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Revision of the Manual for the Negotiation of Bilateral Tax Treaties

Note on the Revision of the Manual for Negotiation of Bilateral Tax Treaties

Summary

This note comprises the second part of the draft revision of the Manual for Negotiation of Bilateral Tax Treaties prepared by the Subcommittee on revision of the Manual. It is provides an introduction to tax evasion and avoidance.

II. INTERNATIONAL TAX EVASION AND AVOIDANCE

A. Concepts and issues

70. Various features of the globalized economy have enabled an increasing number of individuals and companies to resort to tax evasion or tax avoidance. These features include the ease and rapidity of communications, the progressive elimination of obstacles to the movement of persons and property, the expansion of international economic relations, the differences in national tax systems and hence in the tax burden from country to country, and the growing sophistication and aggressiveness of taxpayers and their advisers in developing legal and illegal techniques for taking advantage of weaknesses in national tax systems.

1. The concepts of tax evasion and tax avoidance

71. Tax Evasion-The terms "tax evasion" and "tax avoidance" have not always been used precisely or with a uniform meaning.[1] Tax evasion is usually associated with the commission of a criminal offense. It can be considered to consist of wilful and conscious non-compliance with the laws of a taxing jurisdiction which can include a deliberate concealment of facts from revenue authorities. Tax evasion is an action by which a taxpayer tries to escape legal obligations by fraudulent or other illegal means. It may result from the evasion of tax on

horities of one's presence in the

country if he is carrying on taxable activities;

- The failure to report the full amount of income;

concept is one of avoidance.

2 Maurice H. Collins, Evasion and Avoidance of Tax at the Unternational Level (Eurpoean Taxation, September 1988)

73. Tax Avoidance-Tax avoidance is not tax evasion. Tax avoidance, in contrast, involves the attempt to reduce the amount of taxes otherwise owed by employing legal means.[3] Tax avoidance occurs when persons arrange their affairs in such a way as to take advantage of weaknesses or ambiguities in the tax law. Although the means employed are legal and not fraudulent, the results are considered improper or abusive. Because of the subjectivity of the interpretation and application of tax avoidance the borderline between evasion and avoidance in specific cases may be difficult to define. For one thing, the criminal laws of countries differ, so that behaviour that is criminal under the laws of one country may not be criminal under the laws of another.[4] In addition, the definitions of civil and criminal tax fraud may overlap, so that it is within administrative discretion whether or not to pursue a criminal fraud case in a specific instance. In reality, there is a continuum of behaviour, ranging from criminal fraud on one extreme, to civil fraud, to tax avoidance that is not fraudulent but which runs afoul of judicial or statutory anti-avoidance rules and therefore does not succeed in minimizing tax according to law, and finally to tax-planning behaviour which is successful in legal tax reduction. The compound expression "tax avoidance an The European Court of Justice (ECJ) defined tax avoidance as "artificial arrangements aimed at circumventing tax law."5

74. Tax Planning-Many countries make a distinction between acceptable tax avoidance and unacceptable tax avoidance. Unacceptable tax avoidance is achieved by transactions that are genuine and legal but involves decit or pretence or sham structures;6 it is an indirect violation or an improper use of the tax laws or treaties. Acceptable tax avoidance methods or tax planning however reduces tax liability through transaction or other activities that are intended by legislation.

75. Courts in most countries have consistently recognized the right of taxpayers to avoid taxes by means that are within the law.[7] However, courts in many countries have also found that the tax laws should be interpreted so as to prevent their avoidance by the use of transactions that have no business purpose, although there is considerable variety in the approaches of courts in different countries.[8] Tax laws also typically include a variety of specific or general anti-

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[3] Black's Law Dictionary (Fifth Edition) has defined 'tax avoidance' as: "The minimization of one's tax liability by taking advantage of legally available tax planning opportunities. Tax avoidance may be contrasted with tax evasion, which entails the reduction of tax liability by using illegal means".

[4] While most countries define criminal tax fraud fairly broadly, there are some exceptions. For example, Switzerland has a narrow concept of "tax fraud", which is an offence subject to imprisonment, defining it as the use of "forged, falsified or substantially incorrect documents". See Direct Federal Tax Law, art. 186.

5 See *Lankhorst-hohorst* (C-324/00)(point 37).

6 See *ensign Tankers (Leasing) Ltd. V. Stokes* (1992) STC 226.

[7] In the United Kingdom the classic statement of this principle was made by Lord Tomlin in *IRC vs. Duke of Westminster* [1936] AC: "Every man is entitled, if he can, to order his affairs so that tax attaching under the appropriate Acts is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

For the United States of America, see *Helvering vs. Gregory*, 69 F 2d 809, 810 (2nd Cir. 1934): "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes" (per Learned Hand, J.).

For Belgium, see Judgment of February 27, 1987, Cour de Cassation, 1987 Pas. Be. 1, No. 387, at 777 (taxpayer allowed to choose "the lesser taxed way").

[8] For example, in the United Kingdom, the leading case of the modern era is *WT Ramsay Ltd. vs. CIR*

avoidance rules. Tax avoidance is a less precise concept than

the Committee is able to develop and promote the adoption of practices that should enable tax

Over the past several years there has been a marked change, as many of the industrialized nations have recognized the importance of exchange of tax information; the absence thereof serves to encourage not only tax avoidance and evasion but also criminal tax fraud, money-laundering, illegal drug trafficking, and other criminal activity.

(b) Tax planning and treaty shopping

82. Another aspect of the bilateral tax treaty policy to deal with tax avoidance and evasion is to include in all treaties comprehensive provisions designed to prevent "treaty shopping". This abuse of the treaty can take a number of forms, but it generally involves a resident of a third state C that has either no treaty with the country A or a relatively unfavourable one, establishing an entity in a treaty partner B that has a relatively favourable treaty with the country A. This entity is used to hold title to the person's investme

specified in those articles. Contracting States which may wish to specifically address the issue are advised to include the specified clause in their bilateral tax treaties.

85. It is necessary to include anti-abuse rules in bilateral tax treaties in view of several concurrent developments in international tax law. Firstly, although an overwhelming majority of taxpayers who avail themselves of treaty benefits are entitled to those benefits and are not engaged in abusive transactions, aggressive abuse of treaties has increased. It is relevant to point out that both the commentary to Article 1 of the OECD Model Tax Treaty and the OECD Report on Harmful Tax Competition make clear that countries can impose their domestic anti-abuse rules to claims for treaty benefits. In fact, concerns about the adequacy of current treaty rules to prevent abuses have stimulated work in the OECD on this subject.

86. The increase in treaty abuses has unfortunate results for both the treasury of the country and the taxpayers; it requires the treasury to divert resources to fighting abuse that it might otherwise devote to improving the treaty network. The emergence internationally of anti-abuse rules addresses the abuse problem, while at the same time frees up the treasury resources to provide greater benefits to the taxpayers. Most bilateral tax treaties contain only benefits for taxpayers and no provisions that increase tax burdens. As such, it is appropriate to impose reasonable limits on those benefits to curb abusive transactions that may be developed in the future.

(c) Tax avoidance through low-tax jurisdictions

87. In the most general terms, a low-tax jurisdiction can be defined as a jurisdiction which imposes little or no tax on companies, trusts or other entities organized there. By forming a company in such a jurisdiction and arranging for that company to derive income from third countries, a multinational enterprise may be able to shelter income from taxation both at the source and in its residence country. By forming

collected anonymously at a financial institution in a third country where the securities are held in custody. This type of income also lends itself to many fraudulent practices through the skilful use of certain special provisions of domestic laws. Thus, certain institutions whose prime purpose is economic or financial are frequently used to facilitate tax evasion or avoidance.

95. Investment trusts and holding companies are of particular concern in this connection. The anonymity of the owners of the securities held by an investment trust is normally assured by the form of their holdings in the trust and also by the fact that often the trust has no tax liability or obligation to report information to the tax administration of the country where it is established. Where the trust is not itself a taxable entity, it pays no tax on profits from its dealings or on income. The owners of the securities who are the true recipients of the profits and income may not be subjected to personal taxation, if the tax administration is not aware of their identity. That identity may be concealed, for example, by holding the securities in bearer form or, if registered, in the name of nominees. As for holding companies, the preferential tax regime applied to them in some countries likewise encourages the creation of legal structures, which may facilitate tax evasion or avoidance with respect to the income from holdings in companies anywhere in the world. As in the case of investment trusts, this situation results first from the fact that no tax, or very little, may be payable by the holding company in respect of the income which it receives and redistributes, and second from the lack of information as to the identity of the individuals or companies receiving distributions of profits from the holding companies.

Business income

96. Taxes on business income are reduced at times by means of deliberate failure to keep accurate books and records within the taxing jurisdiction. A second set of books, which is accurate, may be maintained outside the taxing jurisdiction, and beyond the reach of the authorities of that country. In some instances, the maintenance of false books within the taxing jurisdiction is facilitated by limitations in domestic law on the extent to which the taxpayer's books and records may be examined by the tax authorities. With the advent of electronic bookkeeping, it may be easier to keep two sets of paper records or to falsify paper records, since a computer keeps a record of all changes made to a file. Those changes can in many cases provide an audit trail that is much harder to destroy than physical documents.

97. Business profits properly allocable to the source country may be shifted to other countries by such devices as the establishment of artificial transfer prices for imports and exports, the improper allocation of costs, and licensing agreements under which the user of technology is obliged to purchase imported inputs, equipment and spare parts at inflated prices. Such devices, which transnational corporations are particularly well situated to use, are of great concern to developing countries, whose tax officials often lack the time and expertise to challenge effectively the prices set between affiliated companies.

Thin capitalization

98. Many countries allow corporations to take a deduction for interest expenses but do not allow a deduction for the payment of dividends. This differential treatment of interest and dividends creates a bias in favour of debt finance over equity finance. The bias is particularly

establishment in the country, whereas the fees for technical assistance may be the subject to a withholding tax. To minimize the withholding tax, the foreign corporation may claim that the technical assistance has little value.

iii. Fictitious deductions

102. In a variety of circumstances, a taxpayer may claim fictitious or inflated business expenses as deductions. In employing this tactic, the taxpayer may claim that the purported payment was made to a person located outside the taxing jurisdiction, thereby making an audit of the expenses difficult for the tax authorities. For example, if the taxpayer purchases goods outside the taxing jurisdiction, false invoices may be prepared to show a purchase price greater than the actual amount paid by the taxpayer.

103. Payments characterized as commissions, royalties, technical service fees and similar expenses are sometimes paid by a resident of the taxing jurisdiction to a related non-resident and claimed as a deduction, even though the related non-resident has done nothing to earn these payments.

iv. Credit for fictitious tax

104. A taxpayer who resides in a country that allows a foreign tax credit as a method of relieving double taxation and receives income from another country may seek to reduce tax in the residence country by claiming fictitious or excessive credits for taxes allegedly paid to the other country.

v. Improper characterization of income or expense items

105. Tax may be reduced by improperly characterizing an income or expense item in order to make use of an exemption or reduced rate.

vi. Inconsistent characterizations

106. A taxpayer may characterize a particular transaction in one way in country A, and in a contrary way in country B, in order to obtain tax benefits in both countries. For example, advances by a parent in country A to a subsidiary in country B may be treated as equity in country A (in order to avoid the necessity for reporting interest income to country A), but as debt in country B (in order to avoid capital stock taxes in country B). Payments made by a subsidiary in country A to its parent in country B may be treated as the purchase price of goods in country A but as royalties or dividends in country B. In some cases, however, inconsistencies of this type may be justified by differences in the internal laws of the two jurisdictions.

vii. Utilizing temporary taxpayer status

107. Where taxation is based on a temporary status, tax evasion or avoidance may occur through transactions that take advantage of that temporary status. For example, because a borrower is not liable to tax on the proceeds of a loan, a foreign national may arrange an

ostensible loan while he is a resident of the taxing jurisdiction, and then sell the collateral for the alleged loan to the lender following his departure from the taxing jurisdiction (when he is no longer taxable on sales profit within that jurisdiction), with the "loan" being credited against the sale price.

viii. Flight to evade payment of tax

108. When a taxing jurisdiction determines that a resident alien has taxable income or assesses

ii. Use of bearer securities

112. In many instances, withholding taxes can be avoided by holding securities in bearer form, particularly if they are in the custody of a broker, nominee or agent within the country of the issuing corporation. Again, this method of avoidance assumes that the person holding the bearer securities is prepared to violate the law by failing to withhold when remittances are made to the true owner.

iii. Erroneous characterization of income items

113. Where the withholding rates on certain types of income are lower than the rates on other types of income, related entities may disguise the true character of a payment in order to take advantage of the lower rate. For example, dividends may be paid in the guise of fees or commissions.

iv. Unreported income and fictitious expenses

114. An individual who is temporarily present in the taxing jurisdiction, but is neither a

transfer of investments from one owner to another without reporting the transaction and paying the tax due by reason of the transfer. It is difficult to police such transactions from a tax standpoint because the use of bearer securities is widespread and entirely legal in many countries.

iii. Foreign holding companies and trusts

119. Under the laws of some countries, a resident may legally avoid tax by placing income producing property in a foreign corporation or trust which he controls. However, under the laws of other countries, the investment income is taxable by the country of residence whether or not it is actually distributed by the foreign corporation or trust to the resident owner. In cases of the latter type, tax is frequently evaded by illegally concealing the existence of the foreign holding company or trust from the tax authorities of the country or residence.

iv. Artificial bank loans

120. A major technique for international tax evasion consists of purportedly borrowing funds that are actually owned by the borrower. This practice not only enables the "borrower" to make open use of funds previously concealed in the name of a nominee or in a numbered bank account, but it also gives the borrower a pretext for claiming fictiti

124. Tax is sometimes avoided or evaded by transferring income-producing assets at an artificially low cost from the taxing jurisdiction to a controlled entity in a foreign tax-haven country where income from the assets will be taxed at a lower rate or escape tax entirely. The assets transferred to the foreign tax-haven company may consist of:

- Stocks, securities, rental properties, and intangibles such as licensed patents, trade-marks and copyrights that will generate passive income; or
- Property of any kind which will be resold by the tax-haven entity to unrelated third parties at a gain.

In many cases, there is no limitation on the amount of income which may be accumulated tax free in the foreign tax-haven entity.

ii. Nominal transfer of income-producing functions to a tax-haven entity

125. An entity in a high-tax country may avoid or evade tax in that country by rendering, or appearing to render services to unrelated persons through a controlled entity in a tax-haven jurisdiction. In the typical case, the controlled entity is a shell corporation that is incapable of performing the services unless it uses personnel or property of the controlling entity.

iii. Payment of deductible expenses to a tax-haven entity

126. An entity in a high-tax jurisdiction may pay management fees, technical service fees, or other deductible fees to a related entity in a tax-haven jurisdiction, although the related entity has not actually earned those fees and will not pay significant taxes on them.

iv. Payment of deductible expenses which benefit a tax-haven entity

127. An entity in a high-tax country may incur deductible expenses in acquiring or developing property which is then made available without adequate reimbursement to a related entity in a tax-haven country. For example, the entity in the high-tax country may take interest deductions with respect to borrowed funds which are re-lent to the related entity interest free. Similarly, the entity in the high-tax country may take depreciation deductions for tangible property that is leased or licensed to the related entity for an artificially low consideration.

128. As previously stated, some of the techniques described above may be legal methods of reducing tax, rather than illegal methods of evading tax, depending on the law of the particular countries involved.

B. Legislative and Judicial Anti-Avoidance Measures

129. The manner in which tax avoidance can be met can include legislative and judicial response. In some cases a jurisdiction will enact specific provisions that identify the type of transaction to be dealt with and prescribe specific legislative remedies to combat such avoidance. Another legislative method would be to enact broad types of avoidance practices in specific areas; another would be to control tax avoidance through the discretion of the tax authorities.

Finally requiring related parties treat transaction in the same manner as independent parties can be another response. Most jurisdictions rely on specific anti-avoidance rules in their domestic legislation and judicial case law.

130. Where the legislative response to tax avoidance has been ineffective court have developed judicial doctrines to counter serious cases of tax avoidance. These judicial decisions tend to be more flexible than statutory rules under the domestic law and often overlap with each other.

131. Common judicial doctrines are derived from common law and include:

- *Business Purpose Rule*-the business purpose rule attacks avoidance transactions which have no business purpose and are created to avoid taxes;
- *Substance of Form*- Under the substance over form principle, the facts must be assesses according to *bona fide* substance and not formal content;
- *Sham Transactions*- a sham transaction conceals the true nature of a transaction that exist in form only;
- *Doctrine of the Label*- the parties use the wrong label or description to classify or characterize a transaction or relationship for tax purposes;
- *Step Transaction Doctrine*- in a step transaction, the intermediate steps in a chain of predetermined transactions may [illegible] tion may be treated as one integrated tr[illegible] be broken up into its distinct steps to [illegible] ses. The step transaction doctrine mai[illegible] nnot obscure the substance of the transaction.10
- *Abuse de droit* ("Abuse of Right") – An abuse of right is the manipulation of the intention or spirit of the law in such case the court will disregard the legal form where the transaction is undertaken solely or predominantly to avoid tax without a *bona fide* business purpose;
- *Fraus Legis* ("Abuse of Law") the *fraus legis* principle allows a court h disregard a transaction enal 5re the these ju-21.3e-21.38. taxory7(nd t]TJy7 343.08 393 .00.84 r

saying that a State has to be sure that the aim of assistance in collection of taxes is suitable and desirable within its treaty policy before it inserts such a provision in a treaty.

140. A State which wishes to introduce such an article has to consider at least the following issues. In the first place, a State needs to possess a legislative framework which allows the implementation in practice of this provision. Secondly, the tax administration should be capable and able to collect the tax revenues. Furthermore, it should be considered whether the mutual advantages would justify the new obligations between the two Contracting States. It should be noted, in this respect, that reciprocity with equal revenue is not necessary. However, it might be an element a State might try to obtain. Other important aspects to consider are the size of the economic relationships, the efficiency to collect the tax revenue in both States and the legal protection of the taxpayer.

141. If two States would like to insert a similar article, it would be desirable to include the following issues. Firstly, the scope of the article of assistance in the collection of taxes. To which direct taxes and persons will it apply? For persons, the scope could be stretched to residents instead of just citizens. Secondly, the legislation which can be used to collect the revenue. Usually the legislation of the requested State will be applied. This will normally imply that the requested State will be limited in its measures to collect the revenue on the basis of its own law. Further, the requested State has normally no obligation to use executorial instruments, if the requesting State does not have these instruments at its disposal. The time limit of appeal to court will usually be found in the legislation of the requesting State. It should be considered that the taxes of the requesting State may not have the same preferential status as in the requested State. Exceptions on the obligations to assist can be found in the argument that the requesting State has not used all possible measures of collecting the revenues or that the request interferes with the interest of the requested State. Thirdly, the settlement of the costs which have been made for the collection. The requested State will have to pay normally for the ordinary costs. Unreasonably high costs are likely to be paid by the requestin

the first category, each Contracting State is required to make available to the other States all information in its possession that is “foreseeably