits to the taxpayer.

15.4.3. 2006: MIL Investments – Canada[1058]

431. At the outset, it should be noted that in Canada, tax treaties are interpreted in the same manner as domestic legislation when analyzing abusive avoidance transactions with respect to the statutory GAAR (*see section 3.3.1*). This case dealt with a structure that was implemented to benefit from the provisions of the 1989 Canada-Luxembourg tax treaty ("1989 tax treaty"). In this case, Mr Boulle, a tax resident of Monaco, owned more than 10% of the equity in a Canadian listed resident company viz., DFR, a company engaged in the mining business. The shares of DFR were owned by Mr Boulle via his wholly owned Cayman Island Company viz MIL ("taxpayer"). As DFR had explored a blockbuster mining property, another Canadian mining company viz., Inco wished to acquire DFR. In order to achieve the acquisition, Inco approached several shareholders, among them, Mr Boulle in order to acquire their shareholding in DFR. Thereafter, Mr Boulle agreed to alienate his shareholdings as he needed to

[1058] CTC: MIL (Investments) SA v Canada, 9 ITLR 25, August 18th, 2006, pp. 25-88. Followed by CFCA: MIL (Investments) SA v Canada, 9 ITLR 1111, June 13th, 2007, pp. 1111-1113.

improve his cash position in order to focus on his African operations and repay outstanding debts (it is important to note that all shareholders of DFR sold their shares and that there were sound commercial reasons for doing so). Thus, Mr Boulle entered into the following series of transactions. Firstly, he had MIL exchange shares in DFR for shares of Inco, so that MIL's shareholding in DFR fell below 10%. This transaction was tax neutral for Canadian tax purposes due to a specific provision in the CITA. Secondly, he had MIL move into Luxembourg so that the company became a tax resident therein. The move was also tax neutral for Canadian tax purposes. Thirdly, MIL sold the shares in Inco and DFR and realised a huge capital gain. The gains made on these transactions were not subject to tax in Canada as Art. 13(4)(b) read in conjunction with Art. 13(5) of the 1989 tax treaty allocated taxing rights over capital gains to Luxembourg. Also, as Luxembourg did not tax these gains, the transactions led to double non-taxation[1059]. The Canadian tax authorities invoked the statutory GAAR to deny the benefit (exemption) claimed by MIL under the 1989 tax treaty as they considered the transaction to be an abusive tax avoidance transaction. Alternatively, they also contended, as an independent argument, that an inherent anti-abuse rule exits in a tax treaty to attack the transactions.

432. After a thorough analysis of the facts of the case, the CTC held that the conditions to invoke the GAAR were not satisfied as the circumstances surrounding the case clearly indicated that there were many *bonafide* business reasons for undertaking the aforementioned steps[1060]. Nevertheless, the CTC analyzed the question as to whether the transactions could be

[1059] Art. 13(4) of the tax treaty provided that *"Gains derived by a resident of a Contracting State from the alienation of: a) shares forming part of a substantial interest in the capital stock of a company which is a resident of the other Contracting State the value of which shares is derived principally from immovable property situated in that other State; or b) an interest in a partnership, trust or estate, the value of which is derived principally from immovable property situated in that other State, may be taxed in that other State. For the purposes of this paragraph, the term "immovable property" includes the shares of a company the value of which shares is derived principally from immovable property or an interest in a partnership, trust or estate referred to in sub-paragraph (b), but does not include property (other than rental property) in which the business of the company, partnership, trust or estate was carried on; and a substantial interest exists when the resident and persons related thereto own 10% or more of the shares of any class of the capital stock of a company."* Art. 13(5) provides that "*Gains from the alienation of any property other than that mentioned in paragraphs 1 to 4 shall be taxable only in the Contracting State of which the alienator is a resident"*.

[1060] CTC: Paras. 43-69, MIL case.

considered as abusive tax avoidance transactions for the purpose of the 1989 tax treaty. With respect to MIL moving into Luxembourg, the CTC provided that "*the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the use of the selected treaty that must be examined"*[1061]. Further, the Court examined Art. 13(5) and Art. 13(4) of the 1989 tax treaty and held that "*The general rule, contained in art 13(5) of the treaty, is that capital gains are taxable only in the country in which the taxpayer is resident (Luxembourg). An exception is made for the taxation of immovable property situated in the other state (Canada). Exempt from Canada's right to tax the capital gain on immovable property are two further restrictions found in art 13(4). These are the right to tax immoveable property from which a business is carried on and the right to tax immovable property in which the taxpayer owns less than a substantial interest (less than 10%)"*. The Court went on the say that "*The two exemptions found in art 13(4) are not found in the OECD model convention upon which the treaty is based. In drafting those exemptions it must be presumed that Canada had a valid reason to allow Luxembourg to retain the right to tax capital gains in those specific circumstances, for example, the desire to encourage foreign investment in Canadian property. The appellant's reliance upon a treaty provision as agreed upon by both Canada and Luxembourg cannot be viewed as being a misuse or abuse. Canada, if concerned with the preferable tax rates of any of its treaty partners, instead of applying s 245, should seek recourse by attempting to renegotiate selected tax treaties"*[1062].

433. This meant that the Court considered the object and purpose of Art. 13(5) and Art. 13(4) to be to allocate taxing rights between Canada and Luxembourg. Furthermore, it was provided that MIL was a non-resident of Canada at all times. The company's "*decision to continue from the Cayman Islands to Luxembourg did not change the reality that the appellant was a foreign company owning shares of a Canadian corporation"* [1063]. To summarize, the CTC held that as Canada had forgone taxing rights in favour of Luxembourg vis-à-vis capital gains and as MIL was always a non-resident for Canadian tax purposes, the fact that MIL moved into Luxembourg and

[1061] CTC: Para. 72, MIL case.
[1062] CTC: Paras. 73-74, MIL case.
[1063] CTC: Para. 75, MIL case.

alienated the shares of DFR and Inco could not be considered to be abusive for the purpose of the tax treaty[1064].

434. Finally, the CTC analyzed whether the 1989 tax treaty contained an inherent anti-abuse rule[1065] (*see section 21.3.1.1*). To establish this rule, the tax authorities presented the evidence of a Luxembourg tax expert viz., Prof. Steichen who seemed to suggest that an inherent anti-abuse principle can be applied in situations where both parties to a tax treaty have domestic anti-avoidance rules that would deny treaty benefits. Initially, he sought to establish whether the Luxembourg tax law would apply to deny tax treaty benefits in a 'reversed scenario' i.e. a hypothetical situation where the same Cayman Island company would have allegedly moved its corporate residence to Canada in order to avoid the Luxembourg domestic capital gains taxation pursuant to the provisions of Art. 13 of the tax treaty. However, the expert's opinion did not address this issue. Instead, it was indicated that domestic anti-abuse provisions can be applied to a tax treaty only if such rules are preserved in tax treaties. Further, the expert suggested that only in the case of an ambiguity under the tax treaty could the principles of international public law (Art. 26, 31 and 32 of the VCLT) be referred to infer the proper meaning of the treaty. The expert contended that silence in the tax treaty concerning the application of domestic anti-avoidance principles constituted an 'ambiguity' and that ambiguity could only be avoided by a specific provision of the tax treaty stating that the domestic anti-avoidance rules cannot affect the application of the tax treaty. He seemed to conclude that that in the absence of such a provision there would be an ambiguity as to whether an implicit anti-abuse provision exists or not[1066]. Nevertheless, the expert, by referring to Para. 7 of the 1977 OECD Commentary on Article 1, testified that if a tax treaty lacks an express provision allowing the use of a domestic anti-avoidance measure then such a measure cannot be applied to a tax treaty. Overall, in the author's opinion the position advocated by the expert was really confusing. The arguments lacked a clear line of reasoning. The CTC, after considering these confusing arguments, held as follows. It referred to the CSC's decision in *1995 Crown Forest Industries case*[1067] and endorsed the use of OECD Commentaries that were in force when the treaty was entered into. The CTC refused to take into

[1064] DE BROE, Thesis, p. 437.
[1065] CTC: Paras. 76-87, MIL case.
[1066] WARD, Abuse, p. 23.
[1067] CSC: Crown Forest Industries Ltd. v. Canada, 2 SCR 802, June 22nd, 1995, Paras. 54-55.

consideration the 2003 OECD Commentary on Art. 1 because that commentary did not fall within Art. 31 VCLT. The Court provided that "*one can only consult the OECD commentary in existence at the time the treaty was negotiated without reference to subsequent revisions"*[1068]. The Court concluded that "*Overall, I found Steichen's opinion and testimony not substantively convincing. In particular, in light of the OECD commentary and the decision by Canada and Luxembourg not to include an explicit reference to anti-avoidance rules in their carefully negotiated treaty, I find there is no ambiguity in the treaty permitting it to be construed as containing an inherent anti-abuse rule. Simply put, the 'ordinary meaning' of the treaty allowing the appellant to claim the exemption must be respected"* [1069]. Therefore, the Court declined to depart from the ordinary meaning of the words in Art. 13.

435. The tax authorities appealed the decision. On appeal, the CFCA upheld the decision of the CTC. It was held that "t*he appellant urged us to look behind this textual compliance with the relevant provisions to find an object or purpose whose abuse would justify our departure from the plain words of the disposition. We are unable to find such an object or purpose"*[1070]. In essence, the CFCA declined to depart from the ordinary meaning of the treaty terms as they could not find a valid treaty objective and purpose that could justify such a departure[1071]. With this conclusion, the CFCA agreed with the CTC, saying it was clear that: (i) the 1989 tax treaty intended to exempt Luxembourg residents from taxation on gains from the disposition of certain Canadian property and (ii) under the terms of the tax treaty, the shares of DFR held by MIL were such exempt property. If the exempting provision was intended to be limited to portfolio investments or to non-controlling interests in immoveable property then "*it would have been easy enough to say so"* in the tax treaty.

[1068] CTC: Para. 86, MIL case.
[1069] CTC: Para. 87, MIL case.
[1070] CFCA: Para. 6, MIL case.
[1071] DE BROE, Thesis, p. 437.

15.4.4. 2007: Yanko Weiss – Israel [1072]

436. This case dealt with a structure that was implemented to seek benefit from the provisions of the 1975 Israel-Belgium tax treaty ("1975 tax treaty"). The taxpayer was a company that was incorporated in Israel in the year 1996. Thereafter, in the year 1999, the taxpayer moved its registered office, management and activity to Belgium. Thus it became a tax resident of Belgium for corporate income tax purposes. Soon afterwards, the taxpayer received a dividend from its Israeli subsidiary. It claimed that it was entitled to the access the 1975 tax treaty and therefore the dividends should be subject to a lower withholding tax as prescribed by the tax treaty. However, the tax authorities invoked the Israeli domestic statutory GAAR to disallow treaty benefits to the taxpayer[1073]. The tax authorities mainly argued that there was no economic reason for the taxpayer to move to Belgium. Consequently, by applying the domestic statutory GAAR they took a position that the taxpayer's change in residence was a fictitious transaction and accordingly a sham. To support the applicability of the domestic GAAR to the treaty situation the tax authorities relied on Paras 9.2 and 9.3 of the 2003 OECD Commentary on Article 1. Conversely, the taxpayer contended that the domestic statutory GAAR could not be applied in treaty situations because it contradicts with the "*Pacta Sunt Servanda"* principle as found in Art. 26 of the VCLT. Moreover it was argued that, in the Israeli tax sphere, in the event of a conflict between the domestic law and tax treaties, the latter take precedence. Therefore, the domestic statutory GAAR could not be applied to tax treaty situations. Also, it was argued that a reference to the 2003 OECD Commentary on Art. 1 could not be made as the treaty was concluded before 2003.

437. The case went to trial and the District Court ruled in favor of the tax authorities. Many interesting observations were made. Firstly, the District Court seems to hold held that the provisions of a tax treaty are to be applied only after a tax liability is crystallized pursuant to the domestic law (which

[1072] District Court of Tel Aviv-Yafo: Yanko-Weiss Holdings Ltd v Holon Assessing Office, 10 ITLR 524, December 30th 2007, pp.524-550.

[1073] The Israeli domestic GAAR (a codified rule) permitted the tax authorities to disregard a transaction which is sham, artificial or fictitious or a transaction whose main objective is to avoid or reduce the tax. KATZ, Tax Avoidance, p. 410.

also includes domestic anti-avoidance provisions)[1074]. Secondly, the District Court makes a reference to Art. 31 of the VCLT and provides that the doctrine of "*good faith*" encompasses the principle that tax treaties should not be "*used improperly*". In this regard, the District Court provides that the doctrine of "*good faith*" warrants/implies the existence of an inherent anti-abuse rule in Israeli tax treaties. To support the position that an inherent anti-abuse rule exists in tax treaties, the District Court makes a reference to the 2003 OECD Commentary which it considers to carry substantial weight in tax treaty interpretation (even though the Court does not consider the Commentary as a binding instrument). The Court refers to Para 7, 7.1, 8 and 9.3 of the 2003 OECD Commentary and concludes that the benefits of tax treaties should not be granted in "*improper*" circumstances. As the tax authorities had determined that the taxpayer had improperly used the tax treaty, the Court concluded that the taxpayer could not access the tax treaty.

438. The decision can be criticized on several grounds. Firstly, in the author's opinion, the facts of the case as provided in the judgment are incomplete[1075]. It is difficult to ascertain if this case dealt with the issue of concurrent residence ie was the taxpayer a resident of Israel and Belgium at the same time. If it did, then the author believes that the case should have discussed the applicability of the tie breaker rules. Also, it is difficult to ascertain the reasons as to why the taxpayer moved to Belgium. In the facts, it is stated that this was done to access the lower withholding tax rate on dividends as provided in the 1975 tax treaty. However, the Article on dividends is not reproduced in the text of the case. The author believes that the facts described were limited probably due to the fact that the case discussed here is an unofficial translation. Due to the absence of clear facts, a proper analysis of the judgment cannot be made. Secondly, the Court starts discussing the interaction of the domestic statutory GAAR with tax treaties. It states that tax treaties are to be applied pursuant to such rules. However, the Court stops there and does not elaborate on this issue i.e. what would happen if the domestic statutory GAAR conflicts with a tax treaty. Thirdly, the Court upholds the view that the principle of "*good faith*" implies that treaty benefits should not be given in "*improper*" situations. However, in the author's view, the District Court does not clearly set out why the migration

[1074] The District Court does not elaborate on this issue and moves towards discussing the issue of whether the principle of "*good faith*" encompasses the principle that tax treaties should not be improperly used.

[1075] KATZ, Tax Avoidance, p. 417.

from Israel to Belgium was "*improper*" for Tax Treaty purposes. Moreover, the Court does not refer to Para 9.5 which provides for a guiding principle to determine if abuse exists. It was not clearly shown by the Court as to how i) a main purpose for moving from Israel to Belgium was to secure a more favourable tax position and ii) obtaining that more favourable treatment was contrary to the object and purpose of the relevant provisions. Overall, in the author's opinion, the English translation of the case is really confusing. Given this fact, the author believes that the case has limited value and should not be referred too.

15.4.5. 2009: Antle – Canada [1076]

439. For the facts of this case, *see section 12.3.2*. In the dispute, the tax authorities also argued that the Canadian GAAR applied as the "*capital property step-up strategy*" scheme was an abusive tax avoidance scheme. Thus, they maintained that treaty benefits should be denied to the taxpayer. In this regard, the CTC ruled that the conditions for invoking the GAAR were satisfied as there was a tax benefit[1077], an avoidance transaction[1078] and the avoidance transaction was abusive[1079]. In essence, the GAAR applied to the tax treaty and treaty benefits should be denied to the taxpayer[1080].

440. On examining the question as to whether the transaction undertaken by Mr. Antle is abusive for the purpose of Art. 14(4), the CTC preliminarily provides that the words of the treaty Article "*are also clear. The intention and purpose was to exempt gains realized by residents of Barbados from Canadian tax on the disposition of capital property in Canada*". Nevertheless, the CTC qualifies its position by stating that the conclusion is subject to the "*interpretative result in the context of what tax treaties generally are intended to accomplish*"[1081]. To understand what treaties are designed to accomplish the CTC refers to the OECD Commentary (which it considered to be relevant in the tax treaty interpretation process pursuant to

[1076] CTC: Antle v R; Marquis-Antle Spousal Trust v R; Antle and another v R, 12 ITLR 359, September 18th 2009, pp. 359-408. Followed by CFCA: Antle v Her Majesty the Queen; Marquis-Antle Spousal Trust v Her Majesty the Queen; 13 ITELR 591, October 21st, 2010, pp. 591-598.
[1077] CTC: Para. 79, Antle case.
[1078] CTC: Paras. 80-82, Antle case.
[1079] CTC: Paras. 85-99, Antle case.
[1080] CTC: Para. 87, Antle case.
[1081] CTC: Para. 96, Antle case.

the CSC's decision in the *1995 Crown Forest Industries case)*. Specifically, to ascertain the treaty's object and purpose, the CTC refers to Para 7 of the OECD Commentary on Article 1 which states that the purpose of tax treaties is to prevent tax avoidance and evasion to ascertain the treaties object and purpose. In response, the taxpayer argued that the purpose of the tax treaty was to "*allocate taxing jurisdiction over various types of income between two countries, and not to prevent double non-taxation. In giving up its right to tax Barbados residents on capital gains, Canada would have foreseen double non-taxation*". Nevertheless, the CTC counters this argument by referring to the preamble of the tax treaty which provided that "*The Government of Canada and the Government of Barbados desiring to conclude an agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital, have agreed as follows"* (it should be noted that the preamble did not include an explicit reference to the prevention of tax avoidance). In light of the preamble the Court then held that the "*Certainly, Canada has agreed to not tax Barbados residents, including trusts, on capital gains. But does that policy preclude the taxation of an individual Canadian resident on its capital gain in Canada, when arranging to shift the gain to the Barbados trust? I think not. The appellant may be correct in identifying the difficulty in finding that non-taxation of the trust is abusive of the treaty, but that does not save Mr Antle. The object, spirit and purpose of the Canadian legislation as it pertains to a Canadian resident is not to be swept aside because the policy of the treaty…especially when one considers an overarching policy of entering treaties to prevent tax avoidance by Canadian residents"*[1082]. This implies that Canadian tax treaties are to be interpreted so as to prevent tax avoidance. In summary, the Court held that "*the reasonable tax consequence is to deny Mr. Antle the ability to take advantage of the rollover to the Trust, and to include the taxable capital gain in his hands*". On appeal by the taxpayer, the CFCA also held in favour of the tax authorities. However, it declined to consider whether the GAAR could be used to deny the tax benefits.

441. The author does not agree with the following observations. Firstly, the preamble of the 1980 tax treaty provides that it does not include prevention of tax avoidance. Nevertheless, the CTC seems to have relied on the preamble so as to conclude that the prevention of tax avoidance is a treaty

[1082] CTC: Para. 98, Antle case.

objective[1083]. Secondly, the author wonders as to which version of the OECD Commentary the CTC referred too. In the author's opinion, the CTC seems to have referred to the 2003 OECD Commentary. This is because the passage i.e. Para 9 of Art. 1 that is quoted in the case[1084] resembles the 2003 OECD Commentary as opposed to its previous versions. This implies that the CTC considered subsequent versions of the OECD Commentary to be relevant in tax treaty interpretation. This clearly contrasts with the approach taken by the same Court in the *2006 MIL case (see section 15.4.3).*

15.4.6. 2009: Garron – Canada[1085]

442. This case also dealt with a structure that was implemented to exploit the provisions of the 1980 Canada-Barbados tax treaty ("1980 tax treaty"). Two Canadian resident individuals owned shares in a Canadian operating company ("Op Co"). Subsequent to a business reorganization, these two residents incorporated Canadian holding companies ("Hold Co"). At the same time, and in conjunction with a non-resident friend, they settled irrevocable discretionary family trusts in Barbados in which the Canadian residents (also their family members) were beneficiaries. A sole corporate trustee, resident in Barbados, managed the trusts. These trusts then subscribed to the shares of the Hold Co which, in turn, subscribed to the shares of the Op Co. After a couple of years, the shares of the Hold Co were sold by the trust (via the trustees) to a private equity fund. The capital gain made on this sale was claimed to be exempt from tax pursuant to Art. 14(4) of the 1980 tax treaty[1086]. The Canadian tax authorities objected to this structure and claimed that Canada had a right to tax the gains on the following grounds. Firstly, they contended that under the general legal principles, the trusts should be considered as tax residents in Canada as the POEM of these trusts was in Canada. Secondly, the tax authorities argued that two SAARs of the CITA are applicable in this case. The first rule (Section 94 of the CITA) dealt with a deemed residence concept, under

[1083] CTC: Para. 111, Antle case.

[1084] CTC: Para. 96, Antle case.

[1085] CTC: Garron and another v R; Re Garron Family Trust; Garron v R; St Michael Trust Corp v R; Re Fundy Settlement; Dunin v R; St Michael Trust Corp v R; Re Summersby Settlement, 12 ITLR 79, September 10th 2009, pp. 79-148; Followed by CFCA: St Michael Trust Corp v R; Re Fundy Settlement; St Michael Trust Corp v R; Re Summersby Settlement, 13 ITLR 400, November 17th 2010, pp.400-431.

[1086] Art. 14(4) of the tax treaty provided that "*Gains from the alienation of any property, other than those mentioned in paragraphs 1, 2 and 3 may be taxed only in the Contracting State of which the alienator is a resident*".

which, if certain conditions were satisfied the trusts were then considered to be tax residents of Canada. Nevertheless, even if this rule applied, the trusts were subject to a limited tax liability as opposed to worldwide tax liability. The second rule (section 75(2)) operated, more or less, as a CFC rule under which the gains of non-resident trusts were attributed to the beneficiaries, if they were residents in Canada. By applying these rules, the tax authorities sought to tax the gains made by the trusts (*see section 18.4.9*). Lastly, the Canadian tax authorities argued that the transactions undertaken were abusive tax avoidance transactions and therefore invoked the statutory GAAR to this case. Consequently, they argued that treaty benefits should be denied to the taxpayer.

443. With respect to the statutory GAAR, the CTC discussed the issue of whether the GAAR could be invoked. In this respect it was found that there was a tax benefit and an avoidance transaction[1087]. However, with respect to whether the transactions were abusive for the purposes of the tax treaty, the CTC held that an abusive tax avoidance transaction did not exist. The tax authorities had argued that the transactions were abusive because they were undertaken to minimize Canadian income taxation, in particular, the transactions were undertaken to avoid the application of section 94 (the deemed residence rule) by relying on Art. 14(4) of the 1980 tax treaty. With respect to this, the Court concluded that the mere fact that a transaction was subject to tax under an anti-avoidance provision of the Act, but is relieved by a tax treaty ie Art. 14(4), did not necessarily result in a misuse or abuse for the purposes of the GAAR. In support of this conclusion, the Court noted that the 1977 OECD Commentary (which the Court considered not to be binding) indicated that domestic anti-avoidance rules need to preserved in the text of the treaty to give them effect for the purposes of the tax treaty[1088]. Accordingly, this meant that if section 94 had to be applied at the level of the tax treaty, then the tax treaty should have adopted language which would allow the application of this domestic anti-avoidance rule. Further, the Court seems to have watered down the impact of the *RMM case*, which considered prevention of tax avoidance to be a treaty purpose[1089]. Furthermore, the tax authorities had made an argument that the benefit of Art. 14(4) should be given only if there is double taxation i.e. in this case, if Barbados had taxed the gains. However, the Court ruled that a tax treaty allocates taxing rights

[1087] CTC: Para. 343, Garron case.
[1088] CTC: Paras. 374-376, Garron case.
[1089] CTC: Paras. 378-379, Garron case.

and but nothing in the tax treaty compels a jurisdiction to exercise that right[1090]. Accordingly, even if Barbados did not tax the gains, it could not be argued that the transactions were abusive. The tax authorities appealed the decision of the CTC. The CFCA upheld it however and held that the Canadian GAAR could not be invoked as there was no abusive tax avoidance transaction.

444. Several interesting points arise from this case. Firstly, in contrast to its earlier decisions, the CTC considered the OECD Commentary to be non-binding. Nevertheless, it took into consideration the 1977 OECD Commentary to interpret a tax treaty concluded in 1980. Secondly, the Court seems to have implicitly accepted that the prevention of tax avoidance was not a purpose of the tax treaty. This is because the tax authorities had argued that "*the treaty exemption was not intended to apply to the trusts because they had very little connection with Barbados. It was noted that the assets, contributors and beneficiaries are all Canadian. To apply the treaty exemption in these circumstances would facilitate the avoidance of tax by Canadians*"[1091]. In response, the CTC held that "*The problem that I have with this argument is that, if accepted, it would result in a selective application of the treaty to residents of Barbados, depending on criteria other than residence. It seems to me that this is contrary to the object and spirit of the treaty, which is apparent in art I and art IV(1). Residents of Barbados, as defined for purposes of the treaty, are entitled to the benefits of art XIV(4) as long as they are not also residents of Canada"*[1092]. Thus, as long as a person qualifies as a resident for the purpose of the tax treaty then that person should be given treaty benefits. Thirdly, the CTC upheld the view that the purpose of a tax treaty does not extend to prevention of double non-taxation. The author subscribes to this conclusion (*see section 9.2.3*).

[1090] CTC: Paras. 388-392, Garron case.
[1091] CTC: Para. 380, Garron case.
[1092] CTC: Para. 381, Garron case.

15.5. Author's view on the case study

15.5.1. Implications under the T-S tax treaty

15.5.1.1. Treaty entitlement

445. In the context of judicial doctrines, the 2014 TTA and 2015 Final TTA reports state that (*see section 8.2.3.3.4*) in the process of statutory interpretation, the courts of many countries have developed doctrines such as sham, substance over form, step-transaction, fraus legis, economic substance, business purpose and abuse of law. These doctrines, which differ from country to country, are opinions expressed by courts on the methods for interpretation of tax legislation. While the provisions of the VCLT govern the interpretation of tax treaties, these provisions do not prevent the application of similar judicial doctrines and principles to the interpretation of the provisions of tax treaties. As an example it is provided that if "*the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach from being adopted with respect to the application of the provisions of a tax treaty to similar transactions*". This is illustrated by a case where the "*sham*" doctrine is applied to ascertain the correct facts of the case (*see section no. 12.2*). Interestingly, it is clearly stated that "*In that case, to the extent that the sham transaction doctrine developed by the courts of State A does not conflict with the rules of interpretation of treaties, it will be possible to apply that doctrine when interpreting*" tax treaties.

446. Firstly, the author would like to comment that it is not reasonable to discuss the treaty compatibility of all the doctrines under one heading. As seen previously (*see section 3.2*), the effects of applying judicial doctrines are quite diverse. The effect of each doctrine needs to be analysed on a case by case basis to check whether or not a conflict arises with treaty provisions. Secondly, the author would point out that the example in the previous paragraph, refers to "*economic substance*" of the transactions whereas the case that is used to illustrate the example refers to the "*sham*" doctrine. The doctrines have different scope and the OECD seems to have mixed them up. In the example it is stated that the judicial doctrines can be applied to tax treaties even though the provisions of the VCLT govern treaty interpretation whereas in the case it is clearly mentioned that the "*sham*" doctrine can be

applied only to the extent it does not conflict with treaty interpretation rules. From this it can be deduced that, on one hand, the OECD suggests that there is no conflict between judicial doctrines and treaty law whereas on the other hand it suggests that a conflict can arise. These remarks are indeed confusing.

447. In the author's opinion, domestic law and treaty law are distinct set of rules. If a taxpayer qualifies as a "*person*" that is a "*resident*" and a "*beneficial owner*" to whom the dividends are "*paid*" (as discussed in the case study) then that taxpayer should be given treaty benefits (*see section 13.5.1.2*). In the case study at hand, from the perspective of State S and State T, a State T resident (B Corp) receives the dividend income. Thus, treaty benefits should indeed be provided as the German and Canadian Court decisions (*MIL* and *Garron*) discussed in this chapter illustrate. Barring treaty benefits on the basis of a domestic anti-avoidance rule, such as an interpretative judicial doctrine, or a statutory GAAR or SAAR (up to the extent they deny treaty benefits) – clearly conflicts with the provisions of tax treaties. As discussed in *section 13.4.6*, it is debated as to whether the Austrian GAAR is an interpretation guideline or a rule that determines a taxable event. Some author's argue that if the GAAR is considered to be a rule of interpretation then treaty benefits cannot be denied to the taxpayer. This is because the interpretation of tax treaties is to be considered independently of the interpretation of domestic tax law[1093].

15.5.1.2. The issue of double taxation

448. Should State T provide relief from double taxation even if State S taxes that item of income pursuant to its domestic anti-avoidance rule? Under either Art. 23A or Art. 23B, the OECD Model provides that State T should provide relief from double taxation with respect to items of income which "*in accordance with the provisions of this convention*" are taxable in State S. If State S applies its domestic anti-avoidance rule to deny treaty benefits, the answer should be in the negative because State T would rightly argue that State S has not levied the taxes "*in accordance with the provisions of this Convention*" as provided by Art. 23. To elaborate, State T would argue that State S has used a domestic anti-avoidance rule that clearly conflicts with the treaty interpretation rules. Thus, State S is not under an obligation to

[1093] HOHENWARTER, Abuse, pp. 202-203.

provide relief from double taxation[1094]. As the domestic anti-avoidance rule also leads to double taxation, an argument can be made that the application of such a rule should be prevented. This is because such a rule defeats the primary object and purpose of the tax treaty, namely to prevent double taxation.

15.5.1.3. The impact of the guiding principle (or PPT rule)

449. Interestingly, in the Swiss *A Holding case*, the court referred to the 2003 OECD Commentary on Art. 1 to interpret a treaty concluded in 1973 in order to arrive at the conclusion that treaty benefits can be denied to the taxpayer. However, it is absurd that the Court did not take into consideration the guiding principle. Likewise, in the *Yanko Weiss case*, the court referred to the 2003 OECD Commentary on Art. 1 for a treaty concluded in 1975 to arrive at the conclusion that treaty benefits can be denied to the taxpayer. Similarly, in the *Antle case*, the CTC seems to have referred to the 2003 OECD Commentary. However, once again, the guiding principle was not taken into consideration. The position taken in this thesis is that the guiding principle applies for tax treaties concluded by OECD or UN member States after January and June 2003 respectively (*see section 9.1*). *The following analysis can also be extended to treaties that may incorporate the PPT rule in light of the BEPS Action Plan.*

450. Firstly, it needs to be ascertained if there is a treaty benefit. The Commentary to the PPT rule provides that the term "*benefit*" includes "*all limitations… imposed on the State of source under Articles 6 through 22 of the Convention*" [1095]. Accordingly, a benefit does arise for the taxpayer under Art. 10. By applying the provisions of Art. 10, the State of source is restricted from taxing the dividends. Secondly, it needs to be ascertained as to whether a main purpose for creating B Corp was to secure a more favourable tax position. It could be argued that the creation of B Corp in State T (depending on the facts and circumstances) was mainly due to non-tax reasons. However, at the same time the tax authorities could argue that one of the main purposes to insert B Corp, into this series of transactions, is to obtain a tax benefit under the T-S treaty (reduction of taxes in the source State). As one of the purposes was to obtain a more favourable tax position, the subjective test is satisfied (*see section 13.5.1.4*). The next question is

[1094] 2003/2014 OECD Comm. Art. 23, Paras. 32.5.
[1095] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 7).

whether the taxpayer was acting against the object and purpose of Art. 10(2)? In the author's view, the purpose of such a distributive rule is to allocate taxing rights among States. Thus, the objective element should not be satisfied, as the taxpayer has not acted against that object and purpose. However, if the Courts read Art. 10(2) as intended to prevent tax avoidance then the author does not rule out the possibility of the objective test being satisfied. Therefore, the application of the guiding principle leads to uncertainty.

15.5.2. Summary

451. In the author's opinion, the T-S tax treaty applies to the facts of this case. This is because B Corp qualifies as a "*person*" under Art. 3(1)(a) that is a "*resident*" under Art. 4(1) of State T and the "*beneficial owner*" under Art. 10(2) – treaty benefits can be denied if B Corp does not qualify as the "*beneficial owner*". To summarize, State S should not apply the effect of its domestic anti-avoidance rule to deny treaty benefits as this could clearly breach the "*pacta sunt servanda*" principle (refer to the decision of the ISC in the *Azadi Bachao Andolan case – see section 12.3.1* & the *Vodafone case – see section 12.3.3.* In these cases the Courts held that treaty benefits could not be denied to Mauritian entities). Nevertheless, treaty benefits could be denied under the guiding principle (or PPT rule). However, whether the objective element of the principle/rule is satisfied is highly questionable. This would depend on the facts and circumstances of each case.

15.5.3. The issue of treaty override

452. In the previous sections it was concluded that a domestic anti-avoidance rule, which denies a treaty benefit, conflicts with the provisions of a tax treaty. Logically, even if such a rule is introduced/applied after the conclusion of a tax treaty, that rule should not be applicable as the provisions of the tax treaty take precedence. Accordingly, if the legislature (as a standalone SAAR or as a part of statutory GAAR) or the judiciary (typically by developing and applying a business purpose test) introduces/applies a posterior domestic anti-avoidance rule that denies a treaty benefit to the taxpayer, notwithstanding the conflict, a strong argument can me made that a treaty override occurs. This is because such a rule disturbs the allocation of taxing rights.

453. To elaborate on this position, reference is made to the OECD position to ascertain whether the introduction of such an anti-avoidance rule by a State after the conclusion of a tax treaty can constitute a treaty override. The OECD provided two examples of treaty overrides (*see section 4.4.3.2*). The second example is of relevance to the discussion here. In that example, the enactment of new legislation by the State to counteract tax avoidance through immoveable property companies was considered to be a treaty override. It should be noted that in the example provided by the OECD the enactment of the new legislation by one contracting State immediately affects persons that are residents of the other contracting State i.e. persons who can claim the application of Art. 13(4) of the 1977 OECD Model before the enactment of the new legislation. Put differently the enactment of the new legislation by the State in which the immovable property was situated was sufficient to convert an exclusive right to tax (attributed to the State of residence) into a shared right to tax (with the State of source). As a result, the State of residence is no longer granted the exclusive right to tax the income derived from the sale of shares.

454. If we transpose this example to the domestic anti-avoidance rule at stake, the conclusion will be that the enactment of a domestic anti-voidance rule by a State after the conclusion of a tax treaty is a treaty override. This is because the domestic anti-avoidance rule leads to a shift in the allocation of taxing rights i.e. a limited right to tax that is available to State S pursuant to Art. 10(2) is converted to a full right to tax. Also, if the rule leads to unresolved juridical double taxation, it can be concluded that a treaty override occurs. For instance, in the author's opinion a provision such as the German anti-treaty shopping provision, which denies benefits to non-resident intermediaries established in treaty jurisdictions, is clearly a treaty override[1096]. Thus a material breach arises for the purposes of Art. 60(1) VCLT.

[1096] PERDELWITZ, Override, p. 445; LINN, Tax Avoidance, p. 343; KAHLENBERG, Override, p. 486.

16. Source State: domestic anti-avoidance rules that deny deductions for payments made to non-resident taxpayers

16.1. The domestic anti-avoidance rule

455. In this chapter, the author discusses the treaty compatibility of a domestic anti-avoidance rule that is applied by the source State pursuant to which payments made to non-residents are disallowed for tax purposes. The analysis is restricted to interest payments made by a resident of one State to a non-resident of another State and both the resident and non-resident qualify as "*associated enterprises*" for the purpose of Art. 9. The analysis does not extend to other type of payments.

16.2. The case study fact pattern

456. Consider the following thin capitalization situation. Corp R, a resident of State R, invests in Corp S (its associated enterprise), a resident of State S, with minimal equity and excess loans. Corp S pays interest to Corp R. It is assumed for the purpose of this case that Corp R and Corp S qualify as "*associated enterprises*" for the purposes of Art. 9. Assume the following situations in which State S applies its domestic anti-avoidance rules to deny the interest deduction: i) State S re-characterizes the funding instrument from loan to equity for private law (commercial law) purpose by invoking the sham/simulation doctrine. By doing so, the interest attributable to the debt that was converted into equity is denied as a deduction ii) State S, by invoking its TP rules, re-characterizes the funding instrument from loan to equity for tax law purpose. By doing so, the interest attributable to the debt that was converted into equity is denied as a deduction; as an alternate measure, State S by invoking its TP rules denies the interest deduction (that it considers excessive). Under both situations the adjustments are made up to the arm's length standard iii) State S, by invoking its judicial doctrine or statutory GAAR, re-characterizes the funding instrument from loan to equity for tax law purpose. By doing so, the interest attributable to the debt that was converted into equity is denied as a deduction; or State S, by invoking its

judicial doctrine or statutory GAAR denies the interest deduction (because it considers it excessive) and; iv) State S, by invoking a SAAR such as a fixed debt/equity ratio, denies the interest deduction (that it considers excessive). The question arises as to whether State S is restricted by any provisions of the tax treaty?

16.3. The OECD/UN view

16.3.1. The view expressed with respect to thin capitalization regimes

457. The OECD's view on the interaction between such domestic anti-avoidance measures, especially thin capitalization regimes, with tax treaties has evolved over a period of time. Specifically, the compatibility of thin capitalization legislation's has been tested with the various Articles of the OECD Model. The various provisions that are relevant to the analysis are as follows. Firstly, Art. 9 is relevant as thin capitalization regimes are mainly applicable to transactions between associated enterprises. The basic issue here is whether such regimes should respect the arm's length principle i.e. if an adjustment is made to the borrower's profit then should such an adjustment be in accordance with the arm's length principle. Secondly, a thin capitalization regime may reclassify interest as dividends. In such a case, the question arises as to whether this deemed dividend is governed by the definition of dividends or interest as defined in Art. 10(3) or Art. 11(3) respectively (this issue is discussed in *chapter 14* and will not be discussed again in this chapter). Thirdly, excess interest payments can be disallowed from the taxable base of the borrower in accordance with Art. 11(6). In this regard, the question arises as to what extent such regimes are compatible with Art. 11(6). Essentially, the question is what is the relationship between Art. 9(1) and Art. 11(6) with respect to thin capitalization regimes? Fourthly, the compatibility of such regimes needs to be tested against the provisions dealing with non-discrimination. The issue arises is whether Art. 24(4) or 24(5) could prohibit the application of thin capitalization regimes: if they apply only to non-residents and not resident of a State.

16.3.2. The OECD Position

16.3.2.1. The 1979 TPG[1097]

458. The 1979 TPG sought to provide guidance on determining the arm's length price vis-à-vis various transactions between associated enterprises[1098]. This publication did not deal directly with the issue of thin capitalization but Section I, Chapter 5 thereof dealt with definition of loans[1099]. It was acknowledged that for tax reasons equity contributions could be disguised as loans and thereafter various approaches followed by the OECD member countries to distinguish between equity and loan were laid out[1100]. Subsequently, tentative guidelines were provided and the TPG recommended that a flexible approach should be followed to reclassify debt to equity[1101]. To elaborate, a flexible approach would take into consideration various factors to determine whether debt was actually equity. The factors, basically, include i) whether the principal amount of the loan is payable at a future date ii) whether the loan is subordinated to the rights of other creditors iii) whether the debt is convertible to equity iv) whether the parties intended to create a debtor-creditor relationship v) whether the debt-equity ratio exceeds a certain percentage etc[1102]. The 1979 TPG, provided that it would not be desirable, to use a hard and fast debt equity ratio to convert debt to equity[1103]. Accordingly, it can be ascertained that at this point in time the OECD favoured a facts and circumstance test (ascertainment of the various factors mentioned in the flexible approach) over a pure fixed ratio approach test.

16.3.2.2. The 1986 Thin Capitalization Report[1104]

16.3.2.2.1. Preliminary remarks

459. At the outset, the 1986 OECD report on thin capitalization (hereafter "1986 TC Report") analyses the various options available in corporate

[1097] OECD, 1979 TP Guidelines.
[1098] OECD, 1979 TP Guidelines, Paras. 7-8.
[1099] OECD, 1979 TP Guidelines, Para. 182.
[1100] OECD, 1979 TP Guidelines, Paras. 184-190.
[1101] OECD, 1979 TP Guidelines, Para. 191.
[1102] OECD, 1979 TP Guidelines, Paras. 186-187.
[1103] OECD, 1979 TP Guidelines, Para. 191.
[1104] OECD, Thin Capitalization report.

financing and provides that a company can be financed, broadly, by equity or debt[1105]. It then provides the legal and economic differences between equity and loan capital and provides that the most important difference is that equity investment produces a return for the investor in the form of a dividend while the return on a loan is interest[1106]. Then, the 1986 TC Report discusses the choice of financing and its implications for taxation and provides that the basic difference between choosing equity or debt from a tax viewpoint is that dividend distribution is not deductible for the borrower whereas an interest payment is deductible[1107]. Thereafter, the 1986 TC Report discusses the taxation of dividends and interest in a national and international context and provides that loan financing could be more beneficial than equity financing from a tax perspective - especially in situations involving hybrid financing[1108]. In this regard, the Report states that a multinational group may obtain tax advantages by financing companies in the group though intercompany loans. To illustrate, a tax advantage exists where loans are routed to a borrowing subsidiary located in a high tax jurisdiction via an intermediary company established in a low tax or no tax jurisdiction and the former and later jurisdictions have a tax treaty which provides for a low or nil withholding tax rate on the outbound interest payments. In such situations, the borrower can deduct the interest expense for tax purposes and the lender can receive interest income which is taxed at low or nil rates. By doing this, the multinational group reduces its overall effective tax rate[1109]. As loan financing and the associated interest deductions impact a Country's tax revenue, the 1986 TC Report goes on to forest out several factors that may be considered by policy makers to combat erosion of a State's tax base[1110].

460. Subsequently, the Report discusses the approaches adopted by countries in their domestic law to deal with problems arising from thin capitalization. These approaches are broadly divided in the Report between those that are based on the application of general rules countering abuse and those that involve the use of fixed ratios. To elaborate, under the former approach, a country looks at all facts and circumstances i.e. the terms and

[1105] OECD, Thin Capitalization report, Para. 2.
[1106] OECD, Thin Capitalization report, Paras. 3-5.
[1107] OECD, Thin Capitalization report, Paras. 6-7.
[1108] OECD, Thin Capitalization report, Paras. 8-11.
[1109] OECD, Thin Capitalization report, Paras. 15-16. The example has been made based on the language used in the Report.
[1110] OECD, Thin Capitalization report, Paras. 17-18.

nature of a contribution and the circumstances in which it has been made to determine whether the contribution is debt or equity. Such facts and circumstances can be ascertained pursuant to either general anti-abuse rules (such as statutory GAAR's, abuse of law, substance over form etc) or pursuant to domestic TP rules which use the arm's length standard[1111.] Under the latter approach, countries compare the debtor company's total debt to its equity capital and if the debt exceeds the equity by a certain proportion then the interest payment attributable to the excess debt is disallowed for tax purposes (the interest payment may retain its original character or may be re-characterized as dividends). This approach could be applied to transactions with related parties or could be used as a safe haven measure thereby giving the taxpayer the option of showing that the relevant company's debt/equity ratio is an arm's length ratio or is otherwise acceptable[1112] (*see section 3.4.2.2*). The 1986 TC Report then moves on and discusses the interaction of these approaches with different Articles of the OECD Model[1113].

16.3.2.2.2. Interaction with Art. 9(1)

461. As discussed previously (*see section 3.4.1*), Art. 9 deals with adjustments to profits that may be made for tax purposes where transactions between associated enterprises are made on non-arm's length conditions[1114]. Art. 9(1) of the OECD Model allows the tax authorities of a State to adjust the profits of the enterprises resident in that State if, as a result of the special relations between that enterprise and other associated enterprises resident in other States, the profits of the first enterprise have been diverted to the other associated enterprises, due to the fact that they operate with each other on a non-arm's length basis. Where the tax authorities have adjusted the profits, Art. 9(2) of the OECD Model aims at eliminating the economic double taxation that may arise pursuant to Art. 9(1). In many States domestic thin capitalization regimes apply to related parties[1115]. Accordingly, Art. 9 becomes relevant to thin capitalization issues as profit shifting between

[1111] OECD, Thin Capitalization report, Para. 25(i).
[1112] OECD, Thin Capitalization report, Para. 25(ii).
[1113] The report tests the compatibility of the thin capitalization provisions with Art. 9, Art. 10, Art. 11, Art. 23 and Art. 24 of the 1977 OECD Model. To a great extent, the provisions of the 1977 OECD Model are similar to the provisions of the subsequent versions of the OECD Model.
[1114] 2014 OECD Comm. Art. 9, Para. 1.
[1115] OECD, Thin Capitalization report, Para. 21.

associated enterprises could take place through loan financing and interest payments that arise as a consequence of such financing[1116].

462. The 1986 TC Report raises several questions regarding the interaction of domestic thin capitalization regimes with Art. 9. The first question is whether Art. 9(1) can be used to decide whether a payment which is prima facie an interest payment can be treated as a distribution of profit ie whether this Article can be used to re-characterize debt to equity[1117]. In response to this question, the 1986 TC Report provides that Art. 9 is relevant not only in determining whether the rate of the interest is an arm's length rate but also in determining whether a loan can be considered as a loan or as some other kind of contribution ie equity[1118]. The 1986 TC Report supports this view by arguing that Art. 9(1) allows the tax authority of a State to adjust the profits of an enterprise of that State to reflect the profits that would have arisen if the enterprise had been acting at arm's length. This would mean that if in an arm's length situation equity would have been provided instead of debt, the tax authority can reclassify debt to equity. Accordingly, it can be established that the 1986 TC Report proposes a broad interpretation of Art. 9(1) [1119].

463. The 1986 TC Report then raises the second question on the application of Art. 9 in thin capitalization scenarios viz., is Art. 9 restrictive or illustrative in its scope? To elaborate, a restrictive interpretation of Art. 9 would lead to the conclusion that it prohibits the adjustment of profits to an amount exceeding the arm's length amount whereas an illustrative interpretation would lead to the conclusion that Art. 9 does not prohibit a country from adjusting the profits to an amount exceeding the arm's length profit - pursuant to its domestic thin capitalization rules[1120]. In response to this question the 1986 TC Report provides that even though different views exist among the OECD Member countries, a restrictive interpretation of Art. 9 should prevail and the profits of associated enterprises can only be adjusted up to an arm's length profit. The OECD Commentary, which states that profit adjustments are not required when a transaction between associated enterprises is at arm's length, also confirms this[1121].

[1116] DE BROE, Thesis, p. 504.
[1117] OECD, Thin Capitalization report, Para. 28.
[1118] OECD, Thin Capitalization report, Para. 48.
[1119] OECD, Thin Capitalization report, Para. 49.
[1120] OECD, Thin Capitalization report, Paras. 29-30.
[1121] 2014 OECD Comm. Art. 9, Para. 2.

464. The third question raised by the 1986 TC Report can be framed as follows. If Art. 9(1) disallows a payment (interest deduction) because the transaction if conducted at arm's length would be a distribution (dividend distribution) should the tax authorities in applying Art. 9 be governed by the definition of "*dividend*" or "*interest*" as provided in Art. 10(3) and 11(3) of the OECD Model respectively or should they apply their domestic law definitions pursuant to Art. 3(2) of the OECD Model[1122]. If the answer to this question is that the treaty definitions should apply then a payment that was clearly interest as defined in Art. 11(3) would have to be treated as interest for the purposes of Art. 9 notwithstanding that domestic thin capitalization rules treat it as a distribution of profit[1123]. Framed differently, the issue here is whether a State is restricted in applying its domestic thin capitalization legislation that reclassifies a payment as a distribution, pursuant to Art. 9, because the definition of "*interest*" as defined in Art. 11(3) is prevailing and has to be used to interpret Art. 9. If the treaty definition of interest is used for the purpose of Art. 9 then a State cannot reclassify an interest payment as a dividend distribution[1124].

465. The 1986 TC Report does not provide a conclusive response to this question. It states that that Country practices are divided. In some legal systems this would not be an issue as the domestic law definition of dividends and interest would be given precedence for the purpose of Art. 9[1125]. In other legal systems this would be an issue because these countries use the definition of "*dividends*" and "*interest*" as provided in Arts. 10(3) and 11(3) for the purpose of Art. 9. In such situations, the report suggests that these countries may change the wording of Art. 11(3) in a tax treaty so as to protect the operation of domestic thin capitalization rules[1126]. One commentator does not agree with this position. He submits that the residence State of the borrower cannot be restricted from applying its domestic thin capitalization rules and the definitions arising pursuant to it as long as such rules are consistent with the arm's length standard[1127]. This is because the definition of "*dividends*" and "*interest*" as provided in Arts. 10(3) and 11(3)

[1122] OECD, Thin Capitalization report, Para. 31.
[1123] OECD, Thin Capitalization report, Para. 51.
[1124] DE BROE, Thesis, p. 510.
[1125] OECD, Thin Capitalization report, Para. 52.
[1126] OECD, Thin Capitalization report, Para. 53.
[1127] DE BROE, Thesis, p. 510.

are only relevant for the purposes of those Articles[1128] or potentially for the purposes of other Articles in a tax treaty where the term "*dividends*" or "*interest*" has been used[1129]. Art. 9 does not use the words "*dividends*" or "*interest*" but uses the word "*profits*". Accordingly, as the term "*profits*" is not defined, reference has to be made to the domestic law of the State applying the treaty, pursuant to Art. 3(2), in order to ascertain the meaning of this term, unless the context otherwise requires. If such profits (which is a general term) include the re-characterized interest ie dividends, then it could be argued that a State is not restricted from applying its domestic law definitions pursuant to its thin capitalization rules. This argument is strengthened if one compares the scope of Art. 9 with Art. 10 or Art. 11. Art. 9, is general in scope, and is intended to adjust the profits of an enterprise which would reflect the arm's length standard. The profits could include and encompass all income as contained in other Articles of the OECD Model. On the other hand, Art. 10 and 11 are limited to the application of taxes (mainly in the form of withholding) on dividends or interest. There does not seem to be a sufficient nexus between Art. 9 and Art.10/ Art. 11 to import the definition provided in the latter Articles into the former Article[1130]. The 1986 TC Report, nevertheless, in a cautious manner agrees that as long as the domestic thin capitalization rules are consistent with Art. 9 the automatic application of Art. 10 and Art. 11 to the rest of the treaty may not create any difficulty[1131].

466. The fourth and final question raised by the 1986 TC Report relates to the practical guidelines available to the taxpayer for the application of Art. 9 [1132]. To reiterate, the 1986 TC Report states that domestic thin capitalization rules are broadly divided between those that are based on rules which take into consideration all facts and circumstances and those that involve the use of fixed ratios. Further, the 1986 TC Report states that such domestic thin capitalization rules should respect the arm's length standard to be compatible with Art. 9. Accordingly, the question which arises here is as to how do we determine the arm's length standard for such domestic thin

[1128] This is clear from the text of the Art. 10(3) provides that "*The term dividends as used in this Article (…)*". Art. 11(3) provides that "*the term interest as used in this Article (…)*".

[1129] For a detailed discussion on whether the definition of dividends as used in Art. 10(3) can be used for the purpose of other Arts. which use the term "*dividends*". See AVERY JONES, Dividends, pp. 163-173.

[1130] DE BROE, Thesis, pp. 511-512.

[1131] OECD, Thin Capitalization report, Para. 54.

[1132] OECD, Thin Capitalization report, Para. 32.

capitalization rules. This is important as we need to establish if such rules are compatible with Art. 9 or not[1133].

467. For thin capitalization rules which ascertain the facts and circumstances of each case, the 1986 TC Report provides that tax authorities should take into consideration several factors in order to examine if debt is actually equity including evidence of whether independent enterprises would enter into such a transaction. These factors include i) whether the borrower has a high debt/equity ratio either before the loan was granted or as a result of it ii) whether the loan was designed to finance the long term needs of the borrower iii) whether the loan was provided by the lender in proportion to its existing shareholdings or as a condition of such shareholdings iv) whether the loan was designed to improve the financial situation of the enterprise v) whether the interest payable on the loan is linked to the success of the borrowers business vi) whether the loan was convertible into equity at a later stage vii) whether the interest on the loan exceeded a reasonable commercial return viii) whether the payment of interest on the loan or the repayment of the amount lent was subordinated to the rights of other creditors ix) whether a repayment clause is provided in the loan agreement and x) whether the loan repayment is dependent upon the profits of the borrower.

468. The 1986 TC Report indicates that the presence of one these factors would not necessarily mean that the purported loan is equity but the presence of a combination of such factors would, nevertheless, be an important indication that the loan is actually equity[1134]. Further, the 1986 TC Report states that these factors have to be analysed in light of whether an independent enterprise would provide such a loan i.e. would it agree to provide a high proportion of debt to the borrower. Accordingly, a subject of reference is needed. The 1986 TC Report provides that an ideal subject of reference would be an independent bank which would take into consideration the borrower's financial and economic condition in order to determine whether a loan should be provided. However, the 1986 TC Report provides that the independent banker comparator should not be applied in a strict sense, because it could be possible that an associated enterprise (such

[1133] OECD, Thin Capitalization report, Para. 74.
[1134] OECD, Thin Capitalization report, Para. 75.

as the parent company) may have a better understanding of the borrower's (such as a subsidiary) profit potential than an independent banker[1135].

469. To conclude, the 1986 TC Report provides that domestic thin capitalization rules that ascertain all facts and circumstances and rely on evidence of transactions between independent persons are compatible with the provisions of Art. 9[1136]. Interestingly the 1986 TC Report, after discussing the general impact of Art. 9 on thin capitalization rules, leaves open the question of whether domestic thin capitalization rules which re-characterize debt to equity pursuant to judicial doctrines or statutory GAARs need to be tested against Art. 9[1137]. This statement of the OECD seems to be contradictory to the overall analysis of Art. 9 with different thin capitalization rules. Accordingly, it can be ascertained that the OECD's view is that thin capitalization rules which gather all facts and circumstances to re-characterize debt to equity are compatible with the provisions of Art. 9(1). However, the OECD is silent in its position for rules that re-characterize debt to equity pursuant to domestic general anti abuse rules such as judicial doctrines or statutory GAAR's.

470. For thin capitalization rules which follow a pure fixed ratio approach, the 1986 TC Report states that such ratios are arbitrary, even if they are determined on the basis of open market terms. Accordingly, it can be concluded that a thin capitalization rule that is based on a pure fixed ratio approach can be considered to be contrary to Art. 9 as it does not respect the arm's length standard[1138]. The 1986 TC Report, nevertheless, provides that if a domestic thin capitalization rule uses a combination approach, i.e. it provides a fixed ratio as a safe haven rule and gives the taxpayer (borrower) the option of demonstrating that such a ratio is an arm's length ratio, then such a rule can be considered to be compatible with Art. 9. In this regard, the 1986 TC Report highlights that a domestic thin capitalization rule which provides such a safe haven ratio should allow as high as possible a proportion of debt to equity or should be flexible as to minimise the number of taxpayers who are obliged to make use of the option. Accordingly,

[1135] OECD, Thin Capitalization report, Para. 76.
[1136] OECD, Thin Capitalization report, Para. 78.
[1137] OECD, Thin Capitalization report, Para. 80.
[1138] OECD, Thin Capitalization report, para. 79; HANLON, Thin Cap, p. 16. In this contribution, the author argues that Australia's thin capitalization rules which followed a pure fixed ratio approach are contrary to Art. 9(1).

domestic thin capitalization rules that use the combination approach can be considered to be at arm's length[1139].

16.3.2.2.3. Interaction with Art. 11(6)

471. The 1986 TC Report then discusses the interaction of domestic thin capitalization regimes with Art. 11(6) of the OECD Model[1140]. Art. 11(6) provides that if by a reason of a special relationship between the payer (debtor) of interest and the beneficial owner (or between both of them and some other person) the amount of the interest paid exceeds an arm's length amount, then Art. 11 will not be applicable to the excess amount. Consequently, the excess amount will then be taxable as per the domestic law of the States which have entered into a tax treaty – with due regard being given to the other provisions of the tax treaty[1141]. Accordingly, as Art. 11(6) also mandates the use of the arm's length principle, the 1986 TC Report raises the question of whether or to what extent this Article coincides or conflicts with Art. 9 of the Model where interest is paid between related persons, especially in rules affecting thin capitalization[1142].

472. Art. 9 and Art. 11 (6), in principle, do not conflict but coincide with each other insofar as they make an arm's length adjustment of interest paid on loans between related parties. Nevertheless, it should be noted that Art. 11(6) is broader in its application vis-à-vis Art. 9 as it uses the term "*special relationship*" whereas Art. 9 uses the term "*associated enterprises*". The OECD Commentary provides that the term "*special relationship"* is similar or analogous to the cases contemplated by Art. 9[1143]. Further, the OECD Commentary provides that the concept of "*special relationship"* also covers

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[1139] DE BROE, Thesis, p. 509.

[1140] Art. 11(6) of the OECD Model provides that *"Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention*". 1977 OECD Model. Art. 11, Para. 6. The provision has not changed and is reproduced in the same format in the 2014 OECD Model. Art. 11, Para. 6.

[1141] 2014 OECD Comm. Art. 11, Para. 32.

[1142] OECD, Thin Capitalization report, Para. 40.

[1143] 2014 OECD Comm. Art. 11, Para. 33.

relationship by blood or marriage and any other interests (such as community of interest) as distinct from the legal relationships giving rise to the payment of the interest[1144]. This indicates that the concept of "*special relationship*" is broader than the term "*associated enterprises*" [1145] . Accordingly, transactions, which may not be covered by Art. 9, may be caught by Art. 11(6) vis-à-vis payments of interest.

473. Further, it should be noted that Art. 11(6) is limited in the sense that it only allows for adjustment of interest rates but does not allow for conversion of debt to equity. This is because it uses the phrase *"having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon"* which limits its application. The 1986 TC Report also confirms this view[1146]. Hence, in thin capitalization situations, if the parties to the transaction do not charge interest rates at arm's length rates, Art. 11(6) can be invoked to disallow the excesses interest. This excess interest will be taxable as per the domestic law of the States which have entered into tax treaty - with due regard being given to the other provisions of a tax treaty viz., Art. 9 and Art. 10[1147].

[1144] 2014 OECD Comm. Art. 11, Para. 34.

[1145] VOGEL, Commentary, pp. 758-759; DE BROE, Thesis, pp. 538-540. These author's agree that the concept of "*special relationship"* is broader.

[1146] The 1986 TC Report provides that the wording of Art. 11(6) would have to be modified to allow a conversion of debt to equity. The 1986 TC Report suggests that as an example "f*or such an adjustment to be possible under Article 11(6) it would be necessary to substitute other words for the phrase "having regard to the debt claim for which it is paid". (Article 11(6) excludes, from the operation of Article 11, interest which "having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon" in the arm's length situation. In some bilateral treaties the Contracting States have, in fact, in order to overcome this difficulty, excluded instead interest which "for whatever reason" exceeds the amount which would have been agreed upon in the arm's length situation)"*. OECD, Thin Capitalization report, Para. 61; This approach has been followed by the UK in its tax treaty policy. VOGEL, Commentary, p. 759.

[1147] DE BROE, Thesis, p. 540. The author notes that a potential conflict could, nevertheless, arise. The author states that "*A conflict may arise where a debt instrument can at the same time partially be characterized as equity under Article 9 and provides for an excessive interest. In that case all interest that relates to the part of the debt that is re-characterized as equity may be treated as a dividend, while the excessive part of the interest that relates to the entire debt can only be disallowed as an expense*". OECD, Thin Capitalization report, Para. 62.

16.3.2.2.4. Interaction with Art. 24(4)

474. The 1986 TC Report raises the question of the compatibility of different thin capitalization legislation's with Art. 24 which deals with non-discrimination. This Article contains four clauses which protect taxpayers against discrimination (discrimination based on nationality, discrimination against PEs, discrimination against deductions and discrimination based on ownership) [1148]. The 1986 TC Report discusses the interaction of thin capitalization regimes with Arts. 24(5) and 24(6) of the 1977 OECD Model (renumbered Art. 24(4) and 24(5) since 1992). The subsequent discussion will firstly focus on the interaction of domestic thin capitalization regimes with Art. 24(4) and then with Art. 24(5) of the 2014 OECD Model.

475. Art. 24(4) aims to end discrimination pertaining to deduction of expenses/debt from the taxable base of an enterprise based on the residence of the recipient. To explain, in certain countries a deduction of interest, royalties and other expenses is allowed only if the recipient of such income is a resident of that country whereas the deduction is restricted or prohibited when the recipient is a non-resident. This situation is also found in the field of capital taxation, where a deduction of debt is not allowed if it is contracted from a non-resident [1149]. Accordingly, this Article aims to end discrimination of the payer based on whether the recipient of the payment is a resident or a non-resident [1150]. The first sentence of Art. 24(4) is relevant to the discussion on thin capitalization which provides that "*Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State*" [1151].

476. This provision is relevant because thin capitalization rules can apply only when interest payments are made to non-resident creditors, who are typically associated with the payer, and not resident recipients [1152].

[1148] HOSSON, MICHIELSE, Thin Cap, p. 483.
[1149] 2014 OECD Comm. Art. 24, Para. 73.
[1150] VOGEL, Commentary, p. 1326; DE BROE, Thesis, pp. 544-545.
[1151] 2014 OECD Model. Art. 24, Para. 4.
[1152] HINNEKENS, HINNEKENS, Non Discrimination, p. 33.

Accordingly, in such situations a conflict can arise with Art. 24(4)[1153]. The 1986 TC Report identifies this conflict and raises the question of whether Art. 24(4) prevents the treatment of interest as a distribution of profit under thin capitalization rules if the treatment applies only in respect of payments to non-residents[1154].

477. In this regard, it should be noted that it clear that the application of Art. 24(4) is subject to the provisions of Art. 9(1) or Art. 11(6). Thus, if profit adjustments have been made to the borrower pursuant to domestic thin capitalization rules that are in conformity with Art. 9(1) or Art. 11(6), the provisions of Art. 24(4) do not apply even if the thin capitalization rules target only interest payments to non-residents creditors[1155]. The 1986 TC Report agrees with this view and provides that thin capitalization rules that respect the arm's length principle can be considered to be compatible with Art. 24(4)[1156]. This being established, the question arises as to whether a thin capitalization rule, which does not confirm to Art. 9(1) (such as a rule which provides only for a fixed debt to equity ratio) and which is only applicable to interest payments to non-residents (and not to residents), is compatible with Art. 24(4). In such situations, the 1986 TC Report provides that such rules contravene Art. 24(4) and the State enforcing its thin capitalization legislation will be precluded from applying such rules[1157].

16.3.2.2.5. Interaction with Art. 24(5)

478. Art. 24(5)[1158] aims to end discrimination of domestic enterprises by prohibiting a State from giving less favourable treatment to an enterprise, the capital of which is owned or controlled, by non-residents (wholly or partly, directly or indirectly)[1159]. Thin capitalization rules may apply to interest payments made to non-resident creditors who can at the same time own or

[1153] DE BROE, Thesis, p. 545.
[1154] OECD, Thin Capitalization report, Paras. 43-44.
[1155] HINNEKENS, HINNEKENS, Non Discrimination, p. 33.
[1156] OECD, Thin Capitalization report, Para. 44 and Para. 66a.
[1157] OECD, Thin Capitalization report, Para. 66a.
[1158] The provision provides that "*Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first mentioned State are or may be subjected*". 2014 OECD Model. Art. 24, Para. 5.
[1159] 2014 OECD Comm. Art. 24, Para. 76.

control capital of the payer. Accordingly, the 1986 TC Report raises a question as to whether Art. 24(5) prohibits the application of thin capitalization rules which disallow the deduction of interest paid to non-resident shareholders of companies controlled by such non-residents if under similar circumstances, the interest would be deductible for similar enterprises that are resident in the State enforcing its thin capitalization legislation[1160].

479. Prior to answering this question, it is important to analyse a part of the provisions of Art. 24(5). It should be noted that this Article provides that an enterprises of a State, the capital of which is owned or controlled by non-residents, should be extended the same tax treatment as is applicable to "*other similar enterprises of that State"*. Accordingly, the question arises as to what the expression "*other similar enterprises of that State"* mean i.e. what is the right object of comparison?

480. Neither the OECD Commentary (not explicitly) nor the 1986 TC Report provides any guidance on this issue[1161]. At the outset, two different interpretations are possible. The object of comparison could be an enterprise which is a resident of that State whose shares are owned or controlled by either i) residents of other States (non-residents) or ii) residents of the same State [1162]. This analysis is essential as thin capitalization rules can be applicable only to interest payments made on loans provided by non-resident creditors who can at the same time own or control capital of the payer. Accordingly, if the object of comparison is an enterprise that is owned and controlled by non-residents, then thin capitalization rules which apply only to non-residents creditors (who are also the shareholders) would not be contrary to Art. 24(5). This is because the affected domestic taxpayer, whose capital is owned or controlled by non-residents, will be compared to another domestic taxpayer whose capital is owned or controlled by non-residents. Thus, if the thin capitalization rules apply to cross-border but not domestic situations, such rules will be compatible with Art. 24(5). Conversely, if the object of comparison is an enterprise that is owned or controlled by resident creditors who are also shareholders, then thin capitalization rules that apply

[1160] OECD, Thin Capitalization report, Para. 46.
[1161] DE BROE, Thesis, p. 555.
[1162] DE BROE, Thesis, p. 554; VOGEL, Commentary, p. 1331; HOSSON, MICHIELSE, Thin Cap, p. 484; MICHIELSE, Thin Cap, p. 571.

only to non-resident creditors who are also shareholders would be contrary to Art. 24(5)[1163].

481. Commentators are of the opinion that the first interpretation i.e. the object of comparison is a domestic enterprise with non-resident shareholders is extremely narrow and deprives Art. 24(5) of any practical effect[1164]. A State could then argue that any rule that is more burdensome vis-à-vis taxation of a non-resident is always compatible with Art. 24(5). This is clearly against the aim of such Article. The second interpretation i.e. the object of comparison is a domestic enterprise with domestic shareholders seems to be the preferred view among commentators[1165]. Broadly, this is because the second view gives effect to the provisions of Art. 24(4). Also, the OECD in its draft 2007 report on non – discrimination (hereafter "2007 ND Report") has subsequently clarified this view[1166]. Accordingly, for the purposes of comparison, the comparator should be a resident enterprise with resident shareholders. Consequently, if a thin capitalization rule targets interest payments on loans from non-residents shareholders and not resident shareholders, such rules will be incompatible with Art. 24(5). This conclusion depends, however, on the way one in which one interprets the relationship between Art. 9(1), Art. 24(4) and Art. 24(5).

482. To reiterate, it was previously established that thin capitalization rules that do not respect the arm's length standard and are applicable only to non-resident creditors, are incompatible with Art. 24(4). Such rules, logically, will also be incompatible with Art. 24(5) if they are applicable only to loans provided by non-resident creditors who are also shareholders. An issue arises with respect to thin capitalization rules that respect the arm's length standard prescribed by Art. 9(1). It was established that such rules do not conflict with Art. 24(4). However, an issue arises vis-à-vis such rules in the context of Art. 24(5). The issue is whether a thin capitalization rule which respects the arm's length standard and is in conformity with Art. 24(4), is nonetheless, incompatible with Art. 24(5), if it applies only to loans provided by non-resident shareholders whereas such rules are not applicable in pure domestic

[1163] PILTZ, Thin Cap, p. 134.
[1164] DE BROE, Thesis, p. 556.
[1165] DE BROE, Thesis, p. 559; Vogel, Commentary, p. 1331 ; HOSSON, MICHIELSE, Thin Cap, p. 484; MICHIELSE, Thin Cap, p. 572; CARRERO, Thin Cap, p. 294; VELDT, Thin Cap, p. 296; AVERY JONES, Non-Discrimination, p. 339.
[1166] OECD, Non-Discrimination Report, Para. 88; HINNEKENS, HINNEKENS, Non-Discrimination, p. 35.

scenario i.e. loans provided by domestic shareholders. The issue arises because Art. 24(4), unlike Art. 24(5) is not subject to the provisions of Art. 9(1) as the wording of the Art. 24(5) does not make any reference to Art. 9(1). Framed differently, the issue at stake is whether it is correct to import the arm's length principle as provided in Art. 9(1) to the provisions of Art. 24(5).

483. In response, the 1986 TC Report provides that i) Art. 24(5) is relevant to thin capitalization but is worded in a general way and aims broadly at preventing *tax protectionism* i.e. the deterrence by tax measures of investment from outside the country ii) these provisions do not deal with measures introduced to prevent the transfer of profits under the guise of interest and iii) since this paragraph is worded in a general way, the provisions of Art. 24(4) which deal with non-discrimination issues regarding interest payments will take precedence over the provisions of Art. 24(5)[1167]. The 1986 TC Report, does not provide a clear answer to this issue but provides that Art. 24(4) prevails over (*lex specialis*) Art. 24(5). Some commentators share this view[1168] i.e. the *lex specialis* nature of Art. 24(4) but others do not[1169]. The OECD Commentary (prior to 2008) did not discuss the issue either. Nevertheless, in light of the draft 2007 ND Report[1170], the OECD Commentary was clarified and it provided that the provisions of Art. 24 "*must be read in the context of the other Articles of the Convention so that measures that are mandated or expressly authorised by the provisions of these other Articles cannot be considered to violate the provisions*" of Art. 24[1171].

16.3.2.3. The 1992 OECD Commentary

484. In light of the 1986 TC Report, many changes were made to the OECD Commentary to reflect the OECD's position. Firstly, a section was added to the Commentary on Art. 9. The Commentary provided that Art. 9 does not prevent the application of thin capitalization rules which adjust the profits of the borrower in accordance with the arm's length principle[1172]. Further, it was provided that Art. 9 applies not only to determine whether the

[1167] OECD, Thin Capitalization report, Para. 66b.
[1168] VOGEL, Commentary, p. 1329; DE BROE, Thesis, p. 562.
[1169] HOSSON, MICHIELSE, Thin Cap, p. 483.
[1170] OECD, Non-Discrimination Report, Para. 1 and Para. 6.
[1171] 2014 OECD Comm. Art. 24, Para. 4.
[1172] 1992 OECD Comm. Art. 9, Para. 2(a).

interest rates charged are at arm's length but this Article is also applicable to determine whether a loan can be considered as equity[1173]. It was also stated that thin capitalization rules should not increase the taxable profits of the borrower to more than the arm's length profit[1174]. The US entered an observation to this addition made to the Commentary on Art. 9. The observation provided that alternative methods could be used to address the issue of thin capitalization other than changing debt to equity and as an example provided that the State enforcing its thin capitalization regime can defer the deduction of the interest paid for later years[1175]. This observation was made in light of the treatment of disallowed interest under the earning stripping rules contained in section 163(j) of the US tax law (*see section 3.4.2.2*).

485. Secondly, amendments were made to the Commentary on Art. 11(6). It was clarified that the provisions of Art. 11(6) permit adjustments only of non-arm's length interest rates and do not provide for a reclassification of loan into equity[1176]. Lastly, changes were made to the provisions of Art. 24. The Commentary to Art. 24(4) provided that if the domestic thin capitalization rules respect the arm's length standard as provided by Art. 9(1) and re-characterize interest as dividends, then such rules will be compatible with tax treaties. If such rules are not in accordance with the arm's length standard and apply only to non-residents such rules can be considered to be incompatible with tax treaties[1177]. It should be noted that the report only analyzed the interaction of Art. 24(4) with thin capitalization regimes that re-characterized interest to dividends and not thin capitalization regimes that disallowed the interest deduction or a deferral of it. Further, the Commentary to Art. 24(5) provided that, in principle, this Article is relevant to thin capitalization but as it is general in scope, Art. 24(4) which is more specific, will take precedence over Art. 24(5)[1178]. It did not expressly clarify

[1173] 1992 OECD Comm. Art. 9, Para. 2(b).
[1174] 1992 OECD Comm. Art. 9, Para. 2(c).
[1175] The US observed that *"there may be reasonable ways to address cases of thin capitalisation other than changing the character of the financial instrument from debt to equity and the character of the payment from interest to a dividend. For instance, in appropriate cases, the character of the instrument (as debt) and the character of the payment (as interest) may be unchanged, but the taxing State may defer the deduction for interest paid that otherwise would be allowed in computing the borrower's net income"*. See 1992 OECD Comm. Art. 9, Para. 15.
[1176]. 1992 OECD Comm. Art. 11, Para. 35.
[1177] 1992 OECD Comm. Art. 24, Para. 56.
[1178] 1992 OECD Comm. Art. 24, Para. 58.

whether the Art. 9(1) could be imported into Art. 24(5). These unresolved issues were discussed in the subsequent work of the OECD.

16.3.2.4. The 2008 OECD Commentary

486. In 2008, changes were made to the OECD Commentary on Art. 24[1179]. These changes were a result of the OECD's draft 2007 ND Report[1180]. In that ND report, the OECD once again discussed the interaction of thin capitalization regimes with Art. 24(4) and Art. 24(5). In relation to Art. 24(4), the Working Group for the 2007 ND Report agreed that the 1992 OECD Commentary[1181] tested only the thin capitalisation rules that have the effect of re-characterizing interest as a dividend against Art. 24(4) and did not deal with thin capitalization rules that have the effect of disallowing or deferring the interest deduction (such as the earning stripping rules in the US). Accordingly, a change was made to the Commentary to Art. 24(4) to clarify that the article applies generally to all thin capitalization rules that disallow, defer or treat the interest as dividend[1182]. Thus, the current Commentary reflects this position[1183].

487. Significant changes were made to the position expressed in the 1992 OECD Commentary to Art. 24(5)[1184]. To reiterate, the 1992 OECD Commentary provided that, in principle, Art. 24(5) is applicable to thin capitalization situations. Nonetheless, as Art. 24(4) is more specific it takes precedence over Art. 24(5). The Commentary at least recognized that Art. 24(5) was relevant. However, the Working Group in the 2007 ND Report concluded that Art. 24(5) would not be relevant for most thin capitalization rules because Art. 24(5) deals with resolving discrimination issues for company-shareholder relationships (discrimination based on foreign ownership of the capital of the enterprise) and not debtor-creditor relationships (discrimination based on the residence of the lender). This was

[1179] BRUNS, Non-Discrimination, pp. 487-488.
[1180] OECD, Non-Discrimination Report, Para. 88.
[1181] 1992 OECD Comm. Art. 24, Para. 56.
[1182] OECD, Non-Discrimination Report, Para. 81.
[1183] The Commentary provides that "*Paragraph 4 does not prohibit the country of the borrower from applying its domestic rules on thin capitalization insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4*". 2014 OECD Comm. Art. 24, Para. 74.
[1184] 1992 OECD Comm. Art. 24, Para. 58.

explained by the fact that the thin capitalization rules of most countries would apply to a local subsidiary with a local parent that is making interest payments to foreign related companies. According to the 2007 ND Report, on this view thin capitalisation rules would be outside the scope of Art. 24(5) as they would not constitute discrimination based on foreign ownership of the capital of a domestic enterprise but on the fact that the domestic enterprise has foreign related creditors[1185]. The conclusion of the OECD is logical. Art. 24(5) applies only when discrimination of the domestic enterprise is based on foreign ownership of its capital: if a parent company and its subsidiary are resident in the same country and the domestic thin capitalization legislation disallows interest payments made to a foreign associated enterprise whereas the rules will not be applicable when the payments are made to a domestic associated enterprise, in which case Art. 24(5) would obviously not be applicable. This is because the payer is not owned or controlled by non-residents. The only issue that arises is in regard to the statement that Art. 24(5) is not applicable to most thin capitalization situations because these rules mainly apply to a "*local company with a local parent that makes interest payments to foreign related creditors"*. This statement is not true as thin capitalization rules can also apply to a local company with a foreign parent and interest payments are made to the foreign parent. Nevertheless, the 2007 ND Report clarifies that even if in cases where thin capitalization rules apply only to the enterprises of a Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by non-residents, such rules do not violate paragraph 5 to the extent that they are compatible with Art. 9 (1) or Art. 11 (6)[1186]. Thus, the 2008 and 2010 OECD Commentary reflects the positions taken in the OECD draft 2007 ND Report[1187].

16.3.2.5. The general view expressed in the commentary to Art. 1

488. Para 22.1 of the 2003/2014 OECD Commentary (*see section 8.2.1.7*) provides that the provisions of a tax treaty will be applied only after a domestic anti-avoidance rule re-determines the taxpayer or re-characterizes an item of income. It does not discuss a situation where a domestic anti-avoidance rule is used to deny deductions to a taxpayer i.e. to residents of

[1185] OECD, Non-Discrimination Report, Para. 82.
[1186] OECD, Non-Discrimination Report, Para. 83.
[1187] 2014 OECD Comm. Art. 24, Para. 74.

the State of source. Accordingly, the question arises as to whether such a rule is outside the scope of these OECD's comments. In the author's opinion such rules would be outside the scope of these OECD's comments (*see section 12.2*). However, if it is argued that such rules are included in the OECD's comments (especially for statutory GAARs) then these rules have to be applied having regard to the guiding principle (whether or not the guiding principle prohibits the application of such rules is examined below (*see section16.5.1.2)*. Similarly, the 2014 TTA report and 2015 Final TTA report also provide that the conclusions already reflected in the 2003/2014 OECD Commentary on Art. 1 with respect to domestic anti-avoidance rules remain applicable even with respect to treaties that do not incorporate the PPT rule. It is also stated that no conflict will arise if a domestic statutory GAAR is in conformity with the guiding principle. Essentially, the guiding principle (or PPT rule) is required to be seen as a treaty GAAR.

16.3.3. The UN Position

489. The position expressed in the 2011 UN Commentary on the interaction of thin capitalization regimes with tax treaties is based on the findings and conclusions of the OECD. The Commentary on Art. 1 quotes the OECD view several times[1188] and provides that thin capitalization rules that are compatible with the arm's length principle will be compatible with tax treaties. Nevertheless, the Commentary specifically provides that it will be difficult for a country to justify the compatibility of its thin capitalization rules with the arm's length principle if such rules are based on fixed debt/equity ratios[1189]. In such circumstances, the Commentary, by quoting France as an example, suggests that such countries should strive to insert specific anti-abuse rules in tax treaties to give effect to domestic thin capitalization rules[1190].

[1188] 2011 UN Comm. Art. 1, Paras. 64-68.

[1189] 2011 UN Comm. Art. 1, Para. 69.

[1190] The Commentary provides that "*For that reason, countries that have adopted thin capitalization rules based on a fixed ratio approach often consider that they need to include in their treaties provisions that expressly allow the application of these rules. For example, Article 13 of the Protocol to the treaty between France and Estonia provides as follows: The provisions of the Convention shall in no case restrict France from applying the provisions of Article 212 of its tax code (code general des impôts) relating to thin capitalization or any substantially similar provisions which may amend or replace the provisions of that Article*". 2011 UN Comm. Art. 1, Para. 70.

16.4. The view expressed in International case law

16.4.1. 1999: Specialty Manufacturing – Canada[1191]

490. This case dealt with the interaction of the Canadian thin capitalization rules with the Canada – USA tax treaty concluded in 1942 ("1942 tax treaty") and in 1980 ("1980 tax treaty"). The issue was whether the tax treaties could prevent Canada from applying its domestic thin capitalization rules. The erstwhile Canadian domestic thin capitalization rules provided that interest on loans granted by non-resident shareholders (shareholders owning more than 25% of the Canadian corporation) would not be allowed as a deduction (only the excess interest) if the loan exceeded a debt equity ratio of 3:1. At the treaty level, Art. 4(1) of the 1942 tax treaty[1192] and Art. 9(1) of the 1980 tax treaty[1193] contained the arm's length provisions (these Articles did not contain equivalent wording to Art. 9 of the OECD Model but nevertheless had the same effect). Further, Art. 25(7) of the 1980 tax treaty[1194] provided for the deduction non-discrimination clause (this Article was similar to Art. 24(4) of the OECD Model). Moreover, Art. 25(8) of the

[1191] CTC: Specialty Manufacturing v. The Queen, Case no. 95-781(IT)G, August 25th 1997; Followed by CFCA: Specialty Manufacturing v. The Queen, Docket: A-659-97, May 18th 1999.

[1192] Art. 4(1)(a) of the 1942 tax treaty provided that "*When a United States enterprise, by reason of its participation in the management or capital of a Canadian enterprise, makes or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with an independent enterprise, any profits which should normally have appeared in the balance sheet of the Canadian enterprise but which have been, in this matter, diverted to the United States enterprise, may be incorporated in the taxable profits of the Canadian enterprise, subject to applicable measures of appeal*".

[1193] Art. 9(1) of the 1980 tax treaty provided that "*Where a person in a Contracting State and a person in the other Contracting State are related and where the arrangements between them differ from those which would be made between unrelated persons, each State may adjust the amount of the income, loss or tax payable to reflect the income, deductions, credits or allowances which would, but for those arrangements, have been taken into account in computing such income, loss or tax*".

[1194] Art. 25(7) of the 1980 tax treaty provided that "*Except where the provisions of paragraph 1 of Article IX (Related Persons), paragraph 7 of Article X1 (Interest) or paragraph 7 of Article X11 (Royalties) apply, interest, royalties and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable capital of the first-mentioned resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State".*

1980 tax treaty[1195] explicitly stated that the provisions of Art. 25(7) do not restrict a State from applying the thin capitalization provisions.

491. The facts were as follows. A US Corporation (in association with another US Corporation) provided a significant amount in loans to its Canadian subsidiary ("taxpayer"). The debt/equity ratio was almost 10,000,000:100. As the loan amounts were in excess of the prescribed debt/equity ratio, the tax authorities denied the interest deduction on the loan amount that breached the specified ceiling. Being aggrieved, the taxpayer argued that for the tax year 1984-85 – Art. 4(1) of the 1942 tax treaty prevented Canada from applying its thin capitalization rules. This was because the controlled transaction i.e. payment of interest from the taxpayer to the US Corporation was at arm's length. As the payment of interest was at arm's length, the tax authorities could not make an adjustment pursuant to the domestic thin capitalization rules under which the taxable profits of the Canadian company exceeded the arm's length profit. Further, for the tax years 1985-86, the taxpayer made a similar argument and stated that Art. 9(1) of the 1980 tax treaty prevented Canada from applying its thin capitalization rules as the taxpayer was paying an arm's length interest. Furthermore, the taxpayer argued that Art. 9(1) was an independent defence in comparison to Art. 25(7) and Art. 25(8). In other words, it was submitted that "*Articles IX(1) and XXV(7) together indicate that domestic adjustments to the profits of one State's enterprise (e.g. as contemplated by subsection 18(4)) are subject to a dual restriction, the first being the arm's length criterion in Article IX(1) and the second the non-discrimination rules of Article XXV. The fact that the second restriction is eliminated by Article XXV(8)(a) says nothing about the continued restriction of Article IX(1)*".

492. The case went to the CTC. In relation to the 1942 tax treaty, the CTC rejected the application of Art. 4(1). Firstly the CTC held that Art. 4(1) targeted situations that are not at arm's length and it did not address the issue of excessive interest rate deductions. The Court concluded that "*Article IV is*

[1195] Art. 25(8) of the 1980 tax treaty provided that "*The provisions of paragraph 7 shall not affect the operation of any provision of the taxation laws of a Contracting State: (a) relating to the deductibility of interest and which is in force on the date of signature of this Convention (including any subsequent modification of such provisions that does not change the general nature thereof); or (b) adopted after such date by a Contracting State and which is designed to ensure that a person who is not a resident of that State does not enjoy, under the laws of that State, a tax treatment that is more favourable than that enjoyed by residents of that State*".

concerned with the diversion of profits to related United States companies; it makes no mention of the domestic company's tax treatment of the consequences of its non-arm's length financial relations. More particularly, Article IV(1)(a) does not address the manner in which the Canadian company chooses to treat the payment of interest for tax purposes". This position clearly contrasts with the OECD position that Art. 9 is relevant in thin capitalization situations and domestic thin capitalization rules which adjust profits over and above the arm's length profits could be incompatible with tax treaties based on the OECD Model). Secondly, the CTC looked into the intention of the parties while negotiating the tax treaty. The Court noted that Canada or the US never intended to address the issue of thin capitalization while concluding the tax treaty. Accordingly, the treaty could not prevent the thin capitalization rules. In relation to the 1980 tax treaty, the CTC also ruled that Art. 9(1) does not apply to thin capitalization situations. Further, the CTC ruled that it would make no sense to argue that Art. 9(1) prohibits the application of the Canadian thin capitalization rules when Art. 25(8) clearly preserves the application of such rules to tax treaties.

493. Subsequently, the taxpayer appealed before the CFCA. The CFCA ruled against the taxpayer and held that thin capitalization provisions fall outside the scope of Art. 4(1) of the 1942 tax treaty and Art. 9(1) of the 1980 tax treaty. Further, the CFCA ruled that even though the interest payments made by the taxpayer were at the arm's length, the capital structure was definitely not at arm's length. This is due to the fact that in an arm's length scenario, the taxpayer would not be able to obtain such a significant amount in loans. To arrive at this conclusion, the CFCA noted that the taxpayer had almost no equity capital and almost all of the taxpayer's financing came from the loans provided by the two related US corporations. In an arm's length scenario no arm's length lender would have loaned the taxpayer as much money as the two related U.S. corporations had loaned it. Hence, as the capital structure was not at arm's length, the tax authorities were justified in applying the domestic thin capitalization rules.

494. The conclusion reached by the CFCA seems to be confusing. It is confusing because the CFCA looked only at the capital structure and ruled it was not at arm's length. As the capital structure was not at arm's length the CFCA was of the view that the "*associated enterprises*" Article in the respective tax treaties could not be invoked. This approach seems to be questionable. On the other hand, the CFCA seems to have accepted that the

arm's length provisions in tax treaties can protect the taxpayer only if the controlled transactions resemble transactions that would be undertaken by independent parties. In addition to the interest rate, the CFCA questioned whether the capital structure of the enterprise was at arm's length. Though, the CFCA did not refer to the OECD position, the position taken in the case seems to be line with the OECD view that Art. 9(1) can be used to question whether the capital structure is at arm's length or not. However, the CFCA omitted to analyze whether the Canadian thin capitalization rules as such were at arm's length or not. Since, the rules provide a mere fixed ratio, such rules seem to be contrary to Art. 9(1). However, as their application was preserved in the treaty, the rules could nevertheless be applied[1196].

16.4.2. 2002: Unknown Taxpayer – France[1197]

495. This case dealt with the interaction of the French thin capitalization rules with the French – Belgium tax treaty concluded in 1964 ("tax treaty"). The French domestic thin capitalization rules provided that interest on loans granted by foreign associated enterprises, which owned the capital of a French subsidiary (managing shareholders or shareholders holding more than 50% of the borrower), will not be allowed as a deduction (the excess interest) if the loan exceeds 150% of the share capital (a debt/equity ratio of 1.5:1). At the same time, the rules were not applicable to loans granted by a French parent to a French subsidiary. The facts are as follows.

496. A Belgium Company ("Parent Co") held the entire share capital in its French subsidiary ("taxpayer"). As the Parent Co funded the taxpayer in addition to the prescribed debt/equity ratio, the tax authorities disallowed the excess interest as per the thin capitalization rules. The taxpayer, after losing the case before the Administrative Tribunal of Strasbourg, brought the case before the French Administrative Court of Appeals ("Court"). The taxpayer claimed that the French thin capitalization rules were contrary to the nationality non-discrimination clause as per Art. 25(1) of the tax treaty. The clause, which was based on Art. 24(1) of the OECD Model[1198] and read from

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[1196] SASSEVILLE, Abuse, p. 52.

[1197] French Administrative Court of Appeals (Nancy): Unknown taxpayer, Case no. 98-1741, October 10th 2002. The original text of the case is in French and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported by in the IBFD Tax Treaty Case Law database was referred too.

[1198] 2014 OECD Model. Art. 24, Para. 4. The provision provides that "*Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or*

the perspective of Belgium, provided that nationals of Belgium "*shall not be subject to taxation or any requirement connected therewith, which is other or more burdensome than the taxation and related requirements to which nationals"* of the France in the same circumstances are subjected.

497. The Court, after taking into consideration the provisions of Art. 25(1) ruled that the French thin capitalization rules applied to the French company and not the nationals of Belgium. The Court also observed that even if it was possible for the taxpayer to invoke the nationality non-discrimination provision, the taxpayer was not in the same position as a French company owned by a French corporate shareholder. It should be noted that at the time the decision was issued, the tax treaty did not contain the deduction non-discrimination or the ownership non-discrimination clauses. Such rules were, nevertheless, considered to be incompatible with the ownership non-discrimination clause in another judgement (see below).

16.4.3. 2003: Société Andritz – France[1199]

498. This case dealt with the interaction of the French thin capitalization rules with the French – Austrian tax treaty concluded in 1959 and updated via a protocol in 1970 ("the tax treaty"). Two main issues were at stake. The first issue was whether the ownership non-discrimination clause contained in the tax treaty prevented France from applying its thin capitalization rules. The second issue at stake was whether the French TP provisions could be used to reclassify debt to equity.

499. The French domestic thin capitalization rules provided that interest on loans granted by associated enterprises will not be allowed as a deduction (the excess interest) if the loan exceeds a debt equity ratio of 1.5:1. An exception was provided for parent companies of the payer that were subject to French corporate tax. Accordingly, if the parent company was a tax resident in France or if such a parent company operated through a PE in France and was subject to the French corporate tax, then the thin

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any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States".

[1199] FSC: Re Société Andritz Sprout Bauer, 6 ITLR 604, December 30th 2003, pp. 605-641; ROUMELIAN, Thin Cap, pp. 244-247.

capitalization rules did not apply. At the treaty level, Art. 6(5), Art. 17A(4) and Art. 26(3) of the tax treaty were similar to Art. 9(1), Art. 11(6) and Art. 24(5) of the OECD Model respectively.

500. The facts of the case are straight forward. An Austrian Company ("Parent Co") held a majority of the shares in its French subsidiary ("taxpayer"). As the Parent Co funded the taxpayer in addition to the prescribed debt/equity ratio, the tax authorities disallowed the excess interest (the exception to the thin capitalization rule did not apply as the Parent Co was not subject to French corporate tax). However, the taxpayer argued that the French domestic thin capitalization rules were not compatible with Art. 26(3) – the ownership non-discrimination clause of the tax treaty. This was because the French domestic thin capitalization rules were not applicable where the interest was paid to French parent companies but was applied to non-French parent companies i.e. non-residents who owned and controlled the capital of French companies. The taxpayer won the case at the level of the Administrative Tribunal of Orleans but lost the case in response to the tax authority's appeal, before the Administrative Court of Appeal of Nantes. The taxpayer then appealed to the FSC. The tax authorities put forward another argument before the FSC: it was argued that the French domestic TP rules read in conjunction with Art. 6(5) and Art. 17A(4) of the tax treaty can reclassify debt to equity. Reliance was placed on the 1992 OECD Commentary on Art. 9(1) which provides for this.

501. The FSC ruled as follows. Firstly, it was held that the OECD Commentary could not be referred to as the tax treaty in question was concluded much before the Commentary was changed i.e. the Commentary was subsequent to the adoption of the provisions. Stating this, the FSC held that the French TP provisions read with Art. 6(5) and Art. 17A(4) of the tax treaty could not reclassify debt to equity. The FSC provided that the expression "*conditions...grants to or imposes upon…between the two enterprises in their commercial or financial relations"*[1200] should be read narrowly to mean that only the established contractual terms between two parties can be taken into consideration. Further, it was provided that the TP provisions could be used to determine if the interest rate was charged at arm's length or not but could not be applied to reclassify debt as equity.

[1200] The unofficial translation used this phrase instead of the words "*made or imposed*" as provided in Art. 9(1).

Secondly, the FSC ruled that the domestic thin capitalization rules were not compatible with Art. 26(3), the non-discrimination provision. It was stated that for the purposes of that provision, the Austrian Parent Co with a French subsidiary should be compared to a French Parent Company with a French subsidiary. As the thin capitalization rules were applicable only to the former but not to the latter, discrimination did exist. Accordingly, Art. 26(3) prohibited France from applying its thin capitalization rules. The decision of the FSC on the issue of non-discrimination seems to be reasonable. As rightly pointed out by the FSC, the object of comparison for the purposes of Art. 24(5) situation should be a domestic enterprise with domestic shareholders. However, the interpretation given by the FSC vis-à-vis the phrase "*grants to or imposes upon"* is not in line with the OECD's view which mandates a broad interpretation of Art. 9 i.e. whether the capital structure is at arm's length or not.

16.4.4. 2006: Unknown Taxpayer – Spain[1201]

502. This case dealt with the interaction of the Spanish thin capitalization rules with the Spain – Belgium tax treaty concluded in 1995 ("tax treaty"). The Spanish domestic thin capitalization rules provided that interest on loans granted by foreign associated enterprises will not be allowed as a deduction (the excess interest) if the loan exceeded a debt equity ratio of 3:1. Such excess interest will then be regarded as constructive dividends[1202]. At the treaty level Art. 24(4) of the tax treaty was similar to Art. 24(5) of the OECD Model.

503. A Dutch Company ("Parent Co") held the entire share capital in its Spanish subsidiary ("taxpayer"). Parent Co also held shares in a Belgian Company ("Sister Co"). As Sister Co funded the taxpayer in addition to the prescribed debt/equity ratio, the tax authorities disallowed the excess interest under the thin capitalization rules and re-characterized the payments as dividends. The taxpayer brought the case before the Spanish Central Economic Administrative Court ("the Court"). The Court, after taking into consideration the provisions of Art. 24(4) ruled that the Spanish thin capitalization rules were compatible with the tax treaty. This view, in the

[1201] Spanish Central Economic Administrative Court: Unknown Taxpayer, Case no. 2335/2002, February 2nd, 2006. The original text of the case is in Spanish and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported by in the IBFD Tax Treaty Case Law database was referred too.

[1202] For a detailed description of the rules see CARRERO, Thin Cap, pp. 286-293.

author's opinion, is highly disputable. If these rules are applicable only to non-resident shareholders and not to resident shareholders of Spanish companies and are not backed by the arm's length approach either they should be incompatible with tax treaties[1203].

16.4.5. 2007: Unknown Taxpayer – Spain[1204]

504. This case dealt with the interaction of the Spanish thin capitalization rules with the Spain – Morocoo tax treaty concluded in 1978 ("tax treaty"). The Spanish domestic thin capitalization rules provided that interest on loans granted by foreign associated enterprises will not be allowed as a deduction (the excess interest) if the loan exceeded a debt/equity ratio of 3:1. Such excess interest would then be regarded as constructive dividends. At the treaty level Art. 9(1) and Art. 24(4) of the tax treaty was similar to Art. 9(1) and Art. 24(5) of the OECD Model[1205].

505. A Moroccan resident ("lender") held the share capital in its Spanish company ("taxpayer"). As the lender funded the taxpayer in addition to the prescribed debt equity ratio, the tax authorities disallowed the excess interest under the thin capitalization rules and re-characterized the payments as dividends. The taxpayer brought the case before the Spanish Central Economic Administrative Court ("Court"). The Court, after taking into consideration the provisions of Art. 9(1) and Art. 24(4) ruled that the Spanish thin capitalization rules were compatible with the tax treaty. This view, in the author's opinion, is highly disputable. It is quite obvious that such rules follow a fixed debt/equity ration and in no manner adhere to the arm's length principle. Also, if rules are applicable only to non-resident shareholders and not to resident shareholders of Spanish companies and are not backed by the arm's length approach either, they should be incompatible

[1203] The reporter provides that the Court considered the Spanish thin capitalization rules to be incompatible with the provisions of Art. 24(1) and not Art. 24(5). Thereafter the reporter provides that the Court should have decided the case on the basis of Art. 25(5) of the treaty. The author agrees with the reporter. However, a critical analysis of the judgment could not be undertaken as the author did not have access to the text of the decision in English.

[1204] Spanish Central Economic Administrative Court: Unknown Taxpayer, December 20th, 2007. The original text of the case is in Spanish and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported by in the IBFD Tax Treaty Case Law database was referred to.

[1205] For a detailed description of the rules see CARRERO, Thin Cap, pp. 286-293.

with tax treaties[1206]. This issues seems to have been resolved by the Supreme Court of Spain (*see section 16.4.7*).

16.4.6. 2010: Re Shareholder Discrimination – Germany[1207]

506. This case dealt with the interaction of the German thin capitalization rules with the German – Switzerland tax treaty concluded in 1971 and updated via a protocol in 1992 ("tax treaty"). The German domestic thin capitalization rules that were tested in this case are as follows. Up to the year 2000 (old rules), the German tax law provided that interest on loans granted by shareholders to German corporations (with unlimited tax liability) will be reclassified as dividends, if the loan exceeded a debt/equity ratio of 3:1. The rule applied if the shareholder was not entitled to a corporation tax credit under the imputation system[1208]. From the year 2000 onwards the law was modified (new rules). The new law provided that interest on loans granted by shareholders to German corporations (with unlimited tax liability) would be reclassified as dividends if the loan exceeded a debt/equity ratio of 1:1.5. This rule applied if the interest was paid to taxpayers who were i) owners of the corporation and not subject to German tax assessment or to any person affiliated to the owner who was not subject to tax on the interest by the way of assessment, or ii) were affiliated to the owner without being subject to tax on the interest[1209]. It should be noted that both rules (old and new), though not expressly mentioned, were mainly applicable to non-resident shareholders of German corporations. This being said, the rules also applied to domestic shareholders that were basically exempt entities.

[1206] The reporter provides that the Court considered the Spanish thin capitalization rules to be incompatible with the provisions of Art. 24(1) and not Art. 24(5). Thereafter the reporter provides that the Court should have decided the case on the basis of Art. 25(5) of the treaty. The author agrees with the reporter. However, a critical analysis of the judgment could not be undertaken as the author did not have access to the text of the decision in English.

[1207] GFFC: Re Shareholder Discrimination by Germany Thin Capitalization Rules, 13 ITLR 646, September 8th 2010, pp. 646-668.

[1208] Under this regime the owner of a German corporation would obtain a credit for the corporation tax paid by the corporation.

[1209] The law provided that the rule was applicable if the interest was paid to "*(i) the owner of the borrowing corporation without being taxed at the level of the owner by way of assessment or (ii) another person affiliated with the owner without being subject to German taxation at the level of the recipient or (iii) a third party with recourse to the owner or its affiliated person*".

507. Two main issues were at stake from a treaty perspective. The first issue was whether the ownership non-discrimination clause contained in the tax treaty, ie Art. 25(3) (corresponding to the provision of Art. 24(5) of the OECD Model) prevented Germany from applying its thin capitalization rules. The second issue discussed related to the interaction between Art. 9(1) and Art. 11(4) of the tax treaty (these provisions correspond to Art. 9(1) and Art. 11(6) of the OECD Model) with the ownership non-discrimination clause. This was an issue because the tax treaty did not contain a clause equivalent to Art. 24(4) of the OECD Model. The question was whether the arm's length provisions had to be read into the ownership non-discrimination provisions.

508. The facts are as follows. A Swiss incorporated but German managed company ("taxpayer"), which was subject to unlimited German tax liability, was owned by a Swiss shareholder. The shareholder provided loans to the taxpayer during the years 1991 to 2001. Accordingly, as the loans exceeded the debt/equity ratio, the tax authorities applied the thin capitalization rules (old and new) and reclassified the interest on the loans as dividends. The taxpayer appealed by arguing that the ownership non-discrimination clause prevented Germany from applying its thin capitalization rules because such rules were applicable mainly to non-resident shareholders and not to resident shareholders. The Fiscal Court of Köln held in favour of the taxpayer. The tax authorities appealed to the GFFC.

509. The GFFC ruled firstly, it ruled that the German thin capitalization rules were contrary to the ownership non-discrimination clause in the tax treaty. To reiterate, the rules did not expressly discriminate against non-resident shareholders but the law was worded in such a way that the rules mainly applied to non-resident shareholders. The GFFC found this –indirect discrimination – sufficient to violate the non-discrimination provisions. To reach this conclusion, the GFFC referred to the case law of the ECJ according to which it is sufficient that discrimination exists when the national rule primarily and effectively covers cross-border situations even if the wording does not directly reflect that. Accordingly, in the GFFC's opinion the German thin capitalization rules were more burdensome from a tax perspective for German corporations with Swiss shareholders as compared to German corporations with German shareholders. Hence, the

rules were discriminatory[1210]. Secondly, the GFFC ruled that the arm's length provisions (Art. 9 or Art. 11(4) of the tax treaty) should not be read into Art. 25(3). Accordingly, even if the German thin capitalization rules were consistent with Art. 9(1) or Art. 11(4) such rules, would nevertheless, be incompatible with Art. 25(3). In reaching this conclusion, the GFFC observed that a clause equivalent to Art. 24(4) of the OECD Model was missing in the tax treaty. If such clause had been present, then the German thin capitalization rules which were in accordance with the arm's length provisions would indeed have been compatible with Art. 24(4) – even if the rules applied only to non-resident shareholders. As such a clause was missing; the GFFC held that even thin capitalization rules that are in line

[1210] The Court ruled that "*With regard to the reclassification to the plaintiff's disadvantage of the interest payments as a covert distribution of profits, both the old and the new versions of s 8a.1.1.2 KStG operate a distinction according to whether the corporation with unlimited tax liability in Germany has a shareholder not entitled to corporation tax credit or a shareholder resident in Germany. If that is the case, the reclassification does not apply. This means that enterprises of a contracting state, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other contracting state, are always at a tax disadvantage in relation to similar enterprises with shareholders resident in Germany. It is irrelevant to the matter in hand that the distinguishing criteria of non-entitlement to corporation tax credit (in s 8a.1.1.2 KStG 1999 old version) and non-assessment (in s 8a.1.1.2 in conjunction with sentence 2 KStG 1999 new version) do not apply directly to the shareholders' place of residence. Rather, without prejudice to all other differences between the non-discrimination rule in EU law and the non-discrimination rule in the tax treaty, reference on this point should be made to the Community law viewpoint, which is parallel as far as the criterion for comparison is concerned (cf also court decision in Federal Fiscal Court Decisions 201, 463, Federal Tax Bulletin II 2004, 1043), as is apparent from the judgment of the Court of Justice of the European Communities, now the Court of Justice of the European Union, of 12 December 2002 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt (Case C-324/00) (2002) 5 ITLR 467, [2003] STC 607. Here as there, the determining factor is that shareholders resident in the other contracting state are affected both by non-entitlement to tax credit and the possibility of non-assessment, thereby causing discriminatory unequal treatment of corporations with German and foreign shareholders. Hence, the tax treatment of German corporations with shareholders resident in Switzerland within the meaning of art 25.3 DTT Switzerland is--directly and not merely indirectly--other or more burdensome than the tax treatment to which 'other similar enterprises'--in terms of both activity and legal form (cf eg Rust in Vogel/Lehner, op cit, art 24 par a 168)--in Germany are or may be subjected. The fact that in particular situations s 8a.1.1.2 KStG may also be applicable to the same extent to corporations with German shareholders is irrelevant; the aim of the above-mentioned provisions on the tax restriction of shareholder loans to corporations is, according to the sense and purpose of the rule, primarily and effectively to cover cross-border instances of thin capitalisation with foreign shareholders. The consequence of this unequal treatment and the subsequent breach of art 25.3 DTT Switzerland is non-application of the discriminating tax rules"*. GFFC: Para. 23, *Shareholder Discrimination case*.

with the arm's length provisions must not discriminate against a company whose owner is a resident of a treaty partner state. Further, the GFFC seems to state that the OECD Model and its Commentary is not binding on States vis-à-vis treaty interpretation. Also, the GFFC implicitly held that later versions of the OECD Commentary could not be considered as the tax treaty was concluded in 1971[1211]. The case clearly contrasts with the view expressed by the OECD. The 2007 ND Report raised the question as to whether the provisions of Art. 24 deal with direct (overt) as well as indirect (covert) discrimination[1212]. The Working Group reached to the conclusion that the Article prevents only direct discrimination[1213]. In 2008, the OECD Commentary was modified to reflect this conclusion[1214]. Leading

[1211] GFFC: Para. 27, *Shareholder Discrimination case*.

[1212] The report raises the question that it "*has been asked whether and to what extent the non-discrimination provisions of Article 24 can be interpreted to cover not only "overt" discrimination (i.e. a case where the relevant tax measure clearly distinguishes the two categories of taxpayers compared in the relevant provision, such as a tax measure that would treat nationals and non-nationals differently), but also "covert" discrimination (i.e. a case where the relevant tax measure does not directly distinguish between the two categories of taxpayers compared in the relevant provision but may have that indirect effect, such as a measure that, in practice, applies almost exclusively to non-nationals)? In other words, do the provisions of Article 24 cover "indirect" discrimination, e.g. cases where it may be considered impossible for a foreign taxpayer to meet the conditions for a specific tax treatment although the wording of the provision itself does not exclude foreign taxpayers? The issue would be relevant, for example, where a thin capitalisation rule does not expressly deny the deduction of interest paid to non-residents (so as to potentially contravene paragraph 4 of Article 24) but does so with respect to interest paid to taxpayers who are not subject to the most comprehensive tax liability, which is typically the case of non-residents as opposed to residents*". OECD, Non-Discrimination Report, Para. 1.

[1213] OECD, Non-Discrimination Report, Para. 3.

[1214] The Commentary provides that "*This Article deals with the elimination of tax discrimination in certain precise circumstances. All tax systems incorporate legitimate distinctions based, for example, on differences in liability to tax or ability to pay. The non-discrimination provisions of the Article seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions. For that reason, the Article should not be unduly extended to cover so-called "indirect" discrimination. For example, whilst paragraph 1, which deals with discrimination on the basis of nationality, would prevent a different treatment that is really a disguised form of discrimination based on nationality such as a different treatment of individuals based on whether or not they hold, or are entitled to, a passport issued by the State, it could not be argued that non-residents of a given State include primarily persons who are not nationals of that State to conclude that a different treatment based on residence is indirectly a discrimination based on nationality for purposes of that paragraph"* 2014 OECD Comm. Art. 24, Para. 1.

commentators support this position too[1215]. However, the GFFC in this case, ruled that the provisions of Art. 24(4) also prohibit indirect discrimination. Secondly, the GFFC seems to adopt a static interpretation of the tax treaty. The GFFC referred to the OECD Commentary on Art. 24(5) but concluded that as it was not taken into consideration when the tax treaty was concluded in 1971 the position expressed in the Commentary would not be applicable.

16.4.7. 2011: Hero Espana – Spain[1216]

510. This case dealt with the interaction of the Spanish thin capitalization rules with the Spain – Switzerland tax treaty concluded in 1966 ("tax treaty"). The Spanish domestic thin capitalization rules provided that interest on loans granted by foreign associated enterprises would not be allowed as a deduction (the excess interest) if the loan exceeded a debt/equity ratio of 3:1. Such excess interest would then be regarded as constructive dividends. At the treaty level Art. 9(1), Art. 24(1) and Art. 24(5) of the tax treaty were similar to Art. 9(1), Art. 24(1) and Art. 24(5) of the OECD Model.

511. A Swiss Company ("Parent Co") held the entire share capital in its Spanish subsidiary ("taxpayer"). As the Parent Co, in association with a Luxembourg bank, funded the taxpayer in addition to the prescribed debt/equity ratio, the tax authorities disallowed the excess interest. The taxpayer, after several appeals against this brought the case before the SPSC ("Court"). The Court, after taking into consideration, the provisions of Art. 9 and Art. 24 ruled that the Spanish thin capitalization rules were incompatible with the tax treaty. In relation to Art. 9(1), the Court observed that a thin capitalization regime has to be compatible with the arm's length principle. Such compatibility has to be proven by the tax authority. As the tax authorities could not prove the compatibility of such rules with Art. 9(1), the Spanish thin capitalization regime could be considered incompatible with the tax treaty. Secondly, the Court also ruled that the rules were incompatible with the non-discrimination provisions of the tax treaty as they were

[1215] VOGEL, Commentary, pp. 1282-1283.

[1216] SPSC: Hero Espana SA v Direccion General de Tributos, Case no. 5871/2006, March 17th 2011. The original text of the case is in Spanish and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported by in the IBFD Tax Treaty Case Law database was referred too. Also see FROSS, Thin Cap, p. 513.

applicable only to non-resident shareholders and not to resident shareholders of Spanish companies[1217].

16.5. Author's view on the interaction with treaty rules

16.5.1. Implications under the R-S tax treaty

16.5.1.1. Conflict with treaty provisions

16.5.1.1.1. Sham/simulation

512. At the outset, the author states that if the sham/simulation doctrine is applied to the facts of this case and it is determined that the loan is actually equity for private law purposes, with the result that the interest payment is denied as a deduction, then it cannot be argued that the provisions of the domestic law or treaty are breached. This is because the doctrine establishes the true fact pattern to which the provisions of the domestic law and treaty apply (*see chapter 12*).

16.5.1.1.2. Denial of interest deductions pursuant to the arm's length standard

513. The author provides that the development of the OECD Commentary on thin capitalization represents a clarification. Accordingly, subsequent versions of the OECD Commentary should be referred to. Consequently, the author does not agree with the opinions of the Courts expressed in the *Sociéte Andritz and Shareholder Discrimination* cases.

514. If State S applies its TP rules (which are applicable among associated enterprises) and re-characterizes the funding instrument from loan to equity for tax law purpose – to the extent the adjustment is authorized by the

[1217] The reporter provides that the Court considered the Spanish thin capitalization rules to be incompatible with the provisions of Art. 24(1) and not Art. 24(5). Thereafter the reporter provides that the Court should have decided the case on the basis of Art. 25(5) of the treaty. The author agrees with the reporter. However, a critical analysis of the judgment could not be undertaken as the author did not have access to the text of the decision in English.

domestic law – the analysis is as follows. The OECD and the UN are of the view that Art. 9(1) allows the tax authority of a State to question whether the capital structure of an enterprise is at arm's length or not. However, this position has been criticized in academic literature. It is stated that Art. 9(1) can only be used to determine whether the interest rate charged on loans between associated enterprises is an arm's length rate and cannot be used to reclassify debt to equity[1218]. The view is based mainly on a literal reading of Art. 9(1). Art. 9(1) refers to "*conditions...made or imposed…between the two enterprises in their commercial or financial relations"*. Accordingly, it is argued that an examination of the contracted terms which have already been made or imposed needs to be undertaken for the purposes of Art. 9(1) rather than the entire contract itself. To elaborate, it is argued that a literal reading of the term "*conditions...made or imposed"* only refers to the terms of the contract (such as interest rate, terms of payments etc) and not to the existing financial relations between the associated enterprises. Thus, Art. 9(1) would not permit a re-characterization of debt to equity. At the same time, other commentators suggest that the view proposed against such re-characterization is extremely narrow as Art. 9 is broad and indeed covers situations where debt can be re-characterized as equity. This is because the word "*imposed*" in relation to the word "*conditions*" indicates that not only the contractual terms but also other terms i.e. overall financial relations of the associated enterprises are to be taken into consideration[1219].

515. The CFCA (though not dealing directly with the issue at stake) seems to have adopted this approach in the *Specialty Manufacturing* case wherein it looked at the capital structure of the Canadian taxpayer and ruled that it was not at arm's length (though it did not comment directly on the comparable provisions to Art. 9). However, the FSC in the *2003 Andritz* case arrived at the opposite conclusion and ruled that Art. 9(1) could not be used to reclassify debt into equity. The author does not agree with the interpretation given by the FSC vis-à-vis Art. 9(1). This is because the Article should be interpreted broadly and the word "*imposed*" in relation to the word "*conditions*" in the sentence *conditions...made or imposed…between the two enterprises in their commercial or financial relations"* indicates that not only the contractual terms but also other terms i.e. overall financial relations

[1218] HOSSON, MICHIELSE, Thin Cap, p. 480; MICHIELSE, Thin Cap, p. 568; WITTENDORFF, TP, pp. 115-119; BECKER, Thin Cap, p. 52.

[1219] DE BROE, Thesis, p. 505; VOGEL, Commentary, p. 625; HELMINEN, Thesis, pp. 334-341; LUTHI, Thin Cap, p. 451; AVERY JONES, Non-Discrimination, p. 343.

of the associated enterprises are to be taken into consideration. In support of this view reference is also made to the 1995 TPG that are used as a global guide for TP issues[1220]. These guidelines provide that tax authorities can re-characterize debt as equity if the economic circumstances of the transaction reflects that the contribution is indeed equity[1221]. Consequently, it is stated that Art. 9(1) allows debt to be reclassified as equity pursuant to the arm's length approach. Therefore, if States S denies an interest deduction by re-characterizing the funding instrument from loan to equity for tax law purpose (up to the arm's length standard), it cannot be argued that such a rule is contrary to Art 9.

516. Furthermore, it is clear from the text of Art. 9(1) that it applies to determine if interest payments among associated enterprises are at arm's length or not. In line with the OECD's view, the author believes that Art. 9 is restrictive and prohibits the adjustment of profits to an amount exceeding the arm's length amount. This is in line with the arm's length principle. The author agrees with this approach as tax treaties are generally restrictive in nature i.e. they have a negative effect in the sense that they leave the fiscal jurisdiction of the State unchanged or restrict it but they cannot extend it[1222]. Accordingly, thin capitalization rules, following the arm's length standard, can be considered to be compatible with Art. 9(1) only if the adjustment of profits pursuant to such rules does not exceed the arm's length amount. Therefore, if State S invokes its TP rules and makes profit adjustments in respect of the borrower up to the arm's length standard, it cannot be argued that such a rule contravenes the provisions of Art. 9. Logically, if the domestic thin capitalization rule uses the arm's length standard and adjusts

[1220] OECD, 1995 TP Guidelines.

[1221] The OECD TP Guidelines provide that "*In cases where the economic substance of a transaction differs from its form... the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital*". OECD, 1995 TP Guidelines, Para. 1.65.

[1222] VAN RAAD, Fundamental rules, pp. 587-590; HOSSON, MICHIELSE, Thin Cap, p. 482; MICHIELSE, Thin Cap, p. 569; FROSS, Thin Cap, p. 511.

the profits over and above the arm's length profits then such a rule would be incompatible with tax treaties based on the OECD Model[1223].

517. Further, with respect to the interaction of such rules with Art. 11(6), in the author's opinion, Art. 9 and Art. 11 (6), in principle, do not conflict but coincide with each other in relation to making an arm's length adjustment of interest paid on loans between related parties. Further, Art. 11(6) only allows for adjustment of interest rates but does not allow for conversion of debt to equity. This is because it uses the phrase *"having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon"* which limits its application. Accordingly, in thin capitalization situations, if the parties to the transaction do not charge interest rates at arm's length, Art. 9 or Art. 11(6) can be invoked to disallow the excess interest.

518. The question then arises as to whether the non-discrimination provisions prevent the application of thin capitalization rules that are based on the arm's length standard and which apply only to loans received from non-resident creditors and not loans received from residents creditors [1224]. In the author's view, Art. 24(4) is subject to the provisions of Art. 9(1) and Art. 11(6). Therefore, if profit adjustments have been made by the source State to the borrower pursuant to domestic thin capitalization rules which are in conformity with Art. 9(1) and Art. 11(6), the provisions of Art. 24(4) do not apply even if the thin capitalization rules apply only to non-resident creditors. Many commentators support this conclusion[1225].

519. With respect to the application of the ownership non-discrimination clause, in the author's opinion, the object of comparison should be a domestic enterprise with domestic shareholders. The author agrees with the conclusion that Art. 24(5) is deprived of any practical effect if the object of comparison is a domestic enterprise with non-resident shareholders. Accordingly, for the purpose of comparison, the comparator should be a

[1223] OECD, Thin Capitalization report, Paras. 49-50; PILTZ, Thin Cap, p. 129.
[1224] OECD, Thin Capitalization report, Paras. 43-44.
[1225] Agreeing: DE BROE, Thesis, p. 551; VOGEL, Commentary, p. 1326; PILTZ, p. 133 ; THOEMMES, Thin Cap, p. 132; CARRERO, Thin Cap, p. 294; VELDT, Thin Cap, p. 296, BAMMENS, Thesis, pp. 349-351; Dissenting**:** MICHIELSE, Thin Cap, p. 571. This author argues that thin capitalization regulations are not covered by Art. 9. Hence, Art. 24(4) applies to prevent the application of thin capitalization rules.

resident enterprise with resident shareholders[1226]. Further, in line with the OECD view the author believes that it is correct to import the arm's length principle even to the provisions of Art. 24(5)[1227]. This is because Art. 24 must be read in the context of the other Articles of the Convention in such a manner that measures that are authorized by the provisions of other Articles cannot be considered to violate the provisions of Art. 24. Accordingly, Art. 24(5) cannot prohibit an arm's length thin capitalization regime even if it applies only to loans provided by non-resident creditors who are also shareholders i.e. creditors who at the same time own or control capital of the payer. The author does not agree with the findings of the GFFC in the *Shareholder Discrimination* case. The GFFC held that the arm's length provisions should not be read into the ownership non-discrimination clause in the absence of the deduction non-discrimination clause. In the author's view, even if a tax treaty contains the ownership non-discrimination clause and not the deduction non-discrimination clause, the arm's length provisions have to be imported into Art. 24(5). This is in line with the reasoning that measures that are mandated or expressly authorized by the provisions of these other Articles cannot be considered to violate the provisions of Art. 24.

16.5.1.1.3. Denial of interest deductions pursuant to judicial doctrines or statutory GAARs

520. If State S applies its judicial doctrine or statutory GAAR and re-characterizes the funding instrument from loan to equity for tax law purposes (and denies the interest deductions) or simply denies the interest deduction the analysis is as follows. The question arises as to whether such rules need to respect the arm's length standard i.e. are they required to be tested against the provisions of Art. 9 as the re-characterization of the funding instrument from loan to equity or denial of interest deduction takes place between "*associated enterprises*".

521. The OECD refrains from commenting on the question in the 1986 TC Report. In the author's opinion, the current position of the OECD is not clear as to whether such rules need to be tested with the provisions of Art. 9 or not. This opinion is based on a comparison of the OECD Commentary on

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[1226] BAMMENS, Thesis, pp. 403-405.

[1227] AULT, SASSEVILLE, Non-Discrimination, p. 117; AVERY JONES, Non-Discrimination, p. 344; Further refer to the subsequent discussion in relation to the 2008/2010 OECD Commentary.

Art. 1 with the OECD Commentary on Art. 9. As indicated earlier, the current position of the OECD, as expressed in Art. 1, is that such rules do not conflict with tax treaties (*see section 8.2.1.7*). In contrast, in light of the 1986 TC Report, the 1992 OECD Commentary provided that Art. 9 does not prevent the application of domestic thin capitalization rules that make profit adjustments up to the arm's length standard. The 1992 OECD Commentary (and the subsequent versions) explicitly provides that national rules on thin capitalization have to respect the arm's length standard if applicable between "*associated enterprises*". Accordingly, it can be ascertained that while on the one hand the OECD is of the view that judicial doctrines/statutory GAARs do not conflict with tax treaties whereas on the other hand in relation to thin capitalization rules the OECD provides that such rules need to comply with the arm's length standard. This would seem to be a contradiction. In the author's opinion, judicial doctrines/statutory GAARs that re-characterizes the funding instrument from loan to equity for tax law purpose or denies the interest deduction among associated enterprises have to respect the arm's length standard in order for them to be compatible with tax treaties[1228].

522. The question then arises as to whether the non-discrimination provisions prevent the application of judicial doctrines and statutory GAARs that deny interest deductions. The comparative analysis in *chapter 3*, indicates that judicial doctrines or statutory GAARs can be used to counteract payments made to residents as well as non-residents. As these rules apply to resident creditors as well as non-resident creditors (that may own or not own any capital of the borrower), in the author's opinion, discrimination issues do not arise under Art. 24(4) or Art 24(5). However, if such rules are applicable only to non-residents and do not comply with Art. 9 or Art. 11(6), discrimination issues can indeed arise pursuant to Art. 24(4) or Art 24(5).

16.5.1.1.4. Denial of interest deductions pursuant to SAARs that follow a fixed ratio approach

523. For thin capitalization rules that use fixed ratios a difference is required to be made between rules that use i) only fixed ratios and ii) rules that follow a combination approach i.e. use fixed ratios as a safe haven

[1228] DE BROE, Thesis, p. 509; PILTZ, Thin Cap, p. 129.

measure and give the taxpayer the option of demonstrating that a loan is at arm's length, if the safe haven measure is breached.

524. For rules that follow a combination approach, the author's view in line with the OECD's view is that such rules are compatible with the provisions of Art. 9. This is because such rules give the taxpayer the option of demonstrating that the related party transaction is comparable to an unrelated party transaction and is thus at arm's length. Furthermore, as these rules comply with the arm's length standard, in the author's opinion the provisions of the non-discrimination articles cannot be invoked, even if, such rules apply only to non-resident enterprises.

525. For rules that use only fixed ratios (and that apply only to associated enterprises), the author's view, again in line with the OECD and UNs view is that such rules are not compatible with the provisions of Art. 9. This is because such rules are arbitrary and cannot be regarded as complying with the arm's length standard as they could lead to the adjustment of profits to an amount exceeding the arm's length amount. This being established, the question also arises as to whether such a rule, which does not conform to Art. 9(1) and which is only applicable to interest payments to non-residents (and not to residents), is compatible with Art. 24(4). In such situations, in line with the OECD's view, the author believes that such rules contravene Art. 24(4) and the State enforcing its thin capitalization legislation will be precluded from applying such rules. Many commentators also support this conclusion[1229]. If Art. 24(4) is not included in a tax treaty[1230] and only Art. 24(5) is included in a tax treaty, then a thin capitalization regime which is not consistent with Art. 9(1) and is applicable to non-residents who are creditors and shareholders of the payer, will also be contrary to Art. 24(5). For instance see the decisions of the Courts in the *Sociéte Andritz, Shareholder Discrimination* and *Hero Espana* cases.

[1229] DE BROE, Thesis, p. 551; VOGEL, Commentary, p. 1326; PILTZ, Thin Cap, p. 133 ; THOEMMES, Thin Cap, p. 132; CARRERO, Thin Cap, p. 294; VELDT, Thin Cap, p. 296; AULT, SASSEVILLE, Non-Discrimination, p. 117.

[1230] Many countries do not include the provisions of Art. 24(4) in their tax treaties. PILTZ, Thin Cap, p. 134; MICHIELSE, Thin Cap, p. 571.

16.5.1.2. The impact of the guiding principle (or PPT rule)

526. The position taken in this thesis is that the guiding principle applies for tax treaties concluded by OECD or UN member States after January and June 2003 respectively. The guiding principle can be considered to be a treaty GAAR. *The following analysis can also be extended to treaties that may incorporate the PPT rule in light of the BEPS Action Plan.* Assume that State S has a domestic thin capitalization rule such as a fixed ratio rule that applies only to non-resident creditors and which conflicts with treaty provisions i.e. Art. 9(1) or Art. 24(4). The question analysed in this section is whether the benefit derived by the taxpayer under Art. 9(1) or Art. 24(4) – the non-application of the thin capitalization rule pursuant to such treaty provisions – can be denied under the guiding principle?

527. At the outset, it should be noted that the fixed ratio rule is applied to deny a deduction to Corp S, a resident of State S as opposed to Corp R, a resident of State R. The taxpayer impacted by the application of the fixed ratio rule is Corp S. Accordingly; the question arises as to whether the fixed ratio rule has to be applied with regard to the guiding principle? In the author's opinion, the guiding principle acts as a restriction to the application of domestic anti-avoidance rules that deny treaty benefits to a taxpayer i.e. benefits that flow from a tax treaty. In other words, the guiding principle (or PPT rule), which is a treaty GAAR, can be used only for denying treaty benefits. For example, if the taxpayer, resident of State R, engages in a treaty shopping or a rule shopping transaction with the aim of reducing source State taxes pursuant to Art. 6-22. Another example is of a situation wherein the taxpayer, resident of State R, tries to take advantage of the relief provisions to reduce its home State taxes pursuant to Art. 23 for foreign source income derived from other States. In those situations, the taxpayer tries to abuse the provisions of the tax treaty.

528. In the current situation, Corp S – that is a resident of State S – reduces the State S taxable basis through interest deductions. Thus, a State S resident seeks to avoid State S domestic taxes (or abuse State S domestic tax law provisions) without benefiting from the tax treaty. Put differently, the taxpayer does not abuse the provisions of tax treaties but rather abuses the provisions of domestic law. In order to counteract such domestic law abuse,

State S applies its domestic fixed ratio rule. As the object of abuse is the domestic law as opposed to provisions of the treaties, such rules fall outside the scope of the guiding principle (or PPT rule). This would imply that the treaty, in particular, Art. 9(1) or Art. 24(4) would restrict the application of such a fixed ratio rule and the case should not be analysed under the guiding principle or PPT rule.

16.5.1.3. The impact of the US type Saving clause in the R-S tax treaty

529. Previously, it was concluded that thin capitalization rules based on fixed debt/equity ratios conflict with Art. 9(1). Furthermore, such rules conflict with Art. 24(4) and Art. 24(5), if they apply only to non-residents. The question analysed in this section is can such a conflict be neutralized if the R-S tax treaty has a US type saving clause? The clause provides that "*This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23, 24 and 25 and 28"*. To reiterate, when State S applies a fixed ratio rule, an interest deduction (partially) is denied to Corp S, a State S resident. The rule clearly conflicts with Art. 9(1). However, as Art. 9(1) is not listed as an exception in the Saving clause it could be argued that the R-S tax treaty shall not affect the taxation, by State S, of its own resident. Accordingly, the rule could apply notwithstanding the conflict with Art. 9(1). The author agrees with this position[1231]. Nevertheless, if the treaty contains Art. 24(4) or Art. 24(5) and that rules applies to non-residents then an argument cannot be made that the Saving clause protects the application of the fixed ratio rule. This is because that clause lists Art. 24 as an exception[1232].

16.5.2. The issue of treaty override

530. In the previous sections it was concluded that the domestic anti-avoidance rule, typically a rule that follows the rigid fixed ratio approach (applicable to associated enterprises) to deny interest deductions, conflicts with the provisions of a tax treaty. Logically, even if the rule is introduced after the conclusion of a tax treaty, that rule should not be applicable as the

[1231] SASSEVILLE, Abuse, pp. 53-54.
[1232] DE BROE, LUTS, BEPS, p. 139.

provisions of the tax treaty take precedence. Accordingly, if the legislator (as a standalone SAAR or as a part of a statutory GAAR) introduces a posterior domestic anti-avoidance rule, that notwithstanding the conflict, denies an interest deduction to the taxpayer on a arbitrary basis then an argument can be made that a treaty override occurs. The position adopted in this thesis is that a posterior domestic anti-avoidance rule can be considered to be a treaty override if that rule leads to a shift in the allocation of taxing rights. Accordingly, it needs to be ascertained if this rule recaptures a taxing right by the State that introduces such a rule.

531. It is obvious that Art 9. is the only provision that is placed within the distributive rules (Art. 6-22) that does not govern the allocation of taxing rights over a specific item of income. However, it was previously established that Art. 9 is restrictive in nature and thus prohibits the adjustment of profits to an amount exceeding the arm's length amount. Accordingly, if the posterior rule, based on the fixed ratio approach, makes adjustment of profits to an amount exceeding the arm's length amount, then a strong argument can be made that such a rule is a treaty override. Put differently, Art. 9(1) allows allocation of profits between associated enterprises on the basis that their financial relations resemble the financial relations between independent enterprises. This provision applies to thin capitalization situations. Accordingly, interest limitation rules applicable among associated enterprises have to conform to the arm's length standard. An interest limitation rule based on the fixed ratio approach is an "*arbitrary*" rule whereas Art. 9 is based on the arm's length standard. Therefore, such a rule conflicts with the provisions of Art. 9. One commentator by referring to the US earning stripping rules (*see section 3.4.2.2*) reaches a similar conclusion[1233]. Further, if that rule applies only to non-resident creditors then the provisions of Art. 24(4) are also breached. Art. 24(4) allows discrimination only if the rule respects the arm's length standard. As a fixed ratio rule does not respect the arm's length standard then a conflict also arises with the deduction non-discrimination clause[1234]. Also, if that rule applies only to non-residents creditors who are also shareholders in the paying entity then the provisions of Art. 24(5) are also breached. This is because the rule denies a deduction made to a non-resident shareholder and not to a resident shareholder [1235].

[1233] MISEY, Thin Cap, p. 23.
[1234] MISEY, Thin Cap, p. 24.
[1235] MISEY, Thin Cap, p. 25.

16.6. The impact of the BEPS project on limiting interest deductions

16.6.1. Action 4 of the BEPS Plan

532. Action 4 of the BEPS Plan deals with limiting interest deductions. The final report[1236] provides recommendations in designing domestic law rules to prevent base erosion through the use of (excess) interest expenses. Essentially, a fixed ratio rule is recommended to restrict interest deductions. In particular, the rule restricts the interest payment of an entity of a group to a percentage of that entity EBITDA as opposed to debt equity rules. The recommendation leaves open the possibility for States to choose a percentage between 10 – 30% based on certain parameters. Furthermore, the report recommends countries to incorporate a group ratio rule alongside the fixed ratio rule. This approach would enable entities with net interest expense above a country's fixed ratio rule to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group[1237]. This clearly demonstrates that the OECD is moving away from a facts and circumstances approach to a fixed ratio approach to deny interest deductions. It is proposed that the rules will be applicable to domestic and cross-border situations/groups. Accordingly, non-discrimination issues from a tax treaty perspective may not arise[1238]. However, depending on the structure of the rule, it could well be possible that these rules would apply to restrict the deductibility of cross-border interest payments among associated enterprises (that are a part of a multinational group) as opposed to deductibility of domestic interest payments. Therefore, it needs to be analyzed as to whether a possible conflict arises with Art. 24(4) or Art. 24(5). With respect to Art. 9(1), as established previously, such a conflict could be negated pursuant to a US type Saving clause (*see section 16.5.1.3*).

[1236] 2015 OECD, Final Report on Interest Deductions.
[1237] 2015 OECD, Final Report on Interest Deductions, pp. 11-13.
[1238] 2015 OECD, Final Report on Interest Deductions, Para. 25.

16.6.2. Action 2 of the BEPS Plan

533. Action 2 of the BEPS Plan deals with neutralizing the effects of hybrid mismatch arrangements. The final report [1239] recommends that States introduce domestic law rules and proposes changes to the OECD Model Convention to prevent hybrid mismatches. Essentially, in Part I, the report recommends rules to address mismatches caused by hybrid financial instruments (such as a hybrid loan – *see section 2.2.2*) or hybrid entities. Broadly speaking, linking rules are recommended. Such rules "*align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction*" [1240]. Primary and secondary or defensive rules are provided to ensure double taxation is avoided. The primary rule is that the State of the payer (State S) denies a deduction to a taxpayer for a payment to the extent that it is not included in the taxable income of a taxpayer in the State of the recipient (State R). If State S does not apply the primary rule then State R, by applying the defensive rule, treats the deductible payment as income of the recipient[1241].

534. The report, in Part II, also discusses the interaction of such proposed domestic law rules with the non-discrimination provisions. Essentially, the report provides that "*Some of the domestic law recommendations to neutralise the effects of hybrid mismatch arrangements that are included in Part I may impact payments to non-residents more than they will impact payments to residents. This, however, is not relevant for the purposes of Article 24 as long as the distinction is based on the treatment of the payments in the hands of the payers and recipients. The fact that a mismatch in the tax treatment of an entity or payment is less likely in a purely domestic context (i.e. one would expect a country to be consistent in the way it characterises domestic payments and entities) cannot be interpreted as meaning that rules that are strictly based on the existence of such a mismatch are treating payments to non-residents, or to non-resident owned enterprises, differently from the way payments to residents, or resident-owned enterprises, are treated under domestic law*" [1242].

[1239] 2015 OECD, Final Report on Hybrid Mismatches.
[1240] 2015 OECD, Final Report on Hybrid Mismatches, pp. 11-12.
[1241] 2015 OECD, Final Report on Hybrid Mismatches, pp. 11-12.
[1242] 2015 OECD, Final Report on Hybrid Mismatches, Para. 448.

535. In the author's opinion, such a general conclusion should not be given considerable weightage. It could well be possible that such rules are drafted in such a way so as to apply only to non-residents or non-residents that may also own or control the paying entity. The compatibility of such rules needs to be tested with Art. 24(4) or Art. 24(5) to determine whether or not a conflict arises. To this end, the report clearly documents its general conclusion with a caveat by providing that "*subject to an analysis of the precise wording of the domestic rules that would be drafted to implement the recommendations, the recommendations set out in Part I of this report would not appear to raise concerns about a possible conflict with the provisions of Article 24*"[1243].

16.7. Rules restricting other payments

536. This chapter focused primarily on the treaty compatibility of rules that deny interest deductions. It could well be possible that States introduce payment limitation rules that i) apply to associated enterprises and make profit adjustments at the level of the paying entity in addition to that mandated by the arm's length standard and ii) apply to non residents only or to non-residents that may also own or control the paying entity. Such rules will also have to be tested against Art. 9(1), Art. 11(6), Art. 12(4)[1244], Art. 24(4) or Art. 24(5) to determine whether or not a conflict arises. With respect to Art. 9(1), Art. 11(6) and Art. 12(4), as established previously, such conflicts could be negated pursuant to a US type Saving clause (*see section 16.5.1.3*).

[1243] 2015 OECD, Final Report on Hybrid Mismatches, Para. 450.

[1244] Art. 12(4) of the OECD Model, which deals with excess royalty payments, has a similar scope as Art. 11(6). See 2014 OECD Model. Art. 12, Para. 4.

17. Residence State: domestic anti-avoidance rules that deem non-residents to be residents

17.1. The domestic anti-avoidance rule

537. In this section, the author discusses the treaty compatibility of a domestic anti-avoidance rule that is applied by the residence State pursuant to which a taxpayer, a resident of another State, is considered to be a resident of the former State. By applying this rule, the former State imposes an unlimited tax liability on the taxpayer that is a resident of another State.

17.2. The case study fact pattern

17.2.1. Deemed unlimited extended tax liability for individuals

538. Consider the following situation. Mr. X, a tax resident of State R (high tax country) owns shares in companies (which do not own immoveable property) resident in that jurisdiction. In such a case, if Mr. X sells the shares and makes a gain, tax must be paid in State R. In order to avoid these high taxes, the taxpayer migrates to a low-tax country and becomes a tax resident therein (State T). Subsequently, the shares are sold. If State R and T have a tax treaty based on the OECD Model then the gains will not be taxable in R. This is because Art. 13(5) of the OECD Model provides that gains from alienation of shares are taxable only in the residence state of the alienator, which in our case, is State T. Assume that State R considers this migration abusive and applies a domestic anti-avoidance rule (judicial doctrine, statutory GAAR or SAAR and not general rules for determining an individuals residence) and deems Mr. X to be a resident of State R even after his migration. Accordingly, by applying this rule Mr. X is subject to tax on his worldwide income (including gains from alienation of shares) in State R. The question arises as to whether the application of such a domestic anti-avoidance rule conflicts with treaty provisions?

17.2.2. Deemed unlimited tax liability for taxpayers other than individuals

539. Consider the following situation. X, a tax resident of State R, wishes to invest in high dividend paying companies in State S. Instead of investing directly, the investor chooses to invest through Corp B, a company, which is legally constituted as per the laws of State T (a low tax jurisdiction). Corp B qualifies as a tax resident for the purpose of the domestic law and treaties concluded by State T (treaties concluded by this State do not include the LOB clause or PPT rule). State T is considered because the T-S tax treaty provides for a zero tax rate whereas the State R-S tax treaty provides for a 10% tax rate on the Art. dealing with dividends. Assume that State R considers the insertion of Corp B into this transaction as abusive. It applies its domestic anti-avoidance rule (judicial doctrine, statutory GAAR or SAAR and not general rules for determining corporate residence) and deems that the residence of Corp B is in State R. The question arises as to whether the application of such a domestic anti-avoidance rule conflicts with treaty provisions?

17.3. The OECD/UN view

540. The 2003/2014 OECD Commentary (*see section 8.2.1.7*) provides that the provisions of a tax treaty will be applied only after a domestic anti-avoidance rule re-determines the taxpayer or re-characterizes an item of income. In this situation, the taxpayer is not re-determined nor is an item of income re-characterized. It is also stated that as a general rule a conflict does not arise between domestic anti-avoidance rules and tax treaties.

541. Nonetheless, with respect to individuals, Para. 9 of the 2003/2014 OECD Commentary on Art 1. considers the following situation as abusive "*an individual who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, and who, essentially in order to sell the shares and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 5 of Article 13), transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax*" [1245]. However, the Commentary does not discuss the interaction of a domestic

[1245] Also see 2015 OECD, Final Report on Treaty Abuse, p. 80.

anti-avoidance rule that is applied by the emigration State with tax treaties.

542. With respect to base companies, as discussed previously (*see section 8.2.1.3*), the OECD's opinion in the 1986 BC report with respect to judicial doctrines or statutory GAARs that deem a base company to be a resident of the shareholders country[1246] by arguing that the POEM is in the shareholders State, is contrary to Art. 4(3), especially when it can be proved that the POEM of the base company is in the State of the base company itself[1247]. Accordingly, a conflict arises between the domestic anti-avoidance rule and the tax treaty provisions.

17.4. The view expressed in international case law

17.4.1. 2001: Unknown Taxpayer – Netherlands[1248]

543. At the outset, the author provides that this case does not discuss the interaction of a domestic anti-avoidance rule with tax treaties. However, the principles established in the case could be used as a benchmark to deal with a domestic anti-avoidance rule that is applied by the residence State pursuant to which a taxpayer, a resident of another State, is considered to be a resident of the former State.

544. A Dutch couple, who were residents of Netherlands, incorporated a Dutch Company ("Dutch Co"). One of the connecting factors to determine tax residence for companies in the Netherlands is based on the incorporation criteria. Accordingly, the Dutch Co was a tax resident of the Netherlands. In 1990, the Dutch couple moved to Belgium and became residents thereof. In the same year, the POEM of the Dutch company was moved from the Netherlands to the Netherlands Antilles. Accordingly, as from this year the Dutch Co was a dual resident and pursuant to the tie breaker rule contained in Art. 34(2) of the 1964 Netherlands – Netherlands Antilles Tax Regulation (which was similar to Art. 4(3) of the OECD Model), the Dutch Co was a tax resident of the Netherlands Antilles and thus subject to corporate taxes there.

[1246] OECD, Base Companies Report, Para. 21b).

[1247] OECD, Base Companies Report, Para. 35.

[1248] DSC: Unknown Taxpayer, Case no. 35.557, February 28th 2001. The original text of the case is in Dutch and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported by in the IBFD Tax Treaty Case Law database was referred to.

However, this did not change the fact that the Dutch Co was still a resident of the Netherlands under the domestic law. Subsequently, the Dutch Co distributed dividends to the shareholders in Belgium. The Dutch domestic law provided that dividends were subject to a withholding tax. Nevertheless, Art. 10(2) of the 1970 Dutch – Belgium tax treaty (which is patterned on the OECD Model) provided that the Netherlands could withhold tax if a resident company of the Netherlands paid the dividends.

545. The tax authorities argued that a Dutch resident company had paid the dividends and thus the withholding tax was applicable. However, the taxpayer argued that the Dutch Co was not a resident of the Netherlands but was a resident of the Netherlands Antilles. This was due to the fact that the Dutch Co was not subject to worldwide taxation pursuant to Art. 34(2) of the Tax Regulation. Consequently, as the Dutch Co did not qualify as a tax resident of the Netherlands due to the Tax regulation, it could not qualify as a resident company for the purposes of Art. 10 of the Dutch – Belgium tax treaty. The case went to a hearing. The key issue discussed was whether the tiebreaker rule contained in the Tax Regulation had any impact on the residence of the Dutch Co for the purposes of applying the Dutch – Belgium tax treaty.

546. The Court of Appeals held that the Dutch Co was a dual resident at the time the dividend distribution was made. However, as the POEM of the Dutch Co was in the Netherlands Antilles, the Dutch Co was a resident of the latter State. Accordingly, as the Tax Regulation eliminated the Dutch Co's residence (and converted the taxpayer's liability from unlimited to limited), the Dutch Co could not be regarded as a resident for the purposes of applying Art. 10 of the Dutch – Belgium tax treaty. The DSC upheld the view of the Court of Appeals. The DSC held that Art. 10(2) of the Dutch – Belgium tax treaty provides that the Netherlands can withhold taxes if a resident company pays the dividend. A company is a resident if it is subject to unlimited tax liability in the Netherlands. As the Dutch Co was not subject to unlimited tax liability in the Netherlands that corporation could not be considered to be a resident for the purpose of applying Art. 10(2) of the Dutch – Belgium tax treaty. Therefore, the Dutch withholding tax did not apply.

547. The principle that can be inferred from this case is that, a company which is incorporated in one State (State R) but has its POEM in another

State (State T), will be a tax resident of the latter State (State T). Furthermore, that company cannot invoke the tax treaties concluded by State R with other States. This is because the provisions of the R-T tax treaty prevent the company from being subject to unlimited tax liability in State R[1249]. The principle has been added to the OECD Commentary which provides that the definition of residence for the purpose of Art. 4(1) "*excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States*" [1250].

17.4.2. 2011: Unknown Taxpayer – Portugal[1251]

548. In 2011, the Portuguese Supreme Administrative Court had to decide on the compatibility of a domestic deemed residence rule (which had an anti-avoidance character) with the provisions of the 1980 Portugal – Germany tax treaty. The domestic law of Portugal provided that all persons in a family unit (Mr X and his wife, Mrs X) are deemed to be resident in Portugal if one of the persons in charge of the unit (Mrs X) was a resident in Portugal. At the tax treaty level, Art. 4 of the treaty was based on the OECD Model.

549. The facts of the case are as follows. Mr X (taxpayer), a Portuguese national, has been living in Germany since 1969. In the tax years 1997 and 1998, he derived his income from German sources. The Portuguese tax authorities contended that this income was subject to tax in Portugal on a worldwide basis for the aforementioned tax years. This was because the deemed residence rules were triggered as Mrs X, a member of the family unit, resided therein. Mr X argued that the deemed residence concept did not fall under Art. 4(1) of the tax treaty, thus, he was not a resident of Portugal. Furthermore, even if the rule considered him as a resident, the taxpayer argued that he was a resident of Germany as he had his centre of vital interest and habitual abode in that State. The case went before the Portuguese Supreme Administrative Court.

[1249] PETERS, ROELOFSEN, Tax Avoidance, pp. 566-567.

[1250] 2014 OECD Comm. Art. 4, Para. 8.2.

[1251] Portuguese Supreme Administrative Court: Unknown Taxpayer, Case no. 876/10, February 24th 2011. The original text of the case is in Portuguese and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported by in the IBFD Tax Treaty Case Law database was referred to.

550. The Court held that the notion of residence under Art. 4(1) did not include such deemed residence concepts even though such concepts imposed worldwide taxation on the taxpayer. The Court agreed that residence is determined as per domestic law for the purpose of Art. 4(1). However, the Portuguese deemed residence concept does not fall under the treaty provisions as Mr X was not liable to tax in Portugal by virtue of criteria similar to "*his domicile, residence, place of management…*"[1252]. In essence, the Court ruled that as the deemed residence concept did not give the taxpayer real and effective personal attachment to the Portuguese territory that concept cannot be used to determine residence under of Art. 4(1). The Court also ruled that the taxpayer's residence is to be determined by his actual position and not because of his marital status. The residence of the wife is in this respect is thus irrelevant. After taking into consideration all the facts, the Court ruled that the taxpayer was a resident of Germany for the purpose of the tax treaty.

17.5. Author's view on the interaction with treaty rules

17.5.1. Deemed unlimited extended tax liability for individuals

17.5.1.1. Conflict with the R – T tax treaty

551. Art. 4(1) of the OECD Model provides that a "*resident of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof*"[1253]. At this point an issue arises from State R's perspective in relation to its deemed residence concept namely whether the deemed residence concept could fall under the provisions of Art. 4(1). Framed differently, the question here is whether Mr X is "*liable to tax … by reason of his domicile, residence, place of management or any other criterion of a similar nature*" in State R pursuant to its deemed residence concept. If the deemed residence concept

[1252] 2014 OECD Model, Art. 4, Para. 1.
[1253] 2014 OECD Model, Art. 4, Para. 1.

falls under Art. 4(1) then the taxpayer will be considered to be a resident and he can invoke the provisions of the tax treaty. However, if it does not fall under Art. 4(1) then the taxpayer cannot invoke the provisions of the treaty. The analysis at this point will only take place from State R's perspective.

552. The OECD Commentary provides that residence of taxpayers is determined as per the provisions of the domestic law. If the domestic law of a State imposes a comprehensive tax liability on a taxpayer then that taxpayer will be considered to be a resident for the purpose of the treaty[1254]. The OECD Commentary further elucidates the concept of residence for tax treaties by indicating that is also includes deemed residence concepts as long as the deemed resident is subject to comprehensive tax liability. The example of diplomats and people working in government service is provided to illustrate this[1255]. The question then arises as to whether the deemed resident concept of State R, which leads to comprehensive tax liability, can fit into Art. 4(1)? The Portuguese Supreme Administrative Court ruled that a deemed residence concept can fit into Art. 4(1) only if the concept is similar to the other connecting factors such as "*his domicile, residence, place of management…*". It is only when the deemed residence concept gives real and effective personal attachment to State R that it can be used to determine residence under the provisions of Art. 4(1). The author agrees with this position. Accordingly, a position could be taken that, if a State has a deemed residence concept which entails full tax liability for its deemed resident as a result of that individuals personal attachment to it then that deemed resident will also be a tax resident for the purpose of tax treaties. This would clearly be applicable for States which impose an unlimited extended tax liability (if the unlimited tax liability is due to effective personal and real attachment). However, in most situations the migrating taxpayer becomes a resident of a new State (State T in the case at hand) and is also subject to comprehensive taxation therein.

553. As the taxpayer will be considered to be a tax resident of both State R and State T, the provisions of Art. 4(2) of the OECD Model[1256] need to be looked into to solve the case of double residence. If it is assumed that the

[1254] 2014 OECD Comm. Art. 4, Para. 3.
[1255] 2014 OECD Comm. Art. 4, Para. 8.
[1256] 2014 OECD Model, Art. 4, Para. 2. For a detailed analysis of Art. 4(2), see 2014 OECD Comm. Para. 9-20. Also see SASSEVILLE, Residence, pp. 153-166; BAKER, Residence, pp. 167-180; STUART, Residence, pp. 181-196.

migrating taxpayer has not kept close connections with the former State of residence (if it is assumed that the former resident does not have a permanent home, social or economic interests, and habitual abode in his former state of residence) the application of the tie-breaker rules will attribute the status of State of the residence exclusively to the State where the person moved after emigration (State T). Therefore, the application of the residence provisions, Art. 4(1) and Art. 4(2), coupled with Art. 13(5) of the OECD model will restrict the former State of residence's right to tax any capital gains derived after emigration. This is because Art. 13(5) provides that gains are only taxable in the State where the alienator is a resident[1257].

554. As a result of the above, it is possible to conclude that unless the former State of residence has reserved its right to tax former residents under its tax treaties, it will not be able to apply its capital gains tax to former residents as it had previously intended, at least in situations involving a State with which it has signed a tax treaty identical to the OECD Model and when no source/situs connection is available. This conclusion is also supported by the case law pronounced by the SSAC in the *A case* which ruled on the compatibility of the Swedish extended tax liability regime with tax treaties[1258]. In this case, the SSAC ruled that the provisions of a tax treaty prevented Sweden from applying its domestic extended tax liability rule which provided that Sweden could tax the capital gains of a former resident for a period of 10 years after the taxpayers emigration. This was because the taxpayer was a resident of a new State when the rule was being enforced.

17.5.1.2. The impact of the guiding principle (or PPT rule)

555. The position taken in this thesis is that the guiding principle applies for tax treaties concluded by OECD or UN member States after January and June 2003 respectively (*see section 9.1*)[1259]. It was concluded previously that a conflict does arise between unlimited extended tax liability regime and tax treaties and the latter should prevail. The question analysed here is whether the treaty benefit can be denied by resorting to the guiding principle? *The following analysis can also be extended to treaties that may incorporate the PPT rule in light of the BEPS Action Plan.*

[1257] SHARKEY, Residence, pp. 73-74.

[1258] SSAC: Swedish Tax Agengy vs A, Case No.: 283-10, 13 ITLR 802, December 14th 2010, pp. 802-838.

[1259] A similar analysis can be made for the application of the PPT rule.

556. The 2014 OECD TTA report and 2015 Final TTA report provide that in the case of a conflict between a domestic SAAR and tax treaty, the latter will prevail. However, the report also states that even though, a conflict arises between a domestic SAAR and treaty provisions, treaty benefits may nevertheless be denied under the guiding principle (*see section 8.2.3.3.2*). The reports provide for the following example: "*An example of such a case would be where a domestic law rule that State A adopted to prevent temporary changes of residence for tax purposes would provide for the taxation of an individual who is a resident of State B on gains from the alienation of property situated in a third State if that individual was a resident of State A when the property was acquired and was a resident of State A for at least seven of the 10 years preceding the alienation. In such a case, to the extent that paragraph 5 of Article 13 would prevent the taxation of that individual by State A upon the alienation of the property, the Convention would prevent the application of that domestic rule unless the benefits of the paragraph 5 of Article 13 could be denied, in that specific case, under … (the guiding principle in paragraph 9.5 of the Commentary on Article 1)*". The report does not discuss if the components of the guiding principle are satisfied or not.

557. Accordingly, it needs to be ascertained, firstly, if there is a treaty benefit. The Commentary to the PPT rule provides that the term "*benefit*" includes "*all limitations… imposed on the State of source under Articles 6 through 22 of the Convention*" [1260]. Accordingly, a benefit does arise for the taxpayer under Art. 13(5). By applying the provisions of Art. 13(5), the State of source (State R) is restricted from taxing the capital gains. Secondly, it needs to be ascertained as to whether a main purpose for the migration was to secure a more favourable tax position. If the taxpayer becomes a resident of State T pursuant to the tie breaker rule a reasonable argument can be made that Mr. X has real and effective residence in State T (because his personal home, centre of vital interests or habitual abode is in that State). Accordingly, it could be argued that the migration is not motivated for tax purposes. Hence the subjective element should not be satisfied. Even if it is proved that the subjective element is satisfied, the objective test needs to be met. Is the migration of Mr X against the object and purpose of Art. 13(5)? As discussed in this thesis (*see section no. 9.3.4*), the purpose of such a

[1260] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 7).

distributive rule is to allocate taxing rights with respect to capital gains. Thus, the objective element should not be satisfied, as the taxpayer has not acted against that object and purpose. However, if the Courts read Art. 13(5) in order to prevent tax avoidance then the author does not rule out the possibility of the objective test being satisfied. Therefore, the application of the guiding principle leads to uncertainty.

17.5.2. Deemed unlimited tax liability for taxpayers other than individuals

17.5.2.1. Conflict with the R-T tax treaty

558. In general, the connecting factors for determining tax residence for corporations is either the incorporation[1261] or control or management[1262] or place of management criteria[1263] etc[1264]. Accordingly, if Corp B is treated as a resident of State T due to one of these criteria's, it will qualify as a resident of that State for domestic law purposes. Also, if State R applies its domestic anti-avoidance rule, and based on all facts and circumstances, argues that Corp B is a resident of State R because its place of management or control is in that State then Corp B will also qualify as a resident of State R for domestic law purposes. Accordingly, Corp B will be a dual resident. Even for the purpose of Art. 4(1) of the OECD Model, Corp B will be considered to be a resident of State T as well as State R. To solve dual residence situations, Art. 4(3) of the OECD Model provides that "*Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated*" [1265]. In general, the POEM exists in the place where the "*key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made*" [1266]. Therefore, if it is

[1261] For instance, in the USA. See Section 7701(a)(4), US IRC; MISEY, SCHADEWALD, US Tax, p. 18.

[1262] For instance, in addition to the incorporation criteria, in the UK. See PANAYI, Corporate Residence, pp. 825-835.

[1263] For instance, in Switzerland. See Art. 50, SDTL; MARAIA, Corporate Residence, pp. 802-808.

[1264] For a detailed analysis of corporate residence – see COUZIN, Residence, pp. 25-99.

[1265] 2014 OECD Model, Art. 4, Para. 3.

[1266] 2014 OECD Comm. Art. 4, Para. 24. For a detailed analysis of Art. 4(3), see SASSEVILLE, Corporate Residence, pp. 287-300; VAN WEEGHEL, Corporate Residence, pp. 303-307.

established that the POEM of Corp B is situated in State T, the author agrees with the findings of the 1986 BC report that State R will be restricted from applying its domestic anti-avoidance rule.

559. It should be noted that the 2014 TTA and 2015 Final TTA reports propose to modify Art. 4(3) in order to counteract dual resident tax avoidance arrangements. The modified provision provides that "*Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States…the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States*". Accordingly, the competent authorities will solve dual residence cases via the MAP procedure[1267]. If the competent authorities establish that the POEM of Corp B is situated in State T, in the author's opinion, State R will be restricted from applying its domestic anti-avoidance rule.

17.5.2.2. The impact of the guiding principle (or PPT rule)

560. The position taken in this thesis is that the guiding principle applies for tax treaties concluded by OECD or UN member States after 2003 (*see section 9.1*)[1268]. It was concluded previously that a conflict does arise between such domestic anti-avoidance rules and tax treaties and the latter should prevail. The question analysed here is whether the treaty benefit can be denied by resorting to the guiding principle? *The following analysis can also be extended to treaties that may incorporate the PPT rule in light of the BEPS Action Plan.*

561. At the outset, it needs to be ascertained if a benefit arises under the R-T tax treaty. A benefit could arise for the taxpayer if it contends that a conflict arises between a domestic anti-avoidance rule that deems a non-

[1267] 2014 OECD, Report on Treaty Abuse, Para. 39; 2015 OECD, Final Report on Treaty Abuse, Para. 48.

[1268] A similar analysis can be made for the application of the PPT rule.

resident to be a resident and treaty provisions. The benefit arises by invoking Art. 4(3) coupled with the relevant distributive rule (Art. 10). However, the Commentary to the PPT rule provides that the term "*benefit*" includes "*all limitations… imposed on the State of source under Articles 6 through 22 of the Convention*" [1269]. It could be argued that the term "*benefit*" does not include any benefits conferred by Art. 4, in particular, Art. 4(3). Therefore, a benefit does not arise under the R-T tax treaty. Thus, the guiding principle should not apply. Furthermore, if it does apply (as it is argued that the benefit is pursuant to the distributive rules as opposed to the residence provisions), in the author's opinion, the taxpayer could argue that Corp B was not set up to obtain a "*benefit*" under the R-T tax treaty (it was set up to obtain a benefit under the T-S tax treaty). Accordingly, the subjective element should not be satisfied. Moreover, if the taxpayer becomes a resident of State T pursuant to the tie breaker rule a reasonable argument can be made that Corp B has real and effective residence in State T (because of its POEM). Accordingly, it could be argued that Corp B was not set up solely for tax purposes. Hence the subjective element should not be satisfied. Even, if it is found to be satisfied, it will be hard to prove that obtaining that benefit will be contrary to the object and purpose of Art. 4(3) and Art. 10. This is because these Articles deal with solving dual residence issues and allocation of taxing rights with respect to dividends. Thus, the taxpayer cannot be denied treaty benefits by invoking the guiding principle if the POEM is in State T.

17.5.3. The issue of treaty override

562. In the previous sections it was concluded that the domestic anti-avoidance rule, which deems non-residents to be residents, conflicts with the provisions of a tax treaty. Logically, even if the rule is introduced after the conclusion of a tax treaty, it should not be applicable as the provisions of the tax treaty take precedence. Accordingly, if the legislator (as a standalone SAAR or as a part of statutory GAAR) or the judiciary (typically by developing and applying a substance (economic and not legal) over form doctrine) introduces/applies a posterior domestic anti-avoidance rule that, notwithstanding the conflict, deems a non-resident to be a resident under certain conditions then an argument can be made that a treaty override occurs. This is because such a rule disturbs the allocation of taxing rights.

[1269] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 7).

563. To elaborate on this position, reference is made to the OECD position to ascertain whether the introduction of such an anti-avoidance rule by a State after the conclusion of a tax treaty can constitute a treaty override. The OECD provided two examples of treaty overrides (*see section 4.4.3.2*). The second example is of relevance to the discussion here. In that example, the enactment of new legislation by the State to counteract tax avoidance through immoveable property companies was considered to amount to a treaty override. It should be noted that in the example provided by the OECD, the enactment of the new legislation by one contracting State immediately affects persons that are residents of the other contracting State i.e. persons who could claim the application of Art. 13(4) before the enactment of the new legislation. In other words the enactment of the new legislation by the State in which the immovable property is situated is sufficient to convert an exclusive right to tax (attributed to the State of residence) into a shared right to tax (with the State of source). As a result, the State of residence is no longer granted the exclusive right to tax the income derived from the sale of shares.

564. If we transpose this example to the domestic anti-avoidance rule at stake, the conclusion will be that the enactment/application of a domestic anti-avoidance rule by a State after the conclusion of a tax treaty is a treaty override. This is because the domestic anti-avoidance rule deems residents of State T to be residents of State R and subjects them to taxation on a worldwide income basis, where in fact, State R should only be entitled to levy taxes on a limited basis. Therefore, the domestic anti-avoidance rule leads to a shift in the allocation of taxing rights ie a limited right to tax that is available to State R is converted to a full right to tax. Thus a material breach arises for the purpose of Art. 60(1) VCLT.

17.5.4. Impact of the US type Saving clause in the R-T tax treaty under both case studies

565. Previously, it was argued that a deemed unlimited tax liability regime for individuals or companies does conflict with treaty provisions. The question analysed in this section is whether the conflict can be neutralized if the R-T tax treaty has a US type saving clause? The clause provides that "*This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to …"*. The term "*resident*" as reflected in the clause is not defined. In the author's opinion, the term "*resident*" should be interpreted in light of Art. 4(1) [1270]. If that interpretation applies, the taxpayer will be a resident of two States i.e. State R and State T. If the tiebreaker rules of Art. 4(2) and Art. 4(3), as discussed previously, break the tie to State T then State R would be prevented from imposing its unlimited tax liability rule for individuals or companies. The 2015 TTA confirms this position by stating that the saving clause "*does not apply to an individual or legal person who is a resident of one of the Contracting States under the laws of that State but who, for the purposes of the Convention, is deemed to be a resident only of the other Contracting State"*. In this case, for the purpose of the convention, the taxpayers are residents of State T. Therefore; State R cannot preserve the application of its domestic anti-avoidance rule pursuant to the saving clause. Consequently, the taxpayers would be subject to State R taxes only to the extent permitted by the treaty[1271].

[1270] 2015 OECD, Final Report on Treaty Abuse, p. 88.
[1271] 2006 US Technical Explanation, Art. 1(4).

18. Residence State: domestic anti-avoidance rules that impute income of non-residents to residents

18.1. The domestic anti-avoidance rule

566. In this section, the author discusses the treaty compatibility of a domestic anti-avoidance rule that is applied by the residence State pursuant to which income of a non-resident taxpayer is imputed to a resident taxpayer. In other words, the income that a resident of another State is legally entitled to receive, is attributed to a resident taxpayer pursuant to a domestic anti-avoidance rule.

18.2. The case study fact pattern

567. Consider the following situation. X, a tax resident of State R, wishes to invest in high dividend paying companies in State S. Instead of investing directly, the investor chooses to invest through Corp B, a company, which is legally constituted as per the laws of State T (a low corporate tax jurisdiction). Corp B qualifies as a tax resident for the purposes of the domestic law and treaties concluded by State T (treaties concluded by this State do not include the LOB clause or PPT rule). State T is chosen because Art. 10 of the T-S tax treaty provides for a zero tax rate whereas Art. 10 of the State R-S tax treaty provides for a 10% tax rate on dividends. The other reason for choosing State T is because the T-S tax treaty provides for residence State taxation of capital gains (which are then exempt as per domestic law) whereas the R-S tax treaty provides for source State taxation of capital gains (which are then taxable as per the domestic law of both States).

568. Assume that State R considers the insertion of Corp B into this transaction as abusive as it is incorporated in a low tax jurisdiction. It applies its domestic anti-avoidance rule (judicial doctrine, statutory GAAR or SAAR) and attributes the dividends/capital gains emanating from State S companies for tax purposes to X. The attribution could take place by either recognizing or disregarding Corp B (taxable entity or transparent entity

approach). If the former approach is applied then the following four situations can be envisaged: i) State R could deem that the profits arising in Corp B are attributed to X as "*business profits*" ii) State R could deem that the profits arising in Corp B are attributed to X as "*notional income*" iii) State R could deem that the profits arising in Corp B are attributed to X as "*deemed dividends*" or iv) State R could deem the capital gains derived by Corp B are attributed to X as "*capital gains*". If the latter approach is applied then the dividends or capital gains are directly attributed to X even though from the perspective of State T and S the dividends are also allocated to Corp B.

18.3. The OECD/UN view

569. As discussed previously (*see section 8.2.1.3*), the OECD's opinion in the 1986 BC report with respect to a domestic general anti-avoidance rules that attributes income of a non-resident taxpayer to a resident taxpayer is that a conflict with treaty provisions does not arise as these rules determine which facts give rise to a tax liability.

570. Further, with respect to CFC rules that impute income of non-residents in the hands of resident taxpayers (*see section 3.4.3.1*), the 1986 BC report provides the methodology followed by States to tax the CFC's income in the hands of the resident shareholder. Specifically, it is provided that the shareholder taxation rests on the assumption that the CFC's income is deemed i) to be distributed ii) to have directly arisen in the hands of the shareholder i.e. the company's activities are attributed to him or iii) to constitute a capital yield[1272]. Thereafter, the 1986 BC Report discusses the interaction of CFC legislation with tax treaties and puts forward technical and policy related arguments to establish that CFC legislation does not conflict with tax treaties.

571. The first argument put forward by the 1986 BC Report is that a tax treaty applies only to income flows between the treaty partners. CFC legislations, *per se*, does not deal with income flows because such SAARs follow a deemed attribution methodology. Thus, such measures are outside the scope of the tax treaty because a tax treaty between the State enforcing

[1272] OECD, Base Companies Report, Para. 24.

the CFC legislation and the State of the base company protects only income flows between those two countries[1273].

572. The second argument put forward by the 1986 BC Report is that CFC rules "*attribute…income to a shareholder, which is not contrary to tax treaties*"[1274]. To elaborate, this argument means that a State can decide what the taxable event is, what the taxable amount is and who the taxpayer is. Such rules are not addressed in tax treaties and are therefore not affected by them. Accordingly, a State can determine the circumstances under which it can attribute income of a CFC to its resident shareholder and tax the shareholder on the undistributed profits of the CFC[1275]. To elaborate, the distributive rules under which CFC legislation is primarily tested are Art. 7(1), Art. 10(5) and Art. 21(1). These distributive rules use undefined terms such as "*profits*" and "*income*". Accordingly, pursuant to Art. 3(2), reference has to be made to the domestic law of the State applying the treaty to ascertain the meaning of these terms[1276]. "*Income*" or "*profits*" only exist when a State decides to categorize an event as a taxable event and to subject the income generated by that event to tax. Further, it is also up to that State to decide who the taxable person is vis-à-vis the taxable event[1277]. Therefore, the domestic law has to be referred to in order to understand who the taxpayer is, what the taxable event is and how much income is taxable[1278]. With respect to CFC legislation income is attributed by the CFC's residence jurisdiction to the CFC and by the shareholders residence jurisdiction to the shareholder. Each State attributes income to its own taxpayer. Consequently, the attribution of income by each State to its own taxpayer should be seen independently as tax treaties do not interfere with such decisions[1279]. Thus, the methodology followed by the shareholders residence jurisdiction to attribute income of the CFC to the shareholder (such as deemed dividend, piercing the veil, capital yield) should not, in principle, matter[1280].

[1273] OECD, Base Companies Report, Para. 43.
[1274] OECD, Base Companies Report, Para. 45a read in conjunction with Para. 39 & Para. 40.
[1275] DE BROE, Thesis, p. 576.
[1276] Art. 7(1) uses the term "*profits*" in the expression "*profits of an enterprise*". Art. 10(3) uses the term "*income*" in the expression "*income from shares…..income from other corporate rights*" while defining the meaning of dividend. Art. 21(1) uses the term "*income*" in the expression "*items of income of a resident*". 2014 OECD Model.
[1277] DE BROE, Thesis, p. 578.
[1278] DE BROE, Thesis, p. 578.
[1279] DE BROE, Thesis, p. 579.
[1280] LANG, CFC, pp. 53-55.

573. The 1986 BC Report then puts forward the third argument. It provides that a tax treaty offers protection from international juridical double taxation and not international economic double taxation[1281]. As CFC legislation involve taxation of the same item of income by different states in the hands of different taxpayers – economic double taxation arises. It arises to the extent that the CFC's profits are taxed in the State of residence of the CFC in the name of the CFC and in the State of residence of the shareholder in the name of the shareholder and the latter State does not provide for relief from double taxation[1282].

574. Nevertheless, in relation to CFC legislation that imputes a deemed dividend to the shareholder, the 1986 BC Report deviates from the first argument (CFC legislation is not within the scope of tax treaties) and provides that the distributive rules in a tax treaty become relevant[1283]. Specifically, it is provided that the deemed dividend could be characterized as "*dividends"* under Art. 10 or as "*other income"* under Art. 21 of the OECD Model but does not provide a conclusive answer[1284]. Regardless of this, it is stated that the State of the shareholder of the CFC cannot be prevented from taxing the deemed dividend[1285]. Specific comments are provided for the interaction of CFC legislation following the deemed dividend approach with Art. 10(5) of the OECD Model that bans extra territorial taxation of dividends.

575. Art. 10(5) provides "*Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the*

[1281] OECD, Base Companies Report, Para 43; DE BROE, Thesis, p. 578. The only provisions in the tax treaty which provide for relief against international economic double taxation are Art. 9(2) read along with Art. 23A or Art. 23B. However, these provisions are not relevant for CFCs as CFC legislation is not concerned with enterprises operating at arms-length but primarily aim at countering tax deferral. DE BROE, Thesis, p. 580.
[1282] DE BROE, Thesis, p. 580.
[1283] OECD, Base Companies Report, Para. 45a read in conjunction with Paras. 49-50.
[1284] OECD, Base Companies Report, Para. 50.
[1285] OECD, Base Companies Report, Para. 45a.

company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State"[1286].

576. The 1986 BC Report provides that it might be argued that CFC legislation following the deemed dividend approach conflict with Art. 10(5). This is because the State of the shareholder taxes undistributed profits of the CFC, which is a resident of another State[1287]. To explain, Art. 10(5) from the perspective of the State enforcing the CFC legislation would read as follows: *Where a company which is a resident of a Contracting State* (CFC State) *derives profits or income from the other Contracting State* (Shareholder State), *that other State* (Shareholder State) *may not* (. . .) *subject the company's* (CFC's) *undistributed profits to tax on the company's undistributed profits, even if* (. . .) *the undistributed profits consist wholly or partly of profits or income arising in such other State* (Shareholder State)"[1288].

577. Thus, it would be possible to argue that Art. 10(5) restricted the shareholders State of residence from taxing the CFC's income. In this regard, the 1986 BC Report provides two arguments in support of the position that CFC legislation following the deemed dividend approach is not contrary to tax treaties. Firstly, it is stated that Art. 10(5) deals with taxation at source and thus has no bearing on the taxation in the State of residence under an anti-avoidance measure. Secondly, it is provided that Art. 10(5) deals only with taxation of the CFC's undistributed profits and not with the taxation of the shareholder[1289]. In essence, it is suggested that the shareholders residence State cannot be prevented from levying its CFC charge as Art. 10(5) restricts taxation of undistributed profits of a company

[1286] 2014 OECD Model, Art. 10(5). In other words, Art. 10(5) prevents taxation by a contracting State (State A) of distributed or undistributed profits of a company resident in another contracting State (State B) even if that income/profits has been derived from State A. State A can tax the income only if the dividends are paid to a resident of State A or the holding in respect of which the dividends are paid is effectively connected with a permanent establishment which the recipient of income maintains in State A.

[1287] OECD, Base Companies Report, Para. 49.

[1288] MADERIA, NEVES, Dividends, pp. 480-482.

[1289] OECD, Base Companies Report, Para. 49.

and not taxation of the same income in the hands of a shareholder. Several commentators share this view[1290].

578. In terms of policy related arguments the 1986 BC Report provides that tax treaties are not intended to provide protection to taxpayers who set up base companies to defer tax and accumulate profits overseas[1291]. It further provides that when countries regard it as a sovereign right to shape their fiscal system in a way which might negatively affect other countries, tax authorities in those other countries must safeguard their sovereign right to preserve the equity and neutrality of their own tax systems. It has never been intended that tax treaties would replace national sovereign rights with international co-operation to safeguard the integrity of tax systems[1292].

579. The 1986 BC Report notes that the above arguments are accepted by a large majority of the OECD countries[1293]. However, the Report also acknowledges arguments voiced by a small minority of OECD countries who argue that CFC legislation is inconsistent with tax treaties. They consider CFC legislation's as incompatible due to two reasons. Firstly, it is argued that CFC legislation is contrary to Art. 7(1) as the CFC's income is taxed in the State of the shareholder; even if, the CFC does not maintain a PE in that State[1294]. The 1986 BC Report does not expand on this argument. In essence, this argument means that the shareholder's State of residence should be restricted from taxing the CFC's income as the CFC does not maintain a PE there (even if the income is taxed in the hands of another taxpayer). Secondly, it is argued that CFC rules are against the spirit of tax treaties that is to avoid double taxation. CFC legislation leads to double taxation[1295]. Accordingly, such legislation is incompatible with tax treaties. With respect to the compatibility issue, only Switzerland entered an observation to the 1986 BC Report and stated that CFC legislation is contrary to the spirit of bilateral double tax conventions because they lead to extra territorial application of domestic legislation[1296].

[1290] LANG, CFC, p. 56; AIGNER, CFC, pp. 34-36; RUST, CFC, p. 269; HASLINGER, CFC, pp. 88-90; VOGEL, Commentary, p. 696.
[1291] OECD, Base Companies Report, Para. 45b.
[1292] OECD, Base Companies Report, Para. 45c.
[1293] OECD, Base Companies Report, Para. 39 & 46.
[1294] OECD, Base Companies Report, Para. 40.
[1295] OECD, Base Companies Report, Para. 39.
[1296] OECD, Base Companies Report, Paras. 95-96.

580. In light of the dissenting minority the 1986 BC Report provides careful suggestions to States that implement CFC rules[1297]. Firstly, it is provided that CFC legislation should comply with the spirit of tax treaties and strive to relieve double taxation[1298]. Secondly, it provides that CFC rules should not extend to genuine active activities which are clearly related to the economic environment of the country where the CFC is a resident and where the activities are carried out in such a way that no tax avoidance can be suspected (*bonifide business activity test*). Nor should such rules apply to countries in which taxation is comparable to that of the country of residence of the taxpayer (*comparable tax test*)[1299]. Thirdly, the 1986 BC Report provides that if the country of the CFC levies a withholding tax on dividend distributions, then the State of the shareholder should strive to provide relief for such taxes, even if the distributed profit was taxed in the previous years under the CFC legislation[1300].

581. In the author's view, the conclusions reached by the OECD can be criticized. Firstly, the 1986 BC Report puts forward the view of the majority and minority OECD countries without reaching a conclusion as to the correct view (*see section 8.2.1.3*). Secondly, the 1986 BC Report puts forward the argument that CFC legislation does not come under the scope of a tax treaty. However, for CFC legislation following the deemed dividend approach, the 1986 BC Report mentions that a tax treaty could be applicable. Thirdly, the 1986 BC Report does not discuss and deliberate on the interaction of CFC legislation with Art. 7(1)[1301]. Further, it should be noted that the 1986 BC Report does not test the compatibility of CFC legislation with Art. 5(7) of the OECD Model which provides that a subsidiary cannot be considered as a PE of its parent company because the former is controlled by the later[1302]. In essence the argument is as follows. Pursuant to its CFC legislation, the State of the shareholder taxes the undistributed profits of the CFC that is resident in another State. Consequently, the State of the Shareholder considers the

[1297] DE BROE, Thesis, p. 585.
[1298] OECD, Base Companies Report, Para. 46.
[1299] OECD, Base Companies Report, Para. 47.
[1300] OECD, Base Companies Report, Para. 51.
[1301] DE BROE, Thesis, p. 586.
[1302] Art. 5(7) provides that "*The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other*". 2014 OECD Model, Art. 5(7).

CFC as a PE and exercises its taxing rights vis-à-vis the PE. On the one hand, the OECD recognizes the separate legal existence of subsidiaries[1303] whereas on the other hand it contradicts this fundamental recognition by consolidating the results of the subsidiary and the controlling shareholder[1304]. Accordingly, CFC legislation is incompatible with tax treaties.

582. The views expressed by the OECD in the 1986 BC Report were inserted in the 1992 update to the OECD Commentary. Firstly, changes were made to the Commentary on Art. 1. In particular, the Commentary considers setting up a base company as abusive and analyses the possible ways to deal with such abuse viz., through judicial doctrines or specific SAARs such as Subpart F rules (CFC rules). It then repeats its opinion discussed in the 1986 BC Report on the interaction of domestic anti-avoidance rules with tax treaties and also expresses the majority and minority views of the OECD member countries without specifying the correct view[1305]. Then, the Commentary provides that domestic anti-avoidance measures should not be applicable if the taxpayer satisfies the *bonafide business activity* or *comparable tax test*[1306].

583. Secondly, changes were made to the Commentary on Art. 10. The 1992 Commentary provided that Art. 10(5) does not preclude the application of CFC legislations[1307]. Then, as the 1986 BC Report does, the Commentary leaves open the issue of whether a deemed dividend pursuant to CFC legislation is to be characterized as "*dividends*" under Art. 10 or as "*other income*" under Art. 21[1308]. It also comments on whether such deemed dividends qualify for exemption under a participation or affiliation exemption regimes and concludes that it is doubtful that countries would

[1303] The OECD Commentary provides that "*It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company*". 2014 OECD Comm. Art. 5, Para. 40.
[1304] DE BROE, Thesis, p. 593.
[1305] 1992 OECD Comm. Art. 1, Paras. 23-25.
[1306] 1992 OECD Comm. Art. 1, Para. 26.
[1307] 1992 OECD Comm. Art. 10, Para. 37.
[1308] 1992 OECD Comm. Art. 10, Para. 38.

adopt such an approach[1309]. Further, the Commentary also comments on the taxation of subsequent dividends distributed by the CFC. As provided in the 1986 BC Report, the Commentary also provides that if the country of the CFC imposes a withholding tax on the subsequent dividend distribution then the country of residence of the shareholder should provide relief for such withholding taxes, even if, the distributed profit (the dividend) has been taxed in the previous years under the CFC legislation. However, the Commentary adds that the obligation to give a credit remains doubtful and taxpayers cannot blame the technicalities of the tax credit legislation of the State of residence of the shareholder if a credit is not granted. The Commentary justifies such a statement by providing that taxpayers who have recourse to artificial arrangements are taking risks in terms of which they cannot be fully safeguarded against tax authorities[1310].

584. In the 1998 HTC Report, the OECD proposed that countries that do not have CFC rules should consider adopting them and that countries that have such rules should ensure that they apply in a fashion consistent with the desirability of curbing harmful tax practices[1311]. Accordingly, it can be ascertained that the OECD promoted the incorporation of CFC rules in domestic tax legislation.

585. Also, the 2003 OECD Commentary provided that abuse through base companies can be tackled either through judicial doctrines/statutory GAAR's on the one hand and CFC rules on the other. For the former, by referring to Para 22.1 of the 2003/2014 OECD Commentary (*see section 8.2.1.7*), it is provided that the provisions of a tax treaty will be applied only after a domestic anti-avoidance rule redetermines the taxpayer (this statement could hold true for imputation rules that ignore the intermediary). For the latter, the Commentary now provides that CFC legislation is not contrary to Art. 10(5) or Art. 7(1) of the OECD Model and need not be preserved in tax treaties in order to be applicable. This was justified with the Commentary on Art. 10(5)[1312] (remain unchanged since 1992). Further, a portion was added to the Commentary on Art. 7(1), which provided that this Article does not limit the

[1309] 1992 OECD Comm. Art. 10, Para. 39.
[1310] 1992 OECD Comm. Art. 10, Para. 40. It has been opined that this statement contradicts the conclusion reached by the OECD in its base companies report that CFC legislation should strive to relieve double taxation. DE BROE, Thesis, p. 588.
[1311] OECD, Competition Report, Paras. 97-100.
[1312] 2003 OECD Comm. Art. 10, Paras. 37-39.

right of a contracting State to tax its own residents under CFC provisions[1313]. Furthermore, the Commentary on the business activity test[1314] was deleted.

586. The 2003 update to the Commentary clearly reflected the position of the OECD on the consistency of CFC rules with tax treaties. The impression given by the OECD is that it has been internationally accepted that CFC rules are consistent with tax treaties[1315]. However, in response to this update, a few OECD member countries recorded observations to the changed Commentary. Belgium recorded the strongest observation[1316] and indicated that it considers CFC rules contrary to Art. 5(7), 7(1) and 10(5) of the OECD Model as such regimes disregard the legal personality of foreign entities[1317]. Switzerland[1318] observed that CFC legislation could be incompatible with Art. 7. The Netherlands [1319] and Ireland [1320] also considered that CFC

[1313] 2003 OECD Comm. Art. 7, Para. 10.1. This change could have been made pursuant to the OECD's finding in its report on harmful taxation. Refer OECD, Competition Report, Para. 123. Also this amendment was probably pursuant to the FSC decision in 2002. *See section 18.4.3*.

[1314] 2003 OECD Comm. Art. 1, Paras. 26. The revised Commentary led to the deletion of the *"business activity"* test; ARNOLD, VAN WEEGHEL, Abuse, p. 84. This amendment was probably pursuant to the Finnish Court decision in 2002. See *section 18.4.2*.

[1315] DE BROE, Thesis, p. 592.

[1316] ARNOLD, VAN WEEGHEL, Abuse, p. 87.

[1317] Belgium observed that it "*considers that the application of controlled foreign companies legislation is contrary to the provisions of paragraph 7 of Article 5, paragraph 1 of Article 7 and paragraph 5 of Article 10 of the Convention. This is especially the case where a Contracting State taxes one of its residents on income derived by a foreign entity by using a fiction attributing to that resident, in proportion to his participation in the capital of the foreign entity, the income derived by that entity. By doing so, that State increases the tax base of its resident by including in it income which has not been derived by that resident but by a foreign entity which is not taxable in that State in accordance with the Convention. That Contracting State thus disregards the legal personality of the foreign entity and therefore acts contrary to the Convention*". 2003 OECD Comm. Art. 1, Para. 27.4.

[1318] Switzerland observed that it "*Switzerland considers that controlled foreign corporation legislation may, depending on the relevant concept, be contrary to the spirit of Article 7"*. 2003 OECD Comm. Art. 1, Para. 27.9.

[1319] The Netherlands observed that it "*does not adhere to the statements in the Commentaries that as a general rule domestic anti-avoidance rules and controlled foreign companies provisions do not conflict with the provisions of tax conventions. The compatibility of such rules and provisions with tax treaties is, among other things, dependent on the nature and wording of the specific provision, the wording and purpose of the relevant treaty provision and the relationship between domestic and international law in a country"*. 2003 OECD Comm. Art. 1, Para. 27.7.

[1320] Ireland observed that "*in relation to potential conflicts between anti-abuse provisions (including CFC's) in domestic law and the provisions of tax treaties, Ireland considers*

regulations maybe contrary to tax treaties but this would depend on the particular country's CFC rules, the provisions of a particular treaty and the relationship between tax treaties and domestic law in the particular country.

587. The UN view is in line with the OECD's position. In the Commentary to the 2011 UN Model on Art. 1, the Committee of Experts, in accordance with the OECD's view, also expresses the view that they do not consider CFC rules to be incompatible with Art. 10(5) or Art. 7(1) of a tax treaty[1321].

18.4. The view expressed in International case law

18.4.1. 1997: Bricom Holding – UK[1322]

588. In this case, the UK SC and the UK COA held that the UK CFC legislation – Introduced in 1984 – was not contrary to the 1980 UK – Netherlands tax treaty ("*UK-NL tax treaty*"). Bricom Group Limited ("BGL"), a UK resident company, indirectly owned another UK resident company viz. Bricom Holding Limited ("taxpayer" or "Bricom"). The

that it is not possible to have a simple general conclusion that no conflict will exist or that any conflict must be resolved in favour of the domestic law. This will depend on the nature of the domestic law provision and also on the legal and constitutional relationship in individual member countries between domestic law and international agreements and law. Also, Ireland does not agree with the deletion of the language in paragraph 26 (as it read until 2002), which stated: It would be contrary to the general principles underlying the Model Convention and to the spirit of tax treaties in general if counteracting measures were to be extended to activities such as production, normal rendering of services or trading of companies engaged in real industrial or commercial activity, when they are clearly related to the economic environment of the country where they are resident in a situation where these activities are carried out in such a way that no tax avoidance could be suspected". 2003 OECD Comm. Art. 1, Para. 27.5.

[1321] The UN Commentary in relation to base companies provides that "*One of the most effective approaches to dealing with such cases is the inclusion, in domestic legislation, of controlled foreign corporation (CFC) legislation. While the view has sometimes be expressed that such legislation could violate certain provisions of tax treaties, the Committee considers that this would not be the case of typical CFC rules, as indicated in paragraph 23 of the Commentary on Article 1 of the OECD Model Convention (and as further explained in paragraphs 14 of the Commentary on Article 7 and 37 of the Commentary on Article 10 of that Model)*". 2011 UN Comm. Art. 1, Para. 74.

[1322] UK SC: Bricom Holdings Ltd v Inland Revenue Commissioners, [1996] STC (SCD) 228, April 3rd, 1996. Followed by UK COA: Bricom Holdings Limited vs Inland Revenue Commissioners, Appeal No OOTRF 96/1522/B, July 25th 1997, 1 oflr ITLR 365, pp. 366-379; Also see MORTON, SKYES, Tax Avoidance, pp. 810-812; MCAREE, SVASTI, Attribution, pp. 660-662; CLYSON, UK CFC, pp. 326-333; ULLAH, CFC, pp. 625-631.

taxpayer, in turn, owned a subsidiary in the Netherlands viz., Spinneys International BV ("Spinneys" or "Sub Co"), an investment holding company. Out of its surplus funds, Spinneys provided an interest bearing loan to BGL. Interest was paid on the loan by BGL ("UK source interest") and that amount was subject to tax only in the Netherlands. Nevertheless, pursuant to the UK CFC rules, the HMRC took the view that Spinneys was a CFC of Bricom. Accordingly, as per the UK CFC regulations, "*chargeable profits*" of Spinneys were apportioned to Bricom[1323].

589. There was no dispute that Spinneys was a CFC. However, the taxpayer's main argument was that the Art. 11 of the UK – NL tax treaty-prevented the UK from taxing the UK source interest in its hands. This was because the UK source interest was only taxable in the Netherlands[1324]. In response, the tax authorities relied on the technical language of the CFC legislation and highlighted that the income taxed at the level of Bricom was a notional amount, determined as per certain assumptions, and was not UK source interest as such. Accordingly, it was argued that the tax treaty could not prevent the CFC charge.

590. The case went for trial. The UK SC regarded the UK CFC regime as a three stage process as follows. Firstly, the chargeable profits of the CFC are computed on the assumption that the CFC was a UK resident. Secondly, the chargeable profits are apportioned to the shareholders owning an interest in the CFC. Thirdly, the UK resident companies have to pay corporation tax on the attributed profits. According to the UK SC, the UK source interest lost its identity at the first stage itself. Consequently, as Bricom was apportioned a notional amount and not UK source interest it could not argue that Art. 11 of the UK-NL tax treaty prevented the UK from applying its CFC legislation[1325].

[1323] The chargeable profits attributable are required to be computed under the assumption that the CFC is a resident in the UK and UK corporation tax is payable by the CFC after taking into consideration all relevant deductions against the taxable profits. Certain amounts are excluded and included. Essentially, a notional amount is attributed to the persons holding an interest in the CFC on which UK corporation tax is payable. HMRC, CFC 210010.

[1324] Art. 11(1) of the UK-NL tax treaty provided that "*interest arising in one of the States which is derived and beneficially owned by a resident of the other State shall be taxable only in that other State*". This provision allocates the taxing rights only to the State of residence of the taxpayer.

[1325] DE BROE, Thesis, p. 596.

591. The decision of the UK SC was then appealed by the taxpayer. The taxpayer modified its arguments. However, in principle it continued to rely on Art. 11 of the UK – NL tax treaty and contended that the provision prevented the UK CFC charge. In response, the UK COA also held in favour of the tax authorities although for different reasons. The UK COA did not agree with the UK SC's finding that the interest lost its original character but instead provided that "*the chargeable profits" as defined by Section 747(6)(a) are a purely notional sum. They do not represent any profits of Spinneys on which United Kingdom corporation tax is chargeable, for there are no such profits. Nor do they represent any actual payments or receipts of Spinneys, whether of interest or anything else. They are merely the product of a mathematical calculation made on a hypothetical basis and making counterfactual assumptions. The "chargeable profits" which are defined by Section 747(6)(a) exist only as a measure of imputation. What is apportioned to the Taxpayer and subjected to tax is not Spinneys' actual profits but a notional sum which is the product of an artificial calculation*". In essence, the UK COA held that the amount apportioned to the taxpayer was not the CFCs profits but a notional sum determined as per the UK CFC rules. Thus, Article 11 of the UK – NL tax treaty could not protect the taxpayer.

592. It should be noted that the case was decided on the basis of the technicalities of the domestic CFC rules. In the author's view, the taxpayer should not have relied only on Art. 11 of the UK-NL tax treaty. The taxpayer should have also put forward the argument that the Article on business profits (equivalent to Art. 7(1) of the OECD Model) or dividends (equivalent to Art. 10(5) of the OECD Model) or Art. 5(7) (subsidiary is not a PE) prevented the notional CFC charge. However, such arguments were not made.

18.4.2. 2002: Re A Oyj Abp – Finland[1326]

593. In this case, a Finnish Company viz., Oyj Abp ("Fin Co" or "taxpayer") owned a wholly owned subsidiary in Belgium viz., A Finance NV ("Sub Co"). The Sub Co benefited from Belgium's favourable tax

[1326] FSAC: Re A Oyj Abp, KHO:2002.26, 4 ITLR 1009, March 20th 2002, pp. 1009-1076; HELMINEN, CFC, pp. 204-207; LEHTIMAJA, Tax Avoidance, pp. 305-306. The case also deals with the compatibility of the Finnish CFC rules with EU tax law. However, this is not discussed here as the author focusses on tax treaty issues.

regime for coordination centres and was subject to a low level of tax. Consequently, as per the Finnish CFC rules - enacted in 1994 - the Sub Co qualified as a CFC of the Fin Co and the Fin Co was subject to tax on the profits of the Sub Co.

594. The taxpayer applied for an advance ruling on whether it could be taxed in Finland on the basis of the 1976 (amended in 1991) Finland – Belgium tax treaty ("*Belgium – Finland tax treaty*"). In response to the application, the Central Board of taxation ruled that the Belgium – Finland tax treaty did not prevent the Fin Co from being taxable under the local CFC rules. The reasoning was mainly based on the 1992 OECD Commentary on Art. 1 which provided that CFC rules could not be precluded by tax treaties.

595. The taxpayer then appealed to the FSAC. The main arguments that were advanced against the compatibility of the CFC legislation with the Finland – Belgium tax treaty were as follows. Firstly, it was argued that the Finnish CFC rules contravened the provisions for taxation of business profits in Art. 7 (equivalent to Art. 7 of the OECD Model) of the treaty because the Sub Co's income was taxed in Finland, even though the latter company had no PE in Finland. By subjecting the profits of the Sub Co to tax in the hands of the taxpayer, Finland technically circumvented the provisions of the tax treaty. Secondly, it was argued that the purpose of the tax treaty is to remove double taxation and the application of the CFC legislation therefore conflicted with the purpose and wording of the tax treaty. This is because CFC legislation results in economic double taxation. Further, the fact that economic double taxation is not covered by the tax treaty could not be used as a valid argument to justify its compatibility. Thirdly, it was argued that that the 1992 OECD Commentary on Art. 1 only expresses the majority view of the OECD countries vis-à-vis the interaction of CFC legislation with tax treaties and in no way should be considered conclusive. It was also argued that the OECD Commentary lays down certain criteria for CFC legislation and the Finnish CFC rules failed to meet these criteria (*business activity* and *comparable tax tests*). Furthermore, the OECD Model and its Commentary could not be used as an actual source of law. Fourthly, it was argued that the Finnish CFC rules were incompatible with Art. 10(5) and Art. 5(7) of the tax treaty. In relation to Art. 10(5) it was argued that this provision prohibited extra territorial taxation and consequently, Finland could not apply its CFC rules. In relation to Art. 5(7), it was argued that the Finnish CFC provisions were once again incompatible. By imposing a tax liability on a Finnish

shareholder of a Belgian co-ordination centre on the undistributed profits of the latter and by granting a credit for the tax payable in Belgium, Finland in facts treated the co-ordination centre as a PE of the Finnish company which was contrary to Art. 5(7). Lastly, it was argued that Finland could not apply its CFC legislation unless explicit provisions which allow such implementation were inserted into its tax treaties. As the tax treaty and the supplement to it did not include such a provision, Finland could not apply its CFC legislation to Belgian resident companies.

596. In response, the main arguments put forward by the tax authorities for the compatibility of CFC rules with tax treaties were as follows. Firstly, it was argued that the purpose of the CFC legislation was to prevent tax avoidance schemes which were put in place by setting up an overseas corporation in a low tax jurisdiction. Secondly, it was argued that every country has the right to attribute income to its own residents and tax them. To elaborate, the Finnish CFC rules attribute income to a Finnish resident shareholder on the profits of the CFC and taxes them. The provisions of the tax treaty viz., Art. 7 or Art. 21 (*other income*) did not restrict Finland from taxing the Finnish resident shareholder. Thirdly, it was argued that tax treaties deal with resolving juridical double taxation and not economic double taxation. As the Finnish CFC rules led to economic double taxation, these rules were outside the scope of a tax treaty. Further, it was even argued that even though economic double taxation is not dealt by tax treaties, the Finnish domestic law relieves economic double taxation by providing a credit for the taxes paid by the CFC. Lastly, it was argued that the OECD Model and its related commentary reflect the positions that are supported by a significantly large majority of the OECD member countries. In this regard, it was highlighted that a large majority of the OECD member countries consider the decision to introduce CFC legislation as a domestic matter and tax treaty provisions do not affect the applicability of such CFC rules. Since this was the position of a significantly large majority of the OECD member countries, it could be said to amount to an established international practice.

597. After taking into consideration the above arguments for and against CFC legislation the FSAC gave its verdict. Firstly, before interpreting the provisions of the tax treaty, the Court examined the CFC legislation to determine its effects and objectives and the characterization of the attributed income to the shareholder in the domestic law. In relation to the effects and objectives the Court ruled that the Finnish CFC legislation was drafted in

conformity with international standards and its purpose to prevent tax avoidance and evasion was acceptable from an international standpoint. In relation to characterization of the income, the Court observed that the Finnish tax rules did not provide any definition on the character of such income. After a detailed analysis, the Court held that the income attributed to the shareholder was to be characterized as business income and not deemed dividend. Secondly, the Court held that tax treaties in general are concerned with resolving juridical double taxation and not economic double taxation. The tax treaty at stake resolved only the former type of double taxation. The Court also held that attribution of income is governed by domestic law and tax treaties do not take independent attribution decisions. Thirdly, the Court held that, in principle, the OECD Model and its related Commentary is not binding for interpreting tax treaties. Nevertheless, such material should be regarded as an auxiliary source of interpretation if a tax treaty follows the OECD Model. Further, subsequent amendments made to the Commentary are relevant (for pre-existing tax treaties) as they comment on new situations and phenomena. After establishing this fact, the Court referred to the OECD Commentary on Art. 1, especially, with respect to CFCs and concluded that CFC legislation does not contravene tax treaties. Additionally, the Court held that the outcome of its decision would remain the same, even if, the tax treaty did not preserve the application of Finland's CFC legislation. Lastly, in terms of interaction of the CFC legislation with the treaty provisions, the Court, after taking into consideration the OECD Commentary on Art. 1, once again ruled that no conflict arose either with Art. 5(7) or Art. 7(1). This was because each country could determine its own tax base i.e. tax its own residents. The interaction with Art. 10(5) was not considered relevant as the income in question was characterized as business income and not deemed dividend.

598. It should be noted that the Court relied heavily on the OECD view to reach this conclusion. Therefore, the main criticism that was raised was that it relied excessively on the statements made in Art. 1 of the 1992 OECD Commentary to interpret a tax treaty concluded in 1976[1327]. Accordingly, it was argued that the Court's interpretation of the issue at stake was incorrect as it relied on the subsequent versions of the OECD Commentary.

[1327] LANG, CFC, pp. 52-53.

18.4.3. 2002: Re Société Schneider Electric – France[1328]

599. A French Company viz., Schneider Electric ("French Co" or "taxpayer") owned a wholly owned subsidiary in Switzerland viz., Paramer ("Sub Co"). The Sub Co benefited from Switzerland's favorable tax regime for holding companies and was subject to a low level of tax. As per the French CFC rules, the Sub Co qualified as a CFC of the French Co. Consequently, the tax authorities imputed the profits of the Sub Co to the French Co.

600. The taxpayer appealed the assessment before the Administrative Tribunal of Paris ("Tribunal"), mainly arguing that the French CFC legislation was not compatible with Art. 7(1) (comparable to Art. 7(1) of the OECD Model) of the 1966 France –Switzerland tax treaty ("1966 tax treaty"). However, the Tribunal ruled in favour of the tax authorities. Thereafter, the taxpayer appealed the decision of the Tribunal before the Administrative Court of Appeal which then ruled in favour of the taxpayer and provided that the provisions of Art. 7(1) of 1966 tax treaty prevented the application of French CFC legislation.

601. The tax authorities then filed an appeal before the FSC (*Conseil d'Etat*). The *Conseil d'Etat* followed a two-step approach, that is, it first considered the question of characterization of the attributed income under the French domestic tax law and then examined whether the treaty restricted the taxing rights of France. The *Conseil d'Etat* held that the income attributed to the French shareholder was to be characterized as business income and not deemed dividend. After establishing this fact, the *Conseil d'Etat* analyzed the impact of the internal law characterization with Art. 7(1). It noted that the term "*profits*" as used in Art. 7(1) was not defined in the 1966 tax treaty and hence pursuant to Art. 3(2), reference had to be made to the domestic tax law of France. It ruled that the profits imputed to the French Co were identical to the profits of the Sub Co. As per Art. 7(1), France was entitled to tax the profits of the Sub Co, only if, the Sub Co carried out business in France through a PE. As the Sub Co did not carry out its activities in France through a PE, France could not tax the profits. Accordingly, the CFC legislation was incompatible with tax treaties. The

[1328] FSC: Re Societe Schneider Electric, Appeal no 232276, 4 ITLR 1077, June 28th 2002, pp. 1106-1129; GUTMANN, CFC, pp. 156-162; YVES, MBWA, CFC, pp. 493-498; KABBAJ, RAINGEARD, CFC, pp. 625-631.

Conseil d'Etat also ruled that the purpose of the treaty (elimination of double taxation) did not justify an incorrect application of Art. 7(1) on the sole ground that taxation in France (the profits of the Sub Co) was not in the name of the Sub Co but in the hands of the taxpayer.

602. It should be noted that in this case, the *Conseil d'Etat* implicitly assumed that tax treaties contain independent attribution rules (contrary to the decision of the FSAC in the *2002 Oyj Abp case*). Accordingly, it has been criticized that the approach followed is not correct due to the fact that tax treaties do not take independent attribution decisions (refer to the technical arguments made in the 1986 BC Report)[1329]. However, other commentators have argued that the approach followed in this decision should be seen as correct as the court followed a purposive interpretation methodology[1330].

18.4.4. 2004: Unknown Taxpayer – Germany[1331]

603. In this case, a German Company ("German Co" or "taxpayer") owned investments in two Irish companies ("Irish Co's") which carried out passive investment activities. The income that Irish Co's earned from their investments was taxable in Ireland at a privileged rate. Thereafter, when the Irish Co's distributed dividends, the German Co claimed an exemption from the German corporate tax pursuant to Art. 22(2) of the 1962 Irish-German tax treaty which provided that when an Irish Co pays dividends to a German Co (that is a substantial shareholder) then those dividends are exempt from tax in Germany. It should be noted that in this case, it was clearly established that the Irish Co's did not have any employees. All the activities of the Irish Co's were outsourced i.e. they were carried out and managed by a bank. Nevertheless, the Irish Co's did pay taxes on their income. The German tax authorities refused to grant treaty benefits to the taxpayer on the dividend income. They argued that there were no economic reasons for routing the investments through the Irish Co's. Consequently, by invoking the domestic statutory GAAR the tax authorities reasoned that the creation of the Irish Co's was abusive and therefore they attributed the income earned by the Irish Co's directly to German Co. Conversely, the taxpayer argued that the

[1329] Lang, CFC, pp. 53-55.
[1330] YVES, MBWA, CFC, p. 498.
[1331] GFFC: Case No. IR 42/02, February 25th 2004. The author did not manage to get a translation of this case. So reliance was made on the summary of the case as available on the IBFD Tax Treaty case law database.

Irish Co's could not be disregarded and the treaty benefits should be extended to the German Co.

604. The case went for trial and the GFFC ruled in favour of the taxpayer. Firstly, it was provided that the setting up of the Irish Co's was not abusive. The Court provided that a distinction had to be made between a non-operative base company and an operative capital investment company. The former could be considered as an abusive arrangement whereas the latter could not. According to the Court, the Irish Co's could be classified as operative capital investment companies. This was because the companies were set up for a long period of time. The fact that all their investment activities were carried out by a bank did not really matter as this was common practice in the investment business. Therefore, treaty benefits had to be granted to the taxpayer and their income could not be attributed to the German Co's.

18.4.5. 2004: Unknown Taxpayer – Austria[1332]

605. In this case, an Austrian Company ("Austrian Co" or "taxpayer") owned an Irish Subsidiary ("Irish Co") which carried out passive investment activities. The income that the Irish Co earned from its investments was taxable in Ireland at a rate of 10%. This was because the Irish Co participated in an Irish privileged tax regime. Thereafter, when the Irish Co distributed dividends, the Austrian Co claimed an exemption from the Austrian corporate tax pursuant to its participation exemption regime. Further, Art. 8(4) of the 1966 Irish-Austrian tax treaty[1333] also provided that when an Irish Co paid dividends to an Austrian Co then those dividends were exempt from tax in Austria. It should be noted that in this case, it was clearly established that the Irish Co did not have any employees. Nor did it have its own business premises. All the activities of the Irish Co were outsourced i.e. they were carried out and managed by a bank and

[1332] ASAC: Case No. 2002/14/0074, December 9th 2004. The author did not manage to get a translation of this case. So reliance was made on the summary of the case as available on the IBFD Tax Treaty case law database. Also refer OBERMAIR, WENINGER, Treaty shopping, pp. 466-469.

[1333] Art. 8(4) of the tax treaty provided that "*Dividends paid by a company which is a resident of Ireland to a company which is a resident of Austria shall, notwithstanding the provisions of subparagraph (a) of paragraph 1, be exempt from Austrian tax. This exemption shall not apply unless in accordance with the laws of Austria the dividends would have been exempt from Austrian tax if the first-mentioned company had been a resident of Austria and not a resident of Ireland*".

independent managers. Nevertheless, the Irish Co did pay taxes on its income.

606. The tax authorities refused the grant the participation exemption regime (domestically and as provided in the 1966 tax treaty) to the taxpayer. They argued that if the taxpayer had made the investments directly (without the Irish Co) then that income would have been subject to Austrian corporate taxation. Thus, in order to avoid Austrian corporate taxation the taxpayer had created the Irish Co, so that, the income generated by the Irish Co would initially be taxable in Ireland at a lower corporate tax rate and the subsequent dividend distribution by the Irish Co would be exempt from Austrian taxation. It was contended that there was no economic reason for creating the Irish Co other than to avoid taxes and the Irish Co was merely a "*letter box*" company. Consequently, by invoking the domestic statutory GAAR the tax authorities reasoned that the creation of the Irish Co was an "*abuse of law*" and therefore attributed the income earned by the Irish Co to the Austrian Co (*see section 13.4.6*).

607. The case went for trial and the ASAC ruled in favour of the tax authorities. Firstly, it was provided that the conditions for invoking the statutory GAAR were satisfied because there was no economic reason for the taxpayer to create the Irish Co other than to achieve considerable tax savings. Secondly, it was held that it would be against the treaty's object and purpose to grant treaty benefits in abusive situations. Lastly, as provided in the 2000 *N AG case* (*see section 13.4.7*), the Court ruled that the non-existence of specific anti-abuse provisions in a tax treaty did not mean that the treaty allowed an abuse of legal structures of civil law. Therefore, domestic statutory GAARs could be applied to treaty situations even if they were not preserved in them. Once again, to support this conclusion, the Court mentioned that it was internationally accepted that domestic GAARs could be applied to treaty situations to prevent abuse. In the author's opinion, the outcome of the case can be criticized on the same ground as in the 2000 *N AG case* i.e. the Court considers that "*international practice*" provides that GAARs can be applied to tax treaties. However, the ASAC did not seem to be concerned about these critical remarks, since, in a similar

case in 2005, it held that the Austrian domestic GAAR could be applied to tax treaty situations[1334].

18.4.6. 2006: Eagle Distribuidora (Eagle I) – Brazil[1335]

608. A Brazilian Company ("taxpayer" or "Parent Co"), after undergoing a reorganization, owned a Spanish Subsidiary ("Spanish Sub Co") and a Gibraltar Subsidiary ("Gibraltar Sub Co"). The Spanish Sub Co further held subsidiaries incorporated in Uruguay ("Urg Sub") and Argentina ("Arg Sub"). As per the Brazilian CFC rules, the Spanish Sub Co and Gibraltar Sub Co qualified as CFCs. Accordingly, the tax authorities imputed the profits of these subsidiaries to the taxpayer. It should be noted that the profits of the Spanish Sub Co were imputed to the taxpayer without taking into consideration the tax treaty between Brazil and Spain ("tax treaty"). Being aggrieved, the taxpayer appealed before the *Conselho de Contribuintes* ("Court").

609. In this regard, the taxpayer put forward several arguments to defend its position. From a tax treaty perspective, the taxpayer argued that Art. 7 (equivalent to Article 7(1) of the OECD Model) of the 1974 Spain-Brazil tax treaty ("*1974 tax treaty*") restricted Brazil from taxing the income. Further, it was also contended that, even if, the income was not covered by Art. 7, it would be covered by Art. 10 (equivalent to Article 10 of the OECD Model). If this is the case, Brazil would have to exempt the dividend income pursuant to Art. 23(4) - which provides for such an exemption.

610. The Court, after taking into consideration the taxpayers arguments, firstly held that the income attributed to the taxpayer, from a domestic perspective, was to be regarded as business profits of foreign entities and not deemed dividends distributed by foreign entities[1336]. Secondly, the Court,

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[1334] ASAC: Case No. 2001/13/0018 and 0019, August 10th 2005. The author did not manage to get a translation of this case. So reliance was made on the summary of the case as available on the IBFD Tax Treaty case law database.

[1335] Conselho de Contribuintes (Council of Taxpayers): Eagle Distribuidora de Bebidas SA v Second group of the Revenue Department in Brasilia, Case no. 148.709, 9 ITLR 627, October 19th 2006, pp. 627-661.

[1336] It should be noted that prior to this case, the same Court had held that the Brazilian CFC rules applied the deemed dividend approach. See Conselho de Contribuintes (Council of Taxpayers): Case no. 108-08765. The author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported in the IBFD Tax Treaty Case Law database was referred. VIOLIN, CFC, p. 98.

relying on the OECD Commentary (which it considered to be an aid to interpretation) held that, pursuant to Art. 3(2) of the tax treaty (reference to domestic law to ascertain the meaning of undefined terms) the income qualified as business profits and thus Art. 7 was applicable. As the Brazilian CFC rules tax the business profits of foreign entities, the Court ruled that Art. 7 of the tax treaty indeed restricted Brazil from taxing the income. The Court argued that the Brazilian CFC rules were taxing the profits of the Spanish Sub Co and these were taxable only in Spain as per the tax treaty (as the Spanish Sub Co did not have a PE in Brazil). The Court also ruled that, even if, the income were to be considered as deemed dividends, Brazil would be under an obligation to exempt such income pursuant to Art. 23(4) which provides for such an exemption. Accordingly, the Court ruled in favour of the taxpayer. This case is in line with the *Schneider case* discussed earlier wherein it was held that the provisions of a tax treaty trump domestic CFC legislation. The Court in this case implicitly considered that tax treaties govern independent attribution decisions. Interestingly, the Court held that if the CFC legislation imputes a deemed dividend to the taxpayer, such dividends qualify for exemption. The OECD Commentary[1337] does not give a clear cut answer to this issue.

18.4.7. 2008: Eagle Distribuidora (Eagle II) – Brazil [1338]

611. The case relates to the same taxpayer discussed above but concerns a different year. To reiterate the facts, the taxpayer, owned a Spanish Sub Co which in turn held an Urg Sub and an Arg Sub. The profits of the Spanish Sub Co (derived from holding equity interests in the Urg Sub and Arg Sub), pursuant to the Brazilian CFC rules, were taxed in Brazil. However, the *Conselho de Contribuintes* ("Court"), in this case, ruled against the taxpayer.

612. In principle, the Court provided that the Brazilian CFC rules impute a business profit to its resident taxpayer and do not impute a deemed dividend.

[1337] 2014 OECD Comm. Art. 10, Para. 38.

[1338] Conselho de Contribuintes (Council of Taxpayers): Eagle Distribuidora de Bebidas SA v Federal Revenue Service (tax authorities): Case no. 16327.000530/2008-28, Sentense No. 101-97070. The author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported in the IBFD Tax Treaty Case Law database was referred to. Also refer BRIGAGAO, BRUNELL, CFC, pp. 17-21; VIOLIN, CFC, p. 98.

However, the Court ruled that the tax treaty prevented Brazil only from taxing the profits derived in Spain and not the profits derived by the Urg and Arg Subs. To elaborate, the profits that were being taxed by Brazilian CFC rules were not the profits of the Spanish Sub Co, but, instead, they were the profits of the Urg Sub and Arg Sub. For that reason, the relationship between Brazil and Argentina and Brazil and Uruguay had to be considered and not the relationship between Brazil and Spain. Accordingly, the 1974 Brazilian-Spain tax treaty was not applicable.

613. It seems that the Court looked through the Spanish Sub Co and attributed the income of the underlying subsidiaries to the taxpayer (not the profits of the Spanish Sub Co). If this was the case, then the Court should have taken into consideration the tax treaty concluded by Brazil with Argentina (no treaty exists with Uruguay). However, this was not taken into account. Accordingly, this case can be considered to be highly questionable and misleading[1339].

18.4.8. 2008: X AB – Sweden[1340]

614. A Swedish Company ("taxpayer" or "Parent Co") owned a Swiss reinsurance Company ("Sub Co"). As per the Swedish CFC rules, the Sub Co qualified as a CFC and its income was attributed to the taxpayer. Being aggrieved with the Swedish CFC rules, the taxpayer applied for a ruling with the Council for Advance Tax Rulings ("Council"). In the application, the taxpayer sought to ascertain if the CFC rules were compatible with the tax treaty between Sweden and Switzerland ("tax treaty"). It is important to note that in this case, the tax treaty was concluded in 1965 whereas the Swedish CFC rules were introduced in 1990.

615. In response to the application, the Council held that the Swedish CFC rules were compatible with the tax treaty. Firstly, the Council established that the domestic law and not tax treaties determines the attribution of income to a taxpayer. Accordingly, the Swedish CFC rules could indeed

[1339] BRIGAGAO, BRUNELL, CFC, p. 19.

[1340] SSAC: X AB v Swedish Tax Agency: Case No. 2695-05, 12 ITLR 311, pp. 311-342; HILLING, CFC, pp. 455-461; BENKTSSON, JOHANSSON, Tax Avoidance, pp. 761-762. The case also deals with the compatibility of the Swedish CFC rules with EU tax law. However, this not discussed here.

attribute income to a taxpayer. Secondly, the Council considered the interaction of the CFC rules with the distributive rules in a tax treaty viz., Art. 7 (*Business profits*), Art. 10 (*Dividends*) and Art. 23 (*Other income*). In this regard, the Council excluded the application of Art. 10 as it held that the income attributed to the taxpayer was not dividend income. Nevertheless, the Council established that the CFC income could be covered by the distributive rules on "*business profits"* or "*other income"* ie by Art. 7 or Art. 23 respectively. As these Articles allow Sweden to tax the income, as it was the State of residence of the taxpayer, the tax treaty does not prevent the application of the Swedish CFC rules.

616. The taxpayer, then, appealed the decision of the Council to the SSAC ("Court"). The Court agreed with the conclusion of the Council. However, the reasoning adopted was entirely different. The Court found it unnecessary to interpret the provisions of the tax treaty to answer the compatibility issue. Instead the Court focused on the relationship between tax treaties and Swedish domestic law. Specifically, the Court held that the "*later in time"* doctrine prevails in Sweden to resolve a conflict between a tax treaty and domestic law. Thus, subsequently enacted legislation takes precedence over former legislation (*see section 4.3.4*). Accordingly, interpreting the tax treaty becomes irrelevant and the tax treaty does not restrict Sweden. The decision of the Court has been criticized as the Court did not think it was necessary to discuss the interaction of the CFC rules with the distributive rules in the tax treaty[1341].

18.4.9. 2009: Garron[1342]

617. For the facts of this case, *see section 15.4.6*. In addition to several arguments, the tax authorities argued that section 75(2) operated, more or less, as a CFC rule under which the gains of non-resident trusts were attributed to Canadian resident beneficiaries, if the latter resided in Canada. By applying these rules, the tax authorities sought to tax the gains made by the trust in the hands of the resident beneficiaries. On the contrary, the

[1341] HILLING, CFC, p. 459.

[1342] CTC: Garron and another v R; Re Garron Family Trust; Garron v R; St Michael Trust Corp v R; Re Fundy Settlement; Dunin v R; St Michael Trust Corp v R; Re Summersby Settlement, 12 ITLR 79, September 10th 2009, pp. 79-148; Followed by CFCA: St Michael Trust Corp v R; Re Fundy Settlement; St Michael Trust Corp v R; Re Summersby Settlement, 13 ITLR 400, November 17th 2010, pp.400-431.

taxpayer argued that Art. 14(4) of this treaty precluded Canada from taxing this item of income.

618. The CTC considered the issue of whether Section 75(2) could be invoked pursuant to which the gains could be attributed to the beneficiaries. The CTC held that the conditions to invoke the deemed attribution rules were not satisfied[1343]. Nevertheless, the CTC seems to have held that the provisions of Art. 14(4) would have restricted Canada from applying this deemed attribution rule even if all the conditions to invoke the deemed attribution rules had been satisfied. The Court considered that the deemed attribution rule leads to double taxation that is clearly contrary to the object and purpose of a tax treaty. The Court held that "*The position of the Minister potentially frustrates this objective, and contravenes the plain meaning of art XIV(4)"*[1344].

619. It should be noted that in this case, the tax authorities also argued that Art. 30(2) of the 1980 Canada-Barbados tax treaty which reads as follows, "*Nothing in this Agreement shall be construed so as to prevent Canada from imposing its tax on amounts included in the income of a resident of Canada according to section 91 of the Canadian Income Tax Act*", preserves the application of the deemed attribution rules. However, the CTC held that the provision only preserved the application of the Canadian CFC rules to tax treaties and not the Canadian deemed attribution rules for trusts. Therefore, "*If the drafters of the Treaty had intended an override for other attribution rules, they could have been specifically provided for it"* [1345] (this finding is discussed in *section 10.2*).

18.4.10. 2009: Glaxo Kabushiki – Japan[1346]

620. In this case, a Japanese Company ("Japanese Co" or "taxpayer") owned a Singapore Company ("Sub Co"). Sub Co was engaged in the business of producing and selling gastric ulcer medicines in Singapore, but in due course, it transferred its business to a related company. Thereafter, Sub Co sold certain stock/shares it owned and recorded a huge capital gain that was subject to tax in Singapore at a low tax rate. As per the Japanese

[1343] CTC: Paras 322-326, Garron case.
[1344] CTC: Para. 337, Garron case.
[1345] CTC: Para. 338, Garron case.
[1346] JSC: Glaxo Kabushiki Kaisha vs Director of Kojimachi Tax Office, Case No. 2008 (Gyou Hi), 12 ITLR 644, October 29th 2009, pp. 644-657; ASATSUMA, CFC, pp. 517- 525.

CFC rules, the Sub Co qualified as a CFC. Consequently, the tax authorities included the profits of the Sub Co in the taxable income of the taxpayer. The taxpayer appealed against this act of the tax authorities before the Tokyo District Court and Tokyo High Court by arguing that the Japanese CFC rules were contrary to the 1994 Japan and Singapore tax treaty ("1994 tax treaty"). However, the taxpayer lost the case on both occasions. Subsequently, the taxpayer appealed to the JSC. However, the JSC, in line with the Tokyo District and High Court ruled in favour of the tax authorities.

621. The important aspects discussed by the Court are as follows. Firstly, the Court discussed the interaction of the Japanese CFC legislation with Art. 7(1) of the 1994 tax treaty (equivalent to the OECD Model). In this regard, the Court held that Art. 7(1) is concerned with the taxation of a Singaporean enterprise that has a PE in Japan and is intended to prevent double taxation of that enterprise on its profits. It is concerned solely with taxation of that Singaporean enterprise, not the taxation of the profits in the hands of a Japanese enterprise, which is the taxpayer. Thus, as Art. 7(1) was not applicable, Japan could tax the income pursuant to its CFC rules. In arriving at this conclusion, reference was made to the OECD Commentary (the Court considered the Commentary to be a supplementary means of interpretation) on Art. 7(1) which provides that CFC rules do not conflict with tax treaties. Secondly, the Court analyzed the Japanese CFC legislation and ruled that the Japanese CFC rules were consistent with the purpose and intent of tax treaties. Towards this end, the Court provided that Japanese CFC rules do not apply to *bona fide* business activities and even if they did apply, a credit would always be provided for foreign taxes to prevent economic double taxation. Accordingly, no conflict arose with the tax treaty at stake. It is noteworthy that this judgment cites the OECD Commentary on Art. 7 in relation to CFCs. Accordingly, the Court considered that later amendments made to the OECD Commentary after conclusion of a tax treaty are relevant in the treaty interpretation process.

18.4.11. 2010: Smallwood[1347]

622. This case dealt with a "*round the world scheme*" that was prevalent in the UK tax avoidance industry. The facts of the case are as follows. The taxpayer viz., Mr Smallwood, a UK tax resident settled the shares of UK Companies in a Jersey discretionary trust for the benefit of himself and his family. At the time of settlement, the trustees (corporate trustees) were also tax residents of Jersey. As the value of the shares in the UK companies increased significantly - the taxpayer wanted the trustees to alienate the shareholding. The UK domestic tax law provided that if the alienation had taken place from Jersey then the gains from that sale would have been subject to UK capital gains tax ("CGT"). This was because, specific provisions of the domestic tax law attributed gains made by non-resident trusts to UK settlors or beneficiaries[1348]. Consequently, in order to avoid the CGT, a corporate trustee in Mauritius was appointed. Thereafter, the Mauritius trustee sold the shares and realized the capital gain. Soon afterwards (within the same tax year as applicable in Mauritius and the UK) the Mauritius trustees resigned and Mr Smallwood and his wife were appointed as trustees. The main reason for appointing Mauritius trustees was that Art. 13(4) of the 1981 UK-Mauritius tax treaty ("1981 tax treaty") provided that gains from the sale of shares is taxable in the State where the alienator is a resident[1349]. It was contended by the taxpayer that at the time of sale the trustees were residents of Mauritius for the purposes of Art. 4(1) of the tax treaty[1350]. Accordingly, by relying on the fact that the exclusive taxation right on capital gains vested in Mauritius, it was argued that the domestic deemed attribution rules did not apply. It was also contended that, even if it is held that the trustees were residents of both the UK and

[1347] UK SC: Smallwood and another v Revenue and Customs Commissioners, 10 ITLR 574, February 19th, 2008, pp. 574-627; Followed by UK HC: Smallwood and another v Revenue and Customs Commissioners, 11 ITLR 943, April 8th, 2009, pp. 943-976; Followed by UK COA: Smallwood and another v Revenue and Customs Commissioners, 12 ITLR 1002, July 8th, 2010, pp. 1002-1036.

[1348] Section 77 and Section 86, UK TCGA.

[1349] Art. 13(4) of the tax treaty provided that "*Capital gains from the alienation of any property other than that mentioned in paragraphs (1), (2) and (3) of this Article shall be taxable only in the Contracting State of which the alienator is a resident*".

[1350] Art. 4(1) provided that "*For the purposes of this Convention, the term "resident of a Contracting State" means, subject to the provisions of paragraphs (2) and (3) of this Article, any person who, under the law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. The terms "resident of the UK" and "resident of Mauritius" shall be construed accordingly*".

Mauritius, then pursuant to Art. 4(3) – the tie breaker clause which provided that in case of dual residence the tie is allocated to the State where the POEM is situated – the residence of the trust should be allocated to Mauritius as the POEM of the trust is in that State[1351]. The tax authorities contended otherwise and argued that the trust was a resident of the UK for the purposes of the 1981 tax treaty. The case went to a hearing.

623. The UK SC held that there was concurrent residence i.e. the trust was a resident of both Mauritius and UK for the purposes of the 1981 tax treaty. This was because the trust was a resident of Mauritius during the relevant taxable period (July 1st 2000 to June 30th 2001) as applicable in Mauritius and a resident of the UK in the relevant taxable period (April 6th 2000 to April 5th 2001)[1352]. Accordingly, the POEM of the trust had to be ascertained in order to determine the outcome under the tax treaty. In this respect, the UK SC then held that the POEM means the State in which "*the real top level management (or the realistic, positive management) of the trustee qua trustee is found*"[1353]. The UK SC found that the POEM of the trusts could not be considered to be in Mauritius as the "*real top level management, or the realistic, positive management of the trust, remained in the United Kingdom. We accept that the administration of the trust moved to Mauritius but in our view the 'key' decisions were made in the United Kingdom*"[1354]. This was mainly due to the fact that Mr Smallwood had retained the right to appoint the trustee to the trust and the entire tax planning scheme was devised in the UK.

624. The taxpayer appealed this decision before the UK HC. The UK HC then reversed the decision of the UK SC by stating that the case did not deal with the issue of concurrent residence but rather dealt with the issue of successive residence[1355]. It was held that the trust was initially a resident of Jersey, then Mauritius and finally the UK within a taxable period. At the time of sale the trust was a resident of only Mauritius. Accordingly, pursuant to Art. 13(4) only Mauritius could tax the gain on the sale of shares. The

[1351] Art. 4(3) provided that "*Where by reason of the provisions of paragraph (1) of this Article a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the Contracting State in which its place of effective management is situated*".
[1352] UK SC: Para. 107, Smallwood case.
[1353] UK SC: Para. 130, Smallwood case.
[1354] UK SC: Para. 140, Smallwood case.
[1355] UK HC: Para. 44, Smallwood case.

Court did not decide on the issue of the POEM as it was unnecessary since it believed that there was no issue of concurrent residence. The tax authorities appealed to the decision of the UK HC before the UK COA.

625. The UK COA reversed the decision of the UK HC and reinstated the decision of the UK SC[1356]. Essentially, the UK COA held that the trust was a resident of both Mauritius and the UK. The Court declined to accept the "*snapshot*" approach proposed by the taxpayer and held that "*It seems… unlikely that the draftsman of the model convention intended that capital gains which are to be taxable only on the basis of residence should depend exclusively on residence at the date of disposal and so exclude the rights of a contracting state to tax gains by reference to residence within the same tax year"*[1357]. This means that if a taxpayer is a resident of two contracting States within a taxable period and if the period of residence overlapped then the tie breaker provisions have to be looked into in order to determine the treaty residence of the taxpayer. With regard to the issue of POEM, the UK COA held that "*The scheme was devised in the United Kingdom by Mr Smallwood…The steps taken in the scheme were carefully orchestrated throughout from the United Kingdom… And it was integral to the scheme that the trust should be exported to Mauritius for a brief temporary period only and then be returned, within the fiscal year, to the United Kingdom, which occurred. Mr Smallwood remained throughout in the UK. There was a scheme of management of this trust which went above and beyond the day to day management exercised by the trustees for the time being, and the control of it was located in the United Kingdom*[1358].

626. The UK SC and UK COA counteracted the "*round the world*" tax avoidance scheme by a proper construction of the term "*residence*" and "*POEM*". The author agrees with the conclusion of this case. If it can be proved that a taxpayer is a resident of two or more States then the tie breaker rules have to be looked into to determine the treaty residence of the taxpayer. The treaty distributive rules will only be applied after that. However, one issue remains open. In a hypothetical situation, if it is assumed that the POEM of the trust was in Mauritius, then could it still be contended that the domestic deemed attribution rule as provided in Section 77 and Section 86, UK TCGA did not apply? In the author's opinion, from the way that the UK

[1356] UK COA: Para. 44, Smallwood case.
[1357] UK COA: Para. 40, Smallwood case.
[1358] UK COA: Para. 70, Smallwood case.

SC and the UK COA handled the case, it can be inferred that the UK would be precluded from applying its deemed attribution rule. This is because the gains would have only been taxable in Mauritius[1359]. However, this position is not clear.

18.4.12. 2011: Cia Vale do Rio Doce – Brazil[1360]

627. A Brazilian Company ("taxpayer" or "Parent Co"), owned subsidiaries in Belgium, Denmark and Luxembourg ("Sub Co's"). As per the Brazilian CFC rules, the Sub Co's qualified as CFCs. Accordingly, the tax authorities imputed the profits of these subsidiaries to the taxpayer. It should be noted that the profits of the Sub Co's were imputed to the taxpayer without taking into consideration the 1972 Brazil – Belgium tax treaty, 1974 Brazil – Denmark tax treaty and the 1978 Brazil – Luxembourg tax treaty ("tax treaties"). Among the various arguments put forth in this case, from a tax treaty perspective, the taxpayer argued that Art. 7 (equivalent to Art. 7(1) of the OECD Model) of the tax treaties restricted Brazil from taxing the income. However, the Federal Regional Court of the 2nd Region ("Court"), held that Art. 7 could not be used to prevent the CFC charge. This was because the CFC rules tax resident companies (i.e. tax foreign profits at the level of the resident company) and not foreign subsidiaries as such. This conclusion seems to be in line with the position expressed in the OECD Commentary on Art. 7.

18.4.13. 2012: Russel – Australia[1361]

628. In this case, Mr Russell, an Australian resident, ("the taxpayer") owned a New Zealand Company ("Ancath"). Ancath, which was engaged in the business of providing services, entered into an agreement with an unrelated Australian company ("Tradecorp") for the provision of the taxpayer's services. Tradecorp made payments to Ancath as per the agreement. Thereafter, from time to time, Ancath made payments (some sort of service fees) to a partnership in which the taxpayer was a partner. As per

[1359] MORTON, SKYES, Tax Avoidance, p. 812.

[1360] Federal Regional Court of the 2nd Region: Case no. 2003.51.01.002937-0. The author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported in the IBFD Tax Treaty Case Law database was referred too.

[1361] AU FFC: Russell v Commissioner of Taxation [2011] FCAFC 10, February 4th, 2011. Followed by AU HC: Anthony Whitworth Russell v Commissioner of Taxation, No B 20 of 2011, February 10th , 2012.

the Australian tax rules, the income derived by Ancath was subject to the Australian Personal Services Income rules (PSI rules). These rules, which function like CFC rules, imputed income of a personal service company in the hands of the resident taxpayer. Consequently, the tax authorities included the profits of Ancath in the taxable income of the taxpayer. The taxpayer appealed against this act of the tax authorities before the AU FFC by arguing that the PSI rules were contrary to the Australia – New Zealand ("tax treaty").

629. Firstly, it was argued that the PSI rules led to double taxation. This is because the taxpayer was subject to income taxes (in Australia) and no relief was provided with respect to taxes paid by Ancath on its profits (in New Zealand) and Ancath was subject to corporate taxes (in New Zealand) without any relief being provided for the taxes paid by the taxpayer (in Australia). Thus, double taxation arose. Secondly, it was argued that the PSI rules contravened the provisions of Art. 7 (equivalent to Art. 7 of the OECD Model) of the treaty because Ancath's income was taxed in Australia, even though the latter company had no PE in Australia. By subjecting the profits of Ancath to tax in the hands of the taxpayer, Australia was technically circumventing the provisions of the tax treaty.

630. The AU FFC ruled against the taxpayer. The Court discussed the interaction of the PSI rules with Art. 7(1) of the tax treaty. In this regard, the Court held that Art. 7(1) was concerned with the taxation of a New Zealand enterprise that has a PE in Australia and is intended to prevent double taxation of that enterprise on its profits. It is concerned solely with taxation of the New Zealand enterprise and not the taxation of the profits in the hands of an Australian resident taxpayer. As the PSI rules targeted Australian residents the provisions of the tax treaty could not be used to protect the taxpayer. The taxpayer appealed to the AU HC. However, the AU HC refused to grant special leave to the taxpayer and upheld the decision of the AU FFC.

18.5. Author's view on the case study

18.5.1. Implications under the R – T tax treaty

18.5.1.1. Attribution of income is governed by domestic law

631. As discussed previously (*see section 13.5.1.1*), the author believes that domestic tax law governs attribution of income. A State can indeed decide as to what the taxable event is, what the taxable amount is and who the taxpayer is. Accordingly, a State can attribute the income of a non-resident to its resident irrespective of the fact that such income is also attributed to the non-resident by the non-residents State of residence. This is confirmed by the fact that the distributive rules in tax treaties use undefined terms such as "*profits"* or *"income"* or "*gains"* and pursuant to Art. 3(2), reference has to be made to the domestic law of the State applying the treaty to ascertain the meaning of these terms unless the context otherwise requires. In the author's opinion, neither the "*internal context*" nor "*external context*" of a tax treaty prohibits a reference to the domestic law. "*Income*" and "*profits*" exist when a State decides to categorize an event as a taxable event and to subject the income generated by that event to tax. Therefore, the domestic law has to be referred to in order to understand who the taxpayer is, what the taxable event is and how much income is taxable. In deemed imputation rules (such as CFC rules) each State attributes income to its own resident taxpayer. Consequently, the attribution of income by each State to its own taxpayer should be seen independently as tax treaties do not interfere with such decisions. This view was expressed explicitly in the *Oyj Abp case* and the *Cia Vale do Rio Doce* cases. The author agrees with the finding of the Courts in this regard. This view is also shared by leading commentators who provide that domestic law governs the attribution of income to a taxpayer and that tax treaties do not determine independent attribution decisions[1362]. However, this view was implicitly dissented from in the *Schneider case* wherein the FSC seemed to follow the view that tax treaties can take independent attribution decisions. The view that treaties take independent attribution decisions should therefore be rejected.

[1362] LANG, CFC, pp. 53-55; AIGNER, CFC, pp. 31-34; UUSTALU, CFC, pp. 181-185; HELMINEN, CFC, pp. 204-214; RUST, CFC, pp. 267-270; FAVI, CFC, pp. 362-364; PREBBLE, CFC, p.5.

632. This being established, the author also believes that once the domestic law attributes income to a taxpayer – a tax treaty will indeed apply. Therefore, income attribution decisions, once triggered by the domestic law, are indeed affected by tax treaties. If a State has entered into a tax treaty, then the provisions of that tax treaty have to be analysed in order to understand whether the State imposing the tax can be restricted from taxing the income. In relation to domestic anti-avoidance rules that attributes income of non-residents to residents, if the State enforcing its anti-avoidance rule attributes income to a resident, it is necessary to check whether the provisions of the tax treaty between that State and the State of residence of the intermediary can prevent the former State from applying its deemed attribution mechanism.

18.5.1.2. Domestic anti-avoidance rule that recognizes the intermediary

18.5.1.2.1. Introductory remarks

633. At the outset, it is assumed that the State applying its domestic anti-avoidance rule does not consider the intermediary (CFC or any other taxpayer) as transparent for tax purposes i.e. it does not disregard the intermediary's legal personality but nevertheless imputes the intermediary's income (CFC or any other taxpayer) as "*business profits*" or "*notional income*" or "*deemed dividend*" or "*capital gains*" to a resident taxpayer based on some sort of participation in the intermediary (such as shareholder's participation in the CFC or a beneficiary's participation in a trust). In other words, the State applying its domestic anti-avoidance rule sees the income being earned by the nonresident intermediary but then imputes the non-resident intermediary's income to its own resident.

18.5.1.2.2. Imputation of business profits

634. This type of attribution, typically, arises in the context of CFC rules (see for instance the *A Oyj Abp, Schneider* or *Eagle II* cases). If CFC rules attribute the CFC's income as "*business profits*" in the hands of the resident shareholder then such legislation will have to be tested in the light of the various Articles of the OECD Model. The first Article that can be used to challenge such a CFC rule is Art. 5(7). To reiterate, Art. 5(7) provides that a subsidiary cannot be considered as a PE of its parent company because the

former is controlled by the latter. Generally, imputation of profits to a resident shareholder takes place only if such a shareholder controls the CFC. Accordingly, if a CFC's income is attributed to the resident shareholder as "*business profits*" it can be argued that such rules would be contrary to Art. 5(7). This is because the State of the Shareholder disregards the CFC and considers it as a PE and thus exercises its taxing rights vis-à-vis the PE. By doing this, the State of the shareholder disregards the independent legal existence of the CFC. The OECD Commentary does not comment on this. The only reported Court case where this issue was considered is the *Oyj Abp* case. However, the FSAC decided that in that case this provision could not be considered as the Finnish CFC legislation was attributing profits to the Finnish resident shareholder and in no way encroached Belgium's right to tax the CFC. The author agrees with this conclusion.

635. The main purpose of Art. 5 is to define the concept of PE and consequently determine if a State (for example State B) can tax the profits of the enterprise of another State (for example State A)[1363]. In other words, Art. 7(1) provides that State B cannot tax the profits of an enterprise of State A unless such an enterprise carries on business through a PE situated in State B. The focus of Art. 5 is to define a PE in order to ascertain whether or not State B can tax the profits of an enterprise situated in State A. On the contrary, with CFC legislation the focus is on the shareholder (resident of State A) to whom the income is attributed and not to determine if such a shareholder has a PE in State B. Accordingly, Art. 5(7) cannot conflict with CFC legislation as such. An economic argument can also be made to support that CFC legislation conflicts with Art. 5(7). The argument is as follows. The OECD Commentary on Art. 5 provides that the "*substance*" of a transaction should prevail over the "*form*" [1364]. So why should the substance of a piece of legislation not prevail over its form too? CFC legislation ("*form*") essentially attributes income to the shareholder, which is in substance, income of the CFC. Accordingly, such legislation ignores the CFC's legal existence and in essence treats it as a PE and exercises taxing rights vis-à-vis the PE. However, in the author's opinion this argument is far reaching as a comparison is made between the substance of a transaction and the substance of the legislation. This argument cannot be supported as the terms of the treaty do not warrant such a conclusion.

[1363] 2014 OECD Comm. Art. 5, Para. 1.
[1364] 2014 OECD Comm. Art. 5, Para. 32.1.

636. The second Article that can be used to challenge such CFC rules is Art. 7(1). The argument on the compatibility of CFC legislation with Art. 7(1) was made in the *Schneider, Oyj Abp, Eagle I, Glaxo, Cia Vale do Rio Doce and Russel* cases. In the *Schneider* case, the FSC firstly ascertained that the income that was being attributed to the shareholder was essentially the profits of the Swiss company. Then, it analyzed Art. 7(1) and ruled that the France could not tax the profits of a Swiss Company unless the Swiss company carries on business through a PE in France. A similar analysis was undertaken by the Brazilian Court in the *Eagle I* case wherein it was held that the Brazilian CFC legislation could not tax the profits of a Spanish company as the Spanish Co did not have a PE in Brazil. It seems that these Courts adopted a "*purposive interpretation*" of Art. 7(1) by considering i) the effect of the domestic CFC legislation i.e. does the legislation tax the profits of the foreign entities and ii) if so, does the treaty allow for such taxation. Once it was ascertained that the domestic CFC legislation attributed the profits of the foreign entities then Art. 7(1) was read is such a way that the foreign entities could be taxable in France or Brazil only if they carried out activities through a PE. As the PE did not exist, the States enforcing the CFC legislation were restricted. Many commentators share this view[1365]. The author disagrees with this approach because in his view the attribution of income is determined as per the domestic law. The Courts, in these cases, seem to have ignored the fact that their CFC legislation did not tax the CFC but taxed the shareholder. The shareholder and the CFC are two different taxpayers. Art. 7(1) read from the perspective of shareholder's State of residence will read as follows: "*The profits of an enterprise of a France/Brazil shall be taxable only in France/Brazil unless the enterprise carries on business in the Switzerland/Spain through a permanent establishment situated therein*". From the perspective of the CFCs "*The profits of an enterprise of a Switzerland/Spain shall be taxable only in Switzerland/Spain unless the enterprise carries on business in the France/Brazil through a permanent establishment situated therein*". The OECD Commentary, UN Commentary and the verdict pronounced in the *Oyj Abp, Glaxo, Cia Vale do Rio Doce* and *Russell* cases also support such a conclusion. In the *Oyj Abp,* the FSAC held that domestic law governed attribution decisions and hence it cannot be argued that Finland was restricted from taxing its own resident taxpayer. In the *Glaxo* case the JSC

[1365] RIX, CFC, pp. 152-164; NOGUERA, STEICHEN, CFC, pp. 422-424.

held, by referring to the OECD Commentary, that Art. 7(1) could not preclude Japan from imposing its CFC charge. This is because Japan taxed its own resident shareholder. A similar conclusion was reflected in the *Cia Vale do Rio Doce* and *Russel* cases. Accordingly, in the author's view a conflict with Art. 7(1) should not arise[1366].

637. The third Article that can be used to challenge such CFC rules is Art. 10(5), which, prohibits extra territorial taxation of dividends/undistributed profits. The issue of compatibility of CFC legislation with Art. 10(5) was raised in the *Oyj Abp* case. However, the FSAC did not consider it necessary to comment on the issue as the income that was attributed to the shareholder was a "*business profit*" and not "*dividends"*. The author believes that even if the domestic law characterizes the income as "*business profit*" and not "*dividends*", such CFC rules have to be tested against Art. 10(5). This is because the language of the provision prohibits not only extra territorial taxation of dividends but applies to undistributed profits of a company as well. As CFC rules tax the undistributed profits of the Company in the hands of the shareholder (both residing in different States) Art. 10(5) may apply. However, in the author's view, Art. 10(5) does not prohibit the application of CFC rules. This is because Art. 10(5) primarily deals with the taxation of the undistributed profits of a company and not with the taxation of the shareholder. This line of reasoning is in line with the OECD Commentary on Art. 10 and the argument that attribution decisions are governed by domestic law and not tax treaties.

638. The fourth Article that can be used to the test the compatibility of CFC regimes with tax treaties is Art. 23 of the OECD Model. It can be argued that CFC legislation leads to double taxation and hence is contrary to the provisions of Art. 23. In this regard, a difference should be made between juridical and economic double taxation. This is important as Art. 23 of the OECD Model deals only with relieving the former type of double taxation and not the latter[1367]. CFC rules may lead to economic double taxation as well as juridical double taxation. Economic double taxation can arise to the extent that the CFCs profits are taxed in the State of residence of the CFC in the name of the CFC and in the State of residence of the shareholder in the name of the shareholder and the latter State does not provide relief. Juridical

[1366] DE BROE, Thesis, p. 609.
[1367] 2014 OECD Comm. Art. 23, Paras. 1-2.

double taxation can arise when the CFC distributes its earnings to its shareholder in the form of dividends and both States i.e. the CFC's State of residence (usually through the form of a withholding tax) as well as the residence State of the shareholder taxes such dividend income (it is assumed that the State of the shareholder taxes the undistributed profits as well as the distributed profits of the CFC). It is submitted that Art. 23 does not resolve economic double taxation. Accordingly, if CFC rules lead to economic double taxation it cannot be argued that such rules are contrary to the provisions of Art. 23. This was explicitly confirmed by the FSAC in the *Oyj Abp* case. The 2015 Final TTA Report also endorses the position that Art. 23A and Art. 23B do not provide relief from economic double taxation. Towards this end, the text of Art. 23 is modified so as to read that "*Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State)…*". By adding the phrase *(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State)*, the Report clarifies that "*States are not reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer"*[1368]. Further in the *Glaxo* case, the JSC held that the Japanese CFC legislation could not be considered contrary to tax treaties because it allowed a foreign tax credit against the tax on the attributed income. So, the author submits that even if economic double taxation is not relieved pursuant to a tax treaty (and if the domestic law grants relief from such taxation) – then CFC legislation cannot be construed to be incompatible with tax treaties. However, the author believes that if CFC rules lead to juridical double taxation then a strong argument exists that such rules are contrary to Art. 23. Nevertheless, it should be noted that the State of the shareholder usually exempts the actual dividend distribution from further taxation. Moreover, relief is also provided for the withholding taxes levied by the CFC's State of residence (*see section 18.5.1.4*). Accordingly, such rules in the author's opinion do not conflict with the provisions of Art. 23.

[1368] 2015 OECD, Final Report on Treaty Abuse, Para. 64.

18.5.1.2.3. Imputation of notional income

639. This type of attribution, typically, arises in the context of CFC rules. Under such an approach, the shareholder of the CFC is taxed on an amount computed in function to the CFC's income. If CFC rules attribute the CFC's income as "*notional income*" in the hands of the resident shareholder (see for instance the *Bricom case*) then such legislation will have to be tested in the light of Art. 5(7), 7(1), 10(5), 21(1) and 23. However, in light of the discussions in the previous sections, in the author's view such CFC rules do not conflict with tax treaties. In the author's opinion, income of the CFC attributed to a resident shareholder as "*notional income*", (or even "*other income*"), will fall under the provisions of Art. 21(1) and thus the State enforcing the CFC legislation cannot be prohibited from applying its CFC charge.

18.5.1.2.4. Imputation of deemed dividend

640. This type of attribution also arises in the context of CFC rules. The first issue that arises is which provision governs the taxation of such deemed dividends. At the outset, the application of Art. 7(1) should be considered. Nevertheless, pursuant to Art. 7(4)[1369], it has to be ascertained whether other Articles of the treaty apply. As we are dealing with taxation of deemed dividends, we need to check if Art. 10 is applicable. If Art. 10 does not apply then it has to be checked if Art. 21 is applicable. The OECD Commentary on Art. 10 confirms this position wherein it states that if CFC rules attribute deemed dividends to the shareholder then the provisions of Art. 10 or 21 may apply. However, the OECD Commentary does not provide a concrete answer and leaves the question open. It should be noted that even if Art. 10 or Art. 21 applies, the State of residence of the shareholder cannot be prevented from taxing the dividends. This is because Art. 10(1) and Art. 21(1) allow the residence State of the shareholder to tax the deemed dividends. The following discussion confirms this.

641. Art. 10(1) provides that "*dividends paid by a company*" which is a resident of a State to a resident in another State may be taxed by the latter State. Art. 10(2) provides that such "*dividends*" may also be taxed in the State of the company making the distribution. Art. 10(3) defines "*dividends*". The definition is divided in three parts. It includes i) income from shares,

[1369] 2014 OECD Model, Art. 7(4); Art. 7(7) in the previous versions of the OECD Model.

'jouissance' shares or 'jouissance' rights, mining shares, founder's shares ii) income from other rights, not being debt claims, participating in profits and iii) income from other corporate rights which is subject to the same taxation treatment as income from shares by the laws of the State of residence of the distributing company. It should be noted that i) and ii) contain an autonomous definition of *"dividends"* whereas iii) requires recourse to the domestic law to ascertain if an item of income can be considered to be "*dividends"*. A question arises at this moment. Whether the definition of "*dividends"* as provided in Art. 10(3) includes deemed dividends pursuant to the CFC legislation? It has been argued that deemed dividends would fall under the autonomous part of the definition of "*dividends"*. To elaborate, i) provides that "*income from shares"* is "*dividends"*. This means that if the domestic law of the State enforcing the CFC legislation attributes to the shareholder a deemed dividend then such dividends will be covered by the autonomous part of the definition i.e. they can be considered to be "*income from shares"*. Reference need not be made to the domestic law of the State of the distributing company to ascertain the meaning of "*dividends"*. This is because the reference can only be made to the domestic law of the State of the distributing company under iii)[1370] i.e. if i) or ii) do not apply. Thus, deemed dividends can be classified under the autonomous part of the treaty definition. This would be the case, even if, the domestic law of the State of the distributing company does not include in its domestic definition of "*dividends"* such deemed dividends[1371]. This reasoning seems logical.

642. However, the author does not support this conclusion. In the author's view, deemed dividends attributed to the shareholder pursuant to the CFC legislation, do not fall under the definition of *"dividends"* because the structure of Art. 10 does not mandate such an interpretation. Art. 10 is a provision with bilateral reach. It is applicable only if dividend is paid by a company which is a resident of a State to a resident of another State. Therefore, it makes sense to check if the State of the company making the distribution classifies an item of income as "*dividends"*. If the State of company making the distribution does not classify an item of income as "*dividends"* then other Articles of the OECD Model will have to be looked into in order to characterize that item of income. In CFC legislation

[1370] iii) is considered to be a renvoi clause i.e. it refers to the domestic law of the State of the distributing company to determine whether an item of income can be considered to be "*dividends"*.

[1371] DE BROE, Thesis, p. 621.

following the deemed dividend approach, the State of the shareholder classifies the CFCs income as "*dividends*" and taxes it. The classification as dividends is not made by the State of the company making the distribution. Accordingly, in the author's view, the autonomous characterization also has to be seen and interpreted from the perspective of the State of the company making the distribution and not from the perspective of the State of the shareholder. As the provisions of Art. 10 do not apply, the author's view is that Art. 21(1) applies. Consequently, such deemed dividends will be classified under Art. 21(1).

643. Even if it is assumed that such deemed dividends are included in the autonomous part of the definition of "*dividends*" (which is not the author's view), another question arises is whether such deemed dividends can be considered to be "*paid to*" a resident of another State. The issue arises because deemed dividends in a literal sense are not "*paid to*" the shareholder. The shareholder does not receive any funds. It is, therefore, necessary, to ascertain the meaning of the term "*paid*". The word paid is not defined in the OECD Model. Accordingly, reference has to be made to the domestic law of the State applying the treaty to understand the meaning of the term – unless the context otherwise requires. The OECD Commentary defines the word paid to have "a *very wide meaning since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or by custom*"[1372]. If one reads the definition, it can be concluded that funds have to be put at the disposal of the shareholder. In CFC legislation, this is not the case. Deemed dividends are not put at the disposal of the shareholder. Accordingly, it can be argued that deemed dividends (a type of fictitious income in this case) do not fall under the Art. 10 as they are not "*paid*" to a taxpayer[1373]. This conclusion, in the author's view, is extremely narrow. This is because the historical development of the word "*paid*" indicates that the drafters wanted this term to be interpreted as broadly as possible.

644. The 1963 draft OECD Model and the 1977 OECD Model use the term "*paid*" in Articles 10, 11, 12, 15, 18, 19 and 20. The 1963 OECD Commentary did not provide a definition of the term "*paid*". Nevertheless, the definition of the term has been featured in the 1977 OECD Commentary

[1372] 2014 OECD Comm. Art. 10, Para. 7.
[1373] WATTEL, MARRES, Fictitious income, pp. 66-73.

which provides a definition of this term at several occasions [1374]. Accordingly, two questions arise here. They are i) what circumstances led to the inclusion of this definition in the 1977 OECD Commentary. Specifically, was this definition included to restrict the scope of income streams that could fit into the aforementioned Articles? or ii) it has been suggested that pure fictions (such as the deemed dividends) cannot fall within Articles 6-20. The drafters to the OECD Model should have used words such as "*imputed"* or "*attributed"* if they wanted pure fictions to be covered under Articles[1375]. Thus, the question arises here is whether the drafters considered to use different attribution terms other than "*paid"*? These two questions are analyzed below.

645. After the 1963 draft OECD Model and its Commentary was released, many OECD member countries made observations to the Commentary. These observations were collectively grouped into one document, which outlined the various issues and difficulties surrounding the draft Model, and its accompanying Commentary[1376]. In the context of Art. 10, the Belgian delegation had made an observation that it had "*made it a rule to substitute for the verb 'pay', wherever it appears in the Article, the verb 'allot' ('attribuer'), which has a wider significance as in Belgian law the event attracting tax is the allotment or putting into payment of the dividends: tax is exigible as soon as a dividend is declared, even before it is actually paid to the shareholders. This observation was also made for Article 11 (interest) and Article 12 (royalties)"*[1377]. This was the only observation made on the word "*paid"*. Subsequently, the OECD FC proposed a list of Working Parties who would deal with the various issues and difficulties surrounding the 1963 draft OECD Model and the Commentary to it[1378]. Germany and Belgium who already constituted Working Party 23 (WP 23) were responsible for clarifying issues surrounding Art. 10. Further, for the purpose of clarifying issues surrounding Arts. 11 and 12, the FC appointed France and Luxembourg who collectively formed WP No. 27 ("*WP 27*").

646. To initiate the issue analyzing and solution process, WP 27 prepared a preliminary report in order to consolidate the comments of the of the OECD

[1374] The word "*paid*" is defined in the OECD Commentary on Art. 10, 11 and 12.
[1375] WATTEL, MARRES, Fictitious income, p. 68.
[1376] Document No. TFD/FC/218.
[1377] *Ibid.*, p. 14.
[1378] Document No. TFD/FC/219.

member countries and the questions raised by them on the text and Commentary to the Articles on Interest and Royalties[1379]. In this preliminary report it was noted that the Belgian Delegation initiated the debate and proposed that the *"expression 'paid' for the purpose of Article 11(1) and 12(1) should be replaced by the term 'allotted' (attributes), on the ground that the latter term has a wider significance"*. In response, the WP 27 provided that the *"term 'to pay' is employed in the sense of the civil law and means to fulfil the obligation to put funds at the disposal of the creditor in the manner required by the contract or by custom'. In this sense the concept of payment covers all cases"*[1380]. By issuing this response it can be inferred that the WP 27 put the word *"paid"* on an equal footing with the words '*allotted*' or '*attributed*'. The working party had the choice to use different attribution terms but chose to use the word *"paid"* as a matter of convenience. Then, this point raised by the Belgian delegation was discussed by the FC in the context of Article 11[1381]. During the discussion the *"delegate for Switzerland shared the view of the Working Party that the term 'paid' was sufficiently wide to cover all cases required, but the delegate for Belgium said that in Belgium fiscal law the term 'paid' had the more restricted sense of 'payment in cash' while the delegate for Germany wondered whether the case of interest not yet paid where there existed an obligation to pay was adequately covered"*. Taking this discussion into consideration, the FC agreed to insert in the Commentary to the Article that the *"term 'to pay' means 'to fulfill the obligation to put funds at the disposal of the creditor in the manner required by the contract or by custom'*[1382]. Thereafter, the FC once again discussed this point in the context of Art. 12(1)[1383] and agreed to insert a similar paragraph in the Commentary to Art. 12[1384]. Consequently, the WP 27 in its report on the suggested amendments to Art. 11 and 12[1385] proposed that the *"term 'paid' should stand and that it be explained in the Commentary that the term 'to pay' means 'to fulfil the obligation to put funds at the disposal of the creditor in the manner required by the contract or by customs and consequently covers all forms of settlement, whether in cash, by transfer to an account, or otherwise"*'[1386]. It

[1379] Document No. FC/WP 27 (68) 1.
[1380] *Ibid.*, Para. 3 & Para. 17.
[1381] Document No. DAF/FC/(69)5.
[1382] *Ibid*., Para. 3.
[1383] Document No. DAF/FC/(69) 10.
[1384] Ibid., Para. 17.
[1385] Document No. FC/WP27(70)1.
[1386] *Ibid.*, Para. 3 & Para. 17.

is interesting to note here that a considerable amount of thought was given by the drafters to this term and the definition of pay was expanded in this amended Report to "*covers all forms of settlement, whether in cash, by transfer to an account, or otherwise"* which clearly indicates that the word "*paid*" should be interpreted as broadly as possible. Further, WP 27 once again discussed this point in its proposal for the amendment of Art. 11 and 12 [1387] and provided that the "*term 'paid' is capable of very wide construction, since the concept of 'payment' means 'the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom"*. The exact definition was then reproduced by the FC in its report on the revised Arts. 11 and 12 of the OECD Draft Convention and the Commentaries thereon[1388]. WP 23, in relation to Art. 10, then also proposed the same definition[1389]. Finally, this definition was included in the 1977 OECD Commentary and still stands today i.e. in the 2014 OECD Commentary on Arts. 10, 11 and 12.

647. Based on the above historical analysis, the answer to the first question is that the definition of the word "*paid"* was not intended to restrict the scope of income streams that could fit into Articles which use the term "*paid"*. The term should be interpreted as broadly as possible and not be interpreted literally. The answer to the second question is that the drafters indeed had the opportunity to use different attribution terms such as "*allotted"* or "*attributed"*. However, as a matter of convenience they used the word "*paid"*. Therefore, in the author's view if the domestic tax law of a State imputes a deemed dividend to the taxpayer (and assuming that the deemed dividends fall under the definition of "*dividends"* as per Art. 10(3) then Art. 10 applies. This is because the word "*paid"* merely expresses that a certain tax liability is allocated to a certain taxpayer by law [1390] (in the author's opinion, in the context of residence-source conflicts, the residence States attribution criteria should prevail – *see section 13.5.1*). Accordingly, if a CFC legislation imputes deemed dividend to the shareholder of the CFC and assuming that such deemed dividends fall under the definition of "*dividends"* as per Art. 10(3), then in the author's view such deemed dividends will be covered by the definition of Art. 10(1).

[1387] Document No. FC/WP27(70)2, p. 1.
[1388] Document No. FC/(71)1.
[1389] Document No. CFA/WP1(73)2.
[1390] LANG, Fictitious income, p. 47.

648. If Art. 10(1) applies, a question arises as to whether the State of residence of the CFC should exempt the dividends if it follows an exemption system i.e. exempts foreign source dividends pursuant to the provisions of tax treaties. The OECD Commentary on Art. 10 does not provide a satisfactory answer and leaves the issue open. Leading commentators provide that an exemption should be extended to such deemed dividends if a tax treaty exempts foreign source dividends[1391]. In principle the author agrees with this conclusion. However, the author, at the same time, believes that it makes no sense for a State to introduce a CFC legislation and then exempt the attributed income in the hands of the taxpayer, if a tax treaty requires so. But if the wording of the treaty mandates such a conclusion then such deemed dividends should be exempt. Another issue arises. Assuming that deemed dividends fall under the definition of "*dividends*" as per Art. 10(3) and consequently Art. 10(1), it needs to be analyzed whether a conflict with the provisions of Art. 10(5) may arise. As discussed before, in the author's view, a conflict with Art. 10(5) should not arise as Art. 10(5) primarily deals with the taxation of the undistributed profits of a company and not with the taxation of the shareholder. Further, Art. 10(5) clearly provides that the State of residence of the shareholder cannot be restricted from taxing the profit/income of an enterprise if it is paid to the shareholder[1392].

18.5.1.2.5. Imputation of capital gains

649. This type of attribution arises in the context of SAARs, such as, the ones discussed in the *Garron* or *Smallwood* cases. These SAARs attribute capital gains derived by non- residents to resident taxpayers. In the *Garron* case the Court explicitly ruled that Art. 14(4) – similar to Art. 13(5) of the OECD Model – precluded Canada from enforcing its deemed attribution rule. In the *Smallwood* case the issue was not explicitly analyzed[1393].

650. In the author's opinion, Art. 13(5) of the R–T tax treaty does not prevent a domestic anti-avoidance rule that imputes the gains derived by a non-resident taxpayer to a resident taxpayer. As in the case of CFCs, the resident taxpayer to whom the non-residents gains are attributed and the non-

[1391] VOGEL, Commentary, pp. 680-681.
[1392] DE BROE, Thesis, p. 626.
[1393] It is indicated that the UK tax authorities, in some situations, agree that a tax treaty precludes the deemed attribution rule. MORTON, SKYES, Tax Avoidance, p. 805.

resident are two different taxpayers. Art. 13(5), read from the perspective of the State enforcing its domestic attribution rule will read as follows: "*Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in State (R) of which the alienator (X) is a resident"*. From the perspective of the non-residents State (Corp B), the treaty will read as follows "*Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in State (T) of which the alienator (Corp B) is a resident*". Therefore, a conflict with treaty provisions does not arise.

651. It can be also be argued that such domestic anti-avoidance rules lead to double taxation and hence are contrary to the provisions of Art. 23. In this regard, a distinction should be made between juridical and economic double taxation. This is important as Art. 23 of the OECD Model deals only with relieving the former type of double taxation and not the latter[1394]. Such attribution rules lead to economic double taxation. It is submitted that Art. 23 does not resolve economic double taxation (*see section 18.5.1.2*). Accordingly, if domestic anti-avoidance rule leads to economic double taxation it cannot be argued that such rules are contrary to the provisions of Art. 23.

18.5.1.3. Domestic anti-avoidance rule that ignores the intermediary

652. This type of attribution, typically, arises in the context of GAARs (could also arise pursuant to CFC rules)[1395]. At the outset, it is assumed that the State applying its domestic anti-avoidance rule considers the intermediary as a transparent i.e. it disregards the intermediary's legal personality and attributes the activities/income derived by the intermediary directly to it (for instance see the *German* and *Austrian cases* discussed in this chapter). It can be argued that the effect of such a rule conflicts with treaty provisions such Art. 5(7), 7(1), 10(5) and 23. However, in light of the analysis carried out previously, the author believes that such rules do not conflict with treaty provisions.

653. A reference can also be made to the principles of the partnership report to justify this conclusion. Example 16 of the partnership report deals with a

[1394] 2014 OECD Comm. Art. 23, Paras. 1-2.
[1395] GARFUNKEL, CFC, p. 66.

situation where two partners (A – a resident of State P and B – a resident of State R) own interests in a partnership (P) that is a resident in State P and the income source (royalty) emanates from State P. State P treats the partnership as a taxable entity whereas State R treats the partnership as a transparent entity. In such a situation, the report provides that a conflict does not arise with treaty provisions as State R and State P are taxing their own residents[1396]. This conclusion was reflected in the OECD Commentary (since 2000) which now provides that "*Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State's right to tax the partnership on its income do not apply to restrict that other State's right to tax the partners who are its own residents on their share of the income of the partnership"* [1397]. The conclusion is also supported by the BEPS reports (*see section 8.2.3.4*).

18.5.1.4. The issue of double taxation

654. It is well established that the application of such rules leads to economic double taxation. Accordingly, the question arises as to whether State R should provide relief from corporate income tax levied by State T on Corp B (even though it is minimal). In the author's opinion, as this case resembles an economic double taxation scenario (taxation of the same item of income in the hands of separate taxpayers) it is outside the scope of a tax treaty (except in cases of economic double taxation that can be resolved under the provisions of Art. 9). Nevertheless, many States, in the context of domestic CFC rules, provide relief from economic double taxation[1398]. For instance, under the US CFC rules, a US shareholder that is a domestic corporation or an individual (on an election basis) which/who owns 10% or more of a CFC's voting stock can claim a deemed paid credit for the CFC's foreign income taxes in the same year that the shareholder is taxed on the CFC's earnings[1399]. Similarly, under the erstwhile Canadian CFC rules, when a Canadian taxpayer was attributed the CFC's income, it could claim relief for foreign taxes paid, (known as foreign accrual taxes) under a gross up and deduction approach. In broad terms, the foreign accrual taxes were grossed up by a relevant tax factor thereby giving the deduction the same

[1396] See OECD, Partnership Report, Paras. 127-129.
[1397] 2014 OECD Comm. Art. 1, Para. 6.1.
[1398] DAHLBERG, WIMAN, Passive income, p. 40.
[1399] MISEY, SCHADEWALD, US Tax, pp. 154-156.

effect as a direct credit for foreign taxes against Canadian taxes[1400].

655. Such relief mechanisms are less relevant when States apply statutory GAARs to tax the income derived by the non-resident in the hands of its resident. Thus, the author submits that statutory GAARs should contain inbuilt provisions to provide relief from economic double taxation. For example reference can be made to the UK statutory GAAR which provides that "*When tax liabilities are adjusted to reflect the counteraction of the abusive transaction by the GAAR, it will be necessary to ensure that these adjustments do not involve any element of double taxation (whether in the hands of the taxpayer who carried out the abusive transaction, or when taking account of the tax liabilities of other persons). Specific provisions are included in the GAAR to eliminate any such double taxation by allowing consequential adjustments to other tax liabilities if a counteraction of a tax advantage under the GAAR requires this to prevent a double charge arising*"[1401]. Such a provision could also be drafted in such a way that it would also apply when a judicial anti-avoidance doctrine applies to this type of transaction. Accordingly, it is submitted that the State applying its domestic anti- avoidance rule to impute the income of non-residents to its residents provides relief from economic double taxation.

656. Another question arises as to whether State R should provide relief from withholding taxes levied by State T (if any) on future dividend distributions. In the author's opinion, it is clear that State R should provide relief from any State T withholding taxes as per Art. 23 of the R-T tax treaty even if a timing mismatch arises. The position is confirmed by the OECD Commentary which provides "*The provisions of the Convention that allow the State of source to tax particular items of income or capital do not provide any restriction as to when such tax is to be levied… Since both Articles 23 A and 23 B require that relief be granted where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention, it follows that such relief must be provided regardless of when the tax is levied by the State of source. The State of residence must therefore provide relief of double taxation through the credit or exemption method with respect to such item of income or capital even though the State of source taxes it in an earlier or later year"*. For States

[1400] RICHARDSON, TKACHENKO, CFC, p. 25.
[1401] HMRC, GAAR Guidance, p. 11.

which do not agree with this outcome the Commentary provides "*Some States, however, do not follow the wording of Article 23 A or 23 B in their bilateral conventions and link the relief of double taxation that they give under tax conventions to what is provided under their domestic laws. These countries, however, would be expected to seek other ways (the mutual agreement procedure, for example) to relieve the double taxation which might otherwise arise in cases where the State of source levies tax in a different taxation year"*.

657. Nevertheless, it should be noted that the domestic law of several States provides relief from double taxation on subsequently distributed income. For instance, under the US CFC rules, on actual profit distributions, the US shareholder can exclude from income distributions of CFC earnings that were previously taxed to the US shareholder under the Subpart F provisions. Further, if any withholding taxes are levied by the CFC jurisdiction on the actual profit distributions, a US shareholder can increase its foreign tax credit limitation and take a credit of the foreign withholding taxes (to a certain extent)[1402]. Also, under the Canadian CFC rules, if any withholding taxes are levied by the CFC's jurisdiction on the actual profit distributions, the taxpayer can also claim these taxes as a deduction[1403].

18.5.1.5. Impact of the guiding principle (or PPT rule)

658. It was previously concluded that domestic anti-avoidance rule that impute income of non-residents to residents do not conflict with treaty provisions. Moreover, it would be difficult to argue that State R is restricted from applying such a measure if the R-T tax treaty contains a Saving clause (*see section 18.5.1.6*). Accordingly, the application of the guiding principle seems to be meaningless. As discussed previously (*see section 16.5.1.2*), in the author's opinion, the guiding principle acts as a restriction to the application of domestic anti-avoidance rules that deny treaty benefits to a taxpayer i.e. benefits that flow from a tax treaty. In other words, the guiding principle, which is a treaty GAAR, can be used only for denying treaty benefits. In the current situation, X – that is a resident of State R – reduces the State R taxable basis by carrying on business through an offshore entity. Thus, a State R resident seeks to avoid State R taxes without relying on a tax treaty. Put differently, the taxpayer does not abuse the provisions of tax

[1402] MISEY, SCHADEWALD, US Tax, p. 159.
[1403] RICHARDSON, TKACHENKO, CFC, p. 25.

treaties but rather abuses the provisions of domestic law (by avoiding a domestic taxing provision). In order to counteract such domestic law abuse, State R applies its domestic imputation rule. Therefore, such rules fall outside the scope of the guiding principle (or PPT rule) as the taxpayer is trying to abuse the provisions of the domestic law (income deferral) as opposed to treaty provisions.

18.5.1.6. Impact of the US type Saving clause in this treaty

659. In the previous section, it was argued that domestic anti-avoidance rules that impute income of non-residents to residents do not conflict with treaty provisions[1404]. Moreover, it would be difficult to argue that State R is restricted from applying such a measure if the R-T tax treaty contains a Saving clause (*see section 8.2.3.4*). This is because that clause reserves a State's right to tax its residents under the rules provided in the domestic laws, notwithstanding any provisions of the tax treaty[1405]. Thus, even if it is argued that a conflict arises, State R will be in a position to apply its domestic anti-avoidance rule[1406].

18.5.2. Implications under the R-S tax treaty

660. This tax treaty would be relevant when the application of the domestic anti-avoidance rule creates a direct relationship between State R and State S. This would typically arise in the situation where the State applying its domestic anti-avoidance rule considers the intermediary as transparent i.e. it disregards the intermediary's legal personality and attributes the activities/income derived by the intermediary directly to a resident taxpayer (*see section 18.5.1.3*).

661. The OECD, in the 2014 TTA and 2015 Final TTA reports, uses the principles of the partnership report as justification for applying residence State domestic anti-avoidance rules. If so, another question needs to be answered, not from the perspective of State R but, from the perspective of State S. Should State S, in the aforementioned illustration, be restricted to taxing the dividend up to zero or up to 10%? This situation resembles

[1404] LANG, CFC, pp. 53-55.
[1405] 2006 US Technical Explanation, Art. 1(4).
[1406] DE BROE/LUTS, BEPS, pp. 137-139.

Example 9 of the Partnership report[1407]. The example deals with a situation where two partners, residents of State R, own interests in a partnership (P) that is a resident in State P and the income source (dividend) emanates from State S. States P and S treat the partnership as a taxable entity whereas State R treats it as a transparent entity. In such a situation, the report provides that State S should follow the residence States attribution criteria to check the treaty entitlement of the partners or the partnership. The report concludes that the partners and partnership should be entitled to treaty benefits as they are "*liable to tax*" on the dividends for the purpose of Art. 4(1). In summary, the report provides that the attribution criterion of State S does not matter. If that logic is followed then State S should indeed be restricted to 0% as this is a case of double treaty entitlement. For a moment, assume that the State T-S tax treaty provides for a 10% tax rate and the State R-S tax treaty provided for a 0% tax rate vis-à-vis the Article dealing with dividends. Will the answer change? If the principles of the partnership report are applied here (source State follows the residence State attribution criteria) then the answer should not change and State S should be restricted to 0% (the lower rate of the R-S tax treaty should apply). However, the OECD has analyzed this issue in the framework of the 1986 BC report and has concluded otherwise[1408]. Thus, references to the partnership report can be misleading, at least, from the perspective of the State of source.

662. The question also arises as to whether State R should provide relief from withholding taxes levied by State S (if any), in accordance, with the R-S tax treaty. The opinion expressed in the 1986 BC report is that State R should not give a credit for the taxes levied in State S as the latter State is not obliged to relieve taxes under this treaty. However, the 1986 BC report concludes by stating "*it is suggested that residence countries, as a general rule, should give full credit for taxes effectively levied at source"* [1409].

663. In the author opinion, as expressed previously, even though the principles of the partnership report are controversial and have been criticized in literature[1410], the author subscribes to the position that the State of source

[1407] OECD, Partnership Report, Paras. 73-75.
[1408] OECD, Base Companies report, Para. 59.
[1409] OECD, Base Companies report, Para. 60.
[1410] For instance, Lang does not agree with the principles of the partnership report. He takes the position that the source States income attribution criteria should prevail for checking the treaty entitlement of the taxpayer. See LANG, Partnership, p. 38.

should follow the residence States income attribution criterion, at least, to resolve residence-source conflicts. This is because this approach assists in achieving the primary objective of tax treaties i.e. elimination of juridical double taxation by State R (*see section 9.2.1*).

18.5.3. The issue of treaty override

664. In the previous sections it was concluded that the domestic anti-avoidance rule, which imputes the income of non-residents to a resident, does not conflict with the treaty provisions. The question analysed here is whether the introduction of such a domestic anti-avoidance rule by the legislator (typically as a SAAR or as a part of a GAAR) or by the judiciary (typically by developing and applying a step transaction or a similar doctrine) can be considered to be treaty override?

665. Arguments have been made in academic literature that the introduction of domestic anti-avoidance rules (in particular CFC regimes[1411] or statutory GAAR's or other similar rules) after the conclusion of a tax treaty amounts to a tax treaty override. This is because the introduction of such legislation is contrary to the object and purpose of tax treaties. To elaborate it is argued that i) such rules lead to double taxation and ii) the State enforcing the new legislation acts against the "*good faith*" principle as it recaptures a taxing right that had been initially given to another State i.e. the State of residence of the CFC.

666. In relation to the first argument, in the author's opinion, such imputation rules mainly lead to economic double taxation. As a tax treaty does not resolve economic double taxation issues (except in Art. 9(2)) it cannot be argued that such rules are contrary to the provisions of a tax treaty. In relation to the second argument, the position adopted in this thesis is that a State does not exercise its obligation in "*good faith*" when it recaptures a taxing right that it had allocated to another State through a subsequent change in its domestic law. The question that arises is whether the introduction of an imputation rule leads to a recapture of a taxing right/upsets the balance in the division of taxing powers by the State enforcing the rule.

[1411] LANG, CFC, p. 57.

667. An argument can be made that such domestic anti-avoidance rules amount to treaty override. They primarily upset the allocation of taxing rights agreed in Art. 7(1), Art. 13(5) or Art. 21(1). When the State of residence of the taxpayer (State R) and the State of residence of the intermediary (State T) entered into a tax treaty they had agreed pursuant to Art. 7(1) that the "*profits of an enterprise*" of State T shall be taxable only in State T unless that enterprise maintains a PE in State R. Likewise, they agreed that capital gains under Art. 13 (except the ones referred to in Para. 1, 2, 3 and 4) shall be taxable only in State T. Similarly, according to Art. 21(1) & 21(2) they agreed that items of income of a resident of State T, "*wherever arising*", not dealt within the other distributive rules shall be taxable only in State T unless that taxpayer maintains a PE in another State to which the income could be attributable. In essence, by imputing the profits of Corp B of State T to a State R taxpayer pursuant to a domestic anti-avoidance rule (even though it is in the hands of a separate taxpayer), State R breaches its treaty obligations as it upsets the balance in the division of taxing powers as agreed in Art. 7(1), Art. 13(5) and Art. 21(1). Thus, the State imposing the imputation rule tries to tax the income of residents of another State, even though; it is in the hands of a separate taxpayer. Reference is made to the two examples of the OECD report on treaty overrides (*see section 4.4.3.2*). It should be noted that in both examples, the enactment of the new legislation by one contracting State immediately affects persons that are residents of the other contracting State ie persons who can claim the application of the relevant distributive rule before the enactment of the new legislation. In the context of imputation rules, the enactment of the new legislation by one State (State R) immediately affects persons who are residents of the other State (State T), i.e. persons who can claim the application of Art. 7(1), Art. 13(5) or 21(1) before the enactment of the new legislation. The enactment of the new legislation by the State enforcing its domestic anti-avoidance rule is sufficient to convert an exclusive right to tax (that was vested with State T) into a non-exclusive right to tax (as State R also taxes that income) although it is in the hands of a separate taxpayer. As a result, a treaty overrides occurs. However, in the author's opinion such arguments are not tenable. At the time when the State R-T treaty was concluded, State R always had a right to tax its resident taxpayer (Corp B) under the provisions of Art. 7(1), Art. 13(5) or 21(1). By introducing an income imputation rule the balance in the division of taxing powers is not disturbed. Therefore, a treaty override does not occur.

18.6. The impact of the BEPS project: Action 3 on CFCs

Action 3 of the BEPS plan[1412] deals with CFC rules. The final report provides recommendations in the form of building blocks for designing CFC rules. Essentially, building blocks with respect to i) definition of a CFC ii) CFC exemption and threshold requirements iii) definition of CFC income iv) computation of CFC income v) attribution of the CFCs income to the shareholder and vi) rules regarding the prevention of double taxation[1413]. The report provides countries with the flexibility to design their CFC rules taking into consideration their overall policy objectives. In light of the foregoing analysis in this chapter, in the author's opinion, such proposed rules do not conflict with treaty provisions.

[1412] 2015 OECD, Final Report on CFC.
[1413] 2015 OECD, Final Report on CFC, p. 9.

19. Residence State: domestic anti-avoidance rules that deem a taxpayer to alienate its assets prior to migration

19.1. The domestic anti-avoidance rule

668. In this section, the author discusses the treaty compatibility of a domestic anti-avoidance rule that is applied by the residence State pursuant to which the assets of a taxpayer are considered to be alienated prior to its migration to another State. Such a domestic anti-avoidance rule could be applied by a State to counteract tax avoidance schemes with respect to transfer or residence.

19.2. The case study fact pattern

669. Consider the following situation. X, a tax resident of State R (high tax country) owns shares in companies (which do not own immoveable property) resident in that jurisdiction. In such a case, if X sells the shares and makes a gain, tax must be paid in State R. In order to avoid these high taxes, the taxpayer migrates to a low-tax country and becomes a tax resident there (State T). Subsequently, the shares are sold. If State R and T have a tax treaty based on the OECD Model then the gains will not be taxable in R. This is because Art. 13(5) of the OECD Model provide that gains from alienation of shares are taxable only in the residence state of the alienator, which in our example, is State T.

670. As an alternative, assume that X has accumulated pension rights that were developed during his period of employment in State R. In such a case, if X receives his pension, tax must be paid in State R. In order to avoid these high taxes, the taxpayer migrates to a low-tax country and becomes a tax resident in State T. Subsequently, the pension is received. If States R and T have a tax treaty based on the OECD Model then the pensions will not be taxable in R. This is because Art. 18 of the OECD Model provides that pensions are taxable only in the residence state of the recipient, which in our example, is State T.

671. Assume that State R considers the migration of X as abusive. It applies its domestic anti-avoidance rule and deems that the taxpayer has alienated his assets/pensions rights prior to its migration. The question then arises as to whether the R-T tax treaty precludes the application of such a rule.

19.3. The OECD/UN view

672. The 2003/2014 OECD Commentary (*see section 8.2.1.7*) provides that the provisions of a tax treaty will be applied only after a domestic anti avoidance rule re-determines the taxpayer or re-characterizes an item of income. In this situation, the taxpayer is neither redetermined nor is an item of income re-characterized. The UN Commentary, without deliberating on whether such a rule conflicts with a treaty provision or not, provides that immediate exit taxes which deem the realization of the income to take place immediately before the change of residence do not conflict with tax treaty provisions[1414]. Similarly, the 2014 TTA and 2015 Final TTA report (*see section 8.2.3.4*), clarify that "*to the extent that the liability to such a tax arises when a person is still a resident of the State that applies the tax and does not extend to income accruing after the cessation of residence, nothing in the Convention... prevents the application of that form of taxation. Thus, tax treaties do not prevent the application of domestic tax rules according to which a person is considered to have realised pension income, or to have alienated property for capital gain tax purposes, immediately before ceasing to be a resident* [1415].

19.4. The view expressed in international case law

19.4.1. 1980: The Davis Case – Canada[1416]

673. This case dealt with the interaction of the Canadian exit tax regime with Art. 8 of the 1942 Canada-US tax treaty ("tax treaty"). The issue was whether Canada was precluded from taxing deemed disposals pursuant to its exit tax regime due to the tax treaty. The domestic law of Canada, since

[1414] 2011 UN Comm. Art. 1, Para. 44.

[1415] 2014 OECD, Report on Treaty Abuse, Para. 55; 2015 OECD, Final Report on Treaty Abuse, Para. 66.

[1416] CFCA: Davis vs Her Majesty the Queen, 80 DTC 6056, January 15th 1980.

1972, deemed a taxpayer to have disposed of his property immediately before ceasing to be Canadian resident. Consequently, the taxpayer was taxed on the difference between the FMV of the assets less their adjusted cost basis. At the tax treaty level, Art. 8 provided that gains derived by a resident of a State from a sale or exchange of capital assets situated in another State were taxable only in the State where the taxpayer was a resident. The clause read as follows: "*Gains derived in one of the Contracting States from the sale or exchange of capital assets by a resident or a corporation or other entity of the other Contracting State shall be exempt from taxation in the former State, provided such resident or corporation or other entity has no permanent establishment in the former State*".

674. The facts are as follows. A Canadian taxpayer ceased to be a resident of Canada and became a tax resident of the US. As the taxpayer ceased to be a Canadian resident, the tax authorities applied the domestic exit tax provisions and deemed the taxpayer to have sold his capital assets immediately before his emigration. Accordingly, the taxpayer was taxed on deemed capital gains. Being aggrieved, the taxpayer appealed before the Federal Court - Trial division but lost the case. The taxpayer then appealed to the CFCA. However the CFCA ruled against the taxpayer.

675. The main line of argument that was put forward by the taxpayer in this case was that the domestic exit tax regime conflicted with Art. 8 of the 1942 tax treaty. The conflict arose because the taxpayer was a resident of the US and the deemed disposal fell within the meaning of the expression "*sale or exchange*" as used in Art. 8. To elaborate, Art. 8 read from the taxpayer's perspective would be as follows: "*Gains derived in Canada from the sale or exchange of capital assets by a resident or a corporation or other entity of US shall be exempt from taxation in the Canada, provided such resident or corporation or other entity has no permanent establishment in the Canada"*. Therefore, as such "*sale or exchange*" was taxable only in the US ie the State of the taxpayer's new residence, Canada was precluded from taxing such gains. However, the CFCA (without discussing the issue in detail) did not agree with the taxpayer and ruled that the 1942 tax treaty did not apply because the capital gains were deemed to have arisen while the taxpayer was a resident in Canada and not after he became a resident of the US.

19.4.2. 1997: Unknown taxpayer – Germany[1417]

676. This case dealt with the interaction of the German exit tax regime with Art. 13(3) of the 1966 Germany-Belgium Tax Treaty ("1966 tax treaty")[1418]. The issue was whether Germany was precluded from taxing deemed disposals pursuant to its exit tax regime due to the 1966 tax treaty. The domestic law of Germany deemed the taxpayer to have disposed of his substantial shareholdings immediately before ceasing to be a German resident (limited immediate exit tax regime). Consequently, the taxpayer was taxed on the difference between FMV of the shares less their adjusted cost basis ie the taxpayer was taxed on the capital appreciation. At the tax treaty level, Art. 13(3) provided that "*Gains from the alienation of any other property shall be taxable only in the Contracting State of which the alienator is a resident*".

677. The facts are as follows. A German taxpayer ceased to be a resident of Germany and became a tax resident of Belgium. As the taxpayer ceased to be a German resident, the tax authority applied the domestic exit tax provisions and deemed the taxpayer to have sold his substantial shareholdings immediately before his emigration. Accordingly, the taxpayer was taxed on deemed capital gains ie capital appreciation. Being aggrieved, the taxpayer appealed before the German Court of First instance but lost the case. The taxpayer then appealed to the GFFC. However the GFFC ruled against the taxpayer. The argument put forward by the taxpayer is not apparent in the summary of the case. Nevertheless, the GFFC ruled that Art. 13(3) read from a German perspective would allow Germany to tax the capital appreciation, as the alienator is still a resident of Germany. Thus, the German domestic exit tax provisions do not conflict with the tax treaty as the deemed disposal was triggered when the individual was a German resident.

[1417] GFFC: Case 1B 108/97, December 17th 1997. The original text of the case is in German and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported in the IBFD Tax Treaty Case Law database was referred too.

[1418] The case also dealt with the interaction of the German exit charge regime with European tax law and German constitutional principles. However, this part is not discussed here.

19.4.3. 2009: Unknown taxpayer – Netherlands[1419]

678. In 2009, the DSC decided three cases which dealt with the interaction of the Dutch exit tax on substantial shareholdings (introduced in 1997) with three different tax treaties i.e. Art. 13(4) of the 1970 Dutch-Belgian tax treaty, Art. 13(4) of the 1980 Dutch-UK tax treaty and Art. 14(7) of the 1992 Dutch-US tax treaty. The issue was whether the Netherlands was restricted from taxing deemed disposals on substantial shareholdings pursuant to its exit tax regime due to the various tax treaties at stake. Since 1997, the domestic law of the Netherlands, has deemed a taxpayer to have disposed of his substantial shareholdings immediately before ceasing to be a Dutch resident. Consequently, the taxpayer was taxed on the difference between the FMV of the shares less their cost basis i.e. the taxpayer was taxed on the capital appreciation with respect to his shares. At the tax treaty level, the Capital Gains Articles in all tax treaties contained a clause similar to Art. 13(5) of the OECD Model.

679. The facts of the cases are as follows. In all three cases, the taxpayers owned substantial shareholdings in Dutch resident companies. Upon migrating from the Netherlands, the tax authorities levied the Dutch exit tax and taxed the taxpayers on the capital appreciation attributable to shares during the taxpayer's period of Dutch residence. The taxpayers opposed the charge, mainly by arguing that it was in conflict with the capital gains Articles in the tax treaties concluded by the Netherlands with Belgium, the UK and the US respectively, which were all entered into before the introduction of the Dutch exit tax.

680. After arguing the cases before the Court of Appeals, the cases finally reached the DSC. The main issue raised before the Netherlands SC was whether or not the provisions on capital gains in the tax treaties precluded the Dutch exit tax. The DSC decided in all cases that the capital gains articles of the tax treaties at stake did not prevent the Netherlands from applying its exit tax. Firstly, the DSC held that the taxpayers could not rely on the tax treaties, since the taxable gain under Dutch domestic law was

[1419] DSC: Case 07/12314; 42.701; 43.760, February 20th 2009. The original text of the case is in Dutch and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported by in the IBFD Tax Treaty Case Law database was referred too. Also, refer POTGENS, Assessments, pp. 187-188; DE BROE, WILLOQUE, Exit tax, pp. 228-231; DE BROE, Emigration taxes, p. 211; De BROE, Residence, p. 119.

deemed to have been derived before the taxpayer's emigration i.e. at a time when no treaty was applicable. Secondly, the DSC held that the Dutch exit tax might be in conflict with the "*good faith*" principle applied in interpretation of tax treaties under Art. 31(1) of the VCLT). The "*good faith*" principle will be breached if a taxing right that was allocated to a State pursuant to a tax treaty is recovered by the Netherlands pursuant to the domestic law. To this end, the DSC looked into the OECD Commentary (as the provisions on capital gains in the tax treaties at stake concerned were all based on the OECD Model) to ascertain whether deemed alienation of shares i.e. capital appreciation could also be considered as "*alienation*" for the purpose of the treaty. In this regard, the DSC deduced from the OECD Commentary on Art. 13 that the reference to "*gains*" as used in these Articles would not preclude a State from deeming as taxable income capital appreciation that is not realized by alienation i.e. the Netherlands is allowed to tax deemed dispositions. In the DSC's opinion, the Dutch exit tax was aimed at no more than taxing the increase in the value of the shares during the period of shareholders residence in the Netherlands. Furthermore, double taxation was avoided by a reverse credit. Therefore, the exit tax did not breach the "*good faith*" principle. In the author's opinion, the Dutch exit tax did not result in a change of allocation of taxing rights. As such it could not be considered a treaty override.

19.4.4. 2009: Unknown taxpayer – Netherlands[1420]

681. In 2009, the DSC also heard three cases which dealt with the interaction of the Dutch exit tax on pensions with three different tax treaties ie Art. 15(1) and Art. 18 of the 1973 Dutch-French tax treaty, Art. 16(1) and Art. 19(1) of the 1978 Dutch-Korean tax treaty and Art. 15(1) and Art. 18(1) of the 1989 Dutch-Philippines tax treaty. The issue was whether the Netherlands was restricted from applying its exit tax on pensions due to the various tax treaties at stake. The domestic law of Netherlands, has provided since 2001, provided that upon emigration of a Dutch resident taxpayer, who has received pension rights in the Netherlands due to his employment, an exit tax is applicable on the FMV of the pension rights accumulated in the Netherlands. The amount was deemed to have been paid before the

[1420] DSC: Case No. 43.978; 07/13267; 08/02288, June 19th 2009. The original text of the case is in Dutch and the author did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported in the IBFD Tax Treaty Case Law database was referred too. Also, refer POTGENS, Assessments, pp. 187-188.

taxpayer's transfer of residence and was classified as income from employment for domestic law purposes. At the tax treaty level, the pension article in all tax treaties contained a clause similar to Art. 18 of the OECD Model, which, provided that pension income derived by a resident of a State is taxable only in that State.

682. The facts of the case are as follows. In all three cases, the taxpayers were Dutch residents who had accumulated pension rights while working in the Netherlands. The pension rights included the previously paid contributions and the income derived from the contributions investments. Upon migrating from the Netherlands, the tax authorities levied the Dutch exit tax on pension rights and taxed the taxpayers on the FMV of the pension rights on the basis that it was considered to be income from employment. The taxpayers opposed the charge, by arguing, mainly that it was in conflict with the Articles dealing with Pensions in the tax treaties concluded by the Netherlands with France, Korea and the Philippines. All of these tax treaties were concluded before the introduction of the Dutch exit tax on pensions.

683. After arguing the cases before the Court of Appeals, the cases finally reached the DSC. The main issue raised before the Netherlands SC was whether or not the Dutch exit tax was precluded by the provisions on pensions in the tax treaties. The DSC decided in all cases that the pension articles of the tax treaties at stake prevented the Netherlands from applying its exit tax. Firstly, the DSC held that the taxpayers were precluded from relying on tax treaties due to the fact that they were residents of the Netherlands when the tax was applicable. Nevertheless, secondly the DSC held that the Dutch exit tax was in conflict with the "*good faith*" principle applied in the interpretation of tax treaties under Art. 31(1) of the VCLT. The "*good faith*" principle would be breached if a taxing right that was allocated to a State pursuant to a tax treaty was recovered by the Netherlands pursuant to its domestic law. To this end, the DSC held that the deeming provision re-characterized the pension income as employment income. The re-characterization permitted the Netherlands to tax that income as employment income under the relevant tax treaties. Therefore, as the Netherlands had recaptured a taxing right allocated to another State, in the DSC's opinion, the Dutch exit tax on pensions breached the "*good faith*" principle. Importantly, the Court stated that the taxing rights over pension income were exclusively vested in the State of residence. The deeming provision not only allowed the Netherlands to tax the previously paid

contributions but also the income that was generated from the invested contributions. Accordingly, it was incompatible with tax treaties[1421].

19.4.5. 2012: Tradehold – South Africa[1422]

684. This case dealt with the interaction of the South African exit tax regime, applicable to companies, with Art. 13(4) of the 1998 South African-Luxembourg tax treaty ("1998 tax treaty"). The issue was whether South Africa was restricted from applying its immediate exit tax on companies due to the tax treaty at stake. A company is considered to be a resident of South Africa if it is either incorporated in South Africa or if its POEM is in South Africa. Prior to February 2003, the domestic law definition of "*residence*" for companies was worded in such a way that if a company was incorporated in South Africa but effectively managed in another Country, then the company would still be regarded as a South African tax resident. The position would be the same even if a tax treaty allocated the residence of this company to another State pursuant to the treaty tie breaker rules. With effect from February 2003 an amendment was made to the domestic definition of "*residence*". It was provided that a person, otherwise meeting the tests of residence, will not be a resident of South Africa if that person is deemed exclusively to be a resident of another country for the purposes of the application of any tax treaty. This meant that if a company was incorporated in South Africa but effectively managed in another Country, it would not be considered to be a South African tax resident under the domestic law, if a tax treaty allocated treaty residence to another country. In these situations, when the company ceased to be a South African resident, the exit tax was triggered. The exit tax deemed the company to have disposed of all its property at FMV. At the tax treaty level, Art. 13(4) provided that "*Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3, shall be taxable only in the Contracting State of which the alienator is a resident*".

685. The facts of the case are summarized as follows. A South African incorporated company ("taxpayer") was an investment holding company. The sole asset of the taxpayer comprised of a 100% interest in another company, which, in turn, owned 100% of a Guernsey company,

[1421] SADA, Domestic law, section 2.1.

[1422] SSCA: Commissioner for the South African Revenue Service v Tradehold Ltd, Case No: 132/11, May 8th 2012; MAZANSKY, Exit tax, pp. 374-376.

which, in turn, owned 65% of a UK Company. In July 2002 the taxpayer's board of directors met in Luxembourg and resolved that all future meetings would be held in that country. Consequently, the taxpayer became a tax resident of Luxembourg from July 2002 onwards for the purpose of the domestic tax law of Luxembourg and Art. 4(3) of the tax treaty (Art. 4(3) provided that for dual resident companies the tie broke to the country where the company was effectively managed). However, as the Company was incorporated in South Africa it was still considered to be a South African tax resident. Accordingly, the exit tax did not apply. The position changed from February 2003 onwards and the taxpayer was not considered to be a South African tax resident anymore due to the change in the domestic definition of "*residence*". As the taxpayer ceased to be a resident of South Africa the tax authorities applied the exit tax and deemed the taxpayer to have sold his asset. Being aggrieved the taxpayer brought the case before the SATC.

686. The main argument advanced by the taxpayer before the SATC was that when the taxpayer was subject to a tax on the deemed disposal i.e. the exit tax, the taxpayer was already a resident of Luxembourg for the purposes of the domestic law and the tax treaty. Accordingly, pursuant to Art. 13(4) of the tax treaty such deemed disposals were taxable only in Luxembourg. Consequently, South Africa was restricted from taxing such deemed gains. In response, the tax authorities argued that the word "*alienation*" as used in Art. 13(4) included only actual disposals and not deemed disposals. After taking into consideration the arguments put forward by both parties, the SATC held that the word "*alienation*" includes deemed disposals too. As the taxpayer was already a resident of Luxembourg at the time when the deemed disposal arose, South Africa was restricted from taxing the gain pursuant to Art. 13(4) of the tax treaty.

687. The tax authorities appealed the decision of the SATC and brought the case before the SSCA. The SSCA, in line with the SATC decision, ruled in favour of the taxpayer. Firstly, the SSCA held that the South African exit tax fell within the meaning of Art. 2 of the tax treaty which deals with "*Taxes Covered*". Then the SSCA held the word "*alienation*" as used in Art. 13(4) was not defined in the tax treaty. Accordingly, reference had to be made to the domestic law. Nevertheless, the SSCA held that the "*term 'alienation' as it is used in the DTA is not restricted to actual alienation. It is a neutral term having a broader meaning, comprehending both actual and deemed*

disposals of assets giving rise to taxable capital gains"[1423]. Consequently, the SSCA held that as the taxpayer was already a resident of Luxembourg when the alienation took place, such alienation would only be taxable in Luxembourg.

19.5. Author's view on the interaction with treaty rules[1424]

19.5.1. Implications under the R – T tax treaty

19.5.1.1. Treaty entitlement

688. Art. 1 of the OECD Model provides that a tax treaty applies to persons who are residents of one or both of the Contracting States. It is clear from the text of the provision that it is sufficient that a person is a resident of one State in order for the tax treaty signed by that State to be applicable to him[1425]. In other words, the Article does not mandate that a tax treaty applies only in cross-border situations. However, it has been submitted that tax treaties are applicable only in cross-border situations. Immediate exit taxes that deem a taxpayer to alienate its assets prior to its migration are applicable when there is no cross-border situation i.e. when the taxpayer is still a resident of the emigration State. Accordingly, such taxes fall outside the scope of a tax treaty[1426]. In response, other commentators believe that this line of reasoning is incorrect. They submit that it is sufficient that a person is a resident of the State imposing the immediate exit tax to make all the tax treaties signed by that State applicable to it[1427]. The author does not agree with the conclusion that for a tax treaty to be applicable – a cross-border situation is required. In the author's view, a tax treaty is applicable to a person as long as that person is resident of a State. This is in accordance with

[1423] SSCA: Para. 25, *Tradehold case*.

[1424] The author has published this analysis in the Bulletin for International Taxation. The author has explicitly agreed with the editor of the Bulletin for International Taxation that this analysis can be used for the purpose of his doctoral thesis. See CHAND, Exit charges, Section 4.

[1425] 2014 OECD Comm. Art. 1, Para. 1.

[1426] DE BROE, Residence, p. 119.

[1427] CEJIE, Exit tax, p. 385.

the provisions of Art. 1[1428]. Accordingly, it cannot be argued that as there is no cross-border situation a tax treaty does not apply to a domestic anti-avoidance rules that deems a taxpayer to alienate its assets/receive its pension rights prior to its migration. Thus, the author does not agree with the remarks of the DSC in the exit tax cases on shares and pensions.

19.5.1.2. Taxes covered

689. Art. 2 deals with the "*Taxes Covered*". In a general way, Art. 2(1) provides that a tax treaty shall apply to "*taxes on income and capital"* imposed on behalf of a State or its political subdivisions or local authorities[1429]. This provision is to be read in conjunction with Art. 2(2) as it elaborates on the definition of taxes on income and capital[1430]. In this respect, Art. 2(2) broadly provides that "*taxes on income and capital*" include all i) taxes imposed on total income ii) taxes imposed on total capital iii) taxes imposed on elements of income or capital iv) taxes on gains from the alienation of moveable or immoveable property, v) taxes on the total amount of wages or salaries paid by enterprises and vi) taxes on capital appreciation[1431]. Further, Art. 2(3) provides a blank list that signatories to a tax treaty are required to fill in. It should be noted that Art. 2(3) merely provides a non-exhaustive list. Accordingly, even if Art. 2(3) does not cover a tax, it may, nevertheless fall under the provisions of Art. 2(1) and 2(2)[1432]. Finally, Art. 2(4) provides that the tax treaty also applies to identical or substantially similar taxes that are imposed after the date of signature of the tax treaty in addition to, or in place of, the existing taxes[1433].

690. In line with the argument on Art. 1, it has been submitted that immediate exit taxes fall outside the scope of Art. 2(1) and Art. 2(2) because an exit tax is a tax that is applicable in relation to a domestic transaction. To elaborate, as immediate exit taxes are assessed just before a change in

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[1428] HATTINGH, Art. 1, pp. 215-221. The author provides the historical development of Art. 1 and its application.

[1429] Art. 2(1) provides that "*This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied"*. 2014 OECD Model. Art. 2, Para. 1.

[1430] 2014 OECD Comm. Art. 2, Para. 3; BRANDSTETTER, Art. 2, p. 29.

[1431] 2014 OECD Model. Art. 2, Para. 2.

[1432] BRANDSTETTER, Art. 2, pp. 30-31.

[1433] 2014 OECD Model. Art. 2, Para. 4.

residence occurs, it is argued that at the time of imposition of the exit tax the taxpayer is a resident only of the country imposing the tax and not of any other State. So the levy of an exit tax cannot be in conflict with a tax treaty since the tax treaty does not apply[1434]. Conversely, it has been argued that taxes on unrealized gains fall under the broad description of Art. 2(1) and Art. 2(2). Accordingly as immediate exit taxes represent a tax on an unrealized gain they fall under the expressions "*taxes on capital appreciation*"[1435]. It can also be argued that they fall under the expression "*taxes on total income*" as the concept of income is extremely broad and can include unrealized gains[1436]. Furthermore, it can also be argued that they fall under the expression "*taxes on gains from alienation of moveable or immoveable property*". This is due to the fact that the term "*alienation*" includes capital appreciation[1437]. However, it cannot be argued that they fall under the expression "*taxes on capital"* as they are not levied on the value of the property but are levied on the increase in the value[1438]. In the author's view, immediate exit taxes on unrealized gains fall under the broad description of taxes outlined in Art. 2(1) read with Art. 2(2). They can be classified under "*taxes on total income*" or "*taxes on capital appreciation*". This position is also confirmed by the SSCA in the *Tradehold* case. Even though the 1998 South-African Luxembourg tax treaty did not have a clause similar to Art. 2(1) and Art. 2(2) of the OECD Model, the SSCA held that the South African exit tax fell under the broad description of the South African "*normal tax*" as provided in Art. 2(1)(b) of the tax treaty[1439]. Similarly, in the author's view, immediate exit taxes on pension claims fall under the heading of "*taxes on total income*" for the purposes of Art. 2(1).

19.5.1.3. Interaction with the distributive rules

19.5.1.3.1. Immediate exit taxes on capital gains

691. Art. 13 of the OECD Model provides for allocation of taxing rights for capital gains. Accordingly, it could be reasonable to assume that the provisions of Art. 13 should be taken into account when analyzing immediate exit taxes as these taxes are levied on the appreciated gains of a

[1434] CEJIE, Exit tax, p. 386; DE BROE, Exit charge, p. 65.
[1435] SIMONTACCHI, Capital gains, p. 191.
[1436] HOLMES, Concept of Income, p. 379.
[1437] 2014 OECD Comm. Art. 13, Para. 7.
[1438] SIMONTACCHI, Capital gains, p. 188; BRANDSTETTER, Art. 2, p. 96.
[1439] SSCA: Para. 22, *Tradehold case*.

taxpayer before his emigration. Specifically, Art. 13(5) of the OECD Model applies. The provision provides that gains derived from "*alienation*" of any property, except the ones covered in paragraphs 1, 2, 3 and 4 shall be taxable only in the State of which the alienator is a resident. It should be noted that Art. 13(5) (and also the other paragraphs of Art. 13) uses the term "*alienation*". The word "*alienation*" is not defined in the OECD Model. Accordingly, recourse can be made to the domestic law of the State applying the treaty, pursuant to Art. 3(2), in order to understand the meaning of the term "*alienation*" unless the context of the treaty requires a different meaning. It has been argued that Art. 13(5) does not cover immediate exit taxes. This is because immediate exit taxes do not involve alienation in the strict sense i.e. transferring of property from a transferor to a transferee. Therefore, they fall outside the scope of Art. 13. Accordingly, it is important to ascertain if the term "*alienation*" includes a transaction that does not involve a transfer of property from a transferor to a transferee.

692. Commentators are divided in their opinion as to whether the term "*alienation*" includes capital appreciation/appreciated gains. Some author's agree that the term "*alienation*" is broad enough to cover capital appreciation[1440]. However, other author's disagree on this point and provide that Art. 13 does not apply to an exit tax which taxes appreciated gains[1441]. The OECD Commentary is silent on this issue. Since 1977, the OECD Commentary in a non-exhaustive manner, defines "*alienation*" to include a list of transactions that entail the transfer of property from a transferor to a transferee[1442]. Nevertheless, the OECD Commentary also recognizes that the many countries tax capital appreciation even though there is no alienation in the strict sense[1443]. The OECD Commentary illustrates this by providing

[1440] SIMONTACCHI, Capital gains, p. 191.

[1441] DE BROE, Exit charge, p. 65; MAN, ALBIN, Exit tax, p.617; CARRAMASCHI, Exit tax, p. 285; CEJIE, Exit tax, p. 388; WEIZMAN, Exit tax, pp. 78-80; KORT, Exit tax, p. 104; BRANDSTETTER, Art. 2, p. 96.

[1442] The OECD Commentary provides that "*The words "alienation of property" are used to cover in particular capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death*". 2014 OECD Comm. Art. 13, Para. 5.

[1443] The OECD Commentary provides that "*As a rule, appreciation in value not associated with the alienation of a capital asset is not taxed, since, as long as the owner still holds the asset in question, the capital gain exists only on paper. There are, however, tax laws under which capital appreciation and revaluation of business assets are taxed even if there is no alienation*". 2014 OECD Comm. Art. 13, Para. 7.

examples and concludes that a tax treaty covers taxes on capital appreciation as these taxes fall under Art. 2[1444]. Further, in relation to the treaty regime applicable to capital appreciation, the OECD Commentary provides that the treaty regime applicable to realized gains should also apply to taxes on capital appreciation[1445]. Accordingly, it could be argued that exit taxes are covered by Art. 13. However, the OECD Commentary at the same time provides that in addition to Art. 13, the provisions of Art. 6, Art. 7 and Art. 21 are relevant to deal with capital appreciation[1446]. Therefore, the OECD Commentary does not provide a clear answer to the issue at stake.

693. In the author's view, the distributive rule applicable to immediate exit taxes (on assets) is Art. 13(5) of the OECD Model. The author believes that the term "*alienation*" should be interpreted as per the domestic law of the State applying the tax treaty. If the domestic law classifies emigration as a taxable event ie "a*lienation*" and taxes the taxpayer on his appreciated gains, then in the author's view, such a tax on deemed disposals would fall under Art. 13(5). Reliance is placed on the judgments issued by the DSC and the SSCA. In the Dutch decision, the DSC seems to have referred to the OECD Commentary to conclude that unrealized gains are covered under the term "c*apital gains*". Likewise, in the *2012 Tradehold* case, the SSCA clearly ruled that a deemed disposal fell under the "*capital gains*" Article even though, due to the peculiar facts of the case, it was held that South Africa

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[1444] The OECD Commentary provides that "*Special circumstances may lead to the taxation of the capital appreciation of an asset that has not been alienated. This may be the case if the value of a capital asset has increased in such a manner that the owner proceeds to the revaluation of this asset in his books. Such revaluation of assets in the books may also occur in the case of a depreciation of the national currency. A number of States levy special taxes on such book profits, amounts put into reserve, an increase in the paid-up capital and other revaluations resulting from the adjustment of the book-value to the intrinsic value of a capital asset. These taxes on capital appreciation (increment taxes) are covered by the Convention according to Article 2.*" 2014 OECD Comm. Art. 13, Para. 8.

[1445] The OECD Commentary provides that "*Where capital appreciation and revaluation of business assets are taxed, the same principle should, as a rule, apply as in the case of the alienation of such assets. It has not been found necessary to mention such cases expressly in the Article or to lay down special rules*". 2014 OECD Comm. Art. 13, Para. 9, 1st sentence.

[1446] The OECD Commentary provides that "*The provisions of the Article as well as those of Articles 6, 7 and 21, seem to be sufficient. As a rule, the right to tax is conferred by the above-mentioned provisions on the State of which the alienator is a resident, except that in the cases of immovable property or of movable property forming part of the business property of a permanent establishment, the prior right to tax belongs to the State where such property is situated*". 2014 OECD Comm. Art. 13, Para. 9, 2nd and 3rd sentence.

was restricted from applying its exit tax. Consequently, when Art. 13(5) is read from the perspective of the State imposing its exit tax regime, it cannot be argued that this State cannot levy its exit tax. This is because the article expressly allows the residence state of the taxpayer to levy a tax on capital gains, even if this amounts to a tax on appreciated gains.

694. It should be noted that even if it is argued that Art. 13(5) does not apply, the other distributive rules that will be applicable are Art. 7(1) or Art. 21(1). However, the outcome will be similar as the State applying its exit tax will not be restricted from taxing the taxpayer as both Art. 7(1) and Art. 21(1) allocate taxing rights to the residence State of the taxpayer. In an immediate exit tax scenario, this will be the emigration State.

19.5.1.3.2. Immediate exit taxes on pension claims

695. Art. 18 of the OECD Model provides rules for allocation of taxing rights for pensions. Accordingly, it could be reasonable to assume that the provisions of Art. 18 should be taken into account when analysing immediate exit taxes on pensions as these taxes are levied on the FMV of the pension rights of a taxpayer before his emigration. Art. 18 of the OECD Model provides that "*pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State*" [1447]. The Article provides that pensions "*paid to*" a resident shall be taxable only in the State of which the recipient is a resident. The phrase "*paid to*" is not defined in the OECD Model. Accordingly, recourse can be made to the domestic law of the State applying the treaty, pursuant to Art. 3(2), in order to understand the meaning of the term ""*paid to*" unless the context of the treaty requires a different meaning. It could be argued that Art. 18 does not cover immediate exit taxes on pensions. This is because pensions have not been "*paid to*" a resident. Thus, the tax falls outside the scope of Art. 18. Accordingly, it would be important to ascertain if the term "*paid to*" includes a transaction that does not involve an actual payment to the taxpayer. As established previously (*see section 18.5.1.2.4*), the term "*paid to*" should be interpreted as broadly as possible and not be interpreted literally. Therefore, in the author's view if the domestic tax law of a State deems a taxpayer to receive pension income then Art. 18 applies even though there is no actual payment. Consequently, when Art. 18 is read from the perspective of the State imposing its exit tax regime, it cannot be

[1447] 2014 OECD Model, Art. 18.

argued that this State cannot levy its exit tax on pensions. This is because the provision expressly allows the residence state of the taxpayer to levy a tax on pensions, even if, the levy is a tax on built up pension rights. It should be noted that even if it is argued that Art. 18 does not apply, the other distributive rule that will be applicable is Art. 21. However, the outcome will be similar as the State applying its exit tax will not be restricted from taxing the taxpayer as Art. 21(1) allocates taxing rights to the residence State of the taxpayer. In an immediate exit tax scenario, this will be the emigration State.

19.5.1.4. The issue of double taxation

696. *The issue of double taxation is illustrated only by discussing immediate exit taxes that deem a taxpayer to have alienated its assets prior to its migration. The analysis would be similar for immediate exit taxes that deem a taxpayer to have received its pension rights prior to migration.*

697. Arguments have been made in academic doctrine that the levy of an immediate exit tax conflicts with the provisions designed to eliminate double taxation in a tax treaty[1448]. This is because immediate exit taxes lead to double taxation i.e. if the emigration State applies the exit tax on unrealized gains and the new State of residence applies a tax on realized gains. A non-concurrent timing mismatch arises which can be explained with the following case.

698. In the tax year 2000, X (a taxpayer who is an individual or a company) a tax resident of State R, purchases shares in PQR Corporation which is also a tax resident of State R. The purchase price for the shares is USD 100. In the tax year 2005, X migrates to State T and become a tax resident of State T. The value of the shares at the time of migration is USD 300. In the tax year 2007, the value of the shares increases to USD 500. At this point of time, X decides to sell his shares. Assume that State R and State T tax capital gains at the time of sale according to their domestic tax law. The tax is levied on the difference between the sale price and the purchase price of the shares. Further, in order to combat abusive taxpayer migrations, State R applies an immediate exit tax regime. Also, State R and State T have concluded a tax treaty ("A-B treaty") based on the OECD Model.

[1448] DE BROE, Exit charge, p. 66; CARRAMASCHI, Exit tax, p. 285; CEJIE, Exit tax, p. 388; WEIZMAN, Exit tax, p. 79; KORT, Exit tax, pp. 104-105.

699. When X migrates, State R will levy its domestic capital gains tax on the difference between the FMV of the shares at the time of migration and the purchase price. Accordingly, State R will tax the gain of USD 200. Further, when X sells the shares when he is a resident of State T, he will once again be taxed on the difference between the FMV of the shares at the time of actual disposal and the initial purchase price. Accordingly, State T taxes the gain of USD 400. State R will not be able to tax the gain at the time of disposal because Art. 13(5) of the A-B tax treaty will prevent State R from taxing the gain. On a careful observation, it is obvious that due to the levy of tax upon emigration, State R has already taxed the difference between USD 300 (value upon emigration) and USD 100 (value upon acquisition of shares) equalling USD 200. This amount is also included in the gain taxed in State B. Consequently, double taxation occurs.

700. The situation is worse for the taxpayer when a third country is involved (It is assumed that all States have concluded tax treaties based on the OECD Model). All facts remaining the same, assume that X owns an immoveable property in State S instead of a Company in State R. Also, let us assume that State S taxes gains on immoveable property when it is sold according to its domestic law. In this situation, when X migrates, State R will levy its exit tax on the difference between the FMV of the immoveable property at the time of migration and the purchase price. Accordingly, State R will tax the gain of USD 200. Further, when X sells the immoveable property, State T and State S will tax the difference between the FMV of the immoveable property at the time of actual disposal and the initial purchase price with the effect that State T will provide relief for taxes levied in State S. To a certain extent, this will result in multiple taxation. Thus, immediate exit taxes are contrary to tax treaties. On the other hand, it has been submitted that immediate exit taxes lead to non-concurrent residence-residence conflicts and since such conflicts are not solved by Art. 23(A) or Art. 23(B) of the OECD Model[1449] they do not contravene the provisions of Art. 23.

701. The OECD identified this issue when it came out with its 2004 Report on ESOPs. The 2004 ESOP Report provided that Art. 23 solves only residence-source conflicts and it does not provide relief for cases involving residence-residence double taxation. It further outlined that the risks of

[1449] CARRAMASCHI, Exit tax, p. 285; CEJIE, Exit tax, p. 388.

multiple taxation may occur in case of countries that have an immediate exit tax regime[1450]. Consequently, as a result of the above report, the OECD Commentary to Art. 23[1451] was changed in 2005 to solve the risk of double or multiple residence conflicts. Surprisingly, the part of the ESOPs report on departure taxes was not inserted into the OECD Commentary. Nevertheless, the OECD Commentary provided solutions to avoid multiple residence taxation for ESOPs. In a bilateral situation, the OECD Commentary proposed that a residence-residence conflict should be to transformed into a regular residence-source conflict[1452]. In a triangular situation, the OECD Commentary suggested that the two States claiming taxation as State of residence should use the MAP to solve the issue[1453].

702. Further, in light of the BEPS initiative, the OECD refers to its suggestions made in the context of ESOPs and recommends that taxpayers resolve double taxation issues, in the context of immediate exit taxes, by invoking the MAP[1454]. It is stated that *"a possible basis for solving double taxation situations arising from the application of departure taxes would be for the competent authorities of the two States involved to agree, through the mutual agreement procedure, that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the income that accrued while the person was a resident of that other State. This would mean that the new State of residence would provide relief for the departure tax levied by the previous State of residence on income that accrued whilst the person was a resident of that other State, except to the extent that the new State of residence would have had source taxation rights at the time that income was taxed (i.e. as a result of paragraphs 2 or 4 of Article 13). States wishing to provide expressly for that result in their tax treaties are free to include provisions to that effect"* [1455].

703. In the author's view, it is true that tax treaties solve residence-source conflicts[1456]. They also solve concurrent residence-residence conflicts by converting them into residence-source conflicts pursuant to treaty tie breaker

[1450] OECD, ESOP Report, Para. 37.
[1451] 2014 OECD Comm. Art. 23, Para. 4.1.
[1452] 2014 OECD Comm. Art. 23, Para. 4.2.
[1453] 2014 OECD Comm. Art. 23, Para. 4.3.
[1454] 2014 OECD, Report on Treaty Abuse, Para 56; 2015 OECD, Final Report on Treaty Abuse, Para. 66.
[1455] 2014 OECD, Report on Treaty Abuse, Para. 57.
[1456] 2014 OECD Comm. Art. 23, Para. 3.

rules as found in Art. 4(2) and 4(3) of the OECD Model[1457]. However, a tax treaty (containing Art. 23A or 23B of the OECD Model) does not solve a non-concurrent residence-residence conflict. Immediate exit taxes lead to a non-concurrent residence-residence conflict. Accordingly, the provisions of a tax treaty cannot be invoked to resolve this type of double taxation.

704. The solutions proposed by the OECD in the context of ESOPs are indeed welcome. However, in the author's view the solutions proposed for taxation of employment income cannot be applied to emigration taxes. This is because the scope of Art. 15(1) is different from the scope of Art. 13(5). Art. 15(1) allocates taxing rights based on the place where the employment is exercised. However, no such rule exists for Art. 13(5) i.e. allocation of taxing rights does not depend on where the taxpayer had his residence when the appreciation in value occurred. As a result, the taxpayer can resolve double taxation issues only pursuant to the MAP as provided in Art. 25(3)[1458]. Therefore, if a tax treaty follows the OECD Model then double taxation arising from a non-concurrent residence-residence conflict will not be solved unless and until a MAP is invoked, which is usually time consuming.

705. In the author's opinion, three possible solutions are feasible to solve such double taxation issues. Firstly, the emigration State (the State applying its exit tax) can resolve double taxation unilaterally by providing reverse credits. Secondly, the emigration State could ensure that it adopts a tax treaty policy to negotiate and insert step up clauses in its tax treaties. The logic behind a step up clause is that the immigration State will tax only the post emigration increase in the value of the property. Lastly, the immigration State, can resolve double taxation issues unilaterally by providing a step up in the value of the assets for an inbound taxpayer. However, this solution is not discussed here as it does not involve the emigration State.

706. Firstly, the emigration State could consider providing reverse credits. For instance, Canada, under its domestic law, provides for a reverse credit with regard to its general exit tax. The credit is limited to the foreign tax paid in respect of the pre-emigration appreciation[1459]. The Netherlands also

[1457] 2014 OECD Comm. Art. 23, Paras. 3- 4.
[1458] CEJIE, Exit tax, p. 389.
[1459] Section 126(2.21), CITA; CAMPBELL, Exit charge, pp. 47-52; DYER, YAGER, Exit charge, p. 196.

provides a reverse credit, but this is limited to the income tax imposed by the immigration state with regard to that part of the gain that was subject to the Netherlands exit tax[1460]. To a great extent, reverse credits assist in the elimination of double taxation. Accordingly, this solution can be adopted by states imposing immediate exit taxes.

707. Secondly, a step-up could be provided in the immigration State. A step-up in the immigration country may be available for a taxpayer if the emigration state negotiates step-up clauses in its tax treaties or the immigration state provides for a step- up unilaterally. The author discusses these solutions separately.

708. Canada, in its treaty policy, tries to ensure that a step-up in the assets is provided to its emigrants subject to the Canadian exit tax when they migrate to other countries. The language typically used in Canadian tax treaties is [1461]: *"Where an individual who ceases to be a resident of a Contracting State, and immediately thereafter becomes a resident of the other Contracting State, is treated for the purposes of taxation in the first-mentioned State as having alienated a property and is taxed in that State by reason thereof, the individual may elect to be treated for the purposes of taxation in the other State as if the individual had, immediately before becoming a resident of that State, sold and repurchased the property for an amount equal to its fair market value at that time"*. By inserting this provision into its tax treaties, Canada ensures that an individual who has been subjected to the Canadian exit tax rules is provided with a step-up in the immigration state. If the taxpayer is not entitled to a step-up because the relevant tax treaty does not contain a step-up clause, the taxpayer may claim a reverse credit in respect of the foreign taxes paid. Similarly, the US, since the introduction of its expatriation tax, has revised the 1982 New Zealand-US treaty to ensure that New Zealand grants a step-up to a taxpayer who has been subject to the US expatriation tax[1462].

[1460] BETTEN, Exit charge, pp. 417-418; POTGENS, Assessments, p. 184.

[1461] CAMPBELL, Exit charge, pp. 48-49. For example, (non exhaustive list) Art. 13(7) of the 1980 CANADA-US Tax Treaty Art.13(7) of the 2001 CANADA-VENEZUELA Tax Treaty; Art. 13(8) of the 1999 CANADA-LUXEMBOURG TAX TREATY; For a complete list refer CAMPBELL, Exit charge, Appendix B.

[1462] Art. 9 of the 2008 protocol to the 1982 US-New Zealand tax treaty.

709. In contrast to individuals, States do not usually provide foreign tax credits against the exit tax payable by emigrating legal entities such as companies. Nor do States negotiate step-up clauses in respect of emigrating corporations in their tax treaties, such that a step-up is provided in the immigration State. To this end, it is suggested that the relief systems for individuals should be extended to legal entities to avoid double taxation[1463].

19.5.1.5. Impact of the guiding principle (or PPT rule)

710. It was previously concluded that a domestic anti-avoidance rule that deems a taxpayer to alienate its assets prior to its migration does not conflict with treaty provisions. Moreover, it would be difficult to argue that State R is restricted from applying such a measure if the R-T tax treaty contains a Saving clause (*see section 19.5.3*). Accordingly, the application of the guiding principle seems to be meaningless. As discussed previously (*see section 16.5.1.2*), in the author's opinion, the guiding principle acts as a restriction to the application of domestic anti-avoidance rules that deny treaty benefits to a taxpayer i.e. benefits that flow from a tax treaty. In other words, the guiding principle, which is a treaty GAAR, can be used only for denying treaty benefits. In the current situation, at the time of exit, the taxpayer does not abuse the provisions of tax treaties (treaties may be abused at the time following the exit). In order to counteract domestic law abuse (i.e. reduction of the State R domestic tax base through transfer of residence), State R applies its immediate exit tax rule. Therefore, such rules fall outside the scope of the guiding principle.

19.5.2. The issue of treaty override

711. In the previous sections it was concluded that the domestic anti-avoidance rule, which deems a taxpayer to dispose of its assets prior to its migration, does not conflict with the provisions. The question analysed here is whether the introduction of such a domestic anti-avoidance rule by the legislature (typically as a SAAR) can be considered to be treaty override?

712. Arguments have been made in literature that the introduction of an exit tax regime on assets after the conclusion of a tax treaty amounts to a tax treaty override. This is because the State of emigration recaptures a taxing

[1463] CHAND, Exit charges, Section 5.

right that had been initially given to another State (the new State of residence of the taxpayer) with the effect that the allocation of taxing rights as agreed during the conclusion of a tax treaty is disturbed. To explain, Art. 13(5) provides that capital gains shall be taxable only in the Contracting State of which the alienator is a resident. Accordingly, only the new State of residence should be able to tax the gains of the taxpayer when alienation/sale takes place. By introducing an exit tax, the State of emigration recaptures an exclusive taxing right that it had given up in favour of the new State of residence of the taxpayer. Accordingly, some author's are of the view that immediate exit taxes constitute a treaty override[1464]. However, at the same time other author's believe that the introduction of an exit tax is not a treaty override. They argue that the fact that a State has decided to tax the appreciated gains derived by its residents immediately before emigration cannot be seen as a breach of its tax treaty obligations as in doing so, that State is levying a tax on its own resident taxpayer[1465].

713. In the author's view immediate exit taxes do not constitute a tax treaty override if introduced after the conclusion of a tax treaty. The reasoning is as follows. If a State introduces an exit tax after the conclusion of a tax treaty, it has to be checked whether such a tax would be covered by Art. 2 of the tax treaty. Art. 2(4) provides that the tax treaty applies to identical or substantially similar taxes that are imposed after the date of signature of the tax treaty. Accordingly, if the immediate exit tax is identical or substantially similar to taxes listed by a State in Art. 2(3) then such a tax will be covered by a tax treaty. Even if the exit tax is not an identical or a substantially similar tax, such an exit tax will fall under the broad descriptions of Art. 2(1) and 2(2). This is because the wording of Art. 2 clearly indicates that Art. 2(1) and 2(2) are independent and stand by themselves. Accordingly, if a tax comes within the descriptions of Art. 2(1) and 2(2), regardless of when it is created, this tax will indisputably be covered under the tax treaty[1466]. If Art. 2 applies then, in the author's view, the provisions of Art. 13(5) will also be applicable with the effect that the emigration State should be able to tax its taxpayer on the appreciated gains.

714. The argument that the introduction of an exit tax disturbs the allocation of taxing rights is not tenable either (the emigration State

[1464] WEIZMAN, Exit tax, p. 80.
[1465] CARRAMASCHI, Exit tax.
[1466] BRANDSTETTER, Art. 2, pp. 42-43.

recaptures an exclusive taxing right given to another State). This is because the State introducing the exit tax taxes its own resident taxpayer just before a change of residence takes place i.e. at the time of imposition of the exit tax the taxpayer is a resident of the State imposing the tax and not of the other State. Nor does the State imposing its exit tax tries to tax residents of another State. To elaborate on this position reference is made to the 1989 TTO Report to ascertain whether the introduction of an immediate exit tax by a State after the conclusion of a tax treaty can constitute a treaty override. The OECD provided two examples of treaty overrides (*see section 4.4.3.2*). The second example is of relevance to the discussion here. In that example, the enactment of the new legislation by one contracting State immediately affects persons that are residents of the other contracting State i.e. persons who can claim the application of Art. 13(5) before the enactment of the new legislation. Put differently the enactment of the new legislation by the State in which the immoveable property was situated was sufficient to convert an *exclusive right* to tax (attributed to the State of residence) into a *shared right to tax* (with the State of source). As a result, the State of residence is no longer granted the *exclusive right* to tax the income derived from the sale of shares.

715. At the outset, if we transpose this example to an immediate exit tax scenario, the preliminary conclusion will be that the enactment of an exit tax regime by a State after the conclusion of a tax treaty is a treaty override. This is because the emigration State tampers with the allocation of taxing rights ie it recaptures an *exclusive right* to tax attributed to another State. Accordingly, this conflicts with the provisions of Art. 13(5). However, it should be noted that there is a difference between the example put forward by the OECD and a situation which deals with immediate exit taxes. As far as immediate exit taxes are concerned, the enactment of the new legislation affects persons who are still residents of the State levying the tax. There is no immediate change in the allocation of taxing rights (for example, persons who are residents of the other State will not be subject to an immediate exit tax). No State is being deprived of its right to tax. Accordingly, if one tries to apply Art. 13(5) (or Art. 7(1) or 21(1)) of the OECD Model) the *exclusive right* to tax will still lie with the State imposing the immediate exit tax. The fact that the person will become a tax resident of a new State does not affect his residence status at the moment the immediate exit tax is assessed. The only way for a person to claim that he is a tax resident of the new State for the purposes of applying a tax treaty is by arguing that future events should

have to be taken into consideration when the immediate exit tax is enacted. But this argument is far reaching. Accordingly, in the author's view the enactment of an exit tax regime by a State after the conclusion of a tax treaty cannot be considered a treaty override[1467].

716. Reliance is also placed on the *DSC case* which deals with exit tax on shareholdings. The DSC dealt with the issue of whether the Dutch exit tax overrode the provisions of the tax treaties at stake since it was argued that the Netherlands recaptured its taxing rights. In this regard, the DSC held that the Dutch exit tax was only taxing the increase in the value of the shares during the period of the shareholders residence in the Netherlands. Accordingly, it did not recapture a taxing right allocated to another State. Also, reliance is made on the *1980 Davis case.* In the Davis case the CFCA, though not addressing the issue of a treaty override, concluded that the Canadian exit tax was compatible with the tax treaty even though the exit tax was introduced years after the conclusion of the tax treaty.

717. On the contrary, the author does not agree with the finding of the DSC cases that deals with exit tax on pensions. Probably the DSC held that the domestic rule was incompatible with treaty provisions because the Dutch domestic law reclassified the pensions as employment income that thereby lead to a shift in the allocation of taxing rights. The author wonders as to what would be the outcome if the Dutch domestic law characterized the income as "*pensions*". Applying Art. 18 from the Dutch perspective would lead to the conclusion that Netherlands would not be restricted from taxing that item of income. This is because the taxpayer would still be a resident of the Netherlands when the tax is levied.

19.5.3. Impact of the US Type Saving clause in this treaty

718. In the previous section, it was argued that domestic anti-avoidance rules that deem a taxpayer to alienate its assets prior to its migration do not conflict with treaty provisions[1468]. Moreover, it would be difficult to argue that State R is restricted from applying such a measure if the State R-T tax treaty contains a Saving clause (*see section 8.2.3.4*). This is because that clause reserves a States right to tax its residents as provided in the domestic

[1467] Also see the arguments put forward by Betten in BETTEN, Exit charge, p. 421.
[1468] LANG, CFC, pp. 53-55.

laws notwithstanding any provisions of the tax treaty[1469]. Thus, even if a conflict arises, State R will be in a position to apply the effect of its domestic anti-avoidance rule.

[1469] 2006 US Technical Explanation, Art. 1(4).

20. Residence State: domestic anti-avoidance rules that deny double taxation relief

20.1. The domestic anti-avoidance rule

719. Several States provide relief from double taxation using the exemption method as provided by Art. 23A of the OECD Model. Such States, typically, exempt items of income that maybe taxable in the State of source. To illustrate, States could exempt income attributable to foreign PEs [1470]. Likewise, States could exempt foreign sourced dividend income received by substantial corporate shareholders in order to avoid recurrent taxation of corporate profits [1471]. In this section, the author discusses the treaty compatibility of a domestic anti-avoidance rule that is applied by the residence State pursuant to which relief from double taxation is denied to the resident taxpayer. Specifically, the residence State by applying its domestic anti avoidance rule denies the exemption method and considers the income to be subject to normal tax rules or by applying a domestic anti-avoidance rule employs (switches over to) the credit method to provide relief for the taxes paid in the State of source.

20.2. The case study fact patterns

20.2.1. Denial of treaty exemption for profits attributable to a foreign PE

720. Consider the following situation: X, a tax resident of State R operates through a PE in State T (a low tax country). The PE derives passive income (such as dividends) from shares held in State T companies. If State R and T have a tax treaty based on the OECD Model (which follows the exemption method) the income will not be taxable in State R. This is because Art. 23(A)(1) of the OECD Model provides that " "*Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall… exempt such income or capital from*

[1470] DAHLBERG, WIMAN, Passive income, p. 49.
[1471] DAHLBERG, WIMAN, Passive income, p. 49.

tax". Accordingly, when X derives income from a PE in State T that maybe taxed in that State, State R should exempt such income from further taxation. Assume that State R considers the setting up of the PE as abusive because the income of the PE was lowly taxed. It applies its domestic anti-avoidance rule and denies the exemption to X and considers the income to be subject to normal tax rules (it may or may not switch over to the credit mechanism). The question then arises as to whether the R-T tax treaty precludes the application of such a rule.

20.2.2. Denial of the treaty participation exemption

721. Consider the following situation: Corp X, a tax resident of State R owns a subsidiary, Corp B, in State T (a low tax country). The State R and T tax treaty provides for a participation exemption with respect to dividend income. The provision provides that State R shall exempt dividends received by State R companies that own more than 25% of the capital of distributing companies resident in State T[1472]. Assume that State R considers the setting up of Corp B as abusive as its income is lowly taxed. It applies its domestic anti-avoidance rule and denies the participation exemption to Corp X (it may or may not switch over to the credit mechanism). The question then arises as to whether the R-T tax treaty precludes the application of such a rule.

20.3. The OECD/UN view

722. Para 22.1 of the 2003/2014 OECD Commentary (*see section 8.2.1.7*) provides that the provisions of a tax treaty will be applied only after a domestic anti-avoidance rule redetermines the taxpayer or re-characterizes an item of income. It does not discuss the situation where a domestic anti-avoidance rule is used to deny a treaty benefit. Accordingly, the question arises as to whether such a rule is outside the scope of the OECD's comments. It was established earlier in this thesis that such rules should, indeed, fall outside the OECD's comments (*see section 12.2*). The development of the 2011 UN Commentary does not discuss such a situation. However, if it is argued that such rules are included in the OECD/UN's comments (for statutory GAARs), then these rules have to be applied having

[1472] For instance, Art. 23(2)(a) of the 1980 Germany – New Zealand tax treaty obligies Germany to exempt dividend income received by German companies that own more than 25% of the capital of the New Zealand distributing company. See LINN, Tax Avoidance, p. 350.

regard to the guiding principle. Similarly, the 2014 TTA and 2015 Final TTA report also provides that the conclusions already reflected in the 2003/2014 OECD Commentary on Art. 1 with respect to domestic anti-avoidance rules remains applicable even with respect to treaties that do not incorporate the PPT rule. It is also stated that no conflict will arise if a domestic statutory GAAR is in conformity with the guiding principle. Essentially, the guiding principle is required to be seen as a treaty GAAR.

20.4. The view expressed in International case law

723. The author has not come across any international case law on this subject that is available in English. Nevertheless, it should be noted that the Austrian Courts have discussed the interaction of the Austrian switch-over clause with tax treaties concluded by Austria. The domestic tax law of Austria provides that a participation exemption regime is applicable to dividends distributed by foreign companies to Austrian parent companies. Furthermore, the regime also applies to capital gains derived from the sale of the foreign subsidiaries. To qualify for the regime, the Austrian parent should hold a minimum of 10% of the share capital of the distributing company. However, the participation exemption is denied if the foreign subsidiary is subject to low taxes and earns mostly passive income. If both conditions are satisfied then a credit is available for the underlying taxes paid by the foreign subsidiary against Austrian corporate income tax[1473]. At the international level, several Austrian tax treaties provide a participation exemption for inbound inter-corporate dividends[1474]. Accordingly, the question has arisen as to whether the switch over clause can be used to deny the participation exemption for foreign dividends without disrupting the treaty provisions. It is highlighted that the Austrian Courts have held that the application of the Austrian switch-over clause in these circumstances does not violate treaty provisions[1475]. However, this position, in the author's opinion is disputable (*see section 20.5.2.1*).

[1473] FÜRNSINN, RÜMMELE, Passive income, pp. 128-131.

[1474] For a list of Austrian tax treaties that prescribe the participation exemption regime for inter-corporate dividends, refer to KOFLER, Tax Avoidance, pp. 115-125.

[1475] FÜRNSINN, RÜMMELE, Passive income, pp. 135-136; KOFLER, Tax Avoidance, pp. 107-108.

20.5. Author's view on the interaction with treaty rules

20.5.1. Denial of exemption for profits attributable to a foreign PE

20.5.1.1. Conflict with the R-T tax treaty

724. As discussed previously (*see section 15.5.1.1*), in the author's opinion, domestic law and treaty law are two completely different legal spheres. If a taxpayer derives income from foreign PEs then that taxpayer should be given treaty benefits. Barring treaty benefits on the basis of a domestic anti-avoidance rule, such as an interpretative judicial doctrine, or a statutory GAAR or SAAR (up to the extent they deny treaty benefits) – clearly conflicts with the provisions of tax treaties. This is because the domestic law provision does not square with the provisions of the tax treaty. To elaborate, Art. 23A requires State R to exempt income from taxation which in accordance with the treaty "*may be*" taxed in the other State. The relief has to be provided by State R irrespective of whether the income is actually taxed, lowly taxed or is not taxed at all in State T[1476]. This issue has been debated in Germany[1477]. Germany, under its longstanding tax treaty policy, provides for the exemption method with respect to several items of income[1478]. Typically, the exemption is provided for income attributable to a PE[1479]. Some tax treaties exempt the PE's income without any conditions[1480] whereas in other treaties the PEs income is exempt only if it is only considered to be "*active*", in the sense that the income derived is from active operations (such as manufacturing, producing, processing, exploration and extraction of natural resources, banking and insurance etc[1481]) and not passive sources (where the PE derives only income from holding shares)[1482].

[1476] DE BROE, Thesis, p. 491.
[1477] LÜDICKE, German Treaty Policy, p. 619.
[1478] LÜDICKE, German Treaty Policy, p. 612; RESCH, Switchover, p. 480; VOGEL, Commentary, p. 1185.
[1479] LINN, Tax Avoidance, p. 344.
[1480] For instance, see Art. 23(2) of the 1980 Germany – New Zealand tax treaty. For a list of other treaties, refer to LINN, Tax Avoidance, p. 350.
[1481] LIPP, German Policy, p. 316.
[1482] For instance, see Art. 23(2)(c) of the 2001 Germany – Canada tax treaty. For a list of other treaties, refer to LINN, Tax Avoidance, p. 350; LÜDICKE, German Treaty Policy, p. 615; VOGEL, Commentary, pp. 1193-1196.

Due to these clauses, it was beneficial for taxpayers to operate with foreign PEs in low tax jurisdictions[1483]. Accordingly, to counteract such schemes (as well as other schemes), the German legislature introduced a domestic switch-over clause that is currently found in Section 20(2) of the German Foreign Transaction Tax Act. The rules provide that the exemption method will be replaced by the credit method where the PEs income is derived from passive sources that are low taxed[1484]. Accordingly, the question arises as to whether the switch-over clause can be used to deny the exemption method for the income derived from the foreign PE without disrupting the treaty provisions. It has been argued in German tax literature that such a domestic provision conflicts with treaties that provide for the exemption method to be applied unconditionally[1485]. The author agrees with this position[1486].

20.5.1.2. Impact of the guiding principle (or PPT rule)

725. The position taken in this thesis is that the guiding principle applies in relation to tax treaties concluded by OECD or UN member States after January and June 2003 respectively (*see section 9.1*). It was concluded previously that a conflict arises between a domestic law provision and tax treaties when the former denies the benefit of the exemption method. The question analysed here is whether the treaty benefit can be denied by resorting to the guiding principle? *The following analysis can also be extended to treaties that may incorporate the PPT rule in light of the BEPS Action Plan.*

726. Firstly, it needs to be ascertained if there is a treaty benefit. The Commentary to the PPT rule provides that the term "*benefit*" includes relief from double taxation as provided by Art. 23[1487]. Accordingly, a benefit does arise for Corp X under Art. 23, which is, reduction of State R taxes by

[1483] LÜDICKE, German Treaty Policy, p. 619.
[1484] LÜDICKE, German Treaty Policy, p. 616.
[1485] LINN, Tax Avoidance, pp. 344-345; SCHÖNFELD, Passive Income, pp. 328-329.
[1486] It should be noted that the 2014 TTA report proposes to introduce a PE anti avoidance rule to counteract tax avoidance arrangements from transfer of mobile assets to a PE. The new provision provides that the State of source should not give treaty benefits with respect to income that is paid to a recipient of the State of residence when that income is attributable to a PE located in a third State and as a result of the attribution to the PE the State of residence exempts or taxes the profits of PEs at low rates. See 2014 OECD, Report on Treaty Abuse, Para. 40; Also see 2015 OECD, Final Report on Treaty Abuse, pp. 75-78.
[1487] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 7).

applying the exemption method. Secondly, it needs to be ascertained if a main purpose of entering into the transaction was to secure the tax benefit. Ideally, if the treaty contains an "*activity*" clause (as in some to the German tax treaties) and if the taxpayer satisfies the clause, it is quite obvious that sufficient commercial nexus exists with State T. Accordingly, a reasonable argument can be made that a main purpose was not to obtain a tax benefit even though the PE is taxed at a lower rate. However, if the taxpayer does not satisfy the activity clause, all the relevant facts and circumstances have to be taken into consideration. This could lead to the conclusion that a main purpose was to obtain a tax benefit. In essence, the author provides that if the activity of the PE is linked to a core business-related activity and its form has not been driven by tax considerations, it is unlikely that a main purpose was to obtain a tax benefit. Where, however, an arrangement is driven only by tax considerations, a benefit may exist. Lastly, even if it is proved that the subjective element is satisfied, the objective test needs to be satisfied too. Is the taxpayer acting against the object and purpose of Art 23A(1)? In the author's opinion, the object and purpose of Art. 23A(1) is to provide relief from double taxation by using the exemption method. It is not the objective of this provision to tackle double non-taxation (*see section 9.2.3*). The application of this method does not depend on whether taxes have been paid in the State of source or not. Thus, the second element should not be satisfied, as the taxpayer has not acted against the object and purpose of that provision. However, if the Courts start to read Art. 23(A) in order to prevent tax avoidance and double non-taxation then the author does not rule out a denial of treaty benefits [1488]. Therefore, the application of the guiding principle leads to uncertainty.

20.5.2. Denial of treaty participation exemption

20.5.2.1. Conflict with the R-T tax treaty

727. In the context of the Austrian switch-over clause, that denies participation exemption as provided by Austrian tax treaties[1489], the author agrees with commentators that the domestic anti-avoidance rule conflicts with treaty provisions, if the latter clearly includes provisions which provide

[1488] DE BROE, Thesis, pp. 491-493.
[1489] KOFLER, Tax Avoidance, p. 107.

an exemption for inter-corporate dividends[1490]. For instance, such a domestic anti-avoidance rule will clearly conflict with Art. 23(3) of the 1978 Austria – Malta tax treaty which provides that "*Where a dividend is distributed by a company which is a resident of Malta to a company which is a resident of Austria, such dividend shall be exempt from the corporation tax and from the business tax in Austria if the Austrian Company receiving the dividend controls not less than 25 per cent of the voting power of the Malta company"*.

20.5.2.2. Impact of the guiding principle (or PPT rule)

728. The position taken in this thesis is that the guiding principle applies for tax treaties concluded by OECD or UN member States after January and June 2003 respectively (*see section 9.1*). It was concluded previously that a conflict arises between a domestic law provision and tax treaties when the former denies the benefit of the treaty participation exemption. The question analysed here is whether the treaty benefit can be denied by resorting to the guiding principle? *The following analysis can also be extended to treaties that may incorporate the PPT rule in light of the BEPS Action Plan.*

729. Firstly, it needs to be ascertained if there is a treaty benefit. The Commentary to the PPT rule provides that the term "*benefit*" includes relief from double taxation as provided by Art. 23[1491]. Accordingly, a benefit does arise for Corp X under Art. 23, which is, reduction of State R taxes by applying the treaty participation exemption. Secondly, it needs to be ascertained if a main purpose of entering into the transaction was to secure the tax benefit. An argument can be made that Corp X invests in State T with a view to expand its business activities. Hence, "*given that a general objective of tax conventions is to encourage cross-border investment, obtaining the benefits of the State R - State S convention for the investment … is in accordance with the object and purpose of the provisions of that convention*" [1492], the subjective element of the guiding principle is not satisfied. Where, however, the arrangement is driven only by tax considerations, the subjective element may be satisfied. Lastly, even if it is proved that subjective element is satisfied, the objective test needs to be

[1490] FÜRNSINN, RÜMMELE, Passive income, pp. 135-136; KOFLER, Tax Avoidance, p. 107.
[1491] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 7).
[1492] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 14).

satisfied too. Has the taxpayer act against the object and purpose of the treaty provision dealing with the treaty participation exemption? In the author's opinion, the object and purpose of such a provision is to provide relief from double taxation for inter-corporate dividends. It is not the objective of this provision to tackle double non-taxation (*see section 9.2.3*). The application of the method does not depend on whether taxes have been paid in the State of source or not. Thus, the second element should not be found to be satisfied. However, if the Courts start to read the treaty provision as intended to prevent tax avoidance and double non-taxation then the author does not rule out a denial of treaty benefits[1493]. Therefore, the application of the guiding principle leads to uncertainty.

20.5.3. The issue of treaty override

730. In the previous sections it was concluded that the domestic anti-avoidance rule, which denies a treaty benefit (exemption method), conflicts with the provisions of a tax treaty. Logically, even if the rule is introduced after the conclusion of a tax treaty, that rule should not be applicable as the provisions of the tax treaty take precedence. Accordingly, if the legislature (as a standalone SAAR or as a part of a statutory GAAR) or the judiciary (typically by developing and applying a business purpose test) introduces a posterior domestic anti-avoidance rule that denies a treaty benefit (exemption method) under certain conditions, notwithstanding the conflict, then an argument can be made that a treaty override occurs. This is because such a rule disturbs the allocation of taxing rights even though it is applied from the perspective of the State of residence.

731. To elaborate on this position, reference is made to the OECD position to ascertain whether the introduction of such an anti-avoidance rule by a State after the conclusion of a tax treaty can constitute a treaty override. The OECD provided two examples of treaty overrides (*see section 4.4.3.2*). The second example is of relevance to the discussion here. In that example, the enactment of new legislation by the State to counteract tax avoidance through immoveable property companies was considered to be a treaty override. It should be noted that in the example provided by the OECD the enactment of the new legislation by one contracting State immediately affects persons that are residents of the other contracting State ie persons who can claim the application of Art. 13(4) of the 1977 OECD Model before

[1493] DE BROE, Thesis, pp. 491-493.

the enactment of the new legislation. Put differently the enactment of the new legislation by the State in which the immovable property is situated was sufficient to convert an exclusive right to tax (attributed to the State of residence) into a shared right to tax (with the State of source). As a result, the State of residence is no longer granted the exclusive right to tax the income derived from the sale of shares.

732. If we transpose this example to the domestic anti-avoidance rule at stake, the conclusion will be that the enactment of a domestic anti-avoidance rule by a State after the conclusion of a tax treaty is a treaty override. This is because the domestic anti-avoidance rule leads to a shift in the allocation of taxing rights. State R, whose taxing rights are limited pursuant to the treaty provisions, now denies the application of the exemption method to the taxpayer. Even if the credit method is applied pursuant to a switch-over clause, the taxpayer may still be subject to an increased tax liability. Therefore, State R enhances its taxing rights pursuant to the domestic anti-avoidance rule. For instance, in the author's opinion a provision such as the German switch-over clause, which denies the exemption method for income attributable to low taxed PEs, is a treaty override[1494]. Likewise, the Austrian switch-over clause, which denies the participation exemption for intercorporate dividends, is a treaty override[1495]. Thus a material breach arises for the purposes of Art. 60(1) VCLT.

20.5.4. Impact of the US type Saving clause in the R-T tax treaty

733. It was argued that a domestic rule that denies treaty benefits conflicts with treaty provisions. The question analysed in this section is whether the conflict can be neutralized under a saving clause, if it is included in the R-T tax treaty? The clause provides that "*This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23, 24 and 25 and 28"*. It is clear that State R can tax Corp X pursuant to the Saving clause. However, the clause lists Art. 23 as an exception[1496]. Thus, the State of residence is not restricted from taxing its own resident except when the provisions of Art. 23 apply. Accordingly,

[1494] LINN, Tax Avoidance, p. 354.
[1495] KOFLER, Tax Avoidance, pp. 107-108; HOHENWARTER, Abuse, pp. 203-204.
[1496] 2006 US Technical Explanation, Art. 1(4).

State R has to provide relief of double taxation to Corp X with respect to the income that State T may tax in accordance with the Convention "*(including profits that are attributable to a permanent establishment situated in the other Contracting State in accordance with paragraph 2 of Article 7*" [1497]. Likewise, if the treaty participation exemption provision is listed in Art. 23, State R must provide exemption for the intercorporate dividends.

[1497] 2014 OECD, Report on Treaty Abuse, Para. 53 (Commentary in Para. 26.19).

PART VI: THE RELATIONSHIP BETWEEN DOMESTIC ANTI-AVOIDANCE RULES AND TREATY ANTI-AVOIDANCE RULES

21. The relationship between domestic anti-avoidance rules and treaty anti-avoidance rules

21.1. Preliminary remarks

734. In this chapter, the author analyses i) the relationship between various domestic anti-avoidance rules ii) the relationship between the various treaty anti-avoidance rules and iii) the relationship between various treaty anti-avoidance rules and domestic anti-avoidance rules.

21.2. The relationship between various domestic anti-avoidance rules

21.2.1. Legislative anti-avoidance rules: Statutory GAAR vs SAAR

735. The comparative analysis in *section 3.3* and *section 3.4*, indicates that statutory GAARs and SAARs co-exist in several countries. The issue analyzed here is whether the statutory GAAR can apply to a transaction that has already been subject to a SAAR. Under the general interpretation rule of "*lex specialis derogat legi generali"* specific legislation overrides general legislation. Applying that rule, a transaction that has been subject to a SAAR should not be covered by a GAAR. However, the answer to this question varies from jurisdiction to jurisdiction and depends on the drafting of the legislation. For instance, in Germany it is well accepted that if a taxpayer's transaction is subject to a SAAR then the statutory GAAR will not apply[1498] although it is contended that an exception is made for CFC rules. This is because for letter box companies the statutory GAAR takes precedence[1499]. A similar approach is followed in the Netherlands where it is contended that SAARs take precedence over the Dutch statutory GAAR (*richtige heffing*)

[1498] LINN, Tax Avoidance, p. 336; EY, GAAR, p. 16; ZIMMER, JAAR, p. 50; REIMER, Avoidance, pp. 33-34.

[1499] One commentator, by quoting case law pronounced by the GFFC (the author could not obtain a translation of these cases), arrives at this conclusion. See SCHÖNFELD, Passive income, p. 326.

although the latter is no longer applicable[1500]. On the other hand, the UK GAAR provisions provide that the GAAR takes priority over any other legislation applying to the taxes that is covers[1501]. Accordingly, it can be ascertained that the UK GAAR operates independently of SAARs[1502]. In India, when the GAAR provisions were being drafted, a proposal was made that when a SAAR is applicable to a particular transaction, then the GAAR shall not be invoked[1503]. However, as the provision uses the terminology that "*Notwithstanding anything contained in the Act",* the GAAR provisions apply in addition to the SAARs. A similar approach is followed in Canada where it is contended that the Canadian GAAR provisions may apply in spite of and in addition to an applicable SAAR provision[1504]. Also, in the US it is contended that the codification of the economic substance doctrine does not displace any other rules of US tax law[1505]. To conclude, in the words of one commentator, "*in the end the legal answer must turn on an overall assessment of the respective roles of the particular provision and the general anti avoidance provision and the relationship between them. This is a matter of statutory construction"* [1506].

21.2.2. Judicial anti-avoidance doctrines vs legislative anti-avoidance rules

736. The comparative analysis in *chapter 3* indicates that judicial doctrines co-exist with legislative anti-avoidance rules in several States. The issue analyzed here is whether judicial doctrines apply, in addition, to legislative anti-avoidance rules (statutory GAARs or SAARs). The picture seems to be mixed if the domestic tax law contains only SAARs. For instance, it is contended that, in the Netherlands, the *fraus legis* doctrine

[1500] IJZERMAN, JAAR, p. 453.

[1501] The GAAR provides that *"(1) Any priority rule has effect subject to the general anti-abuse rule (despite the terms of the priority rule). (2) A "priority rule" means a rule (however expressed) to the effect that particular provisions have effect to the exclusion of, or otherwise in priority to, anything else. (3) Examples of priority rules are— (a) the rule in section 464, 699 or 906 of CTA 2009 (priority of loan relationships rules, derivative contracts rules and intangible fixed assets rules for corporation tax purposes), and (b) the rule in section 6(1) of TIOPA 2010 (effect to be given to double taxation arrangements despite anything in any enactment)"*. UK, Finance Bill 2013, Part V, Section 209. Also see HMRC, GAAR, p. 34.

[1502] HMRC, GAAR, p. 8.

[1503] GAAR, Expert Committee Report, p. 47.

[1504] EY, GAAR, p. 16.

[1505] SANCILIO, Substance, pp. 166-167.

[1506] COOPER, Tax Avoidance, p. 39.

does not apply if a transaction has been subject to a SAAR[1507]. However, this position is disputed[1508]. On the other hand, in the UK (prior to the introduction of the GAAR) it was argued that the principles developed in the *Ramsay* case could apply to a transaction that had already been subject to a SAAR[1509]. A similar position has been adopted in the US where the judicial doctrines are considered to supplement SAARs[1510].

737. If the domestic tax law contains judicial doctrines and statutory GAARs, the analysis is as follows. In the author's opinion, one of the policy reasons behind introducing statutory GAARs seems to have been influenced by judicial precedent. In the US, the economic substance doctrine was codified because Courts adopted different views in terms of its application. In the UK, the statutory GAAR was considered as an appropriate tool to combat tax avoidance as Courts stretched or were tempted to stretch the application of the purposive interpretation approach thereby creating uncertainty. Similarly, in India, the statutory GAAR was introduced as Courts had different views on the application of the substance over form doctrine. On the other hand, as Courts in Canada refused to introduce a judicial anti-avoidance doctrine within the tax system, the GAAR was introduced. Equally, in France the abuse of law provision was codified in light of its judicial development. In contrast, the non-application of the Dutch statutory GAAR seems to be due to the development of the "*fraus legis*" doctrine. Thus, it can reasonably be stated that States introduce statutory GAARs to codify judicial doctrines on what establishes tax avoidance. Accordingly, if a statutory GAAR applies to a transaction then the judicial doctrine should not apply, as the former are broadly sufficient to capture tax avoidance transactions.

[1507] IJZERMAN, JAAR, p. 453; BOTERMAN, GULIK, Passive income, p. 505.
[1508] WILDE, WISMAN, Avoidance, p. 10.
[1509] ZIMMER, JAAR, p. 50.
[1510] STRENG, YODER, JAAR, p. 601.

21.3. The relationship between various treaty anti-avoidance rules

21.3.1. Treaty GAAR and Treaty SAAR vs inherent anti-abuse rule

21.3.1.1. The inherent anti-abuse rule

738. It has been argued that the international law rules should also be applied to interpret tax treaties[1511]. Specifically, reference is made to Art. 38(1)(c) of the UN Statute of the ICJ[1512] which provides that "*the general principles of law recognized by civilized nations*" are a source of international law. Therefore, "*general principles of law*" should be taken into consideration to interpret tax treaties. It is argued that the "*abuse of rights*" doctrine can be considered as a "*general principle of law"* for the purposes of Art. 38(1)(c) of the UN Statute of the ICJ and thus can be used to interpret tax treaties. This is because several civil law countries and International Courts have developed and applied the "*abuse of rights*" doctrine in the non-tax law and tax law cases [1513] (*see section 3.2.5*). Alternatively, it is argued that the anti-abuse doctrine in tax matters exists at the level of international law independently of whether the abuse of rights doctrine exists at the level of international law. This is primarily because the domestic laws of several States contain domestic anti-avoidance rules. Thus, as there is a unanimous acceptance of anti-abuse rules, such rules meet the requirements of Art. 38(1)(c).

739. Consequently, the outcome of the foregoing two arguments is that an "*inherent anti abuse rule*" exists in tax treaties and that rule can be used to counter improper use of tax treaties. Furthermore, it has also been argued that the principle of "*good faith*" (*see section 5.2.2*) enshrined in Art. 26 and Art. 31(1) of the VCLT includes the prohibition of abuse. Accordingly, the principle of "*good faith*" provides a sound legal basis for an "*inherent anti-abuse rule*" in tax treaties. However, commentators and courts seem to be

[1511] WARD, Abuse, p. 18.
[1512] Art. 38(1)(c), UN Statute of the ICJ.
[1513] VAN WEEGHEL, Thesis, pp. 98-102. For a discussion on whether the abuse of rights doctrine constitutes a general principle of EU law see TERRA, WATTEL, European law, pp. 915-921. *Also see section 22.1.2.2.*

divided in their opinion on the existence and application of such an inherent anti-abuse rule to tax treaties.

740. One commentator argues that tax treaties are subject to a general substance over form doctrine based on international law. Accordingly, such a doctrine fits in Article 38(1)(c), UN Statute of the ICJ[1514]. Similarly, another commentator, with reference to the "*the good faith*" principle, decisions of the ICJ/opinions of the judges which recognize the doctrine of abuse of rights, opinions expressed in legal literature, anti-abuse rules found in the domestic tax law of several countries concludes that an anti-abuse rule in tax matters is a "*general principles of law recognized by civilized nations*" [1515]. Likewise, another scholar recognizes that the principle of abuse of rights can be applied in interpreting and applying tax treaties. He argues that wholly artificial arrangements that are only set up for the purpose of avoiding tax can be counteracted by the doctrine of "*fraus pacti*" which can be derived from the obligation to interpret a tax treaty in "*good faith*" [1516].

741. However, other commentators disagree with such a view or propose a cautious approach. In this respect, one commentator has explored whether an international principle on treaty abuse could be ascertained from the doctrines of abuse developed in a non-tax law context. He rejected the proposition arguing that the principles of law that have developed in non-tax law fields are not transferable to the tax law domain. This is because the doctrines in the non-tax law field (such as property law) focus on striking a balance between the opposing interests of parties with the aim of preventing a disproportionate harm to one party as a result of exercise of rights by another. However, the commentator states that in the tax law context, actions by taxpayers to minimize taxation will result in a proportionate loss but not a disproportionate harm to fiscal or other societal interests. Further, the commentator also rejects the notion that the substance over form doctrine applied by countries in the domestic tax law sets a foundation for a arguing the existence of an international abuse of right doctrine in tax matters. This is because the substance over form doctrine has been developed differently in different countries with different thresholds for its application [1517].

[1514] VOGEL, Commentary, p. 125; VOGEL, 2015 Commentary, p. 125.
[1515] WARD, Abuse, pp. 18-19.
[1516] ENGELEN, Good Faith, p. 36.
[1517] VAN WEEGHEL, Thesis, pp. 98-102.

Likewise, another commentator also seems to be inclined towards the argument that it is difficult to deny treaty benefits on the basis of an international accepted abuse of rights doctrine. This is because the doctrine is undefined in its scope and has hardly been used in tax matters. Further, it is argued that there should be international consensus for the application of the "*substance over form*" doctrine. However, as the CSC has rejected the application of the "*substance over form*" doctrine for domestic law purposes (*see section 3.2.2*), the author concludes that it will be difficult for a Canadian Court to apply such a concept at the level of a tax treaty[1518]. Similarly, a scholar argues that public international law recognizes a prohibition on the abuse of treaties i.e. that the execution and interpretation of a treaty must be carried out in good faith. But the author doubts whether such a doctrine could be applied to tax treaties as it does not provide an anti-abuse standard that might be permitted in a tax treaty[1519]. Another leading commentator, initially, concludes that it is questionable whether an abuse of rights doctrine exists in international law. He further provides that Art. 26 of the VCLT cannot be used to contend that an abuse of rights doctrine exists in international law. This is mainly because Art. 26 VCLT deals with interstate relationships as opposed to taxpayers operating at a domestic level and the recognition of an abuse of rights doctrine is not universally accepted. Nevertheless, he suggests that the principle of "*good faith*" enshrined in Art. 31 VCLT can be used to deny treaty benefits to a taxpayer if the granting of such benefits would frustrate a treaty's object and purpose. Furthermore, he discusses the possibility of whether an anti-abuse doctrine in tax matters can be recognized at the level of international law independent of whether an abuse of rights doctrine exists at the level of international law. He seems to favour the existence of such a doctrine but ultimately concludes that such a general principle would be an ineffective rule to counter treaty abuse because State practices are inhomogeneous as far as the formulation of the doctrine is concerned[1520]. Finally, another scholar, initially, argues that the abuse of rights doctrine exists at the level of international law. However, as State practices vary with respect to anti-abuse rules he concludes that it is difficult to establish a doctrine of abuse of rights as a principle of international law in tax matters[1521].

[1518] GOYETTE, Treaty Abuse, pp. 769-773.
[1519] MARTIN JIMENEZ, Anti Abuse – I, pp. 545-547.
[1520] DE BROE, Thesis, pp. 302-316.
[1521] MATTEOTTI, 2003 changes, pp. 342-345.

742. With respect to the position of the Courts, the SFSC in the *A Holding case* held, denying treaty benefits to a taxpayer, that prohibition of abuse is part of the principle of the "*good faith*" to (*see section 15.4.2*). Similarly, in the *2007 Yanko Weiss* case, the District Court of Tel Aviv recognized the concept of abuse of rights applied to tax treaties as a matter of international law (*see section 15.4.4*). However, in the *2006 MIL Investments case,* the CTC rejected the application of an inherent anti-abuse rule in tax treaties (*see section 15.4.3*). Similarly, in the *2012 Vodafone case,* the ISC rejected the application of an inherent anti-abuse rule in tax treaties (*see section 12.3.3*).

21.3.1.2. The relationship of the inherent anti-abuse rule with the treaty GAAR and treaty SAAR

743. In light of the above it is submitted that the existence of such a rule is highly debatable. In the author's opinion, such a rule does not exist given it undefined nature. Even if such a rule exists and a tax treaty contains a GAAR such as the PPT rule (*see section 8.2.3.2*), in the author's opinion, that the treaty GAAR will prevail over the inherent anti-abuse rule. This is because the treaty GAAR is a written anti-avoidance rule and can be considered to be a "*lex specialis"* in comparison to the unwritten anti-abuse rule. Similarly, if the treaty contains only a SAAR (and not the PPT rule) such as the "*beneficial ownership clause*" which targets tax avoidant structures vis-à-vis passive income streams[1522], the author considers that the treaty SAAR should take precedence, as it is a "*lex specialis"* in comparison to the unwritten anti-abuse rule. For a contrary opinion see the decision of the SFSC in the *A Holding case* wherein it was held that the inherent anti-abuse rule applies even though it was conceded by the tax administration that the taxpayer was the "*beneficial owner*" of the income (*see section 15.4.2*). However, the position taken in this thesis is that the guiding principle applies for tax treaties concluded by OECD or UN member States after January and June 2003 respectively (*see section 9.1*). Whether or not the subjective and objective element are satisfied depends on the facts and circumstances of each case.

[1522] Found in 2014 OECD Model, Art. 10, 11 & 12; 2011 UN Model, Art. 10, 11 & 12; 2006 US Model, Art. 10, 11 & 12.

21.3.2. Treaty GAAR vs Treaty SAAR

744. The 2014 TTA and 2015 Final TTA report introduce a treaty GAAR (PPT rule) and many treaty SAARs (notably the LOB clause – *see section 8.2.3.2*). The question arises as to how do these treaty anti-abuse rules interact with each other? The reports provide that the PPT rule applies "*notwithstanding the other provisions of this Convention"*. By using the term "*notwithstanding"* the PPT rule becomes a self-standing provision and applies even if the transaction undertaken by the taxpayer passes the tests of the treaty SAARs [1523]. For instance, consider the following example: A resident individual investor, X, of State R owns shares in a State S company viz., B Corp that owns only moveable and immoveable property. The shares derive 50.01% of their value from moveable property and 49.99% from immoveable property. X sells the shares of B Corp. Pursuant to Art. 13(4) of the OECD Model, which provides that, "*Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State*" [1524], State S will not be in a position to tax the gain as less than 50% of the value is attributable to the immoveable property. Further, assume that the values attributable to the moveable and immoveable property do not change at any time during the year preceding the sale. In such a case, the clause proposed by the 2014 TTA report or 2015 Final TTA report, to modify Art. 13(4) of the OECD Model, will also not apply either as that clause provides "*Gains derived by a resident of a Contracting State from the alienation of shares… may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares… derived more than 50 per cent of their value directly or indirectly from immovable property… situated in that the other State…*"[1525]. Even if these treaty SAARs do not apply, the taxpayer could nevertheless be challenged under the treaty GAAR. In the author's opinion, this is not a reasonable conclusion. If one applies the interpretation doctrine *of lex specialis derogat legi generali* then the treaty SAARs should prevail over treaty GAARs when such anti-abuse rules apply to similar fact patterns. However, by using the term "*notwithstanding"*, the treaty GAAR also applies [1526]. Logically, if the treaty GAAR does not use the

[1523] DE BROE, LUTS, BEPS, p. 133.
[1524] 2014 OECD Model, Art. 13(4).
[1525] 2014 OECD, Report on Treaty Abuse, Para. 35.
[1526] LANG, PPT rule, p. 658; DE BROE, LUTS, BEPS, p. 133.

term "*notwithstanding*", a strong argument can be made that once the taxpayer's transaction meets the test of the treaty SAAR then the treaty GAAR will not apply.

21.3.3. The guiding principle vs Treaty SAAR

745. If the treaty does not incorporate a treaty GAAR (such as the PPT rule) but only treaty SAARs then the question arises as to how these latter rules will interact with the OECD's guiding principle. It could be argued that if the transactions undertaken by the taxpayer satisfy the tests of the treaty SAARs then the guiding principle should not be used to deny treaty benefits to the taxpayer. If one applies the interpretation doctrine *of lex specialis derogat legi generali* then the treaty SAARs should prevail over an treaty GAAR that is derived from the OECD Commentary. However, the position taken in this thesis is that the guiding principle, which is a treaty GAAR, applies for tax treaties concluded by OECD / UN member States after 2003. Therefore, the principle should be read into a tax treaty concluded after the amendments made to the 2003 OECD Commentary. Whether or not the subjective and objective element of the principle are satisfied is questionable depends on the facts and circumstances of each case. For treaties before 2003, in the author's opinion, once the taxpayer meets the tests of the treaty SAAR then the guiding principle should not apply.

21.4. The relationship between various treaty anti-avoidance rules and domestic anti-avoidance rules

21.4.1. A case study from the source State's perspective – Treaty shopping

746. Consider the following treaty shopping situation. A resident investor, X, of State R wishes to invest in State S companies with a view to deriving dividends. The domestic tax law of State S imposes a dividend withholding tax of 35%. As a tax treaty does not exist between States R and S, the withholding tax of 35% is the final tax. Thus, in order to invest in State S companies, X legally sets up a wholly owned subsidiary – B Corp – in State T. B Corp qualifies as a "*person*" for the purpose of Art. 3(1)(a) and as a "*resident*" for the purposes of Art. 4(1). State T also has a participation

exemption regime that exempts dividends for substantial shareholders. B Corp, in turn, invests in State S companies. B Corp, subsequently, receives dividends. The State S withholding tax is not triggered as Art. 10(2) of the T-S treaty, which slightly deviates from the 2014 OECD Model, provides for zero taxation of dividends at source. Assume the following situations.

21.4.2. Narrow treaty SAAR vs narrow SAAR in domestic tax law

747. Lets assume further that the domestic law of State S has a SAAR to combat dividend stripping, such as the Dutch domestic tax law definition of the term "*beneficial owner*". The SAAR provides that if the recipient of the dividend does not qualify as the "*beneficial owner*" then the Dutch dividend withholding tax (15%) will apply. The recipient will not be considered to be the beneficial owner if "*as a consequence of a combination of transactions, a person other than a recipient wholly or partly benefits from the dividends, whereby such person retains, whether directly or indirectly, an interest in the shares on which the dividends were paid and such person is entitled to a credit, reduction, or refund of the dividend withholding tax that is less than to which the recipient is entitled*" too[1527].

748. The term "*beneficial owner*" is undefined for the purpose of the treaty. Accordingly, pursuant to Art. 3(2) of the OECD Model, reference has to be made to the domestic law of State S to interpret the treaty term unless the context otherwise requires. Commentators have raised the question as to whether the "*beneficial owner*" definition under Dutch tax law can be used to interpret the term "*beneficial owner*" for the purpose of applying Art. 10 of the OECD Model[1528]. This is because the term has to be interpreted autonomously and not by reference to domestic law. The author agrees with this position. In the author's opinion, the "*beneficial owner*" concept, as used in Art. 10 has an international fiscal meaning and should be interpreted independently (autonomously) from domestic law. Accordingly, if the definition provided by the Dutch tax law does not square with the international fiscal meaning then that definition should not be applied at the

[1527] DE BOER, BOULONGE, Dividends, p. 796; PETERS, ROELOFSEN, Tax Avoidance, p. 569; SMIT, Beneficial Owner, p. 75.

[1528] SMIT, Beneficial Owner, p. 75; PETERS, ROELOFSEN, Tax Avoidance, p. 569; VAN WEEGHEL, Tax Avoidance, p. 50.

level of the treaty[1529]. The OECD Commentary provides that the beneficial owner is the recipient that *"has the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person"* [1530]. The provision does require checking whether the dividend that is received by B Corp was passed on to X pursuant to a contractual or legal obligation. However, the provision does not require any checking of whether or not X would have been entitled to a lower withholding tax had it received the dividend income directly. Therefore, it is reasonable to conclude that if the domestic SAAR on the concept of beneficial owner is broader than the treaty SAAR then the former should not apply as a conflict arises between the domestic SAAR and the provisions of the treaty. This position is confirmed by the 2011 UN Commentary (*see section 8.2.2.3.1*) and the BEPS report (*see section 8.2.3.3.2*). However, OECD and UN member States can invoke the guiding principle in the interpretation of tax treaties concluded after 2003 to deny treaty benefits to the taxpayer. Whether or not the tests of the guiding principle are satisfied is questionable and depends on the facts and circumstances of each case.

21.4.3. Narrow treaty SAAR vs narrow and broad SAAR in domestic tax law

749. Lets assume that B Corp is the beneficial owner of dividends for the purposes of the T-S tax treaty as it is not under any legal or contractual constraint as far as passing the dividends to its shareholders is concerned. Furthermore, assume that the domestic law of State S has another SAAR such as the German anti-treaty shopping rule (*see section 3.4.2.1*), in addition to the "*beneficial ownership*" definition. The question which arises is can State S apply its domestic anti-treaty shopping provision, even though; B Corp is the beneficial owner of the income? In the author's opinion, the scope of the anti-treaty shopping provision and the concept of beneficial ownership for the purposes of Art. 10 is different. The anti-treaty shopping provision looks into the business purpose of B Corp other than tax purposes whereas the beneficial ownership clause contained in Art. 10 does not look into such purpose. Therefore, as the scope of the domestic SAARs is different, the anti-treaty shopping rule can be invoked vis-à-vis B Corp. The question then arises as to whether this provision conflicts with the treaty provisions. As discussed previously (*see section 15.5.2*), in the author's

[1529] 2014 OECD Comm. Art. 10, Para. 12.1.
[1530] 2014 OECD Comm. Art. 10, Para. 12.4; DANON, Thesis, pp. 326-350.

opinion the T-S tax treaty applies to the facts of this case. This is because B Corp qualifies as a "*person*" under Art. 3(1)(a), that under Art. 4(1) is a "*resident*" of State T and the "*beneficial owner*" under Art. 10(2). To summarize, State S should not apply its domestic anti-avoidance rule to deny treaty benefits as this could clearly breach the "*pacta sunt servanda*" principle. However, OECD and UN member States can invoke the guiding principle when applying tax treaties concluded after 2003 to deny treaty benefits to the taxpayer. Whether or not the tests of the guiding principle are satisfied depends on the facts and circumstances of each case.

21.4.4. Broad treaty SAAR vs broad SAAR in domestic tax law

750. Furthermore, all facts remaining the same, let us assume that the T-S tax treaty has a LOB clause similar to Art. X(1) to X(6) as suggested in the 2015 Final TTA report (*see section 8.2.3*). The question which then arises is whether the LOB clause takes precedence over the anti-treaty shopping rule. In the author's view, it needs to be established whether B Corp can be considered to be a "*qualified person*" for the purposes of Art. X(1) and Art. X(2). The chances of B Corp managing to qualify are negligible if that entity is privately owned by non-residents and is only engaged in conducting passive business activities. Therefore, the LOB clause applies to the facts of the case and we do not need to proceed further to checking whether the anti-treaty shopping rule applies. However, if we assume that instead of investing through B Corp, X via a conduit financing arrangement with a State T listed bank, invests in State S companies. The chance of the bank being considered as a "*qualified person*" is high if that entity is engaged in conducting active business activities. Therefore, the bank can be considered to be a qualified person. In the author's opinion, a reference should not be made to the domestic SAAR such as an anti-treaty shopping provision if the taxpayer satisfies the tests of the LOB clause[1531]. This is because the LOB clause is a "*lex specialis*" in relation to the anti-treaty-shopping rule. Thus, if invoked, the author is of the opinion that the anti-treaty shopping rule will not apply as it is narrower in scope than the LOB clause. Even if the rule were broader the LOB clause would still prevent its application. The question which then arises is whether the bank is the beneficial owner of dividends for the

[1531] LINN, Tax Avoidance, p. 343. The author provides that the GFFC has ruled that the LOB clause (narrower than the one proposed by the 2015 Final TTA report) in a tax treaty takes precedence over the domestic anti-treaty shopping rule.

purpose of the T-S tax treaty (*see section 21.4.2*). If the domestic law of State S has a domestic SAAR on the concept of beneficial owner, which is broader than the treaty concept of beneficial owner then the former should not apply as a conflict arises. However, OECD and UN member States can invoke the guiding principle when applying tax treaties concluded after 2003 to deny treaty benefits to the taxpayer. Whether or not the tests of guiding principle are satisfied is questionable and depends on the facts and circumstances of each case.

21.4.5. Narrow and broad treaty SAAR vs narrow and broad SAAR and GAAR in domestic tax law

751. Continuing with the aforementioned analysis, assume that the domestic tax law of State S has a GAAR such as the Indian GAAR. Applying from a State S perspective, the anti-avoidance rule redetermines the taxpayer in the sense that the dividends are attributed to X as opposed to the bank. The question arises as to whether the treaty SAARs prohibit the application of the domestic anti-avoidance rule? It can be deduced from the 2003 OECD Commentary in Para. 9.6 that domestic GAAR's/judicial doctrines and treaty SAARs can apply concurrently. Accordingly, the fact that a tax treaty has SAARs does not mean that domestic GAARs/judicial doctrines cannot be applied. Similarly, the 2011 UN Commentary, by referring to the OECD's comments in Para. 9.6, considers that tax treaty SAARs supplement domestic GAARs/judicial doctrines [1532]. The OECD Commentary on Art. 10 also provides that even though the recipient of the income satisfies the "*beneficial owner*" requirement, treaty benefit may nevertheless be denied under domestic GAAR's/judicial doctrines [1533]. In the author's opinion, domestic GAARs/judicial doctrines can apply to a transaction even though tax treaties have SAARs as the scope of the former is broader[1534]. The question then arises as to whether the application of the domestic GAAR/judicial doctrines conflicts with the treaty provisions. As discussed previously, if the domestic GAAR/judicial doctrine redetermines the taxpayer to whom the income is attributed from a State S perspective (*see section 13.5.3*), in the author's opinion, the T-S tax treaty applies to the

[1532] 2011 UN Comm. Art. 1, Para. 32.
[1533] 2014 OECD Comm. Art. 10, Para. 12.5.
[1534] A commentator (Rust) argues to the contrary without any elaboration. See VOGEL, 2015 Commentary, p. 128.

facts of this case and State S shall be restricted from applying the effect of its domestic anti-avoidance rule. This is because B Corp qualifies as a "*person*" under Art. 3(1)(a) that is a "*resident*" under Art. 4(1) of State T and the "*beneficial owner*" under Art. 10(2). To summarize, State S should not apply the effect of its domestic GAAR as this could clearly breach the "*pacta sunt servanda*" principle. However, OECD and UN member States can invoke the guiding principle for tax treaties concluded after 2003 to deny treaty benefits to the taxpayer. Whether or not the tests of the guiding principle are satisfied is questionable and depends on the facts and circumstances of each case.

21.4.6. Narrow and broad treaty SAAR and treaty GAAR vs narrow and broad SAAR and GAAR in domestic tax law

752. It is now assumed that, all facts remaining the same, the tax treaty has a GAAR similar to the proposed PPT rule. The question arises as to whether the tax treaty GAAR precludes the application of the domestic GAAR. Continuing with the aforementioned example, if we assume that, even if the bank satisfies the LOB clause the beneficial owner requirement for the purposes of Art. 10 – the PPT rule – applies. This is because the clause provides that the rule is applicable "*notwithstanding"* other provisions of the tax treaty. Thus, the transaction conducted by the bank will be caught by the scope of the PPT provision. If the rule applies and it is proved that one of the principal purposes of the arrangement under which X assigned the right to the dividends to the bank was for the bank to obtain the treaty benefit and if that arrangement is contrary to the object and purpose of the relevant treaty provisions (Art. 10 in this case) then treaty benefits should not be provided to the bank [1535]. Therefore, the PPT rule applies to the facts of the case and we do not need to proceed further.

753. However, if we assume that the PPT rule does not apply as the bank has demonstrated several commercial reasons for entering into the arrangement, the question arises as to whether a domestic GAAR/judicial doctrine can be invoked to the facts of this case? Prior to answering this question it is important to check how State S treats the relationship between a domestic GAAR/judicial doctrine and SAAR. The answer to this question

[1535] 2014 OECD, Report on Treaty Abuse, Para. 17 (Commentary in Para. 7).

depends on the legislation of each State (*see section 21.2*). Even if we assume that the rules apply concurrently then, in the author's opinion, a reference should not be made to the domestic GAAR/judicial doctrines in such a case. This is because the text of the treaty can be considered to be a "*lex specialis*" that represents the common intentions of the parties[1536]. Thus, if the taxpayer comes clean of the LOB test and is the beneficial owner and furthermore satisfies the PPT rule, the domestic GAAR/judicial doctrine should not apply. If we apply the general rule of interpretation of Art. 31 VCLT the treaty has to be interpreted in "*in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose*". It could be argued that the context of a tax treaty prohibits a reference to a domestic GAAR/judicial doctrine as the tax treaty contains a GAAR. It could also be argued that the "*object and purpose*" of the treaty GAAR is to comprehensively deny treaty benefits in abusive situations. If that provision does not apply it could be argued that "*object and purpose*" warrants that treaty benefits should be extended to the taxpayer. This is because, if treaty benefits are not granted pursuant to domestic anti-avoidance rules, double taxation could arise, which is thus contrary to the "*object and purpose*" of the treaty. The 2014 TTA and 2015 Final TTA reports confirm this position by providing that domestic GAARs can be applied to tax treaties only if the conformity with the PPT rule. This means that if the domestic GAAR has a wider scope than that of the PPT rule the latter rule will prevent the application of the former rule.

21.5. Denial of treaty benefits – is it preferable to use domestic anti-avoidance rules or treaty anti-avoidance rules?

754. The toolbox provided by the BEPS project to counter treaty abuse is large. On one hand the OECD suggests the inclusion of the PPT rule and/or the LOB clause and other targeted treaty SAARs whereas on the other hand it clarifies that domestic anti-abuse measures do not conflict with tax treaties. In the author's opinion, treaty abuse (benefits that are derived from tax treaties) should be counteracted by treaty measures as opposed to domestic anti- avoidance measures. This is because the latter measures may

[1536] DE BROE, Thesis, p. 288.

usurp taxing rights and lead to double taxation thereby reducing the value of tax treaties as their application becomes less certain.

PART VII: EU LAW AND DOMESTIC ANTI-AVOIDANCE RULES

22. The impact of EU law on the application of domestic anti-avoidance rules

22.1. Domestic anti-avoidance rules in light of the treaty freedoms

22.1.1. Treaty freedoms

755. The TFEU aims at establishing a common (or internal) market within the EC[1537]. The goal of the internal market, among other requirements, is to enable economic operators to buy or sell goods, work, provide or consume services and invest within the EC without being constrained by national measures that could hamper intra community economic activity. Towards this end, the TFEU includes provisions ("*treaty freedoms*" hereafter), which aim at removing obstacles with respect to the movement of goods, workers, establishment, services and capital/payments. These freedoms ensure market access (right to circulate within the EC) and market equality (prevention of discrimination due to nationality or origin) within the internal market[1538]. An overview of the treaty freedoms is provided below.

756. The free movement of goods provision [1539] prescribes the free circulations of goods within the EC. Essentially, the freedom prohibits the application of customs duties on imports and exports (and similar charges) within the EC. Moreover, it propagates the adoption of a common customs tariff in relation to trading with third countries[1540].

757. The free movement of person provisions[1541] mandate free movement of workers within EC. The freedom gives workers the right to accept employment abroad, to leave their Member State of origin for this purpose and to stay in the State where they are employed during and post employment. Furthermore, the freedom prohibits market in-equality arising

[1537] TERRA, WATTEL, European law, p. 35; DE BROE, Thesis, p. 745.
[1538] TERRA, WATTEL, European law, pp. 35-38.
[1539] TFEU, Art. 28-Art. 37.
[1540] TERRA, WATTEL, European law, p. 57.
[1541] TFEU, Art. 45-Art. 48.

from discriminatory rules established by a Member State with respect to workers from other Member States[1542].

758. The treaty freedom of establishment[1543] includes the right to take up and pursue activities as a self-employed person and to set up and manage undertakings under the conditions laid down by a Member State for its own nationals where such establishment is effected. The freedom affords to nationals (individuals, companies or firms) of a Member State the right to primary establishment (the right to set up new undertakings) and secondary establishment (the right to set up agencies, branches or subsidiaries). Essentially, the freedom prohibits a Member State (Home State) from restricting market access to its nationals or a Member State (Host State) from discriminating nationals of other States with respect to establishment (market equality) [1544] . This freedom typically applies in situations where a shareholder exercises significant influence over an entity[1545].

759. Under the treaty freedom of services[1546], a service provider has the right to provide services in another Member State (market access) and the right to be treated equally as a domestic service provider once it has entered into that market (market equality). It should be noted that the freedom also extends to the purchaser of the services in the sense that the recipient may move to the State of the service provider and invoke the right to national treatment[1547].

760. The free movement of capital provisions[1548] prohibits Member States from enacting legislation that discourages movement of capital not only between Member States but also between Member States and Third States. Essentially, the freedom enables investors to freely invest their capital in other States and enables undertakings to raise capital from other States. However, with respect to third States, the freedom provides for a standstill

[1542] TERRA, WATTEL, European law, pp. 67-68.
[1543] TFEU, Art. 49 – Art. 55.
[1544] TERRA, WATTEL, European law, pp. 68-69.
[1545] TERRA, WATTEL, European law, p. 70. Also see ECJ: C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem, Case No: C-251/98, April 13th, 2000, Para. 22.
[1546] TFEU, Art. 56 – Art. 62.
[1547] TERRA, WATTEL, European law, pp. 65-66; ARMENIA, ZALASINSKI, Passive Income, p. 61.
[1548] TFEU, Art. 63-Art. 66.

clause which states that Member States may preserve restrictive provisions if these provisions existed as at 31 December 1993 and affect i) direct investment including real estate ii) establishment iii) provision of financial services and iv) admission of securities to capital markets. Furthermore, it should be noted that this freedom entitles Member States to apply domestic tax rules that distinguish between resident and non-resident investors and domestic and foreign source capital income subject to the condition that such rules do not amount to arbitrary discrimination or a disguised restriction[1549]. The freedom typically applies in situations where a shareholder makes a portfolio investment in an entity[1550].

22.1.2. Impact of treaty freedoms on domestic anti-avoidance rules: The ECJ's approach

22.1.2.1. Introductory comments

761. To a great extent, indirect taxation within the EU is harmonized[1551]. On the other hand, direct taxation remains largely within each Member States competence although some steps have been taken towards its harmonization through directives *(see section 22.2*). Consequently, national direct tax rules can potentially lead to fiscal obstacles that in turn can impede the functioning of the internal market by restricting market access and denying market equality. Nevertheless, as EU Member States are required to exercise their legal competence in light of the treaty freedoms, domestic direct tax law rules (including domestic anti-avoidance rules) have to comply with EU law in such a manner that they do not create obstacles to the free movement of goods, persons, services and capital[1552].

762. In general, the ECJ interprets the treaty freedoms in light of achieving an obstacle free internal market. Taking this objective into consideration, the ECJ strikes down domestic law measures that conflict with the treaty

[1549] TERRA, WATTEL, European law, pp. 71-77.
[1550] TERRA, WATTEL, European law, pp. 77-78.
[1551] TERRA, WATTEL, European law, p. 36.
[1552] ECJ: Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, Case No: C-324/00, December 12th, 2002, Para. 26; Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, Case No: C-524/04, March 13th, 2007, Para. 25; Lammers & Van Cleeff NV v Belgische Staat, Case No: C-105/07, January 17th, 2008, Para. 12; Also see TERRA, WATTEL, European law, pp. 37-39; DE BROE, Thesis, p. 748; ARMENIA, ZALASINSKI, Passive Income, p. 58; VAN WEEGHEL, Tax Avoidance, p. 54.

freedoms (negative integration within the internal market). Broadly, when the ECJ analyses the compatibility of a domestic rule (including anti-avoidance rules) with the treaty freedoms, it analyses i) whether a taxpayer can access the treaty freedom ii) if yes, whether the domestic rule amounts to a restriction/discrimination of the concerned treaty freedom? ii) if a restriction/discrimination arises then is that rule justified by imperative requirements in general interest? iii) if justified, is that rule proportional? If proportional, then the verdict is that such a rule does not conflict with EU law (treaty freedoms)[1553].

22.1.2.2. Access to treaty freedoms: The abuse of rights doctrine

763. A taxpayer has access to treaty freedoms in situations where it carries out genuine economic activity such as, for example, cross-border sale and purchase of goods, employment, self-employment, establishment of undertakings (such as subsidiaries, branches and agencies), provision of services, active and passive investment[1554].

764. It is clear from ECJ case law that an economic operator cannot invoke EU law (treaty freedoms) in fraudulent situations (for instance sham/simulated transactions or false declarations) [1555]. Moreover, for transactions that are legally effective, an economic operator cannot invoke treaty freedoms to circumvent national laws in abusive scenarios (also, an economic operator cannot utilize secondary law sources such as directives in an abusive manner). In this regard, the ECJ has created an "*abuse of rights*" doctrine[1556] that operates as a principle governing interpretation of EC law

[1553] ARMENIA, ZALASINSKI, p. 59; TERRA, WATTEL, European law, pp. 55-64.

[1554] TERRA, WATTEL, European law, pp. 39-46.

[1555] For instance see the following ECJ decisions: Alexandros Kefalas and Others v Elliniko Dimosio (Greek State) and Organismos Oikonomikis Anasygkrotisis Epicheiriseon AE (OAE), Case No: C-367/96, May 12th, 1998, Para. 20; Dionysios Diamantis v Elliniko Dimosio (Greek State) and Organismos Ikonomikis Anasygkrotisis Epicheiriseon AE (OAE), Case No: C-373/97, March 23rd, 2000, Para. 33; I/S Fini H v Skatteministeriet, Case No: C-32/03, March 3rd, 2005, Para. 32.

[1556] For instance, the following ECJ case law has lead to the creation of the doctrine: J. Knoors v Staatssecretaris van Economische Zaken, Case No: C-115/78, February 7th, 1979; Criminal proceedings against Marc Gaston Bouchoucha, Case No: C-61/89, October 3rd, 1990; The Queen v Immigration Appeal Tribunal and Surinder Singh, ex parte Secretary of State for Home Department, Case No: C-370/90, July 7th, 1992; Vereniging Veronica Omroep Organisatie v Commissariaat voor de Media Department, Case No: C-148/91, February 3rd, 1993; TV10 SA v Commissariaat voor de Media, Case

(including treaty freedoms). This doctrine can be invoked to deny protection (access) under the treaty freedoms despite the fact that the economic operator fulfils all the formal conditions[1557].

765. To elaborate, in the landmark *Emsland Stärke case* [1558], the ECJ suggested a two fold test for determining abuse: *"A finding of an abuse requires, first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by the Community rules, the purpose of those rules has not been achieved* (objective test) [1559]. *It requires, second, a subjective element consisting in the intention to obtain an advantage from the Community rules by creating artificiallly the conditions laid down for obtaining it"* (subjective test) [1560]. Subsequently, in the *Halifax*[1561] judgment, the ECJ once again held that abuse of EC law arises when firstly "*the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions"* [1562] (objective test) and secondly "*it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage*" (subjective test)[1563]. In the author's opinion, even though the subjective and objective elements seem to be framed differently in both judgments[1564], the definition of abuse

No: C-23/93, October 5th, 1994; Centros Ltd v Erhvervs- og Selskabsstyrelsen, Case No: C-212/97, March 9th, 1999.

[1557] TERRA, WATTEL, European law, p. 915.

[1558] ECJ: Emsland-Stärke GmbH v Hauptzollamt Hamburg-Jonas, Case No: C-110/99, December 14st 2000.

[1559] *Ibid*., Para. 52.

[1560] *Ibid*., Para. 53.

[1561] ECJ: Halifax plc and others v Customs and Excise Commissioners, Case No: C-255/02, February 21st 2006.

[1562] *Ibid*., Para. 74.

[1563] *Ibid*., Para. 75.

[1564] For instance, with respect to the subjective element, the key difference between the *Emsland Stärke* and the *Halifax* judgment is that under the latter judgment a transaction is considered abusive if its sole or essential purpose is to obtain a tax advantage. However, the *Halifax* judgment, unlike the *Emsland Stärke* judgement, did not refer to the concept of "*artificiality*". This could imply that the subjective element is satisfied even if the transactions had several business purposes although the tax purpose was the dominant purpose. Further, with respect to the objective element, the *Emsland Stärke* judgment referred to "*combination of objective circumstances"*. This aspect was somehow omitted in the *Halifax* judgment. DE BROE, Thesis, pp. 771-774.

put forward in both judgments is quite similar[1565]. Generally, when an economic operator uses the treaty freedom to trump national law, abuse arises when the operator exercises its right to free movement with the sole intention of obtaining benefits through artificial schemes and granting the benefits would be contrary to the object and purpose of the relevant provisions of EC law[1566]. In such situations, access to the treaty freedoms maybe denied on an independent basis by contending that EC law contains an abuse of rights doctrine (although this is rare) [1567]. However, more often than not, this doctrine is used at the justification/proportionality level (in conjunction with the tax avoidance justification) once the restriction or discrimination has been identified (as provided in the *Cadbury Schweppes*[1568] and *3M*[1569] cases).

22.1.2.3. Domestic anti-avoidance rules as restrictions/discriminations

766. If a taxpayer has access to treaty freedoms, as a next step, the ECJ analyses as to whether a national rule (including a domestic anti-avoidance measure) leads to a restriction or discrimination. In direct tax matters, restrictions are usually created by the home State and the host State is usually responsible for discrimination. In the former situation, a taxpayer is subject to a hindrance under the national law of the home State concerning his ability to enter into a cross-border situation as compared to a purely domestic situation. In the latter case, a taxpayer (typically a non-resident)

[1565] The two elements were also discussed in another judgment. See ECJ: Ministero dell'Economia e delle Finanze v Part Service Srl, Case No: C-425/06, February 21st 2008.

[1566] For instance, the ECJ has held that a national law cannot be circumvented by the treaty freedoms (freedom to provide services) in the cases of abuse. Refer to the following cases: Vereniging Veronica Omroep Organisatie v Commissariaat voor de Media Department, Case No: C-148/91, February 3rd, 1993; TV10 SA v Commissariaat voor de Media, Case No: C-23/93, October 5th, 1994. Moreover, abuse also arises when an economic operator, intends to take advantage of secondary law (directives) in a manner that frustrates the object and purpose of those provisions. For instance, the ECJ has held that secondary law (VAT directive) was abused in the following cases: Emsland-Stärke GmbH v Hauptzollamt Hamburg-Jonas, Case No: C-110/99, December 14st 2000; Halifax plc and others v Customs and Excise Commissioners, Case No: C-255/02, February 21st 2006.

[1567] TERRA, WATTEL, European law, pp. 46-48.

[1568] ECJ: Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case No: C-196/04, September 12th, 2006, Para. 64.

[1569] ECJ: Ministero dell'Economia e delle Finanze and Agenzia delle Entrate v 3M Italia SpA, Case No: C-417/10, March 29th, 2012, Para. 31.

does not receive equal treatment extended to residents in the host State once the free movement has been exercised[1570]. The ECJ has held on a few occasions that domestic anti-avoidance rules constitute an obstacle with respect to the free movement provisions.

767. With respect to CFC rules, in the *Cadbury Schweppes*[1571] judgment, it was held that the UK CFC rules constituted a restriction on the freedom of establishment as they deterred UK companies from setting up subsidiaries overseas whereas the rules did not apply to domestic subsidiaries. Similarly, with respect to a CFC type rule, in the *Commission v UK* case[1572], it was held that the UK attribution of gains rules constituted a restriction on the free movement of capital as they deterred UK residents from setting up subsidiaries overseas and overseas companies from raising capital in the UK.

768. In the context of thin capitalization rules, in the *Lankhorst – Hohorst*[1573] judgment the ECJ held that the German thin capitalization rules, which followed a fixed debt/equity ratio, acted as an obstacle to the freedom of establishment as such rules were a hindrance to foreign parents funding German subsidiaries via loans whereas no such restriction was imposed on German parents funding German subsidiaries. Similarly, in the *Test claimants* judgment[1574], it was held that the UK thin capitalization rules acted as an obstacle to the freedom of establishment as they denied interest paid by UK resident companies to foreign parents whereas no such denial of deduction applied to interest paid to UK parents. Likewise, in the *Lammers & Van Cleef*[1575] judgment, it was held that a Belgian interest limitation rule acted as an obstacle to the freedom of establishment as it denied interest paid by Belgian resident companies to foreign directors whereas no such denial of deduction applied to interest paid to Belgian directors. Also, in the

[1570] See TERRA, WATTEL, European law, pp. 84-92.
[1571] ECJ: Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case No: C-196/04, September 12th, 2006, Para. 46.
[1572] ECJ: Commission v United Kingdom, Case No: C-112/14, November 13th, 2014, Para. 20.
[1573] ECJ: Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, Case No: C-324/00, December 12th, 2002, Para. 32.
[1574] ECJ: Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, Case No: C-524/04, March 13th, 2007, Paras. 59-63.
[1575] ECJ: Lammers & Van Cleeff NV v Belgische Staat, Case No: C-105/07, January 17th, 2008, Paras. 23-24.

Intelcar[1576] judgment, it was held that the Portuguese thin capitalization rule constituted a restriction on the free movement of capital as it deterred Portuguese companies from raising capital from non Member States.

769. As regards a Belgian rule that increased the profits of a Belgian resident company that dealt with non-resident associated enterprises whereas no such increase in profits took place when it dealt with resident enterprises, the ECJ in the *SGI* judgment[1577] held that the rule constituted a restriction on the freedom of establishment.

770. Finally, in relation to immediate exit taxes, the ECJ in judgments such as the *National Grid Indus*[1578], *Commission vs Portugal*[1579], *Commission vs Denmark*[1580] has held that national provisions which tax unrealized gains when a corporation moves to another Member State whereas no such tax is levied when the corporation moves domestically, constitutes a restriction to the freedom of establishment. Equally, for individuals, the ECJ in the cases of *de Lasteyrie du Saillant*[1581] and *N*[1582] cases has held that immediate exit constitute a restriction on the free movement provisions. Accordingly, depending on the scope of a domestic anti-avoidance rule, an obstacle to the free movement provisions may arise.

22.1.2.4. Justifications: The tax avoidance argument

771. If an obstacle to the freedom of movement arises, then the ECJ analyses as to whether the national law measure can be justified in the light of overriding reasons of public interest. For national direct tax law measures that amount to obstacles, the ECJ has accepted justifications[1583] such as the

[1576] ECJ: Itelcar - Automóveis de Aluguer Lda v Fazenda Pública, Case No: C-282/12, October 3rd, 2013, Para. 31.
[1577] ECJ: Société de Gestion Industrielle (SGI) v Belgian State, Case No: C-311/08, January 21st, 2010, Paras. 50-55.
[1578] ECJ: National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam, Case No: C-371/10, November 29th, 2011, Paras. 40-41.
[1579] ECJ: European Commission v Portuguese Republic, Case No: C-38/10, September 6th, 2012., Paras. 28-29.
[1580] ECJ: European Commission v Kingdom of Denmark, Case No: C-261/11, July 18th, 2013, Paras. 1-2.
[1581] ECJ: Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie, Case No: C-9/02, March 11th, 2004, Paras. 46-48.
[1582] ECJ: N v Inspecteur van de Belastingdienst Oost/kantoor Almelo, Case No: C-470/04, September 7th, 2006, Paras. 37-39.
[1583] TERRA, WATTEL, European law, pp. 60-64.

need to maintain the coherence of a tax system[1584], the need to protect balanced allocation of taxing rights[1585], the need for effective fiscal supervision[1586] and the need to prevent tax evasion and avoidance or abuse of law. With respect to the tax avoidance justification, the ECJ, for instance, in the *Marks & Spencer*[1587] judgment held that cross-border transfer of losses could give rise to tax avoidance risks among Member States. Accordingly, national legislation that reduces the risk of tax avoidance could be justified subject to the proportionality requirement[1588].

22.1.2.5. The test of proportionality

772. If a justification is accepted, the ECJ analyses whether the domestic tax law rule is proportional. Specifically, the ECJ analyses whether the rule is suitable for the attainment of the objective it pursues and the rule does not go beyond what is necessary for attainment of the objective[1589]. For instance, in the *Cadbury Schweppes* judgment, the Court held that "*in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality*"[1590]. In this regard, the UK CFC rules, were indeed suitable for the attainment of the objective of

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[1584] ECJ: Hanns-Martin Bachmann v Belgian State, Case No: C-204/90, January 28st, 1992, Paras. 21-28. It should be noted that this justification has been rejected in several direct tax cases pursuant to this judgment. TERRA, WATTEL, European law, p. 61.

[1585] ECJ: N v Inspecteur van de Belastingdienst Oost/kantoor Almelo, Case No: C-470/04, September 7th, 2006.

[1586] ECJ: Futura Participations and Singer v Administration des contributions, Case No: C-250/95, May 15th, 1997, Paras. 31-35; Skatteverket v A, Case No: C-101/05, December 18th, 2007, Paras. 54-55. Also see ZALASINSKI, Proportionality, p. 315.

[1587] ECJ: Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes), Case No: C-446/03, December 13th, 2005, Para. 49.

[1588] ZALASINSKI, Proportionality, pp. 315-321; DE BROE, Observation, pp. 143-145. It is also possible that the ECJ may accept the tax avoidance justification in conjunction with other justifications. See TERRA, WATTEL, European law, pp. 922-924.

[1589] ECJ: Futura Participations and Singer v Administration des contributions, Case No: C-250/95, May 15th, 1997, Para. 25; Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes), Case No: C-446/03, December 13th, 2005, Para. 35; Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie, Case No: C-9/02, March 11th, 2004, Para. 49; Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case No: C-196/04, September 12th, 2006, Para. 47.

[1590] ECJ: Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case No: C-196/04, September 12th, 2006, Para. 55.

preventing wholly artificial arrangement as "*by providing for the inclusion of the profits of a CFC subject to very favourable tax regime in the tax base of the resident company, the legislation on CFCs makes it possible to thwart practices which have no purpose other than to escape the tax normally due on the profits generated by activities carried on in national territory. As the French, Finnish and Swedish Governments stated, such legislation is therefore suitable to achieve the objective for which it was adopted*" [1591]. Nevertheless, the Court also examined whether the UK CFC rules went beyond the objective they pursued. In this regard, by referring to the *Emsland Stärke* and *Halifax* judgments, it was held that if the rules apply only to wholly artificial arrangements then the freedom of establishment is not violated. However, if they apply to arrangements that encompass economic reality then such rules will be contrary to the freedom of establishment provisions even though the arrangement contained tax motives [1592]. In the ECJ's verdict, "*wholly artificial arrangements*" exist when the CFC does not have any "*premises, staff and equipment*" [1593] and can be characterized as a "*letter box*". Accordingly, a reasonable statement can be made that CFC rules are incompatible with the freedom of establishment provisions if they apply to entities in low-tax countries (Member States) that carry out genuine economic activity. In line with this argument, the attribution of gain rules, as discussed in the *Commission v UK* case[1594], was held to violate the free movement of capital provisions as it applied generally and was not restricted to wholly artificial arrangements.

[1591] ECJ: Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case No: C-196/04, September 12th, 2006, Para. 59. However, in the *Jobra* judgment, the ECJ held that the legislation at stake did not satisfy this condition and thus was incompatible with the freedom to provide services. See ECJ: Jobra Vermögensverwaltungs-Gesellschaft mbH v Finanzamt Amstetten Melk Scheibbs, Case No: C-330/07, December 4th, 2008, Para. 39.

[1592] The ECJ in the *ICI* judgment held that, even though the UK legislation on loss carry over constituted a restriction, that legislation could not be justified under the tax avoidance umbrella as it applied generally and did not have the specific purpose of preventing "*wholly artificial arrangements*". See ECJ: Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes), Case No: C-264/96, July 16th, 1998, Para. 26. Similarly, in the *Lankhorst* judgment it was held that the German thin capitalization rules applied generally and not to "*wholly artificial arrangements*". See ECJ: Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, Case No: C-324/00, December 12th, 2002, Para. 37.

[1593] ECJ: Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case No: C-196/04, September 12th, 2006, Para. 66.

[1594] ECJ: Commission v United Kingdom, Case No: C-112/14, November 13th, 2014, Paras. 28-29.

773. Likewise, in the *Test claimants* judgment the ECJ held that the UK thin capitalization rules were indeed suitable for the attainment of the objective of preventing profit shifting to low-tax countries through base eroding interest payments[1595]. Furthermore, when analyzing whether the UK thin capitalization rules went beyond the objective they pursued, the ECJ held that such domestic rules are proportional if i) they provide for objective and verifiable elements to ascertain if the rules apply to "*wholly artificial arrangements*" ii) the taxpayer is given the opportunity to provide a commercial justification for undertaking the transaction without being subject to undue administrative constraints and iii) even if abuse arises, such rules adhere to the arms length standard, that is, they do not adjust the profits of the borrower beyond that mandated by the arm's length standard[1596]. Moreover, in the *Lammers & Van Cleef*[1597] and *Intelcar*[1598] judgments, the ECJ arrived at a similar conclusion. Accordingly, domestic thin capitalization rules are incompatible with the freedom of establishment/free movement of capital provisions if they are not predicated on an assessment of objective and verifiable elements for the purposes of determining whether a transaction represents a "*wholly artificial arrangement*". Even if the rules provide elements for determining the existence of a "*wholly artificial arrangement*" such rules could be found incompatible if the taxpayer is not provided with an opportunity to provide a commercial justification (without being subject to administrative hassles) and such rules make profit adjustments to the borrower that exceed the arm's length standard. The ECJ also arrived at a similar conclusion in the *SGI* judgment wherein the Belgian rule was analyzed under the proportionality test[1599].

774. Furthermore, in the *SIAT*[1600] and *Intelcar*[1601] judgments, the ECJ linked the proportionality test to the concept of legal certainty[1602]. In

[1595] ECJ: Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, Case No: C-524/04, March 13th, 2007, Paras. 76-77.

[1596] ECJ: Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, Case No: C-524/04, March 13th, 2007, Paras. 80-83.

[1597] ECJ: Lammers & Van Cleeff NV v Belgische Staat, Case No: C-105/07, January 17th, 2008, Paras. 28-29.

[1598] ECJ: Itelcar - Automóveis de Aluguer Lda v Fazenda Pública, Case No: C-282/12, October 3rd, 2013, Paras. 37-38.

[1599] ECJ: Société de Gestion Industrielle (SGI) v Belgian State, Case No: C-311/08, January 21st, 2010, Paras. 71-72.

[1600] ECJ: Société d'investissement pour l'agriculture tropicale SA (SIAT) v Belgian State, Case No: C-318/10, July 5th, 2012, Paras. 57-58.

particular, the ECJ held that domestic rules should "*meet the requirements of the principle of legal certainty, in accordance with which rules of law must be clear, precise and predictable as regards their effects, in particular where they may have unfavourable consequences for individuals and undertakings*". Accordingly, if the outcome of applying a domestic anti-avoidance rule is not clear or is ambiguous such a rule may fail to be proportional[1603].

22.1.2.6. Concluding remarks: The impact of ECJ case law on domestic anti-avoidance rules

775. Taxpayers can indeed take advantage of differences in tax systems within EU Member States due to lack of harmonization within the direct tax field (for instance establishing operations in a low-taxed Member State)[1604]. EU Member States can adopt domestic anti- avoidance rules to counter such taxpayer behaviour[1605]. Such rules, nevertheless, need to comply with EU Law. Accordingly, in light of the aforementioned case law analysis, it is quite clear that treaty freedoms do impact the application of domestic anti-avoidance rules. Once a restriction/discrimination has been identified and the tax avoidance justification is invoked, a case by case analysis would have to be carried out to ascertain whether the following conditions are satisfied for a domestic anti-avoidance rule (cumulatively or individually depending on the scope of the rule that is designed to prevent/limit the risk of tax avoidance) to be compatible with the treaty freedoms: i) the rules should provide for objective and verifiable elements to determine whether a transaction represents a wholly artificial arrangement entered into for tax purposes alone; ii) the taxpayer should be given an opportunity to provide any commercial justification that it may have for the arrangement without being subject to unnecessary administrative hassles; iii) if abuse arises then the redetermination of the transaction should be limited to the extent necessary to prevent the abuse: for example, profit adjustments should not be

[1601] ECJ: Itelcar - Automóveis de Aluguer Lda v Fazenda Pública, Case No: C-282/12, October 3rd, 2013, Para. 44.
[1602] ARMENIA, ZALASINSKI, Passive Income, p. 65; Also see ECJ: Halifax plc and others v Customs and Excise Commissioners, Case No: C-255/02, February 21st 2006, Para. 94.
[1603] TERRA, WATTEL, European law, p. 930.
[1604] ECJ: Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, Case No: C-324/00, December 12th, 2002, Para. 37; Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes), Case No: C-264/96, July 16th, 1998, Para. 26.
[1605] DE BROE, Observation, p. 143.

made at the level of the taxpayer in excess of the arm's length standard for rules that deal with the arm's length principle; iv) the rules should respect the principle of legal certainty ie they should be clear, precise and predictable as regards their effect[1606].

22.2. Domestic anti-avoidance rules in light of the direct tax directives

776. Selective directive tax harmonization measures have taken place at the EU level through directives vis-à-vis taxation of companies. Specifically, the Merger Directive[1607] (MD), the Parent-Subsidiary Directive[1608] (PSD) and the Interest and Royalties Directive[1609] (IRD) have been implemented. Specific provisions in these directives deal with abuse.

777. For instance, Art. 11(1)(a) of the MD provides that its benefits will be denied when a reorganization "*has as its principal objective or as one of its principal objectives tax evasion or tax avoidance"*. It is further stated that "*the fact that one of the operations referred to in Article 1 is not carried out for valid commercial reasons such as the restructuring or rationalization of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives*"[1610]. While implementing the directive into their national legislation, different Member States, pursuant to Art. 11(a) have adopted domestic anti-avoidance rules of general nature or predetermined criteria[1611]. This has lead to the denial of the MD benefits even in non-abusive situations. Accordingly, while interpreting

[1606] ARMENIA, ZALASINSKI, Passive Income, p. 65.

[1607] The objective of this directive is to remove tax obstacles for cross-border business reorganizations (mergers, demergers, acquisitions etc) involving companies. See Directive 90/434/EEC as up-dated by Directive 2005/19/EC and Directive 2009/133/EC.

[1608] The objective of this directive is to remove withholding tax obstacles for cross-border profit distributions by subsidiaries to parent companies and eliminating double taxation at the level of the latter. See Directive 90/435/EEC as up-dated by Directive 2003/123/EC. The directive was recently amended once again to include certain anti-abuse clauses. See Directives 2014/86/EU and (EU) 2015/121.

[1609] The objective of this directive is to remove withholding tax obstacles for cross border interest and royalty payments. See Directive 2003/49/EC as updated by Directive 2004/76/EC.

[1610] Art. 11, Directive 90/434/EEC; Art. 15, Directive 2009/133/EC.

[1611] TERRA, WATTEL, European law, pp. 69-690.

this provision, the ECJ in the *Leur-Bloem*[1612] case held that "*Article 11 of the Directive is to be interpreted as meaning that in determining whether the planned operation has as its principal objective or as one of its principal objectives tax evasion or tax avoidance, the competent national authorities must carry out a general examination of the operation in each particular case. Such an examination must be open to judicial review. Under Article 11(1)(a) of the Directive, the Member States may stipulate that the fact that the planned operation is not carried out for valid commercial reasons constitutes a presumption of tax evasion or tax avoidance. It is for the Member States, observing the principle of proportionality, to determine the internal procedures necessary for this purpose. However, the laying down of a general rule automatically excluding certain categories of operations from the tax advantage, on the basis of criteria such as those mentioned in the second answer under (a), whether or not there is actually tax evasion or tax avoidance, would go further than is necessary for preventing such tax evasion or such tax avoidance and would undermine the aim pursued by the Directive*". Likewise, in the *Zwijnenburg* case, the ECJ held that in order to determine whether the re-organization has the objective of tax avoidance, "*national authorities cannot confine themselves to applying predetermined general criteria but must subject each particular case to a general examination*" [1613]. Moreover, in the *Kofoed* case, it was held that "*Article 11(1)(a) …reflects the general Community law principle that abuse of rights is prohibited*" [1614] and directive benefits have to be provided unless "*national rules on abuse of rights, tax evasion or tax avoidance may be interpreted in accordance with Article 11(1)(a) of Directive 90/434 and thus justify the taxation*" [1615]. Therefore, national rules have to be interpreted in light of the anti-abuse provision of the MD which implies that such rules have to be proportional. The ECJ also arrived at a similar conclusion in the *Foggia*[1616] judgment and held that a case-by-case analysis would be required in order to

[1612] ECJ: A. Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2, Case No: C-28/95, July 17th, 1997, Para. 48(b).

[1613] ECJ: Modehuis A. Zwijnenburg BV v Staatssecretaris van Financiën, Case No: C-352/08, May 20th, 2010, Para. 44.

[1614] ECJ: Hans Markus Kofoed v Skatteministeriet, Case No: C-321/05, July 5th, 2007, Para. 38.

[1615] ECJ: Hans Markus Kofoed v Skatteministeriet, Case No: C-321/05, July 5th, 2007, Para. 48.

[1616] ECJ: Foggia - Sociedade Gestora de Participações Sociais SA v Secretário de Estado dos Assuntos Fiscais, Case No: C-126/10, November 10th, 2011, Para. 50.

determine if a presumption of tax avoidance or evasion was at stake[1617]. These rulings imply that national anti-avoidance measures that are drafted as general rules or presumptions (to exclude certain categories of transactions from tax advantages) to deny MD benefits could be disproportionate. Thus, unrebuttable presumptions of tax avoidance or evasion are not acceptable. Consequently, such measures have to be proportional[1618].

778. With respect to the other direct tax directives, it should be noted that Art. 1(2) of the PSD and Art. 5(1) of the IRD respectively state that the directives "*shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse*". The provisions imply that Member States can apply domestic or tax treaty based anti-abuse rules to limit the benefits under the directive, so as to prevent fraud or abuse. In the author's opinion, domestic anti-avoidance rules have to satisfy the ECJ proportionality test to in order to be applicable. Accordingly, such measures have to be suitable for the attainment of their objective (prevention of abuse) and should not go beyond what is necessary for attainment of that objective (i.e. they must not be excessive). As a result, domestic anti-avoidance rules that are drafted as general rules or presumptions (to deny tax advantages for certain category of transactions) to deny PSD or IRD benefits could be disproportionate[1619]. Moreover, treaty based anti-avoidance rules (such as the LOB clause) that could be invoked to deny the directive benefits, have to comply with EU Law.

22.3. Domestic anti-avoidance rules in light of treaty safeguard clauses

779. Due to the absence of harmonization in the area of direct taxes, Member States "*remain at liberty to determine the connecting factors for the allocation of fiscal jurisdiction by means of bilateral agreements*[1620] …

[1617] ECJ: Foggia - Sociedade Gestora de Participações Sociais SA v Secretário de Estado dos Assuntos Fiscais, Case No: C-126/10, November 10th, 2011, Para. 52.

[1618] ARMENIA, ZALASINSKI, Passive Income, p. 65; DOURADO, Abuse, p. 46; HOENJET, Merger Directive, p. 212.

[1619] TERRA, WATTEL, European law, pp. 646-647; ARMENIA, ZALASINSKI, Passive Income, p. 69; EY, PSD, p. 6; HOENJET, Merger Directive, p. 213; WEBER, GAAR, pp. 67-68.

[1620] ECJ: Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin, Case No: C-336/96, May 12th, 1998, Paras. 24-30; Compagnie de Saint-Gobain, Zweigniederlassung

Nonetheless, such an allocation of fiscal jurisdiction does not permit Member States to introduce discriminatory measures which are contrary to the Community rules" [1621]. Accordingly, tax treaty provisions, which constitute a part of the EU legal framework [1622] and are comparable to national law, have to comply with EU Law [1623]. Specifically, treaty anti-abuse rules should not lead to any restriction/discriminations. Even if such restriction/discrimination arise, these rules need to be justified and have to be proportional. For instance, it has been contended that the LOB clause [1624] or the PPT rule [1625] could be contrary to EU Law (PPT rule because of the lack of legal certainty). In one of the previous chapters (*see chapter 10*), the author discusses the impact of treaty safeguard clauses that preserve the application of domestic anti-avoidance rules. If EU Member States adopt such clauses in their treaty network then domestic anti-avoidance measures can indeed be applied. Such domestic rules, nevertheless, have to be applied taking into consideration EU law requirements, especially, the proportionality requirement (*see section 22.1 and 22.2)*.

22.4. Conclusion

780. In 2007, the EC Commission in its communication indicated, "*the need to prevent tax avoidance or abuse can constitute an overriding reason in the public interest capable of justifying a restriction on fundamental freedoms. But in order to be lawful national anti-avoidance rules must be proportionate and serve the specific purpose of preventing wholly artificial arrangements*"[1626]. Further, the OECD, in its various BEPS reports (Action 4[1627] and Action 6[1628]) has recognized that EU law impacts the application of

Deutschland v Finanzamt Aachen-Innenstadt, Case No: C-307/97, September 21st, 1999, Para. 57; Margaretha Bouanich v Skatteverket, Case No: C-265/04, January 19th, 2006, Para. 49.

[1621] ECJ: Margaretha Bouanich v Skatteverket, Case No: C-265/04, January 19th, 2006, Para. 50.

[1622] ECJ: Denkavit Internationaal BV and Denkavit France SARL v Ministre de l'Économie, des Finances et de l'Industrie, Case No: C-170/05, December 14th, 2006, Para. 45.

[1623] TERRA, WATTEL, European law, p. 941.

[1624] TERRA, WATTEL, European law, p. 948; KEMMEREN, BEPS, p. 191; BAKER, BEPS, pp. 409-412 (and all references therein).

[1625] KEMMEREN, BEPS, p. 192; BAKER, BEPS, pp. 412-414.

[1626] European Commission, Anti Avoidance, p. 2.

[1627] 2015 OECD, Final Report on Interest Deductions, pp. 85-86.

[1628] 2015 OECD, Final Report on Treaty Abuse, Para. 6 & Para. 21.

domestic anti-avoidance rules. Similarly, in the author's view, it is essential that various requirements imposed by EU law have to be taken into consideration to apply domestic anti-avoidance rules. Ideally, a difference should be made between the application of domestic anti-avoidance rules between two EU Member States and between EU Members States and Third States. For example, if State R (an EU Member State) wishes to apply its CFC rule to a subsidiary in State S (an EU Member State), the application of such a rule will be constrained by the requirement imposed by the *Cadbury Schweppes* judgment and subsequent ECJ case law. However, if State R wishes to apply its CFC rule to a subsidiary in State T (a Third State), the application of such a rule will not be constrained by the requirements imposed by the *Cadbury Schweppes* judgment. This is because the freedom of establishment does not apply in dealing with Third States [1629]. Accordingly, the application of domestic anti-avoidance rules within the EU may be stricter in comparison to the application of such rules in Third State situations[1630].

[1629] DE BROE, Observation, p. 148.
[1630] European Commission, Anti Avoidance, p. 4.

PART VIII: CONCLUSION AND RECOMMENDATIONS

23. Conclusion

781. The author does not completely agree with the view expressed by the OECD that domestic anti- avoidance rules, in general, do not conflict with tax treaties (*see chapter 8*). The thesis shows that conflicts do arise. Specifically, when the domestic anti-avoidance rule is applied from the source State's perspective and i) the taxpayer is redetermined (*see chapter 13*) ii) the income is re-characterized (*see chapter 14*) iii) a treaty benefit is denied (*see chapter 15*) iv) or the interest deduction is denied under certain circumstances (*see chapter 16*), in the author's opinion, in the situations discussed, a conflict arises between the domestic anti-avoidance rule and tax treaty. Also, if such rules are applied or introduced after the conclusion of the tax treaty – a treaty overrides occurs. Likewise, when the domestic anti-avoidance rule is applied from the residence State's perspective and i) non-residents are treated as residents (*see chapter 17*) or ii) double taxation relief (application of the exemption method) is denied (*see chapter 20*) the author considers that, in the situations discussed, a conflict arises between the domestic anti-avoidance rule and the applicable tax treaty. Moreover, if such rules are applied or introduced after the conclusion of the tax treaty – a treaty overrides occurs.

782. Even if a conflict arises between a domestic anti-avoidance rule and the tax treaty, benefits that flow from tax treaties (for treaties concluded after January 2003 that are based on the OECD Model) can be denied to the taxpayer, independent of the domestic law, by invoking the guiding principle (or through the PPT rule in the future)[1631]. Of course, the benefits that flow from the tax treaty can be denied only if the various elements of the principle (or PPT rule) are satisfied. In the author's opinion, when dealing with this principle, it is straightforward to prove that the subjective element is satisfied as that element uses the low threshold of "*a main purpose*". On the contrary, however, it is quite challenging to prove that the objective element of the principle is satisfied, in the sense, that obtaining the benefit is "*contrary to the object and purpose of the relevant provisions*" (*see chapter 9 and chapters 13 - 20 for the impact of the guiding principle*). This is because the provisions of tax treaties, unlike domestic legislation, are drafted

[1631] Treaty benefits can also be denied to the taxpayer under the PPT rule, only if, the rule is incorporated under the tax treaty.

in general terms [1632] without highlighting the legislatures intention to incorporate a particular rule into the tax treaty. Also, "*the object and purpose of the relevant provisions*" could hold different meanings for different parties. For instance, the taxpayers could argue that the object and purpose of the distributive rules is to allocate taxing rights whereas the tax authorities, by referring to the commentaries, could argue that the object and purpose of such rules, in addition to allocating taxing rights, is to prevent tax avoidance even though the relevant provisions of the tax treaty do not include such an objective.

783. In the end the Courts of a State will have to ascertain whether all the elements of the guiding principle are satisfied or not. Accordingly, there can be no certainty with respect to the application of the guiding principle (or PPT rule). Given the ambiguity surrounding this principle an argument can be made that such a principle be abandoned. However, given the fact that the PPT rule is based on this principle and substantial work has been carried out by the OECD with respect to this rule in the context of BEPS Action 6, a reasonable suggestion would be that this rule is re-drafted. The rule should apply only if "*the sole purpose*" of the transaction was to obtain a tax benefit (*see section 9.3.3*). Moreover, the words "*the object and purpose of the relevant provisions of the Convention*" should be reworded to "*the object and purpose of the Convention*" as the former phrase raises several interpretation issues (*see section 9.3.4*). The object and purpose that is derived from the revised preamble to the tax treaty as outlined in the BEPS report is broad enough to capture arrangements which create "*opportunities for non-taxation or reduced taxation through tax … avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)*".

784. On the other hand, there could be situations where the taxpayer attempts to avoid/abuse domestic law provisions. For instance, when seen from the residence States perspective, the taxpayer could avoid domestic taxing provisions by entering into income deferral or transfer of residence strategies. In order to counteract such techniques, States can apply imputation rules (*see chapter 18*) or assets disposal rules (*see chapter 19*). Such rules, as discussed previously, do not conflict with tax treaties.

[1632] 2011 UN Comm. Art. 1, Para. 8.

Moreover, they do not lead to treaty overrides. Furthermore, the insertion of a US type Saving clause in the treaty network (pursuant to the BEPS plan) negates the argument for a potential conflict to arise as that clause ensures taxation by the State of residence on its residents is unaffected (the clause could also preserve the application of thin capitalization rules in certain situations).

785. To conclude, the author provides that, the answer to the question of whether a domestic anti-avoidance rule conflicts with a treaty provision or not depends on the scope of the domestic anti-avoidance rule and the relevant treaty provisions. A case-by-case analysis needs to be done in order to ascertain if a conflict arises or not. Similarly, the author provides that, the answer to the question of whether a treaty override occurs or not depends on the scope of the domestic anti-avoidance rule, the relevant treaty provisions and the relationship between domestic and international law as applicable in a State. If a conflict arises then the provisions of tax treaties should prevail over domestic law. Nevertheless, if States wish to ensure that conflicts do not arise, they could adopt one of the alternate clauses put forth in the next chapter.

24. Recommendations: Treaty provisions

786. The author refers to the recommendation made in Para. 7 of the 1977 OECD Commentary on Art. 1. The Commentary had suggested that States include a treaty provision to preserve the application of domestic anti-avoidance rules. The author agrees with that suggestion, as it is the best way to avoid conflicts between domestic anti-avoidance rules and tax treaties. In light of that suggestion, the author recommends two alternative provisions that could be inserted into the OECD Model or could be incorporated by States into their tax treaty policy. The alternate provisions could be featured under Chapter VI that provides for "*special provisions*".

(ALTERNATE A) THE APPLICATION OF DOMESITC ANTI-AVOIDANCE RULES

1. The provisions of this Convention shall in no case prevent a Contracting State from applying its domestic anti-avoidance rules. The domestic anti-avoidance rules that are not prevented by this Convention are in particular:

a) (in State A): .....

b) (in State B): .....

2. The Convention shall in no case prevent a Contracting State from applying any domestic anti-avoidance rules that come into effect after the date of signature of the Convention. The competent authorities of the Contracting States shall notify each other of such rules that have come into effect in their respective domestic tax laws in a timely manner.

3. If the foregoing domestic anti avoidance rules result in double taxation then, pursuant to Article 25, the competent authorities shall resolve such double taxation.

COMMENTARY ON THE ARTICLE CONCERNING THE APPLICATION OF DOMESTIC ANTI AVOIDANCE RULES:

I. Preliminary remarks

1. Taxpayers may be tempted to enter into tax avoidance arrangements aimed at securing tax benefits available under domestic laws and tax Conventions. Domestic anti avoidance rules such as statutory GAARs or SAARs and judicial doctrines can also be used to counteract such arrangements in addition to the various anti-avoidance rules found in the Convention (such as the limitation of benefit clause or the principle purpose test). Generally, where domestic anti-avoidance rules conflict with the provisions of the Convention – the latter prevails. However, such conflicts will be avoided if a tax Convention allows the application of domestic anti-avoidance rules.

II. Commentary on the provisions of the Article

Paragraph 1

2. The first sentence of this paragraph provides that the provisions of the Convention shall not restrict a Contracting State from applying its domestic anti-avoidance rules. As domestic anti-avoidance rules vary from country to country in terms of their scope and application, the second sentence of this paragraph should be used by Contracting States to list the domestic anti-avoidance rules that are not prohibited by the Convention. The list is not exhaustive and serves to demonstrate the application of the preceding sentence of the paragraph.

Paragraph 2

3. The first sentence of this paragraph provides that the Convention shall not restrict a Contracting State from applying its domestic anti-avoidance rules that are introduced or applied in a Contracting State after the date of signature of the Convention. Under the second sentence of this paragraph,

the competent authorities of each Contracting State are required to notify each other of any new domestic anti-avoidance rules for example, the enactment of a new statutory GAAR or a SAAR or a judicial doctrine that is created by the highest Court of the State. The notification shall take place in a timely manner. As a minimum standard, the notification shall be made within 6 months from the date of on which the domestic anti-avoidance rule has come into effect. The competent authorities need not notify each other of each and every domestic anti-avoidance rule. The notification shall be restricted to domestic anti-avoidance rules that the competent authorities believe to affect or be affected by the provisions of the Convention. This applies, for example, to a thin capitalization or interest limitation rule that addresses BEPS and applies only to non-residents.

Paragraph 3

4. This paragraph provides that when the application of a domestic anti-avoidance rule leads to double taxation then the competent authorities shall consult with each other, pursuant to Article 25, and ensure that double taxation is avoided in a timely manner. The double taxation specified in this paragraph is not restricted to domestic anti-avoidance rules that lead to juridical double taxation but also extends to domestic anti-avoidance rules that lead to economic double taxation.*

**Note*: *The dispute resolution mechanism in Article 25 is currently being reconsidered in light of BEPS Action Plan 14. The recommendations made by this Plan shall be taken into consideration to ensure that double taxation is avoided.*

Author's explaination:

The proposed provisions not only ensures that tax treaties do not restrict the application of domestic anti-avoidance rules (*Paragraph 1*) but also ensures that treaty overrides do not occur with respect to such rules (*Paragraph 2*). Furthermore, it also ensures that double taxation is avoided (*Paragraph 3*). The author also submits that this provision will ensure that the domestic anti-avoidance rules suggested by the various BEPS Action plans (such as Action

2[1633] and Action 4[1634]) are not restricted by tax treaties. The provision can also be customized for a multilateral tax treaty that is envisaged under BEPS Action Plan 15[1635]. Accordingly, all States to the multilateral tax treaty would be able to apply their domestic anti-avoidance rules without entering into time consuming bilateral negotiations. Moreover, if EU Member States adopt such treaty safeguard clauses in their treaty network then domestic anti-avoidance measures can indeed be applied. Such domestic rules, as discussed previously, have to be applied taking into consideration EU law requirements, especially, the proportionality requirement (*see chapter 22)*.

787. It could be argued that the *Alternate Provision A* may lead to a considerable amount of uncertainty as States could "*easily escape their treaty obligations simply by arguing that legitimate transactions are abusive*" by using domestic anti-avoidance rules [1636], for instance the treaty shopping situation discussed in *section 21.4.6*. In that case it was argued that the domestic GAAR, which redetermined the recipient, should not be found to apply if the taxpayer satisfies the tests of the PPT rule. However, if the R-S treaty includes the *Alternate Provision A*, an argument can be made that State S will not be restricted from applying that rule. Therefore, the author proposes another Model provision, *Alternate Provision B*, which States could use to "*balance the need to prevent treaty abuses with the need to ensure that countries respect their treaty obligations and provide legal certainty to taxpayers*" [1637].

(ALTERNATE B) THE APPLICATION OF DOMESITC ANTI-AVOIDANCE RULES

1. *The provisions of this Convention shall in no case prevent a Contracting State from applying its domestic anti-avoidance rules that are used to counteract arrangements that constitute an abuse of the Convention even if such rules come into effect after the date of signature of the Convention. It is understood that an abuse of the Convention takes place when the main purpose for entering into certain transactions or*

[1633] See OECD, Hybrid Mismatch Arrangements, Chapters 1-7.
[1634] 2014 OECD, Discussion Draft on Financial Payments, Chapters 1-14 .
[1635] 2014 OECD Report on Multilateral Instrument; 2015 OECD Final Report on Multilateral Instrument.
[1636] 2011 UN Comm. Art. 1, Para. 24.
[1637] 2011 UN Comm. Art. 1, Para. 24.

arrangements is to secure a more favorable tax benefit and obtaining that benefit is contrary to the object and purpose of the Convention.

2. Where a benefit under this Convention is denied to a person under Paragraph 1 that person shall nevertheless be entitled to other benefits that it would have been entitled to in the absence of the abusive transaction or arrangement.

3. The provisions of this Convention shall in no case prevent a Contracting State from applying its domestic anti-avoidance rules that target avoidance of its domestic law even if such rules come into effect after the date of signature of the Convention. The domestic anti-avoidance rules that are not prevented by this Convention are in particular:

a) (in State A): .....

b) (in State B): .....

4. If the foregoing domestic anti-avoidance rules result in double taxation then, pursuant to Article 25, the competent authorities shall resolve such double taxation.

COMMENTARY ON THE ARTICLE CONCERNING THE APPLICATION OF DOMESTIC ANTI AVOIDANCE RULES:

I. Preliminary remarks

1. Taxpayers may be tempted to enter into tax avoidance arrangements aimed at securing tax benefits available under domestic laws and tax Conventions. Domestic anti-avoidance rules such as statutory GAARs or SAARs and judicial doctrines can also be used to counteract such arrangements in addition to the various anti-avoidance rules found in the Convention (such as the limitation of benefit clause or the principle purpose test). Generally, where domestic anti-avoidance rules conflict with the provisions of the Convention – the latter prevails. However, such conflicts will be avoided if a tax Convention allows the application of domestic anti-avoidance rules.

II. Commentary on the provisions of the Article

Paragraph 1

2. The first sentence of this paragraph provides that the provisions of the Convention shall not restrict a Contracting State from applying its domestic anti-avoidance rules to combat abuse of the convention (such as treaty or rule shopping). It also provides that the Convention shall not restrict a Contracting State from applying similar domestic anti-avoidance rules that are introduced or applied in a Contracting State after the date of signature of the Convention. On the other hand, the second sentence of this paragraph defines that an abuse of the Convention arises when the main or principal purpose of the transaction is to obtain a tax benefit and that benefit contravenes the object and purpose of the Convention. Accordingly, where the main aspects of these domestic anti-avoidance rules are in conformity with the definition of abuse, it is clear that no conflict will arise. On the contrary, where the main aspects of these domestic anti-avoidance rules are not in conformity with the definition of abuse, it is clear that the domestic anti-avoidance rule may not be applied.

Author's explaination:

The safeguard clause (modified) resembles the clause inserted in the Joint Declarations that Germany has with the UK and Ireland (*see section 10.2.1*). The first sentence of the safeguard clause preserves the application of domestic anti-avoidance rules to counter treaty abuse even if those rules were introduced after the tax treaty came into effect (thus preventing treaty overrides). The second sentence places a restriction on the domestic anti-avoidance rule and provides that treaty abuse arises only when the subjective (*see section 9.3.3*) and objective elements (*see section 9.3.4*) are satisfied. The subjective element is modified here to reflect "*the main purpose*" so that transactions, which pursue genuine economic objectives, come out of the purview of the guiding principle. The objective element is modified here to reflect only "*the object and purpose of the Convention*" as opposed to "*the object and purpose of the relevant provisions of the Convention*" that is used in the guiding principle and PPT rule. Logically, the "*object and purpose"* that needs to be reflected in the text of the treaty, in addition to resolving

double taxation, would be to prevent "*opportunities for non-taxation or reduced taxation through tax … avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)*" as suggested by Action 6 of the BEPS plan. Thus, if the domestic anti-avoidance rule has a wider scope than that of the Model provision (*Alternate B*) to counter treaty abuse the latter rule will prevent the application of the former rule (*see section 21.4.6)*. This provision applies to situations where the tax benefit flows from the treaty itself (see, for instance, the case studies discussed in *chapter 13*, *chapter 14* and *chapter 15*).

Paragraph 2

3. The provision provides that the taxpayer shall be entitled for other benefits of the Convention had the transaction or arrangement referred to in paragraph 1 had not taken place. The determination of the benefits that should be granted is not left to the discretion of the competent authority and should be granted automatically.

Author's explaination:

This clause (modified), that is similar to the one suggested by the 2015 Final TTA report[1638], provides legal certainty to the taxpayer. The clause ensures that the taxpayer is entitled to treaty benefits it would have had, had the abusive transaction or arrangement not taken place. Furthermore, the alternate benefits are conferred to the taxpayer automatically without it being subject to a burdensome administrative mechanism (*see section 9.3.6*).

Paragraph 3

4. The first sentence of this paragraph provides that the provisions of the Convention shall not restrict a Contracting State from applying its domestic anti-avoidance rules that target avoidance of domestic law even if they are introduced or applied in a Contracting State after the date of signature of

[1638] 2015 OECD, Final Report on Treaty Abuse, Para. 26 (Commentary in Paras. 16-18).

the Convention. As such domestic anti-avoidance rules vary from country to country in terms of their scope and application, the second sentence of this paragraph should be used by Contracting States to list the domestic anti-avoidance rules that are not prohibited by the Convention. The list is not exhaustive and serves to demonstrate the application of the preceding sentence of the paragraph. The notification shall be restricted to domestic anti-avoidance rules that the competent authorities believe to affect or be affected by the provisions of the Convention. This applies, for example, to a thin capitalization or interest limitation rule that addresses BEPS and applies only to non-residents.

Author's explaination:

The aforementioned provisions (*Paragraph 1 & 2*) may not permit a Contracting State to apply its other anti-avoidance rules such as a thin capitalization rule that is based on the fixed ratio approach (depending on the structure of the rule) as that rule targets avoidance of domestic law and not tax treaties (*see chapter 16*). Therefore, if a State wants to neutralize the conflict that may arise between the provisions of the treaty and such domestic anti-avoidance rules, *Paragraph 3* could be inserted. In addition to listing thin capitalization rules in that provision, for the sake of clarity, States could also list anti-avoidance rules such as CFC rules or exit taxes to ensure that arguments cannot be made that the provisions of treaties restrict the application of such rules (however these rules need not be listed if the treaty contains the Saving clause). This paragraph will also ensure that the domestic anti-avoidance rules suggested by the various BEPS Action plans (such as Action 2, Action 3 and Action 4) are not restricted by tax treaties.

Paragraph 4

5. This paragraph provides that when the application of a domestic anti-avoidance rule leads to double taxation then the competent authorities shall consult with each other, pursuant to Article 25, and ensure that double taxation is avoided in a timely manner. The double taxation specified in this paragraph is not restricted to domestic anti- avoidance rules that lead to juridical double taxation but also extends to domestic anti-avoidance rules that lead to economic double taxation.*

**Note*: *The dispute resolution mechanism in Article 25 is currently being reconsidered in light of BEPS Action Plan 14. The recommendations made by this Plan shall be taken into consideration to ensure that double taxation is avoided.*

Author's explaination:

This provision (discussed under *Alternate A*) provides relief from juridical and economic double taxation that may arise pursuant to the application of domestic anti-avoidance rules.

788. The aforementioned provisions can also be customized for a multilateral tax treaty that is envisaged under BEPS Action Plan 15[1639]. Moreover, if EU Member States adopt such treaty safeguard clauses in their treaty network then domestic anti-avoidance measures can indeed be applied. Such domestic rules, as discussed previously, have to be applied taking into consideration EU law requirements, especially, the proportionality requirement (*see chapter 22)*. Specifically, *Alternate B(1)* is backed by a subjective (*the main purpose test*) and objective test (*contrary to the objective and purpose of the Convention*). These elements are in line with the ECJ case law on abuse as discussed in the *Emsland Stärke* and *Halifax* judgments. Furthermore, the clause seems similar to the GAAR proposed by the EU Commission where "*the essential purpose"* [1640] of an arrangement "*consists in avoiding taxation where… it defeats the object, spirit and purpose of the tax provisions that would otherwise apply"* [1641]. Additionally, *Alternate B(2)* respects the principle of legal certainty by stating that the taxpayer shall be entitled to other benefits of the convention even if some benefits are denied to it by invoking the first paragraph viz., *Alternate B(1)*. Finally it should be noted that the burden of proof, in line with the guiding principle (*see section 9.3.5*), *prima facie* rests on the tax authorities.

[1639] 2014 OECD Report on Multilateral Instrument; 2015 OECD Final Report on Multilateral Instrument.
[1640] European Commission, GAAR, p. 4.
[1641] European Commission, GAAR, p. 5.

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