

**MASTER OF COMMERCE IN TAXATION
IN THE FIELD OF INTERNATIONAL TAX**

FTX5032W 2014

Topic

A principled evaluation of the effectiveness of selected aspects of the OECD's BEPS proposals to prevent "tax treaty abuse"

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Submission date: 16 February 2015

WORD COUNT: 15 100

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A principled evaluation of the effectiveness of selected aspects of the OECD's BEPS proposals to prevent "tax treaty abuse"

The BEPS Action 6 Report identified "tax treaty abuse", and in particular "treaty shopping", as one of the most important sources of BEPS. As such, the objective and purpose of the Action 6 Report is intended to address "the granting of tax treaty benefits in inappropriate circumstances" to prevent the perceived "tax treaty abuse". This has been a primary focus for the BEPS project. This paper evaluates the effectiveness of selected aspects of the BEPS proposals against this purpose and objectives of the OECD BEPS project. To evaluate the effectiveness of these proposals, this paper examines the development of basic principles to understand what is meant by the term "tax treaty abuse". An overview of these developments proposes to provide clarity and ensure that the broader context is conceptualised for the purposes for this paper.

I. PRE-INTRODUCTORY REMARKS

There are many closely connected issues relating to "tax treaty abuse". For example, this includes the development of domestic law provisions to address treaty abuse and issues relating the application of these domestic general anti-avoidance rules ("GAAR") in the context of treaties. While a GAAR case has not been decided in South Africa, it is a recognised principle that GAAR can apply in the context of tax treaties in South Africa. This statement however neglects to address the practical implications of effectively applying GAAR provisions in the context of tax treaties. It is also observed that within these two concepts, issues of interpretation arise; namely whether a strict literal interpretation should be applied or alternatively, a purposive interpretation preferred which takes into account the object and purpose of the relevant statute.

With the recent focus on the base erosion and profit shifting ("BEPS") project, this paper attempts to evaluate the effectiveness of selected aspects of the Organisation for Economic Co-operation and Development ("OECD") BEPS proposals to prevent "tax treaty abuse". The evaluation will therefore consider literature of a general nature, and while applicable to South Africa not necessary specific to South Africa. In the evaluation, the paper attempts to highlight the broad concepts in the areas of law and in particular the application from an international perspective. The purpose of the study is to therefore focus on the on the literature of a general nature on the topic of treaty abuse to determine if

an understanding of the concept of “tax treaty abuse” can be ascribed to from an international tax perspective. In this way, the paper proposes to develop a contextual framework within which to perform an evaluation of the effectiveness of selected aspects in the OECD BEPS proposals.

1. INTRODUCTION

Literature has recognised that “tax treaty abuse” is a multidimensional concept which has proven difficult to define. This has often resulted in “tax treaty abuse” being misinterpreted and confused with “tax avoidance” and “tax evasion” particularly in the area of tax treaties. These terms are however conceptually different and complex, capable of their own meaning and interpretation. Although what is meant by “tax avoidance” and “tax evasion” is not the focus of this paper, it will be briefly considered. Rather, the purpose of this paper will be to perform a principled evaluation of the effectiveness of selected aspects of the OECD’s BEPS to prevent “tax treaty abuse” in the BEPS Action 6 Report¹ (“the Report”).

The considerations to be discussed in detail within this paper include:

- a) A understanding of the term “tax treaty abuse” by evaluating and reflecting how the term has been interpreted and applied by international organisations, courts and commentators in the field of international tax policy; and
- b) The effectiveness of the “limitation on benefits” (“LoB”) provision, as one of the OECD’s BEPS proposals, to prevent “tax treaty abuse”.

In this section the following paragraphs provide an overview of the international tax landscape to highlight the development of “abuse” within the literature (including international organisations, courts and commentators). This will begin with a brief overview of the rights of the taxpayer, where the concept of “abuse” is relatively undeveloped and move to the position of BEPS, where “tax treaty abuse” is a focus.

¹ OECD, 2014. Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing. Available through OECD website < <http://dx.doi.org/10.1787/9789264219120-en> > [2014, September 16].

1.1. Taxpayers' rights to "tax plan"

Various courts have struggled with the challenge of defining what constitutes "abuse" in evaluating the relationship between the taxpayer and tax authorities. Courts have therefore held in favour of taxpayers' rights to "tax plan" in order to minimise the tax costs. This is supported by the principle established by USA² and UK³ courts which held that there was essentially nothing wrong with taxpayers' arranging their tax affairs in the most tax efficient manner. The principle, also commonly referred to as the principle of "Duke of Westminster", which is consistently followed by courts.⁴

The US Judge Learned Hand in *Gregory v. Helvering*⁵ held that:

"anyone 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."

Similarly, in the UK, Lord Tomlin, in his well-known case of the *Duke of Westminster*⁶ made an equivalent statement that:

*"every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate acts is less than it otherwise would be."*⁷

The established principle applies a literal interpretation of the law to the facts and circumstances. This is supported by the principle of legality which entrenches the taxpayer's need for reasonable certain and accurate statutes regarding tax matters and tax policy to ensure that the taxpayer can conduct his affairs with a level of assurance.⁸

² *Gregory v. Helvering*, 293 U.S. 465 (1935).

³ *Inland Revenue Commissioners v. Westminster (Duke)*, [1936] AC 1 (HL).

⁴ In confirmation that the courts continue to follow the principle, the Supreme Court in the *India-Vodafone International Holdings B.V. v. Union of India & Anr.* [S.L.P. (C) No. 26529 of 2010, dated 20 January 2012] reiterated that a taxpayer is well within his right to carry out genuine tax planning to minimize his tax cost. It follows, that *bona fide* tax planning is the right of the taxpayer. The Supreme Court does however also confirm that tax authorities have the power to investigate and establish the true nature of the taxpayer's transactions for purposes of tax.

⁵ *Ibid.* 2.

⁶ *Ibid.* 3.

⁷ *Ibid.* 3, p. 19.

⁸ *President of the Republic of South Africa v Hugo* 1997 (4) SA 1 (CC).

This literal approach to interpretation was later criticised by courts because it neglected to take account of the true nature of the taxpayer's transaction.⁹ By disregarding the true nature of the taxpayer's transaction, the taxpayer was permitted to avoid provisions of the statute and as a result avoid tax. This criticism was confirmed by the UK courts decisions' *Ramsay v IRC*¹⁰ and *MacNiven v Westmoreland Investments Ltd*.¹¹

The criticism did however not result in a complete rejection of the "*Duke of Westminster*" principle. Rather, the literal interpretational approach applied by courts was developed to contextualise the facts and circumstances when interpreting the provisions of the statute. This progression was confirmed by Lord Hoffman in his speech in the *MacNiven v Westmoreland Investments Ltd*¹² judgement who states that a contextual and purposive interpretation should be applied when evaluating the facts and circumstances of the case within the provisions of the statute.¹³

1.2. Developments of the Duke of Westminster Principle

The *Ramsay v IRC*¹⁴ and *MacNiven v Westmoreland Investments Ltd*¹⁵ judgements highlight the development from a strict literal interpretation to a contextual and purposive interpretation of a taxpayer's transaction, operation, scheme, agreement or understanding.

From a common law perspective, the preference for a contextual and purposive approach is confirmed by the application of the "*plus valet quod agitur quam quod simulate concipitur*" maxim. While

⁹ Lord Wilberforce in *Ramsay v IRC* [1981] STC 174 1982 AC 300 54 TC 101 at page 323, stated that while Lord Tomlin's statement was a "cardinal principle", it did not require a court to "look at a document or a transaction in blinkers".

¹⁰ *Ramsay v IRC* [1981] STC 174 1982 AC 300 54 TC 101.

¹¹ *MacNiven v Westmoreland Investments Ltd* [2001] UHL/1. Lord Hoffmann at paragraph 33 confirmed that "there is nothing new about terms used in tax legislation being construed as referring to business or commercial concepts which may not be capable of being held within the confined of purely juristic analysis." At paragraph 34 he asserts that "it is thus the statute itself which applies the tests of ordinary business. And for present purposes, the significant feature of applying a test of ordinary business is that it may require an aggregation of transactions which transcends their juristic individuality." Lord Hoffmann goes further at paragraph 35 to explain, that in his view, what "Lord Wilberforce was doing in the *Ramsay* case was no more (but certainly no less) than to treat the statutory words "loss" and "disposal" as referring to commercial concepts to which a juristic analysis of the transaction, treating each step as autonomous and independent, might not be determinative. What was fresh and new about *Ramsay* was the realization that such an approach need not be confirmed to well recognized accounting concepts such a profits and loss but could be the appropriate construction of other taxation concepts as well.

¹² *Ibid.*

¹³ *Ibid.* para 33 – 34.

¹⁴ *Ibid.* 9.

¹⁵ *Ibid.* 9.

commonly referred to as the “*plus valet*” principle, the maxim implies that the “real intention carries more influence than a fraudulent formulation or pretence”.¹⁶

From a South African legal perspective, the application of the “*plus valet*” principle is best described in *Zandberg v Van Zyl*¹⁷ where the court held that

“[...] not infrequently, [...] parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a Court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is; not what in form it purports to be... but the words of the rule indicate its limitations. The Court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances, that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The enquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.”

The court therefore makes it clear that no universal principle exists to identify the real intention.

Consequently, the facts and circumstances of each case must be evaluated in the context.¹⁸

¹⁶ Cilliers, C., Anti-Avoidance, in E Brincker and A. de Koker, Eds., *Silke on International Tax*, LexisNexis On-line, at para 46.5. Cilliers states that in the context of statutory avoidance one often encounters the concept of a transaction in “*fraudem legis*”. He argues further that “*fraudem legis*” is seen merely as an application of the “*plus valet*” principle.

¹⁷ *Zandberg v Van Zyl* 1910 AD 302 at 309.

¹⁸ The decision by the Supreme Court of Appeal in *CSARS v NWK Limited 2011 (2) SA 67 (SCA)* created much confusion with regard to what constitutes a simulated transaction and seemed to contradict criteria that had been laid down in the *locus classicus* case of *Zandberg v Van Zyl*. The decision essentially laid down criteria in terms of which a transaction would be regarded as simulated, which would entitle SARS to give effect to the underlying ‘real’ transaction. In the *NWK* case Lewis JA said (at para [55]) that – “in my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms.... The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated.” Willis JA’s judgement in the *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC and Others [2014] ZASCA 40* firstly stated that he rejected the proposition that the SCA in *NWK* had taken the law in a “new direction” and secondly, he affirmed the traditional view that the essence of a simulated transaction is that it involves a disguise. Willis JA said (at para [27]) that – “Whether a particular transaction is a simulated transaction is therefore a question of its genuineness. If it is genuine the court will give effect to it and, if not, the court will give effect to the underlying transaction that it conceals. And whether it is genuine will depend on a consideration of all the facts and circumstances surrounding the transaction.” Willis JA’s judgment concluded (at para [37]) that – “... the notion that INWK transforms our law in relation to simulated transactions or requires more of a court faced with a contention that a transaction is simulated that a careful analysis of all matters surrounding the transaction, including its commercial purpose, if any, is incorrect.” Willis JA went further to confirm that the correct position is that the court examines each particular transaction as a whole, including all surrounding circumstances, any unusual features, and the manner in which the parties intend to implement it, before determining whether the transaction was simulated. In *CSARS v Bosch [2014] ZASCA 171* Willis JA, affirmed the principles that should be applied to determine the meaning of words used in a statute. Willis JS (at para [9]) stated that – “The words of the section provided the starting point and are considered in the light of their context, the apparent purpose of the provision and any relevant background material. There may be rare cases where words used in a statute or contract are only capable of bearing a single meaning, but outside of that situation it is pointless to speak of a statutory provision or a clause in a contract as having a plain meaning. One meaning may strike the reader as syntactically and grammatically more plausible than another, but, as soon as more than one possible meaning is available, the determination of the provision’s proper meaning will depend as much on context, purpose and background as on dictionary definitions or what Schreiner JA referred to as “excessive peering at the language to be interpreted without sufficient attention to the historical contextual scene.” Willis JA essentially distinguished between simulation, which may amount to tax evasion, on the one hand, and arranging one’s affairs so as to pay the least amount of tax (tax avoidance) on the other, confirming that there is nothing impermissible in tax avoidance.

Cilliers argues that in the context of “tax avoidance” the concept of a transaction in “*fraudem legis*” is simply an application of the “plus valet” principle.¹⁹ This statement is partly correct because the evaluation of whether a transaction is contrary the provisions of a statute is a two-pronged analysis, involving an analysis of the transaction to assess the true nature of the transaction against an analysis of the provisions of the statute to decide its applicability.²⁰

Simply put, the “*fraudem legis*” or “plus valet” principles apply in the context of tax treaties because the principle attempts to evaluate the true nature of the transaction.²¹ Through the application of the principle, courts will arguably consider the application tax treaties to the true nature of the transition as intended by the taxpayer.²² While this will not result in a recharacterisation of the fact pattern, it will reveal the true nature of the transaction.²³ Understanding the true nature of the transaction forms a basis from which to identify possible “abuses”.

1.3. Position before BEPS

Numerous attempts have been made through history, prior to BEPS, to provide a definition for “tax treaty abuse”. This is supported by the UN Ad Hoc Group of Experts on International Co-operation in Tax Matters²⁴ in 1987 who “loosely” defined “abuse of tax treaties” as “the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits the treaties were not designed to give them”.²⁵

¹⁹ *Ibid.* 16, para 46.5.

²⁰ *Ibid.*

²¹ *Ibid.* 16, para 46.33.

²² *Ibid.* At para [46.32] Cilliers implies that there is a legal argument to justify the application of South Africa’s GAAR to the country’s tax treaties. He however comments on the potential difficulties (at para [46.33]) where he states that, “... the *plus valet* rule must be distinguished from the GAAR or other statutory anti-avoidance provisions with similar effects. In other words, where it applies the GAAR allows a transaction, which may otherwise be perfectly real and genuine in all respects, to be completely recharacterised for tax purposes. This would, or may, involve a qualification difficulty. The distinction has been succinctly stated by Arnold and Van Weeghel: ‘If a scheme can be regarded as a sham, or if otherwise a determination of the facts reveals a different fiscally relevant fact pattern than that presented by the taxpayer, the treaty must be applied to that different fact pattern. But if the domestic anti-avoidance would go beyond determination of the facts or extensive interpretation, application would be inconsistent with that country’s treaty obligations.’ Also see Arnold, B. & Van Weeghel. S., 2006. The Relationship between Tax Treaties and Domestic Anti-Abuse Measures. In: G. Maisto, ed. Tax treaties and Domestic Law. The Netherlands: IBFD, Volume 2, EC and International Tax Law Series, p. 100.

²³ *Ibid.* 21.

²⁴ UN, 1987,3. The United Nations Ad Hoc Group of Experts on International Co-operation in Tax Matters , Preventions of Abuse of Tax Treaties, Fourth Meeting Geneva, 30 November - 11 December 1987, New York: UN Secretariate.

²⁵ *Ibid.*

Similarly the OECD in 1987 concluded that the use of treaties would be considered improper where a person acts through a legal entity created in a State primarily to obtain treaty benefits which it would otherwise not have been available to him directly.²⁶

The OECD Commentary was revised in 2003 to provide an interpretational tool that was used to identify “tax treaty abuse”. As part of this interpretive tool, the “guiding principle” was formulated to provide more detail criterion to assist in the identification process of “tax treaty abuse”. Although the OECD developed the “guiding principle”, it was noted in the Commentary that there is a clear presumption against the taxpayer entering into an abusive transaction. The “guiding principle” states that it:

“[...] is that the benefits of a convention should not be available where the 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.”

It is important to note that the 2003 revision did not propose the introduction of a standard model provision. Rather, the OECD developed the “guiding principle” to assist in the determination of whether or not a transaction is contrary to the objects of the tax treaty and as a result, considered abusive.²⁷

In 2009 the UN released a Report on the Improper Use of Tax Treaties²⁸ (the “UN Report (2009)”) wherein it agreed with the OECD’s view on introducing the “guiding principle”. Important exceptions to the “guiding principle” were however identified in the UN Report (2009). The exceptions take account of factors including; source state taxation, resource capacity building and the role of tax treaties in allocating taxing rights to avoid potential double taxation. Generally, it is accepted that these factors are recognised as part of the needs of developing countries.

²⁶ *Ibid.*

²⁷ *Ibid.* 16, para 46.42. Cilliers states that “The OECD ‘guiding principle’ ... is also of little true assistance when it comes to treaty shopping. It will be recalled that in terms of the first leg of this guiding principle, tax treaty benefits supposedly ought not to be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position. The important point in the present context is that, even on the OECD’s own formulation, this is not enough – it must also be possible to say that the obtaining of the more favourable tax treatment in the circumstances would be contrary to the object and purpose of the relevant provisions”.

²⁸ UN, 2009, June. United Nations Tax Committee Report on Improper Use of Tax Treaties, New York: UN Secretariate.

1.4. BEPS Action 6

The OECD identified in its Action Plan that “treaty abuse”, and in particular “treaty shopping”, was one of the most important sources of BEPS concerns.²⁹ Action 6 of the BEPS Action Plan was therefore dedicated to address “*the granting of treaty benefits in inappropriate circumstances*”.

The Action 6 Report on *The Granting of Treaty Benefits in Inappropriate Circumstances* (“the Report”) was published on 16 September 2014 and contained the OECD’s final recommendation on the subject matter after the release of the Public Discussion Draft on 14 March 2014. While the Report is considered final, it is subject to the finalisation of the other BEPS Action Plan deliverables expected by September 2015.

In addressing the OECD’s mandate, the Report provides recommendations on the following:

- a) Developing treaty provisions and domestic rules to prevent the granting of treaty benefits in inappropriate circumstances;
- b) Clarification that tax treaties are not intended to be used to generate double non-taxation; and
- c) Tax policy considerations that countries should consider before entering into a tax treaty.

In relation to the first point above, the Report makes a distinction between types of abuse:

- a) Cases where a person tries to circumvent limitations provided by the treaty itself (“type 1”);
and
- b) Cases where a person tries to circumvent the provisions of domestic law using treaty benefits (“type 2”).

The purpose of this paper is to address selected aspects of “type 1” abuse and evaluate the effectiveness of the BEPS proposals to counter the abuse.

²⁹ OECD, 2013. Action Plan on Base Erosion and Profit Shifting. Available through: OECD website <<http://www.oecd.org/ctp/BEPSActionPlan.pdf>> [2014, March 13].

In identifying “type 1” abuses, the Report recommends that:

- a) a clear statement of intent in the title and preamble of the tax treaty that confirms that the countries will avoid creating opportunities for double non-taxation or reduced taxation through tax evasion or avoidance, including treaty shopping;³⁰
- b) specific anti-abuse rules are based on the US-style LoB article;³¹ and
- c) the inclusion of more general anti-abuse rules based on the principle purpose test (“PPT”).³²

It is important to note that a further Public Discussion Draft on the Report was issued on 21 November 2014 to deal with the follow-up work relating to the contents of the model provisions and related Commentary in connection with the LoB provision.

1.5. Approach

It is generally accepted that one of the primary objectives of tax treaties is to promote international trade and investments.³³ It is however important to note that the recent focus on BEPS, the avoidance of “double non-taxation” and “treaty abuse” has however suggested that these aspects be included as objectives of tax treaties. Although, the OECD, through BEPS, has driven the current focus on “tax treaty abuse”, it has arguably failed to provide the appropriate theoretical framework within which to apply the BEPS proposals. This is because the BEPS proposals (and arguably the BEPS project) fail to take into consideration basic principles underlying public international law. One such basic principle includes the principle of State Sovereignty. The other basic principle is that “States must perform their treaty obligations in “good faith” and refrain from abusing their rights”.³⁴ This basic principle underlying public international law is indicative of the fact that the principle of “good faith” is a core attribute of general law including international law.

³⁰ *Ibid.* 1, para 62. The Report states that – “In order to provide the clarification required by Action 6, it has been decided to state clearly, in the title recommended by the OECD Model Tax Convention that the prevention of tax evasion and avoidance is a purpose of tax treaties. It has also been decided that the OECD Model Tax Convention should recommend a preamble that provides expressly that States enter into a tax treaty intended to eliminate double taxation without creating opportunities for tax evasion and avoidance.”

³¹ *Ibid.* 1, para 18. The Report states that – “[...] targeted specific treaty anti-abuse rules generally provide greater certainty for both taxpayers and tax administrations. Such rules are already found in some Articles of the Model Tax Convention (see, for example Articles 13(4) and 17(2)).

³² *Ibid.* 1, para 17. The Report states that the principle purpose test (“PPT”) “incorporates principles already recognised in the Commentary on Article 1 of the OECD Model Tax Convention n, provides a more general way to address treaty avoidance cases, including treaty-shopping situations that are not covered by the limitation of benefits clause.

³³ OECD Commentary (2003) on Article 1, para 7.

³⁴ Article 26 of the Vienna Convention on the Law of Treaties. See also De Broe, L., 2008. International Tax Planning and Prevention of Abuse: A study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies. Volume 14, Doctoral Series ed. The Netherlands: IBFD, p. 305.

While the need to counteract BEPS is recognised as a global initiative, one of the major criticisms of the Report is that it does not address the fundamental building blocks of trying to understand the complex concept of “tax treaty abuse”. Rather, the Report, in a reactionary approach, makes recommendation and revisions to various tax treaty provisions to reduce and combat “tax treaty abuse” and neglects to address what the OECD understand by the term “tax treaty abuse”.

This has arguably created greater uncertainty and instability for taxpayers resulting in the imbalance between trying to combat the alleged “tax treaty abuse” and promoting cross-border commercial investment and activity. The fact that certainty and stability form the basic foundation of any tax system is an important policy consideration that is equally not dealt with in the Report.

From the section above one sees a progression from the “*Duke of Westminster*” principle, where there was arguably no potential for “abuse”, to the development of the concept “abuse of law” where, through the application of a purposive and contextual interpretation, an interpretative tool is applied as a means of identifying “abuse”. Through this interpretation, the principle of “good faith” is inherently applied.³⁵

It is important to note that while the concepts developed around “tax treaty abuse” and BEPS proposals are not new. In evaluating the effectiveness of the proposals it would also be important to understand why the previous guidance has not managed to close the loop on “tax treaty abuse”. While out of the scope of this paper it is necessary that this factor be considered to assess the overall effectiveness of the BEPS proposals.

As a basis from which to evaluate the BEPS proposals, the next section aims to investigate what is understood by the term “tax treaty abuse”. This will be achieved by evaluating how the term has been interpreted and applied by international organisations, courts and commentators in the field of international tax policy.

³⁵ Article 26 of the Vienna Convention on the Law of Treaties.

2. UNDERSTANDING THE CONCEPT OF “TAX TREATY ABUSE”

2.1. Introduction

One of the central criticisms of the Report is that it does not adequately describe what it is understood by “tax treaty abuse”. While this statement appears correct, it may not necessarily be fair. This is because, throughout history, “tax treaty abuse” has proven difficult to define. It is suggested that one of the primary reasons for this difficulty is the lack of a clear understanding of the term “tax treaty abuse”. In this regard, an overlap between terms and concepts (for example, “tax treaty abuse”, “tax avoidance” and “tax evasion”) has led to confusion on the subject matter.

This confusion is further evidenced in the Report where the OECD uses the terms “treaty abuse” and “the granting of treaty benefits in inappropriate circumstances” interchangeably. In support of this confusion it is also noted that at the beginning of the Report the OECD identifies “tax treaty abuse” as one of the main causes of BEPS. Although, the Report later makes reference to recommendations related to “treaty shopping”. This confusion and inconsistencies are indicative of a contextual framework problem of Report.

Generally, the concept of “tax treaty abuse” has been applied in a descriptive manner to serve as a catch-all phrase inclusive of “tax anti-avoidance” measures. The term “tax treaty abuse” has therefore traditionally favoured a broad definition that could range from “tax evasion” at one end of the spectrum to “tax avoidance” on the other side. To add to the complexities, different sources have applied these terms loosely and, at times, developed additional terms such as “abusive tax avoidance” and the “improper use of treaties”. This next section aims to contextualise the concept of “tax treaty abuse”. This will include consideration of various sources and commentators to assess if there is a general understanding of “tax treaty abuse” that is widely accepted in the context of international tax law.

This consideration will include an analysis of the following:³⁶

- a) the views of the OECD and UN, as the two international organisations on international tax policy matter;³⁷
- b) an evaluation of the views of commentators, applying the commentary of the OECD and UN and case law; and
- c) an examination of court cases to assess how the “tax treaty abuse” principles have developed and been applied from a practical perspective in different judiciaries.

This section will also include a brief analysis of the application of international law rules of interpretation as part of developing the contextual framework. This proposes to indirectly assess whether international tax law recognises the principle of “abuse of rights”.

The terms “tax avoidance” and “tax evasion” will firstly be defined as a means to narrow the analysis of “tax treaty abuse”.

2.2. “Tax evasion” and “tax avoidance”

Generally, it is accepted that the simple distinction between “tax evasion” and “tax avoidance” is that the former is illegal while the latter is considered legal although frowned upon within the context of the OECD BEPS project.³⁸

³⁶ The views and opinions taken analysed below represent a selection the views of the commentators. The purpose is merely to highlight the challenge in trying to identify a concise definition of what the meaning of “tax treaty abuse”, and in the same light demonstrate how, being able to understand what is meant by “tax treaty abuse”, is fundamental to any debate and recommended solution on the subject.

³⁷ In the absence of a clear and concise definition, the OECD and UN have provided extensive guidance in an attempt to explain the terms “treaty abuse”. It is therefore important that these be considered in conjunction with any reports and publications dealing with treaty abuse.

³⁸ In addition to mere evasion and avoidance, some argue that there is another category; namely mitigation, where avoidance lies between mitigation and evasion. Where mitigation means reducing one’s tax liability in ways that the law clearly encourages, and avoidance means, contriving artificial transactions to reduce the tax that it otherwise payable. Arguable, there is no meaningful distinction between mitigation and avoidance. Some however see mitigation as the application of provisions that the law provides for whereas avoidance takes the combination of transactions that together take advantage of certain provisions within the law. Also see Prebble, Z. & Prebble, J., 2013. Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law. Available through Victoria University website <<http://www.victoria.ac.nz/law/research/default.aspx>>: Victoria University of Wellington Legal Research Papers, Paper No. 34 of 2013, Volume 3 Issue No. 8.

2.2.1. “Tax evasion”

“Tax evasion” constitutes any illegal attempt to escape paying tax.³⁹ It typically includes circumstances where there has been less than full disclosure together with the intentional withholding of relevant information and may, for example, include an understatement of turnover and claiming of fictitious expenses.⁴⁰

“Tax evasion” therefore constitutes fraud in the strict sense which is criminally sanctioned.⁴¹

2.2.2. “Tax Avoidance”

“Tax avoidance” is a legitimate way of protecting one’s property from unnecessary erosion by taxation within the provisions of the law. It constitutes planning one’s tax affairs to achieve favourable tax outcomes and could include situations in which an anticipated tax liability is eliminated, reduced or merely postponed.⁴²

Contrary to “tax evasion”, complete and full disclosure, without any dishonest behaviour on the part of the taxpayer, is implicit in “tax avoidance”.⁴³ Rather, the consequences of “tax avoidance” is not subject to criminal sanctions.

Notwithstanding the legality of “tax avoidance”, recent tax policies, domestically, through the development of general anti-avoidance rules (“GAAR”) and globally, the OECD through the BEPS project, have proposed preventative measures to clamp down on “tax avoidance” practices.⁴⁴

Although, legally, there appears to be clear distinction between “tax avoidance” and “tax evasion”, recent global policy developments have resulted in this distinction becoming blurred.⁴⁵ From a fiscal policy perspective the argument is that there is no real difference in “tax evasion” and “tax avoidance”

³⁹ *Ibid.* 16, para 46.2.

⁴⁰ *Ibid.*

⁴¹ *Ibid.*

⁴² *Ibid.*

⁴³ *Ibid.*

⁴⁴ *Ibid.*

⁴⁵ *Ibid.* 16, para 46.1.

practices. This is supported by Denis Healy, former UK Chancellor of the Exchequer's, where he stated that the only contrast between "tax avoidance" and "tax evasion" is the thickness of a prison wall.⁴⁶

From a tax policy perspective in the context of BEPS, it is suggested that the terms "tax avoidance" and "tax evasion" have become distorted. However, from a strict legal perspective, "tax avoidance" continues to be a legally accepted manner through which the taxpayer can manage his tax affairs to minimise his tax costs.

This next section will consider the different sources of the development of international tax policy with an aim of developing a contextual framework within which to effectively analyse what is understood by the concept of "tax treaty abuse".

2.3. OECD and UN Commentaries

2.3.1. OECD Commentary

2.3.1.1. 1977 OECD Commentary

The OECD's work on "tax treaty abuse" started to develop from 1977, where the concept of "anti-avoidance" made an appearance in the OECD Commentary in the Model Tax Convention.⁴⁷ In explaining the purpose of tax treaties the 1997 Commentary stated that tax treaties should not help "tax avoidance" or "evasion".⁴⁸

As a possible solution to "tax avoidance" the Commentary suggested that States should adopt domestic "anti-avoidance" provisions in tax treaties.⁴⁹ This is because the Commentary explains that domestic "anti-avoidance" provisions could not inherently be applied to tax treaties unless the domestic "anti-avoidance" provisions were specifically adopted in tax treaties.⁵⁰ States were

⁴⁶ Healy, D., 2000. *The Economist*. Volume 354, Issues 8152 -8163, p. 186.

⁴⁷ De Broe, L., 2008. *International Tax Planning and Prevention of Abuse: A study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*. Volume 14, Doctoral Series Ed. The Netherlands: IBFD, p. 377.

⁴⁸ *Ibid.* Also see the OECD Commentary (1977) on Article 1.

⁴⁹ *Ibid.*

⁵⁰ *Ibid.* The 1977 OECD Commentary also pointed out that some of the provisions of the OECD Model Tax Convention already dealt with tax treaty abuse, i.e. treaty shopping and a form of rule shopping by artistes and athletes, such as the notion of

accordingly encouraged to include specific “anti-abuse” provisions (i.e. the adoption of domestic “anti-avoidance” provisions) in their bilateral tax treaties.⁵¹

While confirming that the purpose of tax treaties was to promote international investments and trade by eliminating double taxation, the Commentary restates that tax treaties are not designed to assist “tax avoidance” or “tax evasion”.⁵²

It is important to note that the 1977 Commentaries refer to concepts of “tax avoidance” and “tax evasion” with no mention of “tax treaty abuse”. Therefore it is debatable that the concept of “tax treaty abuse” did not emerge at the time of the 1977 Commentaries.

2.3.1.2. 1987 Base Companies Report

In 1987, the OECD’s Report on International Tax Avoidance and Evasion, Double Taxation Conventions and the Use of Conduit Companies (the “Base Companies Report”) started developing an understanding of the “improper use of tax treaties”. The Base Companies Report explained that the use of treaties was considered improper where a person, acting through a legal entity, obtained treaty benefits which would not normally be available to him.⁵³

Departing from the 1977 Commentary, the OECD in the Base Companies Report stated that as “abuse of law” and “substance-over-form” rules were underlying principles member States’ domestic laws, it was necessary to adopt or confirm these rules in the context of tax treaties.⁵⁴ Through the application of Articles 26 and 27 of the Vienna Convention on the Law of Treaties (“VCLT”), the Base Companies Report suggests that States would be obliged to grant tax treaty benefits under the principle of *pacta sunt servanda*. It appears that this would be the case even the granting of benefits is considered improper in the circumstances.⁵⁵

“beneficial owner” in Article 10 to 12 OECD Model Tax Convention. States were encouraged to include specific anti-abuse provisions in their bilateral treaties.

⁵¹ OECD Commentary (1977) on Article 1, para 7 – 10.

⁵² OECD Commentary (1977) on Article 1, para 7.

⁵³ OECD, 1987. The OECD Committee on Fiscal Affairs, Report on Double Taxation Conventions and the Use of Conduit Companies, Issues in International Taxation, No.1, Paris: OECD Publishing. In the Report the OECD expressed concern about the improper use of tax treaties by taxpayers acting through legal entities with the main or sole purpose of obtaining treaty benefits which would not otherwise be available directly to such person.

⁵⁴ *Ibid.* para 38 to 40.

⁵⁵ *Ibid.* para 43. Also see De Broe, L. Luts, J., 2015. BEPS Action 6: Tax Treaty Abuse. INTERTAX, 43(2), p. 123.

Although the majority of the OECD member States accepted this application of the VCLT, Switzerland was the only OECD Member Country to enter an observation to Base Companies Report. In the observation, Switzerland explained that certain domestic “anti-avoidance” provisions were contrary to the spirit of tax treaties. This is because the domestic provisions, in particular the “substance over form” and transfer pricing provisions, resulted in the application of one State’s domestic laws in the other Contracting State. To avoid the potential for a unilateral application of a States’ domestic laws, Switzerland recommended a restricted application of domestic provisions which have cross-border purpose. The application of such domestic provisions should only be applied after consultation with the other Contracting State and after taking that State’s interests into consideration.⁵⁶

2.3.1.3. 1992 Commentary

From 1977 to 1992 there appears to be more awareness of “tax treaty abuse”. This is specifically in the context of the 1992 revised Commentary on Article 1 of the OECD Model Tax Convention.⁵⁷

The OECD at this point starts contending with the different views on how and where to address “tax treaty abuse”. These views address the ideas of whether a general principle such as “substance-over-form” can be considered inherent in tax treaties or whether tax treaties need to explicitly confirm its application before placing any reliance on these general principles. This contention includes the interplay between international and domestic laws in the context of tax treaties.

In terms of Articles 26 to 31 of the VCLT, States are obliged to perform their treaty obligations in “good faith”. In light of this obligation, it can be argued that the application of Article 27 of the VCLT implicitly confirms that domestic laws cannot be applied as a justification for non-compliance with treaty obligations. This application however does not preclude States from applying domestic “anti-avoidance” provisions to cases of “tax treaty abuse”.⁵⁸

⁵⁶ *Ibid.* 53, para 95 to 96.

⁵⁷ OECD Commentary (1992) on Article 1, at para 7 – 26.

⁵⁸ *Ibid.* 47, p. 380.

Even though the OECD has developed its understanding of general principles of “substance-over-form”, the OECD resolved to follow and apply a more literal interpretation in the context of tax treaties. Although this may appear contrary to the “good faith” interpretation proposed, the approach to continue the literal approach could be a result of the potential conflict in the inherent application of domestic “anti-avoidance” provisions and States’ responsibility to act in “good faith” in the context of tax treaties. This is also arguably a continuation of the strict application of the “*pacta sunt servanda*” principle.⁵⁹

2.3.1.4. 2003 Commentary

In reacting to the confusion and uncertainty, the 2003 Commentary resulted in an extensive revision of the Commentary on Article 1. This was purportedly undertaken to clarify the relationship between tax treaties and domestic “anti-avoidance” rules.⁶⁰ The revision also aimed to address the problems around the “improper use” or “abuse of tax treaties”.⁶¹

One of the important revisions was the explicit clarification that the purpose of tax treaties was to prevent “tax avoidance” and “tax evasion”.⁶²

The new wording read as follows:-

“Taxpayers may be tempted to abuse the tax laws of a state by exploiting the difference between various countries’ tax laws. Such attempts may be countered by provisions or jurisprudential rules that are part of the domestic law of the State concerned. Such a State is then unlikely to agree to provisions of bilateral double taxation conventions that would have the effect of allowing abusive transactions that would otherwise be prevented by the

⁵⁹ *Ibid.*

⁶⁰ Arnold, B. & Van Weeghel, S., 2006. The Relationship between Tax Treaties and Domestic Anti-Abuse Measures. In: G. Maisto, ed. Tax treaties and Domestic Law. The Netherlands: IBFD, Volume 2, EC and International Tax Law Series, p.81.

⁶¹ *Ibid.*

⁶² OECD Commentary (2003) on Article 1, at para 7.1. Also see De Broe, L., 2008. International Tax Planning and Prevention of Abuse: A study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies. Volume 14, Doctoral Series ed. The Netherlands: IBFD, p. 382.

provisions and rules of this kind contained in its domestic law. Also, it will not wish to apply it bilateral conventions in a way that would have that effect.”⁶³

The important aspects of the 2003 Commentary are summarised below:

- a) as a general rule, there will be no conflict between anti-avoidance provisions which form part of a State’s domestic rules and the provisions of tax conventions;⁶⁴
- b) confirms 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”;⁶⁵
- c) applying a purposive interpretation of tax conventions, some States prefer to view the “abuse” as being an “abuse” of the tax treaty itself, as opposed to an “abuse” of domestic law. This interpretation results from evaluating the object and purpose of tax treaties as well as the obligation to interpret them in “good faith” (Article 31 of the VCLT);⁶⁶
- d) OECD offers a “guiding principle” (which contains both a subjective and objective element) which provides that the benefits of a tax treaty should not be available when two elements are present; i.e. where
 - i. “a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position (*subjective element*) and
 - ii. obtaining that more favourable treatment under these circumstances would be contrary to the object and purpose of the relevant provisions (*objective element*)”.⁶⁷
- e) potential application of general “anti-abuse” provisions does not necessarily mean that there is no need to include specific provisions, aimed at preventing particular forms of “tax avoidance”, in tax treaties.⁶⁸

⁶³ OECD Commentary (2003) on Article 1, at para 7.1.

⁶⁴ OECD Commentary (2003) on Article 1, at para 9.2.

⁶⁵ OECD Commentary (2003) on Article 1, at para 9.4.

⁶⁶ OECD Commentary (2003) on Article 1, at para 9.3.

⁶⁷ OECD Commentary (2003) on Article 1, at para 9.5.

⁶⁸ OECD Commentary (2003) on Article 1, at para 9.6.

2.3.2. UN Commentaries

2.3.2.1. 1987 UN Report

In 1987 the UN Ad Hoc Group of Experts on International Co-operation in Tax Matters broadly defined “abuse of tax treaties” as the improper use of tax treaties to derive benefits that were not initially designed for the taxpayer.⁶⁹

2.3.2.2. 2008 UN Report

In 2008, the UN Committee of Experts on International Cooperation in Tax Matters (“2008 UN Report”) proposed amendments to prevent the “improper use of tax treaties”.⁷⁰ This project commenced in 2005 when the UN recognised that the issue of “treaty abuse” needed to be dealt with within the UN Model Convention. The UN similarly appreciated these issues may be addressed in the Commentary as well as in the Model Tax Convention. Notwithstanding acknowledgment, the UN, in 2006, back-pedalled on their original stance of address the issues of “treaty abuse” in the text of the Model Tax Convention. Instead, the UN followed the OECD’s more conservative approach to provide comprehensive Commentary to Article 1 of the Model Tax Convention. The Commentary proposed to include illustrative examples and proposed wording of “anti-abuse” provisions. This wording focuses on the improper use by the taxpayer.⁷¹

The 2008 UN Report, therefore effectively endorsed the OECD’s “guiding principle” as set out in the 2003 Commentary to Article 1. The UN explained that necessary guidance to determine what constitutes “abuse” of tax treaties is important in the attempt to balance the objectives of tax treaties with the acknowledgment of the importance of the principle of legality from the perspective of the taxpayer.⁷²

⁶⁹ *Ibid.* 24. Also see De Broe, L., 2008. International Tax Planning and Prevention of Abuse: A study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies. Volume 14, Doctoral Series ed. The Netherlands: IBFD, p. 301.

⁷⁰ UN, 2008. UN Committee of Expert on International Cooperation in Tax Matters, Fourth Session, Geneva, Notes by the Coordinator of the Subcommittee of Improper Use of Tax Treaties, New York: UN Secretariate.

⁷¹ *Ibid.* para 1 of p. 3.

⁷² *Ibid.* para 24 of p. 8.

In endorsing the OECD's "guiding principle", the UN acknowledged that the two elements of the "guiding principle" (i.e. the subject and objective elements) are analogous to characteristics of "anti-avoidance" provisions rather than "tax treaty abuse" provisions. In support of this opinion, the 2008 UN Report, expressed the view that these elements will often be found, whether explicitly or implicitly, in general "anti-avoidance" provisions developed by various States.⁷³

Correspondingly, the 2008 UN Report provides a draft general "anti-abuse" provision which applies the OECD's "guiding principle" as the basis. The UN suggests the following wording for an "anti-abuse" provision:

*"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."*⁷⁴

In drafting the provision, the UN explicitly acknowledges the prerequisite that the "abusive" behaviour of the taxpayer is required to be determined on the basis of objective facts and not only on the subjective intentions of the taxpayer.⁷⁵ The UN emphasised that the focus should be on developing objective criteria to identify the "tax treaty abuse". This will create legal certainty for the taxpayer and authorities alike.

⁷³ *Ibid.*

⁷⁴ *Ibid.* para 35 of p.10. For examples of general anti-abuse provisions see paragraph 2 of Article 25 of the Israel and Brazil Treaty signed in 2002 ("A Competent Authority of a Contracting State may deny the benefits, 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.") and paragraph 6 of Article 29 of the Canada-Germany treaty signed 2001 ("Noting 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.").

⁷⁵ UN, 2009, June. United Nations Tax Committee Report on Improper Use of Tax Treaties, New York: UN Secretariat, para 23-27. Also see De Broe, L., Goyette, N., Martin, P., Rohatgi, R., van Weeghel, S., & West, P., 2011. Tax Treaties and Tax Avoidance: Application of Anti-Abuse Provisions. Bulletin for International Taxation, Issue July, p. 374.

2.4. Views of commentators

2.4.1. Defining “treaty abuse”

In 1983 Rosenblom wrote that “tax treaty abuse” is a heavily loaded term that is not only derogatory but implies that the “proper use of tax treaties” can be identified.⁷⁶ This profound statement arguably encapsulates the crux of the problem. It is from this premise that the paper investigates whether there is sufficient common understanding to determine the meaning and understanding of “tax treaty abuse” within the views of commentators.

2.4.2. Inherent application of the principle of good faith

Vogel argues that, in the application of Article 26 of the VCLT⁷⁷, there is an international “anti-abuse” principle inherent in most international treaties.⁷⁸ This follows from the basic principle underlying public international law that States must refrain from abusing their rights and execute treaty obligations in “good faith”.⁷⁹

As a core attribute of public international law, the “good faith” principle is expressly codified in Article 26 of the VCLT.⁸⁰ It is important to note that the “good faith” obligation imposed by the VCLT regulates the relationship between States. From a practical perspective however, a State cannot be said to “abuse” the rights of another State. The “abuse”, therefore, has to arguably take place between the taxpayer and the State. In the context of tax treaties the “good faith” obligation therefore is seen to regulate the relationship between the State and taxpayers.⁸¹

⁷⁶ Rosenblom, H., 1983. Tax Treaty Abuse: Policy and Issues. Law and Policy in International Business, Volume 15, p. 766.

⁷⁷ The obligation of good faith imposed by the VCLT on the Contracting States is not restricted to the performance of the treaty – as Art. 31 VC makes it expressly clear – extends to the interpretation of the treaty as well. Good faith in the interpretation of treaties means that a treaty is interpreted honestly, fairly and reasonably to give effect to its object and purpose and to the common intentions of the parties. Art. 26 of the VCLT do not per se require literal application of the treaty and Art. 31 VC does not require literal interpretation of the treaty either. It is provisionally submitted that the principle of good faith underlying Art. 26 and 31 VC – which is the obverse of abuse of rights – over flexibility to deny treaty benefits if the granting of such benefits would frustrate the treaty’s object and purpose, provided that such denial is supported by the terms of the treaty. This does not mean that the abuse of rights Doctrines under international public law or the principles of good faith underlying Art. 26 VC are of no relevant for the discussion. Also see De Broe, L., 2008. International Tax Planning and Prevention of Abuse: A study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies. Volume 14, Doctoral Series ed. The Netherlands: IBFD, p. 307.

⁷⁸ De Broe, L., 2008. International Tax Planning and Prevention of Abuse: A study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies. Volume 14, Doctoral Series ed. The Netherlands: IBFD, p 306.

⁷⁹ *Ibid.*

⁸⁰ *Ibid.*

⁸¹ *Ibid.*

2.4.3. “Substance-over-form” principle⁸²

Vogel contends further that an international standard of “abuse of tax treaties” can be derived from case law.⁸³ Notwithstanding this contention, Vogel’s views regarding the existence of an international standard of “abuse of tax treaties” has been widely criticised.⁸⁴ One of the most important points of criticism is that Vogel neglects to address the fact that, in the context of international public law, the doctrine of “abuse of rights” is vague.⁸⁵ The endorsement of an international standard of “abuse of rights” by Vogel is therefore unsubstantiated.⁸⁶ Although a detailed analysis of the existence of an international standard of “abuse of rights” is beyond the scope of this paper - the approach of courts with regard to the application of domestic anti-avoidance provisions and treaty abuse provisions will be very briefly explored at paragraph 2.5 below.

Vogel advocates the existence of a general “substance-over-form” principle based on international law. This principle is based on premise that while tax treaties cannot confer rights on individual taxpayers, and States cannot practically “abuse” their rights under tax treaties, a State cannot confer more rights on a taxpayer than those which they possess.⁸⁷ Vogel contends that this principle permits tax authorities and courts to disallow treaty benefits where taxpayers engage in transactions with primary objective to claim tax treaty benefits.⁸⁸

However, the inference of a general “substance-over-form” principle in the context of tax treaties neglects to take account of the objective of the principle. This is because, in the context of international private law, the principle is intended to balance the rights of individuals. However, from an international tax perspective, the principle would be applied to balance the rights of the taxpayer and the State. This extension of the “substance over form” principle could create further challenges

⁸² The “substance-over-form” principle and the “plus valet” principle although use inter-changeably, is arguably distinguishable in its application in private law versus tax law. This being said, in this paper the terms are used inter-changeably unless the context specifies otherwise.

⁸³ *Ibid.* 79, p.306.

⁸⁴ Ward, D., 2008. Access to Tax Treaty Benefits. Canada: Research Report Prepared for the Advisory Panel and Canada's System of International Taxation, Available through Canada's Advisory Panel's website <<http://www.apcsit-gcrcti.ca>>.

⁸⁵ *Ibid.* 79, p.307.

⁸⁶ The reason is because case law in matters of international public law requires a high level of proof to uphold an abuse of rights. It however offers very little guidance to determine when in the many different factual circumstances an individual subject of law abuses his rights under a treaty. In both cases where the PCIJ referred to abuse of rights it stressed that such an abuse cannot be presumed. Also see, Kiss, A., 1992. Abuse of Rights. Encyclopedia of Public International Law, Volume 1, pp. 7-8.

⁸⁷ *Ibid.* 79, p.307.

⁸⁸ *Ibid.* 79, p.306.

and could arguably be seen as unreasonable in the context because the rights of the taxpayer and the State will arguably never be in balance.⁸⁹

In observing this unintended consequences, Vogel, in 1996, clarified his view on the application of a general “substance-over-form” principle. Vogel stated that the “substance-over-form” principle should be applied to tax treaties as the exception rather than the rule.⁹⁰ He further contended that threshold to apply such general application should be set at a high level rather than a low one.⁹¹

On this basis, the proposition is that the “substance-over-form” principle represents an interpretative tool that establishes the true nature of the fact before any application of the law by the Court.⁹² Accordingly, there is no recharacterisation of the facts.⁹³ Rather the law is applied to the true underlying nature of the facts.⁹⁴

2.4.4. *Fraus legis doctrine*

The “*fraus legis*” doctrine is a judge-made doctrine in Dutch law.⁹⁵ The doctrine is a development of the “substance-over-form” principle in that it merely reveals the true nature of the transaction without recharacterising the fact pattern. This is because the “*fraus legis*” doctrine permits tax authorities to substitute the taxpayers’ fact pattern with the true fact pattern such that the tax is levied on that substituted fact pattern.⁹⁶ In applying the doctrine established in the *Hoge Raad*⁹⁷ the tax inspector may substitute a fact pattern that results in a tax liability for the taxpayer if:

- i. *the taxpayer has created a situation in which tax cannot be imposed but which approximates to one in which tax could be imposed,*
- ii. *tax avoidance is the predominant motive of the taxpayer, and*
- iii. *the purpose and intent of the tax law could be frustrated if the non-taxable fact pattern were not treated as a taxable fact pattern.*

⁸⁹ *Ibid.* 79, p.307 – 308.

⁹⁰ Vogel, K., 1996. Double Taxation Convention. 3rd ed. The Netherlands, Kluwer, para 91.

⁹¹ *Ibid.*

⁹² *Ibid.* 16, para.33.

⁹³ *Ibid.*

⁹⁴ *Ibid.*

⁹⁵ *Hoge Raad*, 15 December 1993, BNB 1994/259.

⁹⁶ *Ibid.*

⁹⁷ *Ibid.* 60, p.109. Also see Cilliers, C., Anti-Avoidance, in E Brincker and A. de Koker, Eds., *Silke on International Tax*, LexisNexis On-line, para 46.33.

Although an established doctrine in Dutch domestic law, the *Hoge Raad* rejected the application of the “*fraus legis*” doctrine in the context of tax treaties in a case that involved a dividend stripping structure where Dutch individuals would attempt to escape taxation in respect of dividends and as a result of the application of the *fraus legis* doctrine would allow the capital gain to be recharacterised and taxes as a dividend.⁹⁸ In the reasoning, the *Hoge Raad* explained that it was not evident from the text of the tax treaty or the intentions of the Contracting States that there was a shared understanding to include the provisions of the “*fraus legis*” doctrine in the context of tax treaties.⁹⁹

2.4.5. *Effectiveness of doctrines of general application*

The general application of doctrines and principles developed in private law does not automatically have application in international tax law. This is supported by Vogel’s view that the “substance-over-form” principle applied in the context of tax treaties as an exception rather than the rule.¹⁰⁰ This point is similarly advocated by Van Weeghel when he stated that doctrines such as the “abuse of rights” doctrine, developed in domestic and international private law, cannot easily be applied in the area of international tax law.¹⁰¹ In substantiating his view, Van Weeghel explained that because of the different nature of an agreement in domestic law and international tax law, and given that the taxpayer is not a party to the tax treaty, one cannot simply apply private law doctrines in the context of tax treaties without taking these factors into account.¹⁰² An important point to note is that the purpose and objectives of private law doctrines is to balance the rights of individuals. This is not the same in an international tax context.

As a means to provide a common understanding in the context of tax treaties, Van Weeghel argues that where an OECD Member State models its tax treaty on the OECD Model Tax Convention, the policy objectives of the Member States should be consistent with principles adopted by the OECD as

⁹⁸ *Ibid.*

⁹⁹ *Hoge Raad*, 15 December 1993, BNB 1994/259.

¹⁰⁰ *Ibid.* 90, para 91.

¹⁰¹ Van Weeghel, S., 1998. *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and the United States*. The Netherlands: Kluwer, p. 116.

¹⁰² *Ibid.*

evidenced in the text and Commentary of the Model Tax Convention.¹⁰³ This is however subject to any reservations noted by the Contracting States.¹⁰⁴

Van Weeghel thus contends that by virtue of the Contracting States basing their tax treaties on the OECD Model Tax Convention would be sufficient to create a common understanding regarding the “improper use of tax treaties”.¹⁰⁵ This is because the prevention of “tax avoidance” and “tax evasion” was specifically stated as one of the policy considerations inherent in the OECD Model Tax Convention.¹⁰⁶ In attempting to provide an identification mechanism for these policy consideration Van Weeghel explains that the “improper use of tax treaties” will be established where the sole intention of the taxpayer was to avoid tax of either or both of the Contracting States.¹⁰⁷

2.5. The approach of domestic courts

Several courts have had to consider whether the certain transactions entered into by taxpayers constituted an abuse of tax treaties through either the application of either domestic anti-avoidance/abuse provisions or treaty abuse provisions. In an attempt to assess the application of domestic or treaty abuse provisions, the following cases¹⁰⁸ will briefly be considered:

- a) *Re a Corporation (2002)* 5 ITLR 589 (The Bundesfinanzhof) (Germany);
- b) *A Holding ApS v Federal Tax Administration (2005)* 8 ITLR 536 (Switzerland);
- c) *Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland (2006)* 9 ITLR 683 (France);
- d) *MIL (Investments) SA v Canada (2007)* 9 ITLR 1111 and (2006) 9 ITLR 25 (Canada); and
- e) *Yanko-Weiss Holdings (1996) Ltd. v. Holon Assessing Office, (2007)* 10 ITLR 524 (Israel).

The recognition of an “abuse of rights” principle in international tax law would arguably provide assistance to understand what is meant by the term “tax treaty abuse”. What has become evident from

¹⁰³ *Ibid.* 101, p. 258.

¹⁰⁴ *Ibid.*

¹⁰⁵ *Ibid.*

¹⁰⁶ *Ibid.*

¹⁰⁷ *Ibid.* 101, p. 57 – 58.

¹⁰⁸ The cases have been selected to provide the reader with an overview of the different courts' view on the topic of “abuse of rights”. On this basis, cases from the different jurisdictions were chosen to illustrate the commonalities and differences of the views on the topic.

the cases considered below, is that there is no consistent approach on how “tax treaty abuse” is understood and dealt with by domestic courts.

2.5.1. *Germany: Re a Corporation (2002) 5 ITLR 589 (The Bundesfinanzhof)*

The Bundesfinanzhof considered the claim of a refund of German withholding tax under the German – Netherlands tax treaty against the application of a general (section 42 of the German General Tax Code) and specific (Section 50d(3) of the Income Tax Act) anti-avoidance provision with the context of “base company” cases. The Bundesfinanzhof observed that: ¹⁰⁹

“[...] According to the jurisprudence of the [Bundesfinanzhof] [...], intermediary base companies in the legal form of a corporation in a low tax regime country fulfil the elements of abuse if economic or other acceptable reasons are missing. If income received in Germany passes through a foreign corporation, this is also true if the state of residence of the foreign corporation is not a low tax regime [...]. The court accepts as a principle that tax law respects the civil law construction. But there must be an exception for such constructions [where they possess] only the aim of manipulation. [...]”

In evaluating the level of economic substance of the Dutch B.V., the Bundesfinanzhof considered the fact that the Dutch B.V., in owing 100% of the German entity, did not have any employees, no premises or office equipment and that the director was also serving on the board of the other affiliated companies. The Bundesfinanzhof further did not accept the reasoning that the Dutch B.V. was interposed from group organisation and coordination perspective.¹¹⁰ Based on the facts at hand, the Bundesfinanzhof considered that:¹¹¹

“[...] All these aspects make plain the background of construction of the G-group, they make plain why and how European engagement of the group was concentrated within the Netherlands. But they cannot explain convincingly and justify why the foundation of the

¹⁰⁹ *Re a Corporation (2002) 5 ITLR 589 (The Bundesfinanzhof)* at 600.

¹¹⁰ *Ibid.* p 601.

¹¹¹ *Ibid.*

Dutch B.V. as a letterbox corporation without economic or otherwise acceptable groups was necessary [...]"

Taking the above factors into account the Bundesfinanzhof held that the Dutch B.V.'s participation in the German entity did not fulfil the economic activity requirement under the specific anti-avoidance provision.¹¹²

¹¹² *Ibid.* See also Jain, P., Prebble, J., & Bunting, K., *Conduit Companies, Beneficial Ownership and the Test of Substantive Business Activity in Claims for Relief under Double Tax Treaties*. Available through the Social Science Electronic Publishing Inc. website < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2147594> [2015, February 9], p.39 – 41.

2.5.2. *Switzerland: A Holding ApS v Federal Tax Administration (2005) 8 ITLR 536*

In 2005 the Swiss Federal Court in *A Holdings ApS*¹¹³ case dismissed the appeal for the refund of withholding tax on application of the “abuse of rights” principle that was based on an (unwritten) treaty principle that prohibits treaty abuse, which was established on the application of Article 31 of the VCLT.¹¹⁴ In its judgment, the court explicitly stated that the “good faith” principle as codified in Article 26 of the VCLT as well as the objectives and purpose of the tax treaties should be taken into account when applying the provisions of tax treaties.

In dismissing the appeal, the court found that the Danish corporation was incorporated solely for the purposes of taking advantage of the Denmark-Switzerland tax treaty and as such did not carry on any real economic activity. Interestingly, the Denmark-Switzerland tax treaty did not contain any explicit anti-abuse provisions. In support of its application, the court held that the “abuse of rights” principle court be read into the tax treaty. This is because the principle was consistent with the aim and purpose of the OECD Model Convention. As both Contracting States were members of the OECD, they were therefore obliged to take account of the OECD Model Convention and related Commentaries.¹¹⁵

The court said (in translation) that:¹¹⁶

“3.4.1 [...] A treaty is binding upon the parties and must be performed by them in “good faith” pursuant to Article 26 of the Vienna Convention on the Laws of Treaties. Thus the parties have an agreement which shall be interpreted “in good faith” in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose [...]

¹¹³ *A Holdings ApS v. Federal Tax Administration* (2005) 8 ITLR 536.

¹¹⁴ As a brief summary of the facts, the taxpayer, a Danish resident company, had acquired all the shares in a Swiss resident company that subsequently paid a dividend which, under Swiss domestic law, was subject to a withholding tax of 35%. The Danish company applied for a refund of the withholding tax relying on the dividend article of the Switzerland-Denmark DTT (1973). The sole shareholder of the Danish corporation was a Guernsey corporation whose sole shareholder was a Bermuda corporation whose director was a “person” with its “seat” in Bermuda. The initial application for the refund was refused by the Federal Tax Administration of Switzerland on the basis that the Danish corporation did not carry on any real economic activity and was incorporated solely for the purposes of taking advantage of the Denmark-Switzerland DTT which in itself did not contain any anti-abuse provisions.

¹¹⁵ In the reasons for judgment the Court refers to the recent anti-abuse commentaries added to the OECD Model Convention stating that as member states of the OECD, Switzerland and Denmark are in principle obliged to take into account these commentaries and even the suggested limitation on benefits treaty provisions in para.13 of the commentary on Article 1.

¹¹⁶ See Ward, D., 2008. Access to Tax Treaty Benefits. Canada: Research Report Prepared for the Advisory Panel and Canada's System of International Taxation, Available through Canada's Advisory Panel's website <http://www.apcsit-gcrfi.ca>, p.20.

3.4.2 Therefore, [...], the aim and purpose of the convention are to be taken into account when an international convention is applied. Every Contracting State can expect that the other contracting state acts in accordance with the principles (art 26 of the Vienna Convention on the Laws of Treaties) [...] This includes the tackling of abuses. Because the prohibition of abuses is part of the principle of good faith [...] It prohibits the use of institute of law against its purpose to realise interest which are not protected by it [...] Accordingly, the prohibition of an abuse of rights as regards conventions is not only recognised in Switzerland as a general principle of law, but also on the European level without necessarily adopting an explicit provision in the respective convention [...]

3.4.3 Additionally, the principle of an abuse of rights is – against the opinion of the complainant – recognised in Denmark [reference to authorities omitted]”

2.5.3. *France: Ministere de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland (2006) 9 ITLR 683*

In another application for a refund of withholding tax, the French Conseil d'État in the *Bank of Scotland* case¹¹⁷ similarly dismissed the application on the basis that the American parent company was the beneficial owner.¹¹⁸ After analysing the terms of the contract, the French Conseil d'État found that while Pharmaceutical Inc. was the beneficial owner it had delegated the repayment of the loan to Marion SA.¹¹⁹

The Commissaire du Government, further observed that on the application of logic it is arguable that the dividends paid by the French subsidiary should have been recharacterised as interest in terms of the French – UK tax treaty. This would arguably have taking into account the true nature of the arrangement.

¹¹⁷ *Ministere de l'Economie, des finances et de l'industrie v. Soiete Bank of Scotland* (2006) 9 ITLR 683.

¹¹⁸ As a brief summary of the facts; a UK resident company acquired from a U.S company a usufruct for 3 years over 17,036 preference shares in the U.S Company's French subsidiary. The shares were issued specifically for the particular transaction. The usufruct entitled the Bank of Scotland to preference dividends in an aggregate amount slightly in excess of 270 million francs whereas the usufruct was acquired for a sum slightly in excess of 267 million francs. When the French subsidiary paid the dividends, it was obligated under French domestic law to deduct a withholding tax of 25% whereas the reduced rate under the French-UK tax treaty was 15%. The Bank filed a claim for a refund of the excess amount withheld. If successful, the refund claims would have resulted in a sizable profit on its investment in the usufruct.

¹¹⁹ *Ibid.* 117, p. 703.

The French Conseil d'État consequently rejected the taxpayer's claim for a refund on the basis that it found that the sole purpose of entering into the agreement was to obtain the benefit the tax credit available under the French – US tax treaty.

2.5.4. *Canada: MIL (Investments) SA v Canada (2007) 9 ITLR 1111 and (2006) 9 ITLR 25 (Canada)*

In MIL Investments the Tax Court of Canada specifically looked at the application of GAARs to tax treaties and specifically treaty shopping and questioned whether an inherent anti-abuse rule exists in the context of alleged treaty shopping.

On the question whether treaty shopping constitutes abuse, the court found that “there was nothing inherently proper or improper with selecting one foreign tax jurisdiction over another”.¹²⁰ The court stated that the mere selection of a tax treaty (particularly one of a low tax jurisdiction) cannot, on its own, be viewed as being abusive. The court did however accept that the selection of the jurisdiction “may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction”.¹²¹

In addition, the court, in accepting that both countries had domestic anti-avoidance provisions when they had concluded the tax treaties, rejected the argument that the tax treaties contained an inherent anti-abuse rule.¹²² The court also stated that the tax treaties preamble reference to the prevention of fiscal evasion, independently, this did not constitute an anti-treaty shopping provision. In particular, the court found that the “*pacta sunt servanda*” principle combined with the wording of the tax treaty, implied that MIL was entitled to the tax treaty benefit which it had claimed.¹²³

¹²⁰ Fox, D. L., 2006. *MIL (Investments) S.A. v. The Queen* - Application of General Anti Avoidance Rule to Tax Treaties and Treaty Shopping. *International Tax Planning*, XIII(4), p. 954.

¹²¹ *Ibid.* Rather the Court ruled that it is the use of the selected treaty which must be examined against the facts of the specific case. The Court went further to state that if Canada was concerned about the preferable tax rates of its treaty partners, it ought to renegotiate the treaties instead of applying the GAAR.

¹²² The tax Court referred to the decision is *Union of India & Anor v. Azadi Bachao Andolan & Anor* [2003] 4 L.R.I 172, in which the Supreme Court of India (Civil Appellate Jurisdiction) rejected the existence of an inherent anti-abuse rule in the context of alleged treaty shopping and the Indo-Mauritius Double Taxation Avoidance Convention. Part of the reasoning for the decision of the Indian Court was based on the fact that provisions, specifically precluding non-contracting states from benefits from the tax treaty, should have been incorporated into the tax treaty. It is therefore arguable that the Court might have viewed this approach as providing the certainty required for taxpayers.

¹²³ The decision of the Tax Court in *MIL Investments* has been appealed to the Federal Court of Appeal. It therefore remains to be seen how the Federal Court of Appeal and other courts will view and apply the Court's finding that it is the use of a treaty which must be examined in the GAAR analysis, particularly given that most of Canada's tax treaties do not contain wording which considers the application of anti-avoidance rules. See also Ward, D., 2008. Access to Tax Treaty Benefits. Canada: Research Report Prepared for the Advisory Panel and Canada's System of International Taxation, Available through Canada's Advisory Panel's website <http://www.apcsit-gcrfi.ca>, p.22.

2.5.5. *Israel: Yanko-Weiss Holdings (1996) Ltd. v. Holon Assessing Office, (2007) 10 ITLR 524*

In the *Yanko-Weiss Holdings Case*¹²⁴ the district court of Tel Aviv dismissed an allocation to strike out reliance on domestic “anti-avoidance” provisions in the application of the Israel –Belgium tax treaty. In coming to its decision, the district court accepted the application of domestic anti-avoidance provisions in the context of tax treaties as it forms the basis for determining tax liability.¹²⁵

While the court’s reasoning is not clear, it appears that in accepting the application of domestic “anti-avoidance” provisions the court relied on the general obligation on States to interpret tax treaties in “good faith” as well as the specific OECD Commentary relating to “tax avoidance”.¹²⁶

The court further observes that the doctrine of “preventing improper use” could include additional standards and “anti-avoidance” measures, for example the “substance-over-form”, the reclassification, the commercial essence of the transaction.¹²⁷

The court went further to state that Israeli tax treaties should be read as if they contain LoB provisions in cases where it is proven that there exists “improper use of a tax treaty”, according to standards of domestic law and international law.¹²⁸

2.6. Summary of findings

An evaluation of the views observed and opinions expressed by the different sources above reaffirms the earlier statement that “tax treaty abuse” is a multidimensional concept which has proven difficult to define.

¹²⁴ The case dealt with a taxpayer who was incorporated in 1996 in Israel and then changed its place of management in 1999 to Brussels. It accordingly registered as a Belgium company for the purpose of becoming a resident of Belgium under the Israel-Belgium tax treaty to gain certain Israeli tax treaty benefits. The benefits were initially denied by the assessing office based on an anti-avoidance provision in the domestic law. The taxpayer accordingly sought to strike out reliance on domestic anti-avoidance provisions to support the assessment.

¹²⁵ *Yanko-Weiss Holdings (1996) Ltd. v. Holon Assessing Office, (2007) 10 ITL 524 at 545.*

¹²⁶ *Ibid.* p. 525.

¹²⁷ *Ibid.* 125.

¹²⁸ *Ibid.*

The complex nature of the concept is evident in the number of doctrines, principles and interpretative tools that were observed in this section under the broader concept of “tax treaty abuse”. These concepts include, for example, the:

- a) consideration of an internationally recognised principle of “abuse of rights”;¹²⁹
- b) “substance-over-form” and “economic activity” doctrines;¹³⁰
- c) application of judge-made doctrines;¹³¹
- d) application of domestic “anti-avoidance” provisions to tax treaties;¹³²
- e) application of domestic “anti-avoidance” provisions in the absence of specific treaty provisions;¹³³
- f) specific policy considerations inherent in the application of tax treaties;¹³⁴
- g) development of interpretative tools to identify “tax avoidance”;¹³⁵
- h) consideration of the beneficial ownership test in the context of “tax treaty abuse”;¹³⁶ and
- i) strict literal interpretation versus the purposive and contextual interpretation;¹³⁷

It is therefore submitted that an evaluation of the sources appears to have compounded the problem of attempting to understand the concept of “tax treaty abuse”. This is suggested because the sources evaluated neglect to address the conceptual inconsistencies recognised in the literature over time. In addition, the sources have also observed the evidence of terminological difficulties on the subject matter. This is also arguably one of the primary reasons for the confusion observed in developing a conceptual framework for the concept of “tax treaty abuse”.

Although a complicated task, the next few paragraphs attempt to simplify the different approaches and potential inconsistencies. Whilst this may not be sufficient to provide a contextual framework from which to develop an understanding of the concept of “tax treaty abuse”, the objective is that the building blocks and challenges are identified. It is further noted that questions about the existence of

¹²⁹ See section 2.4.2. & 2.4.3.

¹³⁰ See section 2.5.1.

¹³¹ See section 2.4.4.

¹³² See section 2.3.1.

¹³³ See section 2.5.5.

¹³⁴ See section 2.3.1.4. & 2.4.1.

¹³⁵ See section 2.3.1.2., 2.3.1.4. & 2.3.2.2.

¹³⁶ See section 2.5.3.

¹³⁷ See section 1.1 & 2.3.1.3.

an international principle of “abuse of rights” will not be considered further. This is because the commentators’ observations have indicated that this is at best a vague construct which is not a recognised principle in international law.¹³⁸

In evaluating the sources, there appears to be a distinction between the application of principles and concepts in domestic tax law and international tax law. This distinction will assist to focus the evaluation and form the basis from which to attempt to develop a framework. It is noted that the distinction of principles between domestic and international creates its own conceptual dynamic. This is because an evaluation at domestic law is limited to balancing rights between two individuals or the individual and the tax authorities. This is governed by the application of that specific domestic law. In applying the principle of legality, the application and interpretation of that domestic law is assumed to be clear and concise. In the context of international law, the evaluation essentially takes into consideration domestic laws of the Contracting States in trying to balance the rights of a State (in the tax treaty) and that of the individual.¹³⁹

In some domestic jurisdictions, there appears to be a recognised principle of “abuse of law”. This is based on the recognition of the fact that various domestic laws have either introduced specific “anti-abuse” provisions in domestic law, developed the application of well-established principles such as the “substance-over-form” principle which is entrenched in the domestic law, as well as the developments of the certain judge-made doctrines.

It is observed that the primary objective of these “abuse of law” doctrines and principles is to reveal the underlying true nature of the transaction.¹⁴⁰ This includes an evaluation of the intention of the taxpayer in exposing the true nature of the transaction. It is therefore suggested that an “abuse of law” would generally be recognised where the sole intention of the taxpayer was to enter into a transaction for the purposes of obtaining certain tax benefits. This sole intention is indicative of a fraudulent intent on the part of the taxpayer.

¹³⁸ *Ibid.* 47, p 307.

¹³⁹ *Ibid.* 47, 100.

¹⁴⁰ *Ibid.* 16, para 33.

It has further been observed that in some cases, the presence of “abuse of law” may arguably result in two consequences. On a narrow application of the “substance-over-form” principle, the consequence is that the true nature of the underlying facts is revealed. Developing the application of the “substance-over-form” principle therefore permits tax authorities to substitute the taxpayers’ facts with the true intention. In permitting this recharacterisation, tax authorities are allowed to tax the substituted fact pattern as if it was initiated by the taxpayer. It is suggested that the permission to tax the substituted fact pattern is a true consequence of the “abuse of law” principle. However, based on the inconsistent application of domestic “abuse of law” provisions, the application of the “abuse of law” principle to tax treaties remains an unresolved debate and challenge.¹⁴¹

It therefore follows that what constitutes the concept of “tax treaty abuse” in international tax law is a difficult concept to unpack and understand. Evidence of this difficulty could arguably be seen in the development of terms used to explain the term “tax treaty abuse”. Research indicates that, within the context of tax treaties, the concepts of “tax avoidance” and “tax evasion” are well established. The latter constituting a criminal offence and the former a means to plan ones tax affairs within the bounds of the law.

Certain policy considerations and possible attempt to apply domestic “abuse of law” in the context of tax treaties may have resulted in the difficulty to understand what constitutes “tax treaty abuse”. This is arguably because policy makers have responded in a reactionary approach in setting international tax policies.

The policy considerations are evidenced in the OECD Commentary from 1977 to 2003. It is observed that these policy considerations advocate a clear shift to prevent “tax avoidance”. This is suggested in the evaluation of the policy consideration the OECD and UN which have focused their approach on the “improper use of tax treaties”. On a literal interpretation, the term “improper use of tax treaties” appears more aligned with a discussion and focus on “tax avoidance” as opposed to “tax treaty abuse”. In attempting to prevent the “improper use of tax treaties” the OECD and UN have incorporated a

¹⁴¹ See discussion on the “fraus legis” principle (at section 2.4.4) where the *Hoge Raad* rejected the application of the judge made doctrine in the context of tax treaties. Also see the comments on the *Yanko-Weiss Holdings (1996) Ltd. V. Holon Assessing Office (2007)* 10 ITLR 524 (at section 2.5.5.) where the District Court relied on the domestic “anti-avoidance” provisions in the application of the Israel – Belgium tax treaty.

purposive approach to interpretation into the Commentary together with the introduction of a main purpose test with certain objective factors.¹⁴²

It is further suggested that terminological inconsistencies have arguably added to the development of incoherent policy and theory which has consequently resulted in a proliferation of legally incoherent rules.

The need for objectively stated international norms is therefore recognised as a necessary requirement to assess a claim to benefits under tax treaties. This could be done with reference to the object, spirit, and purpose of the relevant provisions of the treaty.¹⁴³ This will provide a platform from which to objectively evaluate the intention of the taxpayer.¹⁴⁴

It is further suggested that the incoherent development in proper policy considerations has been focused on preventing “tax avoidance” which constitutes a lesser threshold than “tax treaty abuse”. Based on the literature evaluated above and in the absence of a conclusive understanding of “tax treaty abuse” it is nevertheless important to attempt to develop a hypothesis of what constitutes “tax treaty abuse”. It is argued that this development is important even if it is to indicate what does not constitute “tax treaty abuse” especially in the context of evaluating the BEPS project.

¹⁴² OECD Commentary (2003) on Article 1, at para 9.5.

¹⁴³ Suarez, S., 2014. Canada to Unilaterally Override Tax Treaties with Proposed New Anti-Treaty Shopping Rule. Tax Notes International, Tax Analysts, Issue March, p. 801.

¹⁴⁴ *Ibid.*

3. CASE STUDIES: AMAZON, GOOGLE AND STARBUCKS APPLIED AS ILLUSTRATIVE EXAMPLES

The preceding section describes, in detail, the difficulty in understanding the concept of “tax treaty abuse”. In order to prevent “tax treaty abuse” as described in the Report, the challenges identified in the literature further recognises the importance of developing objectively stated international norms by which to identify “tax treaty abuse”. It is therefore argued that without the application of objectively stated international norms, the difficulty in understanding the concept of “tax treaty abuse” will persist. It is further noted that in the absence of these objectively stated international norms, being able to provide a conceptual framework within which to evaluate the BEPS proposals will arguably be limited.

Notwithstanding the challenge of being able to identify a conceptual framework, this section attempts to evaluate the possible effectiveness of the LoB provision proposed in the Report. The reason for this is twofold, namely (i) to recognise the complexities in testing what is meant by “tax treaty abuse” and (ii) to reiterate the importance of international tax policies and tax treaties, i.e. to encourage international trade between States. This is illustrated by evaluating the possible application of the LoB provision in three case studies.

The complexities referred to above, will be addressed by evaluating three case studies which have been widely publicised, namely the Amazon, Google and Starbucks European structures with a specific focus on whether the introduction of a LoB provision would address the concerns in the Report and prevent BEPS. This will be approached by firstly evaluating the tax benefits derived from the organisational structures of these European structures. It is submitted up front that these tax benefits are arguably brought about by the application of specific domestic tax laws and preferential tax regimes.

Although the Amazon, Google and Starbuck European structures will be evaluated, the evaluation will primarily focus on the Google European structure. This is because the Google European structure is the only one of the three that, in particular, interposed an entity to take advantage of specific tax treaty benefits. The other two case studies will be considered to highlight the point that BEPS, as

described in the Report, do not occur necessarily as a result of alleged “tax treaty abuse”. This is submitted for two reasons; (i) the concept of “tax treaty abuse” is difficult to understand and accordingly identify and (ii) there are other non-treaty tax considerations that may lead to BEPS.

By way of an introduction to the case studies this section sets out some preliminary comments on the nature and characteristics of the LoB provision.

3.1. Introduction to the LoB Provision

The LoB provision proposed in the Report is based on Article 22 of the USA Model tax treaty and is currently also present in a couple of treaties concluded by Japan and India.¹⁴⁵ It is a specific anti-abuse provision that limits the availability of treaty benefits to persons and entities by providing a number of tests that, when satisfied, entitle the taxpayer to the treaty benefits. These tests take into account *inter alia* the legal nature, ownership in, and general activities of the persons seeking relief from the tax treaty with the primary concern to ensure that there is a sufficient link between the person and State of residence to substantiate the relief afforded by the tax treaty. In summary, there are two broad structural tests and one business activity test that may be applied to determine the eligibility of a person to the benefits of the tax treaties.¹⁴⁶

The underlying premise of the LoB provision is that if the objective criteria is present, a treaty abuse motive is not *per se* present and the Person is accordingly entitled to the benefits of the tax treaty.¹⁴⁷ The tests are broadly discussed below.

3.1.1. Structural tests

The public company test is the first of the structural tests. It requires that a company be “regularly traded” on one of the “recognised stock exchanges” as defined in the LoB provision. This test relies on the stringent compliance requirements of securities exchanges rules and regulations as well as public

¹⁴⁵ *Ibid* 1, p. 20.

¹⁴⁶ Wardzynski, A., 2014. The Limitation of Benefits Article in the OECD Model: Closing Abusive (undesired) Conduit Gateways. Bulletin for International Taxation, IBFD, 68(9).

¹⁴⁷ *Ibid*. 1, p. 9 – 10.

scrutiny as a means of curtailing potential treaty shopping structuring within the listed environment.¹⁴⁸ On this basis the LoB places reliance on the stock exchange regulatory environment to preclude and discourage potential “treaty abuse”.

The second structural test is referred to as the ownership/base erosion test. This test focuses on a two-pronged approach that (i) evaluates the shareholder percentage holding for the resident of a contracting state and (ii) further assesses what percentage (i.e. less than 50%) of the company’s gross income is paid, whether directly or indirectly (by means of deductible payments) to third state residents. Consequently, the second structural test attempts to indirectly observe whether the majority of the equity and non-equity owners are residents of the contracting state.

3.1.2. Business activity test

The business activity test examines the economic nexus that the entity has with the resident state that consists of a “three-pronged approach” comprising of the following considerations:

- a) The level of active trade or business in the resident state;
- b) Connectedness between the item of income with the business in the resident state; and
- c) Whether or not the business activity is “substantial” compared to the activity generating the item of income in the source state”.¹⁴⁹

The structural and business activity tests develop an eligibility threshold that, for all intents and purposes, evaluates the level of economic activity and commercial connectivity the entity has with the residence State to ensure that the tax treaty benefits availed are not exploited. As a result of creating the economic nexus between the entity and the State, the tests’ attempt to discourage treaty shopping.

As a means of evaluating the efficacy of the proposed LoB provision, the next section considers whether the inclusion of the proposed LoB provision in the applicable tax treaties would have prevented the tax benefits realised by the Amazon, Google and Starbucks non-USA structures. Each

¹⁴⁸ *Ibid.* 146.

¹⁴⁹ *Ibid.* 146.

case study begins with an introduction into the structure, setting out the tax benefits that have been enjoyed by the taxpayer concerned and has also been at the centre of BEPS media uproar. Through the evaluation, it will become evident that a common feature in these structures is that, notwithstanding the fact that the companies have their ultimate parent in the USA, the main tax benefits enjoyed derived from the application of a combination of domestic tax provisions in the USA and Europe. As demonstrated through the case studies below, tax treaties do not always play a role.

3.2. Case Study 1: Google International (non-USA) Corporate Structure

3.2.1. Introduction

The so-called “Double Irish Dutch Sandwich” was a structure used by multinationals including Google to reduce its tax liability on non-USA income. The total tax benefits are maximised by combining the “Double Irish Dutch Sandwich” with the USA cost sharing arrangement.

In particular, as the name implies, the “Double Irish Dutch Sandwich” encompasses two companies incorporated in Ireland, i.e. one IP-Holding Company (“IRESub1”), one Irish Operating Company (“IRESub2”), and one Conduit Company (“NLBV”) incorporated in the Netherlands. These entities file check-the-box elections for US tax purposes and, as a result, the entities are regarded as one single Irish corporation for US tax purposes. As a consequence their respective incomes are consolidated for US tax purposes.¹⁵⁰

In order for the “Double Irish Dutch Sandwich” structure to be effective, IRESub1 is incorporated as a wholly owned subsidiary of the Google US Parent Company. Although IRESub1 is incorporated in Ireland, it is managed and controlled in Bermuda and hence considered to be tax resident in

¹⁵⁰ Fuest, C. (2013). Spengel, C.M., Finke, K., Heckemyer, J., Nusser, H., Profit Shifting and “Aggressive” Tax Planning by Multinational Firms: Issues and Options for Reform. *World Tax Journal* (October), p. 312.

Bermuda¹⁵¹ from an Irish tax perspective.¹⁵² From a US tax perspective IRESUB1 is however regarded as an Irish corporation by virtue of its incorporation in Ireland.¹⁵³

To realise the tax benefits of the “Double Irish Dutch Sandwich” structure, IRESUB1 in turn owns 100% of IRESUB2 and NLBV respectively. IRESUB2 performs advertising services, acts as the contractual partner of all non-US customers and in that way exploits the IP and earns high revenues.

The transaction flows that give rise to the tax benefits are illustrated in the diagram below and explained in the narration beneath.

¹⁵¹ As a result of the EU Parent Subsidiary Directive there is arguably no need for IRESUB1 to be managed and controlled in Bermuda.

¹⁵² The 1990 Directive was designed to eliminate tax obstacles in the area of profits distribution between group companies within the EU by (i) abolishing withholding taxes on payments of dividends between associated companies of different states within the EU and (ii) preventing double taxation of parent companies on the profits of their subsidiaries. http://ec.europa.eu/taxation_customs/taxation/company_tax/parents-subsidiary_directive/index_en.htm accessed on 13 November 2014. On 2 December 2012 the EU Commission presented an Action Plan for a more effective EU response to tax evasion and avoidance. This action set out a comprehensive set of measures, to help Member States protect their tax bases and recapture billions of euros legitimately due. This revision of the Parent Subsidiary directive is one of the measures announced in the action plan. In wake of the recent G20 and G8 meetings, on the 25 November 2013, the EU Commission announced that it is proposing to close certain “loopholes” in the EU Parent- Subsidiary Directive used by some companies to escape taxation (i.e. by exploiting differences in the way intra-group payments are taxed across the EU to avoid paying tax). As part of this proposal, the Directive would update the anti-abuse provision in the Directive and would subsequently require the EU Member States to adopt a common anti-abuse rule that would allow them to ignore artificial arrangements used for tax avoidance purposes and to determine that taxation is based on economic substance. Further, certain tax planning arrangements (e.g. hybrid loan arrangements) could not benefit from tax exemptions. It is expected that the EU Member States are expected to implement the amendments by 31 December 2014. http://europa.eu/rapid/press-release_IP-13-1149_en.htm accessed on 13 November 2014.

¹⁵³ *Ibid.* 150, p. 310.

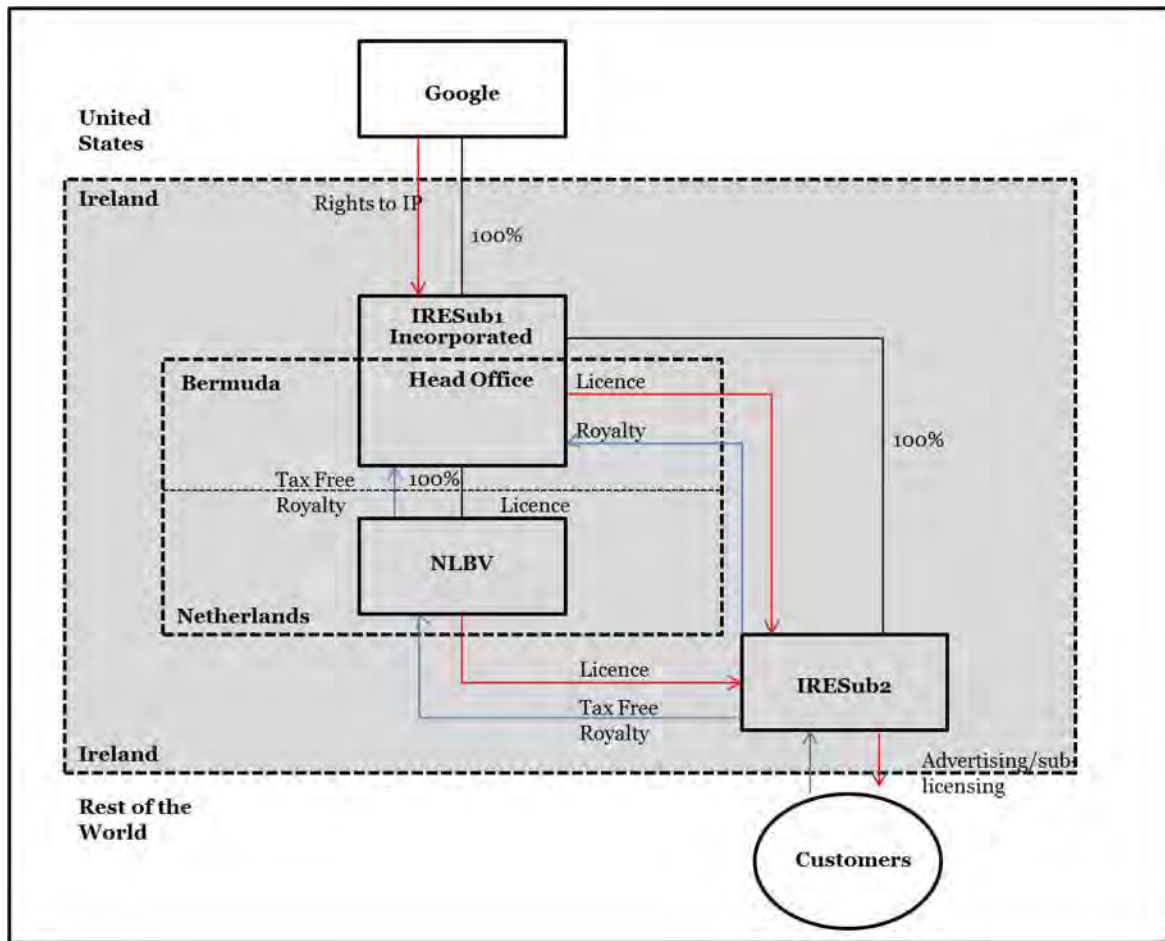


Figure 2: Google International (non-USA) Corporate Structure¹⁵⁴

3.2.2. Considerations of the Google (non-USA) Corporate Structure

3.2.2.1. Cost sharing arrangement between the USA and Ireland

In order for the structure to work and as a first step, Google USA transfers its rights to its IP to IRESub1. In accordance with the USA super royalty rules it is possible for IRESub1 to make a “buy-in” payment and conclude a cost sharing arrangement on the future modification and enhancement of the Google IP from a US tax perspective.

¹⁵⁴ Dr. Kevin Holmes, ADB International Tax Advisor to the Maldives, Department of Finance and Tax University of Cape Town, March 2014, Lecture notes on the Recent Developments in International Tax.

In this way, partially developed IP is often transferred for a less than an arm's length price (notwithstanding the fact that the transaction is deemed to be arm's length in terms of the cost sharing arrangement rules). This avoids potentially high exit costs in the future.¹⁵⁵

3.2.2.2. Exploitation of the IP

IRESUB2 provides advertising services and simultaneously acts as the contractual partner for all non-US Google customers to exploit the IP and earn high revenues. As no physical presence is maintained by IRESUB2 in any other jurisdiction such as the country of final consumption, the profits cannot be taxed in the country of final consumption.¹⁵⁶

Whilst the profits earned by IRESUB2, in respect of the advertising services and sales¹⁵⁷ effected to the rest of the world, are subject to tax in Ireland, as a result of the high royalty payments (for the use of the Google IP) made to IRESUB1, the tax base of IRESUB2 is significantly reduced¹⁵⁸ to the extent that IRESUB2 pays no or significantly low tax.

3.2.2.3. Royalty payments from IRESUB2 to IRESUB1 via NLBV

Royalties are then paid by IRESUB2 to IRESUB1 via NLBV, which has the right to sublicense the IP. NLBV does not perform any economic activity and the sole motivation for interposing NLBV in the structure is because the amounts paid by IRESUB2 to IRESUB1 (the IP-Holding Company), a Bermuda resident for Irish tax purposes, will be subject to withholding tax on royalties.¹⁵⁹

¹⁵⁵ *Ibid.* 150, p. 310.

¹⁵⁶ *Ibid.* 150, p 311.

¹⁵⁷ Through these structures it is evident that functions in customers' residence states like the delivery of products or marketing activities are usually assigned to low-risk group companies. These group service providers work on a cost-plus basis keeping the tax base in the country of final consumption low. Also see Fuest, C. (2013). Spengel, C.M., Finke, K., Heckemyer, J., Nusser, H., Profit Shifting and "Aggressive" Tax Planning by Multinational Firms: Issues and Options for Reform. *World Tax Journal* (October), p. 311.

¹⁵⁸ Although transfer pricing rules have been introduced in Ireland, these transfer pricing rules do not apply to contracts and terms agreed before July 2010. As a result, companies using the "Double Irish Dutch Sandwich" remains able to erode the Irish tax base by paying far exceeding arm's length royalties. See also Fuest, C. (2013). Spengel, C.M., Finke, K., Heckemyer, J., Nusser, H., Profit Shifting and "Aggressive" Tax Planning by Multinational Firms: Issues and Options for Reform. *World Tax Journal* (October), p. 310-312.

¹⁵⁹ *Ibid.* 150, p. 312.

By interposing NLBV and directing the royalties through NLBV, any potential withholding tax can be completely avoided with the result that royalties paid by IRESUB2 via the Netherlands are paid tax-free in terms of the EU Interest and Royalty Directive. Further, the Netherlands does not levy withholding tax on any outbound royalty payments, irrespective of the resident state of the receiving company.¹⁶⁰ Accordingly, the only cost suffered on the royalty charge that passes through the Netherlands is a small fee payable in the Netherlands.¹⁶¹

In the absence of the EU Interest and Royalty Directive, Article 10 of the Ireland / Netherlands tax treaty grants the exclusive right to tax royalties to the Netherlands. As such, IRESUB2 may not impose taxes on the royalty payments paid to NLBV. In addition, in terms of Dutch domestic tax laws, the Netherlands does not impose withholding taxes on outbound royalty payments. In this regard, by interposing NLBV, the Ireland / Netherlands tax treaty provided a benefit to IRESUB2 by taking advantage of the exclusive taxing rights granted to the Netherlands. The Dutch domestic tax laws further provided a further benefit that the royalty payments, paid to IRESUB1 by NLBV, would not be subject to any taxes in the Netherlands.

3.2.2.4. IRESUB1 not subject to tax

Bermuda does not impose corporate income tax. As such, IRESUB1 (being tax resident in Bermuda) is not liable to corporate income tax in Bermuda. Further, on the basis that no dividends are declared by IRESUB1 to the US, all “profits earned in the EU leave the EU virtually untaxed”.¹⁶²

3.2.2.5. Income not distributed to the US

Provided that non-USA income is not redistributed as dividends to the USA or qualify as Subpart F income (USA controlled foreign company income in terms of the Internal USA Tax Code) the non-USA income is not subject to tax in the US.¹⁶³

¹⁶⁰ *Ibid.*

¹⁶¹ *Ibid.*

¹⁶² *Ibid.*

¹⁶³ In terms of US tax laws, the profits will only be subject to US tax when they are repatriated to the US through distributions to the shareholders. In this regard, any potential US tax charge is delayed by simply not distributing any dividends.

By filing US check-the-box elections for IRESub1 and NLBV it is possible to avoid Subpart F income inclusions and view IRESub1 and IRESub2 and NLBV effectively as one single Irish corporation for USA tax purposes¹⁶⁴ and, as a result, “their income is combined for USA tax purposes”.¹⁶⁵

Consequently, royalty payments affected between IRESub2, NLBV and IRESub2 are disregarded for US tax purposes.¹⁶⁶ Income from transactions with customers¹⁶⁷ may however be subject to tax from a USA tax perspective, subject to certain exceptions in the Subpart F income rules.

3.2.3. Evaluation of the Google (non-USA) Corporate Structure and the application of the proposed LoB provision

Generally, royalties paid by IRESub2 to IRESub1 would normally be subject to withholding tax and accordingly result in a tax leakage within the Group.

In the absence of the EU Interest and Royalty Directive, Google interpose NLBV to eliminate the tax costs on the royalties paid by IRESub2 to IRESub1. In this regard, by interposing NLBV, the Ireland / Netherlands tax treaty provides benefits on the royalties paid between IRESub2 and NLBV from an international and domestic tax perspective.

In terms of the Ireland / Netherlands tax treaty the Netherlands is granted the exclusive right to tax the royalties. Ireland is therefore precluded from taxing the royalties paid by IRESub2 on the basis that it has no taxing rights in terms of the tax treaty. In this way, the tax treaty prevents any taxes being paid on the royalties paid from IRESub2 to IRESub1 via NLBV.

If the Ireland / Netherlands tax treaty however included a LoB provision, on the basis that there was very little economic activity being carried on by NLBV such that it did not meet the LoB eligibility threshold, the LoB provision would preclude NLBV from relying on the royalties article to exclusively

¹⁶⁴ *Ibid.* 150, p. 312.

¹⁶⁵ *Ibid.*

¹⁶⁶ *Ibid.*

¹⁶⁷ A specific exception in the Subpart F rules typically do not result in the transactions with the customers qualifying as Subpart F income. See also Fuest, C. (2013). Spengel, C.M., Finke, K., Heckemyer, J., Nusser, H., Profit Shifting and “Aggressive” Tax Planning by Multinational Firms: Issues and Options for Reform. *World Tax Journal* (October), p. 312.

tax the royalties in the Netherlands. In the absence of the royalty article, IRESUB2 would be allowed to tax the royalties paid to IRESUB1 via NLBV. In this way, the LoB provision, if appearing in the applicable tax treaty, can become effective in taking away the treaty benefits where there is no real activity taking place in the Netherlands. In this instance, the potential treaty benefits obtained is arguably as a result of treaty shopping.

Although Ireland has a substantial treaty network, the other tax benefits realised by Google's (non-USA) Corporate Structure are not really dependent on the application of the treaty with the Netherlands. Rather, the tax benefits are achieved through the application of carefully planned structures that make use of specific domestic tax regimes. Consequently, these benefits will not be precluded by the introduction of the proposed LoB provision. It is also noted that subsequent to interposing NLBV, the EU Interest and Royalty Directive was introduced resulting in no withholding tax being levied on the cross border royalty and interest payments within EU Group of Companies.

3.3. Case Study 2: Amazon European Corporate Structure

3.3.1. Introduction

The e-commerce retail businesses of the Amazon EU websites are operated by Amazon Luxembourg SubCo ("Lux SubCo"), a wholly owned subsidiary of Luxembourg Holding Company. This is important to note for the purposes of the case study. Accordingly, Lux SubCo owns the inventory, earns the profits associated with the selling of the products to the end customer and in turn bears the commercial risks associated with those operations. Consequently, Lux SubCo acts as the regional processing and payment hub for all its EU customers.

All the rights to the technology and intellectual property ("IP") used to operate Amazon's EU websites is held by the Luxembourg Holding Company, which is in turn owned by USA based companies. The technology and IP is primarily developed in the USA and used by the Luxembourg Holding Company (and subsidiaries) as part of a cost – sharing arrangement permitted in terms of the USA transfer pricing rules.

3.3.2. Separation of the sale and services operations

Amazon sells goods to its UK customers directly from Lux SubCo via the EU websites (also held by Luxembourg). The warehousing and logistical services required to deliver the goods to the end customer is rendered by Amazon UK on behalf of the Lux SubCo.

The services include the fulfilment and logistics services (including warehousing and delivery services); customer support services; accounting services; accountancy, tax, legal human resources, localisation and similar back office services; merchandising and marketing support services; and purchasing assistance. Arguably, as a result of the limited and more routine activities performed in the UK, it only earns a margin on its operating costs for providing these services to Lux SubCo.

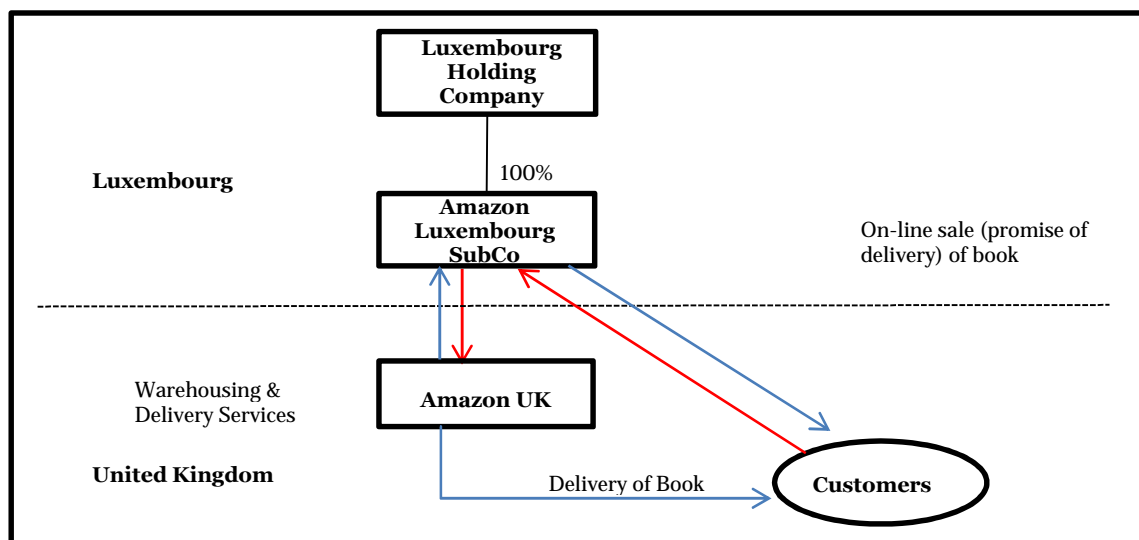


Figure 1: Amazon European Corporate Structure¹⁶⁸

3.3.3. Specific considerations of the Amazon European Corporate Structure

3.3.3.1. Cost sharing arrangement between the USA and Luxembourg

In terms of the USA domestic transfer pricing rules, parties are allowed to enter into a cost sharing arrangement whereby the parties agree to share the cost of developing one or more intangibles that

¹⁶⁸ Dr. Kevin Holmes, ADB International Tax Advisor to the Maldives, Department of Finance and Tax University of Cape Town, March 2014, Lecture notes on the Recent Developments in International Tax.

will generally be exploited separately by each of the parties without owing additional compensation to the other party. The parties share in the development costs in proportion to their share of the benefits they reasonably anticipate from their exploitation of the costs shared intangibles. In accordance with these USA treasury regulations, assuming all the requirements are met, the cost sharing arrangements produce an arm's length result.

Subject to compliance with the cost sharing arrangement requirements, the arrangement itself is deemed to be arm's length. It follows that Article 9, the Associated Enterprise Article, of the USA / Luxembourg tax treaty (which consequently has an extensive LoB provision) is not in point and does not apply.

3.3.3.2. Royalties paid for the use of the IP

Lux SubCo pays tax free royalties to Luxembourg Holding Company in terms of the Luxembourg domestic laws. These royalties are subsequently taxed at a preferential rate in Luxembourg. In terms of the cost sharing arrangements, no further fees are paid to the USA for the use of/development of the IP.

3.3.3.3. Separation of functions

Separating the sales and services functions in the EU corporate structure allows Amazon to benefit from the following:

- a) the low tax rate in Luxembourg on which profits from the sales are taxed;
- b) Luxembourg only levies 3% VAT on e-books compared to the 20% VAT levied in the UK; and
- c) The UK earns a margin on its operating costs for performing the services on behalf of Lux SubCo.

As a result of the limited functions performed in the UK, no permanent establishment is created in the UK for Lux SubCo.

3.3.4. Evaluation of the Amazon European Corporate Structure and the application of the proposed LoB provision

Notwithstanding the fact that Luxembourg has an extensive tax treaty network of approximately 68 tax treaties (as of 1 January 2014), from the above, it is evident that the Amazon EU Structure is in actual fact not dependent on any treaty benefits. Consequently, there is no need to meet the tests to determine the eligibility threshold of the entity.

Evident from the analysis, is that the structure simply takes advantage of the differences in the domestic tax regimes within Europe and the USA including the specific benefits available within the European Union (i.e. the single market within the European Union) in order to optimise tax payments and in turn maximise profits at the most tax efficient jurisdiction.

As a result of the public outcry on the lack of tax being paid by the multinational, on 7 October 2014, the European Commission opened an in-depth investigation into the provisions of a tax ruling to Amazon in relation to its Luxembourg corporate income tax position. Depending on the outcome of the formal investigation, the European Commission will determine whether Amazon benefited from unlawful State Aid granted by Luxembourg.¹⁶⁹

In the event that the UK amends its domestic tax laws to the extent that it recognises that Lux SubCo earns UK source income, the UK / Luxembourg tax treaty will provide a benefit to Lux SubCo by the application of Article 7 of the tax treaty. In particular, the benefit in terms of the business profits article (Article 7) of the UK / Luxembourg tax treaty will preclude the taxing of such UK source tax on the basis that Lux SubCo does not have a permanent establishment in the UK. As such, the tax treaty provides protection to Lux SubCo against any future tax policy and domestic tax law changes in the UK. In such a future event, the inclusion of a LoB provision in the UK / Luxembourg tax treaty, can become effective in eliminating the protection Article 7 provides to Lux SubCo where Lux SubCo does not meet the LoB eligibility threshold requirements.

¹⁶⁹ Tax Insights from International Tax Services, 2014. European Commission to Investigate Amazon Tax Rulings in Luxembourg. PricewaterhouseCoopers LLP.

Case Study 3: Starbucks European Corporate Structure

3.3.5. Introduction

Similarly to the Amazon and Google European Corporate Structures, the Starbucks European Corporate Structure benefits from an IP regime established using Switzerland and the Netherlands. In addition to the IP regime, Starbucks also charges intra-group financing charges which is payable to the USA entity.

In this regard, Starbucks structure benefits from the following:

- a) a premium rate for royalties charged to Starbucks Group companies,
- b) a reduced tax rate imposed on royalties in Switzerland,
- c) the allocation of profits to functions with regard to the supply chain (i.e. the purchasing of the coffee beans) and
- d) a premium intra-group financing costs paid to the USA.

Consequently, Starbucks UK pays a premium price, to the Netherlands, for the coffee beans, a premium royalty, to the Netherlands, for the use of the IP and an 'excessive' interest charge, to the US, on the intra-group loan.

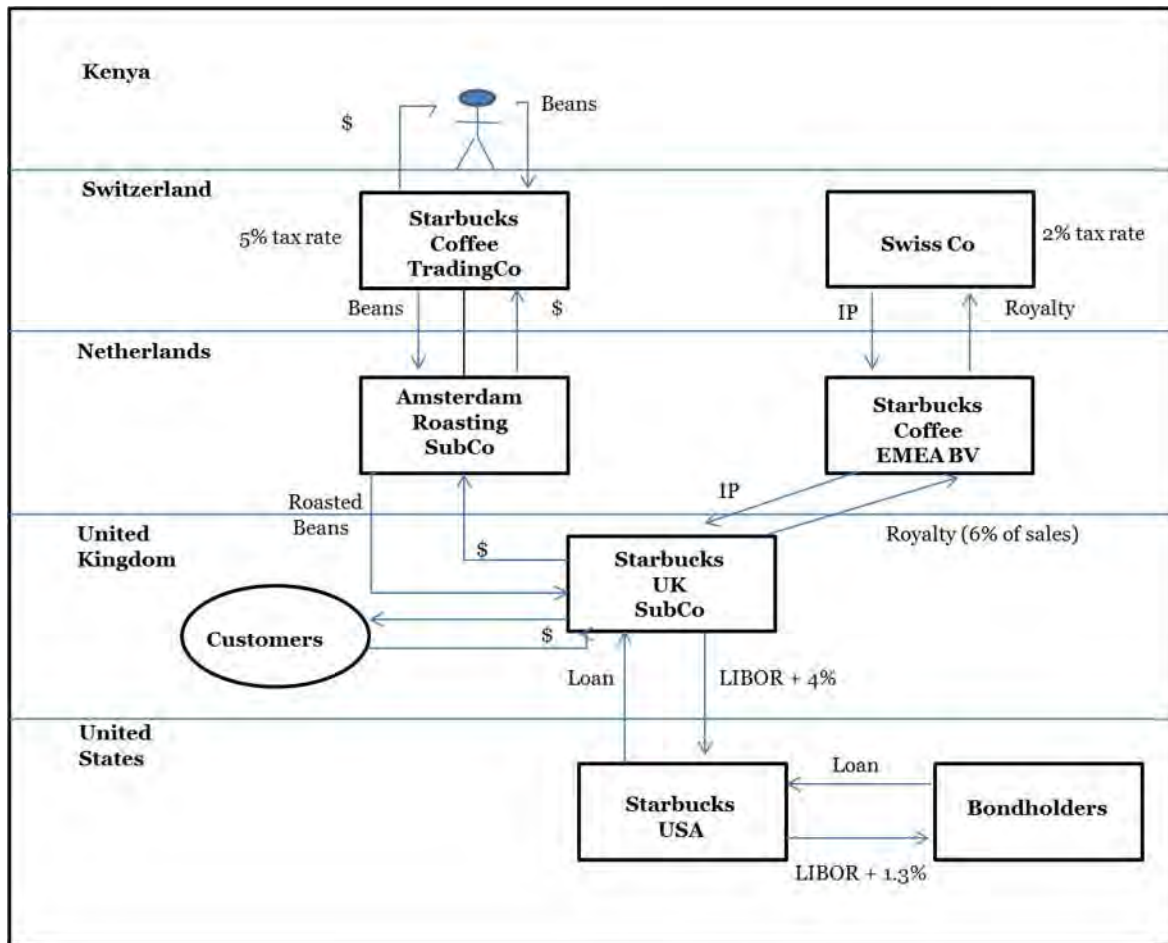


Figure 3: Starbucks European Corporate Structure¹⁷⁰

3.3.6. Considerations of the Starbucks European Corporate Structure

3.3.6.1. Purchase of coffee beans from Kenya

Coffee beans are purchased by Starbucks Coffee TradingCo (a company incorporated under the laws of Switzerland) at a relatively low price from the Kenya Coffee Traders. Starbucks Coffee TradingCo is taxed in Switzerland at a corporate income tax rate of 5%. The coffee beans are consequently on sold to Amsterdam Roasting SubCo, a company incorporated in Netherlands, and then on sold to Starbucks UK SubCo, a company incorporated in the UK.

As the coffee beans are being on sold through the Starbucks structure, there is a certain level of mark-up being added to the price as it is sold through the structure to the extent that Starbucks UK SubCo

¹⁷⁰ Dr. Kevin Holmes, ADB International Tax Advisor to the Maldives, Department of Finance and Tax University of Cape Town, March 2014, Lecture notes on the Recent Developments in International Tax.

ends up paying a premium price for coffee beans originally sourced through Kenya at significantly lower prices without adding any real value-add as the coffee beans are sold to Starbucks Coffee TradingCo (based in Switzerland) and Amsterdam Roasting SubCo (based in the Netherlands).

3.3.6.2. Exploitation of the Starbucks IP

In contrast to Amazon and Google that applies the cost contribution arrangement with regard to the transfer of IP from the USA to Luxembourg and Ireland respectively, the Starbucks IP is held by Swizz Co, a company incorporated in Switzerland. The IP is licenced to Starbucks Coffee EMEA BV ("Starbuck EMEA"), incorporated in the Netherlands. Starbucks EMEA in turn sub-licences the IP to Starbucks UK at a rate of 6% of sales, later reduced to 4.7% of sales.¹⁷¹

Together with the premium price paid for the coffee beans, the royalty payments made by Starbucks UK SubCo to Starbucks EMEA significantly reduces the taxable income of Starbucks UK. As a result, Starbucks UK SubCo pays very little to no tax in the UK.

The royalty received by Starbucks EMEA is subsequently on paid to Swiss Co in terms of the initial license agreement. These royalties are accordingly taxed at a rate of 2% in Switzerland and little tax in the Netherlands.

3.3.6.3. Excessive interest in connection with the intra-group loan

In terms of an intra-group loan between Starbucks UK SubCo and Starbucks USA, Starbucks UK SubCo is charged an interest rate of Libor + 4%. This is in contrast to an interest charge of LIBOR + 1.3% charged by the bondholders to Starbucks USA.

¹⁷¹ The royalty rate has since been reduced to 4.7% after being challenged by the UK tax authorities. This is also supposedly in line with the similar type royalties paid within the McDonalds Group. See also <http://www.reuters.com/article/2012/10/15/us-britain-starbucks-tax-idUSBRE89E0EX20121015>, accessed on 30 September 2014. Also see <http://www.bbc.com/news/business-20288077>, accessed on 30 September 2014.

Accordingly, Starbucks USA generates additional interest in the amount of 2.7%. This excessive interest charge¹⁷² further reduces the taxable income of Starbucks UK SubCo. Together with the premium price for the coffee beans and the royalty charge for the use of the IP, the tax base of Starbucks UK SubCo has been substantially reduced.

3.3.7. Evaluation of the Starbucks European Corporate Structure and the application of the proposed LoB provision

All things being equal, while there is no tax treaty in place between Switzerland and Kenya, using the economic principles of “supply and demand” and the “willing buyer and willing seller”, it can be contended that the coffee beans were bought at an arm’s length price. However, as the coffee beans are sold through Switzerland and the Netherlands, a mark-up is added. The prices are not subject to transfer pricing legislation in Switzerland, as the State is of the opinion that matters of transfer pricing cannot be addressed through legislation.¹⁷³ In this regard, there is subsequently no application of the associated parties’ article in the Switzerland / Netherlands tax treaty. Consequently, the application of the LoB provision is not in point on this leg of the transaction.

The sales between Amsterdam Roasting SubCo and Starbucks UK SubCo would be subject to transfer pricing rules in terms of Article 9 of the UK / Netherlands tax treaty. Although transfer pricing policies can be agreed upfront through the UK’s advanced pricing agreement (“APA”) process, this will not invalidate the application of a tax treaty.

The EU Interest and Royalty Directive provide further that the royalty to be paid to Starbuck EMEA without attracting any withholding tax. Starbucks maintains that the royalty of 6% of sales is in line with the arm’s length standard.¹⁷⁴

¹⁷² For comparison, KFC charges its subsidiaries approximately LIBOR plus 2% whereas the McDonalds in the UK are charged an interest rate below the LIBOR rate. See also <http://www.reuters.com/article/2012/10/15/us-britain-starbucks-tax-idUSBRE89E0EX20121015>, accessed on 30 September 2014.

¹⁷³ It is further understood that Switzerland has not plan to introduce domestic transfer pricing provisions in the near future.

¹⁷⁴ In order to show that the royalty is arm’s length is to illustrate that a license for which the royalty is paid is key to the subsidiary’s profitability. In this regard, Starbuck would need to show a track record of profitability to the Swiss Revenue Authorities. Notwithstanding this, Starbucks maintains that the royalty is in line with the arm’s length principle. See <http://www.reuters.com/article/2012/10/15/us-britain-starbucks-tax-idUSBRE89E0EX20121015>, accessed on 30 September 2014.

Where the UK unilaterally adjusts transfer prices in the future, the Dutch companies may (notwithstanding APAs and the EU Interest and Royalty Directive) be precluded from relying on Article 9 of the UK / Netherlands tax treaty to force the UK to consider the arm's length nature of the transactions where such tax treaty includes a LoB provision. The preclusion of the application of the LoB provision is on the basis that there appears to be very little economic activity taking place in the Amsterdam Roasting SubCo and Starbucks EMEA and consequently the eligibility criteria to access tax treaty benefits will not be met. In this regard it is possible that the premium price paid for the coffee beans and the royalty charge will not be capable of being challenged from a Dutch transfer pricing perspective. Where however the eligibility criteria of the LoB provision is met, the tax treaty will provide protection against unilateral future changes of tax policy and domestic tax laws in the UK.

An examination of Starbucks accounts shows that the Starbucks UK SubCo is entirely funded by intra-group loans to the extent that it paid GBP2 million in interest to Starbucks USA in 2011.¹⁷⁵

The current USA / UK tax treaty, which contains a LoB provision, has not prevented the undue reduction in the tax base of Starbucks UK SubCo with regard to the excessive interest charge. On the basis that the treaty benefits are not prevented by the existence of a LoB provisions, it must therefore be examined whether the introduction of the proposed LoB provision in terms of the Report does effectively achieve the objectives of prohibited these types of transactions.

On the basis that Starbucks is listed and provided that Starbucks meets the definition of being "regularly traded" on one of the "recognised stock exchanges", it would have passed the threshold of the first structural test of the proposed LoB provision. As such, Starbucks would have met the eligibility criteria and benefited from the zero withholding tax on interest provided for in the tax treaty. In this way, the interest charge between Starbucks UK SubCo and Starbucks USA does not attract any withholding taxes.

¹⁷⁵ See <http://www.reuters.com/article/2012/10/15/us-britain-starbucks-tax-idUSBRE89E0EX20121015>, accessed on 30 September 2014.

It is therefore clear that the LoB provision does not in any way inhibit the application of the tax treaty benefits once the eligibility tests are passed. In the case of Starbucks, passing the eligibility tests appears to be easily attainable.

3.4. Summary

From the case studies evaluated it is arguable whether the tax benefits derived were principally as a result of the “improper use of tax treaties”. Besides interposing NLBV (in the Google European structure) to specifically take advantage of tax treaty benefits, the other tax benefits derived from the Amazon, Google and Starbucks European structures are as a result of other provisions, for example specific domestic tax laws, preferential tax regimes and EU Directives. Tax treaties provide, at most, protection to these structures against future unilateral tax policy and law change in, for example, the UK. The introduction of LoB clauses could take away such future protection.

Although, LoB provisions can, in certain circumstances, prevent tax treaty benefits being obtained, they are not the main remedial mechanism necessary to address BEPS concerns. This is because the features of tax laws and tax treaties that cause BEPS are multifaceted.

It is therefore proposed that the introduction of the LoB provision (as recommended in the Report to combat BEPS in the context of tax treaties) is likely to be of limited application but still relevant. It is further suggested that the limited application of the proposed LoB provision is indicative of the challenging in developing more precise conceptual and terminological understanding of what is meant by “tax treaty abuse”. By properly identifying the issue at hand it is only possible to properly address the problem by putting mechanisms in place that combat the perceived BEPS in the context of tax treaties.

4. CONCLUSION

The evaluation of the literature in section 2 identifies the difficulty of establishing the meaning of the concept of “tax treaty abuse” as ascribed to in international law. Section 2 further demonstrates the difficulty observed in understanding what is meant by the concept of “tax treaty abuse”. These difficulties arguably render the objective and purpose of the Report and the BEPS project in the context of “tax treaty abuse” challenging to conceptually understand and consequently evaluate. The varying views in the literature considered in section 2 have arguably also not assisted in understanding the conceptual framework required to properly evaluate the subject matter.

In summary, the observations in section 2 draw a distinction between the concept of domestic “abuse of law” and “tax treaty abuse” in the context of international tax. While it has arguably been difficult to conclude on the understanding of what is meant and understood by the concept of “tax treaty abuse”, it is suggested that certain policy considerations and related guidance, on the matter, as advocated by the OECD Commentary, is more aligned with the concept of “tax avoidance”. This is because the guidance established and proposals recommended, are all understood against the background and in the context of what is meant by the “improper use of tax treaties”.

As a result, certain conceptual difficulties and terminological inconsistencies were highlighted in section 2. This further recognises the need for objectively stated international norms to be able to identify and consequently, accurately address the phenomenon referred to as “tax treaty abuse”.

Section 2 therefore does not aid in identifying a conceptual framework within which to evaluate the effectiveness of the BEPS proposals in the Report. Notwithstanding this lack of conceptual framework, section 3 of the paper attempts to evaluate the effectiveness of the specific inclusion of the LoB provisions in tax treaties to address tax avoidance structures used by selected multinational taxpayers.

The case studies in section 3 demonstrate that the issue of BEPS in the context of tax treaties is a multidimensional concept that is not only related to the inappropriate application of the tax treaties. Instead, the evaluation of the case studies show that other elements such as domestic tax laws and

preferential tax regimes resulted in certain tax benefits that were arguably the cause of the BEPS concerns in specific jurisdictions.

An evaluation of the literature therefore suggests that the concept of “abuse of law”, as understood in the context of domestic provisions, and the concept of “tax treaty abuse”, as explained in the Report, are not synonymous. The Report rather suggests that the concept of “tax treaty abuse” is more akin to the concept of “tax avoidance”. This is because, in the application of the “abuse of law” principle a specific “abuse” needs to be identified against the subjective intentions on the part of the taxpayer. However, in the context of “tax treaty abuse”, the difficulty of identifying this specific “abuse” is highlighted. This paper therefore suggests that objectively stated international norms needs to be developed to be able to identify “tax treaty abuse”. Consideration could also be given to replacing the term “tax treaty abuse” with “tax treaty avoidance” which is a more general term and arguably easier to understand and identify.

In conclusion, this paper has observed the following: -

- a) That the concept of “tax treaty abuse” is an imprecise term which has been difficult to conceptualise because it does not have a settled legal meaning in literature or foreign case law;
- b) The concept of “tax treaty abuse” as generally applied in the Report is more in line with the concept of “tax avoidance”;
- c) The evaluation of the case studies indicated that the application of specific domestic tax laws and other preferential tax regimes may also have caused BEPS concerns; and
- d) Further that the introduction of a LoB provision would not necessarily resolve the perceived “tax treaty abuse” in all cases and will therefore have a limited effect.

On this basis, the paper questions whether the introduction of a LOB provision will adequately address and prevent “tax treaty abuse” broadly as suggested in the Report. In addition, the paper further submits that the introduction of a LoB provision may result in additional complexities in the implementation and application of the provision. This is because the LoB provision includes the introduction further undefined terms as well as the application of subjective criterion. To the extent that, if at the end the application of the treaty remains uncertain; the decision on whether the tax

treaty applies is left to the competent authorities which would result in greater uncertainty. Accordingly, without a proper framework, the introduction of the LoB provision could potentially bring a host of other considerations that may not have been anticipated.

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Annexure A:

**ARTICLE X
ENTITLEMENT TO BENEFITS**

1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25), unless such resident is a “qualified person”, as defined in paragraph 2, at the time that the benefit would be accorded.

2. A resident of a Contracting State shall be a qualified person at a time when a benefit would otherwise be accorded by the Convention if, at that time, the resident is:
 - a) an individual;
 - b) a Contracting State, or a political subdivision or local authority thereof, or a person that is wholly-owned by such State, political subdivision or local authority;
 - c) a company or other entity, if, throughout the taxable period that includes that time
 - i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:
 - A. its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or
 - B. the company’s or entity’s primary place of management and control is in the Contracting State of which it is a resident; or
 - ii) at least 50 per cent of the aggregate voting power and value of the shares (and at least 50 per cent of any disproportionate class of shares) in the company or entity is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subdivision i) of this subparagraph, [provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State];
 - d) a person, other than an individual, that
 - i) is a [list of the relevant non-profit organisations found in each Contracting State],
 - ii) was constituted and is operated exclusively to administer or provide pension or other similar benefits, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident in either Contracting State,
 - iii) or was constituted and is operated to invest funds for the benefit of persons referred to in subdivision ii), provided that substantially all the income of that person is derived from investments made for the benefit of these persons;
 - e) a person other than an individual, if

- i) on at least half the days of the taxable period that includes that time, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph a), b) or d), or subdivision i) of subparagraph c), of this paragraph own, directly or indirectly, shares representing at least 50 per cent of the aggregate voting power and value (and at least 50 per cent of any disproportionate class of shares) of the person, [provided that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State], and
 - ii) less than 50 per cent of the person's gross income, as determined in the person's Contracting State of residence, for the taxable period that includes that time is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b) or d), or subdivision i) of subparagraph c), of this paragraph in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property);
- f) [possible provision on collective investment vehicles]¹

[Footnote 1:] This subparagraph should be drafted (or omitted) based on how collective investment vehicles are treated in the Convention and are used and treated in each Contracting State: see the Commentary on the subparagraph and paragraphs 6.4 to 6.38 of the Commentary on Article 1.]

3. a) A resident of a Contracting State will be entitled to benefits of this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a business in the first mentioned Contracting State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank or [list financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer respectively), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that business.

b) If a resident of a Contracting State derives an item of income from a business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other Contracting State from an associated enterprise, the conditions described in subparagraph a) shall be considered to be satisfied with respect to such item only if the business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the business activity carried on by the resident or associated enterprise in the other Contracting State. Whether a business activity is substantial for the purposes of this paragraph will be determined based on all the facts and circumstances.

c) For purposes of applying this paragraph, activities conducted by persons connected to a person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or another person possesses at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate voting power and value of the company's shares or of the beneficial equity interest in the company) in each person. In any case, a person shall be considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

- [4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention if, at the time when that benefit would be accorded:
- a. at least 95 per cent of the aggregate voting power and value of its shares (and at least 50 per cent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary, and
 - b. less than 50 per cent of the company's gross income, as determined in the company's State of residence, for the taxable period that includes that time, is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm's length payments in the ordinary course of business for services or tangible property) that are deductible for the purposes of the taxes covered by this Convention in the company's State of residence.]
5. If a resident of a Contracting State is not entitled, under the preceding provisions of this Article, to all benefits provided under this Convention, the competent authority of the Contracting State that would otherwise have granted benefits to which that resident is not entitled shall nevertheless treat that resident as being entitled to these benefits, or benefits with respect to a specific item of income or capital, if such competent authority, upon request from that resident and after consideration of the relevant facts and circumstances, determines that the establishment, acquisition or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the Contracting State to which the request has been made will consult with the competent authority of the other State before rejecting a request made under this paragraph by a resident of that other State.

6. For purposes of the preceding provisions of this Article:

- a. the term “recognised stock exchange” means:
 - i) [list of stock exchanges agreed to at the time of signature]; and
 - ii) any other stock exchange agreed upon by the competent authorities of the Contracting States;
- b. the term “principal class of shares” means the ordinary or common shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. If no single class of ordinary or common shares represents the majority of the aggregate voting power and value of the company, the “principal class of shares” are those classes that in the aggregate represent a majority of the aggregate voting power and value of the company. In the case of a company participating in a dual listed company arrangement, the principal class of shares will be determined after excluding the special voting shares which were issued as a means of establishing that dual listed company arrangement;
- c. the term “disproportionate class of shares” means any class of shares of a company resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other Contracting State by particular assets or activities of the company;
- d. a company’s “primary place of management and control” will be in the Contracting State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that Contracting State than in any other State and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions in that Contracting State than in any other State;
- e) [possible definition of “collective investment vehicle”]; 1 [Footnote 1: A definition of the term “collective investment vehicle” should be added if a provision on collective investment vehicles is included in paragraph 2 (see subparagraph 2 f)].];
- [f] the term “equivalent beneficiary” means a resident of any other State, but only if that resident
 - i) A) would be entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed under provisions analogous

to subparagraph a), b) or d), or subdivision i) of subparagraph c), of paragraph 2 of this Article, provided that if such convention does not contain a comprehensive limitation on benefits article, the person would be entitled to the benefits of this Convention by reason of subparagraph a), b) or d), or subdivision i) of subparagraph c), of paragraph 2 of this Article if such person were a resident of one of the Contracting States under Article 4 of this Convention; and B) with respect to income referred to in Articles 10, 11 and 12 of this Convention, would be entitled under such convention to a rate of tax with respect to the particular class of income for which benefits are being claimed under this Convention that is at least as low as the rate applicable under this Convention; or

ii) is a resident of a Contracting State that is entitled to the benefits of this Convention by reason of subparagraph a), b), subdivision i) of subparagraph c) or subparagraph d) of paragraph 2 of this Article;]

g) the term “dual listed company arrangement” means an arrangement pursuant to which two publicly listed companies, while maintaining their separate legal entity status, shareholdings and listings, align their strategic directions and the economic interests of their respective shareholders through:

- i) the appointment of common (or almost identical) boards of directors, except where relevant regulatory requirements prevent this;
- ii) management of the operations of the two companies on a unified basis;
- iii) equalised distributions to shareholders in accordance with an equalisation ratio applying between the two companies, including in the event of a winding up of one or both of the companies;
- iv) the shareholders of both companies voting in effect as a single decision-making body on substantial issues affecting their combined interests; and
- v) cross-guarantees as to, or similar financial support for, each other's material obligations or operations except where the effect of the relevant regulatory requirements prevents such guarantees or financial support; and
- vi) with respect to entities that are not companies, the term “shares” means interests that are comparable to shares.