Papers on Selected Topics in Protecting the Tax Base of Developing Countries

Draft Outline - Paper No. 5
May 2014

Preventing Tax Treaty Abuse

Graeme S. Cooper
Professor of Tax Law, University of Sydney, Australia

United Nations
Department of Economic and Social Affairs
United Nations Secretariat, DC2-2178
New York, N.Y. 10017, USA
Tel: (1-212) 963-8762 • Fax: (1-212) 963-0443
e-mail: TaxffdCapDev@un.org
http://www.un.org/esa/ffd/tax/2014TBP/

Preventing Tax Treaty Abuse

Graeme S. Cooper

Many developing countries have already negotiated a number of tax treaties with their neighbours and with capital exporting countries, while others are keen to expand their existing tax treaty network. This chapter is about how developing countries can protect their domestic tax base against erosion through the abuse of the tax treaties they have negotiated or are pursuing. This chapter will provide an overview of the problem of tax treaty abuse and the range of potential options available to developing countries to counter it, including examples of country practices. Measures to counter the abuse of treaties can involve changes to domestic tax law and domestic administrative rules as well as changing provisions in future (and existing) treaties.

1 Some preliminary definitions and concepts: What is tax treaty abuse and why is it a problem?

Treaties as a limit on source country tax. One of the principal effects of a tax treaty is to limit the ability of source countries to retain tax claimed under domestic law. As developing countries are predominantly source countries, rather than capital exporting countries, this effect is particularly important for them. When developing countries negotiate a treaty, therefore, they are making a decision to surrender tax claimed under domestic law in exchange for the benefits that the treaty promises.

Treaties as negotiated bargains. Treaties are individually negotiated between sovereign states with the intention that the benefits delivered by a treaty are enjoyed only by the residents of the other contracting state. Where residents of third states are able to enjoy those benefits, governments cannot be sure that they will enjoy the other aspects of the bargain they have struck.

The role of "intention" or "purpose" in defining the problem. It is not always easy to identify whether non-residents claiming to be entitled to the benefits of a treaty should be denied those benefits. Many different definitions and different terms are used to denote the inappropriate enjoyment of treaty benefits – the most common being "treaty shopping." Most of the definitions of treaty shopping or treaty abuse involve some notion of purpose or

intention that is the result of deliberate planning and conscious decision making, rather than a more objective set of facts and circumstances.

Tests which rely upon notions of "purpose" or "intention" are notoriously difficult for tax administrations to administer and for taxpayers to comply with. It is not surprising, therefore, that other less abstract tests are used to control the misuse of treaties. These tests, however, can create their own problems if they are triggered in inappropriate circumstances.

It can, therefore, be important to have a further fall-back, allowing the competent authorities to deliver access to treaties or deny access that might otherwise be given.

Different types of treaty abuse. It can be helpful to draw a distinction between:

- shopping into a tax treaty – a taxpayer resident in State C (a state which does not have a treaty with the source country, State A) puts in place a mechanism to get access to the treaty between State A and State B, and
- shopping between tax treaties – a taxpayer resident in State C (a state which has a treaty with the source country, State A) puts in place a mechanism to get access to the treaty between State A and State B, instead of being subject to the terms of the treaty between State A and State B.

As we will see, the difference can matter when tax officials try to decide what situation should be taxed in lieu of the offending situation – ie, if the benefits of the treaty are to be denied what tax consequences follow instead?

The importance of divergence in making treaty abuse attractive. The principal factors which encourage shopping into tax treaties and shopping between tax treaties are:

- the extent of the divergence of the tax treaty from the claims made under domestic tax law; and
- the extent of the divergences between tax treaties negotiated with different countries.

Where the tax claims made by domestic law are not significantly reduced by the terms of a treaty and the terms of the individual treaties in a State's treaty network are not significantly different, the attractiveness of treaty shopping is much reduced. There is a place for States to consider the settings in their domestic law as a means of controlling treaty abuse.

Important issues in choosing treaty partners. Source countries surrender tax claimed under domestic law in exchange for the benefits that the treaty promises. But source countries should also take into account whether amounts of income which they will no longer

be taxing will instead be taxed in the residence country. If income is not taxed in the residence country, this may be significant to the source country.

2 Examples of structures and instruments that might be used to defeat limits on treaty benefits

This part of the chapter describes some common mechanisms used by multinational enterprises and investors by which treaty benefits can be inappropriately enjoyed:

- dual residence arrangements
- agency arrangements
- nominees and custodians
- bare trusts
- fiscally transparent entities
- interposed (shell) corporations
- interposed (substantive) corporations making base eroding payments
- tax exempt entities
- tax preference regimes
- labour hire arrangements
- income assignments
- income re-characterization
- indirect asset transfers

Many of these arrangements should already be viewed as ineffective to deliver treaty benefits under language commonly used in the Model Treaties. However, some might not be able to be struck down.

3 Some examples of domestic law approaches to prevent treaty abuse

Most countries will have domestic rules which can prevent or minimise the scope for tax treaty abuse. Two issues arise: making sure that a country has a complete set of domestic anti-avoidance rules and making sure that their operation is not limited by the terms of the country's tax treaties. Administrative requirements for overseeing access to treaty benefits can also be important.

Administrative oversight of access to treaty benefits

- whether to deliver treaty benefits at source
- requirements for proving the entitlements to treaty benefits

- ex post confirmation and verification
- using exchange of information to verify / detect

Domestic tax base anti-avoidance rules

- thin capitalization rules
- CFC and PFIC rules
- offshore asset transfer rules
- transfer pricing rules
- SAARs
- GAARs

Existing judicial doctrines may also play a role in preventing tax treaty abuse.

4 Implicit protections underlying the interpretation and operation of tax treaties

The UN and the OECD Models have very detailed Commentary on the operation of various provisions in their Model Treaties. This Commentary also outlines doctrines and ideas which already underlie the operation and interpretation of tax treaties as international instruments.

The Commentary to Article 1 of the UN Model examines the notion of the abuse of a treaty as a doctrine of international law which might allow the benefits of a treaty to be denied.

The Commentary on individual articles in each Model also contains many passages which draw attention to possible interpretations of the text which can buttress the arguments of tax officials seeking to deny treaty benefits.

The chapter will also discuss adjusting the preamble to future treaties as a means of clarifying the scope and application of the treaty.

5 Existing provisions in treaties to prevent treaty abuse

This part of the chapter examines the operation of some common provisions in the text of the UN and OECD Models that already give a measure of protection against tax treaty abuse

- treaty definition of ‘resident’ – and how to handle transparent entities
- handling PEs properly
- beneficial ownership requirements

- entertainers and athletes article

6 Provisions currently <u>being encouraged</u> to prevent abuse

This part of the chapter examines a number of provisions that are currently being encouraged by the OECD and UN. Some are in common use; others are not. Developing countries may wish to include provisions such as these in their treaties in order to enhance the integrity of future treaties.

- specific limitation of benefit articles, especially in the dividend, interest and royalties articles
- conduit financing – back to back transaction rules
- general limitation of benefit articles based on observable structural features
    - Status: listed and actively traded
    - Ownership: owned by resident individuals
    - Activity: engaged in active trade or business
- general limitation of benefits article based on a purpose test

7 <u>Reconstruction</u> of tax liabilities after the denial of benefits

This part of the chapter considers the next question: having struck down an arrangement as involving the abuse of a particular treaty, what should be the tax consequences instead? This can be important in cases of shopping between treaties.

8 Modifying <u>existing treaties</u> to prevent treaty abuse

This part of the chapter considers the special problem of a state that already has an extensive treaty network. In this situation, a slightly different question arises: what can be done to buttress that network, once the terms of the treaty have been negotiated?

- renegotiation
- exchange of notes
- unilateral treaty override
- terminating treaties

9 References

The chapter will include references to sources (available free on the Internet) discussing the problem of tax treaty abuse and mechanisms used by countries to protect the integrity of their tax treaty network