

Anti-avoidance Measures in International Taxation

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OECD and anti-abuse rules

- Introduction of the 1963 Draft Convention:
“...the Fiscal Committee has recently brought under study the question of the improper use of double taxation Conventions and of fiscal evasion which can result from the interaction of the Conventions and the domestic laws.”
- The 1977 Model (added section on Improper Use of the Convention)
“The Committee on Fiscal Affairs has examined the question of the improper use of double taxation conventions but, in view of the complexity of the problem, it has limited itself, for the time being, to discussing the problem briefly in the Commentary on Article 1 and to settling a certain number of special cases [...] The Committee intends to make an in-depth study of such problems and of other ways of dealing with them.”

Abuse of tax treaties

- The "in-depth" study led to the 1987 reports on
 - "Double Taxation Conventions and the Use of Base Companies"
 - "Double Taxation Conventions and the Use of Conduit Companies".
- Based on these two reports, the section on "Improper Use of the Convention" was substantially extended in 1992
- Introduction to the Model Tax Convention was amended to indicate that "[t]he Committee on Fiscal Affairs continues to examine both the improper use of tax conventions and international tax evasion.
- 1998 report on Harmful Tax Competition and 2003 changes to the section on Improper Use of Tax Convention

Summary

- Specific anti-avoidance rules
 - a) treaties and specific domestic law anti-avoidance rules
 - b) specific anti-avoidance rules of tax treaties
- General anti-avoidance rules
 - a) treaties and legislative GAAR rules
 - b) treaties and judicial rules
 - c) rules inherent in tax treaties

Treaties and domestic law specific anti-abuse rules

- Rules may not apply solely to abusive transactions
- Examples:
 - CFC rules (also FIF)
 - FIF rules
 - Conduit financing rules
 - Thin capitalisation rules
 - Exit or departure taxes
 - Dividend stripping rules
 - Transfer pricing rules

Treaties and CFC rules

- An old debate
- Relevant provisions of tax treaties
 - Article 7, paragraph 1
 - Article 10, paragraph 5

The OECD position

- o Article 7

"10.1 The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises that are residents of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10)."

The OECD position

- Article 10

"37. It might be argued that where the taxpayer's country of residence, pursuant to its controlled foreign companies legislation or other rules with similar effect seeks to tax profits which have not been distributed, it is acting contrary to the provisions of paragraph 5. However, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder."

United States: the "savings" clause

o US- Italy (1999) Art. 1

2. Notwithstanding any provision of this Convention except paragraph 3 of this Article, a Contracting State may tax:

- (a) its residents (as determined under Article 4 (Resident)); and
- (b) its citizens by reason of citizenship

as if there were no convention between the Government of the United States of America and the Government of the Italian Republic for the avoidance of double taxation [...]

Canada

- Protocol to Canada- Italy:
- “(k) nothing in this Convention shall be construed as preventing the application of the provisions of the domestic law of each Contracting State concerning fiscal evasion, in particular the taxation of income of persons in respect of their participation in non-resident companies.”

Canada: new version

Canada- Algeria (1999): Protocol

10. Nothing in the Convention shall be construed as preventing Canada from imposing a tax on amounts included in the income of a resident of Canada with respect to a partnership, trust, or controlled foreign affiliate, in which that resident has an interest.

Germany

Germany-Kazakhstan: Art. 28

1. This Agreement shall not be interpreted to mean that a Contracting State is prevented from applying its domestic legal provisions on the prevention of tax evasion or tax avoidance.

Case law

- o United Kingdom: Bricom Holdings held that no conflict between the treaty provisions and the UK CFC rules (but ECJ may have different view as regards EC Treaty)
- o France: Decision of the Conseil d'Etat in Schneider Electric: Article 7 of the France-Switzerland treaty prevents application of Article 209B (which has now been redrafted)
- o Finland: no conflict between the treaty provisions and the UK CFC rules

FIF rules and rules on accrual taxation

- Same issue as CFC rules in the case of an interest in a collective investment vehicle structured as a company?
- How about Articles 10, 11 and 13?
- The position of countries that consider that tax treaties prevent the application of CFC rules

Thin capitalisation

- Assume a domestic thin capitalisation rule that is based on a strict debt-equity ratio (e.g. Canada, France...)
- Do treaties prevent the application of such a rule?

Article 24, paragraph 3

- Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest [...] 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. [...]

Article 24, paragraph 5

- Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

Article 9

- "... conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued ..."

Commentary on Article 9

3. As discussed in the Committee on Fiscal Affairs' Report on Thin Capitalisation, there is an interplay between tax treaties and domestic rules on thin capitalisation relevant to the scope of the Article. The Committee considers that:

- a) the Article does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;

Commentary on Article 9

- b) the Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;

- c) the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties.

Commentary on Article 24

56. 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.

Commentary on Article 24

58. Paragraph 5, though relevant in principle to thin capitalisation, is worded in such general terms that it must take second place to more specific provisions in the Convention. Thus paragraph 4 (referring to paragraph 1 of Article 9 and paragraph 6 of Article 11) takes precedence over this paragraph in relation to the deduction of interest.

Thin capitalisation report

On Article 9

50. If however the effect of such re-categorisation goes beyond this and includes more than the arm's length profit in the taxable profit of the domestic enterprise, the answer to the question whether Article 9 may inhibit the operation of the relevant thin capitalisation rules may depend on whether Article 9 is held to be "restrictive" or merely "illustrative" in its scope. There is some diversity of opinion about this.

Canada's Federal Court of Appeal: Specialty Manufacturing

- Facts: taxpayer borrowed money from related US corporations in violation of the Canadian thin capitalization rules
- Issue: does Article 9 override thin capitalisation even though non-discrimination article includes a specific rule allowing the thin capitalisation rules

Specialty Manufacturing

- o Held: taxpayer has nominal equity capital
 - taxpayer's capital structure is not arm's length
 - therefore, treaty allows application of thin capitalisation rule
- o What was totally ignored?

SA Andritz

- French Conseil d'Etat (2004)
- Andritz paid interest to its 99% Austrian parent
- A tax adjustment denies deduction of interest under Article 212(1) of the General Tax Code, which denies deduction of interest if debt to related parties exceeds 1.5 equity (unless parent company is subject in France to corporation tax at the normal rate)

SA Andritz: decision

- Article 26(3) of the France-Austria treaty applies (equivalent to 24(5) OECD Model) -- even if the deduction is denied based on the fact that parent does not pay French tax (as opposed to being foreign)
- OECD Commentaries cannot be relied upon as they are subsequent to the treaty

SA Andritz: decision

- o Article 6(5) (Article 9 OECD) of the same Convention does not prevent the application of Article 26(3); it "mentions only the commercial or financial "conditions" imposed or granted by one enterprise on or to another and necessarily imply comparing transactions concluded between enterprises from a single group to those which would be negotiated by independent enterprises but cannot, however, be used to allow a State to judge whether it was normal for a company to choose to grant a loan, rather than inject equity capital, in order to finance the activity of another enterprise which it possesses or controls and to draw, where relevant, any tax consequences..."

SA Andritz

- "it is not the purpose or effect of the said provisions of Article 57 of the General Tax Code, any more than of the provisions of Article 6(5) of the Franco-Austrian Convention, to authorise the tax authorities to assess the normality of the choice made by a foreign enterprise to finance, by granting a loan instead of an injection of equity capital, the activity of a French enterprise which it owns or controls and to draw from this, where appropriate, any tax consequences"

SA Andritz

- OECD Commentary and Thin Capitalisation report are not relevant as post-date the treaty (not inconceivable to use posterior Commentary but should not extend the scope of the Article).
- In any event, the Thin Capitalisation report would not authorize a mechanism as "crude" as the French one but rather cases such as Specialty Manufacturing (ratio 10 000 000 / 100) [?]

Thin capitalisation and Article 9

- A level of indebtedness is not a transaction
- A loan is a transaction
- Between unrelated parties, high debt-equity ratio may simply require higher rate of interest
- The real issue: article 24 paragraph 4
- How about a rule that applies to charities and pension funds?

Article 9 and rules denying deduction of expenses

- Does Article 9 govern the deductibility of expenses (relevant for thin capitalisation rule and other specific anti-avoidance rules that deny deduction of expenses)?
- Example of parent selling inventory land to subsidiary which acquires it as capital asset
- BUT paragraph 4 of Article 24 is a national treatment rule that govern the deduction of expenses

Specific anti-abuse provisions in tax treaties

- "Beneficial owner" (in Articles 10, 11, and 12)
- "Special relationship" rule applicable to interest and royalties
- Rule on alienation of shares of immovable property companies (paragraph 4 of Article 13)
- Rule on "star-companies" (paragraph 2 of Article 17).
- Article 9 on transfer pricing (?)

Anti-abuse rules in Commentary

- Treaty shopping provisions in section on “Improper use of the Convention”; 2003 update added a comprehensive limitation-of-benefits provision to the list
- New paragraphs 21. to 21.5 of the section similarly include alternative provisions that may be included to deal with other forms of treaty abuses; these include:
 - provisions which are aimed at entities benefiting from preferential tax regimes;
 - provisions which are aimed at particular types of income that is subject to low or no tax under a preferential tax regime;
 - anti-abuse rules dealing with source taxation of specific types of income;
 - provisions which are aimed at preferential regimes introduced after the signature of the convention.

Anti-abuse rules in the Commentary

- Paragraphs 6.3 and 18 of the Commentary on Article 5 (to deal with attempts to abuse the 12-month rule applicable to construction sites);
- Paragraph 17 of the Commentary on Article 10 (to deal with attempts to abuse the preferential rate of source taxation on dividends from substantial shareholdings);
- Commentary on Articles 10, 11 and 12 (to avoid granting the benefits of Articles 10, 11 and 12 to non-resident-owned companies that enjoy preferential tax treatment);
- Paragraph 6 of the Commentary on Article 21 and paragraph 53 of the Commentary on Article 24 (to deal with cases where shares, loans or rights would be transferred to a permanent establishment in the other State to enjoy a preferential treatment and benefit from the exemption method);
- Paragraphs 31, 31.1 and 35 of the Commentary on Articles 23A and 23B (to deal with low or non-taxation situations arising from the exemption method)

Other specific treaty anti-abuse rules

- Provisions excluding certain entities (Luxembourg holding companies, Barbados IBCs, etc...)
- Hiring-out of labour rules

Using specific anti-abuse rules

- Provide more certainty
- Can only be drafted once a particular avoidance strategy has been identified and treaties take a long time to amend or replace
- Can seriously weaken the case as regards the application of general anti-abuse rules or doctrines to other forms of treaty abuses
- Third Protocol to the Canada-United States tax treaty (LoB provision)

"7. It is understood that the fact that the preceding provisions of this Article apply only for the purposes of the application of the Convention by the United States shall not be construed as restricting in any manner the right of a Contracting State to deny benefits under the Convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Convention."

Domestic general anti-abuse rules

- General anti-avoidance rule
- Judicial doctrines
 - Step-transaction
 - Business purpose
 - Substance over form
 - Abuse of rights; *Fraus legis*
 - Economic substance
 - Sham
 - Piercing corporate veil
 - Others?
- A general anti-abuse rule inherent in tax treaties

Interaction between treaties and domestic anti-abuse approaches

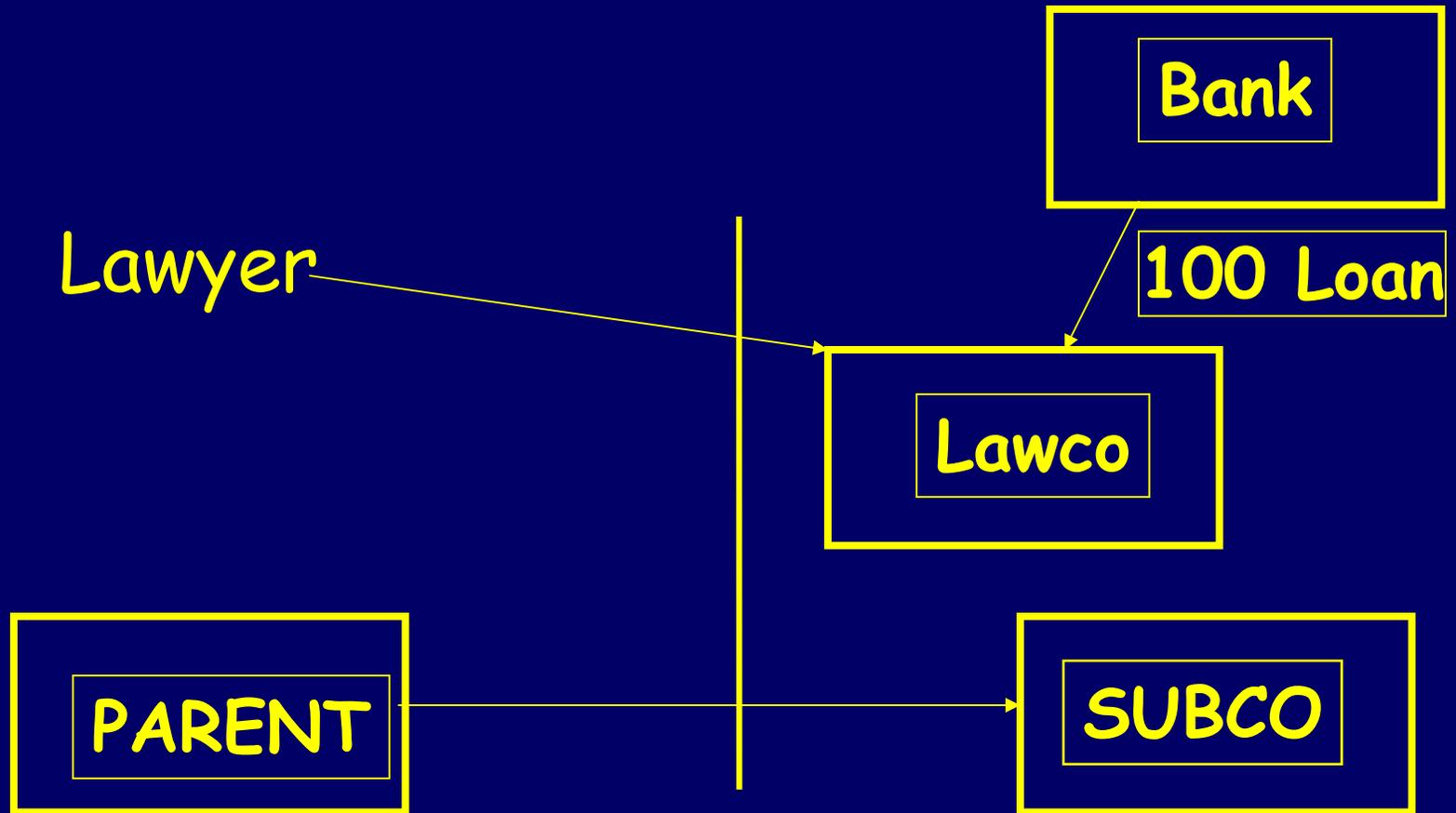
- Few domestic rules deal specifically with treaty abuses
 - 1962 Swiss Decree on treaty shopping
 - GAAR rules that apply to treaty abuses
- Domestic rules generally deal with domestic law abuses
- Both types raise the issue of the interaction with tax treaties

Interaction between domestic law anti-abuse rules and treaties

- In case of conflict between the provisions of tax treaties and those of domestic law, the provisions of tax treaties must prevail
- "*Pacta sunt servanda*"; Article 26 of the *Vienna Convention on the Law of Treaties*
- Do domestic law anti-abuse rules conflict with tax treaties?
 - Tax is imposed under domestic law, not under the treaty
 - Abuse of a tax treaty provision results in an abuse of domestic law

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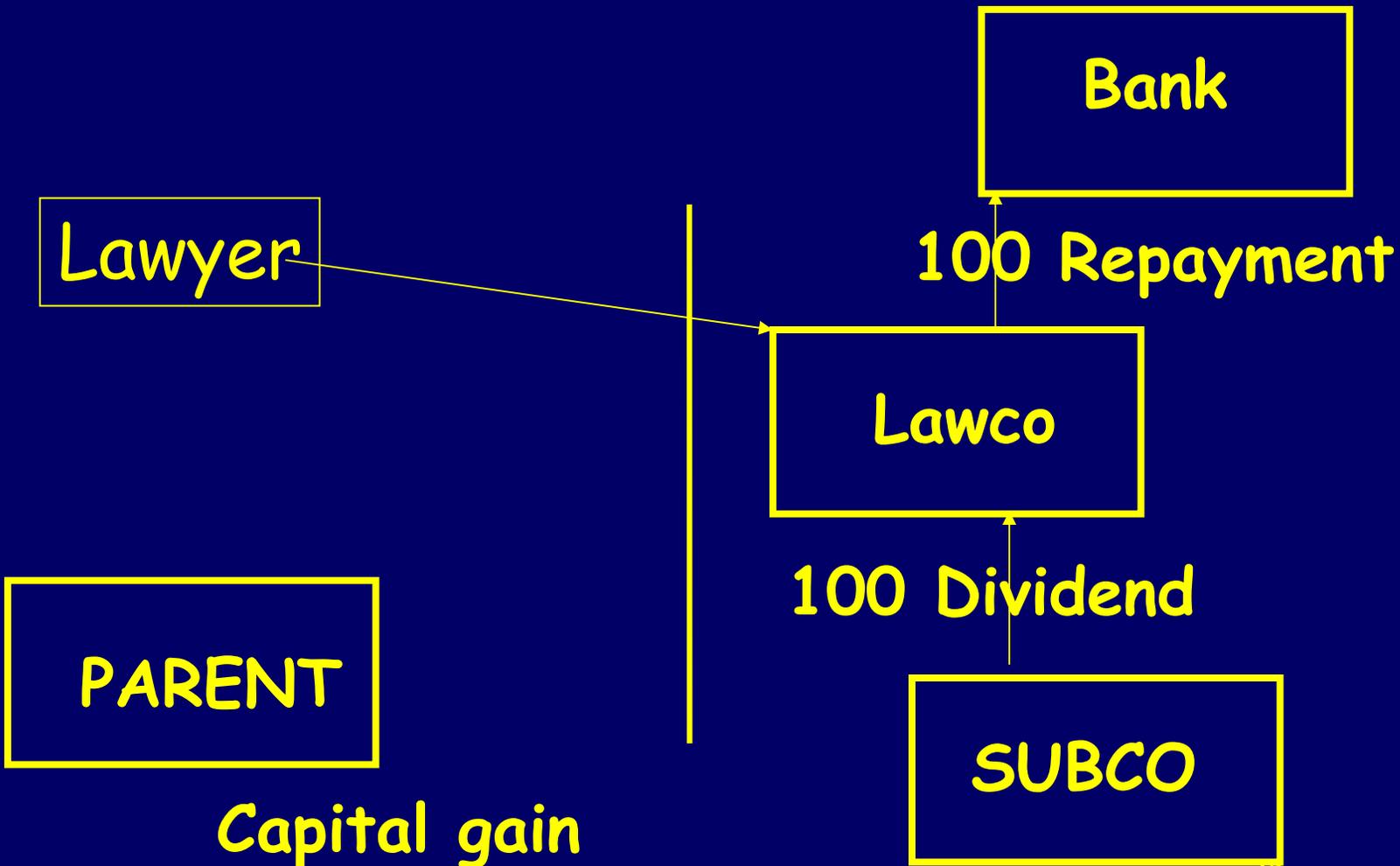
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100 Dividends ?

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Possible domestic approaches

- Specific dividend stripping rule
- Application of GAAR rule or doctrine
- Effect: recharacterize capital gain into dividend
- Does it become a dividend for treaty purposes?

Conclusion of OECD

New paragraphs 22 and 22.1 of the Commentary on Article 1:

22. Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including "substance-over-form", "economic substance" and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties [...]

22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict. [...]"

Paragraph 9.5

- "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."
- This paragraph 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.

The two elements

- Two elements of the guiding principle
 - 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.
- Compare with ECJ decision in *Hughes de Lasteyrie du Saillant and Ministère de l'Economie, des Finances et de l'Industrie*

"...designed to exclude from a tax advantage purely artificial arrangements aimed at circumventing French tax law".^[2]

The Indian use of judicial rules

- McDowell
- Azadi Bachao Andolan
- Current situation?

Azadi Bachao Andolan and Anr. Piercing the corporate veil

- "There is no doubt that, where necessary, the Courts are empowered to lift the veil of incorporation while applying the domestic law. In the situation where the terms of the DTAC have been made applicable by reason of section 90 of the Income-Tax Act, 1961, even if they derogate from the provisions of the Income-tax Act, it is not possible to say that this principle of lifting the veil of incorporation should be applied by the court."

Azadi Bachao Andolan and Anr: sham

- "Though the words 'sham', and 'device' were loosely used in connection with the incorporation under the Mauritius law, we deem it fit to enter a caveat here."
- Court adopts Snook vs. London and West Riding Investments Ltd: "if it has any meaning in law, it means acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create"

India: a judicial general anti-abuse rule?

- "The respondents contend that anti-abuse provisions need not be incorporated in the treaty since it is assumed that the treaty would only be used for the benefit of the parties (reference to Report of the working group on non-resident taxation)"
- "We are afraid that the weighty recommendations of the Working Group on Non-Resident Taxation are again about what the law ought to be, and a pointer to the Parliament and the Executive for incorporating suitable limitation provisions in the treaty itself or by domestic legislation."

India: a judicial general anti-abuse rule?

- "...it is argued that McDowell^E has changed the concept of fiscal jurisprudence in this country and any tax planning which is intended to and results in avoidance of tax must be struck down by the Court"
- "It is also urged that McDowell's radical departure was in tune with the changed thinking on fiscal jurisprudence by the English Courts, as evidenced in W.T. Ramsay Ltd. v. IRC, Inland Revenue Commissioners v. Burman Oil Company Ltd and Furniss v. Dawson"

India: a judicial general anti-abuse rule?

- "As we shall show presently, far from being exorcised in its country of origin, Duke of Westminster continues to be alive and kicking in England. "

India: a judicial general anti-abuse rule?

- o Reference to McDowell:

"This opinion of the majority is a far cry from the view of Chinnappa Reddy, J: "In our view the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether a provision should be construed liberally or principally, nor whether the transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it."

India: a judicial general anti-abuse rule?

- “We are afraid that we are unable to read or comprehend the majority judgment in McDowell as having endorsed this extreme view of Chinnappa Reddy, J, which, in our considered opinion, actually militates against the observations of the majority of the Judges which we have just extracted from the leading judgment [...]”

India: a judicial general anti-abuse rule?

- In Mathuram Agrawal v. State of Madhya Pradesh another Constitution Bench had occasion to consider the issue. The Bench observed:

“The intention of the legislature in a taxation statute is to be gathered from the language of the provisions particularly where the language is plain and unambiguous. ...[next slide]

India: a judicial general anti-abuse rule?

- ...In a taxing Act it is not possible to assume any intention or governing purpose of the statute more than what is stated in the plain language. It is not the economic results sought to be obtained by making the provision which is relevant in interpreting a fiscal statute. Equally impermissible is an interpretation which does not follow from the plain, unambiguous language of the statute. Words cannot be added to or substituted so as to give a meaning to the statute which will serve the spirit and intention of the legislature"

India: a judicial general anti-abuse rule?

- "We are unable to agree with the submission that an act which is otherwise valid in law can be treated as *non-est* merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests, as perceived by the respondents"

India: current situation

- o **Industrial Development Corpn. of Orissa Ltd. vs CIT**
(2004) 268 ITR 130; HC (Orissa)

"Thus, in the aforesaid judgment in the case of Union of India v. Azadi Bachao Andolan [2003] 263 ITR 706, the Supreme Court has made it very clear that an act which is otherwise valid in law cannot be treated as non est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests. In other words, if a transaction is otherwise valid in law and results in reduction of tax to an assessee, the same cannot be brushed aside on the ground that the underlying motive of entering into the transaction by the assessee was to reduce its tax liability to the State."

An implicit treaty anti-abuse rule?

- Abuse of Law; *fraus legis*
- Interpretation that takes account of context, object and purpose
- Good faith requirement of Article 26 and 31 of the Vienna Convention
- Example: paragraph 8 of the Commentary on Article 15:
"To prevent such abuse, in situations of this type, the term "employer" should be interpreted in the context of paragraph 2.[...] In this context, substance should prevail over form, i.e. each case should be examined to see whether the functions of employer were exercised mainly by the intermediary or by the user."