Many developing countries have already negotiated a number of tax treaties with their neighbours and with capital exporting countries, while others are keen to expand their existing tax treaty network. An extensive treaty network is typically considered to be an important indicator that a developing country can use to demonstrate that it is keen to attract foreign direct investment and that it is willing to impose tax on foreign investors according to internationally-accepted taxation norms. Bilateral income tax treaties are one visible manifestation of a country's desire for economic development and greater integration in the global economy.

While income tax treaties are thus important signals to the international community, the experience of developing countries, like developed countries, is that treaties can be misused as part of sophisticated tax planning to frustrate the tax claims of developing countries. Tax treaty abuse is a matter which has caught the attention of the revenue authorities of some developing countries already. For example, in response to the questionna8( )] 1t-4(e)/5isticated 44(ct.285.17)/5

Item 6 in the OECD's Base Erosion and Profit Shifting ('   ') Action Plan refers to the ways in which taxpayers abuse a country's network of tax treaties and mechanisms to counter this behaviour. The Action Item requires the OECD to –

> Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate

more detail.[6] It made recommendations for action about those items but it also added a further dimension to the issue. It referred to –

4. instances where a treaty is used as the pretext for an argument that a domestic anti-abuse rule is rendered ineffective.

This additional theme is important because it adds an additional theme to the notion of treaty abuse. The first theme focuses on 'abuse' consisting of wish to consider whether the general approaches will turn out to be sufficient – there is an 'all-the-eggs-in-one-basket' dimension to the recommendations. In other words, it may still be sound policy to employ a number of specific anti-abuse measures even if more general approaches are adopted.

Next, it is worth noting that if the OECD's work on this portion of the BEPS agenda is fruitful, it is likely to be valuable to developing countries. One of the principal effects of a tax treaty is to limit the ability of source countries to retain tax claimed under domestic law. This can come about explicitly through the allocation rules in a treaty (for example, the requirement of a permanent establishment before the source country can tax business profits) and the rate limitation provisions (for dividends, interest and royalties) and less obviously through income classification rules.[7]

As developing countries are predominantly source countries, and less significant capital exporting countries, limits on the ability of source countries to insist on domestic law tax claims are particularly important

Just how serious the threat of improperly accessing a country's tax treaties is depends to some extent on who is gaining access to the treaty. It can be helpful to draw a distinction between two different forms of inappropriate access to a treaty:

> shopping into a tax treaty – a taxpayer resident in State C (a state which does not have a treaty with the source country, State A) puts in place a mechanism to get access to the treaty between State A and State B, and
>
> shopping between tax treaties – a taxpayer resident in State C (a state which has a treaty with the source country, State A) puts in place a mechanism to get access to the treaty between State A and State B, instead of being subject to the terms of the treaty between State A and State B.

The second situation may, but need not, be problematic for a country. And, as we will see, the difference can matter when tax officials try to decide what situation should be taxed in lieu of the offending situation – ie, if the benefits of the treaty are to be denied should other tax consequences follow instead?

The principal factors which encourage shopping into tax treaties and shopping between tax treaties are:

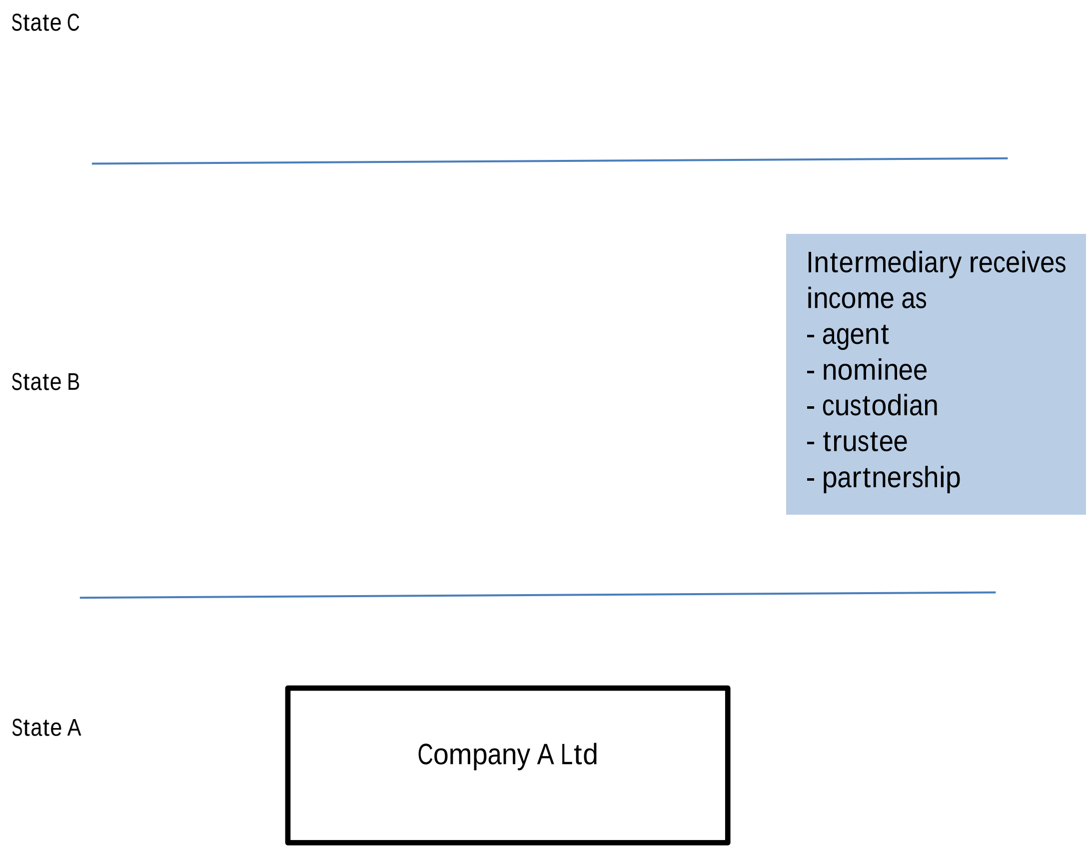
> the extent of the divergence of the tax treaty from the claims made under domestic

This point is worth emphasising as developing countries have traditionally expressed the view that the architecture of the international tax framework should provide greater scope for the taxation of income at source. While greater source taxation may seem appealing, given international competition for investment, it is likely to be sustainable only in cases where the source country has some specific advantage which is peculiar to the country, such as a particular resource. In the absence of some particular advantage, source countries may discover that insisting on high source country taxation produces reduced levels of foreign investment. Consequently, it may well be that in many cases – for example, withholding taxes on interest on debt borrowed from unrelated parties – low source country taxation is necessary in order to attract capital and has the added advantage of reducing the scope for treaty abuse.

The most difficult part of any discussion of 'inappropriate' access to treaties lies in defining what is, and is not, appropriate. The Commentary to article 1 of the UN Model contains a long description of various forms of abuse of treaties and some mechanisms that countries may employ to counter these practices.[12] It is not always easy to identify when nonthat is more mechanical and describes a state of affairs, and a safety-valve in the form of negotiations between the competent authorities.

There are many mechanisms by which treaty benefits can be inappropriately enjoyed unless they are monitored and countered. The simplest arrangements involve the creation in the treaty partner of a contractual or legal arrangement that is transparent for tax purposes under the law of that state. For example, income may be paid to an entity in the treaty partner which receives the income:

as an agent for a principal resident in the non-treaty state,
as a nominee or custodian for a taxpayer resident in a third state,
as trustee of a bare trust for a beneficiary resident in a third state,
as trustee of an active trust for beneficiaries primarily resident in a third state, or
as a partnership of entities primarily resident in a third state.

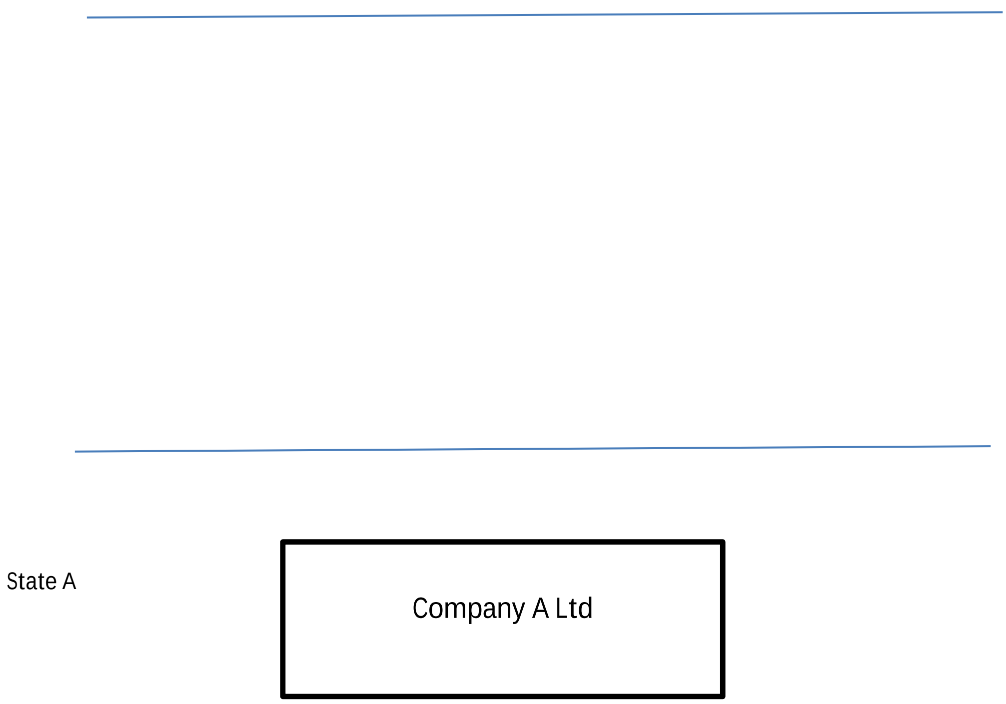

State C
State B
Intermediary receives income as
- agent
- nominee
- custodian
- trustee
- partnership
State A
Company A Ltd

If, under the law of State B, these arrangements are fiscally transparent – that is, no tax is levied in State B on the income in the hands of the agent, nominee, custodian, trustee or partnership – the treaty between State A and State B should not be enlivened to limit State A's tax claims.

This may be appreciated already. Accepted interpretations of several explicit provisions in tax treaties would deny treaty benefits to the Intermediary in State B. For example, where the relevant arrangement is simply contractual (the resident of State C has organised for its income to be collected by an agent or custodian), the relevant 'person' for treaty purposes is the person with whom the resident is dealing and that is the resident of State C, not its agent.[13] Secondly, the Intermediary may not satisfy the requirements to be a 'resident' of State B for the purposes of the treaty – if the tax liability falls on the principal, beneficiary or partners and not the Intermediary, the Intermediary is not a 'person who, under the laws of that State, is liable to tax therein ...' Similarly, if the income involved is a dividend, interest or royalty, the Intermediary ought not to be regarded as the 'beneficial owner' of the income.

However, there will often be less obvious arrangements by which taxpayers can gain access to a treaty network. For example, an entity may be established in the treaty partner which is a taxpayer in that State in its own right and a resident, but in effect it is an empty shell because it pays its entire income to a taxpayer resident in a third country – base erosion. While these payments might sometimes trigger withholding tax on the way out of State B, they may not bear tax at the full corporate rate levied in State B. Indeed, the withholding taxes levied by State B may themselves be reduced if a treaty exists between State B and State C.

[13] This issue is discussed in J. Wheeler, 'Persons Qualifying for Treaty Benefits' in A. Trepelkov, H. Tonino and D. Halka (eds) (2013) http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf


State A
Company A Ltd

that are part of domestic law do have the potential to generate conflicts between the treaty and domestic law, and that in cases where the other treaty partner considers the domestic rule results in a direct conflict, the treaty must be given priority.[15]

But the issue is not simple. It is worth noting that Canada, which is currently undertaking a review into mechanisms to curb treaty abuse, appears inclined to approach the problem through amendments to its domestic law.[16] The position taken by the Government of Canada is that it can approach the problem through domestic provisions because, 'domestic law provisions to prevent tax treaty abuse are not considered by the OECD or the United Nations to be in conflict with tax treaty obligations and a number of other countries have enacted legislation to that effect.'[17] Australia, has attempted to resolve any doubt by inserting a provision in its domestic law which asserts that its general anti-abuse rule will prevail over its treaties, and since that provision has been in place since 1981, it is assumed that all tr

The administrative requirements necessary to enjoy treaty benefits may also play a part in detecting and countering treaty abuse.[19] Clearly, some evidence must exist to establish the entitlement of a non-resident to treaty benefits and States should consider carefully the kind and the extent of the evidence that needs to be provided, the entity to whom this evidence should be provided and who is responsible for retaining this evidence. For income such as dividends, interest, royalties or gains, there may be a question whether treaty benefits are delivered at source or whether non-resident taxpayers must apply to have the relevant tax

One of the measures likely to follow from th

The definition of 'qualified person' is drafted using a number of observable criteria. They are alternative means of satisfying the 'qualified person' test. The discussion below breaks down the OECD's proposed clause into a series of discrete clauses, and explains the kinds of entities and situations to which it is catering. The qualifications and limitations surrounding the rules are also examined.

One set of tests focuses on the status of the foreign entity. So, an who is a resident of one of the contracting states will always be a 'qualified person:'

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:
>
> (a) an individual;

In the same way, the of the other contracting state and some government-owned agencies will also be a 'qualified person.'

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is ...
>
> (b) a Contracting State, or a political subdivision or local authority thereof, or a statutory body, agency or instrumentality of such State, political subdivision or local authority;

Thirdly, various types of will typically be a 'qualified person' if they are established for one of the specified purposes:

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is ...
>
> (d) a person, other than an individual, that -
>
> (i) was constituted and is operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes,

In this formulation, it is not necessary that the entity is exempt from tax in the residence country, although this will often be the case for religious, charitable and similar organisations. Similarly, it is not sufficient that the entity is exempt from tax in the residence country – for example, various sporting organisations or hospitals might be tax exempt in the residence country but they would not qualify under paragraph (d).

Presumably, an entity is being 'operated exclusively' for the appropriate purposes if it owns investments which generate income, even if some of that income might be retained rather than applied to current works. It may be more difficult to say that a company wholly-owned by a charity etc. is being ‘operated exclusively' for the appropriate purposes when its function is to those activities rather than conduct them itself. Similar issues could arise

Paragraph (d) also extends to include , presumably investment funds that are not providing retirement income benefits:

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is ...
>
> (d) a person, other than an individual, that ...
>
> (iii) was constituted and is operated to invest funds for the benefit of persons referred to in subdivision ii), provided that substantially all the income of that person is derived from investments made for the benefit of these persons;

The intended operation of this paragraph is unclear. It refers to an investment fund that was established to invest funds for the benefit of the 'persons referred to in subdivision ii).' The difficulty is that subdivision ii) refers to two 'persons' – one is the 'person' that was constituted to provide pension benefits [ie, the pension fund] and the other is the 'person' who must hold the beneficial interests [ie, the member of the fund resident in one of the States].

If paragraph (d)(iii) is meant to be alluding to the pension fund, then this paragraph could confer the status of 'qualified person' on the various investment funds in

The test is applied to the company’s ‘principal class of shares’ and any ‘disproportionate class of shares’ and it is these shares which must be ‘primarily traded’ on one of the appropriate stock exchanges. Other classes of shares which are insignificant will not count for the purposes of this test; minor trading even in the ‘principal class of shares’ on other exchanges will not disqualify the company.

Notice also the inter-play between the place of the company's residence and the place where its shares are principally traded. A company which is a resident of a third State cannot become a 'qualified person' under this paragraph merely because its shares are traded on the stock exchange of one of the contracting states. And a company which is a resident of one state, would lose access to treaty benefits if its shares are traded primarily on the stock exchange of the other state or a third state.

For publicly-traded companies, the second possibility is that the company's principal place of management and control is located in its state of residence - that is, it is locally managed:

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:
>
> (c) a company, if:
>
> > (i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and ...
> >
> > > (B) the company’s primary place of management and control is in the Contracting State of which it is a resident

The definition of ' primary place of management and control' in paragraph 5 says -

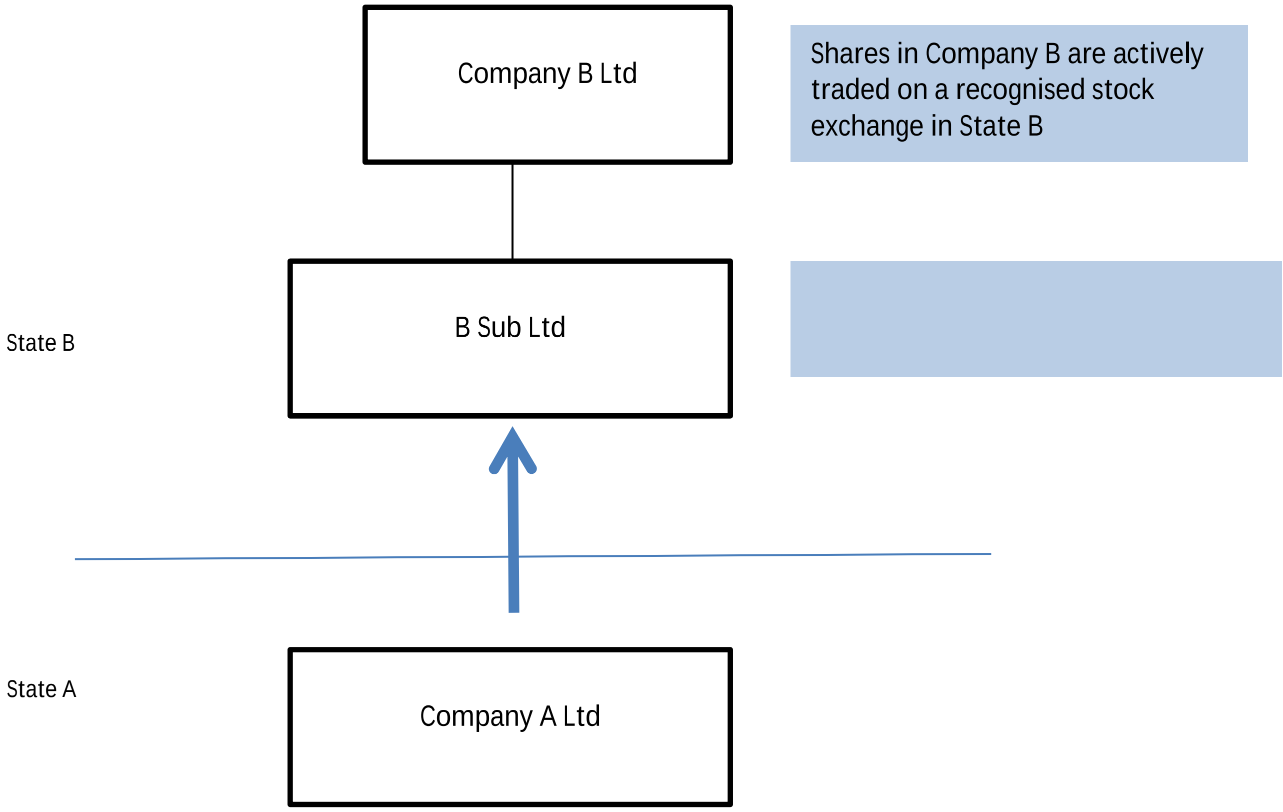
> (d) a company’s “primary place of management and control” will be in the Contracting State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more

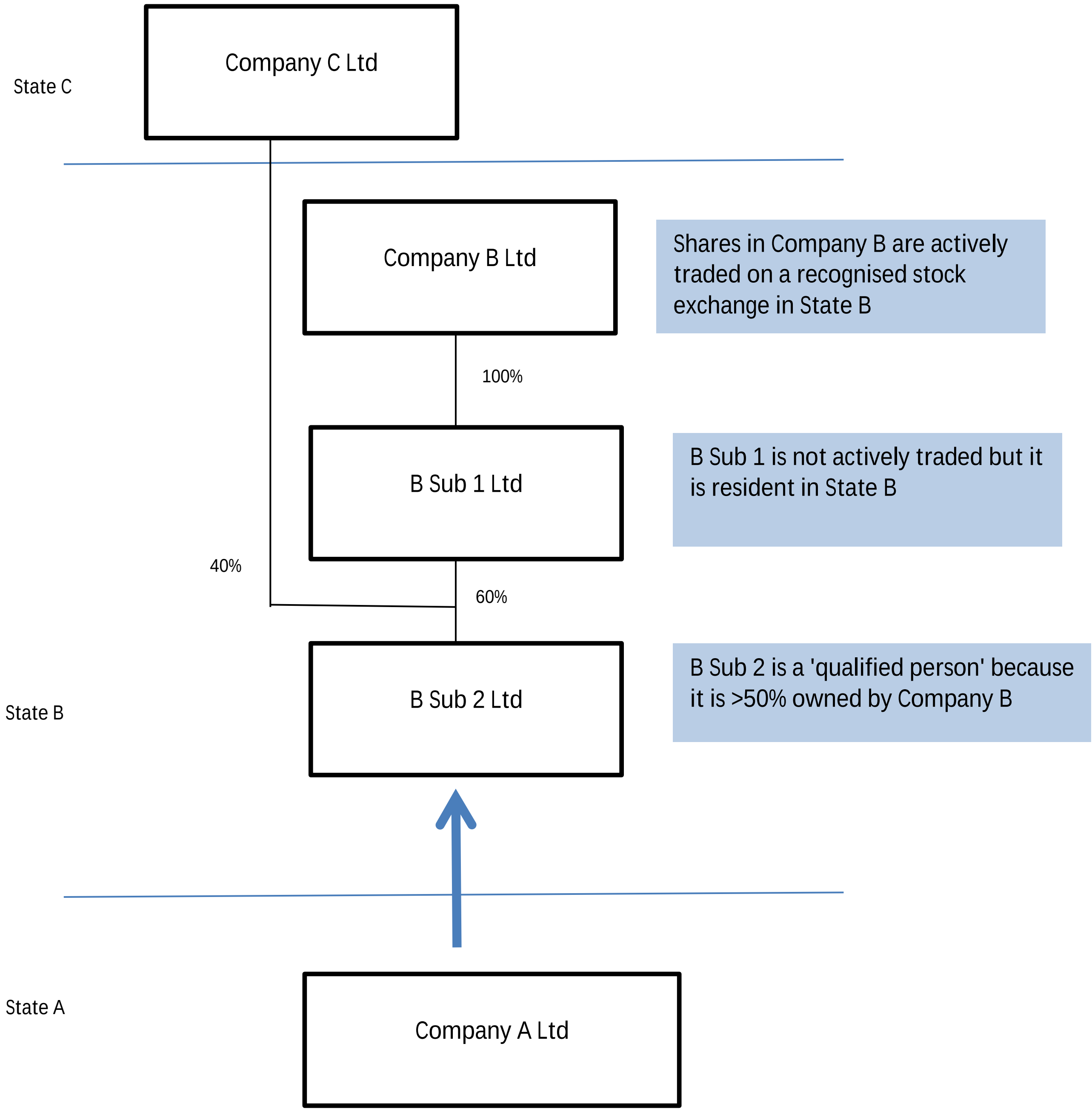
benefits for dividends, interest and royalties received from its subsidiary in the source country, and treaty benefits for income from business activities conducted in the source state without a permanent establishment.

A second rule exists for companies that are – that is, a company can be a 'qualified person' if it is at least 50% owned by a listed and publicly traded company that is resident in one of the States and itself a ‘qualified person’:

> 2. A resident of a Contracting State shall be a qualified person for a taxable year if the resident is:
>
> (c) a company, if ...
>
> (ii) at least 50 percent of the aggregate voting power and value of the shares (and at least 50 percent of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subdivision i) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;

The test can extend to partly-owned subsidiaries and joint-venture companies: the test will be satisfied by tracing at least 50% of the shareholding in the relevant company to one or more publicly-traded companies resident in either state. And the test does allow for a significant portion of the company being examined to be owned by shareholders resident in a third state.


Company B Ltd
Shares in Company B are actively traded on a recognised stock exchange in State B
B Sub Ltd
State B
State A
Company A Ltd


Company C Ltd
State C
Company B Ltd
Shares in Company B are actively traded on a recognised stock exchange in State B
100%
B Sub 1 Ltd
B Sub 1 is not actively traded but it is resident in State B
40%
60%
B Sub 2 Ltd
B Sub 2 is a 'qualified person' because it is >50% owned by Company B
State B
State A
Company A Ltd

The final rule in paragraph (e) is a residual test that applies to any ‘person other than individual.’ So, for example, paragraph (e) could apply to:

an entity that is not a company – for example, a trust or partnership. The test extends beyond companies and refers to entities which issue ‘shares’ and those which issue other types of ‘beneficial interest’. This may be relevant, for example, for investment funds and other collective investment vehicles if they are not structured as companies;

an entity that is privately-held – ie, its shares are not listed on a stock exchange. Again, this may be relevant for investment funds where interests in the fund are issued and redeemed, rather than traded on a stock exchange;

a listed company that is actively traded on a stock exchange but does not satisfy either the ‘locally traded’ or ‘locally managed’ elements of that test; and

cannot rely upon the status of its immediate owner; it must trace through to the ultimate listed parent.

The base erosion test focuses on the proportion of gross income that is paid to residents of third countries or to persons who are residents but are not 'qualified persons.' Again, up to 50% of the gross income of the tested entity can leak to residents of third countries without offending this rule. The reference to amounts flowing 'directly or indirectly' to such persons may prove very problematic in practice where income flows are supplemented or dissipated as they move through successive taxpayers.

The exception for payments for 'services or tangible property' will need some explanation in the Commentary. The obvious intention of the provision is to require that payments for interest and payments for the use of intangibles (eg, royalty payments for the use of intellectual property) must be examined; payment of arm's length prices for inventory, equipment or real estate do not need to be examined. Developing countries may however be concerned that payments of management fees would not need to be tested provided they are at arm's length prices – they are presumably payments for 'services.'

The base erosion test focuses on one particular mechanism by which income might leak to a third country – an amount is 'paid or accrued … in the form of payments that are deductible for purposes of the taxes covered by this Convention …' The situation being described is one where the recipient of the income would be taxable but it reduces the tax payable by making tax deductible payments. The same result could, however, be achieved in other ways: the recipient might not be taxable at all if it distributes sufficient of its receipts – in other words, the recipient is or can become transparent for tax purposes. Alternatively, the relevant domestic rules might make the fund the proper taxpayer on retained income and the investor the proper taxpayer on distributed income. In this respect, it is worth returning to paragraph (d)(iii) which was mentioned above. It includes as a 'qualified person' –

> (d) a person, other than an individual, that …
>
> (iii) was constituted and is operated to invest funds for the benefit of

It was noted above that this clause seems directed at investment funds and that paragraph (e) is potentially also applicable to investment funds. There will be an interesting question whether the test in paragraph (e) is easier or harder to satisfy than that in paragraph (d) in any year: paragraph (e) might be easier to satisfy where the mechanism under domestic law which shifts the tax burden works through something other than a tax deduction; but paragraph (e) may be more difficult to satisfy since it requires 'substantially all' of the relevant income to belong to residents.

that exists for ‘making or managing investments.’ The same analysis might apply to a company that exists to just hold intellectual property assets and receive royalty payments, or which is an in-house finance company for the corporate group and exists just to receive interest payments. On the other hand, a company which holds and manages a portfolio of investments for external clients would likely be regarded as engaged in ‘the active conduct of a trade or business’ and this business is not one which is carried on ‘for the resident’s own account.’

A more complicated question arises for companies that do more than engage in ‘active trade or business’ –

> derives an item of income arising in the other Contracting State from an associated enterprise …

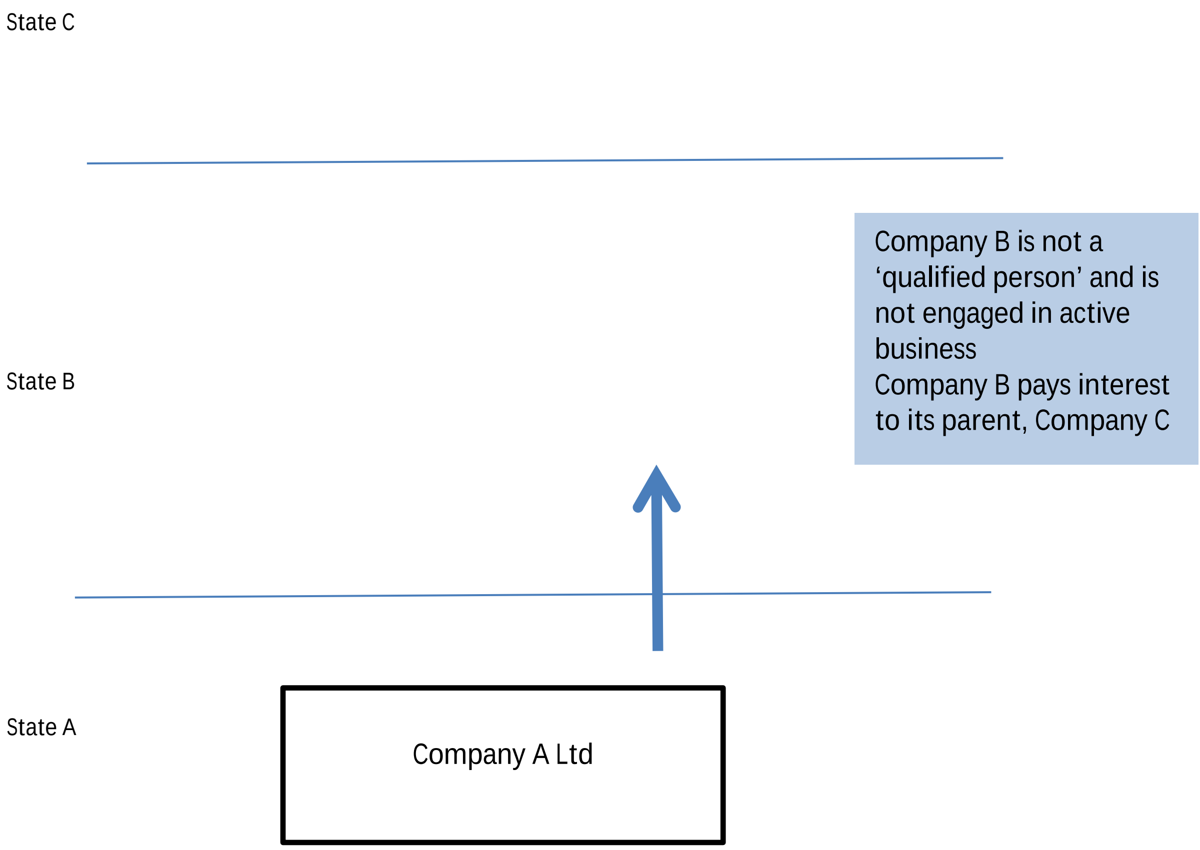
Where either situation exists, the added requirement is that the business operations of the recipient are regarded as 'substantial' when compared to the business operations conducted by the payer. In other words, income will not enjoy treaty benefits if it is being paid to an entity that is largely a wrapper around some modest business activities:

> subparagraph (a) shall be considered to be satisfied with respect to such item only if the trade or business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the trade or business activity carried on by the resident or associated enterprise in the other Contracting State. Whether a trade or business activity is substantial for the purposes of this paragraph will be determined based on all the facts and circumstances.

In applying this test, the payer and the recipient are allowed (and required) to aggregate any 'activities conducted by persons connected to a person …' This aggregation occurs for any entity that shares 50% common ownership or more and may have significant effects in deciding whether activities conducted in the recipient state are substantial when compared to those conducted in the source state.

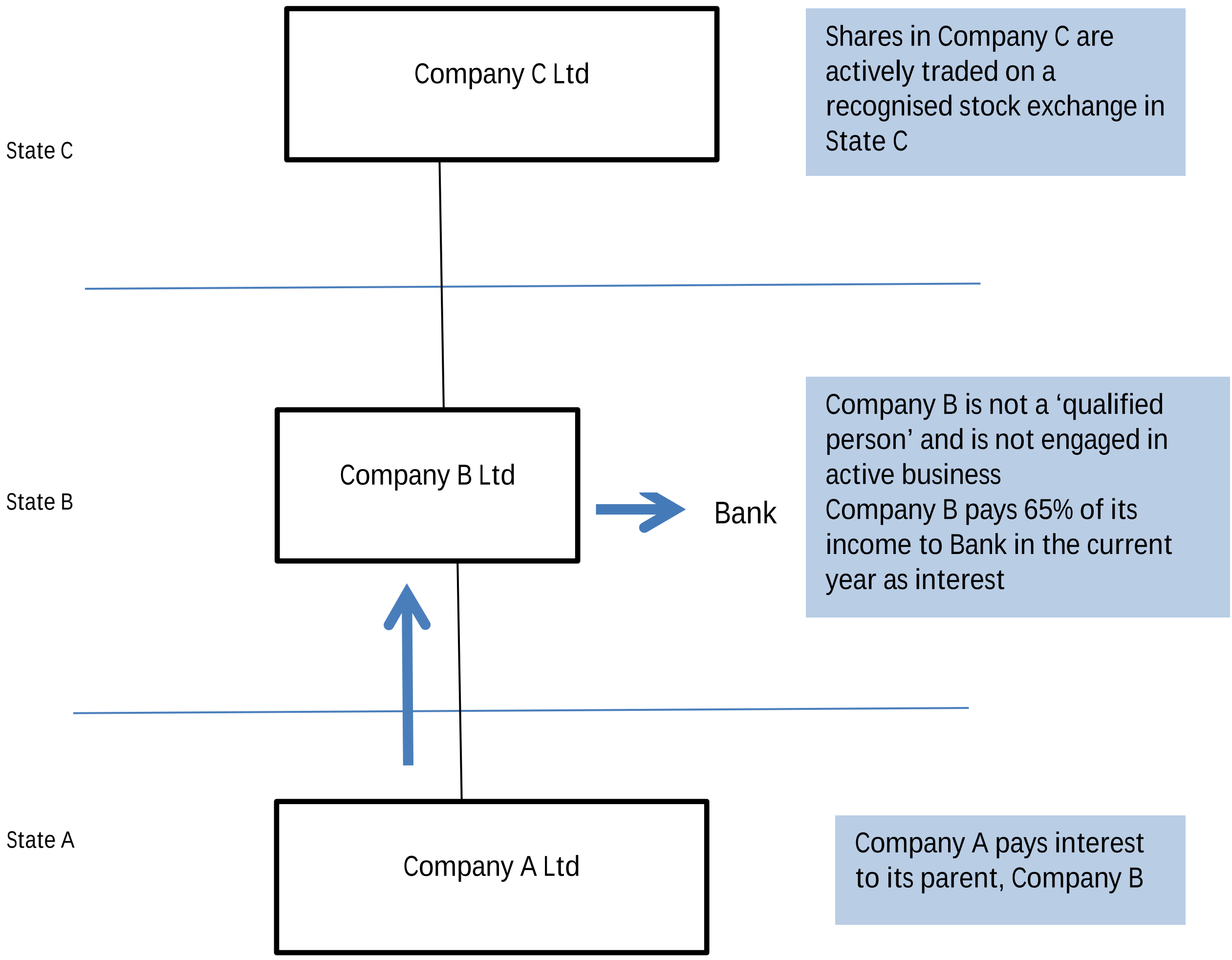
The active income test does not contain a restriction or qualification where base eroding payments are made. So, a company that conducts active business operations in the residence state faces no denial of treaty benefits even though most of its income leaks from the residence state to a third country. This creates a curious outcome. A privately-held company might not satisfy the tests to be a 'qualified person' under paragraph (2)(e) participants in that structure would all be entitled to similar benefits under other treaties. The obvious question is, should the source country simply apply the original treaty anyway, given that it would afford similar benefits if it applied the other relevant treaties instead?

In the example below, Company B may not be entitled to treaty benefits under the A-B treaty where its shares are not traded on a local stock exchange, its only shareholder is resident in State C, and its only activity is to collect and remit interest from Company A. While the structure may seem abusive, it is not obvious that State A has suffered any loss of revenue from applying the A-B treaty when the ultimate owner of the income is an entity that would be entitled instead to the benefits of the identical A-C treaty.


State C
Company B is not a
'qualified person' and is
not engaged in active
business
Company B pays interest
to its parent, Company C
State B
State A
Company A Ltd

(i) (A) would be entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed under provisions analogous to subparagraph a), b), subdvision i) of subparagraph c), or

This part of the clause is significant principally for its impact on other taxpayers, rather than on the company being described; it will assist other tax payers to meet the base erosion tests and in indirect ownership situations. In the example below, Company B is 100% owned


Company C Ltd
Shares in Company C are actively traded on a recognised stock exchange in State C
State C
Company B Ltd
State B
Bank
Company B is not a 'qualified person' and is not engaged in active business
Company B pays 65% of its income to Bank in the current year as interest
State A
Company A Ltd
Company A pays interest to its parent, Company B

> that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

The clause thus contains two distinct elements – a rule which would deny access to treaty benefits based on the 'purposes of any arrangement or transaction,' and an exception which would reinstate access to treaty benefits where doing so 'would be in accordance with the object and purpose' of the treaty provision. The second aspect of the clause is clearly very important: many taxpayers will undoubtedly undertake investments and transactions in the knowledge of the effects of the treaty and intending to enjoy the benefits of the treaty. Indeed, treaties are negotiated in order to induce taxpayers to change their behaviour and so denying treaty benefits simply on the basis that taxpayers have responded to that inducement is inappropriate. Rather, the clause is meant to focus on whether the way in which taxpayers have responded to that inducement – the way they structured their investment or transaction – has produced an outcome that is not in accordance with the object and purpose of the treaty provision being relied upon.

According to the , this article would simply express in the text of the Model notions that are currently contained in the Commentary. Consequently, the new provision is not seen as a major departure from existing principles:

> Paragraph 6 mirrors the guidance in … the Commentary to Article 1. According to that guidance, the benefits of a tax convention should not be available where one of the main purposes of certain transactions or arrangements is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax convention. Paragraph 6 incorporates the principles underlying these paragraphs into the Convention itself …[25]

The discussion in the suggests that this is an objective enquiry to be undertaken based on the evidence of transactions which occurred. The subjective state of mind of the participants is not the focus of attention in this formulation. Instead, the investigation is meant to be about the purpose of 'the arrangement.' This formulation is intended to make the enquiry more objective and more focused on observable facts and

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[25] OECD, above n. 5, para 20.

circumstances than would be the case if the enquiry was directed to finding the state of mind of some taxpayer or their advisers.

The

transactions attempting to eliminate source country taxation from the sale of shares in land-rich companies;

replacing the automatic tie-breaker rule for entities other than individuals with a case-by-case judgment by the competent authorities; and

preventing abuse through the creation of a permanent establishment in a third State.

Some of these transactions are already examined in the Commentary to article 1 of the UN Model.

The recommendations in the will likely lead to recommended changes to the text of the OECD Model, some of which may flow through to changes to the UN Model. Recommended changes to the Models will clearly be influential in the negotiation of future treaties between States, but there is an obvious question about what to do to the text of existing treaties in light of these recommendations?

At this time, there is no easy answer to this problem. It is obviously impractical for a country to renegotiate all of its existing treaties to include changes to the text recommended in the . However, minor adjustments to the terms of the treaty might be effected through a protocol or exchange of notes between the competent authorities, where both States agree with the adjustment. Where one state was unwilling to adjust the existing text and was unwilling to accept changes based on these recommendations, a State might decide that it should simply unilaterally override

There will also likely be changes to the Commentary to the OECD Model as a result of the BEPS Project, which again may flow through to changes to the Commentary to the UN Model. Here, there may be more flexibility about the impact of these changes on the interpretation of existing treaties. The OECD maintains the position that changes to the Commentary can have retrospective effect – that is, additions or revisions to the Commentary should be understood to apply to the interpretation of treaties already on foot –

> other changes or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD member countries as to the proper interpretation of existing provisions and their application to specific situations.[27]

This position may be somewhat ambitious. Some domestic courts have taken the view that, as commentaries form part of the background against which a treaty was negotiated, subsequent changes to the commentary cannot assist the Court to uncover the intention of the contracting states at the time they negotiated their treaty.

Another aspect of item 6 of the BEPS Action Plan is an examination of measures, 'to clarify that tax treaties are not intended to be used to generate double non-taxation.'

The proposes that this part of the Action Item be dealt with by changes to the Title and Preamble to the OECD Model treaty, and some changes to the Commentary explaining what the changes mean. The recommended Title to the Convention would become:

> Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance

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27 OECD, above n. 9, Introduction, para 35.

and the Preamble would now specifically provide that the intention of the States in signing the treaty was 'to further develop their economic relationship and to enhance their cooperation in tax matters' through 'a Convention for the elimination of double taxation with respect to taxes on income

State 'acting in good faith' must reach. And because it does not involve 'tax evasion or avoidance' the result will be allowed to survive.

For example, assume Company A sells all the shares of Subsidiary, a company resident in State B, for a profit. It is quite conceivable that no tax will arise in either State – with a few exceptions, State B will be precluded from taxing Company A under the treaty, and State A may have a participation exemption so that it does not tax profits made on the sale of shares in offshore operating subsidiaries. The result is double non-taxation of Company A and it seems clear that, in the absence of some indication of tax evasion or avoidance, the changes to the Title or Preamble are not meant to overturn that result.

Thus the recommended changes may be helpful in cases where there is evidence of tax evasion or avoidance, and cases where there is some doubt about the way a particular provision should be understood and applied, but the recommended changes would not create a universal rule to negate the operation of a treaty just because double non-taxation will result.

It is worth noting that it would be possible for a developing country to be more ambitious than this proposal, and to insist that treaty provisions may only be invoked against a State where the same amount of income will be (or perhaps, has been) taxed in the hands of the same taxpayer in the other State. This would require specific drafting and goes beyond the current recommendation. But since one major objective of a treaty is to remove double tax as a barrier to closer economic integration, it is entirely consistent with that objective to insist that treaty benefits are conditional upon proving the imposition of tax by the other State.

One theme which emerged in the March 2014 [29] was the need 'to ensure that treaties do not prevent the application of specific domestic law [anti-abuse] provisions that would prevent [abusive] transactions.'[30] The notes arguments have been made that various treaty provisions prevent the application of a wide

[29] OECD, above n. 5.

[30] Id. at 21.

variety of domestic anti-abuse rules: domestic thin capitalisation rules, CFC rules, exit taxes, rules restrict

The proposed Commentary to this new article specifically alludes to the problem of dual residence and notes that a dual resident will not be affected by this clause, even if it is a resident of one State under the domestic laws of that State, if it is taken to be a resident only of the other State under the residence ‘tie-breaker’ rule in the treaty. Or to put this the other way, the domestic tax laws of the residence State can be applied to a dual resident without interference from the treaty if the entity is still a resident after the application of the ‘tie-breaker’ rule.

The blanket immunity for any rule being applied to residents is then made subject to specific exceptions. The residence State must still give effect to those parts of a treaty which –

> adjust the tax position of a resident consequent upon a transfer pricing analysis reallocating profits between the resident and an offshore branch or associated company,
>
> protect from tax income from services rendered by a resident to the government of the other State or as a member of a diplomatic or consular mission of the other State,
>
> protect from tax income earned by a resident student or apprentice in the form of a scholarship provided from another State,
>
> give tax relief in the residence country for income taxed in the other State, and
>
> ensure residents have unfettered rights to protection against discrimination and the ability to seek assistance from the competent authority.

The OECD also notes the possibility that the list could be expanded to deal with other possible situations where the parties might wish to afford treaty benefits to a resident, and gives the examples of pensions and social security benefits.

Action Item 6 in the BEPS Action Plan refers specifically to addressing, 'the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country.'[33] The OECD recommends adding text to taxing, will be taxed in the residence country. The suggests that this is part of the bargain which underlies a treaty,

> where a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State.[35]

This is not simply a self-serving position, ‘if the treaty partner is not going to tax the income we signed in the hope of gaining just administrative benefits may ultimately produce little of lasting value, while at the same time curtailing the source country's tax base.

Finally, the discussion above has suggested an over-arching principle that tax treaties should not result in double non-taxation. Where the source country curtails its own tax claims knowing that the residence country imposes no significant taxation, the country is in effect assisting to produce a double non-taxation outcome.