

**Papers on Selected Topics in Administration of Tax Treaties
for Developing Countries**

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Improper Use of Tax Treaties, Tax Avoidance and Tax

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Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion

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1. Introduction

This paper focuses on several issues, all of them linked to the theme of tax avoidance. In summary, the paper focuses on the following issues:

how to prevent tax treaties from being used improperly as a basis for tax avoidance;

how to ensure that tax treaties do not prevent the effective operation of domestic anti-avoidance rules; and

how to use the administrative assistance provisions in tax treaties as an effective mechanism to support the operation of domestic anti-avoidance rules.

In slightly more detail, the three main issues considered in this paper are as follows:

1.1 Preventing the Improper Use of Tax Treaties

Tax treaties offer a range of tax advantages which countries agree to grant to each other in order to prevent double taxation and eliminate the barrier that double taxation would create to cross-border trade, investment, movement of persons etc. Examples of these tax advantages are: exemption from tax in one or other of the countries¹; reduced withholding taxes on dividends, interest and royalties², and a foreign tax credit or exemption to eliminate double taxation³. These tax advantages are liable to attract the attention of tax planners. For the countries concerned it is a matter of ensuring that the tax treaty is not improperly used a

improper use of the tax treaty would defeat the objective of the two countries in entering into the treaty.

1.2 The Relationship between Domestic Anti-Avoidance Rules and Tax Treaty Provisions

All tax systems will contain some specific, and often some general, anti-avoidance rules. In a cross-border context these rules might sometimes operate to tax a transaction where a provision in a tax treaty would have the effect of preventing the tax being imposed. For example, where a taxpayer has artificially transferred a source of income to a resident of another country, anti-avoidance legislation⁴ might allow the country from which the transfer has been made to continue to tax the income arising. However, a tax treaty may say that the income is taxable only in the other country, and this could be raised as defence to the anti-avoidance legislation. If this has been deliberately planned, the use of the tax treaty to defeat the operation of a domestic anti-avoidance rule is an example of a form of tax treaty abuse.

1.3 Supplementing Domestic Anti-Avoidance Rules

Many domestic anti-avoidance rules can only operate effectively if the revenue authorities know about the tax avoidance scheme or can collect accurate information about the income which is caught by the anti-avoidance rule. In a cross-border context, traditionally it would have been very difficult to obtain this information from another country. The provisions for administrative assistance by exchange of information⁵, and sometimes by assistance in the collection of taxes⁶, may supplement the operation of domestic anti-avoidance rules so that they become more effective.

1.4 The Commentary to the UN Model Convention and Tax Avoidance

There is an extensive discussion of the improper use of tax treaties and of tax avoidance in paragraphs 8 to 103 of the Commentary on Article 1 of the UN Model Convention. That Commentary elaborates on many of the points discussed in this paper; cross references to relevant

⁴ For example, controlled foreign company legislation or transfer of assets abroad legislation.

⁵ See Article 26 of the UN Model Convention.

⁶ See Article 27 of the UN Model Convention.

paragraphs of that Commentary are included here, and readers are advised to consult that Commentary.

It should also be noted that several of the articles of the UN Model Convention contain specific anti-avoidance rules, and these are discussed elsewhere in this collection of papers when the particular articles are discussed⁷. Again, cross references are included to the discussions of those specific anti-avoidance provisions, either elsewhere in this collection of papers or where they are discussed in the Commentary to the UN Model Convention.

1.5 A Note on Terminology: Avoidance, Evasion and Fraud; Abuse of Tax Treaties

Many national tax systems make a distinction between tax evasion, which involves a taxpayer escaping from a tax liability that has already arisen (and which is a criminal matter), and the avoidance of tax liabilities that have not otherwise arisen (which is not criminal though it may possibly give rise to a tax penalty). Tax evasion involves, for example, the deliberate concealment of income or the deliberate miss-reporting of income, and can best be regarded as a form of fraud. Not all tax systems make this distinction so clearly, but it is helpful to think in terms of tax fraud (which involves criminal conduct), and tax avoidance (which may be unacceptable but does not involve criminal conduct).

Many tax treaties have a long title which refers to “the avoidance of double taxation and the prevention of fiscal evasion”⁸. On first impressions, one might think that the tax treaty was only concerned with combating tax evasion and only with criminal conduct by taxpayers. This formulation of the long title has a history to it, and goes to the period before the Second World War when the distinction between tax avoidance and tax evasion was not so carefully made. In practice, the exchange of information provisions in tax treaties, for example, are more commonly used to counter tax avoidance rather than tax evasion. Where criminal tax fraud is involved, different international instruments for co-operation in the investigation and prosecution of criminal offences are more usually used as a basis for administrative assistance⁹.

⁷ For example, see Jan de Goede, Taxation of Investment Income and Capital Gains, Paper 7-A in this collection.

⁸ See, for example, footnote 7 to the title to the UN Model Convention.

⁹ For example, mutual legal assistance conventions relating to co-operation in criminal matters.

One terminological issue that presents itself is the question what constitutes an abuse of a tax treaty. This is discussed in paragraphs 23 – 26 of the Commentary on Article 1 of the UN Model Convention. Quoting the Organization for Economic Co-operation and Development Model Tax Convention on Income and on Capital¹⁰ (“OECD Model Convention”), the UN Commentary adopts the following “guiding principle”:

“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 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.”

The UN Committee of Experts endorsed that principle, and the Commentary explains¹¹ that two elements must be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of the tax treaty: (i) a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position, and (ii) obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions. In deciding what is the object and purpose of the relevant provisions of the tax treaty, the Commentary to the UN Model Convention will clearly be of assistance.

2. Improper Use of Tax Treaties

This section deals with ways of ensuring that the tax advantages in a tax treaty are enjoyed only by those persons who the two countries intended to enjoy them, and that the treaty is not used improperly to obtain an unintended benefit. The section considers first the various ways in which

2.1 The Ways in Which a Country May Ensure that a Tax Treaty is Not Used Improperly

The Commentary on Article 1 of the UN Model Convention discusses six different approaches used by countries to prevent and address the improper use of tax treaties¹². Each of these six approaches is summarized below.

2.1.1 Specific Legislative Anti-Abuse Rules Found in Domestic Law¹³

It is possible for countries to adopt in their domestic law specific anti-abuse rules that prevent particular types of improper use of tax treaties. For example, if a country faces a problem of taxpayers moving their residence temporarily to another country in order to take advantage of the tax treaty with that country to prevent a charge to tax (for example a taxpayer moving temporarily to take advantage of the capital gains article to secure exemption on the disposal of assets), the country might enact a specific anti-avoidance rule to prevent that treaty abuse. This rule might provide, for example, that the country can continue to tax the particular income or capital gain notwithstanding

Model Convention¹⁵ (and the OECD Model Commentary) confirm that such rules are part of the basic domestic rules for determining which facts give rise to a tax liability, and that these rules are not affected by tax treaties.

The point might be made that general anti-abuse rules are often enacted by countries to deal with innovative and often highly-artificial tax avoidance structures. Some of those structures attempt to take advantage of the provisions in domestic tax law, but others take advantage of tax benefits granted by tax treaties. It would risk the danger of making such general anti-abuse rules significantly less effective if they did not apply to abusive arrangements exploiting the provisions in tax treaties. In principle, therefore, general anti-abuse rules found in domestic law should operate in such a way that they deny the benefits of tax treaties where the rules are applicable.

2.1.3 Judicial Doctrines that are Part of Domestic Law

Some countries have developed through their courts various anti-avoidance doctrines, such as the “substance over form” doctrine or the concept of “abuse of law”. These are essentially doctrines relating to interpretation of tax legislation. According to the Commentary on Article 1 of the UN Model Convention, nothing prevents the application of similar judicial approaches to the interpretation of provisions of tax treaties.¹⁶

2.1.4 Specific Anti-Abuse Rules Found in Tax Treaties¹⁷

A number of specific anti-abuse rules are found in the UN Model Convention (and some of them are discussed elsewhere in this collection of papers¹⁸). For example, the provision relating to “star companies” in Article 17(2) of the UN Model Convention is intended to counter a particular form of avoidance which might be used by artistes or sportspersons who assign their income to other persons, typically a company under their control. i73005 TD0 TD0o005 TD0 TD0o005ts of tax

2.1.5 General Anti-Abuse Rules Found in Tax Treaties¹⁹

Aside from specific anti-abuse rules, some countries have the practice of including a *general* anti-abuse rule in their bilateral tax treaties. The current version of the UN Model Convention does not contain such a general anti-abuse rule but there are examples of the type of wording that some countries have included in paragraphs 34, 35 and 36 of the Commentary on Article 1 of the UN Model Convention.

The Commentary (at paragraph 37) also contains a warning that the inclusion of such general anti-abuse rules might give the impression that, absent such a provision, other general approaches to deal with improper use of tax treaties are not possible. This is clearly a warning that countries should consider carefully before including such general anti-abuse rules in their treaties.

2.1.6 The Interpretation of Tax Treaty Provisions²⁰

Provisions contained in a tax treaty are subject to interpretation, and Article 31 of the Vienna Convention on the Law of Treaties²¹ provides that treaties are to be interpreted in good faith in the light of their object and purpose. There is some support for an approach that a good faith interpretation, consistent with a tax treaty's object and purpose, would lead to a conclusion inconsistent with the abuse of tax treaty provisions.²² At present, however, the support is not overwhelming, and this is an issue that should be considered very carefully before a revenue authority raises it.

2.2 Some Common Examples of Transactions Involving Potential Abuse of Tax Treaties

This part considers six common examples of transactions involving potential abuse of tax treaties, and discusses the ways in which they may be countered using the various techniques discussed in the previous section. The six examples are not a complete list of all possibilities: some additional examples are discussed in paragraphs 40 to 99 of the Commentary on Article 1 of the UN Model

¹⁹ Discussed in paragraphs 34 to 37 of the Commentary on Article 1 of the UN Model Convention.

²⁰ This is discussed at paragraphs 38 and 39 of the Commentary on Article 1 of the UN Model Convention.

²¹ Convention on the Law of Treaties, Vienna, 23 May 1969.

²² At present the international case law on this issue is relatively thin, the leading case being a Swiss Federal Supreme Court decision in A Holdings ApS v Federal Tax Administration (2006) 8 ITLR 536.

Convention. Even the examples in the Commentary are not exhaustive, and countries will no doubt encounter novel forms of improper use of tax treaties which need to be countered by use of one of the techniques discussed in the previous section.

2.2.1 Treaty Shopping and the Use of Conduit Companies²³

Perhaps the most common example of tax treaty abuse is treaty shopping, where a person who is not entitled to the benefits of a tax treaty establishes arrangements which employ other persons who are entitled to such benefits to indirectly access the benefits of the treaty. To take a simple example, suppose that a person who is resident in Country A derives income from a source in Country C, but there is no tax treaty between Countries A and C. However, there is a tax treaty between Country B and Country C which offers an attractive tax advantage. The person establishes an entity – typically a “conduit company” – in Country B so that the income flows to that company, which enjoys the benefit of the tax treaty with Country C. Such arrangements will often also rely upon the ability to extract income from Country B without any tax in that country or on the payment out from that country.

Treaty shopping is not a new phenomenon, and the use of conduit companies was discussed by the OECD in a report adopted in 1986.²⁴

Various methods are suggested in the Commentary on Article 1 of the UN Model Convention to deal with treaty shopping, and the Commentary to the OECD Model Convention also contains further discussion of this issue.²⁵ One example of a specific anti-abuse rule found in most tax treaties is the “beneficial ownership” concept in Articles 10, 11 and 12 of the UN Model Convention.²⁶ An examination of the identity of the beneficial owner of dividends or interest, for example, may be an approach that effectively counters an attempt to abuse a treaty by treaty shopping.

²³ This is discussed at paragraphs 47 to 57 of the Commentary on Article 1 of the UN Model Convention.

²⁴ “Double Taxation Conventions and the Use of Conduit Companies”, adopted on the 27th November 1986.

²⁵ This is quoted in the Commentary on Article

2.2.2 Income Shifting²⁷

This topic covers a range of transactions and arrangements that are designed to achieve the result that income that would normally accrue to a taxpayer accrues instead to a related person or entity with the aim of ensuring that treaty advantages are obtained that would not otherwise be available. A simple example might be the use of a “base company”, often situated in a low tax jurisdiction, to which property is transferred so that income accrues to that company. There are other examples of income shifting in the Commentary on Article 1 of the UN Model Convention.

Income shifting can be challenged using the various methods discussed in the earlier part of this paper. For example, base companies may be challenged by the use of Controlled Foreign Corporation (“CFC”) legislation, which is an example of a specific anti-avoidance rule in domestic law.²⁸

2.2.3 The International Hiring-Out of Labour²⁹

Under Article 15 of the UN Model Convention, an employee who is a resident of Country A and who goes to work in Country B for less than 183 days will only be taxable on his salary if his employer is a resident of Country B (or has a permanent establishment in Country B). This has led in the past to a tax avoidance scheme under which employees were sent to work in a country, but their legal contract of employment was with an employer resident outside that country. This would be the case even though the employee was working for the economic benefit of a company in the host state. This gave rise to a problem generally referred to as “international hiring out of labour”.

The answer to this problem is discussed in the Commentary on Article 15 of the UN Model Convention and involves a correct interpretation of the tax treaty to identify who in reality is the employer of the worker. Various of the approaches discussed above may be applied to identify as the true employer the company that directs the work of the employee and receives the economic benefits from that work (sometimes referred to as “the economic employer”).

²⁷ Various examples of income shifting are discussed in at paragraphs 62 to 80 of the Commentary on Article 1 of the UN Model Convention.

2.2.4 Circumventing Treaty Threshold Requirements³⁰

Several provisions found in tax treaties contain thresholds which alter the taxing rights of the two countries. For example, under Article 10(2) of the UN Model Convention the level of withholding tax on dividends paid by a company is generally lower where the shareholder company has a direct investment of at least 10% in the company paying the dividend³¹. A company might enter into an

“shadow-credit” for tax that would have been charged in the host country but for tax incentive legislation which offered a reduced rate or an exemption from tax for activities which are seen as encouraging economic development.

These types of tax sparing credits could give rise to a form of abusive avoidance if, for example, a taxpayer claims a shadow credit to which the taxpayer is not entitled. If a tax treaty provides for a tax sparing credit, it may be necessary for the country of residence of the investor to check carefully (using the provisions for exchange of information discussed below) to ensure that the shadow credit is only granted in circumstances where the taxpayer is properly entitled. This is one of several potential abuses of tax treaties where the exchange of information (discussed in the final part of this paper) may be particularly valuable in assisting countries to combat tax treaty abuse.

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operation of the provisions. Where the possibility of a conflict is foreseen at the time of the negotiation of a tax treaty, the solution that gives the greatest certainty is to include an express provision in the tax treaty confirming that the treaty provisions do not prevent the application of the domestic anti-avoidance rule (or, perhaps the contrary). The problematic cases have occurred where the treaty was silent on the point, so that the argument could be made that the treaty prevented the

4.1 Exchange of Information

Provisions in tax treaties based on the UN Model Convention are not the only ways in which countries can agree to exchange information. On a bilateral basis, countries may enter into Tax Information Exchange Agreements (“TIEAs”) which differ from comprehensive tax treaties in that they deal only with administrative assistance through the exchange of information. Since 2011 the OECD/Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters³⁴ (“Multilateral Convention”) has been opened for signature by countries that are not members of the OECD or Council of Europe. The Multilateral Convention has extensive provisions for mutual administrative assistance through the exchange of information and through cross-border assistance in the collection of taxes.

It is normal practice to include an article on exchange of information in all bilateral tax treaties, generally based upon Article 26 of the UN or OECD

4.2 Assistance in the Collection of Taxes

It is sometimes the case that a country is able to identify and combat particular tax avoidance arrangements, but then is unable to collect the tax because the taxpayer's assets are situated abroad. The 2011 version of the UN Model Convention contains in Article 27 a provision for assistance in the collection of taxes. There are also extensive arrangements for assistance in the collection of taxes in the OECD/Council of Europe Multilateral Convention. These provisions extend to collection of taxes as well as interest, administrative penalties and costs of collection.

5. Concluding Comments

The view is occasionally expressed that countries should be cautious in entering into tax treaties because the treaties may create opportunities for tax avoidance. The danger of the improper use or abuse of tax treaties certainly exists, and countries need to be aware of this, as well as aware of the ways in which they can prevent or counter this abuse.

At the same time, through provisions for administrative assistance by exchange of information or assistance in cross-border collection of taxes, tax treaties can give countries a powerful weapon to detect and counter tax avoidance or tax fraud.

Perhaps a final word of warning is necessary. Treaties relieve from double taxation by reducing taxes