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Treaty Abuse and Treaty Shopping*

Considering the decisions made at the first meeting of the Committee of Experts, past work of the Group of Experts and discussion results of the Group of Experts and the Committee of Experts, the sub-committee has included the following issues in the draft report as the main discussion points:

i) the concept of the tax treaty abuse and treaty shopping
ii) various fact patterns of the abuse of tax treaties
iii) applicability of domestic anti-abuse measures to treaty abuse cases
iv) treaty measures for preventing tax treaty abuse.

Even though a uniform, internationally applicable definition of the tax treaty abuse is difficult to find, concepts of 'treaty abuse', 'treaty shopping' and 'qualification' are explored in this draft report. It should be noted that the concept of 'treaty abuse' can be broken down into 'abuse by one of the contracting states' and 'abuse of tax treaties by individuals and entities'.

Various cases of tax treaty abuse can be categorized based on the behavioural patterns of the schemes: i.e., (i) 'acquiring residency of a specific country', (ii) 'attributing profits or income to a specific entity', (iii) 'changing the character of an income', and (iv) other schemes.

As domestic measures to counter tax treaty abuse, application of 'specific anti-abuse rules', 'general anti-abuse rules' and 'codification of substance-over-form (or economic substance) principle' can be considered. Likewise, as treaty measures for preventing tax treaty abuse, 'safeguard clauses recognizing that the application of domestic anti-abuse provisions does not violate the treaty provisions', 'general anti-abuse rules', and 'specific treaty anti-abuse rules' can be considered.

Members of the Committee are requested to provide their comments (hopefully in written format) on 9 issues raised in this draft report by the end of one month after the 2006 meeting of the Committee of Experts. Such comments are indispensable in developing the guidance on the measures against tax treaty abuse and treaty shopping which will be reflected in the UN Model Convention and its Commentary.

*The present paper was prepared by the subcommittee on treaty abuses and treaty shopping (Mr. Kyung Geun Lee, Coordinator) of the Committee of Experts on International Cooperation in Tax Matters. This paper, even if it reflects relevant opinions of members of the subcommittee extensively, has not got final approval of the subcommittee yet.

Contents

I. Introduction

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

"(a) The issue of treaty abuse needed to be dealt with in the United Nations Model Convention and that this might be addressed in the Commentary as well as in the Convention itself. The Commentary on article 1 of the OECD Model Convention, which addresses methods of combating treaty abuse, would be helpful in this regard. However, it was important to ensure that, in considering the issue of treaty abuse, there was a balance between the need to provide certainty for investors and the need for tax administrations to combat such abuse;

(b) Further consideration needs to be given to addressing methods that might be used to combat specific treaty abuse issues. A sub-committee was appointed, to be coordinated by Mr. Lee and to include Mr. Silitonga, Mr. Lara Yaffar, Mr. Zhang, Prof. Garcia Prats and Mr. Sasseville."[1]

2. Since early 2006, most of members of the sub-committee have provided their comments to the coordinator for the purpose of drafting the Report of the sub-committee. Naturally, this draft report is largely based on these comments.[2] Other bases for this draft report are *i)* the report of Mr. Sasseville (E/C.18/2005/2) presented at the above meeting, *ii)* the report of Prof. Garcia Prats (ST/SG/AC.8/2003/L.3) submitted to the 11th meeting (held on 15-19 December 2003) of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (hereinafter to be called "the Group of Experts") and *iii)* other references on this topic, including comments received from Prof. McIntyre.

3. It would be helpful to first summarize the work of the Group of Experts on treaty abuse up to 2003 and then to review the general views of the Committee of Experts on treaty abuse expressed during its first meeting.

4. The Group of Experts examined abuse of tax treaties on two occasions, at its second meeting in 1983 and at its fourth meeting in 1987. At the latter meeting, it arrived at some important conclusions that form the basis for the present review and update: It identified the main types of abuse of double taxation conventions, considered possible treaty solutions to the problem and examined a number of abusive situations and possible solutions to them. However, it stopped short of embodying these considerations in the update of the United Nations Model Convention in 2001[3].

5. During the 11th and the last meeting of the Group of Experts in 2003, the issues of abuse of tax treaties and treaty shopping were discussed based on the report of Prof. Garcia Prats. Paragraphs 23-25 of the Records[4] of that Meeting summarizes the discussion results as follows:

> "23. OECD has attempted to deal with treaty abuses through amendments to the commentary to article 1 of its Model Tax Convention on Income and on Capital (OECD Model Convention). A proposal on the update of the commentaries on article 1 of the United Nations Model Tax Convention between Developed and Developing Countries

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[1] Paragraph 37 of the Record of the Meeting (E-2005-45).

[2] Comments from other Experts and observers of the Committee are to be distributed as a supplementary note to this draft report.

[3] This history is summarized at paragraph 5-6 of the report of Prof. Garcia Prats

[4] E/2004/51 "Eleventh meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters".

(the United Nations Model Convention) was presented at the meeting. The proposal assumed that any update of the Commentary on article 1 of the United Nations Model Convention should take into account, as a point of departure, the update carried on by the OECD in 2003 to the Commentary on article 1 of the OECD Model Convention. Nevertheless, it was stressed that it was impossible to automatically assume and translate all the amendments made by OECD to its Model Convention, since there had been little discussion on certain issues at the United Nations meeting. The Group of Experts adopted the view that the discussion of changes to the Commentary should continue and should be taken up at the next meeting of the Group of Experts.

24. The general consensus was that the amendment of the Commentary on article 1 of the United Nations Model Convention deserved further attention and that a final decision should not be made until the next meeting of the Group of Experts. It was decided that the process of discussing the different approaches would continue so as to promote a consensus on the substantive amendments to the Commentary prior to the next meeting of the Group of Experts.

25. On the basis of the discussion, it was recommended by the Group of Experts that the question of whether the United Nations should recommend an article in the Model Convention on the limitation of benefits that would be responsive to the needs of developing countries should be discussed. In particular, many developing countries have difficulty negotiating treaties with some developed countries because the major taxpayers in those countries are able to get the benefits of a treaty by using the treaty negotiated with another country. "

6. Discussions on the issues of treaty abuse and treaty shopping at the first meeting of the Committee on the Experts on International Cooperation in Tax Matters were based on (but not confined to) the report of Mr. Sasseville. The Report on the meeting[5] summarizes the discussions as follows:

"21. On the matter of the inclusion of anti-abuse provisions in the treaty, experts were of the view that treaty abuse was not adequately dealt with in the text of either the OECD or the United Nations Model Convention.
22. Many experts were of the view that it would be preferable to combat abuse by means of specific rules in the treaty. What constitutes treaty abuse is often a subjective matter and finding objective criteria to determine whether an abuse has been committed is often difficult.
23. It was noted that there was more to the issue of treaty abuse than just the treaty itself and domestic law; consideration must be given to international law and good-faith compliance by the contracting States. In addition, the needs of commerce should be addressed.
[…]
31. Many experts were of the view that treaties should be responsive to: (a) economic agents; (b) treaty partners; and (c) the domestic courts. The language in the treaty and the Commentary must address each of their concerns.
[…]

[5] E/C.18/2005/11

35. Many experts were of the view that the anti-abuse provisions should be included in the Commentary, which should also contain examples to illustrate situations in which treaty abuse might arise, as this could be of benefit to future negotiators."

7. Considering the decisions made at the first meeting of the Committee of Experts, past work of the Group of Experts and discussion results of the Group of Experts and the Committee of Experts, the sub-committee has included the following issues in this draft report for purposes of discussion by the Committee:

i) the concept of treaty abuse and treaty shopping
ii) various fact patterns of the abuse of tax treaties
iii) applicability of domestic anti-abuse measures to treaty abuse cases
iv) treaty measures for preventing tax treaty abuse.

II. The Concepts of Tax Treaty Abuse and Treaty Shopping

A. Preliminary Considerations

8. For many decades there has been considerable debate about what constitutes the tax treaty abuse. Although there have been some attempts to formulate the concept of the treaty abuse, including the one adopted by the Group of Experts at its meeting in 1987, it has often proved difficult to arrive at a definition acceptable for all international actors, i.e. international investors, states and tax advisors. Nonetheless, it has been recognized that treaty abuse frequently occurs, even though general consensus on its concept has not been reached yet.

9. Some important considerations on the concepts of the treaty abuse before starting full-fledged analysis on the treaty abuse and treaty shopping are well summarized in the report of Prof. Garcia Prats.

"8. To begin with, it can be contrasted with the straightforward and correct use of a treaty. Treaty abuse implies, then, an "incorrect" use of a treaty, without, however, necessarily involving an illegal act or a formal breach of the treaty. Hence, it is sometimes referred to instead as "improper use" of a treaty. The reference to the improper use of a treaty implies a use of the treaty that is contrary to its spirit, object and purpose. However, the term "abuse of tax treaties" can refer to a variety of situations requiring differentiation, since each has its own particular set of characteristics and calls for a different, specific legal response.

9. The first aspect to consider is who is abusing a tax treaty. In this regard, a distinction can be drawn between (a) abuse of the agreed terms of the tax treaty by one of the contracting Parties, that is, a State, and (b) abuse of the treaty provisions by persons (natural or juridical), who may or may not be the intended beneficiaries of the treaty, in order to gain advantages greater than would otherwise result from the context and intent of the tax treaty.

10. This distinction derives from the dual nature of a tax treaty: it is an international agreement between States, but is intended to affect the tax liability of the individuals and entities subject to it, and it is an important one to make in order to identify the factors that lead to such abuse, the conditions that determine the existence of an abuse

and the response mechanisms that are legally acceptable from the standpoint of the international law of treaties.

11. The distinction is recognized in the OECD Model Convention in the commentary on article 1, paragraph 17, formerly paragraph 19, and has been strengthened in the 2003 update of the OECD Model Convention by new paragraphs 21 to 21.5 of the same section, particularly in the cases contemplated in paragraph 21.5."

B. Abuse by One of the Contracting States

10. An abuse of a tax treaty by a State refers to a situation where one of the Contracting States, through the subsequent exercise of its domestic power of taxation, modifies the obligations previously assumed by that State towards the other State and upsets the balance in the division of taxing powers expressed in the tax treaty concluded between these States. By doing so, it may abuse the treaty and cause significant damages to the legitimate financial interests of taxpayers or of the other Contracting State.

11. An example of "abuse by a State" would be the case where a State that exempts certain companies from tax introduces a 1% tax creditable against, and limited to, the annual registration fee of these companies for the sole purpose of allowing these companies to qualify as a resident for purposes of a tax treaty. However, there would also be rather an opposite type of the abuse. That is, a State would try to expand its taxing rights beyond the limit that both States agreed upon when they concluded the tax treaty. For example, if a State tries to define shares as a kind of the immovable properties by changing its domestic laws in order to tax dividends without any limit under an article of the relevant tax treaty, which follows the taxation principle of Article 6 of the UN or OECD Model Convention, such a case can be regarded as an "abuse by a State". This draft report, however, would confine the discussion of the "abuse by a State" to the former because it is more closely related with the topic of treaty abuse and treat shopping.

12. The following is a further elaboration of the "abuse by a State" by Prof. Garcia Prats[6]:

"14. State abuse of a tax treaty may occur in the following situations:
(a)It may result from the post-treaty amendment of a domestic tax law that must be taken in conjunction with a tax treaty in order to be interpreted and actually applied. The process may result in the concession of exceptional or excessive advantages to a certain number of persons or beneficiaries of the treaty that are not derived solely from the text of the treaty but from the treaty provisions in combination with the domestic tax legislation of the state in question. Such situations, however, are sometimes lumped together with other forms of 'treaty shopping'.
(b) Treaty abuse may be the consequence of an administrative practice of one of the contracting states, which has the effect of permitting the relinquishment of any of the objects and purposes of the treaty by defining the conditions for treaty access by persons who were not originally intended to benefit from it."

13. Considering that the tax treaty is a kind of treaty, general principles of international law should be respected in the determination of whether an abuse has occurred or how to sanction such abuse. More precisely, Article 26 of the Vienna Convention on the Law of Treaties

[6] Refer to paragraph 14 of the report of Prof. Garcia Prats.

(VCLT) of 1969, which requires the parties to a treaty to perform it in good faith, and Article 38 of the Statute of the International Court of Justice, which states that the Court shall apply the general principles of law recognized by civilized nations should be governing principles in dealing with issues of the abuse by a State.

14. Verification of the abuse by a State is actually not an easy task since, first, any tax treaty including UN or OECD Model Treaty does not set out a concept of minimum taxation of transnational income or of an obligation to tax such income. Secondly, lack of consensus among tax treaty partners on the harmfulness of double non-taxation makes it very difficult to infer the purpose of tax treaty at the time of its conclusion. Therefore, it is often dubious whether a situation of double exemption from tax should be seen as abusive. Thirdly, most tax treaties including UN or OECD Model Treaty do not provide a well-defined verification procedure by which the abuse of treaty either by a State or a taxpayer can be identified or confirmed. As a consequence, the offended States that wish to correct the situation soon are often tempted to directly rely on unilateral countermeasures.

15. However, the determination on sanctions against the abuse by a State is required to be in line with principles of international law as mentioned above. If the offended State takes the following steps before taking sanctions, it would be regarded as faithful to the principles of international law.

16. The first step: The offended State may make a first call to the abusing State in order to ask for explanations of the supposed abuse of the treaty as a result of a posterior action of the abusing State (legislative, applicative or interpretative action).

The second step: The offended State may start a dispute settlement procedure, if necessary, through the mutual agreement procedure or mechanism provided in the tax treaty.

The third step: If the cooperative mechanism of the tax treaty does not lead to a settlement of the dispute and the offended State still considers the treaty to have been abused, then unilateral measures may be taken against the improper application of the treaty by the other State after notification to the other contracting State. In that case, international law, case law and standards established in the Draft Articles on Responsibility of States for Internationally Wrongful Acts (Articles 49-54) should be respected. Unilateral reaction may consist of retorsion or countermeasures proportionate with the injury suffered, allowing the other State to fulfil the affected obligations again.

17. It is recommended that a sub-committee under the Committee of Experts of the UN be set up with a view to developing mechanisms for the verification of the abuse by a State and the determination of proper measures to counter such an abuse. This job may be conducted as a part of the work of the development of the *dispute settlement mechanism* in general.

① [Members of the Committee are invited to make their comments on the subsection II-B (Abuse by One of the Contracting State).]

III. Abuse of Tax Treaties by Individuals and Entities

A. Analysis on Some Important Concepts

1. Treaty Abuse

18. The Group of Experts roughly defined terms the abuse of tax treaties as “the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits the treaties were not designed to give them”.

19. More sophisticated definition on the term of ‘abuse of tax treaties’ can be found in van Weeghel’s study[7] as follows:

“ [T]he use of that term is arguably narrowed down to those situations where the particular use of a tax treaty *i)* has the sole intention to avoid the tax either or both of the contracting states, and *ii)* defeats fundamental and enduring expectations and policy objectives shared by both states and therefore the purpose of the treaty in a broad sense.” Thus, under this definition, even though a taxpayer acted to avoid tax by using the treaty, the purpose, expectations and policy objectives of the tax treaty should be considered before the determination is made with regard to whether his use of the treaty is regarded as abusive.

20. According to van Weeghel’s analysis, the purpose of a tax treaty is a function of ***i)*** the primary goals to avoid double taxation and to prevent tax evasion; and ***ii)*** the expectations and policy objectives of the treaty partners. He views that the position taken by the OECD as to improper use of tax treaties should be given considerable weight since the purposes of avoidance of double taxation and prevention of tax evasion have their roots in the earliest tax treaties and were further developed by the different committees of the League of Nations and the OECD. While he admits that expectations and policy objectives are set by the Contracting States and thereby may be different at different times, he argues that if the Contracting States modeled their tax treaty after the OECD Model Convention, the expectations and policy objectives of the states should also be consistent with the principles adopted by the OECD as evidenced by the Commentary on the OECD Model Convention, to the extent not reserved upon by (one of the) Contracting States. This logic should also be applicable to the UN Model Convention[8].

2. Treaty Shopping

21. According to van Weeghel, the term “treaty shopping” connotes a situation in which a person who is not entitled to the benefits of a tax treaty makes use – in the widest meaning of the word – of an individual or legal person in order to obtain those treaty benefits that are not available directly[9]. Vogel provides a slightly different definition of “treaty shopping” by referring to a situation where ‘transactions are entered, or entities are established, in other states, solely for the purpose of enjoying the benefit of particular treaty rules existing between the state involved and a third state which otherwise would not be applicable, e.g., because the person claiming the benefit is not a resident of one of the contracting states … ’[10].

22. Treaty shopping, especially using a ‘conduit’, is perceived as improper use of tax treaties by both the OECD[11] and the UN[12]. The OECD expressed that treaty shopping is undesirable for the following reasons:

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[7] Stef van Weeghel, *The Improper Use of Tax Treaties,* Kluwer Law International, 1998, p.117.

[8] *Id.*

[9] Stef van Weeghel, *supra* chapter 8, p 119.

[10] Vogel, K., *On Double Tax Conventions,* Kluwer, Deventer/Boston, 1991, p.50.

[11] OECD Committee on Fiscal Affairs, *International Tax Avoidance and Evasion, Four Related Studies, Issues in International Taxation Series*, No.1, OECD, Paris, 1987, p.90.

[12] United Nations, Ad Hoc Group of Experts on International Co-operation in Tax Matters, Fourth meeting, Geneva, 30 November-11 December 1987, *Prevention of abuse of tax treaties*, United Nations Secretariat, New York, 1987, p.96.

a) Treaty benefits negotiated between two States are economically extended to persons resident in a third State in a way unintended by the contracting States; thus the principle of reciprocity is breached and the balance of sacrifices incurred in tax treaties by the contracting parties altered;

b) Income flowing internationally may be exempted from taxation altogether or be subject to inadequate taxation in a way unintended by the contracting States. This situation is unacceptable because the granting by a country of treaty benefits is based, except in specific circumstances, on the fact that the respective income is taxed in the other State or at least falls under the normal taxing regime of that State;

c) The State or residence of the ultimate income beneficiary has little incentive to enter into a treaty with the State of source, because the residents of the State of residence can indirectly receive treaty benefits from the State of source without the need for the State of residence to provide reciprocal benefits.

23. It seems safe to assume that the views held by the OECD are widely shared by those countries that are opposed to treaty shopping.

24. Prof. Garcia Prats distinguishes the concept of “treaty abuse” from that of “treaty shopping” by stating that the term “treaty shopping” — in other words, searching for a more favorable treaty — should not be equated with treaty abuse. According to his view, the conclusion that a situation is abusive — or that an individual is benefiting from the application of a double taxation treaty in an abusive fashion — requires and implies verification of the occurrence of an indirect, rather than a direct, breach of a provision through a violation of its object, spirit or purpose, something that is difficult to determine a priori[13].

3. Qualification

25. The term ‘qualification’ is often used to denote the process of identifying the treaty object under domestic law and under the treaty[14]. The character of income must be identified so that a tax treaty provision can be applied properly. For example, if a company resident in one Contracting State paid a certain amount of money to its shareholder resident in the other Contracting State, it should be determined whether the money paid constitutes a dividend, interest, or any other kind of income of the shareholder. Depending on the character of income, the State having taxing right on the income and the way of taxation may differ.

26. The process of qualification, in the application of a tax treaty, normally occurs twice in each instance, i.e., the source state will determine which treaty provision can be applied to the item of income in question, and the residence state will do the same. In most instances, the qualification will be the same in the source state and in the residence state, but in a quite a few instances the qualification in the source state and in the residence state may be different from each other. van Weeghel introduces in his book[15] the concept of ‘positive qualification conflict’ as the situation where both States tax the same item of income as a result of the application of different provisions of the treaty. The reverse situation where the compensation would have gone untaxed in both states is referred to as a ‘negative qualification conflict’.

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[13] Paragraph 19 of in the report of Prof. Garcia Prats.

[14] Stef van Weeghel, *supra* chapter 8, pp. 158-160.

[15] *Id.*

27. A taxpayer may try to create a negative qualification conflict in order to avoid every taxation on cross-border income. The question is whether a successful effort to create a negative qualification can be treated as abusive. On the one hand, one could argue that the creation of a negative qualification conflict can never be labeled as abusive because each State applies the treaty to every cross-border income, and the result of its application in principle squares with fundamental and enduring expectations and policy objectives of the tax treaty concluded by both States.

28. On the other hand, one could argue that while the treaty has been applied properly in both States, the result – no or less than single taxation in either State – is not consistent with the above expectations, policy objectives and principles since both States would expect at least single taxation (i.e., being taxed at least once). In this light, the creation of a negative qualification conflict with the sole intention of avoiding every taxation would be regarded as abusive or improper. This would be true if one would give more weight to the overall expectation of the States that any item of income will be taxed at least once than to the fact that each State may be satisfied with the result of its own treaty application without paying attention to the consequence as a whole.

② [Members of the Committee are requested to provide their comments above paragraphs since the stance with regard to 'the negative qualification conflict' is important in developing later part of this draft report.]

B. Identifying Treaty Abuse: Application of the Concept and Domestic Anti-abuse Mechanisms

29. In theory, identifying 'treaty abuse by persons' requires, as a prerequisite, exact understanding of the expectation or purpose of the treaty by the time when it was concluded. Further, it requires the comprehensive understanding as to how a tax treaty is applied and integrated with domestic legislation. Therefore, a thorough verification or identification of treaty abuse in a particular case is quite difficult. For the same reason, it is also difficult to formulate a uniform, internationally acceptable concept of abuse of tax treaties by persons.

30. Despite such difficulties in identifying the treaty abuse in an individual case, however, there are some important features of treaty abuse commonly found in the identification process as specified in the following:

(a) The legitimate financial or revenue interests of the Contracting State that alleges an abuse by a taxpayer may be affected by the relevant transactions;

(b) Verification is done independently by the domestic authorities of each of the Contracting States, since each is fully competent to apply the treaty;

(c) The occurrence of abuse is inferred through the application of domestic mechanisms existing in each Contracting State to counter the abuse of tax laws or of specific rules regarding abuse of tax treaties;

(d) It is not requisite or necessary that both Contracting States should identify the abuse.

31. More importantly, despite the difficulties and a wide variation in the process of identifying treaty abuse, it would be possible to identify some typical patterns of treaty abuse by persons from actual cases. Thus, if the Commentary of the UN Model Convention can do

this job, which is more than citation of certain doctrines or formulas (such as the "substance-over-form" rule), it would be useful particularly to tax experts in developing countries. Having this point in mind, the remaining part of this draft report attempts first to identify various treaty abuse cases based on their fact patterns or conceptual frameworks and then find ways to cope with those cases.

C. Categorization of Treaty Abuse

32. In general, schemes used for treaty shopping or treaty abuse purposes differ depending on the situations where the taxpayer may face. The approach taken for the categorization here relies on the observation that schemes for 'acquiring residency of a specific country', 'attributing profits or income to a specific entity' and 'changing the character of an income' are the ones frequently employed in order to achieve non-taxation (or less than single taxation) in both source state and residence state. Also, other treaty abuse schemes would be further explored here.

1. Acquiring Residency of a Specific Country

33. A person may have a residency in one or more states. In determining his residency, domestic laws of pertinent states are applied in the first place. In order to get the benefit of a tax treaty, however, he must be a resident of either or both contracting states. In other words, if a person is not a resident of any of the two contracting states, he does not deserve tax treaty benefits between the two states. Therefore, if a person wishes to enjoy the benefit of a particular tax treaty, he may establish a taxable entity that meets the requirements of residency in the country concerned and enter into transactions in order to have that entity get the tax treaty benefits. In this situation (i.e. the establishment of an intermediary entity solely to obtain the benefits of the treaty), if this conduct was clearly unintended by the contracting states, his attempt of using the treaty may be regarded as 'abusing the treaty'.

1.1 Conduit Structure

1.1.1 Direct Conduits

34. The OECD summarizes direct conduit structure as follows:

> A company resident of State A receives dividends, interest or royalties from State B. The company claims that, under the tax treaty between States A and B, it is entitled to full or partial exemption from the withholding taxes of State B. The company is wholly owned by a resident of a third State not entitled to the benefit of the treaty between States A and B. It has been created with a view to taking benfefits of this treaty and for this purpose the assets and rights giving rise to the dividends, interest or royalties were transferred to it. The income is tax-exempt in State A, e.g. in the case of dividends, by virtue of a parent-subsidiary regime provided for under the domestic laws of State A, or in the convention between States A and B[16].

1.1.2 'Stepping Stone' Conduits

35. The basic structure is identical to the one described in the previous sub-section. However, the company resident of State A is fully subject to tax in that country. It pays high interest,

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[16] OECD, Committee on Fiscal Affairs, *Double Taxation Convention and the Use of Conduit Companies,* OECD, Paris, 1986, pp.88-89.

commissions, service fees and similar expenses to a second related ‘conduit company’ set up in State D. These payments are deductible in State A and tax-exempt in State D where the company enjoys a special tax regime[17].

36. A conduit company may be a financial intermediary such as an investment company or a holding company (for example, in a back-to-back loan context). The fact that a company carries on the business of financial intermediary may make it difficult for State B to treat that company as a conduit and deny the application of a tax treaty. That is because the main business decisions of the corporation are made (or take an appearance of being made) in State A or D. And in that case it would not be easy for State B to find strong evidence to support its stance. Even in case where State B finds such strong evidence, the company in State A may want to argue against the decision of State B’s authority because there is no literal rule in the pertinent tax treaty for such an alleged conduit situation. The attitude of the tax court varies from country to country with regard to that issue.

37. As another approach to an alleged conduit structure, State B may raise the issue of substantial attribution of the income in question rather than deny the application of the whole provisions of a tax treaty. In this regard, the concept of ‘beneficial ownership’ or ‘substance over form’ rule or similar doctrines may be considered, depending on the circumstances.

1.2 Dual Residence

38. If State A uses either the ‘place of incorporation’ or ‘place of effective management’ as its domestic law criterion for determining the residence of a company, a company X that has its place of incorporation and its place of effective management in State A would be regarded as a resident of State A. If company X pays dividends, interest or royalties to company Y, a resident of State B that has a special relationship with company X, those payments may be subject to withholding tax in State A, depending on the provisions of the tax treaty between States A and B.

39. However, if States A and B have a tax treaty which includes a tie-breaker rule following Article 4(3)[18] of either the UN Model Convention or the OECD Model Convention and if company X moves its place of effective management to State B which also has the ‘place of effective management’ as its domestic law criterion for determining residence of a company, company X will cease to be a resident of State A and be treated as a resident of State B for purposes of the treaty between State A and State B. In this situation, payments (i.e., dividends, interest and royalties) from company X to company Y will not be subject to withholding tax of State A regardless of the provisions on dividends, interest and royalties of the tax treaty between States A and B since such income will no longer be regarded as having its source in State A (it is assumed that company X does not have a permanent establishment in State A by which these payments are borne)..

40. In short, the taxpayer having control over company X and Y can prevent the levy of withholding taxes of state A by shifting the residence of company X from State A to B through the change of its place of effective management[19].

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[17] *Id*.

[18] It provides: “Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated.”

[19] Stef van Weeghel, *supra* Part IV, pp.138-140.

41. If the levy of withholding tax is authorized by the tax treaty concluded by the contracting states (even if the company making payments is genuinely engaged in business – and not merely a treaty shopping device in the state of its residence), one could conclude that the avoidance of withholding taxes by relocating the place of effective management of the company without legitimate non-tax reasons followed by the subsequent payments can be treated as abusive, because it defeats fundamental and enduring expectations and policy objectives shared by both states.

1.3 Triangular Cases

42. The term 'triangular cases' has been used to denote the application of tax treaties where three states are involved. The OECD has described the typical triangular case as one in which:

— income from dividends, interest or royalties is derived from a source in State S;
— such income is received by a permanent establishment in State P;
— the permanent establishment depends on an enterprise resident of State R[20].

43. Tax treaties are generally concluded on a bilateral basis and do not explicitly address triangular situations. This lack of coverage may lead to situations of double taxation despite the existence of bilateral tax treaties between all three states. On the other hand, there may be situations in which income is entirely or almost entirely untaxed. According to views of the OECD, 'the most difficult problem appears to arise in the situation where income arising in State S and paid to a permanent establishment in a tax haven would be taxed very little or not at all'[21]. This problem arises because the State of residence of the permanent establishment, albeit being situated in State P, is regarded as State R.

44. In order to solve the above problem, the Commentary on Article 24(3) of the OECD Model Convention states in paragraph 53 as follows:

> "If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment."[22]

45. However, even though State R and State S agree to include the provisions recommended in the Commentary, the problem may remain unresolved if the enterprise changes its residence from State R to another State (e.g., State Q) which does not have the same type of provisions with State S and thereby the permanent establishment continues to be taxed very little or not at all.

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[20] OECD Committee on Fiscal Affairs, 'Triangular Cases', in *Model Tax Convention*, OECD April 2000, R(11)-3, paragraph 2.
[21] *Id*., R(11)-15, paragraphs 53.
[22] This provision is regarded as relevant for the Commentary on Article 24(3) of the UN Model Convention. See paragraph 4 of the Commentary on Article 24 of the UN Model Convention.

1.4 Transfer of Residency

46. The Commentary on Article 1 of the OECD Model Convention 2005 mentions in paragraphs 8 and 9 an example of case where improper use of tax treaty takes place by transferring residence[23].

> "8. It is also important to note that the extension of double taxation conventions increases the risk of abuse by facilitating the use of artificial legal constructions aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in double taxation convention.
>
> 9. This would be the case, for example, if a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly. Another case would be an individual who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, and who, essentially in order to sell the shares and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 4 of Article 13), **transfers his permanent home** to the other Contracting State, where such gains are subject to little or no tax."

2. Attributing Profits or Income to a Specific Person or Entity

47. A taxpayer may maneuver its taxable profits or income by attributing all or part of such profits or income to a related person or entity over which he has a control. The issue of 'triangular case' discussed above also can be understood as an example falling in this category in that 'the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment'. More broadly, even the conduit cases can be regarded as relating to the method of 'attribution of profits or income to a specific person or entity (hereinafter called as 'attribution of profits')' in the sense that the taxpayer concerned tries to maneuver the related transactions to attribute the relevant profits or income to the conduit.

48. Since most problems derived from the improper or abusive attribution of profits or income between persons or entities dependent on the same taxpayer can be properly addressed through an adequate transfer pricing legislation in accordance with the principles established in Article 9 of the UN or OECD Model Convention and the 1995 transfer pricing guidelines elaborated by the OECD, this Section will focus on the more specific ones such as arrangements related to the *compensation for personal services,* which are usually not covered by the transfer pricing guidelines.

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[23] In order to cope with this situation, some countries include the provision of so-called 'departure tax' as can be found in Article 13 (6) of the '96 Korea-UK tax treaty.

"6. The provisions of paragraph 5 of this Article shall not affect the right of a Contracting State to levy according to its law a tax on capital gains from the alienation of any property derived by an individual who is a resident of the firs-mentioned Contracting State at any time during the five years immediately preceding the alienation of the property."

49. Tax treaties are frequently used by individuals in respect of their income from personal services. Improper use or abuse of tax treaties may be perceived where the individual purportedly creates a qualification conflict with respect to the income from the services rendered as shown in the following examples[24].

2.1 Directors' Fees

50. Article 14 (Independent Services) and Article 15 (Dependent Services) of both the UN Model Convention and '92 OECD Model Convention assign the right to tax the income from independent and dependent services to the state where these services are performed subject to certain conditions. Article 16 (Directors' fees) of the Model Convention, however, takes a different approach by providing that:

> [d]irectors' fees and other similar payments derived by a resident of a Contracting state in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

51. The Commentaries of both the UN and OECD Model Conventions explain this deviation from the rules provided in Articles 14 and 15 by stating that 'it might sometimes be difficult to ascertain where the services are performed'[25].

52. The rule contained in Article 16 has been used in so-called 'salary split' arrangements. For example, multinational A has subsidiaries B and C, which are residents of countries X and Y respectively. Mr. D is employed in a high level managerial capacity by subsidiary B and has his residence in country X. Country X levies an income tax on its residents and non-residents having domestic income, at progressive rates of up to 50%. Country Y has a similar income tax system but with a very low tax rate. Countries X and Y have a tax treaty which employs the exemption system in the residence state for income that may be taxed in the source state under Article 16 of the OECD Model or the UN Model Convention. If Mr. D receives his salary only in respect of services performed in country X for company B, a large part of his salary will be subject to the highest tax rate in that country. Therefore, for the purpose of mitigating tax burdens, it has been decided to appoint Mr.D as a member of the board of directors of company C. This part of his compensation is subject to country Y's income tax at a very low rate, because it falls in the lower income tax brackets. Mr. D invokes the provisions of Article 16 of the treaty to benefit from the exemption from tax in country X in respect of his compensation from company C.

53. If a salary split arrangement is used in a situation where the position of director exists merely in form but not in substance, the application of Article 16 would be improper. Article 16 explicitly states that the fees should be derived 'in [the taxpayer's] capacity as a member of the board of directors' in order for that Article to be applied. It also requires that, if the directorship merely exists in form but not in substance, remuneration should not be made in that capacity. On the other hand, in the situation where the taxpayer really derives the remuneration in his capacity as a member of the board of directors and not as part of an arrangement the sole purpose of which is to avoid tax in the State of residence, this would not constitute an improper use of Article 16 even if the remuneration is subject to a low income tax rate in the country of source[26].

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[24] Stef van Weeghel, *supra* pp.153-158.

[25] Commentaries on Article 16 of the OECD Model Convention and the UN Model Convention

[26] Stef van Weeghel, *supra* p.155.

2.2 Artistes and Sportsmen

54. In the 1963 Draft OECD Model Convention, Article 17 reads as follows:

"Notwithstanding the provisions of Articles 14 and 15, income derived by public entertainers, such as theatre, motion picture, radio or television artistes, and musicians, and by athletes, from their personal activities as such may be taxed in the Contracting State in which these activities are exercised."

55. Under tax treaties employing the above wording in Article 17, a tax avoidance may take place in case where an artiste sets up a company solely for the purpose of the management of his performance and becomes its employee. In this situation, the fee for his performance paid to the company may be attributed to the company and thereby characterized as business profit, not as personal service income to the artiste, whilst the subsequent payment from the company to the artiste is characterized as employment income. The same result may be attained by a loan out agreement[27]. The payment by the borrowing company to the loaning company would be characterized as borrowing fee.

56. In order to circumvent the tax avoidance attempts mentioned above, the 1977 OECD Model Convention added the following paragraph in paragraph 2.

> "Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised."

57. However, old tax treaties such as the 1967 UK-Netherlands treaty[28] or the 1979 Korea-US treaty that have not included the above provision may be vulnerable to the improper use or abuse of a tax treaty by taxpayers.

3. Changing the Character of an Income

58. A taxpayer can choose a legal form of transactions with other counterparts to attain a certain economic result. This freedom in the selection of a legal form is generally respected by tax authorities unless such form deviates from its economic substance to a great degree. However, if this freedom of

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[27] An example of 'single loan-out arrangements': E, an entertainer who is a resident of the United Kingdom and a nonresident alien of the United States, is the sole shareholder of UKC, a United Kingdom corporation. E executes an exclusive service contract with UKC purportedly as an employee. UKC, as E's agent, negotiates a contract with X, a United States person, for the loan-out of E's services to be performed within the United States. E has a veto over the terms of the contract. X pays UKC under the terms of the loan-out agreement, and E receives payment for his services from his wholly-owned corporation. UKC retains a fee for the services rendered. The amount of E's compensation depends on the size of the payment UKC receives from X. X specifically requires the services of E and no other person. X requires that E sign and guarantee all contracts with UKC. X furnishes E with costumes and E performs his services on X's premises and subject to X's control. In these respects X treats E like any employee of X.

[28] *Id.*, pp.159-160.

choice is exercised in a way that entails no tax (or less than single taxation) in both source and resident countries, it may be challenged by tax authorities of either country. Fact patterns of changing the character of an income are summarized as below.

3.1 Conversion of 'Gains from Real Property' to 'Gains from Shares'

59. Most countries impose a tax on the gains from the disposition of real property by non-residents, and under Article 13(1) of the current OECD Model Convention and the UN Model Convention, the right to tax this gain is assigned to the state where the property is situated. However, given Article 13(4) of the '92 OECD Model Convention, it follows that gains from the alienation of shares are taxable only in the state of residence of the alienator.

60. Thus, by creating an indirect ownership interest as opposed to a direct ownership interest, a taxpayer may, if the country of residence and the source country have entered into a tax treaty based on the '92 OECD Model Convention, avoid source state taxation in respect of the alienation of his (indirect) ownership interest in real property situated in the source state[29]. If the taxpayer attempts the conversion of gains pursuing no taxation or less than single taxation in both source and residence states, the above conversion can be regarded as an example of the improper use or abuse of tax treaty.

3.2 Conversion of Dividends to Capital Gains

61. In a situation where a shareholder in State X holds substantial amount of controlling shares in company A residing in State Y, that shareholder may attempt to convert dividends to capital gains if the tax treaty between States X and Y provides for withholding tax on dividends but no taxation on capital gains by State Y (source state). When the shareholder needs cash inflow, he may choose to sell off some of his shares rather than to have company A pay out dividends to shareholders since the former brings out more tax savings than the latter.

62. However, the amount of tax savings may have a certain limit in that the shareholder would not sell off all the shares he owns if he wishes to keep control over company X. While maintaining controls over company X, he can achieve the effect of converting dividends to capital gains by selling only a portion of his shares,[30]. If the shareholder wishes to ensure that he can recover his original holding ratio after selling his shares, he may do so by entering into a repurchase arrangement with his counterpart of the transaction from the beginning. This arrangement may also benefit the counterpart since the capital gains realized on the part of the shareholder mean the capital losses on the part of the counterpart[31] and accordingly the counterpart can utilize the capital losses to offset its capital gains which have been realized in the other part of his business.[32]

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[29] If taxation in the residence state is fully assured, a taxpayer would have little incentive of avoiding source state taxation.
[30] Brian J. Arnold, etc., *General Anti-Avoidance Rules in International Taxation*, Case Studies and notes, IFA, 57th Congress, Sydney, Australia, 2003
[31] If the foreign investor sells some shares just before ex-dividend date and buys it again soon enough so that the market price of the shares drops just by the amount of that dividend to be distributed, the counterpart will recognize capital losses to the same amount of the dividend. For the purpose of simplicity, fee for this repurchase arrangement is not considered here.
[32] Compaq Computer Corporation v. Commissioner, 277F3d 778(2001)

63. The practical issue here is how the source state can determine and prove that the foreign shareholder has changed the character of income for the purpose of tax savings. In some countries where the tax rates for capital gains are zero or lower than those for ordinary income, there are specific provisions to recharacterize the income under some concrete conditions for the application. In some other countries, recharacterization may also be possible under the general anti-avoidance rule or substance-over-form rule. However, there is controversy over whether the source state can recharacterize the income based on the specific or general anti-avoidance rule provided in its domestic tax laws without any specific provision in tax treaty for that purpose.

64. Further, some states may treat all gains from alienation of shares as dividends by defining any income from corporate rights as dividends in a domestic tax. These states may argue that the term "capital gains" is not defined in most tax treaties (even in the UN or OECD Model Conventions) and, under Article 3(2) of Model Conventions, any term not defined in a tax treaty shall have the meaning that it has under the domestic tax law of the source state at the time of the application of the treaty. There may be controversy over this argument as well.

③[Members of the Committee are invited to provide comments particularly on issues raised by the last two paragraphs.]

3.3 Conversion of Dividends to Interest

65. The conversion of dividends to interest can take place in a situation where the tax treaty provides for withholding tax on dividends but no or little withholding tax on interest at source state. For instance, let's assume that a shareholder that is resident of State X has controlling shares of company A (a resident of State Y) and establishes a holding company B with minimal capital contribution by himself in State Y. It is further assumed that the shareholder exchanges the shares of company A in return for notes issued by the holding company B. As a consequence, the holding company B becomes a main investor to company A and thereby dividends are distributed to the holding company B by company A. Likewise, the shareholder in State X comes to possess the above notes and takes interest remitted by the holding company B. Since the amount of the shareholder's notes are big enough to maintain the control over the holding company B, the above swap transaction would not affect the controlling power of the shareholder. However, due to the above swap transaction dividend income has been converted into interest income which is subject to no or little withholding tax in State Y.[33]

3.4 Derivative Transactions

66. As an extension of the above two examples where the pertinent tax treaty gives less taxing rights to the source country for capital gains or interest than dividends, a taxpayer may consider the use of derivate transactions in order to get treaty benefits. That is possible because derivative transactions would enable a taxpayer to enjoy tax treaty benefits of capital gains or interest (i.e., no or less withholding tax at source) based on the formal character of income while allowing him the same cash flows as an owner of shares can enjoy due to the characteristics of derivative transactions, that is,

[33] Pasquale Pistone, *Abusive application of international tax agreements*, Munich, Report of the Proceedings of Seminar D, 2006(6 September) IFA. p.4.

replicating the economic effect of any type of financial transactions regardless of their legal form. The following example shows that a shareholder who does not retain any legal ownership of shares can enjoy substantially the same economic position as if he actually owned the shares.

67. When an investor buys a bond and at the same time buys a cash-settled forward contract which has some shares as its underlying assets the notional amount of which equals the face amount of the bond, he may get the same economic position as an owner of shares does until the expiration date. The apparent legal character of the position is capital gains (or losses) and interest income although dividend income might have accrued to the shares economically during that period.[34]

4. Other Schemes

4.1 Shifting to Lower Tax Bracket

68. When a tax treaty stipulates two tier tax rates for a specific type of income, a taxpayer may attempt to maneuver the transaction as if his income fell under the scope of lower tax rate. The typical example for this is the situation where two tier rates are applicable to dividends income. For example, 5% is applied to major shareholders (e.g., shareholders with 25% or more holdings) while 15% is applied to other minor shareholders as provided in Article 10 (Dividends) of the OECD Model Convention. In this situation, a taxpayer may attempt to raise shareholding ratio in order to be subject to 5% of withholding tax rate rather than 15% of withholding tax rate.

69. In order to raise the holding ratio to be eligible for the lower withholding tax rate (i.e., 5%), a foreign shareholder may establish a holding company which holds the shares of the original operating company. The foreign shareholder may transfer his shares of the operating company to the newly built holding company. By doing so, he is able to recharacterize his dividends received as those from holding of 25% or more of shares.[35]

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[34] A detailed example is as follows: The stock of US Co, on which a $4 dividend is expected in a year, is currently trading at $100 a share. In year 1, F, a foreign investor, buys a $100 US Treasury bond paying a riskless return of 6% and enters into a cash-settled forward contract to buy 100 shares of US Co for $102 in year 2. (the forward price is the current share price($100) plus the riskless return ($6) minus the expected dividend ($4)). Assuming that US Co pays the expected dividend, F's position in year 2 in this example will be identical in value to what it would have been had he purchased of 100 shares of US Co in year 1. In either case, the total value will be the year 2 value of the US Co stock plus $4. Although an actual purchase of US Co stock would trigger a withholding tax on the dividend, the synthetic equity will produce no US taxation. Interest on the bond is exempt portfolio interest, while capital gain on the forward will not be subject to US withholding tax.

[35] The following is a detailed example for this scheme: Company A, resident in the US owns 7 percent of the nominal paid-in capital of public company B, resident in the Netherlands. It owns the shares as an investor. Dividends paid by company B to company A will be subject to 15 per cent Dutch withholding tax pursuant to Article 10(2)(b) of the 1992 US-Netherlands tax treaty. Since company A cannot effectively credit the Dutch withholding tax against US corporate income tax, company A contributes the shares in company B to its newly incorporated wholly-owned subsidiary C, resident in the Netherlands. As a result of the contribution, company B pays dividends to company C and company C pays dividends to company A. The B-C dividend is exempt from Dutch dividend withholding tax and corporate income tax pursuant to Article 13 of the CITA in conjunction with Article 4(2) of the DTA. The subsequent C-A dividend is subject to only 5 per cent Dutch dividend withholding tax pursuant to Article 10(2)(a) of the 1992 US-Netherlands tax treaty. Thus by interposing a wholly-owned Dutch holding company, company A has effectively reduced the dividend withholding tax from 15 per cent to 5 per cent in a situation where its (now indirect) shareholding in company B is a portfolio investment.

4.2 Dilution or Splitting

70. Both the UN Model Convention and the OECD Model Convention have a number of numeric criteria to set a limit on the taxing right of the source state. These numeric criteria, if adopted by an actual tax treaty, provide certainty in the application of the treaty. Despite such a positive function, however, they are also vulnerable to abusive actions by some taxpayers who intend to reduce their tax burdens in the source state. The abusive actions include the dilution of value of an asset, time splitting and contract splitting as illustrated below.[36]

71. Article 5(3) of the UN Model Convention is provided as follows:

> "3. the term "permanent establishment" also encompasses:
>
> (a) [……]
>
> (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period."

72. Since a service PE is time-based, rather than activity-based like an agency PE, taxpayers can circumvent the time threshold for the existence of a permanent establishment through contract splitting. In other words, taxpayers, with contract splitting, can argue that the projects are disconnected from each other.

73. As an option for solving the above problem, a 'disjunctive test', designed by the Indian Court, can be recommended. According to this test, if one part stands unaffected in the absence of the other, it is a case of two separate contracts. If both parts fall in the event of failure of either of them, it is a composite, or in another term, connected contact. The Commentary on this Article, which provides no clue on this issue, needs to consider the above test as a type of guidance on this issue[37].

74. Similar issues are found in some provisions on capital gains in the Model Conventions. Article 13(4) of the UN Model Convention includes 50% of value threshold for determining whether immovable property is the principal asset of an entity as a pre-condition for source taxation on the capital gains of shares of a company. Likewise, the 2005 OECD Model Convention includes a criterion of whether 50% of asset value of a company is derived from immovable property. If this threshold is passed, the source state has the taxing right on the capital gains of shares of a company.

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[36] The discussion here is based on the comment of Mr. Zhang Zhiyong, previous Chinese Expert of the Committee.

[37] The Group of Expert could try to draft new paragraphs for the Commentary that would put forward a series of factors that would be relevant to determine whether two projects are connected (with the understanding that not all the factors would need to be met for two projects to be connected).

Examples of such factors could be:

1) Is the ultimate client or beneficiary of the projects the same entity?
2) When the contract for the first project is entered into, is it reasonable to consider that the second project will be carried on?
3) Are the two projects two different parts of a larger project?

75. This threshold, however, can be easily abused through the prospective dilution of the value of such property before the actual transfer of a share of the company concerned. Therefore, some tax authorities feel that it would be advisable to add some guidance in the relevant parts of the Commentaries to deter taxpayers from attempting to dilute the value of particular assets[38].

76. Another threshold issue can be raised with regard to Article 13(5) of the UN Model Convention which provides as follows:

> "5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of at least ____ per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State."

77. In fact, a number of actual tax treaties include the similar provision to the above paragraph with a fixed percentage (in most cases 25%), which is usually set in negotiations. The fixed participation ratio, however, can be abused by taxpayers through multiple or time-splitting transfer of shares if further detailed provisions are not provided in the above paragraph[39].

78. In order to reduce room for potential treaty abuse, it seems necessary either to redraft the provision or to add something in the Commentary to clarify the provision. The following is an example of redraft of Article 13(5), which may serve the above purpose.

> "Gains derived by a resident of a Contracting State from the alienation of stock, participation, or other rights in the capital of a company or other legal person which is a resident of the other Contracting State may be taxed in that other Contracting State if the recipient of the gain, during the 12 month period preceding such alienation, had a participation, directly or indirectly, of at least _____ percent in the capital of that company or other legal person."

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[38] For example, the following guidance would be useful:

> "Temporary injection of cash or other assets in the company shortly before the transfer of shares would be disregarded when interpreting paragraph 4."

[39] The following case shows an example of tax avoidance using "dilution or splitting". This case is excerpted from [case 2] of the comments on Abusive Transaction, which Mexican Expert (Mr. Armando Lara Yaffar) of the Committee has submitted:

- Company "A", resident of country X, has a participation of 100% of the capital stock in "B".
- "B" is a company resident of Country Y.
- "A" wants to sell all its participation in "B" to "C".
- "C" is a company resident of Country Y.

The treaty between Country X and Country Y states that gains from the alienation of shares that represent a participation of more than 25% of the capital of a company resident in one of the States may be taxed in that State. However, the tax so charged shall not exceed 20% of the taxable gains. If "A" sells all its participation in "B", the profits derived from such alienation would be subject to a 20% withholding tax. To avoid such taxation, "A" performs several sales not exceeding the 25% participation limit referred to in the Convention, until it reaches the desired 100%. Country X tax capital gains as ordinary income. However, income derived from the alienation of a qualified participation is exempt. The exemption participation scheme, in addition to the restriction set forth in the Convention, results an attractive strategy to those companies residents of Y that want to sell their shares without paying tax. Moreover, when the shareholders residents of X alienate enterprises in Country Y, they can do so without paying taxes in none of the Contracting States.

IV. Reaction to Tax Treaty Abuse: Measures to Counter Tax Treaty Abuse

A. Pool of Domestic Anti-abuse Measures

79. The reaction to treaty abuse would begin with an attempt to apply the domestic tax rules that were set up to prevent tax avoidance cases harmful to the fiscal interests of States. Some domestic anti-abuse measures – i.e. specific anti-abuse rules, general anti-abuse rules (GAAR), codification of "economic ownership" or "substance over form principles" - are summarized in the following.

1. Specific Anti-abuse Rules

80. Most countries have a collection of specific anti-abuse rules designed to deal with situations where abuse cases are likely to arise. The specific anti-abuse rules that are commonly adopted to deal with such situations usually provide, for example, *i)* valuation rules to impute market value to certain transactions between related parties; *ii)* rules to treat certain transactions as unrealized; *iii)* rules to change the character of income from certain transactions. Prevention of tax avoidance can be achieved in many ways. For example, the tax rules may simply prescribe the tax consequences of a defined transaction in all circumstances. Or the tax law may create a presumption which the taxpayer has to rebut if the transaction is to be permitted to operate unchanged. Likewise, tax rules may impugn the transaction only where the taxpayer entered into the transaction with a tainted purpose of achieving a particular tax outcome. Typical examples of specific anti-abuse rules are illustrated in the following.

1.1 Transfer Pricing Rules[40]

81. Where a transaction takes place between related parties, the tax system will treat the transaction as if it occurred at the arm's length (or market) value[41].

1.2 Purpose-based Limits

82. Taxpayers may be entitled to certain tax benefits only if they have not entered into the transaction for the purpose of securing the benefit.[42]

1.3 "Related to the Business" Test for Personal Expenditure

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[40] Some countries may consider that transfer pricing rules are not anti-abuse rules but rules for the proper determination of the tax base.

[41] Example : Section 482 of Internal Revenue Code of the United Sates

In any case of two or more organizations, trades, or businesses … owned or controlled directly or indirectly by the same interests, the [Internal Revenue Service] may distribute, apportion, or allocate gross income, deductions, credits, or allowances, between or among [them], if [it] determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any [of them].

[42] Examples: Section 453of Internal Revenue Code of the United Sates

IRS allows taxpayers to report gains on long-term contracts under the installment method, unless the transaction had "as one of its principle purposes the avoidance of Federal income tax".

83. Where a taxpayer incurs expenditure that is not viewed as being exclusively for the business, that expenditure should not be eligible for tax deduction.

1.4 Re-characterization of Income in case of Conduit Arrangement

84. If *(i)* tax is reduced due to the existence of an intermediary, *(ii)* there is a tax avoidance plan, and *(iii)* it is established that the intermediary would not have participated in the transaction but for the fact that the intermediary is related party, the intermediary will be deemed as a conduit[43]. And therefore the transactions with the conduit should be disregarded.

2. General Anti-Abuse Rules (GAAR)

85. Several countries have adopted a general rule to deal with tax avoidance that is not adequately covered by specific rules applied in certain circumstances or by special rules which protect certain tax incentives against taxpayers' attempts for using such incentives improperly. Mostly these rules are applied to both domestic abuse cases and treaty abuse cases. Examples of a GAAR can be found in Canada[44], Australia, New Zealand and Sweden, etc..

86. In general, a GAAR should possess the characteristics or elements by which the following questions can be raised:
- Whether or not the transaction takes a certain artificial or unnecessarily complex form
- What was the purpose of the taxpayer in entering into the transaction
- Whether the taxpayer obtains a tax benefit for someone else through the transaction
- Whether the taxpayer exercises an election to secure a benefit he intended to have
- What can be done to reconstruct the tax consequences intended by the taxpayer
- How the GAAR fits with the specific rule.

87. It is generally believed that a GAAR should apply to the schemes that bring about the following consequences:
- Omitting taxable income or increasing deductions
- Converting income in one form (e.g. interest) into income in another form (e.g. dividends)

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[43] The U.S. has a provision in its tax law, which enables the IRS to issue regulations that may re-characterize transactions among multiple parties, as categorized as "financing arrangements," into a simpler transaction between two or more parties. Another example is the Foreign Investment in Real Property tax Act adopted by the US in 1980. According to this Act, if a non-resident or a foreign corporation transfers stock in a U.S. corporation 50% or more of whose assets are made up of real property located in the U.S., capital gains arising therefrom would be deemed as effectively connected to business in the U.S. as if the gains had arisen from transfer of the real property itself.

[44] Section 245 of Income Tax Act of Canada

(2) **General anti-avoidance provision.** Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

(3) **Avoidance transaction.** An avoidance transaction means any transaction:

(a) that, but for this section, would result, directly or indirectly, in a tax benefit unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

(4) **Provision not applicable.** For grater certainty, subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

- Converting income from one source (e.g. foreign source) into income from another source (e.g. domestic source)
- Turning an exempt income into a taxable income where associated expenses might be important in reducing an overall tax burden of taxpayers
- Shifting income subject to withholding tax from offshore to onshore where the effective rate on net income is less than the withholding rate on the gross amount
- Reducing the exposure to interest and penalties
- Increasing tax credits.

3. Codification of "Substance-over-form" or "Economic Substance" Principle

88. The substance-over-form principle is generally applied to ensure that taxpayers in the same economic position should bear the same amount of tax burden. This principle frequently functions as an anti-abuse device in that it disregards "form" designed to shift income from the genuine owner of the income to another person. The principle is recognized in most countries as one of the basic taxation principles. However, the interpretation of the term "substance" varies considerably from country to country.[45] That is mainly because countries generally have different views as to the way they approach the issues of the tax avoidance and as to the degree of allowing substance to prevail over form.

89. In some countries such as the US or the UK, the substance-over-form principle is understood as a part of court-made law. However, in some other countries such as South Korea[46] or Japan, this principle is explicitly prescribed in tax laws. It is presumed that the main reason for this codification was to provide clearer basis or guidance for the court's decision regarding tax avoidance cases.

B. Applicability of Domestic Anti-abuse Measures to Treaty Abuse Cases

90. As mentioned above, it is often the case that the national tax authorities responsible for investigating abusive cases apply the domestic anti-abuse measures described above. Such measures are usually bound by the requirements of their own tax systems, rather than by general considerations relating to the special status of the treaty rule that has been abused or evaded. With regard to the issues of whether a domestic anti-abuse measures are applicable to a treaty abuse case, there exit largely two schools of thoughts.

91. The first group is the one that stresses the importance of international aspect of the tax treaty and the treaty obligations as set forth in Article 27 of the Vienna Convention on the Law of

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[45] International Fiscal Association 2002 Oslo Congress, General Report (Frederik Zimmer), *Form and substance in tax law*, Cahiers de droit fiscal international, 2002 Rotterdam (the Netherlands), p.61.

[46] The substance-over-form principle is embodied in Article 14 of the Basic Act for National Taxes as follows: "1. In the case of an international transaction, if a person to which any income, revenue, property, activity or transaction that is the subject of taxation is attributable in name is different from a person to which such income, revenue, property, activity or transaction is attributable in substance, the latter-mentioned person shall be the taxpayer, and tax treaties shall be applied accordingly.
2. In the case of an international transaction, provisions regarding the calculation of the tax base shall be applied based on the substance of the relevant income, revenue, property, activity or transaction, regardless of any term used to refer to them or forms thereof, and tax treaties shall be applied accordingly."

Treaties(VCLT)[47]. The general view of this group is well summarized in the report of Prof. Garcia Prats as follows:

> "29. If the application of the domestic anti-abuse rule leads to a reconsideration of the facts to which the tax rule — in this case the treaty rule — applies, it is difficult to argue that the domestic rule constitutes a breach of treaty obligations, regardless of the validity of the reconstructive mechanisms of proof employed.
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> 30. If, on the other hand, the application of the domestic anti-abuse rule leads to a legal recharacterization of the situation or arrangement devised in order to commit treaty abuse, whether or not there is a unilateral breach of treaty obligations — with reference to the beneficiaries of the treaty — will depend on the impact of the recharacterization on the conditions governing the application and interpretation of the treaty. If the exemptions issue relates to the domestic tax rule, it cannot be argued that there are insuperable obstacles to the application of the recharacterizing domestic tax rule. However, if the **recharacterization** occurs first and gives rise to the application of a different treaty rule with different effects, the increased tax liability of the individual could be seen as a unilateral modification of the conditions governing the application of the treaty, thus contravening the ***pacta sunt servanda*** principle. In that event, the attempt by States to make domestic anti-abuse rule prevail over particular treaty obligations might succeed through the inclusion in the tax treaty itself of a safeguard clause authorizing the application of domestic tax rules."[48]

92. The other group is the one that stresses the aspect of integrity between domestic tax laws and tax treaty in their implementation. According to this view, which is described in the Commentary on Article 1 of the 2003 OECD Model Convention as shown below, domestic anti-abuse measures can be used as valid devices for recharacterizing an income in question if some conditions are met:

> "9.2 […] These States take account of the fact that taxes are ultimately imposed through the provisions of domestic law, as restricted (and in some rare cases, broadened) by the provisions of tax convention. Thus, any abuse of the provisions of a tax convention could also be characterised as an abuse of the provisions of domestic law under which tax will be levied. For these States, the issue then becomes whether the provisions of tax conventions may prevent the application of the anti-abuse provisions of domestic law, which is the second question above. As indicated in paragraph 22.1 below, the answer to that second question is that to the extent these anti-abuse rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions.
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> 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

[47] According to Article 27 of VCLT, "a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty".

[48] Highlights were made for the purpose of comparison with the position of OECD shown in the next paragraph.

secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and the purpose of the relevant provisions.

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, which is the second question mentioned in paragraph 9.1 above.

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. For example, to the extent that the application of the rules referred to in paragraph 22 results in a **recharaterisation** of income in a **redetermination** of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes."[49]

④ [Members of the Committee are invited to provide their comments on the issue of 'Applicability of Domestic Anti-abuse Measures to Treaty Abuse Cases'.]

93. One way to ensure the clarity in the application of the domestic anti-abuse provisions to a treaty abuse case is to include in such treaties an explicit safeguard clause allowing for the application of such provisions against the treaty abuse. From a practical standpoint, this approach has the advantage of making application easy and helping avoid any legal problem caused by a departure from treaty primacy. It should be noted, however, that the use of such "authorizing" clauses does not automatically prejudge whether or not it is possible to apply domestic anti-abuse laws in cases where there is no such clause in tax treaties. Further, this proposal is not helpful in a situation where, despite an offer by a contracting state to include an explicit safeguard clause in the tax treaty, the other contracting state rejects the offer or deliberately avoids starting renegotiation of the tax treaty in question.

C. Treaty Measures for Preventing Tax Treaty Abuse

94. The issues of the "abuse of tax treaties" or the "improper use of tax treaties" are currently dealt with in the Commentary on Article 1 of the UN Model Convention. Current provisions of UN Model Convention on these issues are mainly taken from the relevant parts of the 1992 Commentary on Article 1 of the OECD Model Convention. In 2003, however, the OECD issued extensive revisions to the Commentary on Article 1 of the Model Convention that purport to clarify the relationship between tax treaties and domestic anti-abuse rules, and the problems concerning the improper use or abuse of tax treaties. The guidance and a number of recommended provisions introduced in the above Commentaries are quite useful in understanding the meaning and background of various anti-abuse provisions included in the actual tax treaties among countries.

[49] Highlights were made for the purpose of comparison with the position of Prof. Garcia Prats expressed in the prior paragraph.

95. Various tax measures shown in the above Commentaries and actual tax treaties can be largely divided into three categories as follows:

(i) Safeguard clauses recognizing that the application of domestic anti-abuse provisions does not violate the treaty provisions[50],

(ii) General Anti-abuse rule, and

(iii) Specific Anti-abuse rules.

Following Sub-sections will discuss issues with regard to the above three categories one by one.

1. Safeguard Clauses recognizing that the Application of Domestic Anti-Abuse Provisions does not Violate the Treaty Provisions

96. The approach of this category, as discussed in Section 4.2. of this draft report, basically relies on the fact that tax is levied under the provisions of domestic law, not of treaties and, therefore, an abuse involving tax treaty provisions can also be characterized as an abuse of the provisions of domestic law under which tax must be paid.[51] The following provision excerpted from paragraph 22.1 of the 2003 Commentary on Article 1 of the OECD Model Convention supports this approach:

> "22.1 Such rules (substance-over-form rule, economic substance rule and general anti-abuse rule) 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 […]."

97. Actual treaty provisions following this approach can be found in some tax treaties. Article 27 (Application of the Agreement in Special Cases) of the 2002 Korea-Germany tax treaty might be a good example for this.

> "1. This Agreement shall not be interpreted to mean that
> (a) a Contracting State is prevented from applying its domestic legal provisions, on the prevention of tax evasion or tax avoidance as long as those provisions are in accordance with the principles contained in this Agreement, […]."

98. Another example can be found in Article 1 (e) of the Exchange of Notes of the 2003 Australia-UK tax treaty as follows:

> "(e) Nothing in the Convention shall be construed as restricting, in any manner, the application of any provision of the laws of a Contracting State which is designed to prevent the avoidance or evasion of taxes."

2. General Anti-Abuse Rules (GAAR)

99. It is conceivable to include general anti-abuse provisions in tax treaties as domestic statutes of some countries do (Examples are introduced in Section 4.1.2.). Even though it is not easy to find an example of a GAAR from existing tax treaties, the 'guiding principle' introduced in paragraph 9.5 of the 2003 Commentary on Article 1 of the OECD Model Convention can be regarded as a premise based on which a GAAR of the tax treaty can be

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[50] As a consequence, they bring about the same effect as they authorize the application of domestic anti-abuse provisions without limitation.

[51] See Paragraph 26 of the report of Mr. Sasseville.

developed. The following provision is an example of a GAAR of the treaty by means of the above-mentioned 'guiding principle':

> "The benefits of this Convention shall not be available where a main purpose for entering into transactions or arrangements is to secure a more favorable tax position and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions of this Convention."

100. Even in case where a country does not have such provisions in its tax treaties, if it commits itself to applying the 'guiding principle' of the 2003 OECD Commentary in dealing with treaty abuse cases, by exchange of notes or through MOU with its treaty partners, then the 'guiding principle' will be working as a GAAR of tax treaties in question.

101. Another example to be considered as a candidate for a GAAR of the tax treaty can be found in comments of Prof. McIntyre submitted to the Sub-committee on Tax Treaty Abuse as follows[52]:

> "In determining whether a taxpayer is entitled to a claimed treaty benefit, substance should prevail over form. A Contracting State, at its discretion, may decline to provide a benefit otherwise provided under this Convention if either the transaction (or set of related transactions) giving rise to a claim for that benefit lacks economic substance, or the transaction (or set of related transactions) was not motivated by a *bona fide* business or investment purpose.
> (i) A transaction or set of related transactions shall not be considered to have a *bona fide* business or investment purpose if one of the substantial purposes for entering into the transaction or set of related transactions was the avoidance or evasion of taxes.
> (ii) A transaction or set of related transactions shall be considered to lack economic substance:
> (A) If the reasonably anticipated financial gain from the transaction or set of related transactions, aside from tax benefits, is zero or less; or
> (B) If the reasonably anticipated financial gain from the transaction or set of related transactions, aside from tax benefits, is trivial relative to the capital invested, risks incurred, or services performed.
> (iii) A taxpayer does not have the right to repudiate the form it has chosen for conducting its own transactions or the transactions of related persons or other persons under common control."

102. Anyhow, providing a GAAR in a tax treaty has the implication that domestic anti-abuse rules that do not meet the GAAR in the treaty conflict with the provisions of the tax treaty, and, therefore, the application of such domestic rules can be precluded by tax treaties[53].

103. A close look at paragraphs 9.2 and 22.1 of the 2003 Commentary on Article 1 of the OECD Model Convention leads to the conclusion that the OECD supports the idea of a GAAR provided in tax treaties more than the principle described in Section 4.3.1. (Safeguard Clauses Authorizing the Application of Domestic Anti-Abuse Provisions without Any Limitation) in dealing with the issue of

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[52] Refer to "2 (b) of Article 1 (Interpretation of this Convention)" in "IV. Comments from Mr. McIntyre", Supplementary Note to "Treaty Abuse and Treaty Shopping".

[53] Brian J. Arnold and Stef van Weeghel, 'Chapter 5: The Relationship between Tax Treaties and Domestic Anti-abuse Measures' in *Tax Treaties and Domestic Law,* EC and International Tax Law Series, Vol.2, p.95.

the relationship between tax treaty and domestic anti-abuse measures. Such conclusion is drawn because the OECD Commentary justifies the application of the domestic anti-abuse measures to the cases of treaty abuse **to the extent that** such domestic measures meet the criteria set out in the guiding principle of paragraph 9.5[54] of the 2003 Commentary on Article 1 of the OECD Model Convention as shown below:

> "9.2 […] As indicated in **paragraph 22.1 below**, the answer to that second question is that to the extent these anti-abuse rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions."
>
> "22.1 […] Thus, as a general rule and **having regard to paragraph 9.5**, there will be no conflict […]."

⑤ [Members of the Committee are invited to provide their comment as to whether or not the Commentary of Article 1 of the UN Model Convention should have the same guiding principle as that of the OECD in order to cope with issues of treaty abuse effectively. If the OECD's guiding principle is neither appropriate nor sufficient to deal with issues of tax treaty abuse, what else can be recommended? Is the work of providing the "guiding principle" in an actual tax treaty desirable?]

104. The 2003 OECD Commentary recognizes two possible approaches to dealing with a potential abuse. One approach is to rely on the anti-abuse rules of domestic law discussed above. The other approach is to view some abuses as being abuses of the convention itself as opposed to abuses of domestic law, and to disregard abusive transactions under a proper interpretation of the 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[55]. A GAAR provided in a tax treaty will also be very useful in serving the latter purpose.

3. Specific Treaty Anti-abuse Rules

105. Specific treaty anti-abuse rules provide more certainty to taxpayers and tax administrations. This is acknowledged in paragraph 9.6 of the 2003 Commentary on Article 1 of the OECD Model Convention, which states that such rules can usefully supplement general anti-abuse provisions or judicial approaches[56].

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[54] Under that guiding principle, two elements must 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.

See paragraph 32 of the report of Mr.Sasseville.

[55] *Id*., paragraph 24.

[56] "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 such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy […]."

106. The current UN Model Convention deals with specific treaty anti-abuse rules in Articles 10 (2), 11(2), 11(6), 12(2) and 12(6) for the concept of "beneficial ownership" and Article 17 (2) for the prevention of tax abuse using so-called 'artiste company'. Besides, paragraphs 8 to 11 of the Commentary on Article 1 of the UN Model Convention introduce specific provisions on the criteria for identifying bona fide cases from conduit cases. Further, paragraph 4 of the Commentary on Article 24(3) of the UN Model Convention includes a provision for preventing a treaty abuse technique using the triangular cases discussed in Section 3.3.1.3. of this draft report.

107. All wordings and paragraphs mentioned above reproduce the relevant parts of the 1992 OECD Model Convention and its Commentary. However, as the report of Prof. Garcia Prats shows below, there may be some invalid omission in assimilating appropriate parts of the 1992 OECD Commentary and therefore a further consideration may be needed in updating the UN Model Convention and its Commentary:

> "39. According to paragraphs 28 and 29 of the "Draft report of the Focus Group of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on its second meeting",[6] paragraphs 7 to 10 of the commentary on article 1 of the OECD Model Convention should be inserted into the United Nations Model Convention, and the discussion in the OECD commentary on treaty abuse issues (paragraphs 22 to 26 in the version of the OECD Model Convention current at that time) could usefully be incorporated in the United Nations Model Convention.
>
> 40. However, the material finally inserted differed considerably from this suggestion, although no reason for the omissions emerged in the debate in the Group of Experts. Former paragraph 12 of the OECD commentary on article 1, which contains general considerations to be borne in mind in adopting one approach or another was not inserted. Moreover, the paragraphs enumerating the advantages and disadvantages of adopting each particular approach were omitted (paragraphs 14, 16, 18 and 20). Even conceding that such a wholesale borrowing was unnecessary, the failure to reflect in the United Nations Model Convention the views discussed and noted in the Group of Experts' own 1987 report is difficult to understand. The "channel" clause, an effective mechanism for dealing with "stepping-stone" devices (paragraphs 19 and 20), was not adopted, either, even though the 1987 report discussed that approach […]."

⑥ [Members of the Committee are requested to provide their comments on the proposal of Prof. Garcia Prats.]

108. In 2003, the OECD updated many parts of its Commentary relating to specific treaty abuse rules. Updates included in the Commentary on Article 1 are *(i)* use of the concepts of place of effective management and permanent establishment (para. 10.1- 10.2), *(ii)* a comprehensive limitation-of-benefits provision (para. 20), *(iii)* provisions which are aimed at particular types of income that is subject to low or no tax under a preferential tax regime (para. 21-21.2), *(iv)* anti-abuse rules dealing with source taxation of specific types of income (para. 21.3-21.4), *(v)* provisions which are aimed at preferential regimes introduced after the signature of the convention (para. 21.5), *(vi)* provisions for 'remittance based taxation' (para. 26.1), and *(vii)* provision for 'procedural issues of source taxation' (para.26.2). The 2003 update also includes the further clarification of the concept of "beneficial ownership" in Commentaries on Article 10 (para. 12-12.2), 11 (para. 9-11) and 12 (para. 4-4.2).

109. The question naturally to be raised at this stage is whether or not (and to what extent if incorporation is made) the UN Model Commentary incorporates in its updated version each changed part of the OECD Commentary. Additionally, the question of whether the 'limitation of benefits' should be put forward in an Article of the UN Model needs to be contemplated as the Group of Expert raised that issue at its 11th meeting (held in 2003). In particular, the Group noted that many developing countries have difficulty negotiating treaties with some developed countries because the major taxpayers in those countries are able to get the benefits of a treaty by using the treaty negotiated with another country[57]. However, it should be also noted that many OECD countries prefer other approaches to the approach of 'limitation of benefits' as proposed in paragraph 20 of the 2003 OECD Commentary on Article 1 when dealing with issues of tax treaty abuse. Detailed explanations of Prof. Garcia Prats on the 'limitation-of-benefits' clauses described in his report (para.41-65) can be used as a good reference for responding to the above question.

⑦ [Members of the Committee requested to provide their comments on above questions.]

110. So far, discussion has been focused on how to update the UN Model and its Commentary, based on the presumption that they should keep pace with the development of the OECD Model and its Commentary. However, the UN Model and its Commentary may play a more proactive role by taking an initiative in the formulation of international tax guidance than just a passive role by merely following the guidance already established among some advanced countries. The 2003 update of the OECD Model Convention on the capital gains tax (i.e. the inclusion of Article 13(4) which allows source taxation for capital gains from alienation of shares deriving more than 50% of value from immovable property) demonstrates the fact that the UN Model can play a leading role in establishing the international tax guidance because the UN Model had already contained such a provision in Article 13(4) of its Convention even before the OECD changed its position on the taxation of the capital gains in 2003.

111. In this context, the Committee may give high priority to the work of developing 'specific treaty anti-abuse rules' vis-à-vis various treaty abuse cases (of which prototypes are categorized at Section 3.3. of this draft report) with a view to including them in the UN Model Commentary.

112. As an example of an area for which the UN Model Convention could take an initiative, 'beneficial ownership' concept can be considered. Up to now, provisions of both the OECD and UN Model Conventions regarding beneficial ownership lack integrity in the sense that the concept applies only to certain types of income. Considering that the concept was first introduced to deal with an income that is easily shifted to persons other than genuine owners, it would be natural to expand the scope of its application now so that the concept may cover all of such categories of income. This means that beneficial ownership concept should be expanded to other types of income including capital gains (Article 13) as long as the transaction in question involves a conduit arrangement. Proponents of this proposal argue that the 'beneficial ownership' concept can be understood as a variation of the substance-over-form rule and therefore there is no point in confining its application only to dividends, interest and royalties.

[57] See paragraph 25 of the Summary Record of 11th meeting of the Group of Experts.

113. Another food for thought in the context of the development of specific anti-abuse rules is about the "conduit arrangement" as proposed by previous Chinese Expert in his comment to the sub-committee, which is quoted below[58]:

"The US style of anti-conduit arrangement is to define the term "conduit arrangement" in Article 3 as follows.

k) the term "conduit arrangement" means a transaction or series of transactions:

(i) which is structured in such a way that a resident of a Contracting State entitled to the benefits of this Agreement receives an item of income arising in the other Contracting State but that resident pays, directly or indirectly, all or substantially all of that income (at any time or in any form) to another person who is not a resident of either Contracting State and who, if it received that item of income direct from the other Contracting State, would not be entitled under an Agreement for the avoidance of double taxation between the State in which that other person is resident and the Contracting State in which the income arises, or otherwise, to benefits with respect to that item of income which are equivalent to, or more favorable than, those available under this Agreement to a resident of a Contracting State; and

(ii) *which has as its main purpose, or one of its main purposes, obtaining such increased benefits as are available under this Agreement.*

Then the following paragraph is added in the passive income articles.

The provisions of this paragraph shall not apply in respect of any dividend (interest, royalties) paid under, or as a part of, a conduit arrangement."

⑧ [Members of the Committee are requested to provided their comments concerning the above proposals on "beneficial ownership" and "conduit arrangement".]

114. Clearly, proponents of 'specific treaty anti-abuse rules' may argue that those rules provide more certainty or predictability to both taxpayers and tax administrations. However, the following comments of Mr. Sasseville warning against the extensive reliance on specific treaty anti-abuse rules also need to be considered[59]:

"18. […] One should not, however, underestimate the risks of relying extensively on specific treaty anti-abuse rules to deal with tax treaty avoidance strategies.

19. First, specific tax avoidance rules can only be drafted once a particular avoidance strategy has been identified. It would be extremely naive to believe that all potential avoidance strategies can be identified prospectively. Since a specific anti-avoidance rule will often be drafted only after a particular strategy has become a significant problem, taxpayers that first use that strategy will be advantaged. This particular form of reward for innovation has no place in an equitable tax system: there is no reason why taxpayers who have access to the most imaginative, or aggressive, tax advisers should be advantaged over other taxpayers. The ability to frequently amend domestic tax laws may partly address the

[58] See "II. Comments from China", Supplementary Note to "Treaty Abuse and Treaty Shopping".
[59] See paragraphs 18-22 of Mr. Sassaville's report.

problem in the case of abuses of domestic laws but since tax treaties take so long to amend or replace, this is a very serious deficiency as regards the inclusion of specific anti-abuse rules in tax treaties.

20. Second, the inclusion of a specific anti-abuse provision in a treaty can seriously weaken the case as regards the application of general anti-abuse rules or doctrines to other forms of treaty abuses. Adding specific anti-abuse rules to a tax treaty may well create an expectation that all unacceptable avoidance strategies that rely on treaty provisions will be similarly dealt with and cannot, therefore, be challenged under general anti-abuse rules.

21. Third, in order to specifically address complex avoidance strategies, complex rules may be required. This is especially the case where these rules seek to address the issue through the application of criteria that leave little room for interpretation rather than through more uncertain criteria such as the purposes of a transaction or arrangement. The comprehensive limitation-of-benefits provision put forward in new paragraph 20 of the Commentary on Article 1 provides a good example: that provision attempts to deal with the issue of treaty shopping through precise criteria but is also the longest put forward in the OECD Model Convention. Complex treaty rules are often difficult to negotiate, are more likely to be literally interpreted and carry more risk of affecting non-abusive transactions than short rules that focus on principles.

22. For these reasons, the inclusion of specific anti-abuses rules in tax treaties cannot provide a satisfactory comprehensive solution to treaty abuses."

⑨ [Members of the Committee are invited to provide their comments on the question as to whether or not the UN Model and its Commentary should develop special guidance (or special treaty anti-abuse rule) against each type of treaty anti-abuse case shown in Section III-C of this draft report.]

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