Committee of Experts on International Cooperation in Tax Matters

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I. INTRODUCTION

1. At its first session held on 5-9 December 2005, the Committee of Experts on International Cooperation in Tax Matters ("the Committee of Experts") decided that:

> (a) The issue of treaty abuse needed to be dealt within the United Nations Model Convention and that this might be addressed in the Commentary as well as in the Convention itself. The Commentary on article 1 of the OECD Model Convention, which addresses methods of combating treaty abuse, would be helpful in this regard. However, it is important to ensure that, in considering the issue of treaty abuse, there is a balance between the need to provide certainty for investors and the need for tax administrations to combat such abuse;
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> (b) Further consideration needs to be given to addressing methods that might be used to combat specific treaty abuse issues. A sub-committee was appointed, to be coordinated by Mr. Lee and to include Mr. Silitonga, Mr. Lara Yaffar, Mr. Zhang, Mr. Garcia Prats and Mr. Sasseville.[1]

2. A draft report was presented at the second session of the Committee held on 30 October – 3 November 2006. After discussion, the Committee decided that Mr. Arrindell (Barbados) and Mr. Liao (China, replacing Mr. Zhang) should join the sub-committee. It also revised the mandate of the sub-committee as follows:[2]

> It was decided that the subcommittee should continue its work according to the following mandate: drafting a new Commentary on Article 1 of the Model that would include both practical examples and possible wording of anti-abuse clauses focusing on improper use by taxpayers. It was suggested that in choosing the examples particular reference should be made to misuses affecting developing countries and to responses which would be feasible for such countries. Attention should also be paid to the relationship between treaties and domestic anti-abuse rules. To better reflect its work, the sub-committee would henceforth be referred to as the subcommittee on improper use of treaties.

3. In accordance with this revised mandate, a meeting of the subcommittee was held in Beijing from 5 to 7 April 2007. That meeting was attended by Mr. Lee, Mr. Liao, Mr. Arrindell and Mr. Sasseville of the subcommittee as well as Mr. Ji, State Administration of Taxation (People's Republic of China) and Mr. Ohyama of the Secretariat. Incorporating comments received from Prof. Garcia Prats, Mr. Silitonga and Mr. Lara Yaffar, the subcommittee prepared a draft new section for the Commentary on Article 1 of the UN Model Convention which focussed on the various approaches available to deal with the improper use of tax treaties and included a number of examples illustrating the application of these approaches.

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[1] Paragraph 37 of the Record on the first session (E/2005/45).

[2] Paragraph 19 of the Report on the second session (E/2006/45).

4. That draft new section was included in the report (note E/C.18/2007/CRP.2) that the subcommittee presented at the third session of the Committee held from 29 October to 2 November 2007. As a result of the detailed discussion of the note that took place during the meeting, it was agreed to make a number of drafting changes and the subcommittee was requested to finalize its report for presentation at the Fourth Session of the Committee.

5. This revised version of the report of the subcommittee therefore incorporates the agreed changes and is presented to the Committee for approval at its Fourth session, to be held from 20 to 24 October 2008.

6. As was already noted in the previous version of this report, the subcommittee did not examine situations where one of the Contracting

Extending the concept of beneficial ownership to other Articles of the UN Model

10. The previous version of this report indicated that the interpretation of the concept of "beneficial owner" might be relevant in dealing with cases of improper use of tax treaties

- general anti-abuse rules in tax treaties
- the interpretation of tax treaty provisions

11. These various approaches are examined in the following sections.

Specific legislative anti-abuse rules found in domestic law

12. Tax authorities seeking to address the improper use of a tax treaty may first consider the application of specific anti-abuse rules included in their domestic tax law.

13. Many domestic rules may be relevant for that purpose. For instance, controlled foreign corporation (CFC) rules may apply to prevent certain arrangements involving the use, by residents, of base or conduit companies that are residents of treaty countries; foreign investment funds (FIF) rules may prevent the deferral and avoidance of tax on investment income of residents that invest in foreign investment funds established in treaty countries; thin capitalization rules may apply to restrict the deduction of base-eroding interest payments to residents of treaty countries; transfer pricing rules (even if not designed primarily as anti-abuse rules) may prevent the artificial shifting of income from a resident enterprise to an enterprise that is resident of a treaty country; exit or departure taxes rules may prevent the avoidance of capital gains tax through a change of residence before the realization of a treaty-exempt capital gain and dividend stripping rules may prevent the avoidance of domestic dividend withholding taxes through transactions designed to transform dividends into treaty-exempt capital gains.

14. A common problem that arises from the application of many of these and other specific

conflict, allowing the application of the domestic rules) in the case, for example, of thin capitalization rules, CFC rules or departure tax rules or, more generally, domestic rules aimed at preventing the avoidance of tax.

18. Second, many tax treaty provisions depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person, the determination of what is immovable property and of when income from corporate rights might be treated as a dividend. More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the treaty. In many cases, therefore, the application of domestic anti-abuse rules will impact how the treaty provisions are applied rather than produce conflicting results.

19. Third, the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied on a proper interpretation of the treaty. In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both the interpretation of the treaty and the domestic specific anti-abuse rules. Domestic specific anti-abuse rules, however, are often drafted by reference to objective facts, such as the existence of a certain level of shareholding or a certain debt-equ

22. Having concluded that the approach of relying on such anti-abuse rules does not, as a general rule, conflict with tax treaties, the OECD was therefore able to conclude 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."[3]

23. That conclusion leads logically to the question of what is an abuse of a tax treaty. The OECD did not attempt to provide a comprehensive reply to that question, which would have been difficult given the different approaches of its Member countries. Nevertheless, the OECD presented the following general guidance, which was referred to as a "guiding principle":[4]

> "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."

24. The members of the Committee endorsed that principle. They considered that such guidance as to what constitutes an abuse of treaty provisions serves an important purpose as it attempts 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. Clearly, countries should not be able to escape their treaty obligations simply by arguing that legitimate transactions are abusive and domestic tax rules that affect these tran

general anti-abuse rules or doctrines to other forms of treaty abuses. Adding specific anti-abuse rules to a tax treaty could be wrongly interpreted as suggesting that an unacceptable avoidance strategy that is similar to, but slightly different from, one dealt with by a specific anti-abuse rule included in the treaty is allowed and cannot be challenged under general anti-abuse rules. Third, in order to specifically address complex avoidance strategies, complex rules may be required. This is especially the case where these rules seek to address the issue through the application of criteria that leave little room for interpretation rather than through more flexible criteria such as the purposes of a transaction or arrangement. For these reasons, whilst the inclusion of specific anti-abuse rules in tax treaties is the most appropriate approach to deal with certain situations, it cannot, by itself, provide a comprehensive solution to treaty abuses.

General anti-abuse rules found in tax treaties

34. There are a few examples of treaty provisions that may be considered to be general anti-abuse rules. One such provision is paragraph 2 of Article 25 of the treaty between Israel and Brazil, signed in 2002:

> A competent authority of a Contracting State may deny the benefits of this Convention to any person, or with respect to any transaction, if in its opinion the granting of those benefits would constitute an abuse of the Convention according to its purpose. Notice of the application of this provision will be given by the competent authority of the Contracting State concerned to the competent authority of the other Contracting State.

35. In some cases, countries have merely confirmed that Contracting States were not prevented from denying the benefits of the treaty provisions in abusive cases. In such cases, however, it cannot be said that the power to deny the benefits of treaty arises from the provision itself. An example of that type of provision is found in paragraph 6 of Article 29 of the Canada-Germany treaty signed in 2001:

> Nothing in the Agreement shall be construed as preventing a Contracting State from denying benefits under the Agreement where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Agreement or of the domestic laws of that State.

36. A country that would not feel confident that its domestic law and approach to the interpretation of tax treaties would allow it to adequately address improper uses of its tax treaties could of course consider including a general anti-abuse rule in its

When considering such a provision, some countries may prefer to replace the phrase “a main purpose” by “the main purpose” to make it clear that the provision should only apply to transactions that are, without any doubt, purely tax-motivated. Other countries, however, may consider that, based on their experience with similar general anti-abuse rules found in domestic law, words such as “the main purpose” would impose an unrealistically high threshold

to State B for two years and becomes resident, but not domiciled, in that State. She then sells the shares and claims that the capital gain may not be taxed in State A pursuant to paragraph 6 of Article 13 of the treaty (the relevant treaty does not include a provision similar to paragraph 5 of this Convention).

42. Depending on the facts of a particular case, it might be possible to argue that a change of residence that is primarily intended to access treaty benefits constitutes an abuse of a tax treaty. In cases similar to these three examples, however, it would typically be very difficult to find facts that would show that the change of residence has been done primarily to obtain treaty benefits, especially where the taxpayer has a permanent home or is present in another State for extended periods of time. Many countries have therefore found that specific rules were the best approach to deal with such cases.

43. One approach used by some of these countries has been to

leaves such cases of dual residence to be decided under the mutual agreement procedure. An example of such a provision is found in paragraph 3 of Article 4 of the treaty signed in 2004 by Mexico and Russia, which reads as follows:

> 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 by mutual agreement endeavour to settle the question and to determine the mode of application of the Agreement to such person. In the absence of such agreement, such person shall be considered to be outside the scope of this Agreement, except for the Article "Exchange of information".

46. Example 3 raises the potential for tax avoidance arising from remittance-based taxation. This issue is dealt with in paragraph 26.1 of the Commentary on Article 1 of the OECD Model Tax Convention, which suggests that, in order to deal with such situations, countries may include a specific anti-abuse provision in their tax treaties with countries that allow that form of taxation:

> 26.1 Under the domestic law of some States, persons who qualify as residents but who do not have what is considered to be a permanent link with the State (sometimes referred to as domicile) are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. Such persons are not, therefore, subject to potential double taxation to the extent that foreign income is not remitted to their State of residence and it may be considered inappropriate to give them the benefit of the provisions of the Convention on such income. Contracting States which agree to restrict the application of the provisions of the Convention to income that is effectively taxed in the hands of these persons may do so by adding the following provision to the Convention:
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> > "Where under any provision of this Convention income arising in a Contracting State is relieved in whole or in part from tax in that State and under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then any relief provided by the provisions of this Convention shall apply only to so much of the income as is taxed in the other Contracting State."
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> In some States, the application of that provision could create administrative difficulties if a substantial amount of time elapsed between the time the income arose in a Contracting State and the time it were taxed by the other Contracting State in the hands of a resident of that other State. States concerned by these difficulties could subject the rule in the last part of the above provision, i.e. that the income in question will be entitled to benefits in the first-mentioned State only when taxed in the other State, to the condition that the income must be so taxed in that other State within a specified period of time from the time the income arises in the first-mentioned State.

Treaty shopping

47. "Treaty shopping" is a form of improper use of tax treaties that refers to arrangements through which persons who are not entitled to the benefits of a tax treaty use other persons who are entitled to such benefits in order to indirectly access these benefits. For example, a company that is a resident of a treaty country would act as a conduit for channelling income that would economically accrue to a person that is not a resident of that country so as to improperly access the benefits provided by a tax treaty. The conduit entity is usually a company, but may also be a partnership, trust or similar entity that is entitled to treaty benefits. Granting treaty benefits in these circumstances would be detrimental to the State of source since the benefits of the treaty would then be extended to persons who were not intended to obtain such benefits.

48. A treaty shopping arrangement may take the form of a "direct conduit" or that of a "stepping stone conduit", as illustrated below.[7]

49. Company X, resident of State A, receives dividends, interest or royalties from company Y resident of State B. Company X claims that, under the tax treaty between States A and B, it is entitled to full or partial exemption from the domestic withholding taxes provided for under the tax legislation of State B. Company X is wholly-owned by a resident of third State C who is not entitled to the benefits of the treaty between States A and B. Company X was created for the purpose of obtaining the benefits of the treaty between States A and B and it is for that purpose that the assets and rights giving rise to the dividends, interest or royalties have been transferred to it. The income is exempt from tax in State A, e.g. in the case of dividends, by virtue of a participation exemption provided for under the domestic laws of State A or under the treaty between States A and B. In that case, company X constitute a direct conduit of its shareholder resident of State C.

50. The basic structure of a stepping stone conduit is similar. In that case, however, the income of company X is fully taxable in State A and, in order to eliminate the tax that would be payable in that country, company X pays high interest, commissions, service fees or similar deductible expenses to a second related conduit company Z, a resident of State D. These payments, which are deductible in State A, are tax-exempt in State D by virtue of a special tax regime available in that State.[8] The shareholder resident of State C is therefore seeking to access the benefits of the tax treaty between States A and B by using company X as a stepping stone.

51. In order to deal with such situations, tax authorities have relied on the various approaches described in the previous sections.

52. For instance, specific anti-abuse rules have been included in the domestic law of some countries to deal with such arrangements. One example is that of the US regulations dealing with financing arrangements. For the purposes of these regulations, a financing arrangement is

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7 "Double Taxation Convention and the Use of Conduit Companies", in volume II of the loose-leaf version of the *OECD Model Tax Convention*, OECD, R(6)-1, at page R(6)-4, paragraph 4.

8 *Id.*

a series of transactions by which the financing entity advances money or other property to the financed entity, provided that the money or other property flows through one or more intermediary entities. An intermediary entity will be considered a "conduit", and its participation in the financing arrangements will be disregarded by the tax authorities if (*i*) tax is reduced due to the existence of an intermediary, (*ii*) there is a tax avoidance plan, and (*iii*) it is established that the intermediary would not have participated in the transaction but for the fact that the intermediary is a related party of the financing entity. In such cases, the related income shall be re-characterized according to its substance.

53. Other countries have dealt with the issue of treaty shopping through the interpretation of tax treaty provisions. According to a 1962 decree of the Swiss Federal Council, which is applicable to Swiss treaties with countries that, under the relevant treaties, grant relief from withholding tax that would otherwise be collected by these countries, a claim for such relief is considered abusive if, through such claim, a substantial part of the tax relief would benefit persons not entitled to the relevant tax treaty. The granting of a tax relief shall be deemed improper (a) if the requirements specified in the tax treaty (such as residence rule, beneficial ownership, tax liability, etc.) are not fulfilled and (b) if it constitutes an abuse. The measures which the Swiss tax authorities may take if they determine that a tax relief has been claimed improperly include (a) refusal to certify a claim form, (b) refusal to transmit the claim form, (c) revoking a certification already given, (d) recovering the withholding tax, on behalf of the State of source state, to the extent that the tax relief has been claimed improperly, and (e) informing the tax authorities of the State of source that a tax relief has been claimed improperly.

54. Other countries have relied on their domestic legislative general anti-abuse rules or judicial doctrines to address treaty shopping cases. As already noted, however, legislative general anti-abuse rules and judicial doctrines tend to be the most effective when it is clear that transactions are intended to circumvent the object and purpose of tax treaty provisions.

55. Treaty shopping can also, to some extent, be addressed through anti-abuse rules already found in most tax treaties, such as the concept of "beneficial ownership".

56. Some countries, however, consider that the most effective approach to deal with treaty shopping is to include in their tax treaties specific anti-abuse rules dealing with that issue. Paragraphs 13 to 21.4 of the Commentary on

suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision that would single out cases of improper use with reference to the conduit arrangements themselves (the channel approach). Such

(d) Stock exchange provision

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circumstances, one has control of the other or both are under the control of the same person or persons.

4. Notwithstanding the preceding provisions of this Article, if a company that is a resident of a Contracting State, or a company that controls such a company, has outstanding a class of shares

(a) which is subject to terms or other arrangements which entitle its holders to a portion of the income of the company derived from the other Contracting State that is larger than the portion such holders would receive absent such terms or arrangements ("the disproportionate part of the income"); and

(b) 50 per cent or more of the voting power and value of which is owned by persons who are not qualified persons

the benefits of this Convention shall not apply to the disproportionate part of the income.

5. A resident of a Contracting State that is neither a qualified person pursuant to the provisions of paragraph 2 or entitled to benefits under paragraph 3 or 4 shall, nevertheless, be granted benefits of the Convention if the competent authority of that other Contracting State determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention.

6. For the purposes of this Article the term "recognized stock exchange" means:

(a) in State A ……..;

(b) in State B ……..; and

(c) any other stock exchange which the competent authorities agree to recognize for the purposes of this Article."

Provisions which are aimed at entities benefiting from preferential tax regimes

21. Specific types of companies enjoying tax privileges in their State of residence facilitate conduit arrangements and raise the issue of harmful tax practices. Where tax-exempt (or nearly tax-exempt) companies may be distinguished by special legal characteristics, the improper use of tax treaties may be avoided by denying the tax treaty benefits to these companies (the exclusion approach). As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause which would apply to the income received or paid by such companies and which could be drafted along the following lines:

"No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under section ... of the ... Act, or under any similar provision enacted by ... after the signature of the Convention."

The scope of this provision could be limited by referring only to specific types of income, such as dividends, interest, capital gains, or directors' fees. Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25

(mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information).

21.1 Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State that has created special privileges in its tax law may prevent those privileges from being used in connection with the improper use of tax treaties concluded by that State.

21.2 Where it is not possible or appropriate to identify the companies enjoying tax privileges by reference to their special legal characteristics, a more general formulation will be necessary. The following provision aims at denying the benefits of the Convention to entities which would otherwise qualify as residents of a Contracting State but which 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 than 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."

Provisions which are aimed at particular types of income

21.3 The following provision aims at denying the benefits of the Convention with respect to income that is subject to low or no tax under a preferential tax regime:

> "1. The benefits of this Convention shall not apply to income which may, in accordance with the other provisions of the Convention, be taxed in a Contracting State and which is derived from activities the performance of which do not require substantial presence in that State, including:
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> *(a)* such activities involving banking, shipping, financing, insurance or electronic commerce activities; or
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> *(b)* activities involving headquarter or coordination centre or similar arrangements providing company or group administration, financing or other support; or
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> *(c)* activities which give rise to passive income, such as dividends, interest and royalties
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> where, under the laws or administrative practices of that State, such income is preferentially taxed and, in relation thereto, information is accorded confidential treatment that prevents the effective exchange of information.

2. For the purposes of paragraph 1, income is preferentially taxed in a Contracting State if, other than by reason of the preceding Articles of this Agreement, an item of income:

(a) is exempt from tax; or

(b) is taxable in the hands of a taxpayer but that is subject to a rate of tax that is lower than the rate applicable to an equivalent item that is taxable in the hands of similar taxpayers who are residents of that State; or

(c) benefits from a credit, rebate or other concession or benefit that is provided directly or indirectly in relation to that item of income, other than a credit for foreign tax paid."

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even though they are not taxed in that State by reason of the exemption system applied by

(ii) Thin capitalisation

64. In almost all countries, interest is a deductible expense whereas dividends, being a distribution of profits, are not deductible. A foreign company that wants to provide financing to a wholly-owned subsidiary may therefore find it beneficial, for tax purposes, to provide that financing through debt rather than share capital, depending on the overall tax on the interest paid. A subsidiary may therefore end up with almost all of its financing being provided in the form of debt rather than share capital, a practice known as "thin capitalisation".

65. According to the OECD report on Thin Capitalisation,[12] countries have developed different approaches to deal with this issue. These approaches may be broadly divided between those that are based on the application of a general anti-abuse rules or the arm's length principle and those that involve the use of fixed debt-equity ratios.

66. The former category refers to rules that require an examination of the facts and circumstances of each case in order to determine whether the real nature of the financing is that of debt or equity. This may be implemented through specific legislative rules, general anti-abuse rules, judicial doctrines or the application of transfer pricing legislation based on the arm's length principle.

67. The fixed ratio approach is typically implemented through specific legislative anti-abuse rules; under this approach, if the total debt/equity ratio of a particular company exceeds a predetermined ratio, the interest on the excessive debt may be disallowed, deferred or treated as a dividend.

68. To the extent that a country's thin capitalisation rule applies to payments of interest to non-residents but not to similar payments that would be made to residents, it could be in violation of paragraph 4 of Article 24, which provides that "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". There is a specific exception to that rule, however, where paragraph 1 of Article 9, which deals with transfer pricing adjustments, applies. For that reason, as indicated in the Commentary on paragraph 4 of Article 24:[13]

> Paragraph 4 does not prohibit the country of the borrower from treating interest as a dividend under its domestic rules on thin capitalisation 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.

69. Paragraph 3 of the OECD Commentary on Article 9, which is reproduced under paragraph 6 of the Commentary on the same provision of this Model, clarifies that paragraph 1 of Article 9 allows the application of domestic rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount

[12] "Thin Capitalisation", in volume II of the loose-leaf version of the *OECD Model Tax Convention,* R(4)-1.

[13] Paragraph 56 of the Commentary on Article 24 of the OECD Model Tax Convention, which is reproduced under paragraph 5 of the Commentary on Article 24 of this Model.

corresponding to the profits which would have accrued in an arm's length situation. While this would typically be the case of thin capitalisation rules that are based on the arm's length principle, a country that has adopted thin cap

74. These approaches, however, might not be successful in dealing with arrangements involving companies that have substantial management and economic activities in the countries where they have been established. 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 if the Commentary on Article 1 of the OECD Model Tax Convention (and as further explained in paragraphs 10.1 of the Commentary on Article 7 and 37 of the Commentary on Article 10 of that Model):

> 23. The use of base companies may also be addressed through controlled foreign companies provisions. A significant number of Member and non-member countries have now adopted such legislation. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of controlled foreign companies legislation conflicted with these provisions. For the reasons explained in paragraphs 10.1 of the Commentary on Article 7 and 37 of the Commentary on Article 10, that interpretation does not accord with the text of the provisions. It also does not hold when these provisions are read in their context. Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign companies legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention.

(iv) Directors' fees and remuneration of top-level managers

75. According to Article 16 (Directors' Fees), directors' fees and the remuneration of officials in a top-level managerial position of a compa

amount of interest. Finally, some states have included specific anti-abuse rules in their treaties to deal with such back-to-back arrangements. An example of such a rule is found in paragraph b) of Article 7 of the Protocol to the treaty signed in 2002 by Australia and Mexico, which reads as follows:

> The provisions of […]paragraph [2 of Article 11] shall not apply to interest derived from back-to-back loans. In such case, the interest shall be taxable in accordance with the domestic law of the State in which it arises.

Hiring out of Labour

81. The Commentary on Article 15 reproduces the part of the Commentary on the OECD Model Convention that deals with arrangements known as "international hiring-out of labour". This refers to cases where a local enterprise that wishes to hire a foreign employee for a short period of time enters into an arrangement with a non-resident intermediary who will act as the formal employer. The employee thus appears to fulfil the three conditions of paragraph 2 of Article 15 so as to qualify for the tax exemption in the State where the employment will be exercised. The Commentary on Article 15 includes guidance on how this issue can be dealt with, recognizing that domestic anti-abuse rules and judicial doctrines, as well as a proper construction of the treaty, offer ways of challenging such arrangements.

Artistes and sportspersons

82. A number of older tax treaties do not include paragraph 2 of Article 17 (Artistes and sportspersons), which deals with the use of so-called "star-companies". In order to avoid the possible application of provisions based on paragraph 1 of that Article, residents of countries that have concluded such treaties may be tempted to arrange for the income derived from their activities as artistes or sportspersons, or part thereof, to be paid to a company set up for that purpose.

83. As indicated in the Commentary on Article 17, which reproduces paragraph 11 of the OECD Commentary on that Article, such arrangements may de dealt with under domestic law provisions that would attribute such income to the artistes or sportspersons:

> The third situation involves certain tax avoidance devices in cases where remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to another person, e.g. a so-called artiste company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the artiste or sportsman nor as profits of the enterprise, in the absence of a permanent establishment. Some countries "look through" such arrangements under their domestic law and deem the income to be derived by the artiste or sportsman; where this is so,

> 11.2 As a general rule it should be noted, however, that, regardless of Article 17, 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/sportsman or the star-company in abusive cases, as is recognised in paragraph 24 of the Commentary on Article 1."

85. Finally, as regards the anti-abuse rule found in paragraph 2 of Article 17, tax administrations should note that the rule applies regardless of whether or not the star-company is a resident of the same State as the artiste or sportsperson. This clarification was also added to the OECD Commentary in 2003:

> 11.1 The application of paragraphs 2 is not restricted to situations where both the entertainer or sportsman and the other person to whom the income accrues, e.g. a star-company, are residents of the same Contracting State. The paragraph allows the State in which the activities of an entertainer or sportsman are exercised to tax the income derived from these activities and accruing to another person regardless of other provisions of the Convention that may otherwise be applicable. Thus, notwithstanding the provisions of Article 7, the paragraph allows that State to tax the income derived by a star-company resident of the other Contracting State even where the entertainer or sportsman is not a resident of th

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92. Some countries have modified the definition of royalties to expressly address such cases. For example, subparagraph 3 a) of Article 12 of the treaty between the United States and India provides that

> The term "royalties" as used in this Article means:
>
> a) payments of any kind received as a consideration for the use of, or the right to use, any copyright […] *including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof* … [emphasis added]

(iv) Use of derivative transactions

93. Derivative transactions can allow taxpayers to obtain the economic effects of certain financial transactions under a different legal form. For instance, depending on the treaty provisions and domestic law of each country, a taxpayer may obtain treaty benefits such as no or reduced source taxation when it is in fact in the same economic position as a foreign investor in shares of a local company. Assume, for instance, that company X, a resident of State A, wants to make a large portfolio investment in the shares of a company resident in State B, while company Y, a resident in State B, wants to acquire bonds issued by the government of State A. In order to avoid the cross-border payments of dividends and interest, which would attract withholding taxes, company X may instead acquire the bonds issued in its country and company Y acquire the shares of the company resident in its country that company X wanted to invest into. Companies X and

source State. As noted in the Commentary on Article 10, which reproduces paragraph 17 of the OECD Commentary on that Article:

> The reduction envisaged in subparagraph a) of paragraph 2 should not be granted in cases of abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction. To counteract such manoeuvres Contracting States may find it appropriate to add to subparagraph a) a provision along the following lines:
>
> > "provided that this holding was not acquired primarily for the purpose of taking advantage of this provision".

The following are other examples of arrangements intended to circumvent various thresholds found in the Convention.

Time limit for certain permanent establishments

96. Article 5(3) of the Convention includes a rule according to which, in certain circumstances, the furnishing of services by a foreign enterprise during a certain period under the same or connected projects will constitute a permanent establishment. Taxpayers may be tempted to circumvent the application of that provision by splitting a single project between associated enterprises or by dividing a single contract into different ones so as to argue that these contracts cover different projects. Paragraphs 11 and 12 of the Commentary on Article 5 deal with such arrangements.

Thresholds for the source taxation of capital gains on shares

97. Paragraph 4 of Article 13 allows a State to tax capital gains on shares of a company (and on interests in certain other entities) the property of which consists principally of immovable property situated in that State. For the purposes of that provision, the property of such an entity is considered to consist principally of immovable property situated in a State if the value of such immovable property exceeds 50% of the value of all assets of the entity.

98. One could attempt to circumvent that provision by diluting the percentage of the value of an entity that derives from immovable property situated in a given State in contemplation of the alienation of shares or interests in that entity. In the case of a company, that could be done by injecting a substantial amount of cash in the company in exchange for bonds or preferred shares the conditions of which would provide that such bonds or shares would be redeemed shortly after the alienation of the shares or interests.

99. Where the facts establish that assets have been transferred to an entity for the purpose of avoiding the application of paragraph 4 of Article 13 to a prospective alienation of shares or interests in that entity, a country’s general anti-abuse rules or judicial doctrines may well be applicable. Some countries, however, may wish to provide expressly in their treaties that paragraph 4 will apply in these circumstances. This could be done by adding to Article 13 a provision along the following lines: