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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 a part of the draft revision of the Manual for Negotiation of Bilateral Tax Treaties prepared by the Subcommittee on revision of the Manual. It addresses the “Appendix for Special Consideration Items” - a proposed section to the revised Manual having the purpose of providing a repository for discussion items raised as part of the review of the UN Model Double Taxation Convention between Developed and Developing Countries.

United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries

Appendix for Special Consideration Items

TABLE OF CONTENTS

- **PREAMBLE**
- **INTRODUCTION**
- **COMMENTS**
- **IMPROPER USE OF TAX TREATIES**
- **PROPOSED TOPICS**

PREAMBLE

The Appendix for Special Consideration Items is a proposed section to the revised Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries created for the purpose of providing a repository for discussion items raised as part of the review of the UN Model Double Taxation Convention between Developed and Developing Countries that do not meet established criteria for inclusion in Model provisions or the "Commentary" that accompanies the Model provisions, or represent discussion items that are viewed as having a high level of interest to member countries with an attached priority for the timely and accurate dissemination of helpful information for the treaty negotiation process . Typically, the items included in this section are provided, arise from discussions at meetings of the Committee of Experts on International Cooperation in Tax Matters, but it is proposed that such items could be proposed outside that specific venue, according to protocols agreed to by the Committee members.

The emphasis is on the timely and accurate dissemination of helpful information. To the extent such information emanates from UN documents or Committee meetings and

minutes, the information is reproduced in this section with citations to the official presentation for the reader's reference.

INTRODUCTION

The contemplated purpose for this section of the manual is to provide an identifiable location for the presentation of items that might not have a place in either the Model or the Commentary. Such a situation may result from a number of factors, e.g. the issue is unsettled at the time, the issue might focus on elements that are experience based and so specific that they are deemed inappropriate for inclusion the general provisions of the Model, or the issue might arise in between revisions of the Manual.

Regardless of the reason for non inclusion, the usefulness of the manual may be compromised. The manual should be both timely and accurate. If significant items are not included in the Model, Commentary, or other sections of the manual, integrity or accuracy may be sacrificed. If such information cannot be added on a timely basis, timeliness is sacrificed. It would appear appropriate to have a designated repository for this type of item, a Special Appendix where negotiators will have a single point of reference for items that affect the scope, accuracy, or timeliness of the document.

Further, it should be noted that it is intended that such an appendix should be structured in such a manner that it can be amended with specific items more easily than that which must be undertaken in the process of a review of provisions of the Model or sections of the Commentary.

COMMENTS

As will be indicated in various places in this section, the examples are illustrative. In this, the first rendition of the Special Appendix, it was deemed appropriate to include what appeared to the authors to be essential discussion, and illustrative examples relevant to the two topics included. There appeared to be strong support for including these topics in this section of the Manual. There are no doubt others that should and will be included.

It was the purpose of the authors to provide a first rendition of the Special Appendix, with enough material that the Committee, government observers, and participating observers might discuss these first sections specifically, and to establish protocols by which processes for the selection for inclusion of future issues and the extent of the materials to be presented with regard to current and future inclusions might be enunciated.

IMPROPER USE OF TAX TREATIES

During the discussion of E/C.18/2007/CRP 2 at the October/November 2007, 3rd Meeting of the Committee of Experts on International Cooperation in Tax Matters it was suggested that one matter that can be presented was the discussion of the matter of combating treaty abuse.

The Subcommittee formed to address this issue presented the above referred to document at the 3rd meeting. The focus of the report contained in that document was to present a draft of a new section on the matter of improper use of tax treaties (with the intent to have this considered for inclusion in the next version of the UN Model), and to raise for the attention of the Committee four collateral issues that were investigated in the course of the Subcommittee's work on the primary scope of its charge¹.

In the context of the purpose of this section, it was suggested during discussion that examples of treaty abuse, as presented in Paragraph 21 of the document and the four collateral issues be presented as Special Appendix items.

Paragraph 21 of E/C.18/2007/CRP 2 made reference to the main issue for purposes of applying general anti-abuse provisions as was presented in the proposed provision (pertinent parts cited below):

Improper use of tax treaties

Provisions of tax treaties are drafted in general terms and taxpayers may be tempted to apply these provisions in a narrow technical way so as to obtain benefits in circumstances where the Contracting States did not intend that these benefits be provided. Such improper uses of tax treaties is a source of concerns to all countries but particularly for developing countries that have limited experience in dealing with sophisticated tax-avoidance strategies.

The Committee considered that it would therefore be helpful to examine the various approaches through which those strategies may be dealt with and to provide specific examples of the application of these approaches. In examining this issue, the Committee recognized that for tax treaties to achieve their role, it is important to maintain a balance between the need for tax administrations to protect their tax revenues from the misuse of tax treaty provisions and the need to provide legal certainty and to protect the legitimate expectations of taxpayers.²

The main issue so referenced was that of the application of such general provisions to specific situations. It was considered that the promulgation and examination of various approaches to dealing with anti-abuse strategies would be of help to parties in course of negotiating bi-lateral or multi-lateral treaties.

There were several approaches identified as being in use currently by various countries. These approaches include:

- specific legislative anti-abuse rules found in domestic law
- general legislative anti-abuse rules found in domestic law
- judicial doctrines that are part of domestic law
- specific anti-abuse rules found in tax treaties
- general anti-abuse rules in tax treaties
- the interpretation of tax treaty provisions

A discussion of each of those approaches was presented in following sections of the document and those discussions are replicated here.

Specific legislative anti-abuse rules found in domestic law

Tax authorities seeking to address the improper use of a tax treaty may first consider the application of specific anti-abuse rules included in their domestic tax law.

Many domestic rules may be relevant for that purpose. For instance, controlled foreign corporation (CFC) rules may apply to prevent certain arrangements involving the use, by residents, of base or conduit companies that are residents of treaty countries; foreign investment funds (FIF) rules may prevent the deferral and avoidance of tax on investment income of residents that invest in foreign investment funds established in treaty countries; thin capitalization rules may apply to restrict the deduction of base-eroding interest payments to residents of treaty countries; transfer pricing rules (even if not designed primarily as anti-abuse rules) may prevent the artificial shifting of income from a resident enterprise to an enterprise that is resident of a treaty country; exit or departure taxes rules may prevent the avoidance of capital gains tax through a change of residence before the realization of a treaty-exempt capital gain and dividend stripping rules may prevent the avoidance of domestic dividend withholding taxes

through transactions designed to transform dividends into treaty-exempt capital gains.

A common problem that arises from the application of many of these and other specific anti-abuse rules to arrangements involving the use of tax treaties is that of possible conflicts with the provisions of tax treaties.

Clearly, where the application of provisions of domestic law and of those of tax treaties produces conflicting results, the provisions of tax treaties are generally intended to 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 these 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.

As explained below, however, such conflicts will often be avoided and each case must be analyzed based on its own circumstances.

First, a treaty may specifically allow the application of certain types of specific domestic anti-abuse rules. For example, Article 9 of the Convention specifically authorizes the application of domestic transfer pricing rules in the circumstances defined by that Article. Also, many treaties include specific provisions clarifying that there is no conflict (or, even if there is a conflict, allowing the application of the domestic rules) in the case, for example, of thin capitalization rules, CFC rules or departure tax rules or, more generally, domestic rules aimed at preventing the avoidance of tax.

Second, many tax treaty provisions depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person, the determination of what is immovable property and of when income from corporate rights might be treated as a dividend. More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the treaty. In many cases, therefore, the application of domestic anti-abuse rules will impact how the treaty provisions are applied rather than produce conflicting results.

Third, the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied on a proper interpretation of the treaty. In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both the interpretation of the

treaty and the domestic specific anti-abuse rules. Domestic specific anti-abuse rules, however, are often drafted by reference to objective facts, such as the existence of a certain level of shareholding or a certain debt-equity ratio. While this greatly facilitates their application, it will sometimes result in the application of these rules to transactions that do not constitute abuses. In such cases, of course, a proper interpretation of the treaty provisions that would disregard abusive transactions only will not allow the application of the domestic rules if they conflict with provisions of the treaty.

General legislative anti-abuse rules found in domestic law

Some countries have included in their domestic law a legislative anti-abuse rule of general application, which is intended to prevent abusive arrangements that are not adequately dealt with through specific rules or judicial doctrines.

As is the case for specific anti-abuse rules found in domestic law, the main issue that arises with respect to the application of such general anti-abuse rules to improper uses of a treaty is that of possible conflicts with the provisions of the treaty. To the extent that the application of such general rules is restricted to cases of abuse, however, such conflicts should not arise. This is the general conclusion of the OECD, which is reflected in paragraphs 22 and 22.1 of the Commentary on Article 1 of the OECD Model and with which the Committee agrees:

Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including "substance-over-form", "economic substance" and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties [Paragraph 9.4 of the Commentary on Article 1 of the OECD Model].

Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict. [Paragraph 9.5 of the Commentary on Article 1 of the OECD Model]."

Having concluded that the approach of relying on such anti-abuse rules does not, as a general rule, conflict with tax treaties, the OECD was therefore able to conclude 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" [Paragraph 9.4 of the Commentary on Article 1 of the OECD Model].

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 [Paragraph 9.5 of the Commentary on Article 1 of the OECD Model]: [:

"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."

The members of the Committee endorsed that principle. They considered that such guidance as to what constitutes an abuse of treaty provisions 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 obligations and provide legal certainty to taxpayers. Clearly, countries should not be able to escape their treaty obligations simply by arguing that legitimate transactions are abusive and domestic tax rules that affect these transactions in ways that are contrary to treaty provisions constitute anti-abuse rules.

Under the guiding principle presented above, two elements must therefore 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.

These two elements will also often be found, explicitly or implicitly, in general anti-avoidance rules and doctrines developed in various countries.

In order to minimize the uncertainty that may result from the application of that approach, it is important that this guiding principle be applied on the basis of objective findings of facts, not the alleged intention of the parties. Thus, the determination of whether transactions or arrangements have been entered into primarily to obtain tax advantages should be based on an objective determination, based on all the relevant facts and circumstances, of whether, without these tax advantages, a reasonable taxpayer would have entered into the same transactions or arrangements.

Judicial doctrines that are part of domestic law

In the process of determining how domestic tax law applies to tax avoidance transactions, the courts of many countries have developed different judicial doctrines that have the effect of preventing domestic law abuses. These include the business purpose, substance over form, economic substance, step transaction, abuse of law and *fraus legis* approaches. The particular conditions under which such judicial doctrines apply often vary from country to country and evolve over time based on refinements or changes resulting from subsequent court decisions.

These doctrines are essentially views expressed by courts as to how tax legislation should be interpreted and as such, typically become part of the domestic tax law.

While the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the *Vienna Convention on the Law of Treaties*, nothing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties. If, for example, the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach to be adopted with respect to the application of the provisions of a tax treaty to similar transactions.

Specific anti-abuse rules found in tax treaties

Some forms of treaty abuses can be addressed through specific treaty provisions. A number of such rules are already included in the UN Model; these include the reference to the agent who maintains a stock of goods for delivery purposes (subparagraph 5 b of Article 5), 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).

Clearly, such specific treaty anti-abuse rules provide more certainty to taxpayers. This is acknowledged in paragraph 9.6 of the Commentary of the OECD Commentary, which explains that such rules can usefully supplement general anti-avoidance rules or judicial approaches (“9.6 The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy [...].”)

One should not, however, underestimate the risks of relying extensively on specific treaty anti-abuse rules to deal with tax treaty avoidance strategies. First, specific tax avoidance rules can only be drafted once a particular avoidance strategy has been identified. Second, the inclusion of a specific anti-abuse provision in a treaty can 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 could be wrongly interpreted as suggesting that an unacceptable avoidance strategy that is similar to, but slightly different from, one dealt with by a specific anti-abuse rule included in the treaty is allowed and cannot be challenged under general anti-abuse rules. 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 flexible criteria such as the purposes of a transaction or arrangement. For these reasons, the inclusion of specific anti-abuses rules in tax treaties cannot provide a comprehensive solution to treaty abuses.

General anti-abuse rules found in tax treaties

There are a few examples of treaty provisions that may be considered to be general anti-abuse rules. One such provision is paragraph 2 of Article 25 of the treaty between Israel and Brazil, signed in 2002:

A competent authority of a Contracting State may deny the benefits of this Convention to any person, or with respect to any transaction, if in its opinion the granting of those benefits would constitute an abuse of the

Convention according to its purpose. Notice of the application of this provision will be given by the competent authority of the Contracting State concerned to the competent authority of the other Contracting State.

In some cases, countries have merely confirmed that Contracting States were not prevented from denying the benefits of the treaty provisions in abusive cases. In such cases, however, it cannot be said that the power to deny the benefits of treaty arises from the provision itself. An example of that type of provision is found in paragraph 6 of Article 29 of the Canada-Germany treaty signed in 2001:

Nothing in the Agreement shall be construed as preventing a Contracting State from denying benefits under the Agreement where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Agreement or of the domestic laws of that State.

A country that would not feel confident that its domestic law and approach to the interpretation of tax treaties would allow it to adequately address improper uses of its tax treaties could of course consider including a general anti-abuse rule in its treaties. The guiding principle referred to above could form the basis for such a rule, which could therefore be drafted along the following lines:

"Benefits provided for by this Convention shall not be available where it may reasonably be considered that a main purpose for entering into transactions or arrangements has been to obtain these benefits and obtaining the benefits in these circumstances would be contrary to the object and purpose of the relevant provisions of this Convention."

Many countries, however, will consider that including such a provision in their treaties could be interpreted as an implicit recognition that, absent such a provision, they cannot use other approaches to deal with improper uses of tax treaties. This would be particularly problematic for countries that have already concluded a large number of treaties that did not include such a provision. For that reason, the use of such a provision would probably be considered primarily by countries that have found it difficult to counter improper uses of tax treaties through other approaches.

The interpretation of tax treaty provisions

Another approach that has been used to counter improper uses of treaties has been to consider that there can be abuses 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 (As prescribed by Article 31 of the *Vienna Convention on the Law of Treaties*). As already noted, a number of countries have long used a process of legal interpretation to counteract abuses of their domestic tax laws and it seems entirely appropriate to similarly interpret tax treaty provisions to counteract tax treaty abuses. As noted in paragraph 9.3 of the Commentary on Article 1 of the OECD Model Tax Convention:

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).

The paragraphs above provide guidance as to what should be considered to be a tax treaty abuse. That guidance would obviously be relevant for the purposes of the application of this approach.

Examples of Treaty Abuse Scenarios

The following illustrative examples are reproduced from a comprehensive list of examples as included in paragraphs 40 through 104 of the UN document CRP 2/2007.³

Dual residence and transfer of residence

There have been cases where taxpayers have changed their tax residence primarily for the purposes of getting tax treaty benefits. The following examples illustrate some of these cases

- *Example 1:* Mr. X is a resident of State A who has accumulated significant pension rights in that country. Under the treaty between State A and State B, pensions and other similar payments are only taxable in the State of residence of the recipient. Just before his retirement, Mr. X moves to State B for two years and becomes resident thereof under the domestic tax law of that country. Mr. X is careful to use the rules of paragraph 2 of Article 4 to ensure that he is resident of that country for the purposes of the treaty. During that period, his accrued pension rights are paid to him in the form of a

lump-sum payment, which is not taxable under the domestic law of State B. Mr. X then returns to State A.

- *Example 2:* Company X, a resident of State A, is contemplating the sale of shares of companies that are also residents of State A. Such a sale would trigger a capital gain that would be taxable under the domestic law of State A. Prior to the sale, company A arrange for meetings of its board of directors to now take place in State B, a country that does not tax capital gains on shares of companies and in which the place where a company's directors meet is usually determinative of that company's residence for tax purposes. Company X claims that it has become a resident of State B for the purposes of the tax treaty between States A and B pursuant to paragraph 3 of Article 4 of that treaty, which is identical to this model convention. It then sells the shares and claims that the capital gain may not be taxed in State A pursuant to paragraph 6 of Article 13 of the treaty (paragraph 5 of that Article would not apply as company X does not own substantial participations in the relevant companies).
- *Example 3:* Ms. X, a resident of State A, owns all the shares of a company that is also a resident of State A. The value of these shares has increased significantly over the years. Both States A and B tax capital gains on shares; however, the domestic law of State B provides that residents who are not domiciled in that State are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. In contemplation of the sale of these shares, Ms. X moves to State B for two years and becomes resident, but not domiciled, in that State. She then sells the shares and claims that the capital gain may not be taxed in State A pursuant to paragraph 6 of Article 13 of the treaty (the relevant treaty does not include a provision similar to paragraph 5 of this Convention).

Depending on the facts of a particular case, it might be possible to argue that a change of residence that is primarily intended to access treaty benefits constitutes an abuse of a tax treaty. In cases similar to these three examples, however, it would typically be very difficult to find facts that would show that the change of residence has been done primarily to obtain treaty benefits, especially where the taxpayer has a permanent home or is present in another

State for extended periods of time. Many countries have therefore found that specific rules were the best approach to deal with such cases.

One approach used by some of these countries has been to include in their tax treaties provisions allowing a State of which a taxpayer was previously resident to tax certain types of income, e.g. capital gains on significant participations in companies or lump-sum payments of pension rights, realized during a certain period following the change of residence.

Countries have also dealt with such cases through the use of so-called "departure tax" or "exit charge" provisions, under which the change of residence triggers the realization of certain types of income, e.g. capital gains on shares. In order to avoid a conflict with the provisions of a tax treaty, such domestic rules may deem the realization of the income to take place immediately before the change of residence; they may also be combined with treaty provisions allowing for their application.

A proper interpretation of the provisions of paragraphs 2 and 3 of Article 4 may also be useful in dealing with cases similar to these examples. Concepts such as "centre of vital interests" and "place of effective management" require a strong relationship between a taxpayer and a country. The fact that a taxpayer has a home available to him in a country where he sojourns frequently is not enough to claim that that country is his centre of vital interests; likewise, the mere fact that meetings of a board of directors of a company take place in a country is not sufficient to conclude that this is where the company is effectively managed. Also, some countries have replaced paragraph 3 of Article 4, which deals with cases of dual residence of legal persons on the basis of their place of effective management, by a rule that leaves such cases of dual residence to be decided under the mutual agreement procedure.

Example 3 raises the potential for tax avoidance arising from remittance-based taxation. This issue is dealt with in paragraph 26.1 of the Commentary on Article 1 of the OECD Model Tax Convention, which suggests that, in order to deal with such situations, countries may include a specific anti-abuse provision in their tax treaties with countries that allow that form of taxation:

26.1 Under the domestic law of some States, persons who qualify as residents but who do not have what is considered to be a permanent link with the State (sometimes referred to as domicile) are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. Such persons are not, therefore, subject to potential double taxation to the extent that foreign income is not remitted to their State of

residence and it may be considered inappropriate to give them the benefit of the provisions of the Convention on such income. Contracting States which agree to restrict the application of the provisions of the Convention to income that is effectively taxed in the hands of these persons may do so by adding the following provision to the Convention:

"Where under any provision of this Convention income arising in a Contracting State is relieved in whole or in part from tax in that State and under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then any relief provided by the provisions of this Convention shall apply only to so much of the income as is taxed in the other Contracting State."

In some States, the application of that provision could create administrative difficulties if a substantial amount of time elapsed between the time the income arose in a Contracting State and the time it were taxed by the other Contracting State in the hands of a resident of that other State. States concerned by these difficulties could subject the rule in the last part of the above provision, i.e. that the income in question will be entitled to benefits in the first-mentioned State only when taxed in the other State, to the condition that the income must be so taxed in that other State within a specified period of time from the time the income arises in the first-mentioned State.

Treaty shopping

"Treaty shopping" is a form of improper use of tax treaties that refers to arrangements through which persons who are not entitled to the benefits of a tax treaty use other persons who are entitled to such benefits in order to indirectly access these benefits. For example, a company that is a resident of a treaty country would act as a conduit for channeling income that would economically accrue to a person that is not a resident of that country so as to improperly access the benefits provided by a tax treaty. The conduit entity is usually a company, but may also be a partnership, trust or similar entity that is entitled to treaty benefits. Granting treaty benefits in these circumstances would be detrimental to the State of source since the benefits of the treaty would

then be extended to persons who were not intended to obtain such benefits.

A treaty shopping arrangement may take the form of a "direct conduit" or that of a "stepping stone conduit", as illustrated below.⁴

Company X, resident of State A, receives dividends, interest or royalties from company Y resident of State B. Company X claims that, under the tax treaty between States A and B, it is entitled to full or partial exemption from the domestic withholding taxes provided for under the tax legislation of State B. Company X is wholly-owned by a resident of third State C who is not entitled to the benefits of the treaty between States A and B. Company X was created for the purpose of obtaining the benefits of the treaty between States A and B and it is for that purpose that the assets and rights giving rise to the dividends, interest or royalties have been transferred to it. The income is exempt from tax in State A, e.g. in the case of dividends, by virtue of a participation exemption provided for under the domestic laws of State A or under the treaty between States A and B. In that case, company X constitute a direct conduit of its shareholder resident of State C.

The basic structure of a stepping stone conduit is similar. In that case, however, the income of company X is fully taxable in State A and, in order to eliminate the tax that would be payable in that country, company X pays high interest, commissions, service fees or similar deductible expenses to a second related conduit company Z, a resident of State D. These payments, which are deductible in State A, are tax-exempt in State D by virtue of a special tax regime available in that State. The shareholder resident of State C is therefore seeking to access the benefits of the tax treaty between States A and B by using company X as a stepping stone.

In order to deal with such situations, tax authorities have relied on the various approaches described in the previous sections.

For instance, specific anti-abuse rules have been included in the domestic law of some countries to deal with such arrangements. One example is that of the US regulations dealing with financing arrangements. For the purposes of these regulations, a financing arrangement is a series of transactions by which the financing entity advances money or other property to the financed entity, provided that the money or other property flows through one or more intermediary entities. An intermediary entity will be considered a "conduit", and its

participation in the financing arrangements will be disregarded by the tax authorities if (i) tax is reduced due to the existence of an intermediary, (ii) there is a tax avoidance plan, and (iii) it is established that the intermediary would not have participated in the transaction but for the fact that the intermediary is a related party of the financing entity. In such cases, the related income shall be re-characterized according to its substance.

Other countries have dealt with the issue of treaty shopping through the interpretation of tax treaty provisions. According to a 1962 decree of the Swiss Federal Council, a claim for tax treaty relief is considered abusive if, through such claim, a substantial part of the tax relief would benefit persons not entitled to the relevant tax treaty. The granting of a tax relief shall be deemed improper (a) if the requirements specified in the tax treaty (such as residence rule, beneficial ownership, tax liability, etc.) are not fulfilled and (b) if it constitutes an abuse. The measures which the Swiss tax authorities may take if they determine that a tax relief has been claimed improperly include (a) refusal to certify a claim form, (b) refusal to transmit the claim form, (c) revoking a certification already given, (d) recovering the withholding tax, on behalf of the State of source state, to the extent that the tax relief has been claimed improperly, and (e) informing the tax authorities of the State of source that a tax relief has been claimed improperly.

Other countries have relied on their domestic legislative general anti-abuse rules or judicial doctrines to address treaty shopping cases. As already noted, however, legislative general anti-abuse rules and judicial doctrines tend to be the most effective when it is clear that transactions are intended to circumvent the object and purpose of tax treaty provisions.

Treaty shopping can also, to some extent, be addressed through anti-abuse rules already found in most tax treaties, such as the concept of "beneficial ownership".

As indicated above, the list of examples included here is for illustrative purposes. If the Committee agrees that the inclusions should be exhaustive, such amendments may be easily added. See the "Comments" section above.

TREATMENT OF ISLAMIC FINANCIAL INSTRUMENTS UNDER THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES⁵

At the Third session of the Committee one of the items discussed was the taxation of income from Islamic financial instruments. The working group document stated, in its Summary that the "... current drafting of the United Nations Model Double Taxation Convention between Developed and Developing Countries seems to be capable to deal with Islamic financial instruments, but some language could be included in commentary to provide that the definition of interest would include income from some types of Islamic financial arrangements..." At different points after the Working Group presented its document, it was suggested that such definitional statements, while perhaps not appropriate for inclusion in the Commentaries, would be the type of guidance oriented information that would be appropriate for the Special Appendix. Accordingly, the following items that emanate from the working group document have been included.

The working group emphasized in their presentation that the taxation of income from these financial arrangements is primarily a function of the characterization of the proceeds transferred from the various instruments. The significant distinction in the characterization process is the distinction between the use of a legal, or form-based approach, and an economic based approach to characterize the income. The latter approach looks to the substance or the economic realities of the arrangement. It is also the latter approach that can be interpreted to provide for the recharacterization of most of the Islamic financial arrangements described below into loans and to, therefore, treat the payments made according to the contractual terms of those arrangements as interest.⁶

The following descriptions are based upon the language and limited to the specific examples provided in the E/c.18/2007/9 document. Therefore, it may be deemed that other arrangements would be added to enhance the guidance provided by this item in the Special Appendix.

In the way of background⁷, over the past 1400 years, Islamic law has formulated details on how business is to be conducted, how accounting is to be performed, and how banking and finance is to be executed. Islamic finance methods that were sanctioned by the Quran⁸ and Sunnah⁹, the two main sources of Islamic law, have provided merchants with a framework to engage in commerce and trade. Islam has defined a set of rules for trade and commerce. That which defies Islamic law, also known as *Shariah*, is considered *haram*, not permitted; practices that are permissible are *halal*. Islam has defined a set of rules for trade and commerce. That which defies Islamic law, also known as *Shariah*, is

considered *haram*, not permitted; practices that are permissible are *halal*. Among these rules is the strict prohibition of the payment or collection of interest, also known as usury or *riba*.¹⁰

The Working Group document addressed the following types of instruments or contracts: *musharaka*, *mudaraba*, *murabaha*, *ijara*, *salam*, *istisna'a*, and *sukuk*. Accordingly, they are included in the Special Appendix. The language used in the description is based upon that as presented in the Working Group document¹¹, and various other sources of commentary.

Musharaka

Musharaka means partnership. The essence of the arrangement is an "equity participation contract" where the partners or owners contribute jointly to finance a project. The partners include a bank or banks as well as other forms of participants.

Profits and losses are split according to a pre-agreed formula.

A variation of this arrangement is the "diminishing musharaka" that is a partnership type arrangement that provides for a gradual buyout of one or more of the partners.

In the context of such an arrangement, the profit/loss sharing ratio does not have to reflect the same ratio as the investment ratio. Similar to the partnership rules in the United States tax law, the agreement of the partners is deciding, and as long as there is agreement, generally, the discrepancy between the two ratios is valid.

Mudaraba

This arrangement is characterized as an "investment partnership"¹² where the investor agrees to provide money to another party, an entrepreneur, in order to invest the funds or to undertake a business venture. Profits are distributed on the basis of a pre-agreed formula, while losses are born solely by the investor partner.

The profit sharing scheme is described as perfectly *sharia* compliant.¹³ The scheme is described as: a depositor deposits money with a financial institution (an Islamic bank), which would be used by the institution with the intent to produce a profit. The depositor has no role in deciding how the funds are to be invested. At various times, the institution would credit the depositor with a distribution of profits that have been generated by the institution's use of the funds.

Murabaha

The literal translation of the term is "a sale on a mutually agreed profit." The technical structure is an asset-based financing whereby the party that provides the capital (a bank) purchases an asset, as directed by the client (the capital user), from a third party in an open market, and resells it at a predetermined higher price to the client (client user) in a deferred payment arrangement, without interest, thereby obtaining a credit against the purchase obligation, without paying interest.

This arrangement is subject to strict conditions in the effort to achieve validity, i.e. be sharia compliant. While strict the conditions are not onerous. There must be full disclosure of all costs, including the purchase price, and the profit margin, at the time of the agreement, by the capital provider. Also, there can be no sale of the asset before all ownership issues are settled and the item(s) is reduced to possession and the risks of ownership are assumed by the capital provider.¹⁴

A variation on that theme which raises concerns regarding sharia compliance has the capital provider selling the asset or commodity to the client on a deferred payment contract, who then immediately sells the commodity for cash. This level of immediacy associated with the client's conversion of the commodity to cash gives the appearance of a loan from the capital provider, not a purchase and deferred payment arrangement.¹⁵

Ijara

The term means, literally, to rent. In the context of Islamic jurisprudence, the term includes the "...usufruct of assets and property (rental) and the hire of services of a person for a wage."¹⁶

The Ijara is a mode of financing to the lessee and a mode of investment for the lessor. The essential rules for a basic Ijara transaction include¹⁷:

1. The term of the lease and consideration must be specified.
2. Liabilities given rise through the use of the asset/property will be the responsibility of the lessee. Liabilities surfacing from the ownership of the

property are the responsibility of the lessor. If the lessee damages the property, they must compensate the lessor for it.

3. The day the asset is delivered or available for use is the day the lease is affective.
4. The object of rent cannot be something that can be consumed, like money, gas, or food. This gives rise to a loan and any rent charges constitutes *riba*. The item must stay in the owner's possession for the validity of the contract.

A variation is the *Ijara Waktina* which involves an arrangement whereby an asset is leased with a sale to the lessee at the end of the period.¹⁸

Salam

Referred to as a *bai essalam* (or *salam*) contract, the arrangement is a contract of sale whereby the price (also referred to as capital) is immediately payable and the delivery of the commodity is deferred. The outcome of this structure: the seller is provided with immediate cash to finance his activity and to provide the buyer with the commodity at a relatively low price¹⁹

In Islam, there are three mandatory elements to a sale in order for it to be legitimate. At the time of sale, the product 1: must exist, 2: the seller must own it, and 3: it must be in the seller's possession. The only two exceptions to this general rule are the contracts of *salam* and *istisna'*. Historically, the *salam* arrangement was used in situations where the seller of the commodity needed the cash to finance the production of the commodity.

One example of such a situation is the case of the farmer who needs the funds to finance the growing and harvesting of a crop.²⁰ The benefit to the buyer was generally realized in the form of a discount embedded in the purchase price.

The most important conditions to the validity of the salam are: the capital should be paid immediately (there can be no debt from the buyer to the seller), and the buyer cannot sell the commodity before the salam contract has been settled.

Istisna'a

The other document mentioned in the above discussion of the salam is the istisna'a which is a particular form of sale whereby a party (the purchaser) places an order to another party (the manufacturer) to manufacture a specific commodity for a determined price.²¹ It is generally agreed that the istisna'a is binding on both parties.²²

Of the four main schools of Islamic jurisprudence, three (Maliki, Chafii, and Hanbali schools) take the view of the istisna'a as a form of the salam. The distinction is the type of commodity to which the contract applies. The istisna'a generally applies to manufactured commodities.²³ The requisite elements and conditions of validity for the istisna'a are the same as those for the salam.

The fourth school, the Hanafi school, offers forth the currently prevailing opinion that the istisna'a and salam are separate and distinct forms of contract. The differences between the two are, primarily: advance payment is not a condition of the istisna'a, the time of delivery is not necessarily fixed in the terms of the istisna'a while such element is essential in the salam contract, and once signed, the salam cannot be cancelled unilaterally, while the istisna'a can be cancelled before the manufacturer starts the work.²⁴

In general, the istisna'a is similar in nature to the contract of *salam*, except *istisna'* pertains to specific goods ordered to be produced by a manufacturer. The goods must be manufactured with materials supplied by the manufacturer. Also, the price and specifications of the goods must be agreed upon for the validity of *istisna'*.

It is also pointed out, that, to distinguish from the ijara, the contract is for the manufactured commodity, not the services of the manufacturer. This permits the use of the istisna'a for project financing.

Sukuk

This is usually presented as the Islamic equivalent of the conventional corporate bond. It is better described as an investment certificate that represents a proportionate ownership in an asset. The significant characteristic is that the owner of the sukuk holds a beneficial interest in the asset(s) that is proportional to the amount of the asset investment in the same proportion that is represented by the holders subscription to the total asset investment.²⁵ A primary purpose of this arrangement is to spread the risk of the investment. Ownership shares in a project or investment that may require significant capital are offered to subscribers as a way to generate the capital and spread the risk. The subscribers then share in the profits. The arrangement, in its pure form, is likened to a western joint stock company.²⁶

The sukuk may take different forms. The most popular or familiar forms are the salam sukuk, the istisna'a sukuk and the ijara sukuk. There are also the mudaraba and musharaka sukuk (or notes).²⁷ The following descriptions are taken from information presented in paragraphs 28 through 38 of E/c.18/2007/9.

Salam sukuk

This arrangement represents a fractional ownership in the capital investment of a salam transaction in which the purchaser will issue certificates representing ownership of the commodity to buyers. The benefit to the buyers is that the purchase price of the commodity, the basis for the ownership certificates, is lower than the value. At the time the certificates mature, the buyer is entitled to their respective share of the commodity which can then be sold at the higher, value oriented, price.²⁸

The certificates represent a right to receive a share of the commodity when the underlying salam contract is settled. This point is important to the discussion of whether or not the certificates themselves can be sold. While the debate continues, it appears that most scholars of Islamic financial arrangements take the position that the certificates cannot be transferred as they represent future interests in a commodity that has not been reduced to possession by the purchaser in the salam contract.²⁹

*Istisna'a sukuk*³⁰

The istisna'a involves financing a project consisting of manufacturing or constructing an asset at a price to be paid in future installments. The total amount of these installments includes a profit margin. The istisna'a sukuk is a fractional share in the istisna'a project financing.

The project customer provides the Islamic bank (the capital source) with the details of the project and the bank then engages contractors to submit bids which include specifications as to the timing of delivery of their product and the payment schedule which covers their costs and a profit margin. The bank issues the sukuk certificates based on the expected future income streams from the project.

*Ijara sukuk*³¹

Under the ijara contract the asset or property is leased by the owner to another person for a rental payment. The arrangement is structured to represent a lease for financial statement purposes, and will generate a fixed income stream. The ijara sukuk represents a fractional ownership in this income stream.

Since the ijara sukuk represent an ownership in an existing tangible asset it may be traded in a secondary market.

*Musharaka and mudaraba sukuk*³²

The musharaka and mudaraba represent equity instruments. The musharaka and mudaraba sukuk represent fractional ownership interests in those equity instruments. The equity instruments represent ownership interests in private commercial enterprises or projects.

Holders of the sukuk certificates in a mudaraba sukuk share the profits with the entrepreneur who issues the certificates, but bear, in the totality, any losses arising from the mudaraba operations. While the owners are equity interest holders, they are not registered owners so hold no voting or representation rights. There is no guarantee that the certificate holders will be returned their capital investment, but most Islamic scholars recommend that such a guarantee be voluntary on the part of the entrepreneur.

There remain many questions regarding the issue of Islamic financial instruments but the purpose of this presentation in the Special Appendix is to provide a basic point of reference for representative types of Islamic financial instruments.

Reviewers should consider whether the discussion should include a discussion of the economic or legal theory which facilitates interpretation of the financial realities of these instruments.

Reviewers should also consider whether there are representative examples, such as the ones contained in E/c.18/2007/9, paragraphs 69 through 71, that should be included here.

PROPOSED TOPICS

It was proposed during the 3rd Session of the Committee that examples addressing issues surrounding the schemes for percentage sales and time period for sales of shares in real estate corporations should be included.

It was proposed during the 3rd Session of the Committee that examples reflecting scenarios in which states have refused to furnish requested information be included in order to give states guidance as to how to handle such refusals and factors that affect the alternative strategies for dealing with such situations.

There was also some discussion at the 3rd Session of the Committee that the Special Appendix would be an appropriate place for a “Best Practices” section for such specific topics as dispute resolution.

¹ E/C.18/2007/CRP2, page 3.

² E/C.18/2007/CRP2, page 4.

³ E/C.18/2007/CRP2

⁴ Double Taxation Convention and the Use of Conduit Companies”, in volume II of the loose-leaf version of the *OECD Model Tax Convention*, OECD, R(6)-1, at page R(6)-4, paragraph 4.

⁵ E/C.18/2007/9

⁶ E/c.18/2007/9, “Summary.”

⁷ “Islamic Banking and Accounting,” a research paper submitted by Ms. Sarah Tantawy in partial fulfillment of a course for matriculation of her program at California State University, Sacramento, April 2008.

⁸ The Quran is the Holy Book that Muslims believe was revealed to the Prophet Muhammad as the last revelation sent to mankind and is the primary source used to deduce legislation.

⁹ Along with the Quran, the Sunnah is another primary source used by Jurists and refers to the binding rules derived from the Prophet Muhamad’s sayings.

¹⁰ The Holy Qur'an in verse 278 of the second chapter (Al-Baqarah) states:

“O ye who believe! Fear Allah and give up what remains of your demand for riba, if ye are indeed believers.”

Verse 279 says, “If you do it not, take notice of war from Allah and His Messenger. But if ye turn back, ye shall have your capital sums. Deal not unjustly and you shall not be dealt with unjustly.

¹¹ E/c.18/2007/9, paragraphs 4 through 38.

¹² E/c.18/2007/9, paragraph 7.

¹³ E/c.18/2007/9, paragraph 6.

¹⁴ E/c.18/2007/9, paragraphs 9 and 10.

¹⁵ E/c.18/2007/9, paragraph 11.

¹⁶ E/c.18/2007/9, paragraph 12.

¹⁷ “Islamic Banking and Accounting,” supra.

¹⁸ E/c.18/2007/9, paragraph 13.

¹⁹ E/c.18/2007/9, paragraph 15.

²⁰ “Islamic Banking and Accounting,” supra.

²¹ E/c.18/2007/9, paragraph 18.

²² E/c.18/2007/9, paragraph 19.

²³ E/c.18/2007/9, paragraph 20.

²⁴ E/c.18/2007/9, paragraph 22.

²⁵ E/c.18/2007/9, paragraphs 24 and 25.

²⁶ E/c.18/2007/9, paragraph 25.

²⁷ E/c.18/2007/9, paragraph 26.

²⁸ E/c.18/2007/9, paragraph 28.

²⁹ E/c.18/2007/9, paragraph 29.

³⁰ E/c.18/2007/9, paragraphs 30 and 31.

³¹ E/c.18/2007/9, paragraphs 32 through 35.

³² E/c.18/2007/9, paragraphs 36 through 38.