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Item 3 (a) (ii) of the provisional agenda*
Base erosion and profit-shifting

PROPOSED NEW ARTICLE 1 COMMENTARY

Summary

This note, drawn up as part of the work of the BEPS Subcommittee, proposes a new Commentary for Article 1 relating to improper use of tax treaties, drawing upon discussions within the Committee of Experts on International Cooperation in Tax Matters and in other fora, such as in the context of the OECD/ G20 BEPS Project. Various issues for the committee's particular consideration are highlighted or addressed within square brackets. Indications are also given for each paragraph as to whether it is new, the same as under the existing (2011) UN Model or draws upon changes that will be made to the corresponding Commentary in the OECD Model Tax Convention. These are only to assist evaluation and will not be included in the final text of the Commentary.

Note that this paper does not incorporate changes made as a result of the separate work on hybrid entities (see E/C.18/2015/3). It therefore only addresses proposed changes to <u>*paragraphs 8 and following*</u> *of the current Commentary.*

PROPOSED NEW ARTICLE 1 COMMENTARY

Article 1

PERSONS COVERED

A. GENERAL CONSIDERATIONS

[…]

Improper use of tax treaties

8. The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. However, the provisions of tax treaties are drafted in general terms and taxpayers may be tempted to enter into arrangements so as to obtain benefits in circumstances where the Contracting States did not intend that these benefits be provided. Such improper uses of tax treaties are a source of concern to all countries but particularly for countries that have limited experience in dealing with sophisticated tax-avoidance strategies. [corresponds to old UN 8; OECD new 7 and old 8]

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

10. In the 2017 update the Committee made several changes to the United Nations Model Convention to prevent taxpayers from using the provisions of bilateral tax conventions based on the United Nations Model Convention improperly to obtain treaty benefits. First, the title of the Convention has been amended to refer expressly to "the prevention of tax avoidance and evasion." Second, a new preamble has been added which clarifies that tax conventions are not intended to create opportunities for tax avoidance or evasion including tax avoidance through treaty-shopping arrangements. Third, a new general anti-abuse rule has been included in Article 29, paragraph 9 of the United Nations Model Convention. This general anti-abuse rule and the specific anti-abuse rules included in tax treaties are intended to prevent transactions and arrangements from obtaining treaty benefits in circumstances where granting such benefits would be contrary to the object and purpose of the Convention. [new]

11. These additions to the United Nations Model Convention will make the provisions of the Convention more effective in preventing treaty abuse. However, many countries may have existing bilateral tax conventions that do not contain these new provisions, in particular the

general anti-abuse rule in Article 29,paragraph 9. This part of the Commentary describing the various approaches, which countries may adopt to combat tax avoidance through the improper use of tax treaties, is especially important where their treaties do not include Article 29, paragraph 9. [new]

12. Paragraphs 13 to 53 below are based on the 2017 OECD Commentary on Article 1 with appropriate modifications. In general, the basic approaches to controlling treaty abuse described below are intended to be consistent with the relevant Commentary on Article 1 of the OECD Model Convention. [new] ***[Note to the Committee: The following paragraphs do not quote the OECD paragraphs because the necessary modifications are too extensive and some paragraphs of the OECD Commentary are borrowed from the 2011 UN Commentary.]***

13. There are a number of different approaches used by countries to prevent and address the improper use of tax treaties. In general, these approaches involve the interpretation and application of the provisions of a treaty or the interpretation and application of domestic law. Dealing with tax avoidance through domestic law involves the possible application of:

a. specific anti-abuse rules in domestic law
b. general anti-abuse rules in domestic law and
c. judicial doctrines and principles of interpretation that are part of domestic law.

These domestic-law approaches are discussed generally in paragraphs 14 and 15 below and separately in more detail in paragraphs 30 to 46. Dealing with tax avoidance through tax conventions involves the possible application of

a. specific anti-abuse rules in tax treaties
b. general anti-abuse rules in tax treaties and
c. the interpretation of tax treaty provisions.

These treaty-based approaches are discussed generally in paragraphs 16 to 29_below and separately in more detail in paragraphs 47 to 55.

[Note to the Committee: this paragraph corresponds to paragraphs 10 and 11 of the current Commentary, but has been revised to reflect the addition of the new sections dealing with "Addressing tax avoidance through tax conventions" and "Addressing tax avoidance through domestic law and judicial doctrines."]

1. Approaches to prevent the improper use of tax treaties

***Addressing tax avoidance through domestic anti-abuse rules and judicial doctrines* [new]**

Domestic anti-abuse rules and judicial doctrines may also be used to address transactions and arrangements entered into for the purpose of obtaining treaty benefits in inappropriate circumstances. These rules and doctrines may also address situations where transactions or arrangements are entered into for the purpose of abusing both domestic laws and tax conventions. [corresponds to OECD new 19]

14. For these reasons, domestic anti-abuse rules and judicial doctrines play an important role in preventing treaty benefits from being granted in inappropriate circumstances. The application of such domestic anti-abuse rules and doctrines, however, raises the issue of possible conflicts with treaty provisions, in particular where treaty provisions are relied upon in order to facilitate the abuse of domestic law provisions (e.g. where it is claimed that treaty provisions protect the taxpayer from the application of certain domestic anti-abuse rules). This issue is discussed below in relation to specific legislative anti-abuse rules, general legislative anti-abuse rules and judicial doctrines. [corresponds to OECD new 20]

Addressing tax avoidance through tax conventions [new]

15. Article 29, paragraph 9 and the specific treaty anti-abuse rules included in tax conventions are aimed at transactions and arrangements entered into for the purpose of obtaining treaty benefits in inappropriate circumstances. Where, however, a tax convention does not include such rules, the question may arise whether the benefits of the tax convention should be granted when transactions that constitute an abuse of the provisions of that convention are entered into. [corresponds to OECD new 10]

16. Many States address that question by taking account of the fact that taxes are ultimately imposed through the provisions of domestic law, as restricted (and in some rare cases, broadened) by the provisions of tax conventions. Thus, any abuse of the provisions of a tax convention could also be characterised as an abuse of the provisions of domestic law under which tax is levied. For these States, the issue becomes whether the provisions of tax conventions may prevent the application of the anti-abuse provisions of domestic law, which is the question addressed in paragraphs 32 to 41 below. As explained in these paragraphs, as a general rule, there will be no conflict between such rules and the provisions of tax conventions. [corresponds to OECD new 11]

17. Other States prefer to view some arrangements as abuses of the convention itself, as opposed to abuses of domestic law. These States, however, consider that a proper construction of tax conventions allows them to disregard abusive transactions and arrangements, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties). [corresponds to OECD new 12]

18. Under both approaches, therefore, it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into. [corresponds to OECD new 13]

19. It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions. That principle applies independently from the

provisions of Article 29, paragraph 9, which merely confirm it. [corresponds to OECD new 14]

20. The guiding principle in paragraph 20 above has been endorsed by the OECD in paragraph 14 of the 2017 Commentary on Article 1 of the OECD Model Convention (paragraph 9.5 of the Commentary on Article 1 of the 2003 OECD Model Convention). The members of the Committee endorsed that principle in the 2011 update of the United Nations Model Convention and they continue to endorse it. They consider that such guidance as to what constitutes an abuse of treaty provisions serves an important purpose as it attempts to balance the need to prevent treaty abuses with the need to ensure that countries respect their treaty obligations and provide legal certainty to taxpayers. Clearly, countries should not be able to escape their treaty

obligations simply by arguing that legitimate transactions are abusive and domestic tax rules that affect these transactions in ways that are contrary to treaty provisions constitute anti-abuse rules. [corresponds to UN old 24]

21. Under the guiding principle presented above, two elements must therefore be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of a tax treaty:

- a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position, and
- obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions. [corresponds to old UN 25]

22. These two elements will also often be found, explicitly or implicitly, in general anti-avoidance rules and doctrines developed in various countries. [corresponds to old UN 26]

23. In order to minimize the uncertainty that may result from the application of that approach, it is important that this guiding principle be applied on the basis of objective findings of facts, not solely the alleged intention of the parties. Thus, the determination of whether a main purpose for entering into transactions or arrangements is to obtain tax advantages should be based on an objective determination, based on all the relevant facts and circumstances, of whether, without these tax advantages, a reasonable taxpayer would have entered into the same transactions or arrangements. [corresponds to old UN 27]

24. The potential application of these principles or Article 29, paragraph 9 does not mean that the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance is unnecessary. Where specific avoidance techniques have been identified or the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy. Also, this will be necessary where a State which adopts the view described in paragraph 18 above believes that its domestic law lacks the anti-avoidance rules or principles necessary to properly address such a strategy. [corresponds to OECD new 15]

25. For instance, some forms of tax avoidance have already been expressly dealt with in the Convention, e.g. by the introduction of the concept of "beneficial owner" (in Articles 10, 11, 12, and 12 A) and of special provisions such as paragraph 2 of Article 17 dealing with so-called artiste-companies. Such problems are also mentioned in the Commentaries on Article 10 (paragraph 13 quoting paragraphs 17 and 22 of the Commentary on Article 10 of the OECD Model Convention) and Article 11 (paragraph 18 quoting paragraph 12 of the Commentary on Article 11 of the OECD Model Convention). [corresponds to OECD new 16]

26. Also, in some cases, claims to treaty benefits by subsidiary companies, in particular companies established in tax havens or benefiting from harmful preferential regimes, may be

refused where careful consideration of the facts and circumstances of a case shows that the place of effective management of a subsidiary does not lie in its alleged state of residence but, rather, lies in the state of residence of the parent company so as to make it a resident of that

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latter state for domestic law purposes (this will be relevant where the domestic law of a state uses the place of management of a legal person, or a similar criterion, to determine its residence). [corresponds to OECD new 17]

27. Careful consideration of the facts and circumstances of a case may also show that a subsidiary is managed in the state of residence of its parent in such a way that the subsidiary had a permanent establishment (e.g. by having a place of management) in that state to which all or a substantial part of its profits are properly attributable. [corresponds to OECD new 18]

Specific legislative anti-abuse rules found in domestic law

28. Tax authorities seeking to address the improper use of a tax treaty may first consider the application of specific anti-abuse rules included in their domestic tax law. [corresponds to OECD new 21; old UN 12]

29. Many specific anti-abuse rules found in domestic law may be relevant for that purpose. For instance, controlled foreign corporation (CFC) rules may apply to prevent certain arrangements involving the use, by residents, of base or conduit companies that are residents of treaty countries; thin capitalization rules or earnings stripping rules may apply to restrict the deduction of base-eroding interest payments to residents of treaty countries; transfer pricing rules (even if not designed primarily as anti-abuse rules) may prevent the artificial shifting of income from a resident enterprise to an enterprise that is resident of a treaty country; exit or departure taxes rules may prevent the avoidance of capital gains tax through a change of residence before the realization of a treaty-exempt capital gain and dividend stripping rules may prevent the avoidance of domestic dividend withholding taxes through transactions designed to transform dividends into treaty-exempt capital gains; and anti-conduit rules may prevent certain avoidance transactions involving the use of conduit arrangements. [corresponds to OECD new 22; old UN 13]

30. A common problem that arises from the application of many of these and other specific anti-abuse rules to arrangements involving the use of tax treaties is possible conflicts with the provisions of tax treaties. Where two Contracting States take different views as to whether a specific anti-abuse rule found in the domestic law of one of these States conflicts with the provisions of their tax treaty, the issue may be addressed through the mutual agreement procedure having regard to the following principles. [corresponds to old UN 14]

31. Generally, where the application of provisions of domestic law and the provisions of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of "*pacta sunt servanda*" which is incorporated in Article 26 of the *Vienna Convention on the Law of Treaties*. Thus, if the application of specific anti-abuse rules found in domestic law were to result in a tax treatment that is not in accordance with the provisions of a tax treaty, this would conflict with the provisions of that treaty and the provisions of the treaty should prevail under public international law. [corresponds to OECD new 23; old UN 15]

32. As explained below, however, such conflicts will often be avoided and each case must be analysed based on its own circumstances. [corresponds to OECD new 24; old UN 16]

33. First, a treaty may specifically allow the application of certain types of specific domestic anti-abuse rules. For example, Article 9 of the Convention specifically authorizes the application of domestic transfer pricing rules in the circumstances defined by that Article. Also, many treaties include specific provisions clarifying that there is no conflict or, even if there is a conflict, allowing the application of the domestic rules. This would be the case, for example, for a treaty provision that expressly allows the application of thin capitalization rules, CFC rules or departure tax rules or, more generally, rules aimed at preventing the avoidance of tax found in the domestic law of one or both of the Contracting States. [corresponds to OECD new 25; old UN 17]

34. Second, many tax treaty provisions depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person, the determination of what is immovable property and the determination of when income from corporate rights might be treated as a dividend. More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the treaty. In many cases, therefore, the application of domestic anti-abuse rules will impact how the treaty provisions are applied rather than produce conflicting results. For example, if a domestic law provision treats the profits realised by a shareholder when a company redeems some of its shares as dividends, such a redemption could be considered to constitute an alienation for the purposes of paragraph 5 of Article 13. However, paragraph 14 of the Commentary on Article 10 (quoting paragraph 28 of the Commentary on Article 10 of the OECD Model Convention) recognises that such profits will constitute dividends for the purposes of Article 10 if the profits are treated as dividends under domestic law. [corresponds to OECD new 26; old UN 18]

35. Third, the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied under the general anti-abuse rule in Article 29, paragraph 9, or in the case of a treaty that does not include that Article, under a proper interpretation of the treaty in accordance with the principles in paragraphs __53 to __55 below. In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both the interpretation of the treaty and the application of domestic specific anti-abuse rules. Domestic specific anti-abuse rules, however, are often drafted by reference to objective facts, such as the existence of a certain level of shareholding or a certain debt-equity ratio. While this greatly facilitates their application and provides greater certainty, it may sometimes result in the application of these rules to transactions that do not constitute abuses. In such cases, the Convention will not allow the application of the domestic rule to the extent of the conflict. For example, assume that State A has adopted a domestic rule to prevent temporary changes of residence for tax purposes under which an individual who is a resident of State B is taxable in State A on gains from the alienation of property situated in a third State if that individual was a resident of State A when the property was acquired and was a resident of State A for at least seven of the 10 years preceding the alienation. In such a case, to the extent that paragraph 6 of Article 13 would prevent the taxation of that individual by State A upon the alienation of the property, theConvention would prevent the application of State A's domestic rule unless the benefits of paragraph 6 of Article 13 could be denied, in that specific case, under Article 29, paragraph 9 or the principles in paragraphs 53 to 55 below. [corresponds to OECD new 26.1; old UN 19]

36. Fourth, the application of tax treaty provisions may be denied under judicial doctrines or principles applicable to the interpretation of the treaty (see paragraphs __42 to __46 and 53 to 55 below). In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both a proper interpretation of the treaty and as result of the application of domestic specific anti-abuse rules. Assume, for example, that the domestic law of State A provides for the taxation of gains derived from the alienation of shares of a domestic company in which the alienator holds more than 25 per cent of the capital if that alienator was a resident of State A for at least seven of the 10 years preceding the alienation. In year 2, an individual who was a resident of State A for the previous 10 years becomes a resident of State B. Shortly after becoming a resident of State B, the individual sells all the shares of a small company that he previously established in State A. The facts reveal, however, that all the elements of the sale were finalised in year 1, that an interest-free "loan" corresponding to the sale price was made by the purchaser to the seller at that time, that the purchaser cancelled the loan when the shares were sold to the purchaser in year 2 and that the purchaser exercised de facto control of the company from year 1. Although the gain from the sale of the shares might otherwise fall under paragraph 6 of Article 13 of the State A-State B treaty, the circumstances of the transfer of the shares are such that the alienation in year 2 constitutes a sham within the meaning given to that term by the courts of State A. In that case, to the extent that the sham transaction doctrine developed by the courts of State A does not conflict with the rules of interpretation of treaties, it would be possible to apply that doctrine when interpreting paragraph 6 of Article 13 of the State A-State B treaty, which would allow State A to tax the relevant gain under its domestic law rule. [corresponds to OECD new 26.2]

37. A similar analysis applies in the case of controlled foreign corporation (CFC) rules. A significant number of countries have adopted CFC provisions to address issues related to the use of foreign base companies. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of CFC legislation conflicted with these provisions. Since CFC legislation results in a State taxing its own residents, the new saving provision added to the United Nations Model Convention in the 2017 update as [paragraph 3 of Article 1] confirms that it does not conflict with tax conventions. The same conclusion must be reached in the case of conventions that do not include a provision similar to [paragraph 3 of Article 1]. For the reasons explained in paragraphs 8 of the Commentary on Article 7 and 16 of the Commentary on Article 10, the interpretation according to which these Articles would prevent the application of CFC provisions does not accord with the text of paragraph 1 of Article 7 and paragraph 5 of Article 10. It is also not valid when these provisions are read in their context. Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that their CFC legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that CFC legislation structured in this way is not contrary to the provisions of the Convention. [corresponds to OECD new 26.8]

General legislative anti-abuse rules found in domestic law

38. Many countries have included in their domestic law a legislative anti-abuse rule of general application, which is intended to prevent abusive arrangements that are not adequately dealt with through specific anti-abuse rules or judicial doctrines. [corresponds to OECD new 26.3; old UN 20]

39. The application of such general anti-abuse rules also raises the question of a possible conflict with the provisions of a tax treaty. In the vast majority of cases, however, no such conflict will arise. Conflicts will first be avoided for reasons similar to those presented in paragraphs 37 and 38 above. In addition, where the main aspects of these domestic general anti-abuse rules are in conformity with the guiding principle in paragraph 20 above and are therefore similar to the main aspects of Article 29, paragraph 9, which incorporates this guiding principle, it is clear that no conflict will be possible since the relevant domestic general anti-abuse rule will apply in the same circumstances in which the benefits of the Convention would be denied under Article 29, paragraph 9, or, in the case of a treaty that does not include that Article, under the guiding principle in paragraph 20 above. This is the same general conclusion of the OECD, which is reflected in paragraphs 26.4 of the Commentary on Article 1 of the OECD Model Convention. [corresponds to OECD new 26.4; old UN 21]

Judicial doctrines and principles of interpretation that are part of domestic law

40. In the process of determining how domestic tax law applies to tax avoidance transactions, the courts of many countries have developed different judicial doctrines or principles of interpretation that may have the effect of preventing domestic law abuses. These include the sham, business purpose, substance over form, economic substance, step transaction, abuse of law and *fraus legis* approaches. These judicial doctrines and principles of interpretation vary from country to country and evolve over time based on refinements or changes resulting from subsequent court decisions. [corresponds to OECD new 26.5; old UN 28]

41. These doctrines are essentially views expressed by courts as to how tax legislation should be interpreted and typically become part of the domestic tax law. [corresponds to OECD new 26.5; old UN 29]

42. While the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the *Vienna Convention on the Law of Treaties*, nothing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties. If, for example, the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach to be adopted with respect to the application of the provisions of a tax treaty to similar transactions. This is illustrated by the example in paragraph 38 above. [corresponds to OECD new 26.5; old UN 30]

43. As a general rule and having regard to paragraph 20, therefore, the preceding analysis leads to the conclusion that there will be no conflict between tax conventions and judicial anti-abuse doctrines or general domestic anti-abuse rules. For example, to the extent that the application of a general domestic anti-abuse rule or a judicial doctrine such as “substance over form” or “economic substance” results in a recharacterisation of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes. [corresponds to OECD new 26.6]

44. Whilst these rules do not conflict with tax conventions, there is agreement that member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused. [corresponds to OECD new 26.7]

Specific anti-abuse rules found in tax treaties

45. Some forms of treaty abuse can be addressed through specific treaty provisions. A number of such rules are already included in the United Nations Model Convention; these include, in particular, the reference to an agent who maintains a stock of goods for delivery purposes (subparagraph (5) (b) of Article 5), the concept of “beneficial owner” (in Articles 10, 11, 12, and 12 A), the “special relationship” rule applicable to interest, royalties, and fees for

technical services (paragraph 6 of Article 11, paragraph 6 of Article 12, and paragraph 7 of Article 12 A), the rule on alienation of shares of immovable property companies (paragraph 4 of Article 13) and the rule on "star-companies" (paragraph 2 of Article 17). Another example is the modified version of the limited force-of-attraction rule of paragraph 1 of Article 7 that is found in some tax treaties and that applies only to avoidance cases. [corresponds to old UN 31]

46. Clearly, such specific treaty anti-abuse rules provide more certainty to taxpayers [than broad general anti-abuse rules or doctrines]. This is acknowledged in paragraph 20 above and in paragraph 15 (paragraph 9.6 of the 2003 Commentary on Article 1) of the OECD Commentary on Article 1, which explains that such rules can usefully supplement general anti-avoidance rules or judicial approaches. [corresponds to old UN 32]

47. One should not, however, underestimate the risks of relying extensively on specific treaty anti-abuse rules to deal with tax treaty avoidance strategies. First, specific anti-abuse rules are often drafted once a particular avoidance strategy has been identified. Second, the inclusion of a specific anti-abuse provision in a treaty can weaken the case as regards the application of general anti-abuse rules or doctrines to other forms of treaty abuses. Adding specific anti-abuse rules to a tax treaty could be wrongly interpreted as suggesting that an unacceptable avoidance strategy that is similar to, but slightly different from, one dealt with by a specific anti-abuse rule included in the treaty is allowed and cannot be challenged under general anti-abuse rules. Third, in order to specifically address complex avoidance strategies, complex rules may be required. This is especially the case where these rules seek to address the issue through the application of criteria that leave little room for interpretation rather than through more flexible criteria such as the purposes of a transaction or arrangement. For these reasons, whilst the inclusion of specific anti-abuse rules in tax treaties is the most appropriate approach to deal with certain situations, it cannot, by itself, provide a comprehensive solution to treaty abuses. [corresponds to old UN 33]

General anti-abuse rules found in tax treaties

48. In the 2017 update of the United Nations Model Convention, a general anti-abuse rule was added to the Convention as paragraph 9 of Article 29. Article 29, paragraph 9 is intended to prevent the improper use of tax treaties by denying the benefits of a treaty where a main purpose of a transaction or arrangement is to obtain those benefits and granting those benefits would contrary to the object and purpose of the relevant provisions of the treaty. [new]

49. As explained in paragraph 20 above, Article 29, paragraph 9 is consistent with and confirms the guiding principle for granting treaty benefits. Thus, many countries are able to deny treaty benefits in abusive cases without the need for a general anti-abuse rule, such as Article 29, paragraph 9, in their treaties. For this purpose, these countries can apply a general

anti-abuse rule found in domestic law, judicial doctrines or principles of interpretation found in domestic law or they can interpret the provisions of their tax treaties in order to deny the benefits of a treaty in abusive cases. [new]

50. Some countries may not feel confident that their domestic law and approach to the interpretation of tax treaties would allow them to adequately address improper uses of their tax treaties. These countries could consider including a general anti-abuse rule in their treaties, such as paragraph 9 of Article 29. A country that wishes to include a general anti-abuse rule in its treaties may need to adapt the wording to its own circumstances, particularly as regards the approach that its courts have adopted with respect to tax avoidance. In particular, a country that has a general anti-abuse rule in its domestic law should avoid, as far as possible, any inconsistency between that domestic rule and the general anti-abuse rule included in its treaties. [corresponds to old UN 36]

The interpretation of tax treaty provisions

51. Another approach that has been used to counter improper uses of treaties has been to consider that there can be abuses of the treaty itself and to disregard abusive transactions under a proper interpretation of the relevant treaty provisions that takes account of their context, the object and purpose of the treaty as well as the obligation to interpret these provisions in good faith in accordance with Article 31 of the Vienna Convention on the Law of Treaties. As noted in paragraph 18 above, a number of countries have long used a process of legal interpretation to counteract abuses of their domestic tax laws and it seems entirely appropriate to similarly interpret tax treaty provisions to counteract tax treaty abuses. The guiding principle in paragraph 20 above is equally applicable for the purpose of interpreting the provisions of a treaty to prevent the abuse of the treaty as it is for purposes of determining whether the provisions of a treaty prevent the application of specific or general anti-abuse rules found in domestic law. [corresponds to old UN 38]

52. Paragraphs 22 to 24 above provide guidance as to what should be considered to be a tax treaty abuse. That guidance would obviously be relevant for the purposes of the application of this approach. [corresponds to old UN 39]

53. As part of the 2017 update, the title of the United Nations Model Convention was amended to include an express reference to the prevention of tax avoidance and evasion as a purpose of the Convention. In addition, a new preamble to the Convention was added to clarify that the Contracting States do not intend the provisions of the Convention to create opportunities for non-taxation or reduced taxation through tax avoidance or evasion including through treaty-shopping. Treaty-shopping is only one example of the improper use of tax treaties; other examples can be found in paragraphs 57 to 113 below. Since the title and preamble form part of the context of the United Nations Model Convention, they should play an important role in the interpretation of the provisions of the Convention to prevent treaty

abuse. [new]

2. *Examples of improper uses of tax treaties*

54. The following paragraphs illustrate the application of the approaches described above in various cases involving the improper use of tax treaty provisions (these examples, however, are not intended to prejudge the legal treatment of these transactions in domestic law or under specific treaties). [old para. 40]

Dual residence and transfer of residence

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

– *Example 1*: Mr. X is a resident of State A who has accumulated significant pension rights in that country. Under the treaty between State A and State B, pensions and other similar payments are only taxable in the State of residence of the recipient. Just before his retirement, Mr. X moves to State B for two years and becomes resident thereof under the domestic tax law of that country. Mr. X is careful to use the rules of paragraph 2 of Article 4 to ensure that he is resident of that country for the purposes of the treaty. During that period, his accrued pension rights are paid to him in the form of a lump-sum payment, which is not taxable under the domestic law of State B. Mr. X then returns to State A.

– *Example 2*: Company X, a resident of State A, is contemplating the sale of shares of companies that are also residents of State A. Such a sale would trigger a capital gain that would be taxable under the domestic law of State A. Prior to the sale, company X arranges for meetings of its board of directors to take place in State B, a country that does not tax capital gains on shares of companies and in which the place where a company's directors meet is usually determinative of that company's residence for tax purposes. Company X claims that it has become a resident of State B for the purposes of the tax treaty between States A and B pursuant to paragraph 3 of Article 4 of that treaty, which is identical to the United Nations Model Convention. It then sells the shares and claims that the capital gain may not be taxed in State A pursuant to paragraph 6 of Article 13 of the treaty (paragraph 5 of that Article would not apply as Company X does not own substantial participations in the relevant companies).

– *Example 3*: Ms. X, a resident of State A, owns all the shares of a company that is also a resident of State A. The value of these shares has increased significantly over the years. Both States A and B tax capital gains on shares; however, the domestic law of State B provides that residents who are not domiciled in that State are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. In contemplation of the sale of these shares, Ms. X moves to State B for two years and becomes resident, but not domiciled, in that State. She then sells the shares and claims that the capital gain may not be taxed in State A pursuant to paragraph 6 of Article 13 of the treaty (the relevant treaty does not include a provision similar to paragraph 5 of the United Nations Model Convention). [old para. 41]

56. Depending on the facts of a particular case, it might be possible to argue that a change of residence that is primarily intended to access treaty benefits constitutes an abuse of a tax treaty. In cases similar to these three examples, however, it would typically be very difficult to find facts that would show that the change of residence has been done primarily to obtain treaty benefits, especially where the taxpayer has a permanent home or is present in another State for extended periods of time. Many countries have therefore found that specific rules were the best approach to deal with such cases. [old para. 42]

57. One approach used by some of these countries has been to include in their tax treaties provisions allowing a State of which a taxpayer was previously resident to tax certain types of income, e.g. capital gains on significant participations in companies or lump-sum payments of pension rights, realized during a certain period following the change of residence. An example of such a provision is found in paragraph 5 of Article 13 of the treaty signed in 2002 by the Netherlands and Poland, which reads as follows:

The provisions of paragraph 4 shall not affect the right of each of the Contracting States to levy according to its own law a tax on gains from the alienation of shares or "jouissance" rights in a company, the capital of which is wholly or partly divided into shares and which under the laws of that State is a resident of that State, derived by an individual who is a resident of the other Contracting State and has been a resident of the first-mentioned State in the course of the last ten years preceding the alienation of the shares or "jouissance" rights. [old para. 43]

58. Countries have also dealt with such cases through the use of so-called "departure tax" or exit charge" provisions, under which the change of residence triggers the realization of certain types of income, e.g. capital gains and pensions. To the extent that the liability to such a tax arises when a person is still a resident of the State that applies the tax and does not extend to income accruing after the cessation of residence, nothing in the Convention, and in particular in Articles 13 and 18, prevents the application of that form of taxation. Thus, tax treaties do not prevent the application of domestic tax rules according to which a person is considered to have realised pension income, or to have alienated property for capital gain tax purposes, immediately before ceasing to be a resident. [old para. 44]

59. A proper interpretation of the provisions of paragraphs 2 and 3 of Article 4 may also be useful in dealing with cases similar to these examples. Concepts such as "centre of vital interests" and "place of effective management", **which was the tie-breaker rule for legal entities before the 2017 update of the Convention,** require a strong relationship between a taxpayer and a country. The fact that a taxpayer has a home available to him in a country where he sojourns frequently is not enough to claim that that country is his centre of vital interests; likewise, the mere fact that meetings of a board of directors of a company take place in a country is not sufficient to conclude that this is where the company is effectively managed. **However, because many cases with respect to the dual residence of legal entities involve abusive arrangements, the 2017 update replaced paragraph 3 of Article 4, which deals with cases of dual residence of legal persons on the basis of their place of effective management, by a rule that leaves such cases of dual residence to be decided on a case-by-case under the mutual agreement procedure. [old para. 45; changes shown in bold]**

60. Example 3 raises the potential for tax avoidance arising from remittance-based taxation. This issue is dealt with in paragraph 115 below quoting paragraph 26.35 of the Commentary on Article 1 of the OECD Model Convention.

Treaty shopping

61. "Treaty shopping" is a form of improper use of tax treaties that refers to arrangements through which persons who are not entitled to the benefits of a tax treaty use other persons who are entitled to such benefits in order to indirectly access these benefits. For example, a company that is a resident of a treaty country would act as a conduit for channeling income

that would economically accrue to a person that is not a resident of that country so as to improperly access the benefits provided by a tax treaty. The conduit entity is usually a company, but may also be a partnership, trust or similar entity that is entitled to treaty benefits. Granting treaty benefits in these circumstances would be detrimental to the State of source since the benefits of the treaty would be extended to persons who were not intended to obtain such benefits. [old para. 47]

62. A treaty shopping arrangement may take the form of a "direct conduit" or that of a "stepping stone conduit", as illustrated below.[1] [old para. 48]

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

[1] See page R(6)-4, paragraph 4 of the OECD Report *Double Taxation Conventions and the use of Conduit Companies*. Reproduced in Volume II of the full-length version of the OECD Model Convention at page R(6)-1

e.g. in the case of dividends, by virtue of a participation exemption provided for under the domestic laws of State A or under the treaty between States A and B. In that case, Company X constitutes a direct conduit of its shareholder who is a resident of State C. [old para. 49]

64. The basic structure of a stepping stone conduit is similar. In that case, however, the income of Company X is fully taxable in State A and, in order to eliminate the tax that would be payable in that country, Company X pays high interest, commissions, service fees or similar deductible expenses to a second related conduit company, Company Z, a resident of State D. These payments, which are deductible in State A, are tax-exempt in State D by virtue of a special tax regime available in that State.[2] The shareholder who is a resident of State C is therefore seeking to access the benefits of the tax treaty between States A and B by using Company X as a stepping stone. [old para. 50]

65. In order to deal with such situations, tax authorities have relied on the various approaches described in the previous sections. [old para. 51]

66. For instance, specific anti-abuse rules have been included in the domestic law of some countries to deal with such arrangements. One example is that of the United States regulations dealing with financing arrangements. For the purposes of these regulations, a financing arrangement is a series of transactions by which the financing entity advances

money or other property to the financed entity, provided that the money or other property flows through one or more intermediary entities. An intermediary entity will be considered a "conduit", and its participation in the financing arrangements will be disregarded by the tax authorities if (i) tax is reduced due to the existence of an intermediary, (ii) there is a tax avoidance plan, and (iii) it is established that the intermediary would not have participated in the transaction but for the fact that the intermediary is a related party of the financing entity. In such cases, the related income shall be recharacterized according to its substance. [old para. 52]

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

[2] *Id.*

informing the tax authorities of the State of source that a tax relief has been claimed improperly. [old para. 53]

68. Other countries have relied on their domestic legislative general anti-abuse rules or judicial doctrines to address treaty shopping cases. As already noted, however, legislative general anti-abuse rules and judicial doctrines tend to be most effective when it is clear that transactions are intended to circumvent the object and purpose of tax treaty provisions. [old para. 54]

69. Treaty shopping can also, to some extent, be addressed through anti-abuse rules already found in most tax treaties, such as the concept of "beneficial ownership". [old para. 55]

70. Some countries, however, consider that the most effective approach to deal with treaty shopping is to include in their tax treaties specific anti-abuse rules dealing with that issue, such as the rules in paragraphs 1 to 7 of Article 29 which were added to the United Nations Model Convention in 2017 [old para. 56]

71. When considering the various approaches for dealing with treaty shopping, countries should take account of their ability to administer those approaches. For many developing countries, it may be difficult to apply very detailed rules that require access to substantial information about foreign entities. These countries might consider that a more limited approach which has the effect of denying the benefits of specific Articles of the Convention where transactions have been entered into for a main purpose of obtaining those benefits, might be more adapted to their own circumstances. The Articles concerned are 10, 11, 12 and 21; the provision should be slightly modified as indicated below to deal with the specific type of income covered by each of these Articles:

> The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the [Article 10: "shares or other rights"; Article 11: "debt-claim"; Articles 12 and 21: "rights"] in respect of which the [Article 10: "dividend"; Article 11: "interest"; Articles 12 "royalties" and Article 21: "income"] is paid to take advantage of this Article by means of that creation or assignment. [old para. 57 and old OECD para. 21.4]

72. In the 2017 update, a new preamble was added to the Convention, which expressly states that the Convention is not intended to create opportunities for tax avoidance including through treaty-shopping arrangements. In addition, the title of the Convention was amended to provide that the purposes of the Convention include the prevention of tax avoidance andevasion. These changes should play an important role in ensuring that the provisions of the Convention are interpreted and applied to prevent abusive treaty shopping arrangements. [new]

73. The general anti-abuse rule in paragraph 9 of Article 29, which was added to the Convention in the 2017 update, may also be effective in preventing abusive treaty shopping arrangements. [new]

Triangular Cases

74. With respect to tax treaties, the phrase "triangular cases" refers to the application of tax treaties in situations where three States are involved. A typical triangular case that may constitute an improper use of a tax treaty is one in which:

- dividends, interest, royalties or fees for technical services are derived from State S by a resident of State R, which is an exemption country;
- that income is attributable to a permanent establishment established in State P, a low tax jurisdiction where that income will not be taxed.[3] [old para. 58]

75. Under the State R-State S tax treaty, State S has to apply the benefits of the treaty to such income because it is derived by a resident of State R, even though the income is not taxed in that State by reason of the exemption system applied by that State. [old para. 59]

76. In the 2017 update, paragraph 8 of Article 29 was added to the Convention to deal with triangular cases. Under that provision, the benefits of the Convention are denied if the tax imposed on the income by the State in which the permanent establishment is located is less than 60 percent of the tax that would have been imposed by the residence State if the income had been derived by a resident of that State and was not attributable to a permanent establishment in a third state. See paragraphs __ to __ of the Commentary on Article 29 with respect to paragraph 8 of Article 29. [new; replaces old para. 60]

77. If similar provisions are not systematically included in the treaties that have been concluded by the State of source of such dividends, interest, royalties or fees for technical services with countries that have an exemption system, there is a risk that the relevant assets will be transferred to or the relevant services will be provided by associated enterprises that are residents of countries that do not have that type of provision in their treaty with the State of source. [old para. 61]

Attributing Profits or Income to a Specific Person or Entity

78. A taxpayer may enter into transactions or arrangements in order that income that would normally accrue to that taxpayer accrues to a related person or entity so as to obtain treaty benefits that would not otherwise be available. Some of the ways in which this may be done

[3] "Triangular Cases", in volume II of the full-length version of the *OECD Model Tax Convention*, OECD,

R(11)-3, at paragraph 53.

(e.g. treaty shopping and the use of permanent establishments in low-tax countries) have already been discussed. The following discusses other income shifting scenarios. [old para. 62]

i) Non arm's length transfer prices

79. It has long been recognized that profits can be shifted between associated enterprises through the use of non arm's length prices and the tax legislation of most countries now includes transfer pricing rules that address such cases. These rules are specifically authorized by Article 9 of the United Nations and OECD Model Conventions. This, however, is a complex area, as shown by the extensive guidance produced by the OECD[4] and the Committee[5] as to how these rules should operate. [old para. 63]

ii) Thin capitalization

80. In almost all countries, interest is a deductible expense whereas dividends, being a distribution of profits, are not deductible. A foreign company that wants to provide financing to a wholly-owned subsidiary may therefore find it beneficial, for tax purposes, to provide that financing through debt rather than share capital, depending on the overall tax on the interest paid. A subsidiary may therefore have almost all of its financing provided in the form of debt rather than share capital, a practice known as "thin capitalization," or it may claim excessive interest deductions relative to its earnings, a practice known as "earnings stripping." [old para. 64]

81. According to the OECD report on Thin Capitalisation[6], countries have developed different approaches to deal with this issue. These approaches may be broadly divided between those that are based on the application of general anti-abuse rules or the arm's length principle and those that involve the use of fixed debt-equity or interest-earnings ratios. [old para. 65]

82. The former category refers to rules that require an examination of the facts and circumstances of each case in order to determine whether the real nature of the financing is that of debt or equity. This may be implemented through specific legislative rules, general anti-abuse rules, judicial doctrines or the application of transfer pricing legislation based on the arm's length principle. [old para. 66]

83. The fixed ratio approach is typically implemented through specific legislative anti-abuse rules; under this approach, if the total debt/equity or interest/earnings ratio of a particular company exceeds a predetermined ratio, the interest on the excessive debt or the interest in excess of the specified percentage of earnings may be disallowed, deferred or treated as a dividend. [old para. 67]

84. To the extent that a country's thin capitalization or earnings stripping rule applies to

payments of interest to non-residents but not to similar payments that would be made to residents, it could be in violation of paragraph 4 of Article 24, which provides that "interest, royalties and other

[4] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 1995 (as updated).
[5] United Nations, *Practical Manual on Transfer Pricing for Developing Countries, United Nations*, New York, 2013 (as updated).
[6] *Thin Capitalisation*. Reproduced in volume II of the full-length version of the OECD Model Convention at page R(4)-1. Available at www.oecd.org/dataoecd/ 42/20/42649592.pdf.

disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State". There is a specific exception to that rule, however, where paragraph 1 of Article 9, which deals with transfer pricing adjustments, applies. For that reason, as indicated in paragraph 74 of the OECD Commentary on Article 24:[7]

> Paragraph 4 does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4. [old para. 68]

85. Paragraph 3 of the OECD Commentary on Article 9, which is reproduced under paragraph 5 of the Commentary on the same provision of this Model, clarifies that paragraph 1 of Article 9 allows the application of domestic rules on thin capitalization insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation. While this would typically be the case of thin capitalization rules that are based on the arm's length principle, a country that has adopted thin capitalization rules based on a fixed ratio approach would, however, typically find it difficult to establish that its thin capitalization rules, which do not refer to what independent parties would have done, satisfy that requirement. [old para. 69]

86. For that reason, countries that have adopted thin capitalization or earnings stripping rules based on a fixed ratio approach often consider that they need to include in their treaties provisions that expressly allow the application of these rules. For example, Article 13 of the Protocol to the treaty between France and Estonia provides as follows:

> The provisions of the Convention shall in no case restrict France from applying the provisions of Article 212 of its tax code (code général des impôts) relating to thin capitalization or any substantially similar provisions which may amend or replace the provisions of that Article. [old para. 70]

iii) *The use of base companies*

87. Base companies situated in low-tax jurisdictions may be used for the purposes of diverting income to a country where that income will be subjected to taxes that are substantially lower than those that would have been payable if the income had been derived directly by the shareholders of that company. [old para. 71]

88. Various approaches have been used to deal with such arrangements. For example, a company that is a mere shell with no employees and no substantial economic activity could,

[7] Paragraph 74 of the OECD Commentary on Article 24 is reproduced in the Commentary on Article 24 of this Model.

in some countries, be disregarded for tax purposes pursuant to general anti-abuse rules or judicial doctrines. It could also be possible to consider that a base company that is effectively managed by shareholders who are residents of another State has its residence or a permanent establishment in that State. The first approach is described in paragraph 28 above. [old para. 72] The second approach is described in paragraph 29 above. [old para. 73]

89. These approaches, however, might not be successful in dealing with arrangements involving companies that have substantial management and economic activities in the countries where they have been established. One of the most effective approaches to dealing with such cases is the inclusion, in domestic legislation, of controlled foreign corporation (CFC) legislation. While the view has sometimes been expressed that such legislation could violate certain provisions of tax treaties, the Committee considers that this would not be the case of typical CFC rules, as indicated in paragraph 39 above. [old para. 74]

iv) Directors' fees and remuneration of top-level managers

90. According to Article 16 (Directors' fees and Remuneration of Top-Level Managerial Officials), directors' fees and the remuneration of officials in a top-level managerial position of a company may be taxed in the State of residence of the company regardless of where the services of these directors and top-level managers are performed. A "salary split" arrangement could be used in order to reduce the taxes that would be payable in that State pursuant to that Article. Assume, for example, that Company A, a resident of State A, has two subsidiaries, Company B and Company C, which are residents of State X and State Y respectively. Mr. D, a resident of State X, is a director and an official in a top-level managerial position of Company B. State X levies an income tax at progressive rates of up to 50 per cent. State Y has a similar income tax system but with a very low tax rate. Countries X and Y have a tax treaty which provides that State X applies the exemption method to income that may be taxed in State Y. For the purpose of reducing the tax burden of Mr. D, Company A may

appoint him as a director and an official in a top-level managerial position of Company C and arrange for most of his remuneration to be attributed to these functions. [old para. 75]

91. Paragraph 1 of Article 16 applies to directors' fees that a person receives "in his capacity" as a director of a company and paragraph 2 applies to salaries, wages and other similar remuneration that a person receives "in his capacity" as an official in top-level managerial position of a company. Thus, apart from the fact that such an arrangement could probably be successfully challenged under general anti-abuse rules or judicial doctrines, it could also be attacked through a proper analysis of the services rendered by Mr. D to each company from which he receives his income, as well as an analysis of the fees and remuneration paid to other directors and top-level managers of Company C, in order to determine the extent to which director's fees and remuneration received from that company by Mr. D can reasonably be considered to be derived from activities performed as a director or top-level manager of that company. [old para. 76]

v) Attribution of interest to a tax-exempt or government entity

92. According to paragraph 12 of the Commentary on Article 11, countries may agree during bilateral negotiations to include in their treaties an exemption for interest of the following categories:[8]

– Interest paid to Governments or government agencies;
– Interest guaranteed by Governments or government agencies;
– Interest paid to central banks;
– Interest paid to banks or other financial institutions;
– Interest on long-term loans;
– Interest on loans to finance special equipment or public works; or
– Interest on other government-approved types of investments (e.g. export finance). [old para. 77]

93. Where a tax treaty includes one or more of these provisions, it may be possible for a party that is entitled to such an exemption to engage in back-to-back arrangements with other parties that are not entitled to that exemption or, where a contract provides for the payment of interest and other types of income that would not be exempt (e.g. royalties), to attribute a greater share of the overall consideration to the payment of interest. Such arrangements would constitute improper uses of these exemptions. [old para. 78]

94. While it could be argued that an easy solution would be to avoid including such exemptions in a tax treaty, it is important to note that these are included for valid policy purposes, taking into account that source taxation on gross payments of interest will frequently act as a tariff and be borne by the borrower. Also, as long as a country has agreed

[8] Many treaties additionally exempt from source taxation interest paid to financial institutions and interest on sales on credit (see paragraphs 12 and 13 of the Commentary on Article 11).

to include such exemptions in one of its treaties, it becomes difficult to refrain from granting these in treaty negotiations with other similar countries. [old para. 79]

95. Many of the approaches referred to above in the case of treaty shopping may be relevant to deal with back-to-back arrangements aimed at accessing the benefits of these exemptions. Also, cases where the consideration provided for in a mixed contract has been improperly attributed to interest payments can be challenged using specific domestic anti-abuse rules applicable to such cases, general domestic anti-abuse rules or doctrines or a proper interpretation of the treaty provisions. Where the overall consideration is divided among related parties, paragraph 6 of Article 11 and paragraph 1 of Article 9 may also be relevant to ensure that the benefit of the treaty exemption only applies to the proper amount of interest. Finally, some countries have included specific anti-abuse rules in their treaties to deal with such back-to-back arrangements. An example of such a rule is found in paragraph *b)* of Article 7 of the Protocol to the treaty signed in 2002 by Australia and Mexico, which reads as follows:

> The provisions of […] paragraph [2 of Article 11] shall not apply to interest derived from back-to-back loans. In such case, the interest shall be taxable in accordance with the domestic law of the State in which it arises. [old para. 80]

Hiring-out of Labour

96. The Commentary on Article 15 reproduces the part of the Commentary on the OECD Model Convention that deals inter alia with arrangements known as "international hiring-out of labour". This refers to cases where a local enterprise that wishes to hire a foreign employee for a short period of time enters into an arrangement with a non-resident intermediary who will act as the formal employer. The employee thus appears to fulfil the three conditions of paragraph 2 of Article 15 so as to qualify for the tax exemption in the State where the employment will be exercised. The Commentary on Article 15 includes guidance on how this issue can be dealt with, recognizing that domestic anti-abuse rules and judicial doctrines, as well as a proper construction of the treaty, offer ways of challenging such arrangements. [old para. 81]

Artistes and sportspersons

97. A number of older tax treaties do not include paragraph 2 of Article 17 (Artistes and Sportspersons), which deals with the use of so-called "star-companies". In order to avoid the possible application of provisions based on paragraph 1 of that Article, residents of countries that have concluded such treaties may be tempted to arrange for the income derived

from their activities as artistes or sportspersons, or part thereof, to be paid to a company set up for that purpose. [old para. 82]

98. As indicated in the Commentary on Article 17, which reproduces paragraph 11 of the OECD Commentary on that Article, such arrangements may be dealt with under domestic law provisions that would attribute such income to the artistes or sportspersons:

> […] The third situation involves certain tax avoidance devices in cases where remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to another person, *e.g.* a so-called artiste company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the artiste or sportsman nor as profits of the enterprise, in the absence of a permanent establishment. Some countries "look through" such arrangements under their domestic law and deem the income to be derived by the artiste or sportsman; where this is so, paragraph 1 enables them to tax income resulting from activities in their territory [...]. [old para. 83]

99. Paragraph 11.2 of the OECD Commentary, which was added in 2003, clarifies that a country could also rely on its general anti-avoidance rules or judicial doctrines to deal with abusive arrangements involving star-companies:

> 11.2 As a general rule it should be noted, however, that, regardless of Article 17, the Convention would not prevent the application of general anti-avoidance rules of the domestic law of the State of source which would allow that State to tax either the entertainer/sportsman or the star-company in abusive cases, as is recognised in paragraph 24 of the Commentary on Article 1. [old para. 84]

100. Finally, as regards the anti-abuse rule found in paragraph 2 of Article 17, tax administrations should note that the rule applies regardless of whether or not the star-company is a resident of the same country as the country in which the artiste or sportsperson is resident. This clarification was also added to the OECD Commentary in 2003:

> 11.1 The application of paragraph 2 is not restricted to situations where both the entertainer or sportsman and the other person to whom the income accrues, *e.g.* a star-company, are residents of the same Contracting State. The paragraph allows the State in which the activities of an entertainer or sportsman are exercised to tax the income derived from these activities and accruing to another person regardless of other provisions of the Convention that may otherwise be applicable. Thus, notwithstanding the provisions of Article 7, the paragraph allows that State to tax the income derived by a star-company resident of the other Contracting State even where the entertainer or sportsman is not a resident of that other State. Conversely, where the income of an entertainer resident in one of the Contracting States accrues to a person, *e.g.* a star-company, who is a resident of a third State with which the State of source does not have a tax convention, nothing will prevent the Contracting State from taxing that person in accordance with its domestic laws. [old para. 85]

Transactions that modify the treaty classification of income

101. Articles 6 to 21 allocate taxing rights differently depending on the nature of the income. The classification of a particular item of income for the purposes of these rules is based on a combination of treaty definitions and domestic law. Since taxpayers determine the contents of the contracts on which classification for the purposes of domestic law and treaty provisions is typically based, they may, in some cases, try to influence that classification so as to obtain unintended treaty benefits. [old para. 86]

102. The following paragraphs provide a few examples of arrangements that seek to change the treaty classification of income. Depending on the circumstances, such arrangements may be addressed through specific domestic or treaty anti-abuse rules or under general anti-abuse rules or judicial doctrines. A practical issue, however, will often be that, in some of these cases, it will be difficult to discover and establish the connection between various transactions that will be entered into for the purpose of altering the treaty classification. [old para. 87]

(i) Conversion of dividends into interest

103. Converting dividends into interest will be advantageous under a treaty that provides for source taxation of dividends but not of interest payments. Assume that X, a resident of State R, owns all the shares of Company A, which is a resident of State S. In contemplation of the payment of an important dividend, X arranges for the creation of holding Company B, which will also be a resident of State S; X is the only shareholder of Company B. X then sells the shares of Company A to Company B in return for interest-bearing notes (State R and State S allow that transfer to be carried out free of tax). The payment of interest by Company B to X will be made possible by the payment of dividends by Company A to Company B, which will escape tax in State S under a participation exemption or similar regime or because of the deduction of interest payments on the notes issued to X; X will thus indirectly receive the dividend paid by Company A in the form of interest payments on the notes issued by Company B and will avoid source taxation in State S. [old para. 88]

(ii) Allocation of price under a mixed contract

104. A mixed contract covers different considerations, such as the provision of goods, services, know-how and the licensing of intangibles. These generate different types of income for treaty purposes. In many cases, the acquirer will be indifferent to the allocation of the price between the various considerations and the provider may therefore wish, in the relevant contract, to allocate a disproportionate part of the price to items of income that will be exempt in the State of source. For instance, a franchising contract may involve the transfer of goods to be sold, the provision of various services, the provision of know-how and royalties for the use of intellectual property (e.g. trademarks and trade names). To the extent that the

non-resident franchisor does not have a permanent establishment in the State of residence of the franchisee, Article 7 would not allow that State to tax the business profits attributable to the provision of inventory goods and services but Article 12 would allow the taxation of the royalties and the payments related to know-how. Since all of these payments would normally be deductible for the franchisee, it may not care about how the overall price is allocated. The contract may therefore be drafted so as to increase the price for the provision of the goods and services and reduce the royalties and the price for the provision of know-how. [old para. 89]

105. Since the parties to the contract are independent, domestic transfer pricing legislation and Article 9 of the Convention would typically not apply to such transactions. Developing countries may be particularly vulnerable to such transactions since custom duties, which would typically have made it less attractive to allocate the price to the transfer of goods, are gradually being reduced and the determination of the proper consideration for intangible property is often a difficult matter, even for sophisticated tax administrations. [old para. 90]

(iii) *Conversion of royalties into capital gains*

106. A non-resident who owns the copyrights in a literary work wishes to grant to a resident of State S the right to translate and reproduce that work in that State in consideration for royalty payments based on the sales of the translated work. Instead of granting a license to the resident, the non-resident enters into a "sale" agreement whereby all rights related to the translated version of that work in State S are disposed of by the non-resident and acquired by the resident. The consideration for that "sale" is a percentage of the total sales of the translated work. The contract further provides that the non-resident will have the option to reacquire these rights after a period of five years. [old para. 91]

107. Some countries have modified the definition of royalties to expressly address such cases. For example, subparagraph *a)* of paragraph 3 of Article 12 of the treaty between the United States and India provides that

> The term "royalties" as used in this Article means:
>
> *a)* payments of any kind received as a consideration for the use of, or the right to use, any copyright […] including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof […]. [old para. 92]

(iv) *Use of derivative transactions*

108. Derivative transactions can allow taxpayers to obtain the economic effects of certain financial transactions under a different legal form. For instance, depending on the treaty

provisions and domestic law of each country, a taxpayer may obtain treaty benefits such as no or reduced source taxation when it is in fact in the same economic position as a foreign investor in shares of a local company. Assume, for instance, that Company X, a resident of State A, wants to make a large portfolio investment in the shares of a company resident in State B, while Company Y, a resident in State B, wants to acquire bonds issued by the government of State A. In order to avoid the cross-border payments of dividends and interest, which would attract withholding taxes, Company X may instead acquire the bonds issued in its country and Company Y may acquire the shares of the company resident in its country that Company X wanted to acquire. Companies X and Y would then enter into a swap arrangement under which they would agree to make swap payments to each other based on the difference between the dividends and interest flows that they receive each year; they would also enter into futures contracts to buy from each other the shares and bonds at some future time. Through these transactions, the taxpayers would have mirrored the economic position of cross-border investments in the shares and bonds without incurring the liability to source withholding taxes (except to the extent that the swap payments, which would only represent the difference between the flows of dividends and interest, would be subject to such taxes under Article 21 and the domestic law of each country). [old para. 93]

Transactions that seek to circumvent thresholds found in treaty provisions

109. Tax treaty provisions sometimes use thresholds to determine a country's taxing rights. One example is that of the lower limit of source tax on dividends found in subparagraph (*a*) of paragraph 2 of Article 10, which only applies if the beneficial owner of the dividends is a company which holds directly at least 25 per cent of the capital of the company paying the dividends. [old para. 94]

110. Taxpayers may enter into arrangements in order to obtain the benefits of such provisions in unintended circumstances. For instance, a non-resident shareholder could, in contemplation of the payment of a dividend, arrange for shares to be temporarily transferred to a resident company or non-resident company in the hands of which the dividends would be exempt or taxed at a lower rate. Such a transfer could be structured in such a way that the value of the expected dividend would be transformed into a capital gain exempt from tax in the source State. Although paragraph 2 of Article 10 was amended in the 2017 update to add a 365-day holding period requirement, as long as the company to which the shares are transferred has own more than 25 per cent of the company paying the dividends for 365 dyas or more, the benefit of the lower rate in paragraph 2 of Article 10 would apply. As noted in the Commentary on Article 10, which reproduces paragraph 17 of the OECD Commentary on that Article:

The reduction envisaged in subparagraph *a)* of paragraph 2 should not be granted in

cases of abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction. To counteract such manoeuvres Contracting States may find it appropriate to add to subparagraph *a)* a provision along the following lines:

> provided that this holding was not acquired primarily for the purpose of taking advantage of this provision.

The following are other examples of arrangements intended to circumvent various thresholds found in the Convention. [old para. 95]

Time limit for certain permanent establishments

111. Article 5, paragraph 3 of the Convention includes a rule according to which, in certain circumstances, the furnishing of services by a foreign enterprise in a State for more than 183 days will constitute a permanent establishment. Taxpayers may be tempted to circumvent the application of that provision by splitting a single project between associated enterprises so that none of the enterprises furnishes services in the State for more than 183 days. Paragraphs 11 and 12 of the Commentary on Article 5 deal with such arrangements. [old para. 96]

Thresholds for the source taxation of capital gains on shares

112. Paragraph 4 of Article 13 allows a State to tax capital gains on shares of a company (and on interests in certain other entities) if the shares derive more than 50 per cent of their value, directly or indirectly, from immovable property situated in that State at any time in the 365 days preceding the alienation of the shares. This 365-day period for testing whether more than 50 per cent of the value of the shares of a company or other entity are derived from immovable property was added to paragraph 4 of Article 13 of the United Nations Model Convention as part of the 2017 update of the Convention. [old para. 97]

113. Before the addition of the 365-day testing period to paragraph 4 of Article 13, one could attempt to circumvent that provision by diluting the percentage of the value of an entity that derives from immovable property situated in a given State in contemplation of the alienation of shares or interests in that entity. In the case of a company, that could be done by injecting a substantial amount of cash in the company in exchange for bonds or preferred shares the conditions of which would provide that such bonds or shares would be redeemed shortly after the alienation of the shares or interests. [old para. 98]

114. If a treaty does not contain a testing period such as the 365-day period in paragraph 4 of Article 13 of the United Nations Model Convention and the facts establish that assets have been transferred to an entity for the purpose of avoiding the application of paragraph 4 of Article 13 to a prospective alienation of shares or interests in that entity, a country's general anti-abuse rules or judicial doctrines or a general anti-abuse rule in the treaty may well be applicable. Some countries, however, may wish to provide expressly in their treaties that paragraph 4 will apply in these circumstances. This could be done by adding to Article 13 a provision along the following lines:

> For the purposes of paragraph 4, in determining the aggregate value of all assets owned by a company, partnership, trust or estate, the assets that have been transferred to that entity primarily to avoid the application of the paragraph shall not be taken into account. [old para. 99]

Restricting treaty benefits with respect to income that is subject to certain features of another State's tax system

115. As indicated in paragraph 17.2 of the Introduction (quoting paragraph 15.2 of the Introduction to the OECD Model Convention):

> … it is assumed that where a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State. Where a State levies no or low income taxes, other States should consider whether there are risks of double taxation that would justify, by themselves, a tax treaty. States should also consider whether there are elements of another State's tax system that could increase the risk of non-taxation, which may include tax advantages that are ring-fenced from the domestic economy.

Accordingly, the Committee decided that the following provisions of the Commentary on Article 1 of the OECD Model Convention, which were added as part of the 2017 update of that Convention, are also relevant for purposes of the United Nations Model Convention.

> 26.10 A State may conclude that certain features of the tax system of another State are not sufficient to prevent the conclusion of a tax treaty but may want to prevent the application of that treaty to income that is subject to no or low tax because of these features. Where the relevant features of the tax system of the other State are known at the time the treaty is being negotiated, it is possible to draft provisions that specifically deny treaty benefits with respect to income that benefits from these features (see, for example, paragraph 26.35 below).
>
> 26.11 Such features might, however, be introduced in the tax system of a treaty partner only after the conclusion of a tax treaty or might be discovered only after the treaty has entered into force. When concluding a tax treaty, a Contracting State may therefore be concerned about features of the tax system of a treaty partner of which it is not aware at

that time or that may subsequently become part of the tax system of that treaty partner. Controlled foreign company provisions (see paragraph 26.8 above) and other approaches discussed in the above section on “Improper use of the Convention” may assist in dealing with some of these features but since the difficulties created by these features arise from the design of the tax laws of treaty partners rather than from tax avoidance strategies designed by taxpayers or their advisers, Contracting States may wish to address these difficulties though specific treaty provisions. The following include examples of provisions that might be adopted for that purpose.

1. Provision on special tax regimes

26.12 Provisions could be included in a tax treaty in order to deny the application of specific treaty provisions with respect to income benefiting from regimes that satisfy the criteria of a general definition of “special tax regimes”. For instance, the benefits of the provisions of Articles 11 and 12 could be denied with respect to interest and royalties that would be derived from a connected person if such interest and royalties benefited, in the State of residence of their beneficial owner, from such a special tax regime; this would be done by adding to Articles 11 and 12 a provision drafted along the following lines (which could be amended to fit the circumstances of the Contracting States or for inclusion in other Articles of the Convention):

> Notwithstanding the provisions of paragraph 1 of this Article, [interest] [royalties] arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is connected to the payer may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits from a special tax regime with respect to the [interest] [royalties] in the State of which it is resident.

26.12.1 For the purposes of the above provision, the reference to a resident that is “connected” to the payer should be interpreted in accordance with the definition of “connected person” which is found in the Commentary on paragraph 7 of Article 29. As indicated in paragraph 127 of that Commentary, if the above provision is included in the Convention, it would seem appropriate to include that definition in paragraph 1 of Article 3, which includes the definitions that apply throughout the Convention. Some States, however, may prefer to replace the reference to a resident that is “connected” to the payer by a reference to a resident that is “closely related” to the payer, the main difference being that, unlike the definition of “connected” person, the definition of “closely related” person found in paragraph 8 of Article 5 does not apply where a person possesses directly or indirectly exactly 50 per cent of the aggregate vote and value of another person (if the definition of “closely related” person is used for the purposes of the above provision, that definition would be more appropriately included in paragraph 1 of Article 3).

26.13 Also, the above provision would require a definition of “special tax regime”, which could be drafted as follows and added to the list of general definitions included in paragraph 1 of Article 3:

> a) the term “special tax regime” means any statute, regulation or administrative practice in a Contracting State with respect to a tax described in Article 2 (Taxes Covered) that meets all of the following conditions:

(i) results in one or more of the following:

A) a preferential rate of taxation for interest, royalties or any combination thereof as compared to income from sales of goods or services;

B) a permanent reduction in the tax base with respect to interest, royalties or any combination thereof without a comparable reduction for income from sales of goods or services, by allowing:

1) an exclusion from gross receipts;

2) a deduction without regard to any corresponding payment or obligation to make a payment;

3) a deduction for dividends paid or accrued; or

4) taxation that is inconsistent with the principles of Article 7 or Article 9; or

C) a preferential rate of taxation or a permanent reduction in the tax base of the type described in parts 1), 2), 3) or 4) of clause B) of this subdivision with respect to substantially all of a company's income or substantially all of a company's foreign source income, for companies that do not engage in the active conduct of a business in that Contracting State;

(ii) in the case of any preferential rate of taxation or permanent reduction in the tax base for royalties, does not condition such benefits on

A) the extent of research and development activities that take place in the Contracting State; or

B) expenditures (excluding any expenditures which relate to subcontracting to a related party or any acquisition costs), which the person enjoying the benefits incurs for the purpose of actual research and development activities;

(iii) is generally expected to result in a rate of taxation that is less than the lesser of either:

A) [rate to be determined bilaterally]; or

B) 60 per cent of the general statutory rate of company tax applicable in the other Contracting State;

(iv) does not apply principally to:

A) recognised pension funds;

B) organisations that are established and maintained exclusively for religious, charitable, scientific, artistic, cultural or educational purposes;

C) persons the taxation of which achieves a single level of taxation either in the hands of the person or the person's shareholders (with at most one year of deferral), that hold a diversified portfolio of securities, that are subject to investor-protection regulation in the Contracting State

and the interests in which are marketed primarily to retail investors; or

D) persons the taxation of which achieves a single level of taxation either in the hands of the person or the person's shareholders (with at most one year of deferral) and that hold predominantly immovable property; and

(v) after consultation with the first-mentioned Contracting State, has been identified by the other Contracting State through diplomatic channels to the first-mentioned Contracting State as satisfying subdivisions (i) through (iv) of this subparagraph.

No statute, regulation or administrative practice shall be treated as a special tax regime until 30 days after the date when the other Contracting State issues a written public notification identifying the regime as satisfying subdivisions (i) through (iv) of this subparagraph.

26.14 The above definition of the term "special tax regime" applies to any legislation, regulation or administrative practice (including a ruling practice) that exists before or comes into effect after the treaty is signed and that meets all of the following five conditions.

26.15 Under the first condition, described in subdivision (i) of the definition, the regime must result in one or more of the following:

A. a preferential rate of taxation for interest, royalties or any combination thereof as compared to income from sales of goods or services;

B. certain permanent reductions in the tax base with respect to interest, royalties or any combination thereof without a comparable reduction for sales or services income; or

C. a preferential rate of taxation or certain permanent reductions in the tax base with respect to substantially all income or substantially all foreign source income for companies that do not engage in the active conduct of a business in that Contracting State. This part of the definition is intended to identify regimes that, in general, tax mobile income more favourably than non-mobile income.

26.16 As provided in clause A), subdivision (i) shall be satisfied if a regime provides a preferential rate of taxation for interest, royalties or a combination of the two as compared to sales or services income. For example, a regime that provides a preferential rate of taxation on royalty income earned by resident companies, but does not provide such preferential rate to income from sales or services, would meet this condition. Furthermore, a regime that provides a preferential rate of taxation for all classes of income, but such preferential rate is in effect available primarily for interest, royalties or a combination of the two, would satisfy subdivision (i) despite the fact that the beneficial treatment is not explicitly limited to those classes of income. For example, a tax authority's administrative practice of issuing routine rulings that provide a preferential rate of taxation for companies that represent that they earn primarily interest income (such as group financing companies) would satisfy subdivision (i) even if such rulings as

a technical matter provide that preferential rate to all forms of income.

26.17 Similarly, as provided in clause B), subdivision (i) shall be satisfied if a regime provides for a permanent reduction in the tax base with respect to interest, royalties or a combination thereof as compared to sales or services income, in one or more of the following ways: an exclusion from gross receipts (such as an automatic fixed reduction in the amount of royalties included in income, whereas such reduction is not also available for income from the sale of goods or services); a deduction without any corresponding payment or obligation to make a payment; a deduction for dividends paid or accrued; or taxation that is inconsistent with the principles of Articles 7 or 9 of the Convention. An example of a tax regime that results in taxation that is inconsistent with the principles of Article 9 is that of a regime under which no interest income would be imputed on an interest-free note that is held by a company resident of a Contracting State and is issued by an associated enterprise that is a resident of the other Contracting State.

26.18 A permanent reduction in a State's tax base does not arise merely from timing differences. For example, the fact that a particular country does not tax interest until it is actually paid, rather than when it economically accrues, is not regarded as a regime that provides a permanent reduction in the tax base, because such a rule represents an ordinary timing difference. However, a regime that results in excessive deferral over a period of many years shall be regarded as providing for a permanent reduction in the tax base, because such a rule in substance constitutes a permanent difference in the base of the taxing country.

26.19 Alternatively, as provided in clause C), subdivision (i) shall be satisfied if a regime provides a preferential rate of taxation or a permanent reduction in the tax base (of the type described above), with respect to substantially all income or substantially all foreign source income, for companies that do not engage in the active conduct of a business in the Contracting State. For example, regimes that provide preferential rates of taxation only to income of group financing companies or holding companies would generally satisfy subdivision (i).

26.20 A regime that provides for beneficial tax treatment that is generally applicable to all income (in particular to income from sales and services) and across all industries should not satisfy subdivision (i). Examples of generally applicable provisions that would not satisfy subdivision (i) include regimes permitting standard deductions, accelerated depreciation, corporate tax consolidation, dividends received deductions, loss carryovers and foreign tax credits.

26.21 The second condition, described in subdivision (ii) of the definition, applies only with respect to royalties and is met if a regime does not condition benefits either on the extent of research and development activities that take place in the Contracting State or on expenditures (excluding any expenditures which relate to subcontracting to a related party or any acquisition costs), which the person enjoying the benefits incurs for the purpose of actual research and development activities. Subdivision (ii) is intended to

ensure that royalties benefiting from patent box or innovation box regimes are eligible for treaty benefits only if such regimes satisfy one of these two requirements. Some States, however, would prefer that the requirements of subdivision (ii) be restricted so as to only be met if a regime conditions benefits on the extent of research and development activities that take place in the Contracting State. States that share that view may prefer to use the following alternative version of subdivision (ii):

> (ii) in the case of any preferential rate of taxation or permanent reduction in the tax base for royalties, does not condition such benefits on the extent of research and development activities that take place in the Contracting State;

Under either version of subdivision (ii), royalty regimes that have been considered by the OECD's Forum on Harmful Tax Practices and were not determined to be "actually harmful" generally would not meet subdivision (ii) and, if so, would not be treated as special tax regimes.

26.22 The third condition, described in subdivision (iii) of the definition, requires that a regime be generally expected to result in a rate of taxation that is less than the lesser of a rate that would be agreed bilaterally between the Contracting States and 60 per cent of the general statutory rate of company tax applicable in the Contracting State that considers the regime of the other State as a potential "special tax regime".

26.23 States may consider it useful to clarify the reference to "rate of taxation" for the purposes of subdivision (iii) by including the following in an instrument reflecting the agreed interpretation of the treaty:

> Except as provided below, the rate of taxation shall be determined based on the income tax principles of the Contracting State that has implemented the regime in question. Therefore, in the case of a regime that provides only for a preferential rate of taxation, the generally expected rate of taxation under the regime shall equal such preferential rate. In the case of a regime that provides only for a permanent reduction in the tax base, the rate of taxation shall equal the statutory rate of company tax generally applicable in the Contracting State to companies subject to the regime in question less the product of such rate and the percentage reduction in the tax base (with the baseline tax base determined under the principles of the Contracting State, but without regard to any permanent reductions in the tax base described in clause B) of subdivision (i)) that the regime is generally expected to provide. For example, a regime that generally provides for a 20 per cent permanent reduction in a company's tax base would have a rate of taxation equal to the applicable statutory rate of company tax reduced by 20 per cent of such statutory rate. In the case of a regime that provides for both a preferential rate of taxation and a permanent reduction in the tax base, the rate of taxation would be based on the preferential rate of taxation reduced by the product of such rate and the percentage reduction in the tax base.

26.24 The preceding would clarify that the rate of taxation should be determined based on the income tax principles of the Contracting State that has implemented the regime in

question. Therefore, in the case of a regime that provides only for a preferential rate of taxation, the generally expected rate of taxation under the regime will equal such preferential rate. In the case of a regime that provides only for a permanent reduction in the tax base, the rate of taxation will equal the statutory rate of company tax in the Contracting State that is generally applicable to companies subject to the regime in question less the product of such rate and the percentage reduction in the tax base (with the baseline tax base determined under the principles of the Contracting State, but without regard to any permanent reductions in the tax base described in clause B) of subdivision (i) of the definition) that the regime is generally expected to provide. For example, a regime that generally provides for a 20 per cent permanent reduction in a company's tax base would have a rate of taxation equal to the applicable statutory rate of company tax reduced by 20 percent of such statutory rate. Therefore, if the applicable statutory rate of company tax in force in a Contracting State were 25 per cent, the rate of taxation resulting from such a regime would be 20 percent (25 – (25 x 0.20)). In the case of a regime that provides for both a preferential rate of taxation and a permanent reduction in the tax base, the rate of taxation would be based on the preferential rate of taxation reduced by the product of such rate and the percentage reduction in the tax base.
26.25 The fourth condition, described in subdivision (iv) of the definition, provides that a regime shall not be regarded as a special tax regime if it applies principally to pension funds or organisations that are established and maintained exclusively for religious, charitable, scientific, artistic, cultural or educational purposes. Under subdivision (iv), a regime shall also not be regarded as a special tax regime if it applies principally to persons the taxation of which achieves a single level of taxation, either in the hands of the person or its shareholders (with at most one year of deferral), that hold a diversified portfolio of securities, that are subject to investor-protection regulation in the residence State, and interests in which are marketed primarily to retail investors. This would generally correspond to the collective investment vehicles referred to in paragraph 6.8 above. Another exception provided in subdivision (iv) applies to regimes that apply principally to persons the taxation of which achieves a single level of taxation, either in the hands of the person or its shareholders (with at most one year of deferral), and such persons hold predominantly immovable property.

26.26 The fifth condition, described in subdivision (v) of the definition, provides that the Contracting State that wishes to treat a regime of the other State as a "special tax regime" must first consult the other Contracting State and notify that State through diplomatic channels that it has determined that the regime meets the other conditions of the definition.

26.27 The final part of the definition requires that the Contracting State that wishes to treat a regime of the other State as a "special tax regime" must issue a written public notification stating that the regime satisfies the definition. For the purposes of the Convention, a special tax regime shall be treated as such 30 days after the date of such written public notification.

2. Provision on subsequent changes to domestic law

26.28 Whilst the above suggested provision on special tax regimes would address the issue of targeted tax regimes, it would not deal with changes of a more general nature which could be introduced into the domestic law of a treaty partner after the conclusion of a tax treaty and which might have prevented the conclusion of the treaty if they had existed at that time. For instance, some Contracting States might be concerned if the overall tax rate that another State levies on corporate income falls below what they consider to be acceptable for the purposes of the conclusion of a tax treaty. Some States might also be concerned if a State that taxed most types of foreign income at the time of the conclusion of a tax treaty decided subsequently to exempt such income from tax when it is derived by a resident company. The following is an example of a provision that would address these concerns, it being understood that the features of that provision would need to be restricted or extended in order to deal adequately with the specific areas of concern of each State:

1. If at any time after the signing of this Convention, a Contracting State

    a) reduces the general statutory rate of company tax that applies with respect to substantially all of the income of resident companies with the result that such rate falls below the lesser of either

        (i) [rate to be determined bilaterally] or

        (ii) 60 per cent of the general statutory rate of company tax applicable in the other Contracting State, or

    b) the first-mentioned Contracting State provides an exemption from taxation to resident companies for substantially all foreign source income (including interest and royalties),

the Contracting States shall consult with a view to amending this Convention to restore an appropriate allocation of taxing rights between the Contracting States. If such consultations do not progress, the other Contracting State may notify the first-mentioned Contracting State through diplomatic channels that it shall cease to apply the provisions of Articles 10, 11, 12 and 21. In such case, the provisions of such Articles shall cease to have effect in both Contracting States with respect to payments to resident companies six months after the date that the other Contracting State issues a written public notification stating that it shall cease to apply the provisions of these Articles.

2. For the purposes of determining the general statutory rate of company tax:

    a) the allowance of generally available deductions based on a percentage of what otherwise would be taxable income, and other similar mechanisms to achieve a reduction in the overall rate of tax, shall be taken into account; and

    b) the following shall not be taken into account:

        (i) a tax that applies to a company only upon a distribution by such company, or that applies to shareholders; and

        (ii) the amount of a tax that is refundable upon the distribution by a company of a dividend.

26.29 This suggested provision provides that if, at any time after the signing of the Convention, either Contracting State enacts certain changes to domestic law, the provisions of Articles 10, 11, 12 and 21 may cease to have effect with respect to payments to companies if, after consultation, the Contracting States fail to agree on amendments to the Convention to restore an appropriate allocation of taxing rights between the Contracting States.

26.30 Paragraph 1 of the suggested provision addresses two types of subsequent changes that could be made by a State, after the signature of a tax treaty, to the tax rules applicable to companies resident of that State. The first type is when that State reduces the general statutory rate of company tax that applies with respect to substantially all of the income of its resident companies, with the result that such rate falls below the lesser of a minimum rate that would need to be determined bilaterally or 60 per cent of the general rate of company tax applicable in the other State.

26.31 For the purposes of paragraph 1, the "general statutory rate of company tax" refers to the general rate of company tax provided by legislation; if rates of company taxes are graduated, it refers to the highest marginal rate, provided that such rate applies to a significantly large portion of corporate taxpayers and was not established merely to circumvent the application of this Article. A general statutory rate of company tax that is applicable to business profits generally or to so-called "trading income" (broadly defined to include income from manufacturing, services or dealing in goods or commodities) shall be treated as applying to substantially all of the income of resident companies, even if narrow categories of income (including income from portfolio investments or other passive activities) are excluded. A reduced rate of tax that applies only with respect to capital gains would not fall within the scope of this Article; the distinction between business profits and capital gains shall be made according to the domestic laws of the residence State. Paragraph 2 addresses specific issues that may arise in determining what is a State's general statutory rate of company tax. Subparagraph a) of paragraph 2 provides that paragraph 1 applies equally to reductions to the general statutory company tax rate, as well as to other changes in domestic law that would have the same effect using a different mechanism. For example, if the statutory company tax rate in a Contracting State was 20 per cent, but, after the signing of the Convention, companies resident in the Contracting State are permitted to claim deductions representing 50 per cent of what otherwise would be their taxable income, the general statutory rate of company tax would be 10 per cent (20 – (20 x 0.50)). Similarly, if the statutory company tax rate in a Contracting State was 20 per cent, but after the signing of the Convention, companies resident in the Contracting State are allowed to deduct an amount equal to a percentage of their equity up to 50 per cent of what otherwise would be their taxable income, and in general, most companies are able to utilize the maximum available deduction, the general rate of company tax would be 10 per cent. Subparagraph b) of paragraph 2 sets forth taxes that shall not be taken into account for purposes of determining the general statutory rate of company tax. First, as provided in subdivision (i) of subparagraph b), taxes imposed at either the company or shareholder level when the company distributes earnings shall not be taken into account

when determining the general rate of company tax (e.g. if resident companies are not subject to any taxation at the company level until a distribution is made, the tax levied upon distribution would not be considered part of the general rate of company tax). Second, as provided in subdivision (ii) of subparagraph b), any amounts of corporate tax that under a country's domestic law would be refundable upon a company's distribution of earnings shall not be taken into account for purposes of determining the general statutory rate of company tax.

26.32 The second type of subsequent change in domestic tax law covered by paragraph 1 is when a State provides an exemption from taxation to companies resident of that State with respect to substantially all foreign source income (including interest and royalties) derived by these companies. The reference to an exemption for substantially all foreign source income earned by a resident company is intended to describe a taxation system under which income (including income from interest and royalties) from sources outside a State is exempt from tax solely by reason of its source being outside that State (so-called "territorial" systems). The reference does not include taxation systems under which only foreign source dividends or business profits from foreign permanent establishments are exempt from tax by the residence State (so-called "dividend exemption" systems).

26.33 When either type of subsequent domestic law change occurs, the Contracting States shall first consult with a view to concluding amendments to the Convention to restore an appropriate allocation of taxing rights between the two Contracting States. In the event that such amendments are agreed, or that the Contracting States agree, after such consultation, that the allocation of taxing rights in the Convention is not disrupted by the relevant change made to the domestic law of one of the States, paragraph 1 has no further application. If, however, after a reasonable period of time, such consultations do not progress, the other State may notify the State whose domestic law has changed, through diplomatic channels, that it shall cease to apply the provisions of Articles 10, 11, 12 and 21. Once such diplomatic notification has been made, in order for paragraph 1 to apply, the source State must announce by public notice that it shall cease to apply the provisions of these Articles. Six months after the date of such written public notification, the provisions of these Articles shall cease to have effect in both Contracting States with respect to payments to companies that are residents of either State.

3. Provision on notional deductions for equity

26.34 One example of a tax regime with respect to which treaty benefits might be specifically restricted relates to domestic law provisions that provide for a notional deduction with respect to equity. Contracting States which agree to prevent the application of the provisions of Article 11 to interest that is paid to connected persons who benefit from such notional deductions may do so by adding the following provision to Article 11:

> 2. Notwithstanding the provisions of paragraph 1 of this Article, interest arising in a Contracting State and beneficially owned by a resident of the other Contracting

State that is connected to the payer (as defined in paragraph 8 of Article 5) may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits, at any time during the taxable year in which the interest is paid, from notional deductions with respect to amounts that the Contracting State of which the beneficial owner is a resident treats as equity.

The explanations in paragraph 26.12.1 above concerning the reference to a resident that is "connected" to the payer apply equally to the above provision.

4. ~~Remittance based taxation~~Provision on remittance based taxation

26.35 Another example of a tax regime with respect to which treaty benefits might be specifically restricted is that of remittance based taxation. Under the domestic law of some States, persons who qualify as residents but who do not have what is considered to be a permanent link with the State (sometimes referred to as domicile) are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. Such persons are not, therefore, subject to potential double taxation to the extent that foreign income is not remitted to their State of residence and it may be considered inappropriate to give them the benefit of the provisions of the Convention on such income. Contracting States which agree to restrict the application of the provisions of the Convention to income that is effectively taxed in the hands of these persons may do so by adding the following provision to the Convention:

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

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

3. The importance of proper mechanisms for the application and interpretation of tax treaties

116. The Committee recognizes the role that proper administrative procedures can play in

minimizing risks of improper uses of tax treaties. Many substantive provisions in tax treaties need to be supported by proper administrative procedures that are in line with the procedural aspects of domestic tax legislation. Developing countries may consider developing their own procedural provisions regarding treaty application by learning from countries that have successful experience of treaty application. [old para. 100]

117. The Committee also recognizes the importance of proper mechanisms for tax treaty interpretation. In many countries, there is a long history of independent judicial interpretations of tax treaties, which provide guidance to tax administrations. Countries that have a weaker judicial system or where there is little judicial expertise in tax treaty interpretation may consider alternative mechanisms to ensure correct, responsive and responsible treaty interpretations. [old para. 101]

118. Whilst anti-abuse rules are important for preventing the improper use of treaties, the application of certain anti-abuse rules may be challenging for tax administrations, especially in developing countries. For instance, whilst an effective application of domestic transfer pricing rules may help countries to deal with certain improper uses of treaty provisions, countries that have limited expertise in the area of transfer pricing may be at a disadvantage. In addition, countries that have inadequate experience of combating improper uses of treaties may feel uncertain about how to apply general anti-abuse rules, especially where a purpose test is involved. This increases the need for appropriate mechanisms to ensure a proper interpretation of tax treaties. [old para. 102]

119. Developing countries may also be hesitant to adopt or apply general anti-abuse rules if they believe that these rules would introduce an unacceptable level of uncertainty that could hinder foreign investment in their territory. Whilst a ruling system that would allow taxpayers to quickly know whether anti-abuse rules would be applied to prospective transactions could help reduce that concern, it is important that such a system safeguards the confidentiality of transactions and, at the same time, avoids discretionary interpretations (which, in some countries, could carry risks of corruption). Clearly, a strong independent judicial system will help to provide taxpayers with the assurance that anti-abuse rules are applied objectively. Similarly, an effective application of the mutual agreement procedure will ensure that disputes concerning the application of anti-abuse rules will be resolved according to internationally accepted principles so as to maintain the integrity of tax treaties. [old para. 103]