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**Committee of Experts on International Cooperation in Tax Matters  
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Item 5 (h) of the provisional agenda

**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 a part of the draft revision of the Manual for Negotiation of Bilateral Tax Treaties prepared by the Subcommittee on revision of the Manual. It addresses the “Appendix for Special Consideration Items” - a proposed section to the



minutes, the information is reproduced in this section with citations to the official presentation for the reader's reference.

## **INTRODUCTION**

## **IMPROPER USE OF TAX TREATIES**

During the discussion of E/C.18/2007/CRP 2 at the October/November 2007, 3<sup>rd</sup> Meeting of the Committee of Experts on International Cooperation in Tax Matters it was suggested that one matter that can be presented was the discussion of the matter of combating treaty abuse.

The Subcommittee formed to address this issue presented the above referred to document at the 3<sup>rd</sup> meeting. The focus of the report contained in that document was to present a draft of a new section on the matter of improper use of tax treaties (with the intent to have this considered for inclusion in the next version of the UN Model), and to raise for the attention of the Committee four collateral issues that were investigated in the course of the Subcommittee's work on the primary scope of its charge<sup>1</sup>.

In the context of the purpose of this section, it was suggested during discussion that examples of treaty abuse, as presented in Paragraph 21 of the document and the four collateral issues be presented as Special Appendix items.

Paragraph 21 of E/C.18/2007/CRP 2 made reference to the main issue for purposes of applying general anti-abuse provisions as was presented in the proposed provision (pertinent parts cited below):

Provisions of tax treaties are drafted in general terms and taxpayers may be tempted to apply these provisions in a narrow technical way so as to obtain benefits in circumstances where the Contracting States did not intend that these benefits be provided. Such improper uses of tax treaties is a source of concerns to all countries but particularly for developing countries that have limited experience in dealing with sophisticated tax avoidance strategies.

The Committee considered that it would therefore be helpful to examine the various approaches through which those strategies may be dealt with and to provide specific examples of the application of these approaches. In examining this issue, the Committee recognized that for tax treaties to achieve their role, it is important to maintain a balance between the need for tax administrations to protect their tax revenues from the misuse of tax treaty provisions and the need to provide legal certainty and to protect the legitimate expectations of taxpayers.<sup>2</sup>



through transactions designed to transform dividends into treaty-exempt capital gains.

A common problem that arises from the application of many of these and other specific anti-abuse rules to arrangements involving the use of tax treaties is that of possible conflicts with the provisions of tax treaties.

Clearly, where the application of provisions of domestic law and of provisions of tax treaties produces conflicting results, the provisions of tax treaties are generally intended to prevail. This is a logical consequence of the principle of *"pacta sunt servanda"* which is incorporated in Article 26 of the *Venna Convention on the Law of the Treaty*. Thus, if the application of these 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.

As explained below, however, such conflicts will often be avoided and each case must be analyzed based on its own circumstances.

*First a treaty is specific as to the application of certain provisions of domestic law. For example, a treaty may provide that dividends received by a resident of a treaty country from a source in the treaty country are exempt from tax. In such a case, the provisions of the treaty are intended to prevail over the provisions of domestic law. If the application of these 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.*

*Second, a treaty may provide that dividends received by a resident of a treaty country from a source in the treaty country are exempt from tax. In such a case, the provisions of the treaty are intended to prevail over the provisions of domestic law. If the application of these 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.*

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a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into” [Paragraph 9.4 of the Commentary on Article 1 of the OECD Model].

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 [Paragraph 9.5 of the Commentary on Article 1 of the OECD Model]: [:

“A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.”

The 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 transactions in ways that are contrary to treaty provisions constitute anti-abuse rules.

Under the guiding principle presented above, two elements must therefore 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 and purpose of the relevant provisions.



In order to minimize the uncertainty that may result from the application of that approach, it is important that this guiding principle be applied on the basis of objective findings of facts, not the alleged intention of the parties. Thus, the determination of whether transactions or arrangements have

property companies (paragraph 4 of Article 13) and the rule on “star-companies” (paragraph 2 of Article 17).

Clearly, such specific treaty anti-abuse rules provide more certainty to taxpayers. This is acknowledged in paragraph 9.6 of the Commentary of the OECD Commentary, which explains that such rules can usefully supplement general anti-avoidance rules or judicial approaches (“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 use of



relevant treaty provisions that takes account of their context, the treaty's object and purpose as well as the obligation to interpret these provisions in good faith (As prescribed by Article 31 of the *Vienna Convention on the Law of Treaties*). As already noted, a number of countries have long used a process of legal interpretation to counteract abuses of their domestic tax laws and it seems entirely appropriate to similarly interpret tax treaty provisions to counteract tax treaty abuses. As noted in paragraph 9.3 of the Commentary on Article 1 of the OECD Model Tax Convention:

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).

The paragraphs above provide guidance as to what should be considered to be a tax treaty abuse. That guidance would obviously be relevant for the purposes of the application of this approach.

### **Examples of Treaty Abuse Scenarios**

The following illustrative examples are reproduced from a comprehensive list of examples as included in paragraphs 40 through 104 of the UN document CRP 2/2007.<sup>3</sup>

#### Dual residence and transfer of residence

There have been cases where taxpayers have changed their tax residence primarily for the purposes of getting tax treaty benefits. The

lump-sum payment, which is not taxable under the domestic law of State B. Mr. X then returns to State A.

- *ap e* : Company X, a resident of State A, is contemplating the sale of shares of companies that are also residents of State A. Such a sale would trigger a capital gain that would be taxable under the domestic law of State A. Prior to the sale, company A arrange for meetings of its board of directors to now take place in State B, a country that does not tax capital gains on shares of companies and in which the place where a company's directors meet is usually determinative of that company's residence for tax purposes. Company X claims that it has become a resident of State B for the purposes of the tax treaty between States A and B pursuant to paragraph 3 of Article 4 of that treaty, which is identical to this model convention. It then sells the shares and claims that the capital gain

State for extended periods of time. Many countries have therefore found that specific rules were the best approach to deal with such cases.

One approach used by some of these countries has been to include in their tax treaties provisions allowing a State of which a taxpayer was previously resident to tax certain types of income, e.g. capital gains on significant participations in companies or lump-sum payments of pension rights, realized during a certain period following the change of residence.

Countries have also dealt with such cases through the use of so-called "departure tax" or "exit charge" provisions, under which the change of residence triggers the realization of certain types of income, e.g. capital gains on shares. In order to avoid a conflict with the provisions of a tax treaty, such domestic rules may deem the realization of the income to take place immediately before the change of residence; they may also be combined with treaty provisions allowing for their application.

A proper interpretation of the provisions of paragraphs 2 and 3 of Article 4 may also be useful in dealing with cases similar to these examples. Concepts such as "centre of vital interests" and "place of effective management" require a strong relationship between a taxpayer and a country. The fact that a taxpayer has a home available to him in a country where he sojourns frequently is not enough to claim that that country is his centre of vital interests; likewise, the mere fact that meetings of a board of directors of a company take place in a country is not sufficient to conclude that this is where the company is effectively managed. Also, some countries have replaced paragraph 3 of Article 4, which deals with cases of dual residence of legal persons on the basis of their place of effective management, by a rule that leaves such cases of dual residence to be decided under the mutual agreement procedure.

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

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:

"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





participation in the financing arrangements will be disregarded by the tax authorities if ( ) tax is reduced due to the existence of an intermediary, ( ) there is a tax avoidance plan, and ( ) 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.

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, a claim for tax treaty 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.

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.

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".

As indicated above, the list of examples included here is for illustrative purposes. If the Committee agrees that the inclusions should be exhaustive, such amendments may be easily added. See the "Comments" section above.

## **TREATMENT OF ISLAMIC FINANCIAL INSTRUMENTS UNDER THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES**

At the Third session of the Committee, one of the items discussed was the taxation of income from Islamic financial instruments. The working group document stated, in its Summary that the "amendment" of the United Nations Model Double Taxation Convention between Developed and Developing Countries seems to be capable to deal with Islamic financial instruments, but some language could be included in commentary to provide clarification. A definition of interest would include income from some types of Islamic financial arrangements..." At different points after the Working Group presented its document, it was suggested that such definitional statements, while perhaps not appropriate for inclusion in the Commentaries, would be the type of guidance oriented information that would be appropriate for the Special Appendix. Accordingly, the following items that emanate from the working group document have been included.

The working group emphasized in their presentation that the taxation of income from these financial arrangements is primarily a function of the characterization of the proceeds transferred from the various instruments. The significant distinction in the characterization process is the distinction between the use of a legal, or form-based approach, and an economic based approach to characterize the income. The latter approach looks to the substance or the economic realities of the arrangement. It is also the latter approach that can be interpreted to provide for the recharacterization of most of the Islamic financial arrangements described below into loans and to, therefore, treat the payments made according to the contractual terms of those arrangements as interest.<sup>6</sup>

The following descriptions are based upon the language and limited to the specific examples provided in the E/c.18/2007/9 document. Therefore, it may be deemed that other arrangements would be added to enhance the guidance provided by this item in the Special Appendix.

In the way of background<sup>7</sup>

considered *ara* not permitted; practices that are permissible are *aa*. Among these rules is the strict prohibition of the payment or collection of interest, also known as usury or *r a*.<sup>10</sup>

The Working Group document addressed the following types of instruments or contracts: *us ara a udara a ura a a ara sa a st sna a and su u*. Accordingly, they are included in the Special Appendix. The language used in the description is based upon that as presented in the Working Group document<sup>11</sup>, and various other sources of commentary.

### Musharaka

Musharaka means partnership. The essence of the arrangement is an "equity participation contract" where the partners or owners contribute jointly to finance a project. The partners include a bank or banks as well as other forms of participants.

Profits and losses are split according to a pre-agreed formula.

A variation of this arrangement is the "diminishing musharaka" that is a partnership type arrangement that provides for a gradual buyout of one or more of the partners.

In the context of such an arrangement, the profit/loss sharing ratio does not have to reflect the same ratio as the investment ratio. Similar to the partnership rules in the United States tax law, the agreement of the partners is deciding, and as long as there is agreement, generally, the discrepancy between the two ratios is valid.

### Mudaraba

This arrangement is characterized as an "investment partnership"<sup>12</sup> where the investor agrees to provide money to another party, an entrepreneur, in order to invest the funds or to undertake a business venture. Profits are distributed on the basis of a pre-agreed formula, while losses are born solely by the investor partner.

The profit sharing scheme is described as perfectly *s ara a* compliant.<sup>13</sup> The scheme is described as: a depositor deposits money with a financial institution (an Islamic bank), which would be used by the institution with the intent to produce a profit. The depositor has no role in deciding how the funds are to be invested. At various times, the institution would credit the depositor with a distribution of profits that have been generated by the institution's use of the funds.

## Murabaha

The literal translation of the term is "a sale on a mutually agreed profit." The technical structure is an asset-based financing whereby the party that provides the capital (a bank) purchases an asset, as directed by the client (the capital user), from a third party in an open market, and resells it at a predetermined higher price to the client (client user) in a deferred payment arrangement, without interest, thereby obtaining a credit against the purchase obligation, without paying interest.

This arrangement is subject to strict conditions in the effort to achieve validity, i.e. be sharia compliant. While strict the conditions are not onerous. There must be full disclosure of all costs, including the purchase price, and the profit margin, at the time of the agreement, by the capital provider. Also, there can be no sale of the asset before all ownership issues are settled and the item(s) is reduced to possession and the risks of ownership are assumed by the capital provider.<sup>14</sup>

A variation on that theme which raises concerns regarding sharia compliance has the capital provider selling the asset or commodity to the client on a deferred payment contract, who then immediately sells the commodity for cash. This level of immediacy associated with the client's conversion of the commodity to cash gives the appearance of a loan from the capital provider, not a purchase and deferred payment arrangement.<sup>15</sup>

## Ijara

The term means, literally, to rent. In the context of Islamic jurisprudence, the term includes the "...usufruct of assets and property (rental) and the hire of services of a person for a wage."<sup>16</sup>

The Ijara is a mode of financing to the lessee and a mode of investment for the lessor. The essential rules for a basic Ijara transaction include<sup>17</sup>:

1. The term of the lease and consideration must be specified.
2. Liabilities given rise through the use of the asset/property will be the responsibility of the lessee. Liabilities surfacing from the ownership of the

property are the responsibility of the lessor. If the lessee damages the property, they must compensate the lessor for it.

3. The day the asset is delivered or available for use is the day the lease is affective.
4. The object of rent cannot be something that can be consumed, like money, gas, or food. This gives rise to a loan and any rent charges constitutes  $r \cdot a$ . The item must stay in the owner's possession for the validity of the contract.

The most important conditions to the validity of the salam are: the capital should be paid immediately (there can be no debt from the buyer to the seller), and the buyer cannot sell the commodity before the salam contract has been settled.

### Istisna'a

The other document mentioned in the above discussion of the salam is the istisna'a which is a particular form of sale whereby a party (the purchaser) places an order to another party (the manufacturer) to manufacture a specific commodity for a determined price.<sup>21</sup> It is generally agreed that the istisna'a is binding on both parties.<sup>22</sup>

Of the four main schools of Islamic jurisprudence, three (Maliki, Chafii, and Hanbali schools) take the view of the istisna'a as a form of the salam. The distinction is the type of commodity to which the contract applies. The istisna'a generally applies to manufactured commodities.<sup>23</sup> The requisite elements and conditions of validity for the istisna'a are the same as those for the salam.

The fourth school, the Hanafi school, offers forth the currently prevailing opinion that the istisna'a and salam are separate and distinct forms of contract. The differences between the two are, primarily: advance payment is not a condition of the istisna'a, the time of delivery is not necessarily fixed in the terms of the istisna'a while such element is essential in the salam contract, and once signed, the salam cannot be cancelled unilaterally, while the istisna'a can be cancelled before the manufacturer starts the work.<sup>24</sup>

In general, the istisna'a is similar in nature to the contract of *sa'a*, except *st sna* pertains to specific goods ordered to be produced by a manufacturer. The goods must be manufactured with materials supplied by the manufacturer. Also, the price and specifications of the goods must be agreed upon for the validity of *st sna*.









There was also some discussion at the 3<sup>rd</sup> Session of the Committee that the Special Appendix would be an appropriate place for a "Best Practices" section for such specific topics as dispute resolution.

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<sup>1</sup> E/C.18/2007/CRP2, page 3.

<sup>2</sup> E/C.18/2007/CRP2, page 4.

<sup>3</sup> E/C.18/2007/CRP2

<sup>4</sup> Double Taxation Convention and the Use of Conduit Companies , in volume II of the loose leaf version of the , OECD, R(6) 1, at page R(6) 4, paragraph 4.

<sup>5</sup> E/C.18/2007/9

<sup>6</sup> E/c.18/2007/9, Summary.

<sup>7</sup> Islamic Banking and Accounting, a research paper submitted by Ms. Sarah Tantawy in partial fulfillment of a course for matriculation of her program at California State University, Sacramento, April 2008.

<sup>8</sup> The Quran is the Holy Book that Muslims believe was revealed to the Prophet Muhammad as the last revelation sent to mankind and is the primary source used to deduce legislation.

<sup>9</sup> Along with the Quran, the Sunnah is another primary source used by Jurists and refers to the binding rules derived from the Prophet Muhamad s sayings.

<sup>10</sup> The Holy Qur'an in verse 278 of the second chapter (Al Baqarah) states:

"O ye who believe! Fear Allah and give up what remains of your demand for riba, if ye are indeed believers." Verse 279 says, "If you do it not, take notice of war from Allah and His Messenger. But if ye turn back, ye shall have your capital sums. Deal not unjustly and you shall not be dealt with unjustly.

<sup>11</sup> E/c.18/2007/9, paragraphs 4 through 38.

<sup>12</sup> E/c.18/2007/9, paragraph 7.

<sup>13</sup> E/c.18/2007/9, paragraph 6.

<sup>14</sup> E/c.18/2007/9, paragraphs 9 and 10.

<sup>15</sup> E/c.18/2007/9, paragraph 11.

<sup>16</sup> E/c.18/2007/9, paragraph 12.

<sup>17</sup> Islamic Banking and Accounting, supra.

<sup>18</sup> E/c.18/2007/9, paragraph 13.

<sup>19</sup> E/c.18/2007/9, paragraph 15.

<sup>20</sup> Islamic Banking and Accounting, supra.

<sup>21</sup> E/c.18/2007/9, paragraph 18.

<sup>22</sup> E/c.18/2007/9, paragraph 19.

<sup>23</sup> E/c.18/2007/9, paragraph 20.

<sup>24</sup> E/c.18/2007/9, paragraph 22.

<sup>25</sup> E/c.18/2007/9, paragraphs 24 and 25.

<sup>26</sup> E/c.18/2007/9, paragraph 25.

<sup>27</sup> E/c.18/2007/9, paragraph 26.

<sup>28</sup> E/c.18/2007/9, paragraph 28.

<sup>29</sup> E/c.18/2007/9, paragraph 29.

<sup>30</sup> E/c.18/2007/9, paragraphs 30 and 31.

<sup>31</sup> E/c.18/2007/9, paragraphs 32 through 35.

<sup>32</sup> E/c.18/2007/9, paragraphs 36 through 38.