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Abuse of tax treaties and treaty shopping*

Summary

This note presents the work done at the December 2003 meeting of the United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters on the topic of abuse of tax treaties and treaty shopping as well as the work on the same topic that has been done by the OECD.

The Committee is invited to use the latest version of the proposal that was presented at the December 2003 meeting of the United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters as a starting point for its work on abuse of tax treaties and treaty shopping and, on the basis of this note, to determine whether and how to amend the current comments on improper use of conventions which are found in the Commentary on Article 1 of the UN Model Tax Convention.

* The present paper was prepared by the Secretariat of the Organisation for Economic Co-operation and Development. The views and opinions expressed are those of the OECD Secretariat and do not necessarily represent those of the United Nations or of the OECD Member countries.

Contents

I. Work of the Ad Hoc Group of Experts on International Cooperation in Tax Matters

1. The issues of abuse of tax treaties and treaty shopping were discussed at the 11th meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (held on 15-19 December 2003) on the basis of note ST/SG/AC.8/2003/L.3, “Abuse of tax treaties and treaty shopping”, prepared by Professor Francisco Alfredo Garcia Prats, Professor of Tax and Financial Law, University of Valencia (Spain).

2. In that note, Prof. Prats reviewed the work done on this issue at earlier meetings of the Ad Hoc Group of Experts:

> "5. The Ad Hoc Group of Experts on International Cooperation in Tax Matters examined abuse of tax treaties on two occasions in the past, at its second meeting in 1983 and at its fourth meeting in 1987. At the latter meeting, it arrived at some important conclusion that form the basis for the present review and update.[1] On that occasion, the Group of Experts 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. It did not, however, embody these considerations in the update of the United Nations Model Convention in 2001."

3. The discussions that proceeded on the basis of that note at the December 2003 meeting of the Group of Experts were summarized in paragraphs 16-25 of the report of the Secretary-General on the meeting (note E/2004/51 "Eleventh meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters"). These paragraphs are reproduced in Annex 1. According to paragraphs 23-25 of that report:

> "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 (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.
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> 24. The general consensus was that the amendment of the Commentary on article 1 of the United Nations Model Convention deserved further attention

1 See United Nations, Contributions to International Cooperation in Tax Matters: Treaty Shopping, Thin Capitalization, Cooperation between Tax Authorities, Resolving International Tax Disputes (United Nations publication, Sales No. E.88.XVI.1).

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. "

4. As indicated above, a proposal on the update of the Commentary on Article 1 of the United Nations Model Convention was presented at the meeting and the decision was made "that the discussion of changes to the Commentary should continue and should be taken up at the next meeting of the Group of Experts."

5. Shortly after the meeting, Prof. Prats sent to participants to the meeting a revised version of the proposal for amending the Commentary on Article 1. That revised proposal appears in Annex 2.

6. The Committee may wish to use the latest version of the proposal by Prof. Prats as a starting point for its work on abuse of tax treaties and treaty shopping. As discussed in section II, the comments on that topic that are currently found in the UN Model Convention are based on, and refer to, an outdated version of the OECD Model and it would seem necessatry to update these comments. In order to provide the Committee with some of the thinking that led to the revision of the part of the OECD Commentary that deals with the same issues, section III of this note provides an explanation of some of the changes that were made to the OECD Model.

II. Discussion of "improper use of conventions" in the UN Model Convention

7. The topic of the improper use of tax treaties is currently dealt with in paragraphs 8 to 11 of the Commentary on Article 1 of the UN Model Convention. These paragraphs reproduce paragraphs 7-10, 13-17 and 21-26 of the pre-2003 version of the Commentary on Article 1 of the OECD Model Tax Convention.

8. In his note, Prof. Prats commented as follows on the treatment of this topic in the UN Model:

"38. We should first, however, review the process by which the views expressed in the commentary on the OECD Model Convention have been assimilated into the most recent published version of the commentary on the United Nations Model Convention.

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",[2] 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. Consideration should be given to correcting these omissions and to incorporating, with some adjustments, the changes made to the OECD Model Convention in its 2003 update."

III. Work of the OECD on these topics

9. The purpose of the changes made in 2003 to the Commentary on Article 1 of the OECD Model Tax Convention was to clarify how tax treaties interact with domestic anti-avoidance rules and, more generally, how countries can address tax treaty abuses.

10. These topics have long been a source of concerns for the OECD. The introduction of the 1963 Draft Convention noted that "…the Fiscal Committee has recently brought under study the question of the improper use of double taxation Conventions and of fiscal evasion which can result from the interaction of the Conventions and the domestic laws."[3] The 1977 Model described the outcome of that study as follows:

> "The Committee on Fiscal Affairs has examined the question of the improper use of double taxation conventions but, in view of the complexity of the problem, it has limited itself, for the time being, to discussing the problem briefly in the Commentary on Article 1 and to settling a certain number of special cases […] The Committee intends to make an in-depth study of such problems and of other ways of dealing with them."[4]

11. The "in-depth" study to which the 1977 Model referred led to the publication, in 1987, of two reports entitled "Double Taxation Conventions and the Use of Base

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2 "Draft report of the Focus Group of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on its second meeting" (English only) (ST/SG/AC.8/1999/CRP.6).

3 Draft Double Taxation Convention on Income and Capital, OECD, Paris, 1963 (page 27, paragraph 54).

4 Id., page 15 (paragraph 31).

Companies" and "Double Taxation Conventions and the Use of Conduit Companies".[5] Based on these two reports, the section on "Improper Use of the Convention" that had been added in 1977 was substantially extended in 1992. At the same time, the Introduction to the Model Tax Convention was amended to indicate that "[t]he Committee on Fiscal Affairs continues to examine both the improper use of tax conventions and international tax evasion."

12. The changes to the section on "Improper use of the Convention" that were adopted in 2003 were primarily made as a result of follow-up work on recommendations made in 1998 in the context of work on harmful tax competition. These changes to the Commentary on Article 1 deal with a number of different issues:

- the specific anti-abuse rules found in tax treaties (paragraphs 9.6 to 10.2);
- the provisions that may be included in a tax treaty to deal with treaty shopping and other forms of abuse (paragraphs 11 to 21.5);
- the interaction between tax treaties and domestic anti-abuse rules (paragraphs 7 to 9.5 and 22 to 26);
- the compatibility of controlled foreign companies (CFC) rules with tax treaties (paragraph 23).

13. Some forms of treaty abuses can be addressed through specific treaty provisions. The OECD Model Tax Convention recognizes the usefulness of such specific anti-abuse rules. As noted in paragraph 10 of the Commentary on Article 1, a number of such rules are included in the OECD Model Tax Convention. These include the concept of "beneficial owner" (in Articles 10, 11, and 12), the "special relationship" rule applicable to interest and royalties (paragraph 6 of Article 11 and paragraph 4 of Article 12), the rule on alienation of shares of immovable property companies (paragraph 4 of Article 13) and the rule on "star-companies" (paragraph 2 of Article 17).

14. A large part of the section of the OECD Model that deals with "Improper use of the Convention" deals with provisions that may be included in a tax treaty to deal with treaty shopping strategies. Most of these provisions were included through the 1992 update as a consequence of the 1987 report on "Double Taxation Conventions and the Use of Conduit Companies". The 2003 update added a comprehensive limitation-of-benefits provision to the list cautioning, however, that "adaptations may be necessary and that many States prefer other approaches to deal with treaty shopping".

15. New paragraphs 21. to 21.5 of the section similarly include alternative provisions that may be included to deal with other forms of treaty abuses; these include:

- provisions which are aimed at entities benefiting from preferential tax regimes;
- provisions which are aimed at particular types of income that is subject to low or no tax under a preferential tax regime;
- anti-abuse rules dealing with source taxation of specific types of income;

5 These two reports are reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention, at pages R(5)-1 and R(6)-1.

– provisions which are aimed at preferential regimes introduced after the signature of the convention.

16. The OECD Model arsenal of specific treaty anti-abuse rules is completed by references, in different parts of the Commentaries, to provisions or modifications that the OECD invites Contracting States to consider including in their bilateral treaties to deal with a number of possible avoidance strategies.[6]

17. Many of the specific anti-abuse rules put forward in the Commentaries are based on provisions that OECD countries include in their treaties. For instance, all recent United States treaties include a comprehensive limitation-of-benefits provision and a recent example of that provision was the basis for the alternative provision in paragraph 20 of the Commentary on Article 1. Similarly, the articles dealing with dividends, interest and royalties[7] found in recent United Kingdom treaties include a provision according to which the relief provided by the relevant article shall not be available if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the property in respect of which the relevant income is paid is to take advantage of the article by means of that creation or assignment;[8] that provision was the basis for the alternative provision now found in paragraph 21.4 of the Commentary on Article 1.

18. Clearly, such specific treaty anti-abuse rules provide more certainty to taxpayers and tax administrations. This is acknowledged in paragraph 9.6 of the Commentary, which explains that such rules can usefully supplement general anti-avoidance rules or judicial approaches.[9] 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

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6 For example: paragraphs 6.3 and 18 of the Commentary on Article 5 (to deal with attempts to abuse the 12-month rule applicable to construction sites); paragraph 17 of the Commentary on Article 10 (to deal with attempts to abuse the preferential rate of source taxation on dividends from substantial shareholdings); paragraph 22 of the Commentary on Article 10, paragraph 12 of the Commentary on Article 11 and paragraph 7 of the Commentary on Article 12 (to avoid granting the benefits of Articles 10, 11 and 12 to non-resident-owned companies that enjoy preferential tax treatment); paragraph 17 and 20 of the Commentary on Article 18 (to deal with attempts to abuse the suggested provision allowing relief for contributions to a foreign pension scheme); paragraph 6 of the Commentary on Article 21 and paragraph 53 of the Commentary on Article 24 (to deal with cases where shares, loans or rights would be transferred to a permanent establishment in the other State to enjoy a preferential treatment and benefit from the exemption method); paragraphs 31, 31.1 and 35 of the Commentary on Articles 23A and 23B (to deal with low or non-taxation situations arising from the exemption method) and paragraph 78.1 of the Commentary on Articles 23A and 23B (to deal with abuses of tax sparing provisions).

7 In some treaties, the provision is also found in the Article on Other Income.

8 For example, four such provisions are found in the United-Kingdom-Australia treaty that entered into force on 17 December 2003: see paragraph 7 of Article 10 (Dividends), paragraph 9 of Article 11 (Interest), paragraph 7 of Article 12 (Royalties) and paragraph 5 of Article 20 (Other Income).

9 “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

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 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.

23. Where no specific treaty anti-abuse rule apply to a particular avoidance strategy involving the provisions of a tax treaty, the OECD Commentary[10] recognizes two possible approaches to dealing with a potential abuse.

24. One approach is to consider that there is an abuse of the treaty itself 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.

25. Paragraph 8 of the Commentary on Article 15 may be seen as an example of that approach. That paragraph refers to the situation where a local employer wishing to hire a foreign worker for less then 183 days recruits him through a non-resident intermediary so as to obtain the benefits of the exception from source taxation provided by paragraph 2 of Article 15. According to the paragraph

> "To prevent such abuse, in situations of this type, the term "employer" should be interpreted in the context of paragraph 2.[…] In this context, substance should prevail over form, i.e. each case should be examined to see whether the functions of employer were exercised mainly by the intermediary or by the user."

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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 […]."

10 New paragraphs 9.2 and 9.3 of the Commentary on Article 1.

26. The second approach is to rely on the anti-abuse rules of domestic law. As explained in new paragraph 9.3 of the Commentary on Article 1, that approach 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 characterised as an abuse of the provisions of domestic law under which tax must be paid.

27. A reference to that approach may be found in paragraph 18 of the Commentary on Article 5, which deals with abuses of the 12-month exception of paragraph 3 of Article 5 applicable to construction sites. According to the Commentary "[…]such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules."[11]

28. A possible difficulty with that second approach, however, is that in case of conflict between the provisions of tax treaties and those of domestic law, the provisions of tax treaties must prevail. This is a logical consequence of the principle of "*pacta sunt servanda*" which is incorporated in Article 26 of the Vienna Convention on the Law of Treaties. Thus, if the application of domestic legislative or judicial anti-avoidance rules had the effect of increasing the tax liability of a taxpayer beyond what is allowed by a tax treaty, this would conflict with the provisions of the treaty and these provisions should prevail under public international law.

29. In the case of domestic legislative or judicial anti-avoidance rules that clearly focus on abuses, however, such conflicts should not arise. This is the general conclusion of the OECD, which is reflected in new paragraphs 22 and 22.1 of the Commentary on Article 1. That view generally corresponds to what was previously presented in the Commentary as the view of the "vast majority of OECD countries".

30. Having concluded that the approach of relying on the anti-abuse rules and judicial doctrines of domestic law does not, as a general rule, conflict with tax treaties, the OECD was therefore able to conclude that "[u]nder both approaches […] States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into."

31. That conclusion leads logically to the question of what is an abuse of a tax treaty. The OECD did not attempt to provide a comprehensive reply to that question, which would have been difficult given the different approaches of its Member countries. Nevertheless, the OECD presented the following general guidance, which was referred to as a "guiding principle":12

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

32. This paragraph serves an important purpose as it attempts to balance the need to prevent treaty abuses with the need to ensure that countries respect their treaty

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11 See also paragraph 32 of the Commentary on Article 10, paragraph 25 of the Commentary on Article 11, paragraph 21 of the Commentary on Article 12 and paragraph 6 of the Commentary on Article 21 (dealing with cases where shares, loans or rights would be transferred to another State's permanent establishment that would enjoy preferential treatment).

12 Paragraph 9.5 of the Commentary on Article 1.

obligations. 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.

33. It is important to note that paragraphs 9.4 and 9.5 focus on the abusive arrangements to which anti-abuse rules could apply rather than on the rules as such. This is clear from the wording of paragraph 9.4, which provides that "States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into"; similarly, the principle of paragraph 9.5 refers to the transactions or arrangements that should not be entitled to treaty benefits. The principles of these paragraphs do not, therefore, apply as a test to decide whether or not a particular domestic rule or doctrine conforms to the provisions of a tax treaty. A particular anti-abuse rule may well conform with treaty obligations even when it applies to non-abusive transactions (this would be the case, for example, of a thin capitalisation rule that meets the conditions described in subparagraph 3*a*) of the Commentary on Article 9 or of controlled foreign companies legislation, as explained in paragraph 23 of the Commentary on Article 1). The conclusions of paragraphs 9.4. and 9.5 would primarily be relevant to justify the application of an anti-abuse rule or approach to a specific abusive case (as described in these two paragraphs) if the application of that rule or approach would prima facie appear to violate specific treaty provisions. Thus, as suggested by the first sentence of paragraph 9.6 and by the wording of paragraph 22, these paragraphs will primarily be relevant as regards the application of general anti-abuse rules or doctrines, which address transactions or arrangements that seem to comply with the specific provisions of the domestic law and of a treaty.

ANNEX 1 : Excerpt from note E/2004/51 (Report of the Secretary-General on the Eleventh meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters

"III. Treaty shopping and treaty abuses

16. Many significant international developments have occurred since the topic of treaty abuses and treaty shopping were last addressed by the Group of Experts.

17. Three main questions were addressed in the meeting. First, what is considered a treaty abuse? In that connection, it is necessary to decide who is to determine the existence of an abuse. Second, how are the standards for dealing with treaty abuse being established? In that connection, the standards for determining an abuse might be included in the treaty itself. Third, is it acceptable to deal with treaty abuse with domestic anti-abuse mechanisms? In that connection, it may be necessary to take account of the legal nature of treaties and the obligations derived from the public International Law of Treaties.

18. Representatives noted that although a precise definition of the term “treaty abuse” is not available, there is a broad recognition that treaty abuses exist and must be dealt with. The impossibility of reaching a common definition of a treaty abuse was partly due to the mechanisms for dealing with tax treaty abuse. Persons covered by a tax treaty are its ultimate beneficiaries, despite the fact that a treaty is signed by contracting States and is intended to advance the interests of the contracting States.

19. The existence of a treaty abuse implies an indirect violation of the law, contrary to its goal and objectives. Such a violation can only be determined after taking into account the specific circumstances of a particular case. In general, a treaty abuse is determined by national authorities under their domestic law and according to their legal tradition. For this reason, the concept of a treaty abuse is likely to vary from State to State. The question of treaty abuse is often a question of who are the bona fide beneficiaries of the treaty.

20. Normally, the term treaty abuse is used to refer to situations in which the taxpayer is seeking to circumvent the law. But consideration should also be given to cases in which one of the contracting States takes advantage of the good faith of the other contracting State to the Treaty by making a future amendment to its laws or by administrative practices that lead to significant losses of resources of the other contracting State. The two situations, abuse by the taxpayer and abuse by the contracting State, should be distinguished in the framing of the rules used to determine the existence of the abuse, in identifying the bodies that would declare the existence of an abuse and in establishing the legal consequences of identifying an abuse.

21. Treaty abuse and treaty shopping should not be confused. Treaty shopping relates to situations in which an individual benefits from a treaty without being the legitimate beneficiary of it. Treaty abuse, on the contrary, refers to situations in which the result of a certain operation is in contradiction with the treaty. Whenever the treaty shopping issue is considered important, it should be addressed specifically in the treaty, including countervailing measures to combat it. Nevertheless, in

certain treaty shopping situations, general measures countervailing abuse could be used even in the absence of a specific provision in the treaty.

22. It was noted that a real need exists for new tools to deal with treaty shopping, taking into consideration the willingness of some States to promote it. In that respect, countries should look carefully into the practices of those States before entering into a treaty with them.

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 (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.

ANNEX 2: Proposal resulting from the discussions at the 11th meeting of the Ad Hoc Group of Experts

The following is the latest version of the proposal for revising the relevant parts of the Commentary on Article 1 of the UN Model Convention. That version was circulated by Prof. Prats shortly after the 11th meeting of the Ad Hoc Group of Experts (***bold italics*** indicate proposed additions to the existing text of the Commentary of the UN Model Convention; ~~strikethrough~~ indicate proposed deletions):

Page 43 [of the English version of the UN Model Convention].

"8. With respect to the improper use of the convention, the OECD Commentary observes as under:

"*Improper use of the Convention*

The ***principal*** purpose of double taxation conventions is to promote,...."

Page 43 (between paragraphs 9 and 10). The recommendation consists on the inclusion of paragraph 9.1, 9.2, 9.3 and 9.4 of the OECD Commentary, with a further explanation of the relationship between the domestic anti-abuse rules and Tax Conventions, which has to be inferred from the Commentaries of the OECD Model Convention, the conclusions of the UN Report of 1987 and the results of the discussion by the Ad Hoc Group of the issue. It is suggested to establish the relationship with a coherent form, for which purpose the paragraphs 22 to 26 of the OECD Commentary are placed consistently after these general considerations.

"....transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax." [para. 9]

" This raises two fundamental questions that are discussed in the following paragraphs:

- ***whether the benefits of tax conventions must be granted when transactions that constitute an abuse of the provisions of these conventions are entered into...; and***
- ***whether specific provisions and jurisprudential rules of the domestic law of a Contracting State that are intended to prevent tax abuse conflict with tax conventions... [para. 9.1]***

Relationship between domestic anti-abuse rules and Tax Conventions

With respect to the relationship between domestic anti-abuse rules and Tax Conventions, the OECD Commentaries observe as under

"For many States, the answer to the first question is based on their answer to the second question. These States take account of the fact that taxes are ultimately imposed through the provisions of domestic law, as restricted (and in some cases, broadened) by the provisions of tax conventions. Thus, any abuse of the provisions of a tax convention could also be characterised as an abuse of the provisions of the 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. ...To the extent these anti-avoidance 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 genera rule, there will be no conflict between such rules and the provisions of tax conventions". [para. 9.2].

"Other States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties)". [para. 9.3]

"Under both approaches, therefore, it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into". [para. 9.4]

Nevertheless, in order that an anti-abuse domestic provision be applied it must respect the primacy of Tax Treaties, and not lead to a result that may override unilaterally the obligations imposed by such a Tax Treaty.

The OECD Model Convention goes on saying:

" 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. Also, this will be necessary where a State which adopts the view described in paragraph 9.2 above believes that its domestic law lacks the anti-avoidance rules or principles necessary to properly address such strategy". [para. 9.6].

If States want to secure the application of anti-abuse domestic provisions against the provisions of a Tax Treaty, the following clause may be added to the Convention:

"The application of the present Tax Treaty will not prevent the application of the domestic rules of the Contracting States on ....".

In order to gain coherence and systematicity it is suggested that the paragraph 11 of the Commentaries on Article 1 of the UN Model Convention (pages 48 and 49) will be replaced after the preceeding paragraphs, with the following amendments:

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

"While these rules do not conflict with tax conventions, there is agreement that Member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused" [para. 22.2.].

It is suggested the deletion of reference to previous paragraphs 23, 24, 25 and 26 of the previous version of the Commentaries on the Article 1 of the OECD Model Convention that have been amended or deleted in the update of 2003. (pages 48 and 49 of the UN Model Convention).

It is also suggested the inclusion of new paragraph 26:

"The OECD Commentary observes as regards the application of controlled foreign companies provisions:

" States that adopt controlled foreign companies provisions or the anti-abuse rules referred to above in their domestic tax laws seek to maintain the equity and neutrality of

these laws in an international environment characterised by very different tax burdens, but such measures should be used only for this purpose. As a general rule, these measures should not be applied where the relevant income has been subjected to taxation that is comparable to that in the country of residence of the taxpayer".[para. 26].

It is suggested not to incorporate paragraphs 10.1 and 10.2 of the Commentaries on Article 1 of the OECD Model Convention as they expressly related to situations dealt in Articles 4 –residence- and 5 –permanent establishment- and could lead to misunderstandings and asystematic interpretations.

The same reasoning applies to the amendments incorporated in paragraphs 11 and 12 of the Commentaries of the OECD Model, as they were not incorporated in the UN Model Convention.

Page 44.

It is suggested the introduction of the sub-title before paragraph 9 of the UN Model with the following wording:

"Conduit company cases

9. The OECD Commentary sets forth a useful inventory of approaches to address the problem of improper uses of the Convention, many of them involving conduit companies, as follows:

"Many countries have attempted to deal with the issue of conduit companies and various approaches have been designed for that purpose. One solution ~~A solution to the problem of conduit companies~~ would be to disallow...**"**

In order to avoid abuse of Tax Treaty benefiting of preferential tax regimes established by the other Contracting State the paragraphs of the UN MC may be reworded and completed following the OECD new wording of old paragraphs 15-16 of the Commentary on Article 1. (at page 44 and 45 of the UN MC)

"Specific types of companies enjoying tax privileges in their State of residence facilitate conduit arrangements and raise the issue of harmful tax competition~~. Conduit situations can be created by the use of~~ Where ***tax-exempt (or nearly tax-exempt) companies*** ~~***that***~~ ***may be distinguished by special legal characteristics*** the~~. The~~ ***improper use of tax treaties may*** ~~then~~ ***be avoided by denying the tax treaty benefits to these companies (the exclusion approach).*** ~~The main cases are specific types of companies enjoying tax privileges in their State of residence giving them in fact a status similar to that of a non-resident.~~ ***As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding*** ~~clause such as the following~~ which would apply to the income received or paid by such companies and which could be drafted along the following lines**:** .....

.....Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (Non-discrimination) and to the benefits of Article 25 (Mutual agreement procedure) and they would be subject to the provisions of Article 26 (Exchange of information)." ~~[para.15]~~ ***[para. 21]***.

Between references to previous paragraphs 15 and 17 of the Commentaries of the OECD Model Convention, it is suggested to insert a new paragraph, following the OECD amendments:

"Where it is not possible or appropriate to identify the companies enjoying tax privileges by reference to their special legal characteristics, a more general formulation will be necessary. The following provision aims at denying the benefits of the Convention to entities which would otherwise qualify as residents of a Contracting State but which

enjoy, in that State, a preferential tax regime restricted to foreign-held entities (i.e. not available to entities that belong to residents of that State):

"Any company, trust or partnership that is a resident of a Contracting State and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that State shall not be entitled to the benefits of this Convention if the amount of the tax imposed on the income or capital of the company, trust or partnership by that State (after taking into account any reduction or offset of the amount of tax in any manner, including a refund, reimbursement, contribution, credit or allowance to the company, trust or partnership, or to any other person) is substantially lower thatn the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or partnership, as the case may be, were beneficially owned by one or more residents of that State". [para. 21.2]

In order to accommodate to the new numbering of paragraphs of the OECD MC the following amendments are suggested:

In page 46 reference to "[para. 17]" should be referred to "[para. 15]".

In page 46 reference to "[para. 21]" should be referred to "[para. 19]".

Taking into account the suggestions made for updating the UN MC in 1999 and the analysis of the so-called channel approach by the UN Report in 1987, it is suggested the inclusion of the following references of the OECD MC in page 46 of the UN MC between the references of previous paragraphs 17 and 21 of the OECD MC:

"Stepping Stone cases

In order to deal with certain stepping-stone arrangements, the OECD includes the following Commentaries:

"...It has been suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision that would single out cases of improper use with reference to the conduit arrangements themselves (the channel approach). Such a provision might have the following wording:

"Where income arising in a Contracting State is received by a company that is a resident of the other Contracting State and one or more persons who are not residents of that other Contracting State

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

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

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on immaterial goods and processes)" [para. 17].

It is suggested not to include paragraph 20 of the Commentaries on Article 1 of the OECD Model Convention to the UN Model, relating to the inclusion of a General LOB Clause in the Model.

In order to avoid abuse of Tax Treaty by States through the introduction of preferential tax regimes after the signature of the Treaty it is recommended the inclusion of the following paragraph at the end of page 47 after paragraph 10 of the Commentaries on Article 1 of the UN MC:

> ***"States may wish to prevent abuses of their conventions involving provisions introduced by a Contracting State after the signature of the Convention. The following provision aims to protect a Contracting State from having to give treaty benefits with respect to income benefiting from a special regime for certain offshore income introduced after the signature of the treaty:***
>
> > ***"The benefits of Articles 6 to 22 of this Convention shall not accrue to persons entitled to any special tax benefit under:***
> >
> > ***a) a law of either one of the States which has been identified in an Exchange of Notes between the States; or***
> >
> > ***b) any substantially similar law subsequently enacted". [para. 21.5]."***