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Revision of the Manual for the Negotiation of Bilateral Tax Treaties

Note on the Revision of the Manual for Negotiation of Bilateral Tax Treaties

Summary

This note comprises the second part of the draft revision of the Manual for Negotiation of Bilateral Tax Treaties prepared by the Subcommittee on revision of the Manual. It is provides an introduction to tax evasion and avoidance.

II. INTERNATIONAL TAX EVASION AND AVOIDANCE

A. Concepts and issues

70. Various features of the globalized economy have enabled an increasing number of individuals and companies to resort to tax evasion or tax avoidance. These features include the ease and rapidity of communications, the progressive elimination of obstacles to the movement of persons and property, the expansion of international economic relations, the differences in national tax systems and hence in the tax burden from country to country, and the growing sophistication and aggressiveness of taxpayers and their advisers in developing legal and illegal techniques for taking advantage of weaknesses in national tax systems.

1. The concepts of tax evasion and tax avoidance

71. Tax Evasion-The terms "tax evasion" and "tax avoidance" have not always been used precisely or with a uniform meaning.[1] Tax evasion is usually associated with the commission of a criminal offense. It can be considered to consist of wilful and conscious non-compliance with the laws of a taxing jurisdiction which can include a deliberate concealment of facts from revenue authorities. Tax evasion is an action by which a taxpayer tries to escape legal obligations by fraudulent or other illegal means. It may result from the evasion of tax on income that arises from illegal activities, such as smuggling, drug trafficking, and money-laundering. In a broader sense, tax evasion may also encompass a reckless or negligent failure to pay taxes legally due, even if there is no deliberate concealment of income or relevant information. Notwithstanding unintended evasion normally leads to only a tax payment with interest and penalties.

72. Some common examples of tax evasion include:

- The failure to notify the taxing authorities of one's presence in the country if he is carrying on taxable activities;
- The failure to report the full amount of income;
- Deductions of claims for false expenses;
- Falsely claiming relief that is not due;
- The failure to pay over the proper amount of tax due;
- Departing from a country without paying a tax due with no intention of paying them;
- The failure to report items or sources of taxable income, profits or gains where there is an obligation to provide such information or if the taxing authorities have made a request for such information2.

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[1] Part of the problem is a linguistic one. In English, "tax evasion" is synonymous with tax fraud, and means criminal activity. In French, "evasion" means avoidance. Tax evasion should therefore be translated into French as "fraude fiscal". Even within the same language, the term "tax evasion" has sometimes been used with a different meaning. For example, section 482 of the United States Internal Revenue Service Code refers to allocation of income that "is necessary to prevent evasion of taxes," but the intended concept is one of avoidance.

2 Maurice H. Collins, Evasion and Avoidance of Tax at the Unternational Level (Eurpoean Taxation, September 1988)

73. Tax Avoidance-Tax avoidance is not tax evasion. Tax avoidance, in contrast, involves the attempt to reduce the amount of taxes otherwise owed by employing legal means.[3] Tax avoidance occurs when persons arrange their affairs in such a way as to take advantage of weaknesses or ambiguities in the tax law. Although the means employed are legal and not fraudulent, the results are considered improper or abusive. Because of the subjectivity of the interpretation and application of tax avoidance the borderline between evasion and avoidance in specific cases may be difficult to define. For one thing, the criminal laws of countries differ, so that behaviour that is criminal under the laws of one country may not be criminal under the laws of another.[4] In addition, the definitions of civil and criminal tax fraud may overlap, so that it is within administrative discretion whether or not to pursue a criminal fraud case in a specific instance. In reality, there is a continuum of behaviour, ranging from criminal fraud on one extreme, to civil fraud, to tax avoidance that is not fraudulent but which runs afoul of judicial or statutory anti-avoidance rules and therefore does not succeed in minimizing tax according to law, and finally to tax-planning behaviour which is successful in legal tax reduction. The compound expression "tax avoidance an The European Court of Justice (ECJ) defined tax avoidance as "artificial arrangements aimed at circumventing tax law."5

74. Tax Planning-Many countries make a distinction between acceptable tax avoidance and unacceptable tax avoidance. Unacceptable tax avoidance is achieved by transactions that are genuine and legal but involves decit or pretence or sham structures;6 it is an indirect violation or an improper use of the tax laws or treaties. Acceptable tax avoidance methods or tax planning however reduces tax liability through transaction or other activities that are intended by legislation.

75. Courts in most countries have consistently recognized the right of taxpayers to avoid taxes by means that are within the law.[7] However, courts in many countries have also found that the tax laws should be interpreted so as to prevent their avoidance by the use of transactions that have no business purpose, although there is considerable variety in the approaches of courts in different countries.[8] Tax laws also typically include a variety of specific or general anti-

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[3] Black's Law Dictionary (Fifth Edition) has defined 'tax avoidance' as: "The minimization of one's tax liability by taking advantage of legally available tax planning opportunities. Tax avoidance may be contrasted with tax evasion, which entails the reduction of tax liability by using illegal means".

[4] While most countries define criminal tax fraud fairly broadly, there are some exceptions. For example, Switzerland has a narrow concept of "tax fraud", which is an offence subject to imprisonment, defining it as the use of "forged, falsified or substantially incorrect documents". See Direct Federal Tax Law, art. 186.

5 See *Lankhorst-hohorst* (C-324/00)(point 37).

6 See *ensign Tankers (Leasing) Ltd. V. Stokes* (1992) STC 226.

[7] In the United Kingdom the classic statement of this principle was made by Lord Tomlin in *IRC vs. Duke of Westminster* [1936] AC: "Every man is entitled, if he can, to order his affairs so that tax attaching under the appropriate Acts is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

For the United States of America, see *Helvering vs. Gregory*, 69 F 2d 809, 810 (2nd Cir. 1934): "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes" (per Learned Hand, J.).

For Belgium, see Judgment of February 27, 1987, Cour de Cassation, 1987 Pas. Be. 1, No. 387, at 777 (taxpayer allowed to choose "the lesser taxed way").

[8] For example, in the United Kingdom, the leading case of the modern era is *WT Ramsay Ltd. vs. CIR*

avoidance rules. Tax avoidance is a less precise concept than tax evasion, as the discussion above suggests. Although tax avoidance may be regarded as immoral in some circumstances, the means employed are legal and not fraudulent.

76. Tax avoidance typically involves four basic techniques:

- Deferred payment of tax liability;
- Re-charicterization of an item of income or expense to tax at a lowe rate;
- Permanent elimination of tax liability, and
- Shifting income from a high taxed person to a low taxed person.

These goals can be accomplishes through the use of international tax shelters through artificial intermediary companies; excessive use of debt over equity; and non-arm's length transactions.

77. Depending on the existence of judicial or statutory anti-avoidance rules, tax avoidance may or may not be successful if a case is audited and litigated. However, to apply anti-avoidance rules, the tax authorities typically must (1) discover the relevant transaction in a tax audit, and (2) obtain and analyse the information necessary to apply the anti-avoidance rules. This may be difficult in a cross-border situation where information is located abroad.

78. Globalization and the removal of impediments to the free movement of capital and exchange controls have promoted sustainable economic development. However, they have also increased the scope for tax avoidance and evasion with consequential substantial loss of revenue. International tax avoidance and tax evasion cause many problems. Governments lose significant amounts of revenue and hence the honest taxpayers who do not escape their liability to pay tax must bear an additional burden to plug the gap. Countries where the tax compliance is the highest lose out, since the trade flows are diverted elsewhere.

(a) International cooperation

79. Tax authorities in the Member States of the OECD have responded to concerns about avoidance and evasion by taking on new powers to collect information from taxpayers. Delegates to the Working Party on Tax Avoidance and Evasion systematically inform other countries about the means at their disposal for countering avoidance. These reports cover legislation, court decisions and audit techniques. It is through this exchange of experiences that

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[1981] 1 All ER 449, where the House of Lords held that, where there is a composite transaction, the court is entitled to determine the tax liability by looking at the end result rather than the individual steps in the transaction. The effect of *Ramsay* has been clarified in subsequent cases, most recently in *McNiven vs. Westmoreland Investments Limited* [2001] STC 237, in the House of Lords in February 200. Lord Nicholls' opinion in *McNiven* stated that *Ramsay* made three points: "First, when it is sought to attach a tax consequence to a transaction, the task of the courts is to ascertain the legal nature of the transaction. If that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded…. Second, this is not to treat a transaction, or any step in a transaction, as though it were a 'sham'…. Nor is this to go behind a transaction for some supposed underlying substance. What this does is to enable the court to look at a document or transaction in the context to which it properly belongs…. Third, having identified the legal nature of the transaction, the courts must then relate this to the language of the statute."

the Committee is able to develop and promote the adoption of practices that should enable tax authorities to administer their tax laws in an effective and equitable manner. An example of the results of such discussions is the OECD recommendation on the use and disclosure of Tax Identification Numbers (TINs) to increase compliance on cross-border income flows.

80. Ways of increasing compliance in cross-border financial transactions and on access to bank information for tax purposes are the focus of current work. Additional work will also be carried out to identify and address other barriers to the identification of beneficial ownership and exchange of such information.

81. The Committee has promoted exchange of information between tax authorities as the best way of fighting non-compliance in transactions across borders. For this reason, the OECD Model Convention contains an article on exchange of information. Current work to improve exchange of information includes looking not only at barriers to effective exchange of information but also at how better use of the latest information technology can help. OECD countries have adopted a standard magnetic format for exchange of information. The Working Party is also considering how technology can be used to improve and expedite procedures for the certification of residence for purposes of granting treaty benefits. A pilot study on the exchange of TINs is being conducted. The Committee is also exploring the relationship between money-laundering and tax-related crimes. In particular, it is examining how tax authorities can obtain access to information gathered by anti-money laundering authorities both to pursue tax offences as well as to exchange that information with foreign tax authorities.

82. A major objective of bilateral tax treaties, apart from avoidance of double taxation, is to prevent tax avoidance and evasion and to ensure that treaty benefits flow only to the intended recipients. Bilateral tax treaties achieve this objective in several ways. Firstly, they provide for exchange of information between the tax authorities of the Contracting States. Secondly, they contain provisions designed to ensure that treaty benefits are limited to *bona fide* residents of the other treaty country and not to treaty shoppers. Under the tax treaties, the competent authorities are authorized to exchange information, as may be necessary for the proper administration of the countries' tax laws. The information that is exchanged may be used for a variety of purposes. For example, the information may be used to identify unreported income or to investigate a transfer pricing case. If a country has bank secrecy rules that prevent or seriously inhibit the exchange of information under the tax treaty, it may not be desirable to conclude a bilateral tax treaty with it. In fact, it is necessary to first discuss the issue of information exchange with the other Contracting State before beginning formal negotiations, because it is one of the very few issues that should be considered as non-negotiable. This may even prevent a country from entering into treaties with some countries with which it may have significant economic ties, but this may be treated as the right policy.

83. Recent technological developments which facilitate international, thus anonymous, communications, and commercial and financial activities can also encourage illegal activities.[9]

[9] United States Treasury International Tax Counsel Mr. Philip R. West's testimony before the Senate Committee on Foreign Relations (October 27, 1999).

Over the past several years there has been a marked change, as many of the industrialized nations have recognized the importance of exchange of tax information; the absence thereof serves to encourage not only tax avoidance and evasion but also criminal tax fraud, money-laundering, illegal drug trafficking, and other criminal activity.

(b) Tax planning and treaty shopping

82. Another aspect of the bilateral tax treaty policy to deal with tax avoidance and evasion is to include in all treaties comprehensive provisions designed to prevent "treaty shopping". This abuse of the treaty can take a number of forms, but it generally involves a resident of a third state C that has either no treaty with the country A or a relatively unfavourable one, establishing an entity in a treaty partner B that has a relatively favourable treaty with the country A. This entity is used to hold title to the person's investments in country A, which could range from portfolio stock investments to major direct investments or other treaty-favoured assets in country A. By placing the investment in the treaty partner, the resident of country C is able to withdraw returns from the country A investments subject to the favourable rates provided in the tax treaty with country B, rather than the higher rate that would be imposed if the person had invested directly into the country A. Of course, the tax imposed by the treaty partner on the intermediate entity must be relatively low, or the structure will not produce tax savings that justify the added transaction costs.

83. Bilateral tax treaties should endeavour to give benefits to the residents of the Contracting States alone. Treaty shopping represents an abusive attempt to siphon off benefits to others. Moreover, if treaty shopping is allowed to occur, then there is less incentive for the third country, with which the country has no treaty, to negotiate a treaty with it. The third country can maintain inappropriate barriers to the first country investment and trade, and yet its companies can obtain the benefits of lower first country tax by organizing its first country transactions so that they flow through a country with a favourable first country treaty. Every country should develop anti-treaty-shopping provisions and encourage other countries to adopt similar provisions that limit the benefits of the treaty to *bona fide* residents of the treaty partner. These provisions cannot be uniform, as each country has its own characteristics that make it more or less inviting to treaty shopping in particular ways. Consequently, each provision must to some extent be tailored to fit the facts and circumstances of the treaty partners' internal laws and practices. Moreover, the provisions need to strike a balance that avoids interfering with legitimate and desirable economic activity.

84. In addition to the treaty-shopping abuses, there are an increasing number of other types of transactions that seek to use treaties to achieve inappropriate results. Anti-abuse rules are generally complementary to the anti-treaty-shopping rules. Anti-treaty-shopping rules take the broad approach of denying all treaty benefits to persons who are not *bona fide* residents of the treaty country. Anti-abuse rules are more targeted in the sense that they are not blanket exclusions from all treaty benefits; they deny specific treaty benefits in abuse cases. It is relevant to mention that the last paragraphs of the commentaries on articles 10, 11, 12 and 21 in the United Nations Model Double Taxation Convention between Developed and Developing Countries refer to the artificial devices entered into by persons to take advantage of the provisions of those articles through creation or assignment of rights in respect of the income

specified in those articles. Contracting States which may wish to specifically address the issue are advised to include the specified clause in their bilateral tax treaties.

85. It is necessary to include anti-abuse rules in bilateral tax treaties in view of several concurrent developments in international tax law. Firstly, although an overwhelming majority of taxpayers who avail themselves of treaty benefits are entitled to those benefits and are not engaged in abusive transactions, aggressive abuse of treaties has increased. It is relevant to point out that both the commentary to Article 1 of the OECD Model Tax Treaty and the OECD Report on Harmful Tax Competition make clear that countries can impose their domestic anti-abuse rules to claims for treaty benefits. In fact, concerns about the adequacy of current treaty rules to prevent abuses have stimulated work in the OECD on this subject.

86. The increase in treaty abuses has unfortunate results for both the treasury of the country and the taxpayers; it requires the treasury to divert resources to fighting abuse that it might otherwise devote to improving the treaty network. The emergence internationally of anti-abuse rules addresses the abuse problem, while at the same time frees up the treasury resources to provide greater benefits to the taxpayers. Most bilateral tax treaties contain only benefits for taxpayers and no provisions that increase tax burdens. As such, it is appropriate to impose reasonable limits on those benefits to curb abusive transactions that may be developed in the future.

(c) Tax avoidance through low-tax jurisdictions

87. In the most general terms, a low-tax jurisdiction can be defined as a jurisdiction which imposes little or no tax on companies, trusts or other entities organized there. By forming a company in such a jurisdiction and arranging for that company to derive income from third countries, a multinational enterprise may be able to shelter income from taxation both at the source and in its residence country. By forming a holding company or a trust in a tax haven, an individual or institution may similarly be able to shelter investment income from taxation. The OECD has distinguished between two types of low-tax jurisdictions – those that simply offer a low-tax environment and those it has identified as "non-cooperative jurisdictions". The OECD has sought to combat the threat of non-cooperative jurisdictions to the legitimate tax-policy objectives of its Member States by putting economic pressure on those jurisdictions to cooperate in the prevention of tax fraud and evasion.

88. Non-cooperative jurisdictions may also be defined as jurisdictions which do not participate in effective exchange of tax information between tax authorities. A lack of effective exchange of tax information may occur where bank secrecy or other laws prohibit the disclosure of information concerning financial transactions carried out in the country, or where there is inadequate information available regarding the beneficial ownership of accounts, financial instruments and other assets held in the country. The likelihood of international tax avoidance utilizing non-cooperative jurisdictions is increased in situations where non-cooperative jurisdictions have lower or no tax on one or more types of income earned by non-resident individuals and corporate entities. By way of example, a multinational enterprise may be able to shelter income from taxation both at source and in its residence country by forming a company in a non-cooperative jurisdiction which has lower or no tax on relevant income. Similarly, an

individual may be able to shelter income by forming a holding company or trust in a non-cooperative jurisdiction which has lower or no tax on relevant income. Examples of both tax avoidance and evasion follow.

(i) Practices resorted to in order to reduce taxes imposed on international income

89. These practices, generally speaking, fall into four categories: a) practices resorted to in order to reduce income taxes imposed by the country of residence or citizenship; b) practices resorted to in order to evade or avoid taxes imposed by the country of source; c) institutional devices and arrangements that facilitate the evasion or avoidance of taxes imposed on international income; and d) the use of related tax-haven entities to reduce such taxes.

a. Practices resorted to in order to reduce taxes imposed by the country of residence or citizenship

90. Many countries impose taxes on income received from abroad by residents or non-resident citizens. The practices resorted to in order to reduce payment of these taxes include the following:

i. Failure to file a return

91. One of the most common practices resorted to in order to reduce payment of taxes on international income consists in the deliberate failure of resident aliens to file tax returns in the country in which they are residing. Persons who spend a portion of each year in each of two or more jurisdictions often make inconsistent claims of residence. When a country taxes the worldwide income of its citizens, a citizen who is residing abroad may fail to file a return in the country of his citizenship.

ii. Failure to report all income subject to tax

92. Another important practice in this category is the wilful or negligent failure to report all items of international income that are subject to tax. The items most often omitted are salaries, wages and non-commercial income, interest and dividends, business income, income from real estate, gains on the disposition of property and royalties.

Salaries, wages and non-commercial income

93. Persons receiving remuneration from abroad in payment for services or in the form of pensions and annuities frequently fail to report this income in tax returns to their country of residence. Consequently, such income, if not taxed at the source, is apt to escape taxation both in the country where it is acquired and in the country in which the recipient is resident.

Interest and dividends

94. In the view of many tax administrators, tax evasion or avoidance is probably most prevalent in connection with this type of income, since interest and dividends can easily be

collected anonymously at a financial institution in a third country where the securities are held in custody. This type of income also lends itself to many fraudulent practices through the skilful use of certain special provisions of domestic laws. Thus, certain institutions whose prime purpose is economic or financial are frequently used to facilitate tax evasion or avoidance.

95. Investment trusts and holding companies are of particular concern in this connection. The anonymity of the owners of the securities held by an investment trust is normally assured by the form of their holdings in the trust and also by the fact that often the trust has no tax liability or obligation to report information to the tax administration of the country where it is established. Where the trust is not itself a taxable entity, it pays no tax on profits from its dealings or on income. The owners of the securities who are the true recipients of the profits and income may not be subjected to personal taxation, if the tax administration is not aware of their identity. That identity may be concealed, for example, by holding the securities in bearer form or, if registered, in the name of nominees. As for holding companies, the preferential tax regime applied to them in some countries likewise encourages the creation of legal structures, which may facilitate tax evasion or avoidance with respect to the income from holdings in companies anywhere in the world. As in the case of investment trusts, this situation results first from the fact that no tax, or very little, may be payable by the holding company in respect of the income which it receives and redistributes, and second from the lack of information as to the identity of the individuals or companies receiving distributions of profits from the holding companies.

Business income

96. Taxes on business income are reduced at times by means of deliberate failure to keep accurate books and records within the taxing jurisdiction. A second set of books, which is accurate, may be maintained outside the taxing jurisdiction, and beyond the reach of the authorities of that country. In some instances, the maintenance of false books within the taxing jurisdiction is facilitated by limitations in domestic law on the extent to which the taxpayer's books and records may be examined by the tax authorities. With the advent of electronic bookkeeping, it may be easier to keep two sets of paper records or to falsify paper records, since a computer keeps a record of all changes made to a file. Those changes can in many cases provide an audit trail that is much harder to destroy than physical documents.

97. Business profits properly allocable to the source country may be shifted to other countries by such devices as the establishment of artificial transfer prices for imports and exports, the improper allocation of costs, and licensing agreements under which the user of technology is obliged to purchase imported inputs, equipment and spare parts at inflated prices. Such devices, which transnational corporations are particularly well situated to use, are of great concern to developing countries, whose tax officials often lack the time and expertise to challenge effectively the prices set between affiliated companies.

Thin capitalization

98. Many countries allow corporations to take a deduction for interest expenses but do not allow a deduction for the payment of dividends. This differential treatment of interest and dividends creates a bias in favour of debt finance over equity finance. The bias is particularly

strong when the dividends or interest would be paid to an affiliated company. For example, if Company P owns all the stock of Company S, it is generally indifferent, aside from tax considerations, as to whether it receives dividends of interest payments from Company S. To prevent corporate taxpayers from distributing their profits to their parent corporation mostly in the form of deductible interest, many countries have adopted so-called "thin capitalization" rules. Under these rules, a corporation that has what is deemed to be an excessive amount of debt capital will be prevented from taking a deduction for payments made with respect to that excessive debt capital. The amount of debt capital of a corporation typically would be characterized as excessive if the ratio of debt to equity exceeded some number. For example, if the debt:equity ratio for a corporation exceeded 2:1, the interest payments on the excess debt might be classified for tax purposes as a non-deductible dividend. Many countries would use a high debt:equity ratio as an indicator of thin capitalization, but would look at all the facts and circumstances of the particular case before characterizing an interest payment as a dividend for tax purposes.

Income from real estate

99. If a resident of one country owns real property in another country, this person may fail to report rents (and amounts that may be assimilated to rent) as income in the country of his fiscal domicile or residence. Such income may also escape taxation in the country in which the property is situated if the tax authorities are not aware of the identity and domicile of the recipient.

Royalties

100. Royalties paid abroad for the use of or the right to use patents, trademarks, know-how or other intangible property may be used to shift profits out of high-tax countries into low-tax or into no-tax countries by fixing the royalties at artificially high rates. Such devices are facilitated by difficulties in estimating the arm's length value of monopoly rights. In addition, multinational firms may transfer intangible property to an affiliated corporation under conditions that would not occur between unrelated persons. For example, a multinational corporation might transfer highly profitable know-how that it would never share with an unrelated person to a corporation organized in a tax haven simply for the purpose of generating a deduction in the country where the intangible property is located.

Technical assistance

101. Affiliated corporations may charge improper technical fees as a way of minimizing taxes for the corporate group. In some cases, they may set the fees too high. For example, a corporation engaged in business in a country may pay an excessive technical assistance fee to a related corporation located in a low-tax jurisdiction in order to take an excessive deduction. The source country may have difficulty determining a proper price for technical assistance because those services tend to be unique and difficult to value. In other cases, a corporate group may set the technical assistance fees too low. For example, a foreign corporation making sales of goods into a country may provide technical assistance in conjunction with those sales. Under its tax treaty, the sales income would be exempt if the foreign corporation has no permanent

establishment in the country, whereas the fees for technical assistance may be the subject to a withholding tax. To minimize the withholding tax, the foreign corporation may claim that the technical assistance has little value.

iii. Fictitious deductions

102. In a variety of circumstances, a taxpayer may claim fictitious or inflated business expenses as deductions. In employing this tactic, the taxpayer may claim that the purported payment was made to a person located outside the taxing jurisdiction, thereby making an audit of the expenses difficult for the tax authorities. For example, if the taxpayer purchases goods outside the taxing jurisdiction, false invoices may be prepared to show a purchase price greater than the actual amount paid by the taxpayer.

103. Payments characterized as commissions, royalties, technical service fees and similar expenses are sometimes paid by a resident of the taxing jurisdiction to a related non-resident and claimed as a deduction, even though the related non-resident has done nothing to earn these payments.

iv. Credit for fictitious tax

104. A taxpayer who resides in a country that allows a foreign tax credit as a method of relieving double taxation and receives income from another country may seek to reduce tax in the residence country by claiming fictitious or excessive credits for taxes allegedly paid to the other country.

v. Improper characterization of income or expense items

105. Tax may be reduced by improperly characterizing an income or expense item in order to make use of an exemption or reduced rate.

vi. Inconsistent characterizations

106. A taxpayer may characterize a particular transaction in one way in country A, and in a contrary way in country B, in order to obtain tax benefits in both countries. For example, advances by a parent in country A to a subsidiary in country B may be treated as equity in country A (in order to avoid the necessity for reporting interest income to country A), but as debt in country B (in order to avoid capital stock taxes in country B). Payments made by a subsidiary in country A to its parent in country B may be treated as the purchase price of goods in country A but as royalties or dividends in country B. In some cases, however, inconsistencies of this type may be justified by differences in the internal laws of the two jurisdictions.

vii. Utilizing temporary taxpayer status

107. Where taxation is based on a temporary status, tax evasion or avoidance may occur through transactions that take advantage of that temporary status. For example, because a borrower is not liable to tax on the proceeds of a loan, a foreign national may arrange an

ostensible loan while he is a resident of the taxing jurisdiction, and then sell the collateral for the alleged loan to the lender following his departure from the taxing jurisdiction (when he is no longer taxable on sales profit within that jurisdiction), with the "loan" being credited against the sale price.

viii. Flight to evade payment of tax

108. When a taxing jurisdiction determines that a resident alien has taxable income or assesses a tax against him, the individual may flee the jurisdiction to escape tax. Even though the authorities of the taxing jurisdiction have properly assessed the tax, it is collectible only to the extent of the taxpayer's property within the reach of the administrative and judicial collection power. Generally, that power is limited to the taxing country and its possessions. Thus, when property is removed from the taxing jurisdiction, a tax department may be unable to levy against it because the courts of one country generally will not enforce a judgement for taxes rendered by the courts of another country in the absence of a treaty that provides for mutual assistance in collection.

ix. Improper allocation of expenses

109. When a foreign corporation operates both within and without a country, it often must allocate certain expenses between its branch operations within the country. In some cases, the allocation rule to apply is quite obvious. For example, if Company P has a branch in country B and makes sales in that country through its branch, the expenses associated with the sale should be allocated to the branch. In many other cases, however, the proper allocation rule is less obvious. For example, it is not obvious how the interest expenses of a corporation should be allocated between a domestic and foreign branch. Other expenses creating problems of allocation include head office expenses, certain legal fees, deductible charitable contributions and certain taxes.

b. Practices resorted to in order to evade or avoid taxes imposed by the country of source

110. Tax on non-business income derived from sources within the taxing country by non-residents is generally collected by requiring the payer of the income to withhold the tax before remitting the balance of the payment to the non-resident. There are a number of common techniques for evading the payment of these withholding taxes.

i. False withholding certificates

111. Tax may be evaded by providing false information to withholding agents. For example, a payer of dividends having no definite knowledge of the status of a shareholder may not be required to withhold tax if, under the laws of the taxing country, dividend payments to resident shareholders are not subject to withholding. Accordingly, a non-resident alien recipient may establish a false address within the country, in order to escape withholding. This method of evasion depends on the willingness of the nominee to violate the law by failing to withhold tax when he makes remittances to the true owner outside the country.

ii. Use of bearer securities

112. In many instances, withholding taxes can be avoided by holding securities in bearer form, particularly if they are in the custody of a broker, nominee or agent within the country of the issuing corporation. Again, this method of avoidance assumes that the person holding the bearer securities is prepared to violate the law by failing to withhold when remittances are made to the true owner.

iii. Erroneous characterization of income items

113. Where the withholding rates on certain types of income are lower than the rates on other types of income, related entities may disguise the true character of a payment in order to take advantage of the lower rate. For example, dividends may be paid in the guise of fees or commissions.

iv. Unreported income and fictitious expenses

114. An individual who is temporarily present in the taxing jurisdiction, but is neither a resident nor a citizen, may evade tax on income earned while he was in the jurisdiction by either understating income or overstating expenses.

c. Institutional devices and arrangements that facilitate evasion

115. A variety of institutional devices are used to conceal the existence of international income or to generate fictitious deductions thereby facilitating international income tax evasion.

i. Dummies, nominees and numbered bank accounts

116. Salaries, investment income, business profits and other items of international income are frequently concealed by having these items paid to dummies, nominees or numbered bank accounts inside or outside the taxing jurisdiction. For example, an official of country A may state that he will permit a subsidiary in country A to make certain remittances to its parent in country B only if the parent makes an unreported payment in funds of country B to a nominee of the official (or a numbered bank account maintained by him) in country B or C. Similarly, a resident of country D who sells property at a gain to a resident of country E may stipulate that the sales proceeds are to be deposited in a numbered bank account inside or outside country D.

117. Once an item of international income has been concealed in a numbered bank account or in the name of a nominee, the concealed amount can be used to generate investment income, which may likewise be concealed from the taxing authorities of the country in which the true owner of the account is residing.

ii. Bearer securities

118. In order to conceal the receipt of dividend or interest income, international investors frequently place investments in bearer form. The use of bearer securities also facilitates the

transfer of investments from one owner to another without reporting the transaction and paying the tax due by reason of the transfer. It is difficult to police such transactions from a tax standpoint because the use of bearer securities is widespread and entirely legal in many countries.

iii. Foreign holding companies and trusts

119. Under the laws of some countries, a resident may legally avoid tax by placing income producing property in a foreign corporation or trust which he controls. However, under the laws of other countries, the investment income is taxable by the country of residence whether or not it is actually distributed by the foreign corporation or trust to the resident owner. In cases of the latter type, tax is frequently evaded by illegally concealing the existence of the foreign holding company or trust from the tax authorities of the country or residence.

iv. Artificial bank loans

120. A major technique for international tax evasion consists of purportedly borrowing funds that are actually owned by the borrower. This practice not only enables the "borrower" to make open use of funds previously concealed in the name of a nominee or in a numbered bank account, but it also gives the borrower a pretext for claiming fictitious interest deductions. For example, a resident of country A who has deposited unreported international income in a numbered bank account in country B arranges to "borrow" an equivalent amount from that bank at 82 per cent interest. If the bank is paying 8 per cent interest to him on his numbered account, he is actually out of pocket only 2 per cent, but on the return which he files in country A he will treat the receipt of the unreported income as a "loan" and will claim a deduction for the entire 82 per cent interest charge that he pays to the bank.

121. To further disguise the true facts, a resident of country A with a numbered bank account in country B may arrange to have the bank in country B forward funds to an unrelated bank in country C from which he will then "borrow" an equivalent amount.

v. Investment trusts

122. An international investment trust, by concentrating funds from many different sources in a single investment pool, may be utilized by numerous investors as a tool for tax evasion. In many cases, an international investment trust will be used to obtain tax treaty benefits for its investors without the tax authorities in their country of residence learning about the income.

d. Use of related tax-haven entities to reduce taxes

123. Taxpayers sometimes utilize entities organized in tax-haven countries to reduce taxes legally, the legality of the transactions depending on the laws of the country where taxpayers are located. The presence of tax-haven countries, however, invites tax evasion activities that initiate essentially false or illegal relationships with the tax-haven country. Some of the latter situations are described below.

i. Transfer of income-producing assets to a tax-haven entity

124. Tax is sometimes avoided or evaded by transferring income-producing assets at an artificially low cost from the taxing jurisdiction to a controlled entity in a foreign tax-haven country where income from the assets will be taxed at a lower rate or escape tax entirely. The assets transferred to the foreign tax-haven company may consist of:

- Stocks, securities, rental properties, and intangibles such as licensed patents, trade-marks and copyrights that will generate passive income; or
- Property of any kind which will be resold by the tax-haven entity to unrelated third parties at a gain.

In many cases, there is no limitation on the amount of income which may be accumulated tax free in the foreign tax-haven entity.

ii. Nominal transfer of income-producing functions to a tax-haven entity

125. An entity in a high-tax country may avoid or evade tax in that country by rendering, or appearing to render services to unrelated persons through a controlled entity in a tax-haven jurisdiction. In the typical case, the controlled entity is a shell corporation that is incapable of performing the services unless it uses personnel or property of the controlling entity.

iii. Payment of deductible expenses to a tax-haven entity

126. An entity in a high-tax jurisdiction may pay management fees, technical service fees, or other deductible fees to a related entity in a tax-haven jurisdiction, although the related entity has not actually earned those fees and will not pay significant taxes on them.

iv. Payment of deductible expenses which benefit a tax-haven entity

127. An entity in a high-tax country may incur deductible expenses in acquiring or developing property which is then made available without adequate reimbursement to a related entity in a tax-haven country. For example, the entity in the high-tax country may take interest deductions with respect to borrowed funds which are re-lent to the related entity interest free. Similarly, the entity in the high-tax country may take depreciation deductions for tangible property that is leased or licensed to the related entity for an artificially low consideration.

128. As previously stated, some of the techniques described above may be legal methods of reducing tax, rather than illegal methods of evading tax, depending on the law of the particular countries involved.

B. Legislative and Judicial Anti-Avoidance Measures

129. The manner in which tax avoidance can be met can include legislative and judicial response. In some cases a jurisdiction will enact specific provisions that identify the type of transaction to be dealt with and prescribe specific legislative remedies to combat such avoidance. Another legislative method would be to enact broad types of avoidance practices in specific areas; another would be to control tax avoidance through the discretion of the tax authorities.

Finally requiring related parties treat transaction in the same manner as independent parties can be another response. Most jurisdictions rely on specific anti-avoidance rules in their domestic legislation and judicial case law.

130. Where the legislative response to tax avoidance has been ineffective court have developed judicial doctrines to counter serious cases of tax avoidance. These judicial decisions tend to be more flexible than statutory rules under the domestic law and often overlap with each other.

131. Common judicial doctrines are derived from common law and include:

- *Business Purpose Rule*-the business purpose rule attacks avoidance transactions which have no business purpose and are created to avoid taxes;
- *Substance of Form*- Under the substance over form principle, the facts must be assesses according to *bona fide* substance and not formal content;
- *Sham Transactions*- a sham transaction conceals the true nature of a transaction that exist in form only;
- *Doctrine of the Label*- the parties use the wrong label or description to classify or characterize a transaction or relationship for tax purposes;
- *Step Transaction Doctrine*- in a step transaction, the intermediate steps in a chain of predetermined transactions may be disregarded and several related transaction may be treated as one integrated transaction. Alternatively the transaction may be broken up into its distinct steps to determine their acceptance for tax purposes. The step transaction doctrine maintains that "purely formal distinctions cannot obscure the substance of the transaction.10
- *Abuse de droit* ("Abuse of Right") – An abuse of right is the manipulation of the intention or spirit of the law in such case the court will disregard the legal form where the transaction is undertaken solely or predominantly to avoid tax without a *bona fide* business purpose;
- *Fraus Legis* ("Abuse of Law") the *fraus legis* principle allows a court h disregard a transaction entered for tax avoidance purposes and to substitute it by a "normal" transaction. The tax is imposed as if the taxpayer did not carry out the "disregarded" transaction but a similar taxable transaction.
- *Simulation*- Certain civil law countries apply the doctrine of simulation to ensure "substance over form."

C. Mutual administrative assistance

139. Increasingly, tax treaties are stipulating assistance in collecting taxes. So far, a similar provision has not been included in the United Nations tax treaty model. Such an article would have two main advantages. Firstly, it increases the chance of collecting taxes from taxpayers living abroad. Secondly, it reduces tax evasion possibilities through emigration. It goes without

10 See *McDonald's Resturant of Illinois v. Comm'r.*, 688 F. 2d 520 (7th Cir. 1982) (US).

saying that a State has to be sure that the aim of assistance in collection of taxes is suitable and desirable within its treaty policy before it inserts such a provision in a treaty.

140. A State which wishes to introduce such an article has to consider at least the following issues. In the first place, a State needs to possess a legislative framework which allows the implementation in practice of this provision. Secondly, the tax administration should be capable and able to collect the tax revenues. Furthermore, it should be considered whether the mutual advantages would justify the new obligations between the two Contracting States. It should be noted, in this respect, that reciprocity with equal revenue is not necessary. However, it might be an element a State might try to obtain. Other important aspects to consider are the size of the economic relationships, the efficiency to collect the tax revenue in both States and the legal protection of the taxpayer.

141. If two States would like to insert a similar article, it would be desirable to include the following issues. Firstly, the scope of the article of assistance in the collection of taxes. To which direct taxes and persons will it apply? For persons, the scope could be stretched to residents instead of just citizens. Secondly, the legislation which can be used to collect the revenue. Usually the legislation of the requested State will be applied. This will normally imply that the requested State will be limited in its measures to collect the revenue on the basis of its own law. Further, the requested State has normally no obligation to use executorial instruments, if the requesting State does not have these instruments at its disposal. The time limit of appeal to court will usually be found in the legislation of the requesting State. It should be considered that the taxes of the requesting State may not have the same preferential status as in the requested State. Exceptions on the obligations to assist can be found in the argument that the requesting State has not used all possible measures of collecting the revenues or that the request interferes with the interest of the requested State. Thirdly, the settlement of the costs which have been made for the collection. The requested State will have to pay normally for the ordinary costs. Unreasonably high costs are likely to be paid by the requesting State. A settled currency rate can be a useful tool to help settle these costs. Fourthly, the exchange of information concerning the collection of the revenue should be considered as well. Finally, the notification of the documents requesting a collection abroad have to be worked out.

142. Moreover, a Multilateral Convention on Mutual Administrative Assistance in Tax Matters has been developed within the Council of Europe, based on a first draft prepared by the OECD Committee on Fiscal Affairs. The multilateral convention was opened for signature on 25 January 1988 and is open to the Member States of the Council of Europe and the Member Countries of the OECD. The Convention has been signed by only a few countries, including several of the Nordic countries, and it has not been ratified by some of the countries that signed it. A sufficient number of signatures has been obtained, however, to bring the Convention into force in 1995. The current signatories include Denmark, Finland, Iceland, the Netherlands, Norway, Poland, Sweden and the United States of America.

143. The Multilateral Convention generally requires that each Contracting State provide administrative assistance in tax matters to each other Contracting State. The Convention provides for three basic categories of assistance, with regard to a wide range of taxes: exchange of information, assistance in the collection of taxes, and service of documents. With respect to

the first category, each Contracting State is required to make available to the other States all information in its possession that is "foreseeably relevant" to the other States' tax administration and collection efforts. Each State must also utilize all means available to it in administering and enforcing its own tax laws to obtain foreseeably relevant information not in its possession if so requested by other States. Also, subject to various procedural limitations, the Convention requires each State to enforce tax claims of the other States as though the taxes were those of the enforcing State. The Convention's provisions on service of documents require each State to utilize its domestic laws for this purpose, as though the tax liability were owed to the serving State. A copy of the Convention may be seen in the Annexes.