INTERNATIONAL TAX ANTI-AVOIDANCE RULES

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Improper Use of Tax Treaties

- Treaties are not identical – may serve different interests
  - E.g. different withholding tax rates
- Taxpayers may wish to benefit from one tax treaty rather than another and structure their affairs in such way as to ensure this
  - Is this tax planning?
  - An improper use of tax treaties?

Improper Use of Tax Treaties: Treaty Shopping

- What is improper use?
- Nothing mentioned in OECD Model (however the OECD issued the conduit entity report that addresses the issue).
- OECD Commentary (on Art 1) recognises this concept. BUT
  - No definition
  - No explanation of what proper use is but refers to *purpose* of tax treaties.

Improper Use of Tax Treaties: The Vienna Convention

- Article 31 of the Vienna Convention:

General rule of interpretation

”A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”.

Treaty Shopping

- The term 'treaty-shopping' not used in Model, but in Commentary to Art 1 (para 20)
- Term 'treaty-shopping' originated in US
  - Analogy with forum shopping
- David Rosenbloom: "*the practice of some investors of 'borrowing' a tax treaty by forming an entity (usually a corporation) in a country having a favourable tax treaty with the country of source – that is, the country where the investment is to be made and the income in question is to be earned*".

- US Model 1996 Technical Explanation contained definition.
  - "*A treaty that provides treaty benefits to any resident of a Contracting State permits 'treaty-shopping': the use, by residents of third states, of legal entities established in a Contracting State with a principal purpose to obtain the benefits of a tax treaty between the United States and the other Contracting State*".
  - BUT this definition "*does not encompass every case in which a third state resident establishes an entity in a US treaty partner, and that entity enjoys treaty benefits to which the third state resident would not itself be entitled. If the third country resident had substantial reasons for establishing the structure that were unrelated to obtaining treaty benefits, the structure would not fall within the definition of treaty-shopping*".
- This is deleted from 2006 US Model. [But see Technical Explanation to LOB clause, Art 22, p. 63]

Improper Use of Tax Treaties: Treaty Shopping

- What types of treaty-shopping are an improper use?
  - Different levels
  - OECD and US perspective
- Conduit structures
  - Conduit arrangement: when a company situated in a treaty country is acting as a conduit for channelling income economically accruing to a person in another State who is thereby able to take advantage improperly of the benefits provided by a tax treaty. (OECD Conduit Companies report)

The US Approach

- Historical background
  - Outbound/Inbound focus
  - Treaty overrides/DTC unilateral terminations
  - Portfolio interest exemption
  - International tax arbitrage/harmful tax competition
- Judiciary
  - Sham and conduit doctrines
- Anti-Conduit Regulations
  - IRS given powers to disregard participation of conduit intermediary in cross-border financing arrangements – not if there is significant financing activity.
  - Regs look for tax reduction, a tax avoidance plan and relationship between parties.
- Treaty-based provisions: LOB

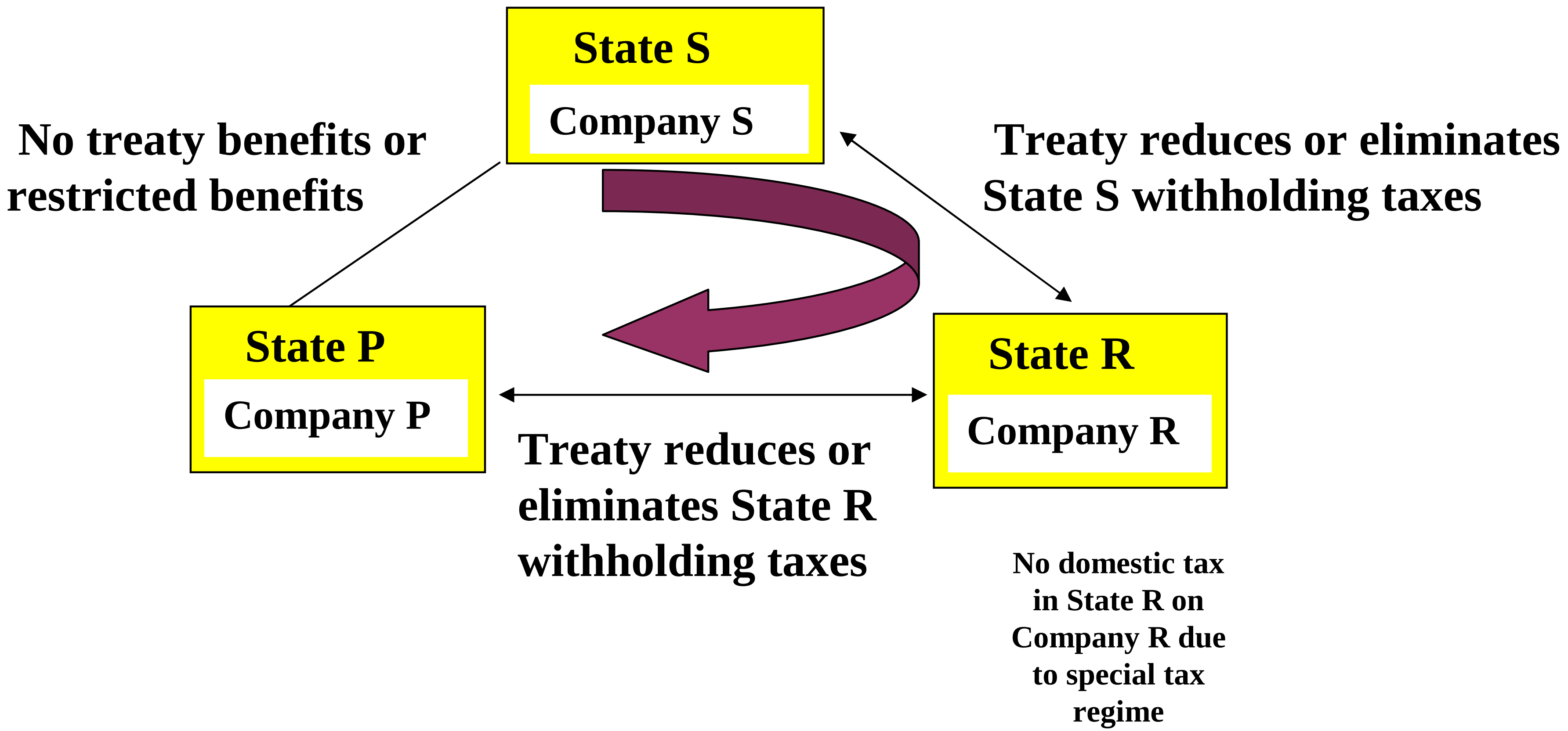
Conduits

- Treaty-shopping through conduits
  1. the beneficial owner of the entity does not reside in the country where the entity is created;
  2. the conduit has minimal economic activity in the jurisdiction in which it is located; and
  3. the income is not subject to tax in the country of residence of the conduit.

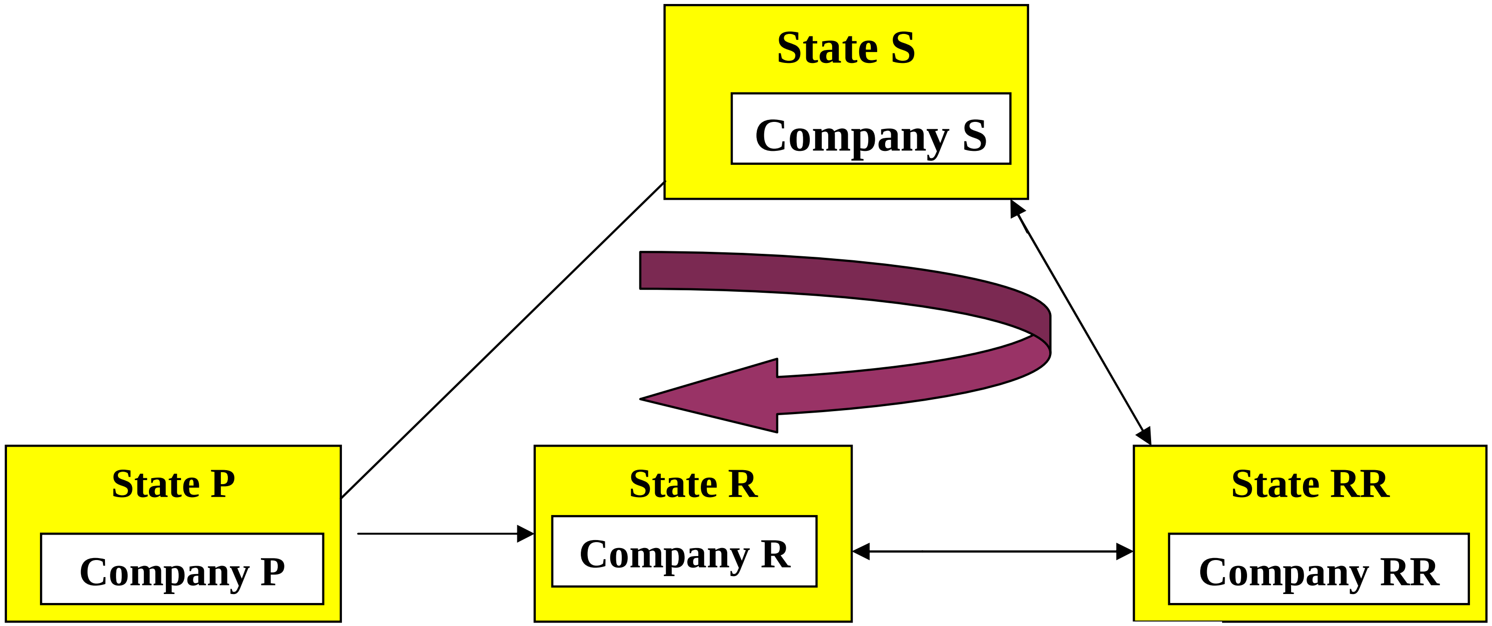
Conduits

- Conduit entity: corporation or partnership or trust or other similar entity. (A transparent entity however might be consider as resident of a country in which its beneficiaries are residents *See para. 8.8 of Art. 4 of the OECD Commentary*). Also see article 1(6) to the US model, and the OECD report on the treatment of Partnerships.
- Most frequent conduit arrangements
  - Direct conduit
  - Stepping-stone conduit

TREATY-SHOPPING – DIRECT CONDUIT COMPANY



TREATY-SHOPPING – STEPPING-STONE CONDUIT



Company RR taxable in State RR (i.e. no special tax regime)

Treaty or State R domestic law reduces or eliminates State R withholding taxes

No domestic tax in State R on Company R due to special tax regime

Treaty or State RR allows deduction of expenses

Combating Treaty Shopping – The OECD Approach

- OECD Model Provisions
  - Abstinence Approach
  - Beneficial Ownership
  - Look-through Approach
  - Channel Approach
  - Limitation on Residence (Subject-to-tax)
  - Exclusion Approach (e.g. Luxemburg 1921 Holding Co.)
  - *Bona Fide* provisions (motive test, activity test, amount-of-tax test, stock-exchange test, alternative relief test)
  - Limitation on Benefits

The OECD Approach

- Initially, only 'beneficial ownership' and 'limitation on residence' provisions.
- OECD Conduit Companies Report recognises deficiencies and makes suggestions
  - Incorporated in 1992 Commentary to Article 1
  - OECD Report on Restricting the Entitlement to Treaty Benefits (2002)
  - Commentary to Article 1 updated in 2003
- Four (not mutually exclusive) approaches suggested
  - To be accompanied by specific provisions to ensure that treaty benefits will be granted in *bona fide* cases
  - LOB clause included as a comprehensive approach

Beneficial ownership

- Focuses on ownership of intermediary company
- Provision in Arts 10-12 OECD Model (some countries include the BO demand also under Art. 13)
  - Prevents extension of treaty benefits to entities which are not beneficial owners of income
- What does it mean?
  - No definition in Model or Commentary but some guidelines
- Commentary to Art. 10, paragraph 12

"[Beneficial ownership] is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance".

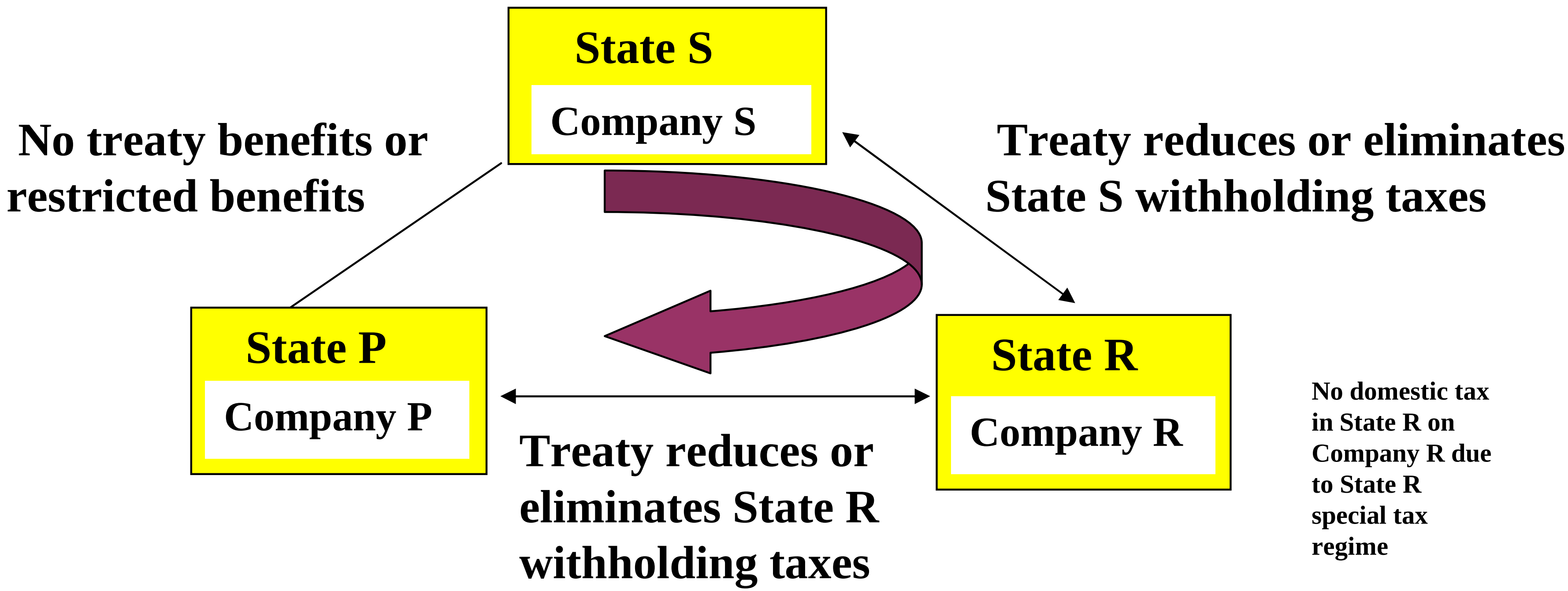
Beneficial ownership

- Conduit Companies Report – Although the Conduit Companies report addresses that a Conduit Company and Beneficial Owner are separate classification therefore while a Conduit Co will never be the BO, a non BO is not necessarily a Conduit.
- The source country treaty limitation would not be available "*when economically, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income*".

Beneficial ownership

- The 2011 OECD report on the clarification of the term Beneficial Ownership. A lack of definition and agreement between the member countries to the term BO lead to a condensed (inefficient) editing to the commentaries on Art. 10,11, and 12 of the OECD model.
- General indicators
  - Is the entity acting as a mere agent/nominee or a mere fiduciary or administrator (even though formal owner)?
  - Is the main function of entity to hold assets or goods?
  - Look at the whole arrangement.

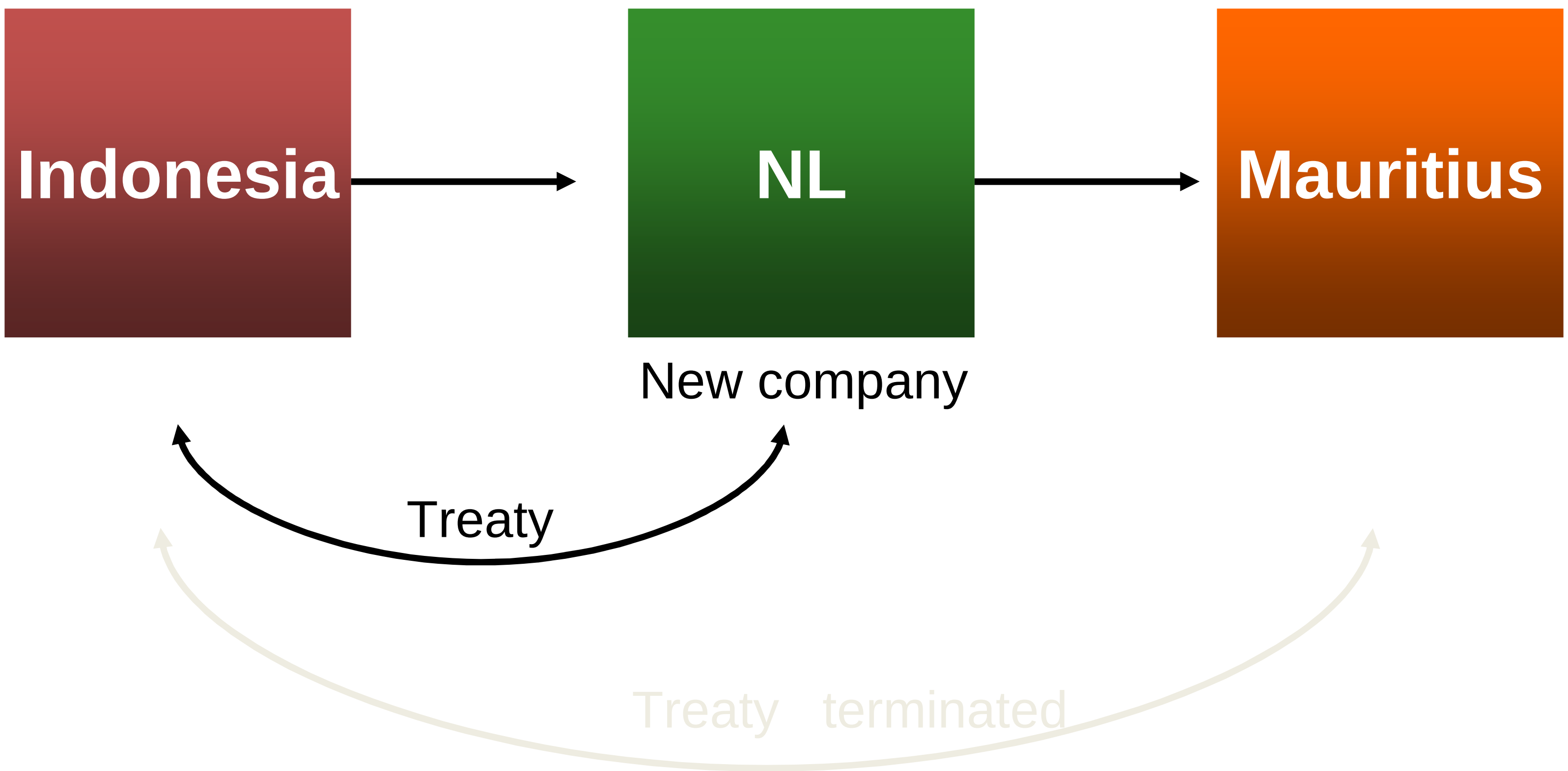
Who is the beneficial owner?



Professor Philip Baker (2001)

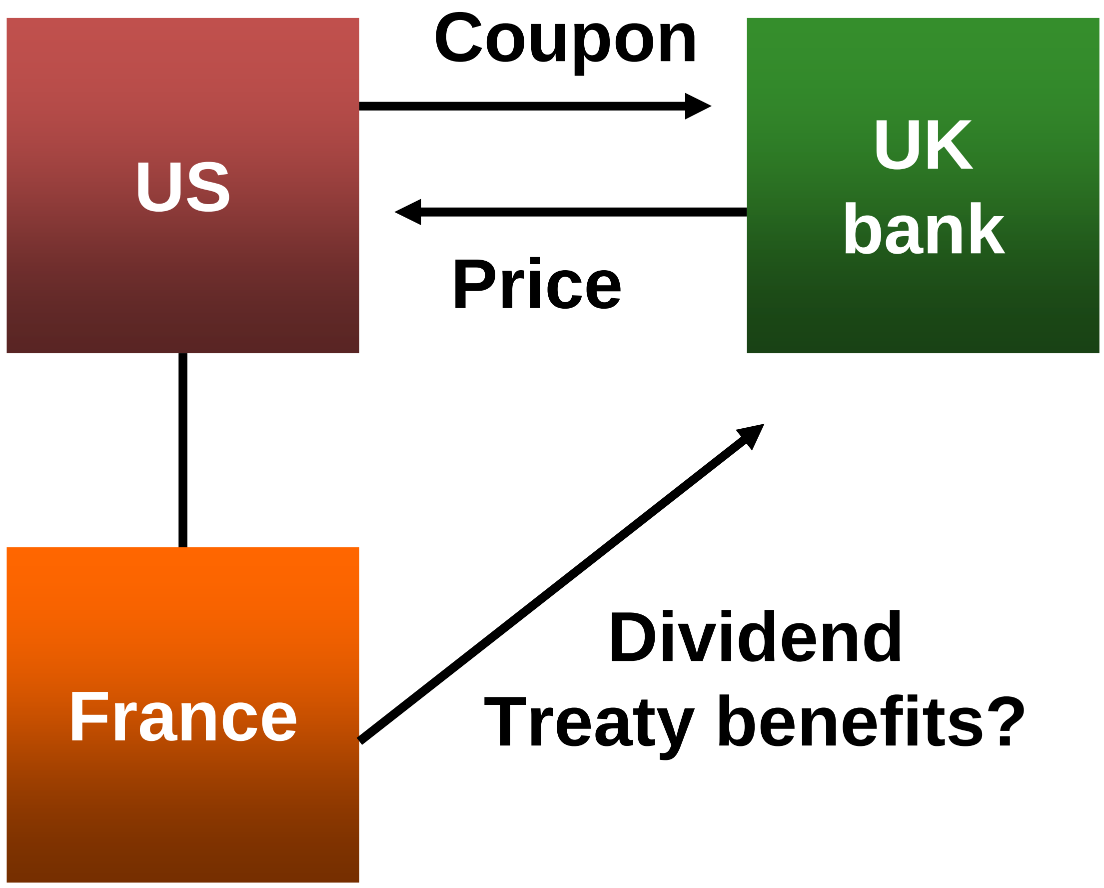
- *"[T]he 'beneficial ownership' limitation is intended to exclude: (a) mere nominees or agents, who are not treated as owners of the income in their country of residence; (b) any other conduit who though the formal owner of the income, has very narrow powers over the income which render the conduit a mere fiduciary or administrator of the income on behalf of the beneficial owner. [T]he mere fact that the recipient may be viewed as a conduit does not mean that it is not the beneficial owner*". Para 10B-10.4
- The term beneficial ownership *"should be accorded an 'international fiscal meaning' not derived from the domestic laws of Contracting States"*. Para 10B-14

Indofood - UK



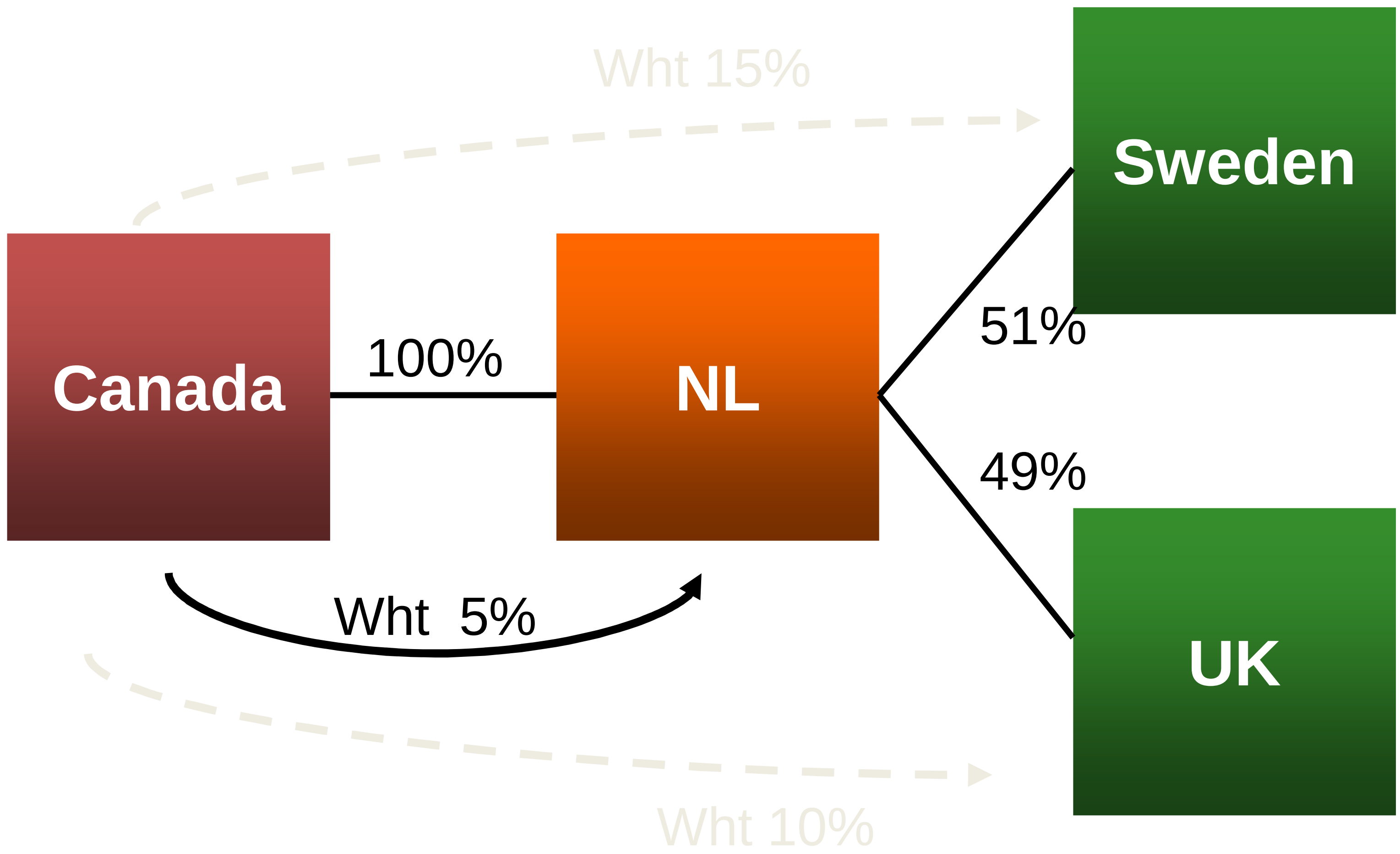
Indofood International Finance Ltd. v. JP Morgan Chase Bank N.A., [2006] EWCA Civ 158

Bank of Scotland Case - France



Bank of Scotland,
CE 29 December 2006, No. 283314

Prevost Case – Canada



Prevost Car Inc. v The Queen
court number 2004-2006(IT)G

Channel clause

- Looks at ownership of intermediary
- Typical wording:

'Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State:

(1) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and

(2) exercise directly or indirectly, alone or together, the management or control of such company,

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, depreciation of any kind of business assets including those on immaterial goods, processes etc)."

Channel clause

- Catches stepping-stone arrangements
- May also catch *bona fide* structures (administratively burdensome).
- Dividend income not included in payments

Limitation on Residence that are not Subject to Tax

- Looks at taxation in country of residence
  – To ensure treaty benefits are given when income is not taxed by country of residence of recipient but not passed on to third country resident.
- See Art 4 OECD Model
  – "[…] the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. *This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein*."
- Too broad? May catch all residents of countries adopting territorial principle of taxation.

Limitation on Residence that are not Subject to Tax

- Questions:
  - Is Subject to Tax = Liable to Tax
  - Does being *SUBJECT* to 0% tax satisfy the condition ?
  - Does being *LIABLE* to 0% tax satisfy the condition ?

  - On April 8, 2010 the Canadian court held in TD Securities (USA) LLC v. The Queen that a disregarded LLC to be consider as liable to tax since its members were.

Exclusion approach

- Again, looks at taxation in country of residence.
  - Treaty benefits will not be denied to companies that are tax-exempt or nearly tax exempt. (Para. 8.6, 8.7 to Art. 4 of the OECD Commentary)
- Typical wording:
  - *"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 signature of the Convention".*
- More fine-tuned but possible overkill if not limited to special tax privileges under special arrangements.

Remittance approach

- Again, looks at taxation in country of residence.
  - Treaty benefits denied income that is taxed only when remitted to the country of residency, to the extant of the unremitted income
- Typical wording:
  - *"Where under any provision of this Convention any income or gains are relieved from tax in a Contracting State and, under the law in force in the other Contracting State a person, in respect of that income or those gains, 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 the relief to be allowed under this Convention in the first-mentioned State shall apply only to so much of the income or gains as is taxed in the other State"*.

Bona fide **clauses**

- General *bona fide* provision or motive test
- Activity test
- Amount-of-tax provision
- Stock-exchange provision
- Alternative relief provision

The LOB

- Originates in US
- US Model
- OECD Commentary to Art 1
- Contains mechanical and substance-based tests
  - Stock-exchange test
  - Ownership/base erosion test
  - Activity test
  - Derivative benefits test
  - Competent authorities approval

The Objections to Treaty Shopping

- Tax Avoidance
- Contrary to purposes of tax treaties
- Reciprocity
- Economic Allegiance
- Revenue Loss
- Disincentive to Negotiate

Developing countries and treaty-shopping

- *Union of India v Azadi Bachao Andolan* [2003]6 ITLR 233; (2003) SOL 619
- Indian Supreme Court refuses to imply an anti-treaty-shopping clause in the India-Mauritius tax treaty.
- In developing countries, treaty shopping was often regarded as a tax incentive to attract scarce foreign capital or technology.
- "Developing countries need foreign investments, and the treaty shopping opportunities can be an additional factor to attract them". *Ibid,* p.280
- Countries had to take a holistic view.

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Developing countries and treaty-shopping

- "The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy. Many of them do not appear to be too concerned unless the revenue losses are significant compared to the other tax and non-tax benefits from the treaty, or the treaty shopping leads to other tax abuses." *Ibid,* p.281
- Treaty shopping may be a necessary evil, tolerated in a developing economy, in the interest of long-term development.

Yanco Weiss

- *AdminC (TA) 5663/07, Yanko Weiss(Holdings)1996 LTD. v. Holon Tax Assessor. PM5767(2007)(Israel***).**
- Israeli District Court allowed to imply Israeli domestic anti avoidance rule – the "Artificial Arrangement" provision of the Israeli Tax Code (§86) to the Israel – Belgium tax treaty even though the treaty does not constitute an anti avoidance rule.

Double non-taxation and the single-tax principle

- Income from cross-border transactions should be subject to tax once and not to be doubled taxed.
- It might be taxed in several jurisdiction.

International Tax Arbitrage

- A transaction structured by a taxpayer so as to benefit from an inconsistent characterisation of the transaction under the tax laws of two or more countries.
- This is because domestic tax rules apply to cross-border transactions without regard to the foreign tax characterisation of the transaction.
- ITA involves cross-border tax synergies or the interaction between two tax systems to achieve favourable results that neither system intended to offer in that way.
- The other side of the double taxation coin.

International Tax Arbitrage

- Examples:
  - Double-Dip leasing
  - Dual resident companies
  - Different income character rules
  - Different source rules
  - Different Transfer Pricing outcomes
  - Dual consolidated loss rules
  - Hybrid entities
- Opportunities increased with US check-the-box regime

International Tax Arbitrage

- See US check-the-box regime (CTB):
  - A taxpayer can elect to be treated as a corporation, a partnership or a disregarded entity (i.e. a branch).
  - A CTB election cannot be made with respect to certain entities that are clearly corporations ('per se' corporations).
  - There is a separate list for domestic and foreign 'per se' companies.
  - An entity that does not fall within the list of 'per se' corporations, will be consider as a Partnership for US tax purposes. Nonetheless, it can elect to be treated as corporation for US tax purposes, even though it has the characteristics of a partnership.

International Tax Arbitrage

- Is this abuse?
  - Single-tax principle
  - Efficiency/equity argument
  - Revenue reduction

- Coherence of arguments
  - What is the difference between domestic and international arbitrage?
  - What is the difference with tax rates arbitrage?

Treaty-Shopping and Community Law

- The prior question: Is treaty-shopping protected under Community law?
  - What type of treaty-shopping arrangement?
  - Treaty-shopping and freedom of establishment
  - Treaty-shopping and free movement of capital
- Anti-treaty-shopping provisions
  - Restrictions and justifications
- The LOB clause in the European Community

Treaty-Shopping and Freedom of Establishment

- Use of intermediary entity in favourable tax jurisdiction
- Arts 43, 48 EC: Concept of establishment
  - Pursuit of effective and genuine activities
  - Participation of Community national, on a stable and continuous basis, in the economic life of a MS
- Abuse/Prevention of tax avoidance
  - Question of abuse: *Halifax, Cadbury Schweppes*
  - Wholly artificial arrangement?
    - Physical presence of subco (premises, staff, equipment)
    - Genuine nature of activity of subco (competence of staff, decision-making)
    - Economic value of activity as regards parentco and group

Treaty-Shopping and Free Movement of Capital

- Is the investment truly indirect (i.e. through intermediary)?
- Art 56, 58 EC and Annex I to Dir 88/361/EEC
  - Capital movement?
  - Is economic integration of establishment relevant?
- Question of abuse/prevention of tax avoidance
  - Same issues as with Art 43?
  - Wholly artificial arrangement test?

The LOB clause in the European Community

- Contains mechanical and substance-based tests.
- Problematic because pre-emptive exclusion of situations?
  - Contrast with *Cadbury Schweppes* test: “wholly artificial arrangements”
  - Lower threshold of impropriety of the US LOB clause?
  - Case C-374/04 *ACT Group Litigation*

THE END