United Nations E/C.18/2005/2

Contents

I. Work of the Ad Hoc Group of Experts on International Cooperation in Tax Matters

and that a final decision should not be made until the next meeting of the

Matters on its second meeting",[2] paragraphs 7 to 10 of the commentary on article 1 of the OECD Model Convention should be inserted into the United Nations Model Convention, and the discussion in the OECD commentary on treaty abuse issues (paragraphs 22 to 26 in the version of the OECD Model Convention current at that time) could usefully be incorporated in the United Nations Model Convention.

40. However, the material finally inserted differed considerably from this suggestion, although no reason for the omissions emerged in the debate in the Group of Experts. Former paragraph 12 of the OECD commentary on article 1, which contains general considerations to be borne in mind in adopting one approach or another was not inserted. Moreover, the paragraphs enumerating the advantages and disadvantages of adopting each particular approach were omitted (paragraphs 14, 16, 18 and 20). Even conceding that such a wholesale

– provisions which are aimed at preferential regimes introduced after the signature of the convention.

16. The OECD Model arsenal of specific treaty anti-abuse rules is completed by references, in different parts of the Commentaries, to provisions or modifications that the OECD invites Contracting States to consider including in their bilateral treaties to deal with a number of possible avoidance strategies.[6]

17. Many of the specific anti-abuse rules put forward in the Commentaries are based on provisions that OECD countries include in their treaties. For instance, all recent United States treaties include a comprehensive limitation-of-benefits provision and a recent example of that provision was the basis for the alternative provision in paragraph 20 of the Commentary on Article 1. Similarly, the articles dealing with dividends, interest and royalties[7] found in recent United Kingdom treaties include a provision according to which the relief provided by the relevant article shall not be available if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the property in respect of which the relevant income is paid is to take advantage of the article by means of that creation or assignment;[8] that provision was the basis for the alternative provision now found in paragraph 21.4 of the Commentary on Article 1.

18. Clearly, such specific treaty anti-abuse rules provide more certainty to taxpayers and tax administrations. This is acknowledged in paragraph 9.6 of the Commentary, which explains that such rules can usefully supplement general anti-avoidance rules or judicial approaches.[9] One should not, however, underestimate the risks of relying extensively on specific treaty anti-abuse rules to deal with tax treaty avoidance strategies.

19. First, specific tax avoidance rules can only be drafted once a particular avoidance strategy has been identified. It would be extremely naive to believe that all potential avoidance strategies can be identified prospectively. Since a specific anti-avoidance rule will often be drafted only after a particular strategy has become a significant problem, taxpayers that first use that strategy will be advantaged. This

---

6 For example: paragraphs 6.3 and 18 of the Commentary on Article 5 (to deal with attempts to abuse the 12-month rule applicable to construction sites); paragraph 17 of the Commentary on Article 10 (to deal with attempts to abuse the preferential rate of source taxation on dividends from substantial shareholdings); paragraph 22 of the Commentary on Article 10, paragraph 12 of the Commentary on Article 11 and paragraph 7 of the Commentary on Article 12 (to avoid granting the benefits of Articles 10, 11 and 12 to non-resident-owned companies that enjoy preferential tax treatment); paragraph 17 and 20 of the Commentary on Article 18 (to deal with attempts to abuse the suggested provision allowing relief for contributions to a foreign pension scheme); paragraph 6 of the Commentary on Article 21 and paragraph 53 of the Commentary on Article 24 (to deal with cases where shares, loans or rights would be transferred to a permanent establishment in the other State to enjoy a preferential treatment and benefit from the exemption method); paragraphs 31, 31.1 and 35 of the Commentary on Articles 23A and 23B (to deal with low or non-taxation situations arising from the exemption method) and paragraph 78.1 of the Commentary on Articles 23A and 23B (to deal with abuses of tax sparing provisions).

7 In some treaties, the provision is also found in the Article on Other Income.

8 For example, four such provisions are found in the United-Kingdom-Australia treaty that entered into force on 17 December 2003: see paragraph 7 of Article 10 (Dividends), paragraph 9 of Article 11 (Interest), paragraph 7 of Article 12 (Royalties) and paragraph 5 of Article 20 (Other Income).

9 “9.6 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. Where specific avoidance techniques have been identified or where the

26. The second approach is to rely on the anti-abuse rules of domestic law. As explained in new paragraph 9.3 of the Commentary on Article 1, that approach relies on the fact that tax is levied under the provisions of domestic law, not of treaties and, therefore, an abuse involving tax treaty provisions can also be characterised as an abuse of the provisions of domestic law under which tax must be paid.

27. A reference to that approach may be found in paragraph 18 of the Commentary on Article 5, which deals with abuses of the 12-month exception of paragraph 3 of Article 5 applicable to construction sites. According to the Commentary "[…]such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules."[11]

28. A possible difficulty with that second approach, however, is that in case of conflict between the provisions of tax treaties and those of domestic law, the provisions of tax treaties must prevail. This is a logical consequence of the principle of "*pacta sunt servanda*" which is incorporated in Article 26 of the Vienna Convention on the Law of Treaties. Thus, if the application of domestic legislative or judicial anti-avoidance rules had the effect of increasing the tax liability of a taxpayer beyond what is allowed by a tax treaty, this would conflict with the provisions of the treaty and these provisions should prevail under public international law.

29. In the case of domestic legislative or judicial anti-avoidance rules that clearly

obligations. Under that guiding principle, two elements must be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of a tax treaty:

- a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position, and
- obtaining that more favourable treatment would be contrary to the object

ANNEX 1 : Excerpt from note E/2004/51 (Report of the Secretary-General on the Eleventh meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters

"III. Treaty shopping and treaty abuses

16. Many significant international developments have occurred since the topic of treaty abuses and treaty shopping were last addressed by the Group of Experts.

17. Three main questions were addressed in the meeting. First, what is considered a treaty abuse? In that connection, it is necessary to decide who is to determine the existence of an abuse. Second, how are the standards for dealing with treaty abuse being established? In that connection, the standards for determining an abuse might be included in the treaty itself. Third, is it acceptable to deal with treaty abuse with domestic anti-abuse mechanisms? In that connection, it may be necessary to take account of the legal nature of treaties and the obligations derived from the public International Law of Treaties.

18. Representatives noted that although a precise definition of the term “treaty abuse” is not available, there is a broad recognition that treaty abuses exist and must be dealt with. The impossibility of reaching a common definition of a treaty abuse was partly due to the mechanisms for dealing with tax treaty abuse. Persons covered by a tax treaty are its ultimate beneficiaries, despite the fact that a treaty is signed by contracting States and is intended to advance the interests of the contracting States.

19. The existence of a treaty abuse implies an indirect violation of the law, contrary to its goal and objectives. Such a violation can only be determined after taking into account the specific circumstances of a particular case. In general, a treaty abuse is determined by national authorities under their domestic law and according to their legal tradition. For this reason, the concept of a treaty abuse is likely to vary from State to State. The question of treaty abuse is often a question of who are the bona fide beneficiaries of the treaty.

20. Normally, the term treaty abuse is used to refer to situations in which the taxpayer is seeking to circumvent the law. But consideration should also be given to cases in which one of the contracting States takes advantage of the good faith of the other contracting State to the Treaty by making a future ame mpment to onof

ANNEX 2: Proposal resulting from the discussions at the 11th meeting of the Ad Hoc Group of Experts

The following is the latest version of the proposal for revising the relevant parts of the Commentary on Article 1 of the UN Model Convention. That version was circulated by Prof. Prats shortly after the 11th meeting of the Ad Hoc Group of Experts (***bold italics*** indicate proposed additions to the existing text of the Commentary of the UN Model Convention; ~~strikethrough~~ indicate proposed deletions):

Page 43 [of the English version of the UN Model Convention].

"89.96 Tf 0.628(N)-39.31001(t)-23.7863(r)-41.2001(i)-23.12(h)-35.8212(e)-30.932( )-42.2653(E)-46.5986(n)-47.998

> ***"Other States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then 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)". [para. 9.3]***
>
> ***"Under both approaches, therefore, it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into". [para. 9.4]***

Nevertheless, in order that an anti-abuse domestic provision be applied it must respect the primacy of Tax Treaties, and not lead to a result t

these laws in an international environment characterised by very different tax burdens, but such measures should be used only for this purpose. As a general rule, these measures should not be applied where the relevant income has been subjected to taxation that is comparable to that in the country of residence of the taxpayer".[para. 26].

It is suggested not to incorporate paragraphs 10.1 and 10.2 of the Commentaries on Article 1 of the OECD Model Convention as they expressly related to situations dealt in Articles 4 –residence- and 5 –permanent establishment- and could lead to m

enjoy, in that State, a preferential tax regime restricted to foreign-held entities (i.e. not available to entities that belong to residents of that State):

> ***"Any company, trust or partnership that is a resident of a Contracting State and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that State shall not be entitled to the benefits of this Convention if the amount of the tax imposed on the income or capital of the company, trust or partnership by that State (after taking into account any reduction or offset of the amount of tax in any manner, including a refund, reimbursement, contribution, credit or allowance to the company, trust or partnership, or to any other person) is substantially lower thatn the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or partnership, as the case may be, were beneficially owned by one or more residents of that State". [para. 21.2]***

In order to accommodate to the new numbering of paragraphs of the OECD MC the following amendments are suggested:

In page 46 reference to "[para. 17]" should be referred to "[para. 15]".

In page 46 reference to "[para. 21]" should be referred to "[para. 19]".

Taking into account the suggestions made for updating the UN MC in 1999 and the analysis of the so-called channel approach by the UN Report in 1987, it is suggested the inclusion of the following references of the OECD MC in page 46 of the UN MC between the references of previous paragraphs 17 and 21 of the OECD MC:

"Stepping Stone cases

In order to avoid abuse of Tax Treaty by States through the introduction of preferential tax regimes after the signature of the Treaty it is recommended the inclusion of the following paragraph at the end of page 47 after paragraph 10 of the Commentaries on Article 1 of the UN MC: