United Nations Practical Portfolio

Protecting the Tax Base

of Developing Countries through the use of General Anti-avoidance Rules

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Protecting the Tax Base
of Developing Countries through the use of **General Anti-avoidance Rules**

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Part I
Introduction

1.1 Background

In 2012 the Organisation for Economic Co-operation and Development (OECD) began working on the problem of base erosion and profit shifting (BEPS). The work on BEPS was a natural outgrowth of the OECD's work on exchange of information as a means of countering international tax avoidance and evasion. In their June 2012 meeting, the G20 finance ministers emphasized "the need to prevent base erosion and profit shifting." In February 2013, in response to the G20, the OECD issued a short note, "Addressing Base Erosion and Profit Shifting," that identified several areas for action and deadlines for the implementation of those actions. On July 19, 2013 the OECD released an "Action Plan on Base Erosion and Profit Shifting." This action plan set out an ambitious agenda with 15 specific action items, some of which were completed in September 2014 and the rest in October 2015.

Early in the BEPS Project, the OECD recognized the importance of involving developing countries in the Project because the tax systems of developing countries are probably more susceptible to base erosion and profit shifting than those of developed countries. In general, revenue from corporate taxes forms a larger part of the total tax revenues of developing countries than that of developed countries, and the tax authorities of developing countries generally have fewer administrative resources than developed countries to combat international tax avoidance and evasion and to prevent BEPS.

The United Nations has been active in assisting developing countries to protect their tax bases against BEPS. Some of these actions predate the OECD's BEPS project. In 2013, the United Nations Committee of Experts on International Cooperation in Tax Matters established a Subcommittee on BEPS with a mandate to consider the implications of BEPS for developing countries and recommend changes to the United Nations Model Tax Convention Between Developed and Developing Countries ("United Nations Model Convention") to deal with BEPS. In addition, the Subcommittee on Transfer Pricing is engaged in work with respect to the effects of the transfer pricing aspects of BEPS on developing countries.

In early 2014, the Capacity Development Unit of the United Nations Financing for Development Office launched a project to assist developing countries in identifying the major risks of base erosion and profit shifting in their domestic tax laws and tax treaties. This project resulted in a book of 10 chapters dealing with six of the OECD/G20's BEPS action items (other than transfer pricing) that are considered by developing countries to be most important—hybrid entities and instruments, the avoidance of permanent establishment (PE) status, interest and other financing expenses, the digital economy, treaty abuse, and disclosure of aggressive international tax planning—and three additional chapters dealing with tax incentives, income from services and capital gains, plus an introductory overview. See United Nations, *Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (2015) (referred to in this Portfolio as *Protecting the Tax Base of Developing Countries.*) A second edition of this Handbook, which deals with the OECD/G20 BEPS Final Reports and adds new chapters analyzing base-eroding payments of rent and royalties and general anti-avoidance rules (GAARs), was published in late 2017 (available electronically at https//www.un/desa).

Part 2 of the September 2014 Report to the G20 Development Working Group (DWG) on the Impact of BEPS on Low Income Countries requested the OECD, International Monetary Fund (IMF), United Nations, World Bank Group (WBG), and regional organizations to assess how practical toolkits could be developed to assist developing countries in implementing rules to deal with base-eroding payments. The DWG Report suggested that such a toolkit could consist of:

- an explanatory note to identify the risks of base-eroding payments,
- a paper on tax policy considerations related to countermeasures to such base-eroding payments,
- an analysis of the advantages and disadvantages of the various options to deal with base-eroding payments,
- model legislation and explanatory notes,
- administrative guidance and practical auditing techniques, and
- training materials.

The Capacity Development Unit of the Financing for Development Office of the United Nations embarked on a project to produce a series

of practical portfolios to assist developing countries in protecting their domestic tax bases against BEPS. This Portfolio, dealing with the use of GAARs to protect the tax base of developing countries, is the fourth in a series of similar portfolios providing practical guidance to developing countries to assist them in combating base erosion in various situations, such as base-eroding payments involving fees for services, interest and other financing expenses, rent, royalties, capital gains and tax incentives.

In April 2016, the United Nations, OECD, International Monetary Fund (IMF) and the World Bank Group (WBG) formed "The Platform for Collaboration on Tax" as the institutional framework for enhanced cooperation in delievering assistance to developing countries in strengthening their tax systems. The work program of the Platform includes a variety of activities, including the development of toolkits. As part of its contribution to the Platform, and in response to the recommendation of the earlier DWG Report, the United Nations Capacity Development Unit of the Financing for Development Office has undertaken to prepare a series of Practical Portfolios (toolkits) to assist developing countries in identifying risks of base erosion and possible responses to those risks. The first two Practical Portfolios, dealing with base-eroding payments for services and base-eroding payments of interest, were issued in 2016. The third Practical Portfolio, dealing with base-eroding payments of rent and royalties, was released in 2017. This Practical Portfolio, dealing with the use of general anti-avoidance rules (GAARs) to protect the tax base of developing countries, is the fourth in the series; other Practical Portfolios dealing with capital gains and tax incentives, for example, are planned.

In February 2016, the OECD created "The Inclusive Framework on BEPS" in response to the G20's request for the timely implementation of the BEPS countermeasures. The functions of the Inclusive Framework are to monitor and support the implementation phase of the BEPS Project; it is open to all countries that are prepared to commit to the BEPS minimum standards. Developing countries can participate in the Inclusive Framework as equals and are entitled to receive capacity-building assitance from international organizations that will allow them to implement BEPS countermeasures effectively.

The Platform and the Inclusive Framework are intended to cooperate closely. The activities of the Inclusive Framework will inform the

work of the Platform, and the Platform will bring issues arising from its work to the attention of the Inclusive Framework.

All the Practical Portfolios are intended for the use of tax officials from developing countries. They are intended to assist these officials in identifying the risks of BEPS with respect to base-eroding payments, understanding the causes of such BEPS and assessing the options for countering them. The material in this Portfolio is not aimed at any particular country or group of countries, but is intended for use by a wide range of developing countries with different tax systems and different levels of economic development. Therefore, the guidance provided in this Portfolio must be adapted to the particular needs and circumstances of each country.

This Practical Portfolio examines the use of general anti-avoidance rules (GAARs) by developing countries to protect their domestic tax bases. It focuses primarily on the use of a GAAR to prevent base erosion and profit shifting, although a GAAR may also be used to prevent tax avoidance more generally. However, any decisions by a particular country about the adoption of a GAAR to counter BEPS must take into account many factors that may go beyond the scope of this Portfolio.

It is worth emphasizing that any country thinking about BEPS should first review the provisions of its domestic tax system to determine whether its tax base is subject to erosion through cross-border payments and transactions. Second, the country must review the operation of the rules of its tax system to determine whether those rules are operating as intended or whether they are allowing or facilitating BEPS. Third, if the existing rules are allowing or facilitating BEPS in certain circumstances, the country should consider what types of action it might take to prevent BEPS.

This Practical Portfolio contains four parts in addition to this introduction. Part 2 is a Tax Policy Assessment Manual consisting of:

- an analysis of the definition of tax avoidance and the distinction between tax avoidance and tax evasion;
- an analysis of the provisions of the domestic law of developing countries dealing with tax avoidance;
- an analysis of the provisions of the tax treaties of developing countries dealing with tax avoidance;

- a description of the information that is necessary or desirable for the tax officials of developing countries to gather in order to formulate tax policy with respect to the adoption of a GAAR to combat tax avoidance; and
- the identification of the risks of BEPS that are not covered by specific countermeasures and the advantages and disadvantages of adopting a GAAR to counter such risks.

This Tax Policy Assessment Manual does not deal with the domestic laws or tax treaties of particular countries. Instead, it examines the general patterns of dealing with tax avoidance and the various types of GAAR that might be used to attack such tax avoidance. Tax officials from developing countries will find it necessary to adapt the material in the Manual to the particular situation in their countries.

Part 3 of the Portfolio provides guidance for tax officials from developing countries in designing and drafting domestic GAARs to counter tax avoidance, including BEPS, and in negotiating tax treaties to include general anti-abuse rules. It begins with a description of the tax policy considerations that should be taken into account in designing a GAAR and a detailed discussion of the design and drafting of the key features of a GAAR with detailed references to aspects of the GAARs of selected countries contained in the Appendix. It also contains two sample GAARs accompanied by explanatory notes as well as several case studies illustrating how the sample GAAR might be applied. Part 4 is a Tax Administration Manual, which provides guidance concerning the administrative aspects of a GAAR in the domestic law of developing countries.

1.2 How to use this Portfolio

Tax officials from developing countries can use this Practical Portfolio in a variety of ways. First, it can be used to obtain a general understanding of the role of a GAAR in a country's domestic law and tax treaties. If this is the goal, Chapters 1 and 2 of Part 2 should be the principal focus. Second, the Portfolio can be used as a guide for analyzing the anti-avoidance provisions of a country's domestic law and tax treaties in terms of their effectiveness in preventing BEPS. In this case, Chapters 1 and 2 should be read carefully with a view to comparing the

particular country's anti-avoidance rules to the GAARs that are commonly used worldwide, and comparing the anti-avoidance provisions of the country's tax treaties to the general anti-avoidance provisions of the United Nations and OECD Model Conventions. The detailed table of contents will be useful for directing readers to the relevant sections of Parts 2, 3 and 4 dealing with various aspects of GAARs. Third, countries that have decided to adopt a general anti-avoidance rule should examine Parts 3 and 4 in detail. Part 3 provides detailed guidance for designing and drafting a GAAR with references to the GAARs of several countries included in the Appendix. Part 3 also contains two sample GAARs — one a simplified GAAR and the other a more detailed GAAR — with explanatory notes and guidance with respect to the inclusion of a general anti-abuse rule in a country's tax treaties. Part 4 deals with several administrative aspects of applying a GAAR.

Part 2

Tax policy assessment manual

Chapter 1

Tax Policy Analysis of a General Anti-Avoidance Rule as a Means of Protecting a Country's Tax Base

1.1 Introduction

A country's tax base may be eroded in many ways. This Portfolio comprehensively examines the use of a general anti-avoidance (GAAR) to prevent base erosion caused by cross-border avoidance transactions. It provides a framework to identify whether a GAAR is necessary to protect a country's tax base; it evaluates the seriousness of the risks of base erosion in the absence of a GAAR; and it outlines and compares the possible responses to cross-border tax avoidance, including a GAAR, that developing countries might consider adopting in order to prevent such base erosion.

Developing countries are usually confronted with the difficult task of balancing competing objectives: the need to attract investment from non-residents and the need to protect the tax base against tax avoidance. Ideally, a country's rules against tax avoidance should not discourage nonresidents from investing in the country through clearly legitimate commercial transactions; however, at the same time, those rules should prevent abusive tax avoidance from eroding a country's tax base. To ensure that these two objectives are balanced, it is important for the tax avoidance rules of developing countries to be consistent with international norms.

This Portfolio deals primarily with cross-border base erosion through tax avoidance although tax avoidance may also occur in exclusively domestic situations where there is no cross-border element and a GAAR should also apply to exclusively domestic tax avoidance situations.

Most countries have a mixture of statutory rules, judicial doctrines and administrative measures to prevent tax avoidance. A

GAAR is an important component of this mixture of anti-avoidance measures. Although this Portfolio focusses primarily on GAARs, it is important to understand that other anti-avoidance measures, such as specific anti-avoidance rules and robust enforcement techniques, are also essential parts of the response of developing countries to abusive tax avoidance.

1.2 The definition of tax avoidance

1.2.1 Introduction

Tax avoidance is difficult to define precisely, and the definition may vary significantly from country to country. Obviously, an essential element of tax avoidance is the reduction of tax in some manner. However, not every reduction in tax is objectionable and constitutes tax avoidance. Often, for example, countries provide tax incentives to encourage certain investments or expenditures by taxpayers. Taxpayers cannot be considered to have engaged in abusive tax avoidance where they take advantage of tax incentives in accordance with the law. In most countries, the law recognizes the rights of taxpayers to arrange their affairs to minimize the amount of tax payable. In other words, there is no obligation on taxpayers to maximize the amount of tax payable. Indeed, such a principle would clearly be contrary to notions of fundamental freedom in most societies. For example, an individual who could earn a large annual income working as a professional but who decides instead to adopt an alternative lifestyle of subsistence farming would not continue to be taxed on the large income that the individual could have earned as a professional.

1.2.2 Tax avoidance in common law countries

In most common law countries, a fundamental principle of law is that persons are entitled to do anything that is not expressly prohibited. This principle also applies for tax purposes, so that taxpayers are entitled to engage in transactions to reduce or avoid tax unless there are rules to prevent them from doing so. In many of these countries, the courts interpret tax legislation literally. As a result, the courts of these countries do not usually play an active role in combating tax avoidance.

In effect, the onus is on the government to enact anti-avoidance legislation to prevent tax avoidance.

1.2.3 Tax avoidance in civil law countries

In many civil law countries, the law contains a general principle that persons are not entitled to exercise their rights to the detriment of other persons. This abuse-of-rights principle is equally applicable to tax legislation in some countries, but in other countries it applies for tax purposes only if it is enacted as a legislative rule.

1.3 The distinction between tax avoidance and tax evasion

In principle, the distinction between tax avoidance and tax evasion is reasonably clear. Tax evasion is conduct that involves the intentional non-payment or underpayment of tax through fraud, non-disclosure or misrepresentation. Tax evasion is generally a criminal offence punishable by fines or imprisonment. In contrast, tax avoidance involves the reduction of tax by legal means rather than by fraud, non-disclosure or misrepresentation. Thus, tax avoidance is not a criminal offence; however, it may be unsuccessful because statutory anti-avoidance rules or judicial anti-avoidance doctrines apply to counteract an avoidance transaction.

There is a great deal of confusion about the terms "tax avoidance" and "tax evasion." Obviously, countries often draw the line between tax avoidance and tax evasion and between acceptable and unacceptable tax avoidance differently.

Example 1

Esther is a resident of Country S. In 2017 she started a small business designing baby clothes. Under the law of Country S, every person that earns income in excess of 10,000 is required to file a tax return reporting their revenue and expenses and other information. Esther did not file a tax return in 2017 because she incurred a loss from her business and had no other source of income. In 2018, Esther's business begins to be successful and she earns net income of 25,000; however, Esther does not file a tax return for 2018.

Esther's failure to file a tax return for 2018 is a clear example of tax evasion. She is required by law to file a tax return and to pay tax as required under Country S's law. Her failure to do so would likely be subject to penalties under the law of Country S, and if her failure is intentional or the result of gross negligence, she would likely be guilty of a criminal offence and subject to criminal penalties.

In 2019, Esther files a tax return as required by law; however, she fails to report a 10,000 payment she received from one of her clients and also claims a deduction for automobile expenses of 5,000 despite the fact that she does not own or lease an automobile.

Esther's failure to report the 10,000 payment and her claim for a deduction for expenses she did not incur would be tax evasion. The payment would clearly be included in her income under the law of Country S and if her failure to report that amount is intentional or the result of gross negligence she would be guilty of tax evasion. Similarly, Esther is guilty of tax evasion by claiming the deduction of false expenses.

In 2020 Esther takes a trip to Paris for two weeks at a cost of 10,000. During the trip she consults with several clothing designers and fabric suppliers. She also spends about half her time in Paris engaged in sightseeing. Esther claims a deduction for travel expenses of 7,500 in computing the income from her business for 2020. Under the tax law of Country S, only expenses incurred for the purpose of earning business income are deductible, but deductible expenses are not required to be incurred wholly or exclusively for the purpose of earning income. The tax authorities of Country S take the position that Esther is entitled to a deduction for her trip to Paris of only 5,000, since she spent half her time there for personal purposes.

On these facts, Esther would not be guilty of tax evasion. The portion of the cost of Esther's trip to Paris that is related to her business is unclear and a matter of opinion on which she and the tax authorities differ. Esther can reasonably argue that the cost of her flights to and from Paris should be deductible in full because otherwise she would have been unable to meet with the clothing designers and fabric suppliers. Although Esther may be allowed to deduct only half her travel expenses, she would not be reasonably considered to have intentionally avoided paying tax.

1.4 The distinction between acceptable and unacceptable tax avoidance

Tax avoidance can be divided into two categories: acceptable or legitimate avoidance (sometimes referred to as tax mitigation) and unacceptable or illegitimate tax avoidance. It is sometimes difficult to know in advance whether any particular tax planning strategy is acceptable or unacceptable. Initially, tax professionals use their knowledge of the law and administrative practice to advise taxpayers as to whether a transaction is likely to fall on one side of the line or the other. The tax authorities must then decide whether to attack the transaction or accept that it reduces tax in accordance with the law. Finally, the courts will ultimately decide whether the transaction is acceptable (within the law) or unacceptable (outside the law).

1.5 Types of tax avoidance

The types of tax avoidance are almost limitless and impossible to describe comprehensively. Nevertheless, for convenience it is useful to divide the types of tax avoidance into various categories. For example, some forms of tax avoidance are purely domestic; some involve cross-border transactions; and some involve the use of tax treaties. The common types of tax avoidance that involve the use of tax treaties are described in Chapter 3, section 3.1.2 below. This section provides a brief general description of the common types of tax avoidance that are problematic for most income tax systems with an emphasis on cross-border tax avoidance transactions.

Tax avoidance transactions are designed to avoid taxes imposed by a particular country. Typically, they are designed to respond to specific provisions of a country's tax law by taking advantage of or avoiding those provisions. However, there are basic similarities in the income tax laws of most countries and tax avoidance schemes that are effective for one country are often effective for other countries as well. The internationalization of tax avoidance schemes has been facilitated by the growth of international law and accounting firms that develop tax avoidance schemes and then tailor those schemes for each country. Common types of tax avoidance transactions or arrangements include:

- transfer pricing of intercompany transactions to shift revenue or expenses from one country to another,
- converting income into capital gains,
- the use of holding companies to reduce or avoid tax,
- diverting income to related persons especially controlled entities in low-tax countries,
- altering the character of various receipts or payments to achieve tax advantages,
- transactions to avoid withholding tax, for example through back-to-back arrangements,
- changing the residence of individuals or entities, and
- the use of hybrid entities and hybrid financial instruments (entities and instruments that are treated one way by one country and a different way by another country).

Most countries have a wide variety of specific anti-avoidance rules to deal these and other common types of tax avoidance. See section 2.4.1 below for a discussion of specific anti-avoidance rules.

1.6 Causes of tax avoidance

The causes of tax avoidance are many and vary from country to country. This section contains a brief discussion of the major causes of tax avoidance. In this context, "the causes of tax avoidance" means the aspects of a tax system that allow tax avoidance to occur. These aspects of a tax system may be intentional — for example, the interpretation of tax legislation literally by the courts — but are usually unintentional.

The possible responses to tax avoidance, discussed in chapter 2 below, are often directly targeted at the aspects of a tax system that allow tax avoidance. For further discussion of these issues, see chapter 2 sections 2.3 and 2.4 below.

1.6.1 Taxpayers' right to arrange their affairs to minimize tax

As mentioned above in section 1.2.1, in most countries there is a fundamental principle, explicit or implicit, that taxpayers are entitled to arrange their affairs to minimize their tax liability. This fundamental

right allows taxpayers to engage in transactions or arrangements to reduce their tax payable — in other words, to engage in tax avoidance. Given this fundamental right, the crucial issue is not whether taxpayers can avoid taxes, but what are the limits on their ability to do so — that is, when does tax avoidance become unacceptable? Thus, the crucial distinction, as discussed in section 1.4 above, is the distinction between acceptable tax avoidance — a reduction in tax is allowed to occur because it is consistent with the object and purpose of the tax legislation — and unacceptable tax avoidance — a reduction in tax is disallowed because it is contrary to the object and purpose of the tax legislation.

1.6.2 Inadequate tax legislation

Perhaps the most obvious cause of tax avoidance is inadequate or deficient tax legislation. For example, tax legislation may not be comprehensive or may have gaps or loopholes so that taxpayers can carry out tax-reduction transactions or arrangements that are outside the scope of the legislation. As discussed below, the response to this problem is better drafting of tax legislation. However, this is easier said than done. Even with sufficient technical (tax policy and drafting) expertise and resources, it is difficult to draft tax legislation that prevents tax avoidance effectively. One difficulty is that as tax legislation becomes more comprehensive, it also becomes more complex. This complexity often has unintended consequences, sometimes even creating additional opportunities for tax avoidance. Moreover, the complexity may make it more difficult for the tax authorities to identify tax avoidance transactions and to successfully maintain tax assessments in the courts when challenged by taxpayers.

1.6.3 Inadequate Enforcement Efforts

Tax avoidance may sometimes be caused by inadequate enforcement efforts by the tax authorities. If taxpayers and their professional advisers conclude, or even suspect, that the tax authorities are unable for some reason to identify and assess tax avoidance transactions, the number of such transactions, especially those carried out by wealthy individuals and large corporations, will inevitably increase. This increase in tax avoidance will occur even where the tax legislation is well drafted and comprehensive.

1.6.4 Aggressive taxpayers and tax advisers

Taxpayers and tax advisers are more aggressive in carrying out tax avoidance transactions in certain countries. Where this is the case, tax avoidance will be a more serious problem. It is unclear why taxpayers and tax advisers are more aggressive in some countries than in others, but the legal culture and nature of society appear to be important factors.

1.6.5 Literal interpretation of tax legislation

Tax avoidance is more likely to be a serious problem in countries where the courts interpret tax legislation literally. Literal interpretation means that transactions that are not within the literal wording of the tax statute are not covered by it. Therefore, in order to avoid tax successfully, taxpayers and their advisers can simply design transactions that are not literally covered by the legislation. Where the courts of a country interpret tax legislation literally, the only way for the country to prevent tax avoidance is to introduce detailed legislative anti-avoidance rules. Usually, this leads to a cat-and-mouse game between taxpayers and tax authorities. Taxpayers and their advisers find a way to avoid the rules in the tax legislation; the government amends the legislation to prevent that particular tax avoidance technique; taxpayers then find ways to avoid the new rules; and so on and so on. From the government's perspective, it is always one step behind taxpayers and their advisers and always playing catch-up.

1.7 The extent of tax avoidance

Taxpayers and their advisers sometimes argue that before a GAAR is adopted, the government must prove that tax avoidance is a serious problem that cannot be adequately controlled through existing anti-avoidance rules and more robust enforcement. Thus, they argue that the government must show that the amount of tax revenue lost through abusive tax avoidance is unacceptably large, which then requires the government to quantify the extent of abusive tax avoidance. Ideally, governments should be able to justify the adoption of a GAAR by showing that abusive tax avoidance results in a substantial loss of tax revenues, and also perhaps that the loss has been increasing

in recent years. However, this is an impossible task, especially given the difficulty of reaching any agreement on a definition of abusive tax avoidance, as discussed in section 1.2. Similarly, it is impossible for taxpayers and their advisers to prove that abusive tax avoidance is not a serious problem. The best available evidence about the extent of abusive tax avoidance is usually anecdotal evidence from audit activities of the tax authorities and from public sources, such as the Panama Papers and the Paradise Papers, which appear to show that, even in developed countries, abusive tax avoidance by wealthy individuals and medium and large corporations is a serious issue.

Chapter 2

Tax Policy Analysis of the Provisions of Domestic Law Dealing with Tax Avoidance

2.1 Introduction

Many countries have GAARs. Some countries, such as Australia, New Zealand, and some civil law countries, have had GAARS for many years; other countries have adopted their GAARs relatively recently. There appears to be a trend for more countries, both developed and developing countries, to adopt a GAAR. Certainly, there is no evidence that countries that have adopted a GAAR are abandoning them.

Not surprisingly, GAARs vary enormously from country to country depending on many factors, including countries' legal and tax cultures, the extent of tax avoidance, and the nature of the economy. However, despite the differences, the underlying fundamental structural aspects of countries' GAARs are often similar. In fact, most countries that have enacted GAARs in the past 30 or 40 years have copied features from the GAARs of other countries. This provides strong evidence that the problems of tax avoidance are fundamentally the same for most countries, and that solutions that work in one country are likely to work in other countries and solutions that do not work in one country are unlikely to work in other countries.

Developing countries have conflicting interests with respect to measures designed to control or prevent tax avoidance by non-residents. On the one hand, developing countries need foreign investment from non-residents and need to have tax systems that attract, or at least do not discourage, such investment. On the other hand, developing countries need tax revenues to finance public goods and services and therefore, they need to protect their tax base from cross-border tax avoidance by non-residents. If anti-avoidance measures are overly

broad, they may have the effect of discouraging foreign investment; however, if they are ineffective, tax revenues may be lost unnecessarily.

Potentially, a GAAR applies to both cross-border and purely domestic tax avoidance. For some countries, controlling domestic tax avoidance may be more important than controlling cross-border tax avoidance, and therefore, they may adopt a GAAR to deal primarily with domestic tax avoidance. However, once a country has made the decision to adopt a GAAR to counter domestic avoidance, it is easy to extend the GAAR to cross-border avoidance; otherwise, the country would be treating non-residents better than its residents.

This chapter focusses exclusively on the use of a GAAR to control domestic and cross-border tax avoidance. It examines the role of a GAAR in the context of an income tax system as a whole. All income tax systems have a variety of measures to deal with tax avoidance. A GAAR is not the only or necessarily the most important anti-avoidance measure; it is part of a suite of anti-avoidance and other measures all of which have an important role to play in combating tax avoidance. Each of the measures discussed below in this chapter is necessary, but not sufficient by itself to deal with tax avoidance; a holistic approach invloving all the measures is necessary.

This chapter attempts to identify and analyze the various anti-avoidance measures, other than a GAAR, that many countries have adopted, as background for confronting the basic question whether the adoption of a GAAR is necessary to deal effectively with tax avoidance. Obviously, the question whether a GAAR is necessary must be answered by each country based on its unique situation. However, as noted above, the problem of tax avoidance and possible responses to deal with it are the same for most countries. The material in this chapter provides a general analysis of the major responses that countries can take and should take to deal with tax avoidance. The final section of the chapter addresses the crucial question of whether a GAAR is necessary.

2.2 The role of the tax authorities in enforcing tax legislation

The tax authorities must enforce tax legislation, including anti-avoidance rules, robustly in order to prevent tax avoidance. Even in a self-assessment

system, tax legislation is not self-executing; it requires tax officials to ensure that the rules are applied or enforced effectively. It is human nature for taxpayers to minimize the amount of tax they pay. Most taxpayers will take all reasonable opportunities within the law to minimize tax and some taxpayers will even take steps that are arguably outside the law to do so. Therefore, in the absence of effective enforcement, even the best tax legislation will not be effective in preventing taxpayers from avoiding their obligations to pay tax in ways that are unacceptable or contrary to the purpose of the tax legislation.

For the tax authorities to deal effectively with tax avoidance, especially cross-border tax avoidance, it is necesary for them to have access to the information required to determine the facts, and especially to identify all the relevant transactions. Since many tax avoidance transactions involve multiple steps, multiple entities, different taxation years and more than one country, it is extremely difficult, but crucially important, for the tax authorities to be able to identify the relevant transactions that result in tax avoidance. For this purpose, the tax authorities need to have the power to obtain a wide variety of relevant information from taxpayers and third parties, such as financial institutions. Thus, developing countries should ensure that their tax legislation gives the tax authorities the authority to gather the necessary information. As discussed below in section 2.4.2, some countries have adopted mandatory disclosure rules that require promoters and/or taxpayers to report certain aggressive tax avoidance transactions that they carry out. These rules reduce the risk that tax avoidance oocurs without the tax authorities even knowing that such transactions have been carried out.

Many countries have established specialized units within the tax administration to deal with tax avoidance; some even have specialized units for dealing with international tax avoidance. Such units require sufficient resources to ensure adequate staffing levels and knowledgeable tax officials. The difficulty of hiring and retaining knowledgeable tax officials to deal with tax avoidance is a significant problem, especially for developing countries. Ongoing training programs for this purpose are necessary. It is also important for tax officials from developing countries to cooperate with tax officials from other countries with respect to international tax avoidance. Such cooperation can involve exchanges of information, joint training programs, joint audits and assistance in the collection of tax.

2.3 The role of domestic courts in combating tax avoidance

2.3.1 Introduction

In most countries, the courts play an important role with respect to tax avoidance. This role may be to either control or facilitate tax avoidance, depending on whether the courts consider that they have a role to play, along with the legislature and the tax authorities, in controlling tax avoidance. If courts do not play this role, taxpayers will be emboldened to be more aggressive in reducing tax and eroding the tax base of developing countries.

In any particular country, the role of the courts in interpreting and applying tax legislation is usually a function of the nature of the country's legal system in general, and in particular, the extent to which the courts are independent from the exceutive and legislative branches of the government. Where courts have independence, their approach to the interpretation and application of tax legislation has an important impact on the extent of tax avoidance. In turn, the interpretation and application of tax legislation by the courts is largely determined by their approach to the interpretation of statutes and the determination of the facts of a particular case. The real issue is whether the courts are prepared to take action — based on the interpretation of tax legislation, the determination of the facts, or the creation and application of judicial anti-avoidance rules — to prevent tax avoidance. The relationship between statutory interpretation, the determination of the facts and judicial anti-avoidance doctrines is complex and unclear. Courts may take use any one approach or a combination of approaches to deal with tax avoidance; or in effect, they may decline to deal with tax avoidance altogether, on the basis that it is the responsibility of the legislature to enact tax legislation to deal with tax avoidance.

The relationship between the approach of the courts to the interpretation of tax legislation and tax avoidance is discussed in section 2.3.2 below. The determination of the tax consequences of taxpayers' transactions is often dependent on how the courts determine the facts and, in particular, on whether they adhere strictly to the legal form of taxpayers' transactions or also consider the economic substance of those transactions. This issue is discussed in section 2.3.3 below. In some countries, the courts have dealt with tax avoidance by creating

judicial anti-avoidance doctrines. These doctrines may be justified as the natural product of the interpretation of tax statutes (for example, some courts may consider that tax statutes do not apply to transactions that are carried out for the purpose of avoiding tax or that lack a bona fide business purpose) or as the proper approach to the determination of the facts of a particular case (for example, the real facts of a transaction must reflect the underlying financial and economic consequences of the transaction rather than just its legal consequences). Judicial anti-avoidance doctrines are discussed in section 2.3.4 below.

2.3.2 Approaches to the interpretation of tax statutes

Scholarly views about statutory interpretation vary widely, from those who consider justifications for court decisions based on approaches to statutory interpretation to be simply ex post facto rationalizations for decisions that were made on other undisclosed grounds, to those who consider the appropriate approach to statutory interpretation to be crucial for the legitimacy of the courts. In some countries, the courts have not articulated an approach to statutory interpretation that they must follow in deciding cases. In these countries, each case is decided on its own merits without regard to prior cases, including prior cases that might have adopted a particular approach to interpretation. In other countries, including common law countries, typically the highest court has adopted guidelines for the interpretation of statutes that lower courts must follow. Usually, these guidelines are broad and vague and allow the courts considerable flexibility in deciding particular cases.

Modern linguistics has clearly established that all language requires interpretation — words in any language do not magicially appear with one single true meaning. Human beings give meanings to words, and these meanings are seldom static; language is dynamic and the meanings of words changes over time. According to linguists, the meaning of words is generally indeterminate due to the inherent ambiguity and vagueness of language. Ambiguity and vagueness are usually resolved on the basis of the context in which the words are used and the purpose for which they are used. If an interpretive approach precludes any reference to context and purpose, then ambiguity and vagueness must be reolved on the basis of some type of presumption — for example, a presumption that any uncertainty in the provisions of a taxing statute must be resolved in favour of the taxpayer.

Courts use many approaches to the interpretation of tax statutes, including:

- literal or strict interpretation, under which the words of a statute are given their plain, ordinary meaning;
- contextual interpretation, under which the words of a provision must be given meaning with reference to the context in which the words are used; this context includes the particular provision in which the words are used, any related provisions, and the entire statute;
- purposive or teleological interpretation, under which the words of a particular provision should be given a meaning that furthers or advances—or at least is consistent with and certainly not contrary to—the purpose of the provision; and
- consequential interpretation, under which the consequences of competing interpretations of the words of a provisions are used to choose the preferable meaning.

The approach to the interpretation of statutes used by courts can have an important impact on tax avoidance. If courts interpret taxing statutes by taking all the relevant information into account — the ordinary meaning of the words, the context, the purpose of the legislation and the consequences of alternative interpretations, but especially the purpose of the legislation — they are more likely to strike down unacceptable aggressive tax avoidance transactions. Presumably, legislatures do not enact tax legislation that is intended to allow taxpayers to carry out transactions or structure their affairs to avoid the obigation to pay tax that the legislation seeks to impose. If courts interpret the tax legislation in accordance with the intention of the legislature or the purpose of the legislation, they are likely to strike down tax avoidance transactions that are contrary to the purpose of the legislation.

In contrast, if courts take a literal approach to the interpretation of tax statutes and refuse to consider any other factors, especially the purpose of the legislation, taxpayers can easily structure transactions so that they either are within or outside the literal meaning of the legislation, depending on the circumstances, and are thereby able to avoid or reduce tax. For example, non-resident employees of a resident employer are often subject to tax by the country in which the employer is resident to the extent that the employees exercise the duties of their

employment in that country. However, non-resident independent contractors may be subject to tax only only if they carry on buiness through a permanent establishment or fixed base in the country in which their clients are resident. Therefore, non-resident employees can avoid tax by the country in which the employer is resident simply by entering into a contractual arrangement as an independent contractor with their former employer on the same terms as their former employment contract.

2.3.3 Adherence to legal form and the role of economic substance

The application of the rules of any income tax system to determine the amount of a taxpayer's income and tax payable requires a determination of the facts relating to each taxpayer for each taxation period. The determination of the facts is made in the first instance by the taxpayer for the purpose of filing the taxpayer's tax return for the period. Typically, the tax authorities will then review the taxpayer's return in order to assess the amount of tax payable for the period. In performing this assessment function, the tax authorities may disagree with the taxpayer's determination of the facts or interpretation of the law. If the taxpayer and the tax authorities are unable to resolve the dispute, it will be resolved by the courts, and for this purpose, the court must also determine the facts and then apply the provisions of the tax law, as interpreted by the court, to those facts.

The facts of any particular case are critical for determining the amount of a taxpayer's income and tax payable for a taxation period. However, determining the facts is often difficult because it involves not only factual issues, such as whether the taxpayer actually incurred expenses of a particular amount, but legal issues as well, such as the nature or character of an amount received by a taxpayer. These legal issues are often determined by applying the relevant general law, rather than the tax law, because in most countries income tax law is imposed on the basis of a taxpayer's legal relationships and transactions determined under the country's legal system. Therefore, for example, if a tax system has rules with respect to transactions between spouses, the application of those rules requires a determination of whether two people are spouses, and this determination will likely be made

by reference to the meaning of spouse under the country's basic legal system (unless the tax system has its own definition of "spouse").

One important issue in determining a taxpayer's legal relationships and transactions to which the tax law applies is the extent to which a country's courts adhere to the legal form of such relationships and transactions. All countries adhere to legal form for tax purposes to a significant extent. Thus, for example, large public companies are almost always taxable as entities separate from their individual shareholders despite the fact that all companies are legal fictions that do not have any real existence apart from their shareholders, officers, and employees.

The important issue with respect to tax avoidance is the extent to which a country's courts apply the tax laws on the basis of the legal form of transactions or their underlying economic substance. This is a complex issue, which goes well beyond the scope of this Portfolio. In some countries, the courts have a well-established practice of applying tax rules on the basis of the economic substance rather than the legal form of transactions, while in other countries the courts adhere strictly to legal form and may disregard the legal form only if a transaction is a sham.[1] If courts adhere strictly to the legal form of transactions, taxpayers can easily structure transactions to avoid or reduce tax.

For example, if dividends and interest are treated differently under a country's tax system (which is the case in many countries), corporations that want to have interest deductions can arrange to borrow funds from a financial insitution and deduct the interest payments on the debt. If, however, a corporation has a loss rather than profits, the effect of additional interest deductions will be to increase the corporation's loss without any immediate benefit to the corporation. In this situation, instead of borrowing, the corporation may issue preferred shares to the financial institution so that the financial institution receives dividends, which may be tax-free. The terms of the preferred shares will be equivalent to the terms of a similar amount of debt: fixed term, fixed rate of dividends, etc. Although the corporation

[1] See Frederik Zimmer, General Report, in International Fiscal Association (IFA), *Form and Substance in Tax Law,* Cahiers de droit fiscal international (The Hague: Kluwer, 2002) 19-67.

is not able to deduct the dividends paid on the preferred shares, the rate of dividends on the preferred shares will be less than the rate of interest charged by the financial institution on the same amount of debt because the financial institution pays tax on the interest, but not on the dividends. Thus, both the corporation and the financial institution will be better off as a result of the preferred-share financing; however, the country's tax revenues will suffer a loss.

2.3.4 Judicial anti-avoidance doctrines

In some countries, the courts have developed judicial anti-avoidance doctrines to control tax avoidance. Sometimes the courts have found the literal interpretation of tax statutes combined with unwavering respect for the legal form of transactions to be too restrictive and have created a variety of anti-avoidance doctrines to prevent taxpayers from engaging in abusive tax avoidance. These doctrines include:

- the ineffective transactions doctrine, under which transactions that are not fully and properly implemented are considered not to be legally effective for tax purposes; courts may scrutinize tax avoidance especially closely from this perspective to ensure that all the taxpayer's "i"s are dotted and "t"s are crossed.
- the sham transaction doctrine, under which acts or transactions are disregarded for tax puirposes if they are intended to give the tax authorities the impression that rights and obligations have been created between the parties that are different from the real rights and obligations;
- the substance-over-form doctrine, under which the tax consequences of a transaction are determined in accordnce with its economic substance rather than its legal form; this doctrine, which may be applied generally or only in connection with tax avoidance arrangements, is discussed in section 2.3.3 above;
- the step transactions doctrine, under which a series of transactions, which includes steps carried out primarily or exclusively to avoid tax, may be taxed in accordance with their result, ignoring the intervening tax-driven steps; and
- the business purpose test, under which transactions without a legitimate business or commercial purpose are disregarded for income tax purposes.

The courts of a country may apply none, some or all of these judicial anti-avoidance doctrines. The doctrines overlap considerably: for example, a sham transaction is likely to lack a business purpose and any economic substance. Some of the doctrines may be considered to relate to the determination of the facts to which the tax law is applied; for example, the ineffective transactions doctrine can be viewed in this way. Income tax is imposed on transactions that a taxpayer actually carries out, not on transactions that the taxpayer intends to carry out but does not in fact carry out. On the other hand, some doctrines may be considered to relate to the interpretation of the provisions of the tax legislation; for example, the business purpose test can be viewed in this way. The tax rules are interpreted not to apply to transactions that lack a business purpose or that are carried out only to avoid tax.

The most significant criticism of judicial anti-avoidance doctrines is their uncertainty. First, unless the courts of a country have already developed anti-avoidance doctrines, it is uncertain, and probably unlikely, that they will do so. Second, most anti-avoidance doctrines are inherently uncertain because their application does not depend on objective criteria that taxpayers, tax officials and courts can apply. Thus, unless the courts are rigorous in developing criteria for applying these doctrines, they risk becoming "smell" tests, which depend on the sense of smell of each judge. This is especially true of the sham, substance-over-form and step-transactions doctrines and the business purpose test. Third, it is uncertain whether the courts will apply these anti-avoidance doctrines in any particular case. The uncertainty associated with judicial anti-avoidance doctrines may discourage taxpayers from attempting to avoid tax, but it may also discourage them from making legitimate investments. In short, judicial anti-avoidance doctrines require knowledgeable judges who can apply those doctrines with the proper balance between preventing abusive tax avoidance but not discouraging legitimate commercial transactions.

2.4 Tax legislation

2.4.1 Specific anti-avoidance rules

Just as it is difficult to define tax avoidance, it is difficult to define anti-avoidance rules. For example, some may view transfer pricing rules

as basic taxing rules, while others view them as specific anti-avoidance rules to prevent non-arm's length parties from using prices above or below fair market value to avoid tax. For the purpose of this Portfolio, it is not particularly important whether rules are categorized as basic taxing rules or as anti-avoidance rules.

Most countries' tax legislation is full of specific anti-avoidance rules. These rules apply to both purely domestic and cross-border tax avoidance arrangements. Although the specific anti-avoidance rules dealing with cross-border tax avoidance vary from country to country, the following rules can be found in most countries:

- transfer pricing rules with respect to transactions between non-arm's length persons;
- thin capitalization rules or earnings-stripping rules to limit the deduction of interest payable to non-residents or non-resident shareholders of resident corporations;
- surplus-stripping rules to prevent non-resident shareholders of resident corporations from receiving a distribution, directly or indirectly, of the accumulated surplus of those corporations that is tax-free or taxable at a reduced tax rate (for example, as a capital gain);
- controlled foreign corporation (CFC) rules, under which resident shareholders of foreign corporations that are controlled by residents are taxable on some or all of the income of those foreign corporations;
- non-resident trust rules, under which resident benficiaries of such trusts or residents who transfer property to such trusts are taxable on the accumulated foreign income of such trusts;
- foreign investment fund rules to prevent residents from obtaining tax advantages from investing in foreign investment entities rather than resident investment entities;
- exit or departure taxes on taxpayers ceasing to be resident in a country, under which tax is imposed on income and gains accrued to the date that they cease to be resident;
- anti-conduit rules to prevent the use of foreign entities without economic or commercial substance to avoid domestic tax;
- rules to prevent the avoidance of withholding taxes on passive investment income such as dividends, interest, royalties and

other amounts paid to non-residents, including rules dealing with back-to-back arrangements;

- rules with respect to interest-free or low-interest loans to related non-resident corporations;
- rules to prevent abuse of foreign tax credits; and
- restrictions on the deduction of foreign losses.

Some of these specific anti-avoidance rules relate to the outbound aspects of a country's international tax system (i.e., residents earning foreign source income); some of the rules relate to the inbound aspects of a country's international tax system (i.e., non-residents earning domestic source income); and some of the rules, such as transfer pricing rules, apply to both the outbound and inbound aspects of a country's international tax system.

Specific anti-avoidance rules are obviously necessary in any income tax system, even a system that contains a general anti-avoidance rule. Where the tax authorities have identified tax avoidance transactions that are not in accordance with the object, spirit and purpose of the tax legislation, but are in accordance with the plain meaning of the legislation (especially where such transactions result in a serious loss of tax revenues), they can attack these transactions through the audit and assessment process. However, if it is questionable whether such an attack will ultimately be upheld by the courts, it may be preferable for the government to quickly enact new rules to prevent taxpayers from using those specific transactions to avoid tax. Such specific anti-avoidance rules provide more certainty for the government that the targeted avoidance transactions will be effectively prevented. Moreover, if the specific anti-avoidance rules are targetted narrowly at specific transactions, they are unlikely to discourage taxpayers from carrying out legitimate commercial transactions. However, specific anti-avoidance rules also provide certainty to taxpayers and their advisers; they provide a roadmap for tax advisers to design new avoidance transactions that are not caught by the specific anti-avoidance rules. The tax authorities are then faced with the necessity either of fighting new avoidance transactions in the courts (on the basis that the existing anti-avoidance rules also apply to the new transactions) or modifying the existing anti-avoidance rules to deal with the new transactions.

Many countries have experienced this ongoing "cat and mouse game" and it seems reasonably clear that taxpayers and their advisers are the winners in the game. The fundamental problem for the tax authorities is that they are always playing catch-up, reacting after the fact to the new tax avoidance strategies employed by taxpayers. For this reason, several countries have decided that it is necessary to adopt a general anti-avoidance rule; such a rule provides the tax authorities with both a mechanism to prevent or discourage taxapyers from entering into abusive tax avoidance transactions and to attack such transactions quickly where taxpayers attempt to avoid tax in unacceptable ways.

2.4.2 Mandatory disclosure rules—BEPS Action 12

One of the major problems that tax authorities of both developed and developing countries have in combating abusive tax avoidance transactions is identifying the transactions that are potentially abusive. Even if a country has a full complement of anti-avoidance measures, including specific anti-avoidance rules and a general anti-avoidance rule, those measures will not be effective unless the tax authorities actually apply the rules to abusive transactions. The first step in applying a general anti-avoidance rule is identifying transactions that should be subject to the rule. This involves the collection of facts about transactions from taxpayers, other persons, and public sources, which requires a commitment of substantial time and resources.

The challenges facing the tax authorities in this regard are substantial. Tax avoidance transactions, especially those carried out by large corporations and wealthy individuals, often involve multiple transactions, multiple parties, multiple tax years, and perhaps multiple jurisdictions. The necessary information may be accessible through a full-scale audit of a taxpayer. However, the tax authorities in most developing countries do not have the resources to conduct full-scale audits of all the taxpyers that might engage in abusive tax avoidance transactions. In addition, it is difficult for the tax authorities, even in the course of a full-scale audit, to reconstruct all the steps in a sophisticated tax avoidance arrangement from the information provided in the taxpayer's tax return. For example, some aspects of an arrangement may involve documents and information held by foreign persons that are beyond the reach of the tax authorities, except perhaps through the use of the exchange-of-information article in an applicable tax treaty.

The most effective response to this problem is to require taxpayers to provide information about any transactions that involve certain objective criteria indicative of abusive tax avoidance transactions. Several countries have these types of mandatory disclosure rules, and the OECD/G20 BEPS Action 12: 2015 Final Report, "Mandatory Disclosure Rules," provides guidance for countries that want to adopt such rules.

Mandatory disclosure rules are intended to provide the tax authorities with information about potentially abusive tax avoidance arrangements and the promoters and users of such arrangements. If this information becomes available to the tax authorities sufficiently early, the tax authorities can take action against such arrangements before they result in a serious loss of tax revenue. The information also allows the tax authorities to perform better risk assessments and to allocate their limited resources more effectively. Moreover, mandatory disclosure rules may have a deterrent effect on taxpayers entering into tax avoidance arrangements.

Mandatory disclosure rules should not be adopted unless the tax authorities have established an administrative framework that is adequately resourced to use the information effectively; otherwise, the rules will impose unnecessary compliance burdens on taxpayers. For this purpose, the tax authorities should consider establishing a specialized unit staffed with highly qualified tax officials to deal with aggressive tax planning arrangements (see Part 4, section 4.1). The information provided by mandatory disclosure rules would be essential for such a specialized unit to deal effectively with abusive tax schemes.

The BEPS Action 12 Final Report includes recommendations for mandatory disclosure rules that balance the need of the tax authorities for timely and comprehensive information and the compliance burden on taxpayers. The major features of mandatory disclosure rules are:

1) Persons required to report

The BEPS Action 12 Final Report recommends that an obligation to report should be placed on both the promoters of tax avoidance schemes and taxpayers taking advantage of such schemes. The primary obligation to report could be placed on the promoter because the promoter, who is the person that designs and markets the tax avoidance

scheme, has more information about the scheme than taxpayers, who simply acquire interests in the scheme. In addition, promoters have the necessary information earlier than taxpayers and can provide that information to the tax authorities earlier than taxpayers.

Alternatively, the obligation could be placed on either the promoter or the taxpayer. Under this alternative, taxpayers would be required to report only if the promoter does not report and taxpayers might be required to provide different information than promoters. For example, promoters can be required to provide a list of their clients participating in a tax avoidance scheme, but taxpayers would not usually have access to this information.

If only promoters are required to report, then no reporting would be made for tax avoidance arrangements where there is no promoter or the promoter is a non-resident. In these situations, taxpayers claiming tax benefits from a scheme should be required to provide information concerning the scheme.

2) Definitions of "promoter" and "reportable transactions"

Mandatory disclosure rules require definitions of a "promoter" of schemes and the transactions ("reportable transactions") about which information must be reported as well as rules with respect to the persons who benefit from such schemes.

A promoter is usually defined to mean a person who is responsable for organizing, designing, selling, financing or managing a scheme. However, "promoter" can also be defined to include persons who make representations or statements about the tax benefits of a scheme in connection with selling the scheme or who provide any material assistance or advice with respect to a scheme.

The definition of tax avoidance schemes or arrangements for purposes of mandatory disclosure rules should be broader than the definition of transactions or arrangements that are subject to a country's GAAR. The purpose of mandatory disclosure rules is to provide notice to the tax authorities of schemes that might possibly be subject to the GAAR so that the tax authorities have an opportunity to review and assess those schemes. Tax avoidance schemes should not avoid the application of the GAAR simply because they are undetected.

Several countries use some type of threshold requirement to target the types of transactions or arrangements that are subject to mandatory disclosure rules. Most countries target only transactions and arrangements if the main benefit or one of the main benefits of the transaction or arrangement is expected to be tax benefits. Such a threshold requires an objective comparison of the monetary value of the tax benefits and the investment returns. Consideration might also be given to the use of *de minimis* thresholds with respect to certain taxpayers or certain types of tax avoidance schemes, such as loss utilization arrangements, based either on the amount of the expected tax benefits or the value of the transaction as a whole.

Most countries with mandatory disclosure rules use hallmarks or distinguishing features to identify the schemes that must be reported. These hallmarks include:

- confidentiality conditions imposed on investors or potential investors by the promoter not to disclose information about the scheme;
- contingent fees payable by investors to the promoter depending on the amount of the tax benefits;
- tax indemnities given by the promoter or a related person to the investors if the expected tax benefits from the scheme are not fully realized;
- mass-marketed schemes with standardized documentation; and
- hallmarks that target certain transactions that pose high risks for the tax authorities, such as loss-creation schemes, leasing schemes, schemes involving entities in tax havens, schemes involving hybrid entities or hybrid financial institutions, and any other listed scheme.

Reporting should be required for any scheme that meets any one of these hallmarks.

3) Timing of disclosure

The obligation to report information with respect to reportable transactions needs to be triggered by a distinct event, such as the date when a scheme is made available to investors or when a scheme is implemented in part or in whole by an investor, such as when an

investor makes a payment with respect to a tax avoidance scheme. It is desirable for the tax authorities to obtain information as early as possible so as to take action, if necessary, to close down the scheme before too much tax revenue is lost. Thus, countries should consider requiring promoters to report when a scheme is first marketed to investors or shortly thereafter, even though no actual revenue loss has been incurred by the government at that point. At that point, all the relevant information about the schemewill be available to the promoter.

The earliest time that taxpayers can reasonably be required to report is when the taxpayer takes the first step in the implementation of the transaction, which would usually be at the time of signing agreements or making a payment. At that point, it will be certain that the scheme will proceed and the taxpayer will have access to information with respect to the scheme. Taxpayers can be required to report in their tax returns for the year in which the scheme is entered into or in a separate information return.

4) Identification of investors

It is important for the tax authorities to obtain information not only about tax avoidance schemes, but also about the taxpayers participating in such schemes. Without information about taxpayers investing in tax avoidance schemes, the tax authorities would be required to discover the identity of taxpayers investing in schemes only through audit or other information-gathering activities. These activities require considerable resources and are likely to yield only random and limited results. Therefore, it is preferable for the promoters of tax avoidance schemes to be required to provide information about their clients, or for the tax authorities to issue identification numbers for tax avoidance schemes that must be provided by promoters to their clients, and the clients must report when they file their tax returns. The issuance of an identification number does not imply that the tax authorities have accepted the scheme or decided that the GAAR applies to the scheme. The number allows the tax authorities to make better risk assessments with respect to particular taxpayers and to track the extent to which particular schemes are being used.

5) Type of information to be reported

Where a scheme meets the conditions for a reportable scheme under the mandatory disclosure rules, the promoter or the investors should be required to provide the following information:

- identification of the promoter or taxpayer and contact details,
- the features of the scheme that make it a reportable transaction under the rules,
- information about how the scheme operates (facts, parties, steps in the scheme) and the nature of the expected tax benefits,
- the statutory provisions relied on for the tax benefits, and
- promoters should be required to provide a list of their clients who have invested in the scheme (this obligation must be a continuing rather than just a one-time obligation).

The promoter or taxpayer filing the information should be required to sign the form and certify that the information provided is complete, true, and accurate.

6) Penalties

Monetary penalties should be imposed for various types of offences in connection with mandatory disclosure rules, including:

- failure to file a report with respect to a scheme when required;
- failure to include required information about a scheme;
- failure of a promoter to maintain or provide client lists or scheme identification numbers; and
- failure of a taxpayer to report a scheme identification number.

Different types of penalties may be appropriate for these different types of non-compliance.

2.5 Assessing the need for a general anti-avoidance rule

2.5.1 Introduction

Whether a GAAR is necessary must be determined from the particular perspective and circumstances of each country, its legal and

tax system, and the approach of its courts to tax avoidance. Typically, countries adopt a GAAR because their tax revenues have declined due to a proliferation of tax avoidance transactions and their existing statutory anti-avoidance rules and judicial anti-avoidance doctrines have proven to be inadequate to deal with the problem. In this section, the arguments for and against a GAAR are presented and briefly described.

Tax avoidance is likely to be a serious problem and the cause of a significant loss of tax revenue in countries where the courts interpret tax legislation literally and adhere strictly to the legal form of transactions, where the tax authorities lack the necessary resources and training to combat tax avoidance, and where the tax legislation does not contain a comprehensive set of specific anti-avoidance rules. However, even in countries where some, but not all, of these conditions exist, tax avoidance is likely to be a serious problem.

2.5.2 The extent of abusive tax avoidance

Taxpayers and their advisers may argue that governments must prove that tax avoidance is a serious problem by quantifying the extent of abusive tax avoidance. Ideally, a government should be able to justify the adoption of a GAAR by showing that abusive tax avoidance results in a substantial loss of tax revenues, and also perhaps that the loss has been increasing. However, this is an impossible task, especially given the difficulty of defining abusive tax avoidance. Similarly, it is impossible for taxpayers and their advisers to prove that abusive tax avoidance is not a serious problem. The best available evidence about the extent of abusive tax avoidance is usually anecdotal evidence from audit activities and public sources. This evidence seems reasonably clear that tax avoidance is a serious issue in many developed countries and it seems reasonable to assume that the situation is likely to be even worse in developing countries.

2.5.3 Is a GAAR consistent with the rule of law and constitutional principles?

Taxpayers and their advisers may argue that a GAAR violates a country's constitutional principles or the rule of law. These constitutional

principles may include the necessity that tax be imposed in accordance with proper legal authority and that it must conform to fundamental principles of substantive and procedural justice such as equal treatment, safeguards against abuse of discretionary power, and legal certainty. These arguments are peculiar to each country's constitution and legal system.[2] However, they are not convincing, especially in light of the fact that many countries have enacted GAARs.

2.5.4 The adequacy of specific anti-avoidance rules

Opponents of a GAAR often argue that a GAAR is unnecessary because a country's existing anti-avoidance rules are sufficient to deal with abusive tax avoidance. This argument is usually supplemented by the argument that the tax authorities should be more aggressive in combating abusive tax avoidance.

As discussed in section 2.4.1 above, there are two fundamental problems with specific anti-avoidance rules. First, specific rules provide a roadmap for tax planners to design transactions that are not caught by the rules, and this inevitably leads to a never-ending cat-and-mouse game between tax authorities and tax advisers. Second, using specific rules to deal with abusive tax avoidance transactions means that the tax authorities are always playing catch-up — as each new abusive transaction is detected, new anti-avoidance rules must be enacted to deal with it. The enactment of such rules takes time, and in the meantime tax revenues are lost. Moreover, this situation rewards taxpayers and tax planners who implement aggressive tax avoidance plans early, before they are detected by the tax authorities.

With respect to the argument that the tax authorities can control abusive tax avoidance effectively simply by enforcing existing rules more aggressively, it is unrealistic to expect this to happen without the tax auhtorities receiving significant additional resources to identify and attack tax avoidance arrangements. Moreover, even if the tax authorities are more aggressive in fighting tax avoidance, it is also necessary for a country's courts to support more aggressive enforcement by the tax authorities, which they may not do, particularly where

[2] Graeme S. Cooper, ed., *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD, 1997).

the courts have adopted literal interpretation of tax legislation. Finally, it would take many years to determine whether the increased enforcement efforts of the tax authorities were successful in dealing with abusive tax avoidance, with the risk that they might not ultimately be successful. In the meantime, the loss of tax revenue due to abusive tax avoidance would have continued.

2.5.5 Uncertainty

The most common argument against a GAAR is that it involves too much uncertainty and that such uncertainty may discourage taxpayers from engaging in legitimate commercial transactions. As a result, developing countries may be concerned that the adoption of a GAAR will discourage non-residents from investing in their countries. Unquestionably, a GAAR involves a significant amount of uncertainty, and this uncertainty inevitably confers considerable discretion on the tax authorities with respect to the application of the rule. However, the effects of the uncertainty of a GAAR are often wildly exaggerated. It is impossible to determine in advance the impact of a GAAR on commercial transactions, and in any case the impact depends on the form of the GAAR and its application by the tax authorities. The uncertainty of a GAAR may also discourage abusive tax avoidance arrangements and this benefit must be balanced against the negative impact of a GAAR on legitmate commercial transactions. Moreover, if the enactment of a GAAR is accompanied by the repeal of some specific anti-avoidance rules that have become unnecessary in the light of the GAAR, the certainty of the tax law as a whole may actually be improved.

Most of the arguments with respect to the uncertainty of a GAAR are directed at the application of the rules by the tax authorities. The enactment of most new tax rules involves some (usually temporary) uncertainty. The tax authorities can reduce the uncertainty associated with the adoption of a GAAR by issuing explanatory notes to accompany the enactment of the GAAR, the explanatory notes provide guidance as to how the provisions of the GAAR are intended to be interpreted and administrative guidance as to how the GAAR will be applied. See Part 3, chapter 4 for explanatory notes with respect to two sample GAARs.

2.5.6 Summary

The argument that a GAAR is necessary is straightforward. Abusive tax avoidance erodes a country's tax base and reduces public confidence in the tax system. The experience of many countries is that specific anti-avoidance rules and other techniques are ineffective in controlling tax avoidance. Some type of GAAR is essential for most countries in order to prevent taxpayers from avoiding the obligation to pay the tax that the tax system seeks to impose.

A GAAR can take the form of a judicial rule or a statutory rule. The courts of some countries have developed broad general judicial doctrines, such as the abuse of law concept in civil law countries; a business purpose test, under which transactions that lack a significant business purpose can be disregarded for tax purposes; and the doctrine of economic substance over legal form, under which transactions are taxed in accordance with their economic substance rather than their legal form. These judicial doctrines may adequately protect the tax systems of these countries against abusive tax avoidance. However, most countries lack well developed judicial anti-avoidance doctrines and therefore the enactment of a statutory GAAR is probably necessary to deal effectively with abusive tax avoidance.

It should be emphasized that, by itself, a GAAR is not sufficient to deal with tax avoidance. It is only one component of a comprehensive response to tax avoidance that (ideally) also includes robust enforcement measures, specific statutory anti-avoidance rules, and judicial anti-avoidance doctrines. Typically, a GAAR applies as a provision of last resort; it deals only with the most abusive cases of tax avoidance that are not dealt with by other statutory provisions, and is applied only after the application of all the other provisions of the tax legislation.

Chapter 3

Tax Policy Analysis of the Provisions of Tax Treaties and Model Tax Treaties Dealing with Tax Avoidance

3.1 Introduction

The previous chapter provided a tax policy analysis of the provisions of domestic tax law dealing with tax avoidance — including better enforcement of domestic tax legislation, specific anti-avoidance rules, judicial anti-avoidance doctrines, and the interpretation of tax legislation to prevent tax avoidance — as background to a detailed discussion of the need for a general anti-avoidance rule. Since tax treaties restrict a country's ability to tax under its domestic law, the provisions of a country's tax treaties may create risks that taxpayers will use these treaties to avoid domestic tax. In this chapter, the provisions of tax treaties are analyzed in order to provide a foundation for assessing the risk that a country's tax treaties may prevent the country from applying its specific and general anti-avoidance rules, and assessing the need for a general anti-abuse rule in a country's tax treaties.

In the balance of this introduction, the nature and types of tax avoidance using tax treaties are described briefly, along with the causes and extent of such tax avoidance.

In section 3.2 below, some basic questions about a country's tax treaty network and the most important provisions of tax treaties dealing with tax avoidance are considered. Then the provisions of the United Nations and OECD Model Conventions and their Commentaries dealing with tax avoidance are analyzed. These model treaties provide a convenient basis for comparison with a particular country's tax treaties.

Since, in general, tax treaties prevail over the provisions of domestic law in the event of a conflict between the two, the possibility arises that tax treaties may prevent the application of domestic anti-avoidance

rules. The United Nations and OECD Model Conventions have been amended at various stages to include specific anti-avoidance, rules and in the 2017 updates to include a general anti-abuse rule. Moreover, the United Nations Commentary (since 2011) and OECD Commentary (since 2003) have included guidance about the interpretation of tax treaties to prevent the use of tax treaties to avoid domestic tax. In addition, several countries have taken steps to protect their tax base from tax avoidance through tax treaties either by enacting special provisions of domestic law to ensure that domestic anti-avoidance provisions override their treaties, or by including anti-avoidance provisions in their tax treaties. Therefore, section 3.3 provides a discussion of the relationship between tax treaties and domestic law with respect to tax avoidance, including the relationship between tax treaties and specific anti-avoidance rules in domestic law and between tax treaties and domestic general anti-avoidance rules (GAARs). Section 3.3 also provides a discussion of the United Nations and OECD Commentaries with respect to the improper use of tax treaties and the mechanisms provided by domestic law and tax treaties to prevent such improper use. This aspect of the United Nations and OECD Commentaries has changed significantly over the years; section 3.3 provides a history of these changes to assist tax officials in determining which version of the Commentary may be relevant for purposes of interpreting a particular treaty in any particular case.

Sections 3.4 and 3.5 deal with specific anti-avoidance rules included in the United Nations and OECD Model Conventions and in actual bilateral treaties, and the interpretation of tax treaties to prevent tax avoidance, respectively. Section 3.6 deals with the inclusion of general anti-abuse rules in tax treaties and in particular, the new general anti-abuse rule included in Article 29(9) of the United Nations and OECD Model Conventions.

In general, tax treaties impose restrictions on the taxes levied by the contracting states under their domestic laws. There are two major questions with respect to tax treaties and tax avoidance. First, to what extent, if any, do the provisions of a country's tax treaties prevent taxpayers from using those treaties to avoid domestic tax? Second, to what extent, if any, do the provisions of a county's tax treaties prevent that country from applying its domestic anti-avoidance rules to prevent taxpayers from using those treaties to avoid domestic tax?

3.1.1 Tax avoidance through tax treaties

In most countries, tax treaties do not impose tax; they provide relief from tax imposed under domestic law. Therefore, tax treaties result in abusive tax avoidance where they reduce domestic tax in inappropriate ways.

As noted in section 1.2 above, tax avoidance is generally considered to be abusive where the relevant transactions are contrary to or frustrate the object and purpose of the provisions of the tax legislation. Similarly, tax avoidance through tax treaties is generally considered to be abusive where the relevant transactions are contrary to or frustrate the object and purpose of the provisions of the treaty. However, because tax treaties reduce tax imposed under domestic law, there is a close relationship between tax treaties and domestic law, and it will often be necessary to consider the object and purpose of both the relevant provisions of the treaty as well as domestic law in determining whether a transaction is abusive. Because tax is imposed under domestic law, conceptually it would appear to be impossible for a transaction to abuse the provisions of a tax treaty without also abusing the provisions of domestic law. However, in contrast, it is conceptually possible for a transaction to abuse domestic law without any abuse of a tax treaty. The relationship between tax treaties and domestic law with respect to tax avoidance is discussed in section 3.3 below.

3.1.2 Types of tax avoidance using tax treaties

As discussed in section 1.5, the types of cross-border tax avoidance are almost limitless. Most of the standard methods of tax avoidance with respect to domestic law identified in section 1.5 are also found with respect to tax treaties. For example, a common form of tax avoidance involves income shifting: diverting income from one person to another or from one country to another. Tax treaties can be used to facilitate this type of tax avoidance through what is commonly referred to as treaty shopping, which is described below. Other examples of standard forms of international tax avoidance that can be implemented through the use of tax treaties include:

- converting income into capital,
- altering the character of payments such as dividends, interest and royalties,

- diverting income to related or non-arm's length persons, and
- misallocating items of revenue and expense.

These standard types of international tax avoidance, which apply to both domestic law and tax treaties, are not discussed further in this section, which is limited to a brief discussion of some common types of tax avoidance that primarily involve the use of tax treaties.

The Commentaries on Article 1 of the United Nations and OECD Model Conventions describe a wide variety of transactions involving the improper use of tax treaties and the various responses to prevent such improper uses. The abusive transactions that primarily involve the use of tax treaties include:

Residence

Since tax treaties generally apply only to residents of a contracting state, taxpayers may be tempted to establish nominal residence in a country in order to take advantage of the tax benefits of its network of tax treaties. Usually, such nominal residence is established by forming a corporation or other entity under the laws of that country. Under the definition of a resident of a contracting state in Article 4(1) of the United Nations Model Convention, a person is a resident of a contracting state if the person is "subject to tax" in that state by reason of residence, domicile, place of management and other similar connecting factors. A shell corporation without any office or employees and with limited assets will generally be subject to tax in the country in which it is incorporated or managed.

Some tax treaties contain specific anti-avoidance rules to deny treaty benefits to corporations and other entities that lack substance. These rules include limitation-on-benefits provisions such as Article 29(1) to (7) of the United Nations and OECD Model Conventions, which were added in the 2017 updates to those models. In effect, these rules try to limit treaty benefits to "real" residents of a contracting state.

Dual Residents

One of the fundamental goals of tax treaties is to eliminate double taxation and one form of double taxation relates to persons who are residents of both contracting states. Tax treaties eliminate this form of double taxation by providing so-called tie-breaker rules in Article

4(2) and (3) with respect to individuals and other persons respectively. However, dual-resident entities are often used for tax avoidance purposes and the tie-breaker rule can be used to facilitate such avoidance. For example, if a company with a loss is a resident of both contracting states, it may be entitled to deduct its loss in both states.

In the 2017 Updates of the United Nations and OECD Model Conventions, the tie-breaker rule in Article 4(3) for persons other than individuals was changed from the place of effective management of the enterprise to the agreement of the competent authorities. Thus, if an entity is a resident of both countries under their domestic law, the competent authorities must consult together to decide, on the basis of certain specified factors, in which country the entity will be considered to be a resident for purposes of the treaty. If the competent authorities cannot agree, the entity is not entitled to the benefits of the treaty as a resident of either country except as the competent authorities agree.

Triangular cases

A typical triangular case involves dividends, interest, royalties or fees for technical services received by a taxpayer resident in one contracting state from the other contracting state where the residence state uses the exemption system to provide relief from double taxation and where the amounts are attributable to a PE that the taxpayer has in a third state, which does not tax the income. The taxpayer derives the benefits of the treaty between the residence country and the source country in the form of the reduction or elimination of source country tax on the income even though the residence country exempts that income. Consequently, the income is not subject to tax in the residence country, the source country or the third country.

The 2017 Updates of the United Nations and OECD Model Conventions add Article 29(8) to both conventions to deny treaty benefits in such triangular cases if the tax imposed by the third state is less than 60 percent of the tax that would have been imposed by the residence country in the absence of the PE in the third state.

Avoidance of permanent establishment (PE) status

With respect to business profits derived by a resident of one contracting state from the other state, the general rule in Article 7 of tax

treaties based on the United Nations Model Convention is that the state in which the business profits arise is entitled to tax those profits only where the taxpayer carries on the business through a permanent establishment (PE) in that state and those profits are attributable to that PE. A PE is defined in Article 5 to be a fixed place of business that generally lasts for at least 6 months and is deemed to include a person (other than an independent agent acting in the ordinary course of business) who acts on behalf of the taxpayer and concludes contracts binding on the taxpayer or (after 2017) who plays the principal role leading to the conclusion of such contracts.

In general, if residents of one contracting state can avoid establishing a PE in the other state, they can avoid paying tax in that state on any business profits derived from that state. Various planning techniques have been used by taxpayers to avoid having a PE in a country while still deriving profits from that country:

- splitting contacts to avoid time thresholds,
- splitting activities among related entities,
- carrying on activities at different locations in a country where the activities at each location do not exceed 6 months,
- commissionnaire arrangements, under which contracts concluded by a commissionaire are not binding on the commissionnaire's principal, and
- limiting the activities and authority of persons acting on behalf of a taxpayer in a country.

Many of these avoidance strategies have been prevented by amendments to the definition of a PE in the 2017 Update of the United Nations and OECD Model Conventions. These specific anti-avoidance rules include:

- new Article 5(4.1) to aggregate activities carried on at multiple places by the taxpayer and closely related enterprises in certain circumstances,
- a new requirement that each specified activity and the overall activity carried on at a fixed place have a preparatory or auxiliary character in order to qualify for the exception in Article 5(4); and
- extending the definition of a dependent-agent PE to include persons habitually playing the principal role leading to the con-

clusion of certain contracts on behalf of a resident of the other state.

Classification of income for treaty purposes

The distributive provisions of tax treaties based on the United Nations and OECD Model Conventions (Articles 6 to 21) deal with different types of income in different ways. Depending on the nature or character of the income, the country in which the income arises or is sourced may be:

- prohibited from taxing the income at all (for example, capital gains from the disposal of certain property and business profits not attributable to a PE in the source country)
- allowed to tax without any limitations (for example, income from immovable property situated in the source country)
- allowed to tax at a reduced tax rate (for example, dividends, interest, royalties and fees for technical services).

To take advantage of the different rules, taxpayers may enter into arrangements to change the character of income so that a more favourable provision of the treaty applies. The Commentary on Article 1 describes the following ways of achieving this result:

- converting dividends into interest (paragraph 104);
- allocating amounts under a mixed contract (paragraphs 105 and 106);
- converting royalties into capital gains (paragraphs 107 and 108); and
- using derivative financial arrangements such as swaps (paragraph 109).

Circumvention of treaty thresholds

The provisions of tax treaties based on the United Nations and OECD Model Conventions contain many provisions with various types of thresholds that must be satisfied in order for a country to impose tax on income or for a taxpayer to be entitled to a treaty benefit. For example, the existence of a PE or a fixed base is a threshold that must be met in order for a country to impose tax on business profits under Article 7 or income from independent personal services under Article 14. Similarly,

several articles contain time thresholds as a condition for source country taxation (for example, the implicit 6-month minimum threshold for a PE or a fixed base or the explicit 183 days of presence threshold in Article 14) or for exemption from source country taxation (for example, the 183-day threshold for the exemption of non-resident employees in Article 15(2)(a)). In addition, share ownership thresholds are used in Article 10(2)(a) as a condition for the lower rate of withholding tax on dividends and in Article 13(5) as a condition for source country taxation of gains from the disposal of substantial shareholdings in resident companies.

Taxpayers may enter into various types of arrangements to meet or avoid these threshold requirements, depending on the particular provision. For example, a taxpayer might acquire shares of a company shortly before a dividend is paid by the company in order to own a sufficient percentage of the shares to get the benefit of the lower rate of withholding tax in Article 10(2)(a). The 2017 Update of the United Nations Model Convention introduces an additional 365-day holding period requirement as a condition for access to the lower rate in order to stop acquisitions of shares shortly before dividends are paid. Similarly, time thresholds can sometimes be avoided by splitting contracts or splitting projects among related enterprises. Once again, the 2017 Update of the United Nations Model Convention contains specific anti-avoidance rules (in Article 5(4.1)) to prevent some of these avoidance arrangements.

Article 13(5) of the United Nations Model Convention allows a country to tax gains from the disposal of shares of a resident company or other entity if the taxpayer owns at least a percentage (to be agreed by the contracting states) of the shares of the company or comparable interests in another entity at any time in the 365-day period before the disposal. This 365-day testing period requirement prevents taxpayers from divesting some shares or interests in a company or entity in order to reduce the taxpayer's percentage holding to less than the minimum threshold, so that the country in which the company or entity is resident is precluded from taxing the gain on the disposal of the remainder of the shares or interests.

Article 13(4) of the United Nations and OECD Model Conventions allows the country in which a company or other entity is resident to tax gains on the disposal of the shares in the company (or comparable interests in another entity) if the value of the property of

the company or other entity consists principally (more than 50 percent of the value) of immovable property located in the country. Prior to the 2017 Updates of the United Nations and OECD Model Conventions, taxpayers could "stuff" assets (other than immovable property) into an entity whose assets consisted principally of immovable property shortly before the sale of the interests in the entity in order to ensure that the threshold (more than 50 percent of the value of the assets of the entity consists of immovable property) is not satisfied and that the country in which the entity is resident is prevented from taxing the gain on the sale of the interests in the entity by Article 13(4). The 2017 Updates of the United Nations and OECD Model Conventions added a 365-day testing period similar to the 365-day testing period in Article 13(5) to prevent such "stuffing" transactions.

Income and entities qualifying for preferential treatment

In general, countries entering into tax treaties give up their right to tax income on the basis that such income will be taxed by the other contracting state. Although countries can protect themselves during the negotiation of their treaties by excluding income or entities qualifying for preferential regimes in the other country that exist at that time, it is possible for preferential regimes to be adopted after the treaty is concluded. As noted in paragraph 116 of the Commentary on Article 1 of the United Nations Model Convention (quoting paragraph 26.11 of the Commentary on Article 1 of the OECD Model Convention), this type of treaty abuse arises as a result of features of the tax law of a treaty partner, not as a result of avoidance arrangements carried out by taxpayers.

The Commentary on Article 1 of the United Nations Model Convention (paragraph 116, quoting paragraphs 26.12 to 26.35 of the Commentary on Article 1 of the OECD Model Convention as updated in 2017) contains alternative provisions that countries can include in their treaties to protect their tax bases from avoidance through preferential tax regimes and other tax changes (for example, tax-rate reductions) adopted by the other contracting state after the treaty is concluded.

Treaty shopping

The term "treaty shopping" does not have an accepted or defined meaning, but is commonly used to refer to tax avoidance strategies that involve

taking advantage of a favourable tax treaty. The 2017 preamble added to both the United Nations and OECD Model Conventions states that the convention is not intended to create "opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefits of residents of third States)." Although treaty shopping may take a variety of forms, customarily it involves the creation of an entity in a country with a favourable tax treaty or the use of a pre-existing entity in such a country.

A blatant example of treaty shopping would be the assignment of the right to receive dividends, interest, royalties or other types of income by a taxpayer resident in Country A to an agent, nominee or conduit resident in Country B. Country A does not have a tax treaty with Country C, the country from which the relevant income is derived; however, Country B does have a tax treaty with Country C. Alternatively, Country A may have a treaty with Country C but the treaty between Country B and Country C contains more favourable provisions (for example, lower rates of withholding tax on certain types of income) than the treaty between Country A and Country C. If the income in this example consisted of dividends, interest, royalties or fees for technical services, the beneficial owner requirement in Article 10, 11, 12 or 12A would not be satisfied by the agent, nominee or conduit receiving the income and the benefits of the treaty would be denied.

However, treaty shopping arrangements may involve treaty benefits under articles of the treaty that do not contain any beneficial owner requirement. For example, a resident of Country A may own 20 percent of the shares of a company resident in Country C. If shares are sold, any gain on the sale is taxable under the domestic law of Country C because there is no tax treaty between Country A and Country C. To avoid tax on the gain by Country C, the shares might be transferred to an entity resident in Country B that is created by the resident of Country A for this purpose. Assume that the laws of Country A allow the transfer to take place on a tax-deferred or tax-free basis. If Country B and Country C have a tax treaty with provisions identical to the provisions of the United Nations Model Convention, Article 13(6) would apply to prevent Country C from taxing the gain on the sale of the shares (assuming that the percentage specified in Article 13(5) is higher than 20 percent).

Whether and in what circumstances treaty shopping arrangements are considered to be abusive is controversial. Some commentators argue that the purpose of treaties is to stimulate investment from non-residents and it does not matter whether such investment is funneled through a treaty country by non-residents of that country. Other commentators disagree and point out that tax treaties are bilateral agreements which are intended to confer benefits only on the residents of the contracting states not on residents of third states. If residents of Country A can invest in Country B with which Country A does not have a tax treaty simply by creating a shell entity in a third country that has a treaty with Country B, in effect, residents of Country A will have access to the benefits of a treaty with Country B but Country A will not have to provide reciprocal benefits to the residents of Country B.

The 2017 Updates of the United Nations and OECD Model Conventions added limitation-on-benefits provisions in Article 29(1) to (7) to allow one state to deny treaty benefits to residents of the other state in certain circumstances where, in general, they are not "real" residents.

3.1.3 Causes of tax avoidance using tax treaties

The causes of tax avoidance through the use of tax treaties are closely related to the causes of tax avoidance generally, which are discussed in Part 2, chapter 1.5 above. In general, tax treaties prevail over the provisions of domestic law in the event of a conflict, and many countries consider international law, including treaties, to be at the top of the hierarchy of laws. As a result, taxpayers can potentially use the provisions of tax treaties to trump anti-avoidance rules in domestic law and thereby avoid domestic tax.

As with tax avoidance generally, tax avoidance through tax treaties is often caused by inadequate or deficient treaty provisions. For example, if a country has a treaty that provides different maximum rates for source country taxes on dividends, interest and royalties, some taxpayers will be tempted and able to convert payments subject to higher withholding taxes into payments of a different character subject to a lower tax rate. However, unlike domestic tax legislation, which a country can take unilateral action to fix, tax treaties are negotiated bilateral agreements, which a country can change only by getting the agreement of the other country or terminating the treaty.

Tax avoidance through tax treaties may also be caused by inadequate enforcement efforts. Tax treaties are specialized international agreements that are significantly different from domestic tax law. As a result, the administration and enforcement of tax treaties to prevent tax avoidance requires a special group of tax officials with expertise in dealing with tax treaties. This is especially true for countries with large treaty networks and tax treaties whose provisions vary significantly.

Tax avoidance may be facilitated if the tax authorities and the courts interpret tax treaties literally, in the same way that the literal interpretation of domestic tax legislation facilitates domestic tax avoidance. If tax treaties are interpreted literally (even if domestic legislation is not interpreted that way), taxpayers can design avoidance transactions that fit within the literal meaning of the treaty. Consequently, the only way that a country can prevent this type of tax avoidance is to add specific anti-avoidance provisions to its tax treaties, which, as discussed above, is difficult to do, especially for countries with large treaty networks.

If a country has tax treaties with several countries and the provisions of those treaties differ widely, taxpayers will be encouraged to engage in "treaty shopping" as described above in section 3.1.2.

The distributive provisions of tax treaties are invariably schedular in nature. In other words, Articles 6 to 21 of the United Nations Model Convention deal with specific types of income rather than income generally. Moreover, these articles apply different conditions for the contracting states to tax different types of income. As a result, taxpayers may attempt to structure their affairs to take advantage of the most favourable treaty provisions in order to minimize tax. For example, under Articles 7 and 14 of the United Nations Model Convention, an individual resident in one contracting state is subject to tax on business profits or income from independent personal services earned in the other state only if the individual has a PE or a fixed base in the other state (or spends more than 183 days in the other state) and the income is attributable to the PE or fixed base. However, if the individual is employed by an employer resident in the other contracting state (or a non-resident employer with a PE in that state) that state is entitled to tax all the individual's income from employment activities performed in that state. Therefore, such individuals may attempt to structure their working relationships as independent contractors

rather than employees in order to get the benefit of the higher threshold for source country taxation of independent contractors under Article 7 or 14.

3.1.4 Extent of tax avoidance through tax treaties

As discussed in section 1.6 above, it is impossible for governments to quantify the extent of tax avoidance through the use of tax treaties because it is difficult to define abusive tax avoidance and to distinguish between tax avoidance implemented through tax treaties and other types of tax avoidance. Nevertheless, there is strong anecdotal evidence of treaty shopping and other types of treaty abuse in most developed and developing countries.

3.2. Tax Treaty Network

Each country's tax treaty network can be analyzed by posing a few basic questions. How many tax treaties does a country have? With what countries does a country have tax treaties? For example, does the country have tax treaties with developed and developing countries; with its major trading partners; with countries that are geographically close; with low-tax countries or tax havens?

Are the country's treaties primarily based on the United Nations Model Convention or the OECD Model Convention (or any other regional model)? What, if any, variations from the United Nations or OECD Model Conventions do the treaties usually contain? Do these variations have an impact on the use of these treaties for tax avoidance? Does the country have a domestic model tax treaty that it uses as a template for negotiations of tax treaties with other countries?

3.3 The Relationship Between Tax Treaties and Domestic Tax Avoidance Rules

3.3.1 In general

The general principle governing the relationship between tax treaties and domestic law is that the provisions of a tax treaty prevail over the

provisions of domestic law in the event of a conflict between them. This principle is enshrined in Article 26 of the Vienna Convention on the law of treaties:

> Pacta sunt servanda
>
> Every treaty in force is binding upon the parties to it and must be performed by them in good faith.

In many countries, the principle of *pacta sunt servanda* also operates as a matter of domestic law. Treaties, including bilateral tax treaties, are considered to have a higher legal status than domestic law, and therefore, in the event of a conflict between the provisions of a tax treaty and the provisions of domestic law, the provisions of the tax treaty must prevail. However, in other countries tax treaties and domestic law have equal status; therefore, in any particular case, it is a matter of interpretation whether the provisions of tax treaties prevail over domestic law, or vice versa.

In all countries, the relationship between tax treaties and domestic law is a question of domestic law. In some countries it is possible, and not uncommon, for domestic legislation to expressly override the provisions of the country's tax treaties. In other countries, such treaty overrides are impossible because the superior legal status of tax treaties is a matter of constitutional law.

This section focusses on the relationship between tax treaties and specific anti-avoidance rules and general anti-avoidance rules in domestic law.

The issue of the relationship between tax treaties and domestic anti-abuse rules has been dealt with in the Commentaries on the United Nations and OECD Model Conventions and is discussed in section 3.3.2 below.

3.3.2 The importance of the United Nations and OECD Commentaries with respect to treaty abuse

3.3.2.1 Introduction

The Commentaries on the United Nations and OECD Model Conventions are relevant for the interpretation of tax treaties to prevent

treaty abuse. The United Nations and OECD Commentaries on Article 1 have dealt with treaty abuse from the beginning, that is, since 1977 for the Commentary on the OECD Model Convention and since 1980 for the Commentary on the United Nations Model Convention. Both Commentaries on Article 1 have been revised extensively over the years.

At the outset, it should be emphasized that the United Nations and OECD Commentaries are not legally binding on the courts of any country. This is clearly the case with respect to the United Nations Commentary because it was created by the United Nations Committee of Experts, whose members act in their personal capacity; thus, the United Nations Model Convention is not a governmental document. It is also the case with respect to the OECD Commentary. That Commentary is prepared by tax officials of the OECD member countries; those countries have agreed to follow the positions set out in the Commentary in the interpretation and application of the provisions of their tax treaties (where those treaties follow the wording of the provisions of the OECD Model Convention) except to the extent that OECD member countries have registered reservations on articles of the OECD Model Convention or observations on the Commentary.

Since 1997, several developing countries have registered their positions on the provisions of the OECD Model Convention and its Commentary. These countries may consider themselves to be bound by their public positions on the provisions of the OECD Model Convention with respect to the provisions of their treaties that follow the wording of the OECD Model Convention; however, the courts of these countries are not legally bound by these positions. Even where a developing country has not registered any position on the OECD Commentary, there is a possibility that the country's courts may take into account the OECD Commentary on Article 1 with respect to treaty abuse in interpreting the provisions of any tax treaty that follows the wording of the provisions of the OECD Model Convention.

According to paragraphs 33-36.1 of the Introduction to the OECD Model Convention, the current version of the Commentary applies for the purpose of interpreting bilateral tax treaties entered into before the time the Commentary was revised. For example, the 2017 OECD Commentary on Article 1 should be applied to interpret

tax treaties entered into both before and after 2017. However, many scholars (and some courts) disagree with this position, mainly because neither the tax officials of the contracting states nor taxpayers could possibly have known about the subsequent Commentary at the time the particular treaty was concluded. The issue of whether the subsequent version of the OECD Commentary should be relevant in interpreting the provisions of treaties concluded before the Commentary was revised has not been resolved in most countries, even most OECD member countries. Therefore, there is a risk that the courts in some countries may decide that only the version of the Commentary that was current at the time a particular tax treaty was concluded is relevant in interpreting that treaty.

It follows that it is important for tax officials of a country to understand which version of the Commentary applies for the purpose of interpreting the countries' tax treaties. Depending on which version of the Commentary applies to a particular treaty, the provisions of that treaty may be more or less effective in preventing treaty abuse. Generally, earlier versions of the United Nations and OECD Commentaries on Article 1, especially versions of the United Nations Commentary on Article 1 before 2011 and versions of the OECD Commentary before 2003, are less effective in preventing treaty abuse than subsequent versions of the Commentary. Therefore, tax treaties that are interpreted in accordance with earlier versions of the Commentary may present a greater risk of treaty abuse; countries may wish to target these treaties for remedial action on a priority basis to prevent them from being used to avoid tax.

The following sections describe the basic approach to the relationship between tax treaties and domestic law with respect to treaty abuse as set out in the versions of the Commentary on Article 1 of both the OECD and United Nations Model Conventions for the relevant time periods. Tax officials from developing countries should determine which version of these Commentaries is likely to apply to their tax treaties and consider whether they need to take some action to reduce or eliminate the risk of treaty abuse. For example, some countries may wish to renegotiate some treaties to include specific anti-avoidance rules and a general anti-abuse rule or, in exceptional circumstances, to consider terminating a treaty that poses serious risks of treaty abuse.

3.3.2.2 OECD Commentary on Article 1: From 1977-1992

In 1977, the OECD Commentary on Article 1 stated that although the purpose of tax treaties was to facilitate cross-border trade and investment, "they should not, however, help tax avoidance or evasion" (paragraph 7). The Commentary went on to acknowledge that taxpayers could exploit differences in countries' tax laws "through the creation of usually artificial legal constructions" and that such exploitation could be facilitated by the proliferation of bilateral tax treaties (paragraph 8). However, the 1977 Commentary emphasized that it was the responsibility of states to deal with tax avoidance in their domestic law and to protect the application of their domestic anti-avoidance rules in their tax treaties:

> … it is for the States concerned to adopt provisions in their domestic laws to counter such manoeuvres. Such states will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind [anti-avoidance rules] contained in their domestic laws.

Therefore, if the OECD Commentary, as it read from 1977 to 1992, applies for purposes of a country's tax treaties, there is a significant risk that those treaties may prevent the application of the country's domestic anti-avoidance rules unless the contracting states had agreed "that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention." (paragraph 10)

3.3.2.3 OECD Commentary on Article 1: From 1992-2003

In 1992, the OECD Commentary was revised to reflect two 1987 OECD Reports on base and conduit companies.[3] These reports explored various methods for dealing with base and conduit companies and described the different country positions on the relationship

[3] OECD, *Double Taxation Conventions and the Use of Base Companies* (Paris: OECD, 1987) and OECD, *Double Taxation Conventions and the Use of Conduit Companies* (Paris: OECD, 1987), reproduced in OECD, *Model Tax Convention on Income and on Capital* (looseleaf), vol. II, R(5) ("Report on Base Companies") and vol. II, R(6) ("Report on Conduit Companies") respectively.

between domestic anti-avoidance rules and tax treaties, but made no recommendations. The 1992 Commentary indicated that the position of "the large majority of OECD Member countries" was that domestic anti-avoidance provisions, including substance-over-form rules and controlled foreign corporation rules, "are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. These rules are not addressed in tax treaties and are therefore not affected by them." [4] However, the 1992 Commentary also recognized the dissenting view of some countries and acknowledged that "it is not easy to reconcile these divergent opinions." (paragraph 24)

The OECD Commentary on Article 1 as it read from 1992 to 2003, dealing with the improper use of tax treaties, was confusing because it did not attempt to distinguish between the various types of domestic anti-avoidance rules, even though some of its statements apply only to particular domestic rules such as controlled foreign corporation (CFC) rules. Although it emphasized that domestic anti-abuse rules against treaty shopping and other forms of treaty abuse are consistent with the provisions of tax treaties, it also accepted the minority view that tax treaties impose limits on the application of domestic anti-abuse rules.

Therefore, if the OECD Commentary on Article 1 as it read from 1992 to 2003 applies for purposes of a country's tax treaties with countries that adhere to the minority position reflected in the Commentary, there is a significant risk that those treaties may prevent the application of the country's domestic anti-avoidance rules.

3.3.2.4 OECD Commentary on Article 1: From 2003-2017

In 2003, the OECD Commentary on Article 1 was revised extensively to deal with treaty abuse. First, the first two paragraphs dealing with treaty abuse were revised to clarify that one of the purposes of tax treaties is to prevent tax avoidance (paragraph 7: "It is also a purpose of tax conventions to prevent tax avoidance and evasion.") and that a country that has enacted domestic anti-avoidance rules would be unlikely to enter into

[4] Paragraph 23 of the Commentary on Article 1 as it read prior to 2003. This statement was retained in the 2003 Commentary (see paragraph 22.1) and the 2017 Commentary (see paragraph ___).

treaties that prevented it from applying those rules (paragraph 7.1). In effect, these paragraphs reverse the onus placed on countries by the prior versions of those paragraphs in the 1977 and 1992 OECD Commentaries.

The 2003 Commentary identifies two basic issues with respect to treaty abuse: first, whether tax treaties can be interpreted to deny treaty benefits with respect to abusive transactions, and second, whether tax treaties prevent the application of domestic anti-avoidance rules (paragraph 9.1). Some countries take the position that any abuse of a tax treaty is necessarily an abuse of domestic law because tax is imposed under domestic law (paragraph 9.2). On the other hand, other countries consider that the provisions of tax treaties can be interpreted to prevent treaty abuse irrespective of domestic anti-avoidance rules (paragraph 9.3). However, according to the OECD Commentary, regardless of which approach is used, treaty benefits should not be given with respect to abusive transactions (paragraph 9.4). The Commentary establishes the following important "guiding principle" for dealing with treaty abuse:

> A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose of 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. (paragraph 9.5)

This guiding principle was also included in the United Nations Commentary on Article 1 in 2011 and continues to be found in the 2017 version of both Commentaries, as discussed below. In effect, the guiding principle formed the basis for the general anti-abuse rule that was added to both the United Nations and OECD Model Conventions as Article 29(9) in 2017.

The guiding principle requires two conditions to be met for treaty benefits to be denied:

1) one of the main purposes for the transaction is to get a benefit under the treaty; and
2) granting that benefit would be contrary to the purpose of the treaty.

As discussed below in Part 3, section 3.4.4 in connection with the design and drafting of a GAAR, a one of the main purposes test is relatively easily satisfied because any transaction that actually results in a significant treaty benefit for a taxpayer is likely to have that benefit as at least one of its main purposes. It is unlikely that any significant treaty benefit would be obtained accidentally or incidentally, especially where sophisticated taxpayers are involved.

The 2003 OECD Commentary on Article 1 also described various types of treaty abuses and the need for specific anti-avoidance rules in tax treaties to deal with such abuses (paragraphs 9.6 to 26.1).

3.3.2.5 OECD Commentary on Article 1: From 2017 on

In the 2017 Update of the OECD Model Convention, the Commentary on Article 1 dealing with treaty abuse was revised significantly but the fundamental treatment of treaty abuse was retained. The OECD Commentary continues to describe two basic approaches that countries have taken to treaty abuse: some countries consider any abuse of a treaty to also be an abuse of domestic law, but other countries consider some abuses to be an abuse of the treaty itself, (rather than an abuse of domestic law), which must be dealt with by applying the provisions of the treaty (paragraphs 58 and 59). In either case, the Commentary reiterates that countries are not obliged to grant treaty benefits in accordance with the same guiding principle articulated in the prior Commentary (see paragraph 61).

The balance of the 2017 OECD Commentary on Article 1 is identical to the 2017 United Nations Commentary on Article 1, which reproduces in paragraph 118 the following aspects of the OECD Commentary:

- paragraphs 82-84 dealing with income subject to certain preferential features of the other country's domestic law;
- paragraphs 85-100 dealing with special tax regimes;
- paragraphs 101-106 dealing with changes to a country's domestic law after the treaty has been concluded;
- paragraph 107 which provides an alternative specific anti-avoidance rule to deny the benefit of Article 11 for payments of interest to connected persons who benefit from deductions for notional equity; and

- paragraph 108 dealing with remittance-based tax systems.

In addition, paragraph 40 of the 2017 United Nations Commentary on Article 1 deals with controlled foreign corporation (CFC) rules in the same way as paragraph 81 of the 2017 OECD Commentary on Article 1.

See section 3.3.2.9 for a more detailed discussion of the 2017 United Nations Commentary on Article 1, most of which also applies to the 2017 OECD Commentary on Article 1. Unlike the 2017 United Nations Commentary on Article 1, the 2017 OECD Commentary does not contain any examples illustrating how the approaches in the Commentary might be applied to prevent treaty abuse.

3.3.2.6 United Nations Commentary on Article 1: From 1980-2001

The Commentary on Article 1 of the first United Nations Model Convention as it read from 1980 to 2001 contained one paragraph on the abuse of treaties, which indicated that the United Nations Model Convention was following the OECD Model Convention on that issue. The wording of the paragraph closely follows the wording of paragraph 10 of the 1977 OECD Commentary, including the final sentence, which puts the onus on those countries wanting to prevent treaty abuse to include provisions in their treaties to achieve that objective:

> It may be appropriate for potential Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention.[5]

Therefore, as is the case with respect to the OECD Commentary as it read from 1977 to 1992, if the United Nations Commentary on Article 1 as it read from 1980 to 2001 applies for purposes of a country's tax treaties, there is a significant risk that those treaties may prevent the application of the country's domestic anti-avoidance rules.

[5] The paragraphs of the 1980 United Nations Commentary were not numbered.

3.3.2.7 United Nations Commentary on Article 1: From 2001-2011

From 2001 to 2011, the United Nations Commentary on Article 1 simply reproduced the relevant paragraphs of the OECD Commentary on Article 1 as it read from 1992 to 2003 dealing with the types of treaty abuse described above. As a result, the United Nations Commentary dealing with treaty abuse from 2001 to 2011 was confusing and reflected the minority position that domestic anti-avoidance rules had to be explicitly protected in tax treaties. There is a significant risk that if a country's tax treaties with countries taking the minority position espoused in the 1992 OECD Commentary are interpreted in accordance with that Commentary, they may prevent the application of the country's domestic anti-avoidance rules.

3.3.2.8 United Nations Commentary on Article 1: From 2011-2017

In 2011, the Commentary on Article 1 of the United Nations Model Convention with respect to treaty abuse was revised extensively to reflect the changes to the OECD Commentary on Article 1 that were made in 2003. However, unlike many parts of the United Nations Commentary, the Commentary on Article 1 did not simply reproduce the relevant portions of the OECD Commentary; instead, the OECD Commentary on treaty abuse was reorganized and rewritten. Although the 2011 United Nations Commentary on treaty abuse still follows the basic position on treaty abuse in the 2003 OECD Commentary, the United Nations Commentary is more comprehensive, consistent and easier to understand.

3.3.2.9 United Nations Commentary on Article 1: From 2017 on

The general approach of the 2011 United Nations Commentary on Article 1 with respect to treaty abuse is maintained and refined in the 2017 Commentary. As discussed above, the 2017 OECD Commentary on Article 1 was revised extensively following the basic pattern of the 2011 United Nations Commentary, and the 2017 United Nations Commentary contains an explicit statement that it is intended to be consistent with the OECD Commentary on treaty abuse:

> 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. (paragraph 12)

The United Nations Commentary on Article 1 with respect to treaty abuse begins with general statements about the misuse of tax treaties, the difficulty for developing countries with limited experience in dealing with sophisticated tax avoidance schemes to combat such schemes, and the need to maintain a balance between the protection of a country's tax revenues and taxpayers' need for certainty (paragraphs 8-9). Although the 2017 Update of the United Nations Model Convention adds a new title and preamble clarifying that tax treaties are intended to prevent tax avoidance (including tax avoidance through treaty shopping) as well as a general anti-abuse rule, the 2017 United Nations Commentary emphasizes the continuing importance of the Commentary on Article 1 for any treaties that do not contain the new title, preamble and general anti-abuse rule (paragraph 11).

Paragraph 13 (see paragraph 10 of the 2003 United Nations Commentary on Article 1) of the 2017 United Nations Commentary on Article 1 maintains the basic structure of the Commentary dealing with treaty abuse by dividing the responses to treaty abuse into the following 6 categories (3 dealing with the provisions of domestic law and 3 dealing with the provisions of tax treaties):

Domestic Law

1. Specific anti-avoidance rules (paragraphs 28-38)

The Commentary indicates that, although the provisions of tax treaties prevail over specific anti-avoidance rules in domestic law in the event of a conflict, such conflicts will often be avoided (paragraph 33) because:

- treaties may expressly allow the application of domestic anti-avoidance rules (for example, Article 9 allows the application of transfer pricing rules)
- many treaty provisions depend on the application of domestic law and domestic anti-avoidance rules are relevant for this purpose

- treaty benefits denied under specific anti-avoidance rules or judicial doctrines in domestic law would also be denied under a proper interpretation of tax treaties.

2. General anti-avoidance rules (paragraphs 39-40)

Similarly, according to the Commentary, "in the vast majority of cases" there will be no conflict between the provisions of tax treaties and the denial of treaty benefits under a domestic GAAR if the treaty benefits would also be denied under a proper interpretation of the treaty or under the application of the guiding principle (paragraph 40).

3. Judicial anti-avoidance doctrines and rules of interpretation (paragraphs 41-45)

According to the Commentary, there will be no conflict between judicial anti-avoidance doctrines, such as sham, substance over form, abuse of law, economic substance or *fraus legis*, developed by domestic courts and tax treaties (paragraph 45). Similarly, there is no conflict between the provisions of tax treaties and the principles of interpretation enshrined in the Vienna Convention that might prevent the use of anti-treaty abuse rules (paragraph 45).

Tax Treaties

4. Specific anti-abuse rules (paragraphs 46-48)

The United Nations Commentary on Article 1 suggests that the inclusion of specific anti-avoidance rules in tax treaties is appropriate and necessary in certain circumstances (paragraph 47); see below for a discussion of the situations in which specific anti-avoidance rules are appropriate. However, the Commentary warns that, although specific anti-avoidance rules are necessary and appropriate, they "cannot . . . provide a comprehensive solution to treaty abuses." (paragraph 48)

5. General anti-abuse rules (paragraphs 49-51)

The United Nations Commentary on Article 1 states that those countries that consider that their domestic laws do not provide sufficient protection against treaty abuse should consider adding

a general anti-abuse rule such as Article 29(9) of the United Nations Model Convention to their tax treaties (paragraph 51). According to the Commentary, Article 29(9) is consistent with the guiding principle on treaty abuse in the Commentary (paragraph 50). The Commentary also suggests that if a country has a domestic GAAR and wants to include a general anti-abuse rule in its treaties, it should ensure that the two rules are consistent ("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" (paragraph 51)). See section 3.6 below for a discussion of the necessity for a general anti-abuse rule in tax treaties and a discussion of Article 29(9).

6. Interpretation of treaties (paragraphs 52-54)

Article 31 of the Vienna Convention on the Law of Treaties provides that treaties should be interpreted in good faith in accordance with the ordinary meaning of the words, the context of the treaty and in light of the purpose of the treaty. The new title and preamble added to both the United Nations and OECD Model Conventions in 2017 explicitly provide that one of the purposes of tax treaties is to prevent tax avoidance, including through treaty shopping. The title and preamble form part of the context of a treaty and are therefore relevant in interpreting the provisions of any treaty in which they are included.

In addition, the Commentary on Article 1 of both Model Conventions has stated explicitly since 2003 (paragraph 7 of the OECD Commentary) and 2011 (paragraph 7 of the United Nations Commentary) that the prevention of tax avoidance is one of the purposes of tax treaties. Therefore, tax officials and courts can use a purposive approach to interpretation based on Article 31 of the Vienna Convention to interpret the provisions of tax treaties in order to prevent treaty abuse (paragraph 52). This approach can be expected from those countries that use the interpretation of domestic tax legislation to prevent tax avoidance. The United Nations Commentary (paragraph 53) emphasizes that the guiding principle in paragraph 20 is relevant in interpreting tax treaties to prevent treaty abuse.

With respect to the application of domestic law to prevent treaty abuse, the United Nations Commentary indicates that the critical issue is whether taxpayers can rely on the provisions of a tax treaty to protect them against the application of domestic anti-abuse rules. With respect to the application of tax treaties that do not contain a general anti-abuse rule or specific anti-abuse rules to prevent treaty abuse, the 2017 United Nations Commentary maintains the basic approach adopted in the 2011 United Nations Commentary and the 2003 OECD Commentary. As described above in section 3.2.2.4, under this approach, some countries consider any abuse of a tax treaty to be an abuse of domestic law, so that the only issue is whether the provisions of an applicable treaty prevent the application of domestic anti-avoidance rules. Other countries consider certain transactions or arrangements to be abuses of the treaty (instead of, or in addition to, abuses of domestic law) so that the issue is whether the provisions of the treaty can be interpreted and applied to prevent the abuse. The United Nations Commentary provides explicitly in paragraph 19 that "[U]nder 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."

In addition, the guiding principle from both the 2003 OECD Commentary and the 2011 United Nations Commentary has been retained in both revised Commentaries (paragraph 61 of the 2017 OECD Commentary and paragraph 22 of the 2017 United Nations Commentary). Thus, the basic two-step test for treaty abuse remains unchanged: first, one of the main purposes of the transaction or arrangement must be to obtain a more favourable tax position, and second, obtaining that position must be inconsistent with or contrary to the object and purpose of the treaty (paragraph 22). These two conditions are usually also found in domestic general anti-avoidance rules. To minimize the uncertainty in applying the guiding principle, the United Nations Commentary on Article 1 (paragraph 24) emphasizes that the one of the main purposes aspect of the test should be applied on the basis of an objective determination of all the relevant facts, rather than solely on the basis of the taxpayer's intention. Despite the guiding principle, the United Nations and OECD Commentaries on Article 1 state expressly that specific anti-avoidance rules are still necessary.

Paragraphs 55 to 116 of the 2017 United Nations Commentary on Article 1 of the United Nations Model Convention provides a series of examples to illustrate how the 6 approaches to dealing with treaty abuse described above might operate with respect to specific cases. Some of these examples involve situations that have been dealt with by specific anti-avoidance rules added to the United Nations Model Convention in 2017. These paragraphs also include specific anti-avoidance rules that some countries may wish to include in their tax treaties to deal with particular types of treaty abuse. These specific rules include:

- an anti-avoidance rule for Articles 10, 11, 12 and 21 based on one of the main purposes for the creation or assignment of the shares, debt-claims or rights giving rise to the dividends, interest, royalties and other income (paragraph 72),
- provisions to allow a country to apply thin capitalization rules (paragraph 87),
- rules to deal with back-to-back arrangements (paragraph 96),
- an amendment to the definition of royalties to include sales of intangible rights where the sale price is contingent on the use of or production from the property (paragraph 108),
- a rule to prevent transfers of assets to a corporation to avoid Article 13(4) (paragraph 115),
- rules to prevent the provision of treaty benefits where the other contracting state adopts a special tax regime after the treaty is concluded (paragraph 116), and
- a provision to deal with remittance-based tax systems (paragraph 116).

3.3.3 The relationship between tax treaties and specific anti-avoidance rules in domestic law

As discussed in section 3.3.1 above, in the case of a conflict between specific anti-avoidance rules in domestic law and the provisions of a tax treaty, the tax treaty should prevail in accordance with the principle *pacta sunt servanda*. However, often such conflicts can be avoided, for a variety of reasons, as dicussed in section 3.3.2. To avoid any risk that the application of domestic anti-avoidance rules may be prevented

by the provisions of a country's tax treaties, countries should consider either including provisions in their tax treaties to expressly allow the application of certain domestic anti-avoidance rules (for example, some countries include provisions in their treaties allowing the application of controlled foreign corporation (CFC) rules) or including specific anti-avoidance rules in their tax treaties that are similar to their domestic specific anti-avoidance rules (this is the case, for example, with respect to Article 9 dealing with transfer pricing).

The United Nations and OECD Commentaries deal in detail with CFC rules, indicating that such rules are not a violation of the provisions of tax treaties and do not have to be explicitly referred to in tax treaties. However, the Commentaries do not discuss other specific anti-avoidance rules, such as thin capitalization rules or earnings-stripping rules, that limit the deduction of interest expenses. Therefore, it is especially important for countries to consider whether the application of any particular domestic anti-avoidance rule needs to be expressly preserved in the countries' tax treaties.

3.3.4 The relationship between tax treaties and general anti-avoidance rules in domestic law

As discussed in section 3.3.1 above, in the case of a conflict between a general anti-avoidance rule in domestic law and the provisions of a tax treaty, the tax treaty should prevail in accordance with the principle *pacta sunt servanda.* However, often such conflicts can be avoided, for a variety of reasons, as discussed in section 3.3.2; in particular, where the provisions of a domestic law are consistent with the guiding principle in paragraph 22 of the United Nations Commentary on Article 1 and paragraph 61 of the OECD Commentary on Article 1, there will not be any conflict between the treaty and domestic law. Consequently, where a domestic GAAR applies to prevent a tax avoidance transaction, the tax treaty will not apply to prevent the application of the domestic GAAR.

Where a tax treaty includes a general anti-abuse rule, such as Article 29(9) of the United Nations and OECD Model Conventions, there should be no conflict between the domestic and the treaty GAARs as long as the two GAARs are reasonably consistent. Therefore, countries that intend to include a general anti-abuse rule in their tax

treaties should ensure that the domestic GAAR and the treaty GAAR are basically similar — i.e., that they both have a purpose test (the main purpose or one of the main purposes of the transaction is to obtain a tax or treaty benefit) and an interpretive test (the transaction is contrary to the purpose of the domestic legislation or tax treaty).

3.4 Specific Anti-Avoidance Rules in Tax Treaties

3.4.1 Introduction

Both the United Nations and the OECD Commentaries on Article 1 emphasize that specific anti-abuse rules in tax treaties are necessary to prevent treaty abuse even if a particular tax treaty includes a general anti-abuse rule. Moreover, both the United Nations and OECD Model Conventions contain several specific anti-avoidance rules, as listed and briefly described in section 3.4.2 below. However, both the United Nations and OECD Commentaries caution that countries should not rely exclusively on specific anti-avoidance rules to prevent treaty abuse (see United Nations Commentary, paragraph 48).

Specific anti-avoidance rules are appropriate in the following circumstances:

- the tax avoidance strategy is well known or can be anticipated,
- a specific anti-avoidance rule can be targeted narrowly at the tax avoidance strategy,
- a specific anti-avoidance rule will be effective in dealing with the particular tax avoidance strategy, and
- a specific anti-avoidance rule will provide greater certainty for tax officials and taxpayers.

For example, a specific anti-avoidance rule may be necessary where a domestic court has decided that a tax avoidance scheme using the provisions of a tax treaty is not prevented by domestic anti-avoidance rules or by the proper interpretation of the treaty. In each case, it is necessary for tax officials to carefully consider the best possible approach to combat a particular tax avoidance scheme.

The primary disadvantage of specific anti-avoidance rules is that they often provide a roadmap for tax planners to develop schemes

that are not caught by the specific rules. This leads to the need to revise the specific anti-avoidance rules or for additional anti-avoidance rules. Since revised or new anti-avoidance rules require the agreement of the other contracting state and the amendment of the treaty, it will often be difficult for countries to respond quickly to new schemes involving the abuse of tax treaties. The only effective response to these difficulties is to add a general anti-abuse rule to a country's tax treaties that can be used to deter or prevent the development of avoidance strategies to take advantage of the provisions of tax treaties.

It is difficult to define specific anti-avoidance rules precisely or to distinguish between specific anti-avoidance rules and ordinary tax rules. For example, transfer pricing rules may be described as basic rules for dealing with prices in related-party transactions or as specific anti-avoidance rules. Similarly, the dependent PE provision in Article 5(5) can be seen as a basic tax rule or as a specific anti-avoidance rule to prevent taxpayers from using dependent agents to carry on business rather than carrying on business through a fixed place of business. For the purposes of this Portfolio, it is unnecessary to distinguish precisely between basic tax provisions and specific anti-avoidance rules since nothing of importance depends on that distinction. Consequently, the approach taken in this Portfolio is to consider specific anti-avoidance rules to include those rules that are generally treated as anti-avoidance rules.

3.4.2 Specific anti-avoidance rules in the United Nations and OECD Model Conventions

This section contains a list with a brief description of the specific anti-avoidance rules in the United Nations and OECD Model Conventions. Most of the specific anti-avoidance rules in the United Nations Model Convention are also contained in the OECD Model Convention; however, there are minor differences between the two Models in this regard. As noted below, developing countries should try to include all these specific anti-avoidance rules in their tax treaties as a matter of course, unless there is some convincing reason not to do so.

The United Nations and OECD Model Conventions contain the following specific anti-avoidance provisions:

- Article 1(2) to prevent the use of hybrid entities to obtain inappropriate tax benefits,
- Article 1(3) to prevent tax treaties from preventing a country from taxing its own residents,
- Article 4(3), which denies treaty benefits to a dual-resident entity if the competent authorities cannot agree on the state in which the entity is resident for purposes of the treaty,
- Article 5(4.1) to prevent splitting activities among related entities in order to take advantage of the exception for preparatory or auxiliary activities,
- Article 9 dealing with transfer pricing,
- Article 10(2)(a), adding a 365-day holding period requirement for access to the lower rate of tax on dividends,
- The beneficial-owner requirement in Articles 10(2), 11(2), 12(2) and 12A(2);
- Articles 11(6), 12(6) and 12A(7) dealing with excessive payments where a special relationship exists between the parties,
- Article 13(4) and (5), adding a 365-day period for testing whether more than 50 percent of the value of interests in an entity is attributable to immovable property or whether a taxpayer holds a substantial interest in an entity,
- Article 17(2) to prevent income of an entertainer or athlete from being assigned to another person,
- Article 29(1)-(7) to deny treaty benefits to residents in certain circumstances, and
- Article 29(8) denying treaty benefits in certain triangular cases.

In addition, the Commentary on both the United Nations and OECD Model Conventions provides several alternative specific anti-avoidance rules that countries might consider including in their treaties.

3.4.3 Anti-conduit rules

As noted in section 3.6 below, the BEPS Final Report on Action 6 mandated a minimum standard for countries to meet in order to prevent their tax treaties from being used improperly to avoid tax and allowed the minimum standard to be met in 3 different ways:

- a general anti-abuse rule, such as Article 29(9),
- a general anti-abuse rules and a limitation-on-benefit rule, such as Article 29(1)-(7), or
- limitation-on-benefits rules plus anti-conduit rules.

Most countries have chosen to satisfy the minimum standard by adopting a general anti-abuse rule, alone or in combination with limitation-on-benefits rules, as indicated by country positions on the MLI (see http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm and see http://www.oecd.org/ctp/treaties/application-toolkit-multilateral-instrument-for-beps-tax-treaty-measures.htm for a toolkit for the application of the MLI to exsiting tax treaties).

Countries that do not adopt a general anti-abuse rule must adopt anti-conduit rules, either in their domestic law or in their tax treaties, to supplement the limitation-on-benefits rules. The Commentary does not provide the wording of anti-conduit rules that countries could include in their tax treaties; instead, the Commentary gives 6 examples of situations in which anti-conduit rules should and should not apply. These examples indicate that abusive conduit arrangements often involve transactions to avoid withholding taxes or to obtain the benefit of reduced withholding taxes through artificial arrangements that are contrary to the purpose of the relevant provisions of domestic law or an applicable tax treaty. The analysis of whether a conduit arrangement is abusive is made in accordance with the same two-step analysis under Article 29(9): first, is one of the principal purposes of the arrangement to reduce or avoid tax, and second, is that reduction or avoidance of tax contrary to the purpose of domestic tax law or the tax treaty.

3.4.4 Specific Anti-Avoidance rules in bilateral tax treaties

As mentioned in section 3.4.3 above, many of the specific anti-avoidance rules included in the United Nations and OECD Model Conventions and the alternative anti-avoidance provisions in the Commentaries have been included in many actual bilateral tax treaties. Often these specific anti-avoidance rules have been modified by the contracting states to suit their particular needs. For example, the limitation-on-benefits included in bilateral treaties vary enormously. Some countries

may want to have broad robust limitation-on-benefits but other countries may not want to have such rules at all. The results of negotiations between countries with different positions on the need for protection against treaty abuse will inevitably result in specific anti-avoidance provisions in their treaties that differ from the standard provisions in the United Nations and OECD Model Conventions.

A detailed discussion or even an inventory of specific anti-avoidance rules found in bilateral tax treaties is well beyond the scope of this Portfolio. Developing countries should be cautious about including specific anti-avoidance provisions in their tax treaties that are different from the rules included in the United Nations and OECD Model Conventions or in their Commentaries because such rules may not have recieved the same type of scrutiny as the rules included in the Model Conventions and their Commentaries.

3.5 Interpretation of Tax Treaties to Prevent Treaty Abuse

Article 31 of the Vienna Convention on the Law of Treaties provides that treaties should be interpreted in good faith in accordance with the ordinary meaning of the words, the context of the treaty and in light of the purpose of the treaty. One of the purposes of tax treaties, as demonstrated by the title and preamble of both the 2017 United Nations and OECD Model Conventions and their Commentaries on Article 1, is to prevent tax avoidance. The title and preamble of a treaty form part of the context of the treaty and are therefore relevant in interpreting the provisions of the treaty. As discussed above in section 3.3.2, the provisions of the Commentaries on the United Nations and OECD Model Conventions are also relevant in interpreting tax treaties in most countries, and in many countries they are considered to have substantial weight.

Therefore, as acknowledged in paragraph 52 of the Commentary on Article 1 of the United Nations Model Convention, it is clearly possible for tax officials and courts to use a purposive approach to interpretation based on Article 31 of the Vienna Convention to interpret the provisions of tax treaties to prevent treaty abuse. For countries that have a judicial tradition of interpreting domestic tax legislation to prevent tax avoidance, tax officials and courts are likely to adopt a similar interpretive approach to preventing treaty abuse.

The United Nations Commentary on Article 1 (paragraph 53) suggests that the guiding principle in paragraph 22 of the United Nations Commentary on Article 1 should be relevant in interpreting tax treaties to prevent treaty abuse. The guiding principle provides that treaty benefits can be denied with respect to transactions or arrangements if one of the main purposes of the transaction or arrangement is to get the benefit of a tax treaty and granting that benefit would be contrary to the object and purpose of the treaty. In effect, this guiding principle is a general anti-abuse rule that is inherent in the provisions of a tax treaty based on the interpretation of the provisions of the treaty in good faith in accordance with Article 31 of the Vienna Convention. It is inconceivable that the provisions of a treaty could be interpreted in good faith in light of its purpose and nevertheless allow treaty abuse. The basic assumption underlying this interpretive approach is that the contracting states do not intend their tax treaties to be abused by taxpayers.

However, it is unclear whether the courts of countries that do not have a judicial tradition of interpreting tax legislation in a purposive manner will nevertheless interpret tax treaties to prevent treaty abuse. For countries that have a judicial tradition of interpreting tax legislation literally, it is possible for the courts of such countries to justify a literal interpretation of tax treaties under Article 31 of the Vienna Convention. As a result, there is a risk for such countries that their courts might not interpret tax treaties to prevent treaty abuse, but might instead interpret those tax treaties to prevent the application of domestic anti-avoidance rules and thereby facilitate treaty abuse. These countries cannot rely on the interpretation of their tax treaties to prevent treaty abuse and need to take more direct action, such as including specific anti-avoidance rules and a general anti-abuse rule in their tax treaties, to prevent treaty abuse.

3.6 General Anti-Abuse Rules in Tax Treaties

3.6.1 Introduction

As discussed in Chapter 2, section 2.1 above with respect to domestic GAARs, the essential difference between a general anti-abuse rule and specific anti-avoidance rules is that a general anti-abuse rule is

potentially applicable to any and all types of treaty abuse; a treaty general anti-abuse is not limited to particular types of income, taxpayers, transactions or provisions of the treaty. Using this definition, treaty GAARs were relatively rare in tax treaties prior to the addition of a treaty GAAR to the United Nations and OECD Model Conventions in 2017. The pre-2017 United Nations Commentary on Article 1 referred to treaty GAARS in two bilateral tax treaties (paragraphs 34 and 35) one of which gave the competent authorities the right to deny treaty benefits in abusive cases and the other of which provides that nothing in the treaty prevents the contracting states from denying treaty benefits in abusive cases.

Although the United Nations and OECD Model Conventions did not include a general anti-abuse rule before 2017, the Commentaries on Article 1 of both Model Conventions provided a treaty GAAR as an alternative rule that countries could include in their treaties if their domestic laws and the interpretation of tax treaties did not provide sufficient protection against treaty abuse. The treaty GAAR included in paragraph 36 of the United Nations Commentary on Article 1 provided as follows:

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

Not surprisingly, this treaty GAAR is based on and closely follows the guiding principle referred to in paragraph 23 of the United Nations Commentary on Article 1 before 2017. Moreover, the general anti-abuse rule added to the United Nations Model Convention as Article 29(9) in 2017 is remarkably similar to the alternative GAAR provision previously included in the Commentary.

Notably, however, the Commentary with respect to the alternative GAAR suggests that some countries may wish to substitute a test based on "the main purpose" of a transaction or arrangement to limit the application of the GAAR to primarily tax-motivated transactions. The prior Commentary emphasizes that countries with large

treaty networks should be cautious about adopting a treaty GAAR in one or a few of its tax treaties because of the risk that such a provision would create a negative implication with respect to its other treaties that do not include a GAAR. Therefore, the prior Commentary on the alternative provision concluded that "the use of such a provision would probably be considered primarily by countries that have found it difficult to counter improper uses of tax treaties through other approaches." (paragraph 37)

The G20/OECD BEPS Final Report on Action 6, *Preventing Treaty Abuse* established a minimum standard for OECD and G20 member countries to adopt to deal with treaty abuse. Countries must meet the minimum standard as a condition for participating in the Inclusive Framework, which had over 100 members as of early 2018. The minimum standard with respect to treaty abuse has three elements:

- the title for tax treaties must include the prevention of tax avoidance as one of the purposes of the treaty;
- the preamble for tax treaties must recite that the treaty is not intended to facilitate treaty abuse including through treaty shopping; and
- countries must include substantive provisions in their tax treaties to deal with treaty abuse consisting of one of the following three options:
  - a general anti-abuse rule (referred to as a principal purpose test or PPT), or
  - a general anti-abuse rule plus a limitation-on-benefits provision, or
  - a limitation-on-benefits provision plus anti-conduit financing rules.

3.6.2 Article 29(9) of the United Nations and OECD Model Conventions

Article 29(9) of the both the United Nations and OECD Model Conventions reads as follows:

> 9. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is

> reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

Certain important features of Article 29(9) are apparent from its wording. First, it applies broadly to any "benefit" under the treaty with respect to an item of income or capital. Second, it prevails over other provisions of the treaty ("Notwithstanding the other provisions of this Convention"). Third, it applies to any "arrangement or transaction" that results in a benefit under the treaty. Fourth, it applies to such an arrangement or transaction if one of its principal purposes was obtaining that benefit. Fifth, it does not apply if the benefit is in accordance with the object and purpose of the relevant provisions of the treaty. These features of Article 29(9) are also found in several domestic GAARs as discussed below in Part 3, Chapter 2 although typically domestic GAARs are more detailed than Article 29(9).

As noted in section 3.6.1, Article 29(9) is similar to the treaty general anti-abuse rule presented as an alternative provision in the pre-2017 United Nations Commentary on Article 1. Both rules contain the basic elements mentioned above, except that the alternative provision did not provide explicitly that it prevailed over any other provisions of the treaty. There are several other subtle between Article 29(9) and the alternative general anti-abuse rule in the prior Commentary:

- The alternative provision states that it applies only if "it may reasonably be considered" that a main purpose of a transaction was to obtain treaty benefits whereas Article 29(9) applies only "if it is reasonable to conclude, having regard to all relevant facts and circumstances" that one of the purposes of a transaction was to obtain treaty benefits. The wording of both provisions appears to be intended to emphasize that the determination of whether the purpose test (i.e., one of the purposes of a transaction is to obtain a treaty benefit) must be made on the basis of objective facts and not just the subjective intention of the taxpayer. Article 29(9) is preferable in this regard because it includes a reference to "all relevant facts and circumstances."

- The alternative provision refers to "benefits provided by" the treaty, but Article 29(9) is more precise in referring to benefits in respect of an item of income or capital.
- The alternative provision uses "a main purpose" test whereas Article 29(9) uses a "one of the principal purposes" test. There would not appear to be any significant difference between these two formulations of the purpose test.
- It is implicit in the alternative provision that the transaction or arrangement results in the treaty benefit; however, Article 29(9) makes this requirement explicit and extends it to situations in which the treaty benefit results directly or indirectly.
- The requirement that the treaty benefit is contrary to the object and purpose of the treaty is structured as an additional condition for the application of the alternative provision whereas in Article 29(9) this requirement is structured as an exception ("unless it is established . . .")
- The onus of establishing that granting the benefit of the treaty would be contrary to its object and purpose is placed expressly on the taxpayer; in other words, treaty benefits will be denied unless the taxpayer who claimed the benefit establishes that the benefit is consistent with the purpose of the relevant provisions of the treaty. In contrast, under the guiding principle in the Commentary on Article 1, the condition that a treaty benefit is contrary to the purpose of the treaty is expressed in a neutral fashion without any explicit onus on either the taxpayer or the tax authorities.

These differences do not appear to reflect any significant intentional differences in the meaning of the two rules. However, the wording of Article 29(9) is preferable because it is clearer and more likely to prevent tax officials and courts from giving the treaty anti-abuse rule an inappropriate interpretation.

3.6.3 The Commentary on Article 29(9) of the United Nations Model Convention

As noted above, Article 29(9) is a brief, simple general anti-avoidance rule. However, the Commentary on Article 29(9) provides important

guidance with respect to the interpretation and application of the rule, including a series of examples. In general, the United Nations Commentary on Article 29(9) reproduces the OECD Commentary on Article 29(9). In addition, the Commentary on Article 29(9) states explicitly that Article 29(9) mirrors the Commentary on Article 1, including the guiding principle in paragraph 22, and incorporates that principle into the text of the convention for those countries whose domestic law does not allow them to effectively attack treaty abuse (paragraph 37, quoting paragraph 169 of the OECD Commentary on Article 29(9).

The Commentary clarifies that the general anti-abuse rule in Article 29(9) is intended to supplement the limitation-on-benefit rules in Article 29(1)-(7) of the United Nations Model Convention (paragraphs 171 and 172). This principle should be equally true of other specific anti-abuse rules in the United Nations Model Convention. In addition, Article 29(9) is not intended to limit the application of the limitation-on-benefit rules or to be limited by those rules. The Commentary provides an example (in paragraph 37, quoting paragraph 173 of the OECD Commentary on Article 29(9)) of how Article 29(9) should be applied in the context of Article 29 and the provisions of the Model Convention read as a whole. A public company whose shares are regularly traded on a recognized stock exchange in the company's country of residence is a "qualified person" under Article 29(2). Treaty benefits should not be denied to such a company under Article 29(9) because of the ownership of its shares by residents of the other country; however, treaty benefits could be denied for other reasons, for example where the public company entered into treaty-shopping transactions.

Although many important terms in Article 29(9) are undefined, the Commentary provides guidance as to how these terms should be interpreted:

- the term "benefit" includes all limitations on taxation under Articles 6-22, relief from double tax under Article 23, and non-discrimination protection under Article 24 (paragraph 175);
- the benefit may result "directly or indirectly" from a transaction or arrangement; this wording is intended to be broad and to include situations in which the treaty benefit is directly related

to a valid commercial transaction but arose because of another transaction. For example, if an interest-bearing loan is assigned to a company resident in a country with a treaty that exempts interest from withholding tax, the loan may be a legitimate commercial transaction none of the purposes of which was to generate treaty benefits; however, the assignment of the loan indirectly results in the treaty benefit (paragraph 176).

- the phrase "transaction or arrangement" is intended to be interpreted broadly to include any agreement, understanding, scheme, or series of transactions, whether or not legally enforceable. It is important for Article 29(9) to potentially apply to both a single transaction or a series of transactions, since most sophisticated tax-avoidance schemes involve arrangements with multiple related transactions (paragraph 177). The Commentary does not, however, provide any elaboration of the meaning of a series of transactions, despite the fact that this concept raises many difficult issues that domestic GAARs have attempted to deal with. See the discussion of the concept of a series of transactions below in Part 3, section 4.2.2.
- The one of the principal purposes condition in Article 29(9) means that a transaction or arrangement is subject to the rule if at least one principal purpose for the transaction or arrangement was to obtain the benefit, even where there are one or more other principal purposes for the transaction or arrangement that have nothing to do with benefits under the treaty (paragraph 180). In effect, the one of the principal purposes condition will be satisfied only if none of the main purposes of a transaction or arrangement is to obtain the treaty benefit. See the detailed discussion of purpose tests in Part 4, section 4.4.
- The purpose test in Article 29(9) should be applied based on an objective analysis of all relevant facts and circumstances of each particular case. This requires objective consideration of the purpose of "all persons putting that arrangement or transaction in place or being a party to it" (paragraph 178).
- Where benefits are obtained under multiple treaties (or, similarly, where multiple benefits are obtained under one treaty), obtaining one benefit should not prevent a finding that one of the principal purposes of the transaction was obtaining any

other benefit. Similarly, just because a transaction also results in domestic tax benefits should not prevent a finding that one of the principal purposes of the transaction was obtaining a treaty benefit (paragraph 181).

The OECD Commentary on Article 29(9) goes on in paragraph 183 to provide 13 examples that show how Article 29(9) should be applied. An additional example that relates to the unique provisions of the United Nations Model Convention is provided in paragraph 38 of the United Nations Commentary on Article 29(9). These examples are helpful at a basic level; however, actual tax avoidance schemes involving tax treaties are often much more sophisticated than the ones provided by the Commentary. A detailed review of the examples in this Portfolio is unnecessary, but a brief summary of the basic principles that can be extracted from them is provided below.

First, it is clear from the examples that the one of the principal purposes condition in Article 29(9) will be easily satisfied in most cases. As a result, the crucial issues in most cases will be whether granting treaty benefits with respect to a particular transaction or arrangement is contrary to the purpose of the relevant provisions of the treaty.

Where a significant treaty benefit results from a transaction or arrangement, it is extremely unlikely that the taxpayer would not have considered that benefit in deciding whether to enter into the transaction or arrangement. Example C is the only example in the Commentary in which it is suggested that it would not be reasonable to conclude that one of the principal purposes of a transaction is to obtain treaty benefits. Example C involves a company that decides to build a manufacturing plant in a country that has a tax treaty with the company's country of residence, rather than in another country without such a treaty. According to the analysis in the Commentary, even though the decision to build the plant in the treaty country is taken in light of the benefits of the treaty, those benefits are not one of the principal purposes for the investment in that country. This conclusion may be problematic, and it may be preferable to conclude that Article 29(9), does not apply on the basis that choosing to invest in a country because of a treaty is clearly consistent with the purpose of the treaty to encourage cross-border investment.

Second, a commercial investment in a treaty country in the form of the establishment or acquisition of a company or other entity

resident in that country, the acquisition of shares in a company or interest in another entity resident in a treaty country, or the acquisition of property in a treaty country will not generally be considered to be a violation of Article 29(9). Such investments are consistent with the purposes of tax treaties. (See examples D, F, G, H, I, K, L and M.)

Third, treaty-shopping arrangements will generally be considered to be abusive and Article 29(9) will apply to such arrangements. (See examples A and B.) The difficulty is deciding whether a particular arrangement is an abusive treaty-shopping arrangement.

Fourth, a genuine acquisition of shares in order to meet an ownership threshold in a treaty (for example, the 25 percent shares ownership threshold to get the lower rate of withholding on dividends in Article 10(2)(a)) is not abusive. (See example E.) Although one of the main purposes of the acquisition is clearly to get the benefit of the lower rate, the acquisition is not contrary to the purpose of Article 10(2)(a). That provision establishes a bright-line test for access to the lower rate. As long as a taxpayer owns the necessary percentage of shares for the required period, the treaty benefit should be available. It should not matter if the taxpayer originally acquires the necessary percentage in one transaction or does so in stages over a period of years. However, if the acquisition is part of a series of transactions whereby, for example, the taxpayer is obligated to dispose of the shares shortly after receiving the dividend, or where the taxpayer does not have the risks and rewards of ownership of the shares, Article 29(9) may well apply.

A similar analysis would apply to transactions or arrangements designed to avoid or take advantage of other treaty thresholds. See Example N, in which a taxpayer limits its services provided in a treaty country to less than 183 days in order to avoid having a PE in that country under Article 5(3)(b) of the United Nations Model Convention. This type of arrangement is not abusive. However, if the taxpayer enters into a contract-splitting arrangement with a related party under which services are provided in the treaty country for more than 183 days in the aggregate, even though each party provides services in the country for less than 183 days, that arrangement could be abusive because it is contrary to the fundamental purpose of the time threshold in Article 5(3)(b).

The Commentary suggests that countries may wish to adopt some type of approval process for the application of Article 29(9). Many countries have such a process for the application of their domestic GAARs, as discussed in Part 4, section 4.4 (paragraph 39, quoting paragraph 183). The Commentary also provides an alternative provision that allows the competent authorities to grant treaty benefits that would otherwise be disallowed under Article 29(9) where those benefits would have been available to the taxpayer if the tax avoidance scheme had not been entered into (paragraph 39, quoting paragraphs 184-186).

Some countries may wish to add this provision to their treaties to accompany Article 29(9), which is a blunt instrument with respect to the determination of the tax consequences where it applies — where Article 29(9) applies, the benefits of the treaty resulting from the transaction or arrangement are simply denied. In contrast, the tax authorities sometimes have broad discretion to determine the appropriate tax consequences where a domestic GAAR applies. Similar discretion may be appropriate with respect to a treaty GAAR; however, a treaty GAAR that simply denies the benefits of a treaty where it applies may serve as an effective deterrent to abusive treaty arrangements.

The United Nations Commentary on Article 29(9) concludes with a reiteration of the need for countries to establish administrative mechanisms for the interpretation and application of treaty general anti-abuse rules so that these rules will both protect the domestic tax base and minimize uncertainty for taxpayers (paragraph 40). A similar caution is found in paragraphs 49 and 122 of the Commentary on Article 1.

In particular, the Commentary raises the following possibilities for minimizing uncertainty:

- an approval process for the application of Article 29(9)
- a rulings procedure
- administrative guidance as to how the tax authorities intend to apply a treaty GAAR
- a strong, independent judicial system
- the availability of an effective mutual agreement procedure to resolve disputes with respect to treaty GAARs

3.6.4 The Multilateral Convention to Implement the BEPS Treaty Measures

One of the potential disadvantages of adopting a general anti-abuse rule in one or a few of a country's tax treaties is the risk of creating a negative implication that the country's tax treaties that do not contain a general anti-abuse rule allow treaty abuse or at least cannot be interpreted to prevent treaty abuse. If there is a serious risk that a country's courts may take this approach, the country is placed in a difficult position. If it includes the general anti-abuse rule in one treaty, taxpayers will not be able to use that treaty to reduce or avoid the country's tax. However, the protection added to that particular treaty may mean that the country's other treaties may be interpreed to permit tax avoidance. One obvious solution to this risk is for the country to add a general anti-abuse rule to all its tax treaties. However, if a country has a sizeable tax treaty network, it may take many years to renegotiate all the treaties. Furthermore, this assumes that the country's treaty partners will readily agree to include a general anti-abuse rule in the treaties, which may or may not be true depending on the treaty partners.

The OECD/G20 BEPS Project recognized the difficulties involved in renegotiating many treaties to include the revisions to tax treaties recommended by BEPS Action 6 to prevent treaty abuse. Therefore, BEPS Action 15 proposed that these changes should be implemented through a multilateral convention (often referred to as the multilateral instrument or MLI).[6] The MLI was released on November 24, 2016 and in June 2017 over 70 countries signed the MLI.

The MLI applies only to those tax treaties that a country signing the MLI chooses to be modified by the MLI (referred to as "Covered Tax Agreements"). A particular tax treaty will be modified by the MLI only if both contracting states sign the MLI and list the treaty as a Covered Tax Agreement. Furthermore, there must be a match between the positions of the contracting states with respect to the modification of the particular provision of the treaty as explained below. The general anti-abuse rule or PPT contained in Article 29(9) of the United Nations and OECD Model Conventions is set out in Article 7(1) of the MLI:

[6] *Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting* (November 2016).

> 1. Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.

If both contracting states accept the general anti-abuse rule in Article 7(1) of the MLI, their tax treaty will be modified to add the general anti-abuse rule or replace any existing purposed-based anti-avoidance rules (Article 7(2) of the MLI). If, however, one of the states enters a reservation under Article 7(15)(a) not to apply a general anti-abuse rule, the states are obliged under Article 7(16) only "to endeavour to reach a mutually satisfactory solution which meets the minimum standard." Thus, it is possible for the two states to agree that one state will use a treaty general anti-abuse rule to prevent treaty abuse but the other state will use limitation-on-benefits rules plus anti-conduit rules.

Under Article 7(4) of the MLI, a country can choose to allow the competent authorities to grant treaty benefits even in situations where those benefits would be denied under the general anti-abuse rule (see the discussion of this alternative provision in paragraph 39 of the Commentary on Article 29(9) (quoting paragraphs 1186 of the OECD Commentary on Article 29(9)) in section 3.6.3 above. Under Article 7(17)(b) of the MLI, Article 7(4) will apply to modify a treaty only if both contracting states agree. Under Article 7(6), a country can choose to apply a simplified limitation-on-benefits provision, as set out in Article 7(8) to (13) of the MLI, to its Covered Tax Agreements in addition to the general anti-abuse rule. If a country chooses to apply a simplified limitation-on-benefits provision, its Covered Tax Agreements will be modified to that extent even if the other contracting state does not choose to do so as long as it consents to the application of the limitation-on-benefits provision by the other state (Article 7(7)).

Chapter 4

Risks of Tax Avoidance Involving Tax Treaties

As detailed in section 3.1.2 above, tax treaties can be used inappropriately to reduce or avoid domestic tax in a wide variety of ways. Some of these abuses of tax treaties can be dealt with through domestic law and some can be dealt with through the provisions of tax treaties themselves. For most countries, the first line of defence is domestic specific anti-avoidance rules and for other countries, a general anti-avoidance rule. A few countries rely on their courts to police tax avoidance through tax treaties. However, there is a serious risk for many countries that these aspects of domestic law to prevent treaty abuse may be ineffective because of the *pacta sunt servanda* principle that tax treaties prevail over provisions of domestic law in the event of a conflict between the two. This risk is more or less serious depending on when a particular tax treaty was entered into because the Commentary on the United Nations and OECD Model Conventions dealing with treaty abuse has varied significantly over the years, as discussed in detail in section 3.3.2.

If a treaty was entered into before 2003 (for treaties for which the OECD Commentary is relevant in interpreting the treaty) or before 2011 (for treaties for which the United Nations Commentary is relevant), the version of the United Nations or OECD Commentary on Article 1 applicable at that time suggested that, unless the treaty itself contained anti-avoidance rules or a provision allowing the application of domestic anti-avoidance rules, the provisions of the treaty might preclude the application of any domestic anti-avoidance rules. This risk is even greater for tax treaties entered into before 1992 (for treaties for which the OECD Commentary is relevant) or before 2001 (for treaties for which the United Nations Commentary is relevant).

However, even for treaties concluded at a time when the Commentary applicable at that time was clear that there is no conflict

between the provisions of the treaty and domestic anti-avoidance rules, and that treaties do not prevent the application of domestic anti-avoidance rules, there is still a risk that domestic courts may ignore the Commentary. If a country concludes that this risk is serious, the only feasible response is to renegotiate its treaties to include specific and general anti-avoidance rules in those treaties. Some countries may be able to make their domestic anti-avoidance rules applicable to their tax treaties by overriding those treaties through domestic legislation. However, many countries are unable to override their treaties in this way and, even if they have the constitutional authority to do so, such treaty overrides are generally viewed with disfavour, especially by a country's treaty partners. As suggested previously, even if a country includes a full complement of specific anti-avoidance rules in its tax treaties (all of the specific anti-avoidance rules in the United Nations Model Convention), there is a risk that taxpayers will be able to avoid the specific anti-avoidance rules and use the country's tax treaties to avoid tax. The response to this risk is for the country to include a GAAR in its tax treaties.

As discussed in section 3.6.4 above, the inclusion of a GAAR in the form of Article 29(9) of the United Nations and OECD Model Conventions in a country's tax treaties in an efficient manner has been facilitated by the MLI. Therefore, countries for which there is a risk of treaty abuse as a result of the absence of a treaty GAAR should carefully consider the possibility of signing the MLI, at least with respect to Articles 6 and 7 dealing with treaty abuse.

Part 3

Designing and Drafting a Statutory General Anti-avoidance Rule

Chapter 1

Introduction

Part 2 of this Portfolio analyzed the risks of tax avoidance for developing countries and the possible responses that they might take to combat such tax avoidance. The basic conclusion from the analysis in Part 2 was that tax avoidance required a comprehensive range of responses including better enforcement of domestic tax laws and administration of tax treaties, better drafting of domestic tax laws and tax treaties, specific anti-avoidance measures and general anti-avoidance rules in both domestic law and tax treaties. With respect to general anti-avoidance rules, Part 2 concluded that specific anti-avoidance rules are not sufficient in themselves and that a GAAR is a necessary part of a country's response to tax avoidance. Similarly, the addition of a general anti-abuse rule, Article 29(9), to both the United Nations and the OECD Model Convention in 2017 was based on the same conclusion with respect to tax treaties (see paragraph 51 of the United Nations Commentary on Article 1). Therefore, there appears to be widespread agreement that countries should have a statutory GAAR as part of their domestic law unless the courts have adopted judicial anti-avoidance rules of general application.

This Part of the Portfolio provides detailed guidance with respect to the design and drafting of a domestic statutory GAAR. It begins with a discussion in chapter 2 of the underlying principles that should be considered by a country in developing a domestic GAAR. Chapter 3 provides a detailed examination of the major features of a domestic GAAR and the options that countries might adopt with respect to these features. These options are generally based on aspects of the actual GAARs of several countries, which are reproduced in an appendix for convenient reference. Chapter 4 provides two sample GAARs—one detailed and the other a simplified version—with

explanatory notes. These sample GAARs are not presented as a recommendation that countries should adopt, but as examples or templates that countries might use as guidance in designing and drafting their GAARs and modify to suit their own particular circumstances. Chapter 5 deals with the inclusion of a general anti-abuse rule in a country's tax treaties.

The adoption of a general anti-avoidance rule often generates strong emotions from taxpayers and tax advisers who can be expected to pressure the government not to adopt a GAAR or to ensure that the GAAR is not very effective. It may be appropriate for tax policy officials to consult with taxpayers and tax advisers about whether a GAAR should be adopted and, if so, how it should be drafted.

Chapter 2

Underlying Tax Policy Principles for a Statutory GAAR

2.1 Introduction

This chapter discusses the major underlying tax policy principles that should be followed in developing a statutory GAAR. These considerations should not be viewed as inflexible recommendations, but rather as guidance as to the fundamental tax policy principles that should be carefully examined in designing and drafting a domestic GAAR. Each country must decide for itself which underlying principles should guide the development of a statutory GAAR. As will be seen, the principles sometimes conflict making it necessary for tax policy officials to balance competing considerations.

2.2 A GAAR should be broad enough to deal with all forms of abusive tax avoidance

As the word "general" in the term "general anti-avoidance rule" signifies, a GAAR should apply to all types of tax avoidance; otherwise, the rule will be subject to the inadequacies and deficiencies of specific anti-avoidance rules as described in Part 2, Chapter 2, sections 2.4.1 and 2.5.4 above. Thus, a GAAR should potentially apply to:

- all transactions or arrangements that may result in the reduction, avoidance or deferral of tax payable or other relevant amounts, such as installments of tax;
- all types of income and expenses;
- all tax deductions, credits, allowances, etc. in computing income, taxable income or tax payable;
- individuals, corporations and all other taxpayers; and
- domestic and cross-border transactions and arrangements.

2.3 A GAAR should distinguish between abusive tax avoidance transactions and legitimate commercial transactions

A GAAR is intended to prevent abusive tax avoidance transactions; it is not intended to prevent or discourage legitimate commercial transactions. Therefore, a GAAR must distinguish in some manner between the two types of transactions. This distinction is one of the most important features of any GAAR. However, it is extremely difficult to formulate objective criteria for making the distinction because neither abusive tax avoidance transactions nor legitimate commercial transactions can be defined precisely. As discussed in Part 3, chapter 3 below, various terms are used by countries in their GAARs to describe transactions that are subject to the GAAR: abusive, artificial, impermissible, illegitimate, and unacceptable. All these terms are conclusory; they do not provide objective criteria that can be applied to determine whether a transaction is abusive or legitimate.

2.4 A purpose test in a GAAR should be objective to the maximum extent possible

Most GAARs contain a purpose test. Typically, a GAAR applies to a transaction only if the primary purpose or one of the primary purposes of the transaction (or the taxpayer's purpose in entering into or carrying out the transaction) is to avoid tax. Tax consequences are usually determined on the basis of the legal, economic, and financial results of transactions. Nevertheless, most tax systems have provisions that depend on a taxpayer's purpose or the purpose of a transaction; for example, many countries have provisions that allow the deduction of expenses only if they are incurred for the purpose of earning income.[7]

[7] A purpose test rather than a results test (that is, expenses are deductible only if income actually results from the expenses) is used because, under a results test, expenses would not be deductible if the taxpayer incurs a loss—in other words, a results test would penalize risky business ventures. See for example Canada, Income Tax Act, section 18(1)(a): "In computing the income of a taxpayer from a business or property no deduction shall be made in respect of (a) an outlay or expenses except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property."

These provisions are usually applied by reference to objective facts and circumstances although the taxpayer's intention may also be relevant.

With respect to a GAAR, it is difficult, if not impossible, to distinguish between abusive tax avoidance transactions and legitimate commercial transactions solely on the basis of the tax results of the transactions, since both types of transactions usually result in the reduction of tax. For this reason, most GAARs are based, at least in part, on the purpose of a transaction. If the main purpose of a transaction or one of the main purposes of a transaction is exclusively or primarily to reduce or avoid tax, it is potentially subject to the GAAR (if the other conditions for the application of the GAAR are met); in contrast, if the sole or primary purpose of a transaction or none of the main purposes of a transaction is something other than tax avoidance, the GAAR does not apply.

A test based on the purpose of a transaction is different from a test based on a taxpayer's motive or intention. A taxpayer's subjective motive or intention is generally a subsidiary consideration for tax purposes; tax consequences are generally determined on the basis of what taxpayers actually do rather than why they do it and certainly not what taxpayers say about why they did something. Although a taxpayer's testimony as to his or her subjective purpose in carrying out a transaction may be relevant in the determination of the purpose of the transaction, it should not be determinative — taxpayers will invariably say that their transactions were carried out solely or primarily for non-tax reasons if that is to their benefit.

2.5 The relationship between a GAAR and other rules including specific anti-avoidance rules

The relationship between a GAAR and other statutory provisions, especially specific anti-avoidance rules, is controversial. From the government's perspective, it may seem that the GAAR should prevail over other provisions in the event of a conflict in the same way that the treaty anti-abuse rule in Article 29(9) applies "Notwithstanding the other provisions of this Convention." However, taxpayers will argue that if a transaction complies with all the specific anti-avoidance rules in the tax law, it cannot reasonably be considered to be abusive and contrary to the object, spirit and purpose of the tax statute. They may

also point to a rule of interpretation that applies in some countries that any conflict between a specific provision and a more general provision should be resolved in favour of the more specific provision. However, under this view a GAAR is completely unnecessary because it could never apply: if a specific anti-avoidance provision applied to a transaction, it would be unnecessary to apply the GAAR; and if a transaction passed all the specific anti-avoidance rules, the GAAR could not apply.

Neither of these positions is appropriate. A GAAR must prevail over or supplement other statutory provisions — in particular, specific anti-avoidance rules — in some circumstances, but specific anti-avoidance rules should prevail over the GAAR in other circumstances. The priority accorded to the GAAR is essential, since a fundamental reason for a GAAR is that specific anti-avoidance rules are insufficient to deal with abusive tax avoidance transactions. Therefore, the GAAR should potentially apply in some circumstances even where an avoidance transaction complies with the other provisions of the tax legislation.

On the other hand, the GAAR should not necessarily apply to transactions whose primary purpose is to avoid tax if those transactions comply with all the other tax provisions. For example, most countries have enacted tax incentives to encourage taxpayers to make certain investments. Clearly, a GAAR should not apply to defeat the purpose of these explicit tax incentives despite the fact that the primary purpose, or one of the primary purposes, of an investment is to reduce tax by means of the tax incentive.

Similarly, in some circumstances, it will be appropriate for a GAAR to supplement a specific anti-avoidance rule in order to prevent taxpayers from avoiding that rule. However, in other circumstances, the GAAR should not apply to supplement a specific rule. The appropriate result often depends on the nature of the specific anti-avoidance rule. For example, if a country has a specific rule to deny the recognition of gains and losses from so-called "wash" sales (a sale of property that is accompanied by an acquisition of the same or similar property within a short time before or after the sale), which applies only to a sale and acquisition within a specified number of days, the GAAR arguably should not apply to a sale and acquisition that occurs outside that period. Such a wash-sale rule uses a bright-line test that

signals to taxpayers that, as long as they are on the right side of the bright-line, their transactions will be effective. Thus, it is questionable in this situation whether a GAAR should apply to a transaction on the right side of the line because it would undermine the certainty of the bright-line rule.

It is difficult to establish any general rule concerning the relationship between a GAAR and other statutory provisions. Thus, it will be the responsibility of the tax authorities in the first instance, and the courts ultimately, to determine on a case-by-case basis whether the GAAR or other specific provisions should prevail.

It may be tempting for countries to include an explicit provision that the GAAR prevails over other provisions (for example, "notwithstanding any other provisions of this Act"). Article 29(9), the general anti-abuse rule added to the United Nations and OECD Model Conventions in 2017, contains wording to this effect.[8] However, both Model Conventions differ from most countries' domestic legislation in two important respects. First, this type of wording is appropriate in the context of the Model Conventions because their provisions generally limit the taxing rights of the contracting states.[9] Second, if the contracting states do not want the general anti-abuse rule to prevail over a particular provision or provisions of the treaty, they can explicitly exclude those provisions from the notwithstanding clause ("notwithstanding any other provision of this Convention, other than …").

2.6 A GAAR should be a provision of last resort

A GAAR is an extraordinary rule that is designed to prevent abusive tax avoidance transactions; a GAAR should not be viewed as a rule to be used frequently and regularly as a basis for the assessment of tax. Therefore, a GAAR should apply only after all the other provisions of a country's tax legislation have been applied; if tax provisions, other than the GAAR, apply to prevent an abusive tax avoidance transaction

[8] See Article 29(9) of the United Nations and OECD Model Conventions, which is discussed above in Part 2, Chapter 3, section 3.6.3.

[9] It is well established that tax treaties do not generally confer taxing rights on the parties to the treaty; instead, they limit the taxes levied under their domestic laws.

from reducing tax, there is no need to apply the GAAR. Only if a transaction complies with all the other provisions of the tax law is it necessary to consider whether the GAAR applies to the transaction.

2.7 Simplicity

Although the interpretation and application of a statutory GAAR may involve considerable uncertainty, the wording of the rule itself should be relatively simple. Arguably, a statutory GAAR should not be drafted with the same type of detailed technical provisions that are characteristic of specific anti-avoidance rules.[10] A GAAR that is short and simple is more readily explained to the public and to the judges responsible for applying it. However, some tax officials and taxpayers may consider that a broad and simple GAAR is too uncertain and does not provide sufficient guidance to tax officials, taxpayers and the courts. Consequently, some countries have expanded their GAARs to include detailed rules with respect to some of the important indicia of abusive tax avoidance transactions, such as the participation of tax-indifferent parties and the absence of any significant change in the economic or financial position of the parties to a transaction.

2.8 The determination of tax consequences if a GAAR applies

If a GAAR applies to a transaction, it is usually inappropriate simply to disregard or ignore the transaction for the purpose of determining the tax consequences. In some circumstances, simply ignoring the transaction or transactions carried out by the taxpayer will not result in appropriate tax consequences. For example, assume that an avoidance transaction involves the transfer of property by a taxpayer to a related party in a manner that inappropriately avoids tax on the accrued gain in respect of the property. If the transfer is ignored, the taxpayer would be considered to still own the property and no tax on the accrued gain would be triggered. In this situation, it may be more appropriate to consider the taxpayer to have disposed of the property for its fair market value and to have realized a taxable gain.

[10] It is interesting to compare the GAARs in the Appendix in this regard.

Therefore, a statutory GAAR should provide rules for determining the tax consequences in any case in which the GAAR applies to a transaction. The difficulty in this regard is that it is impossible to prescribe in advance the appropriate tax consequences for every situation that might be subject to a GAAR. As a result, any provision that prescribes consequences must be sufficiently general to allow the tax authorities, subject to review by the courts as discussed in section 2.9 below, to tailor the tax consequences appropriately for each situation. A reasonable approach might be to have a general provision authorizing the tax authorities to determine the tax consequences for the taxpayer and any other relevant persons reasonably, together with a list of specific actions, such as disallowing deductions or exemptions, allocating income or gain to any person, determining the character of any amount, and ignoring or disregarding certain tax consequences, that the tax authorities can take to determine the tax consequences reasonably. (See section 3.7 below.)

2.9 Taxpayers should be entitled to appeal all aspects of a GAAR

As noted above in Part 2, Chapter 2, section 2.5.5, a GAAR involves a significant element of uncertainty, and this uncertainty gives considerable discretion to the tax authorities in applying the rule. To ensure that the tax authorities do not abuse this discretion, it is important for taxpayers to be able to appeal to the courts all aspects of the application of a GAAR, including whether the rule applies and the determination of the tax consequences where it applies. Transactions subject to a GAAR may involve multiple parties in addition to the particular taxpayer to whom the GAAR is applied. Any person affected by the application of the GAAR should also be granted rights to appeal.

2.10 The relationship between a GAAR and tax treaties

A fundamental principle of the law of treaties is that in the event of a conflict between the provisions of a treaty and the provisions of domestic law, the provisions of the treaty must prevail. (See Article 26 (Pacta Sunt Servanda) of the Vienna Convention on the Law of Treaties). Therefore, the critical question with respect to the relationship between a GAAR and tax treaties is whether there is any conflict

between a country's GAAR and the provisions of its tax treaties. This issue is discussed in detail above in Part 2, Chapter 3.

If a country adopts both a domestic GAAR and a treaty GAAR, those rules should be reasonably consistent. If the two GAARs are significantly different, it will create compliance difficulties for taxpayers and administrative difficulties for the tax authorities because they will be required to understand, interpret and apply two different rules to the same transactions. It seems more appropriate to apply the same general anti-abuse rule to protect domestic law and tax treaties from abusive tax avoidance transactions.

Chapter 3

The Major Features of a Statutory General Anti-avoidance Rule

3.1 Introduction

Typically, a GAAR applies to a transaction or arrangement if three conditions are met:

1) the transaction or arrangement results in a tax benefit,
2) the sole purpose, primary purpose or one of the primary purposes of the transaction or arrangement is to obtain the tax benefit, and
3) the transaction or arrangement frustrates, abuses, defeats or contravenes the underlying purpose of the relevant statutory provisions.

These three conditions, plus the definition of a transaction or arrangement, form the key elements of most GAARs, and are also the key elements of the general anti-abuse rule in Article 29(9) of the United Nations and OECD Model Conventions. The considerations involved in the design and drafting of these key elements are discussed below. In addition, the ancillary aspects of the application of a GAAR, such as the determination of the tax consequences, are also discussed briefly. The following discussion of each of the key elements of a GAAR refers to the GAARs of selected countries (which are reproduced in the Appendix) to illustrate the similarities and differences in the approaches that might be used to achieve the desired legislative result.

3.2 The definition of transaction and series of transactions

3.2.1 The definition of a transaction

In keeping with the underlying purpose of a GAAR, a GAAR should apply to anything that can possibly result in a reduction, avoidance or deferral of tax.

Typically, countries use terms such as "transaction," "arrangement" or "scheme" as the basic building block for identifying the target of a GAAR. These terms are usually defined very broadly. For example, the South African GAAR (section 80L, the definition of "arrangement") defines the term "arrangement" to mean "any transaction, operation, scheme, agreement or understanding (whether enforceable or not) including all steps therein or parts thereof . . . ." The Indian (section 102(1)) and United Kingdom (section 214) GAARs use similar definitions. The Canadian GAAR defines a "transaction" to include an arrangement or event (section 245(1), the definition of "transaction"); thus, "transaction" has its ordinary meaning and also means an arrangement or event. According to the United Nations Commentary on Article 29(9) (paragraph 37 quoting paragraph 177 of the OECD Commentary on Article 29(9)), the phrase "transaction or arrangement" used in Article 29(9) is intended to have a broad meaning and includes "any agreement, understanding, scheme, transaction or series of transactions whether or not they are legally enforceable." The Australian GAAR (section 177A(1)) and International Monetary Fund's (IMF) sample GAAR (section 5) define "scheme" to include "any course of action, agreement, arrangement, understanding, promise, plan, proposal, or undertaking, whether express or implied and whether or not enforceable."

Possibly, the broadest definition is the definition of the term "transaction" in section 811(1) of the Irish GAAR to mean

> "(i) any transaction, action, course of action, course of conduct, scheme, plan or proposal,
>
> (ii) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable or intended to be enforceable by legal proceedings, and

(iii) any series of or combination of the circumstances in paragraphs (i) and (ii)."

Regardless of the term used as the basic building block for a GAAR, it is clearly intended to be as broad as possible so as to include any action that may result in tax avoidance. Two basic approaches can be used for this purpose. A general term, such as transaction, arrangement or scheme, can be defined comprehensively and explicitly or a general term can be left largely undefined, relying on the tax authorities and the courts to give the term a broad meaning. There are risks with both approaches. On the one hand, if a general term is defined comprehensively, the courts may be reluctant to apply the GAAR to any action that is not explicitly covered; on the other hand, if a general term is not defined comprehensively and explicitly, the courts may interpret the term narrowly. Under both approaches, the drafters should carefully consider whether omissions or the failure to act, such as the failure to exercise an option in a contract, and events, such as the making of an election, are potentially subject to the GAAR.

Whatever statutory wording a country adopts with respect to a transaction or arrangement, it is important for explanatory notes to the legislation and administrative guidance issued by the tax authorities to emphasize that the statutory wording is intended to have a broad meaning and include any action that can reduce or avoid tax.

3.2.2 Series of transactions

It is especially important for the GAAR to apply to a series of transactions. Most sophisticated tax planning arrangements involve multiple transactions that are linked or connected in the sense that all the transactions are necessary in order to achieve the desired tax benefits. However, if the steps in the arrangement are viewed separately without consideration of the arrangement as a whole, none of them may be considered to have a primary purpose of avoiding tax or the arrangement as a whole may not be considered to be contrary to the purpose of the tax legislation.

Some GAARs rely on the use of terms, such as scheme, arrangement, course of action or course of conduct, in the definition of a transaction to make a series of transactions subject to the GAAR, but do not

refer explicitly to or define a series of transactions. Other countries use the term series or series of transactions but do not define those terms. It may be preferable to define a series of transactions or an arrangement to ensure that it is sufficiently broad to cover transactions that are connected in some manner. It is important for both separate transactions that are part of a series and the series as a whole to be analyzed in terms of whether the purpose test is met and whether each transaction or the series as a whole is contrary to the object and purpose of the relevant provisions of the legislation.

For example, South Africa's GAAR defines an "arrangement" to mean "any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof" (section 80L). However, the legislation does not provide any elaboration of the meaning of a step in or part of an arrangement. In contrast, the Canadian GAAR expressly applies to a transaction "that is part of a series of transactions" that results directly or indirectly in a tax benefit unless the primary purpose of the transaction was a bona fide purpose other than obtaining the tax benefit (section 245(3)(b)). The term "series of transactions" is not defined but has been given a narrow meaning by the courts. However, a series of transactions is deemed to include any related transactions carried out in contemplation of the series (section 248(10)).

On the one hand, a series of transactions or an arrangement can be defined narrowly so that it includes transactions only if there is a binding legal obligation to carry out one transaction if another transaction is carried out. For example, X transfers property to Y on condition that Y transfers the property to Z. Another example involves back-to-back arrangements with arm's length financial institutions. XCo places funds on deposit with a financial institution on condition that the financial institution loans the funds to XCo's wholly owned subsidiary. On the other hand, a series of transactions or an arrangement can be defined more broadly to include any transaction that is related or connected to another transaction or transactions. Under this approach, a transaction carried out in anticipation of a future transaction or in connection with a past transaction would be considered to be part of a series of transactions or an arrangement. For example, if XCo, resident in Country A, owns shares of a company resident in Country B but there is no tax treaty between Country A and Country

B, XCo may shift its residence to Country C that has a tax treaty with Country B (which exempts capital gains from the disposal of shares) and then sell the shares. Although there is no obligation on XCo to sell the shares after shifting its residence to Country C, the sale is clearly related to the change in residence and the change of residence would be meaningless without the subsequent sale of the shares.

The prospective and retrospective application of the concept of a series of transactions for purposes of the GAAR is necessary to ensure that a series of transactions cannot be designed to avoid the GAAR. Consider the following examples with respect to the concept of a series of transactions to capture both transactions carried out to facilitate future transactions (the prospective aspect of a series of transactions) and transactions carried out to facilitate prior transactions (the retrospective aspect of a series of transactions).

Example of a transaction carried out in the expectation of a future transaction or transactions

A promoter arranges for a series of transactions to prepare property, perhaps in the form of interests in a partnership or shares of a corporation, for sale to arm's length investors. The investors are not under any binding legal obligation to purchase the property and the promoter is not under any binding legal obligation to sell the property. Furthermore, the investors may not be aware of all the prior transactions carried out by the promoter with respect to the property. Nevertheless, without the final sale of the property to the investors, the tax benefits of the series of transaction would not be realized and the prior transactions would be meaningless. In such a situation, the promoter has obviously carried out the prior transactions with the expectation of a subsequent sale of the property.

Example of a transaction carried out because of prior transactions

A taxpayer transfers property to a related person resident in a treaty country so that treaty benefits are obtained with respect to income from the property, and after the income is received the property is transferred back to the original owner. In this typical "bed and breakfast" transaction, the transfer back to the original owner is made because of the prior transactions, which are not abusive assuming that

the original transfer is genuine (i.e. in this situation, permanent). In summary, the definition of a series of transactions or an arrangement should apply both prospectively and retrospectively.

In any event, the drafters should ensure that the GAAR is potentially applicable to a series of transactions, broadly defined. Many tax avoidance schemes involve a complicated series of transactions where each separate step in the series may be considered to be legitimate when viewed separately, but abusive when viewed in the context of the series as a whole. Alternatively, a series of transactions that may be viewed as a bona fide commercial arrangement as a whole, such as a corporate reorganization, may have steps without any commercial justification that are inserted into the arrangement to produce tax benefits. See, for example, section 80G(2) of the South African GAAR, which provides that the purpose of a step in or part of an arrangement may be different from the purpose of the arrangement as a whole. The Indian GAAR provides a rebuttable presumption that, if the main purpose of a step in an arrangement is to obtain a tax benefit, the main purpose of the arrangement as a whole must be considered to be the same unless the taxpayer proves otherwise (section 96(2)). Therefore, it is critical for a GAAR to apply both to transactions considered separately and transactions that are part of a series considered as a whole.

The tax authorities should be able to select any combination of transactions as a series. For example, the South African GAAR provides explicitly that the tax authorities can apply the GAAR to steps in or parts of an arrangement (section 80H).

The concept of a series of transactions has received considerable attention by the courts and commentators in Canada, the United Kingdom and the United States.[11]

According to the United Kingdom House of Lords, for transactions to constitute a series of transactions, each transaction must be pre-ordained in the sense that when the first transaction takes place, there must be "no practical likelihood" that the subsequent transaction

[11] See Michael Kandev, Brian Bloom and Olivier Fournier, "The Meaning of 'Series of Transactions' as Disclosed by a Unified Textual, Contextual, and Purposive Analysis" 58:2 *Canadian Tax Journal* 277-330.

or transactions will not take place.[12] This concept of a series was developed by the House of Lords as part of a judicial anti-avoidance rule and adopted by the Supreme Court of Canada as the proper interpretation of the term "series of transactions" in the Canadian GAAR.[13] This concept of a series of transactions is very narrow. Other meanings of a series of transactions can be drawn from United States case law.[14] Under the end-results approach, separate transactions that are pre-arranged from the outset to achieve an ultimate result are considered to be a single transaction, and the intermediate transactions are disregarded. Under the mutual-interdependence approach, separate transactions are combined into a single transaction if the transactions are interdependent in the sense that they would be meaningless if they were carried out separately.

As noted above, most countries that use the concept of a series of transactions have left undefined the terms or phrases used to describe a series of transactions, such as "series" or "arrangement." As a result, the meaning of a series of transactions is left to the courts to determine, as they decide GAAR cases over time. This process may create considerable uncertainty. The tax authorities can limit this uncertainty by providing administrative guidance as to their understanding of the meaning of a series of transactions and how they intend to apply it. Most importantly, the concept of a series of transactions must be given a broad meaning so that the GAAR can potentially apply to sophisticated tax-avoidance arrangements that invariably involve multiple related transactions. Careful consideration should be given by tax policy officials to include a definition of a series of transactions

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[12] *Furniss v. Dawson* [1984] AC 474 (HL) and *Craven v. White* [1989] AC 398 (HL).

[13] *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54. The Canadian GAAR is supplemented by section 248(10) which deems a series of transactions to include any related transactions carried out in contemplation of the series. This provision, and in particular the words "in contemplation of the series," has been controversial, but has been construed by the courts to extend the basic meaning of a series of transactions to include related transactions carried out before or after the series because of the series.

[14] Yoram Kaiman, "Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification" (2007) vol. 22, *Akron Tax* Journal 45-100.

in the GAAR, which would at least ensure that a series includes all transactions that are related in some significant way. For example, the sample GAAR in section 4.3.1 below defines "series of transactions" to mean "two or more transactions that are connected or related directly or indirectly, whether express or implied and whether enforceable or not . …"

3.3 The definition of a tax benefit

As noted above, a GAAR is targeted only at transactions and series of transactions that would result in the reduction or avoidance of tax in the absence of the application of the GAAR. If there is no reduction or avoidance of tax, it is unnecessary to apply the GAAR. Several countries have copied the Australian concept of a "tax benefit" for the purpose of targeting the GAAR at transactions or arrangements that reduce tax (section 177C). The Hong Kong GAAR defines a tax benefit to mean "the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof" (section 61A(3)). The GAARs of South Africa (section 80L, the definition of "tax benefit"), Ireland (section 811(1)(a), the definition of "tax advantage"), the United Kingdom (section 208, the definition of "tax advantage") and the IMF sample GAAR are similar. In the new Zealand GAAR, the concept of a tax benefit is part of the definition of "tax avoidance" (section OB1, the definition of "tax avoidance"). The Canadian definition is an example of a very broad definition:

> "tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty. (section 245(1), the definition of "tax benefit")

In keeping with a broad definition of the terms "transaction," "arrangement" or "scheme," the term "tax benefit" should also be defined broadly to include all possible tax benefits, including the deferral or postponement of tax. Drafters should also carefully consider extending the definition to include amounts payable other than tax, such as interest on unpaid tax and installments of tax payable, as well

as refunds of tax and other amounts.[15] Reductions in domestic tax as a result of the application of a tax treaty should clearly be within the definition of a tax benefit and potentially subject to the GAAR. The only issue in this regard is whether it is necessary to explicitly refer to treaty benefits in the definition of a tax benefit.

The requirement for a transaction, arrangement or scheme to result in a tax benefit is not intended to be a difficult condition to satisfy for the application of a GAAR. In most cases, it should be clear that a transaction challenged by the tax authorities under the GAAR has resulted in a tax benefit; for example, any deduction in computing income, credit against tax payable, exclusion or exemption of an amount from income and any reduction in tax pursuant to a tax treaty should clearly be a tax benefit. Theoretically, it is arguable that determining whether a transaction results in a tax benefit requires a comparison with the tax consequences of an alternative transaction. This type of approach involves a difficult counterfactual determination,[16] which could lead, inappropriately, to the conclusion that the GAAR does not apply, without any consideration of the more important issues — namely, the purpose of the transaction and whether the transaction is abusive.

The relationship between the relevant transaction and a tax benefit is straightforward. Typically, the GAAR applies if a transaction results in a tax benefit. Where a series of transactions is involved, the tax benefit may result from the series as a whole or from one or more of the transactions in the series. For example, if a series of transactions includes deductible payments, those payments should be treated as transactions that result in tax benefits, namely the deductions. However, a series of transactions may involve various steps, such as the creation of entities, transfers of property and payments, that do not result in any tax benefits because, for example, they occur within a corporate group, and only the final step in the series (for example, a sale of property to an arm's length party), results in a tax benefit. As noted above in section 3.2.2, if

[15] The necessity of dealing with refunds depends on the extent to which a country's tax system provides refunds. Tax refunds can arise for various reasons; for example, a country might provide refundable tax incentives to stimulate investment.

[16] The Australian courts have taken this approach.

the GAAR is applied separately to each transaction in a series, it might not apply to the preliminary steps in the series because they do not result in tax benefits, or to the final step, because it is a legitimate commercial transaction whose primary purpose is not tax avoidance. The GAAR should potentially apply in both situations.

One difficulty that arises with respect to the concept of a tax benefit is where a transaction does not result in any immediate tax saving but has consequences that allow a tax benefit to be realized in the future. For example, if a transaction results in an increase in the cost of property, no tax saving may be realized until depreciation deductions are claimed or the property is sold and the amount of the gain realized on the sale is reduced by the cost of the property. It may be easier for the tax authorities to apply the GAAR at the time that the transaction increases the cost of the property rather than to wait until the tax benefit is realized. Special provisions may be necessary to allow the tax authorities to apply the GAAR to a transaction that does not result in any immediate tax benefit but could result indirectly in a tax benefit in the future. For example, it may be sufficient to refer to transactions that result "directly or indirectly" in a tax benefit as is the case in the Canadian GAAR (see section 245(2) and (3)), Article 29(9) of the United Nations and OECD Model Conventions, and the South African GAAR (see section 80D(1)(b)(i)). The definition of "tax advantage" in section 811(1)(a) of the Irish GAAR refers to "any potential or prospective" reduction, avoidance or deferral of tax. Some GAARs do not refer explicitly to indirect tax benefits.

It is unnecessary to quantify the tax benefit for purposes of determining whether the GAAR potentially applies to a transaction. However, if the GAAR applies to a transaction, the primary consequence should be to deny or eliminate the tax benefit that would otherwise result; therefore, for this purpose it may be necessary for the tax authorities to identify and quantify the tax benefit precisely.

3.4 Taxes covered

It may be necessary to specify the tax or taxes that are relevant to the definition of a tax benefit. For example, where a country imposes income or other taxes through multiple taxes (e.g., separate statutes for income tax on corporations and individuals or for taxes on capital gains), it may

be necessary for a GAAR to be included in each of those statutes. (See for example the definition of "tax" in the Irish GAAR section 811(1)(a) and the South African GAAR section 80L; the United Kingdom GAAR specifies the taxes to which the GAAR applies (section 206(3).) Otherwise, if the definition of a tax benefit refers to the reduction or avoidance of tax under the Act in which the GAAR is included, the application of the GAAR would be limited to the tax imposed under that Act. Therefore, if tax under that Act can be reduced or avoided as a result of the provisions of regulations under that Act, other related statutes, or tax treaties, it may be necessary for the GAAR to include provisions to clarify that these issues. For example, the Canadian GAAR refers to tax payable under the Income Tax Act but applies if the transaction is a misuse or abuse of the Income Tax Act, regulations under that Act, related statutes ("any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in determining any amount that is relevant for the purposes of that computation") or tax treaties (section 245(4)).

3.5 The purpose test

3.5.1 Introduction

As discussed above in section 2.4, it is difficult, if not impossible, to design a GAAR that applies exclusively on the results of transactions. As a result, most GAARs contain some type of purpose test. If the primary purpose of a transaction or arrangement is something other than getting a tax benefit, typically the GAAR does not apply. In other words, the GAAR is not intended to apply to transactions that are primarily driven by commercial considerations even if those transactions result in tax benefits. However, if the primary purpose or one of the primary purposes of a transaction or arrangement that results in a tax benefit is to obtain that tax benefit, the GAAR applies to deny the tax benefit unless the transaction or arrangement is consistent with the underlying policy of the tax legislation.

A purpose test for a GAAR can be drafted either as a condition for the application of the GAAR (for example, the GAAR applies "if the primary purpose (or one of the primary purposes) of a transaction is to reduce tax") (see the South African GAAR section 80A)

or as an exception (for example, the GAAR applies to a transaction "unless the primary purpose (or one of the primary purposes) of the transaction is not to reduce tax") (see the Canadian GAAR section 245(3)). In principle, there is no substantial difference between these two approaches; however, in some countries, the onus of proof with respect to the conditions for the application of the basic conditions of the rule and exceptions to the rule may differ. The issue of onus with respect to a GAAR is discussed below in section 3.4.7.

As discussed in section 2.4 above, the purpose or purposes of a transaction or arrangement should be determined on the basis of objective facts and circumstances rather than the subjective intention or motives of taxpayers, who will always be inclined to justify transactions with self-serving evidence. The wording of the GAAR can reinforce the determination of the purpose of a transaction or arrangement on the basis of objective facts. For example, the South African GAAR requires the main purpose to be "reasonably considered in light of the relevant facts and circumstances" (South African GAAR section 80G(1)). Under the Canadian GAAR, a transaction is an avoidance transaction unless it "may reasonably be considered" to have been carried out primarily for non-tax purposes (the Canadian GAAR section 245(3)). Article 29(9) of the United Nations and OECD Model Conventions requires it to be "reasonable to conclude, having regard to all relevant facts and circumstances" that one of the principal purposes of a transaction or arrangement is to obtain a treaty benefit. Further, the Chinese, South African and Canadian GAARs refer to the purpose of the transaction or arrangement rather than the taxpayer's purpose. In contrast, the IMF's sample GAAR refers explicitly to the purpose of the person or one of the persons who entered into a scheme. Thus, under such wording, it seems more likely that the subjective intention of the taxpayer would not only be relevant, but would also have greater weight.

Three variations of a purpose test are possible: sole or exclusive purpose, primary or main purpose, or one of the primary or main purposes.

3.5.2 Sole or exclusive purpose test

A sole or exclusive purpose test (i.e., the GAAR applies only if the sole or exclusive purpose of a transaction is to avoid tax) is likely to be of

limited effectiveness, since abusive tax avoidance transactions often have both commercial and tax-avoidance purposes. Some GAARs, such as the South African GAAR, the Hong Kong GAAR, and the IMF Sample GAAR, refer to the "sole" purpose of a transaction but as an alternative to the main or dominant purpose of the transaction ("sole or main/dominant" purpose). In effect, the reference to the sole purpose of a transaction in the context of these provisions is probably meaningless since it is unlikely that a court would conclude that the main or dominant purpose of a transaction is not to obtain a tax benefit if its sole purpose is to obtain a tax benefit.

3.5.3 Primary or main purpose test

Several GAARs use a primary or main purpose test to distinguish between abusive tax avoidance and legitimate commercial transactions (see, for example, the Australian GAAR section 177A(5), the Canadian GAAR section 245(3), the Indian GAAR section 96(2), the Irish GAAR section 811(2), the South African GAAR section 80A, the EU GAAR and the IMF Sample GAAR section 1(c)). However, there are two major difficulties with such a test. First, in many cases, it is necessary to weigh the multiple purposes for a transaction in order to determine its primary purpose; this exercise may involve considerable uncertainty in certan situations. Second, the primary purpose of some transactions may be something other than tax avoidance despite the fact that those transactions generate significant tax benefits. For example, it can be argued that the primary purpose of any financing transaction is the commercial purpose of raising funds to use in a business or to make an investment. Therefore, a GAAR using a primary purpose test might not apply to financing transactions despite the fact that debt-financing transactions are sometimes used to generate interest deductions that reduce tax inappropriately. Similarly, the primary purpose of any acquisition of property, such as the shares of a corporation, may reasonably be considered to be to make an investment in the property even though the acquisition may also be made to reduce tax.

3.5.4 One of the primary or main purposes test

A one of the primary purposes test is not subject to this deficiency. However, a one of the primary purposes test will extend the scope of

a GAAR to many more transactions, since many, if not most, commercial transactions are designed to minimize tax. Indeed, it would be unrealistic to expect taxpayers to ignore tax considerations in planning their affairs, and would be tantamount to requiring taxpayers to pay the maximum amount of tax payable contrary to the fundamental principle that taxpayers are entitled to minimize tax, which applies in most countries. Therefore, it is especially important under a GAAR with a one of the primary purposes test to have an effective exception for legitimate commercial transactions (see below section 3.5 for a discussion of such an exception). Of the GAARs included in the appendix, only the New Zealand GAAR and United Kingdom GAAR use a one of the main purposes test. The New Zealand GAAR defines a tax avoidance arrangement in part to be an arrangement that "has tax avoidance as one of its purposes or effects . . . if the purpose or effect is not merely incidental" (section OB1, the definition of "tax arrangement"). Similarly, the United Kingdom GAAR defines a "tax arrangement to be one where "the main purpose, or one of the main purposes, of the arrangement" was to obtain a tax advantage (section 207(1)). Article 29(9), the general anti-abuse rule added to the United Nations and OECD Model Conventions in 2017, also uses a one of the main purposes test.

3.5.5 Structure and wording of a purpose test

A purpose test can be worded in a variety of ways. The South African GAAR potentially applies to "an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit" (section 80A). The purpose test in the Indian GAAR is similar, but refers only to "the main purpose of an arrangement" (section 96). The Chinese GAAR applies to a "business arrangement without a bona fide commercial purpose" which in turn is defined to mean "arrangements whose main purpose is to reduce, avoid or defer tax payments" (article 47). The purpose test in the IMF sample GAAR refers to "a person, or one of the persons, who entered into or carried out the scheme, . . . for the sole or dominant purpose of enabling the person … to obtain a tax benefit" (section 1(c)).

The Canadian GAAR is an example of a purpose test that is structured as an exception; the GAAR applies to transactions that

result in a tax benefit "unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit" (section 245(3)).

3.5.6 Comparison of a main purpose test and a one of the main purposes test

The choice between a main-purpose test and a one of the main purposes test should be considered carefully. Various terms can be used to describe the relevant purpose, including "main," "primary," "principal" and "dominant." There does not appear to be any significant difference in the meaning of these terms — they all mean that the purpose must be one that was a significant reason for the transaction or arrangement and not just an ancillary or incidental reason.

A "one of the main purposes test" is relatively easily satisfied. If a transaction or arrangement actually results in a tax benefit, it seems unlikely that none of the main purposes for the transaction or arrangement was obtaining that tax benefit. Most commercial transactions, such as acquisitions, mergers, reorganizations and financings, involve significant tax consequences that the parties invariably take into account. Therefore, where a GAAR contains an exception or an additional condition based on the purpose of the tax legislation, the decisive factor as to whether the GAAR applies is likely to be whether the transaction or arrangement is contrary to the purpose of the legislation. Where the GAAR does not contain any exception or additional condition, there is the risk that the GAAR will apply to transactions whose main purpose is a legitimate non-tax purpose. With respect to the GAARs in the Appendix, the Australian, Chinese, Hong Kong, New Zealand and the IMF sample GAAR rely exclusively on a purpose test. However, the New Zealand tax authorities only apply their GAAR if the transaction defeats or frustrates the object and purpose of the relevant provisions of the tax legislation. Similarly, although the Chinese GAAR is worded exclusively as a business purpose test, it is intended to apply only to transactions that are contrary to the purpose of the legislation.[17]

[17] Jinyan Li, *International Taxation in China* (Amsterdam: IBFD, 2016) at 479-80.

In contrast, a "main-purpose test" is a more substantial condition for the application of a GAAR. A main-purpose test requires not only that a purpose of a transaction is a main reason for the transaction (which is also what a one of the main purposes test requires) but also requires that that purpose is more important than any other purposes for the transaction. Thus, a main-purpose test requires the tax authorities and the courts to determine whether a transaction or arrangement has multiple purposes and, if so, to weigh those purposes in order to determine the single purpose that is most important.

A main-purpose test does not require one purpose to be more important than all the other purposes combined. For example, if a transaction has three main purposes, and tax avoidance represents 40 percent of the purposes and the other two reasons represent 30 percent each (assuming that the weighing of purpose can be quantified precisely in this manner), it should be concluded that the main purpose for the transaction is tax avoidance. However, if a transaction has three main purposes, each of which represents an equal reason for the transaction, it is difficult to conclude that tax avoidance is the main purpose for the transaction, although it is clearly one of the main purposes. Experience in the countries that have a main purpose test indicates that a main purpose test is not usually applied with this type of precision. Typically, for purposes of applying a main-purpose test, transactions are considered to have commercial or business purposes and tax avoidance purposes, and the tax authorities and the courts must determine which purpose is more important.

3.5.7 Onus of proof

Because the application of a main-purpose test involves weighing multiple purposes, the onus of proof may be an important factor. Does the taxpayer have the burden of establishing that the main purpose of a transaction was not obtaining a tax benefit, or do the tax authorities have the burden of establishing that the main purpose of the transaction was the avoidance of tax? In many countries, a tax assessment issued by the tax authorities is presumed to be correct unless the taxpayer establishes that the assessment is incorrect.

This general presumption may be sufficient to place the burden of proof on the taxpayer with respect to the determination of the main

purpose of a transaction under a GAAR, and can be reinforced by the wording of the purpose test. For example, under the Canadian GAAR, a transaction that results in a tax benefit is potentially subject to the GAAR unless the primary purpose for the transaction is a bona fide purpose other than obtaining the tax benefit (section 245(3)). Such a provision could be worded more explicitly to put the burden on the taxpayer: "unless it is established by the taxpayer that the main purpose is a bona fide purpose other than obtaining the tax benefit." Article 29(9) of the United Nations and OECD Model Conventions is structured in this manner ("unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention"). The South African GAAR goes even further by establishing an explicit presumption that a transaction resulting in a tax benefit has the sole or main purpose of tax avoidance "unless and until the party obtaining a tax benefit proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement" (South African GAAR section 80B(1)).

It seems appropriate to place the burden of establishing a benign, commercial or non-tax purpose for a transaction on the taxpayer because the taxpayer usually has better access to all the relevant information necessary to determine the main purpose or purposes of a transaction.

3.6 An exception or saving provision or an additional condition for the GAAR

3.6.1 The need for an exception or saving provision or an additional condition

As noted in section 3.4.6 above, several GAARs apply without any exceptions or additional conditions if the primary purpose of a transaction is to avoid tax. The Australian, Hong Kong, New Zealand and parts of the Indian and South African GAARs operate in this manner. A GAAR that relies exclusively on a primary purpose or a one of the primary purposes test is likely to apply more broadly than a GAAR that uses both a purpose text and an additional condition or exception of some kind. However, there is a serious risk that a GAAR that uses

only a primary purpose or a one of the primary purposes test may apply to transactions that are not abusive or offensive from a tax policy perspective. In effect, this type of GAAR relies on the tax authorities to use their discretion not to apply the GAAR inappropriately. However, if the tax authorities apply the GAAR inappropriately to a legitimate commercial transaction, the courts would have no legal basis to stop them from applying the GAAR to such a transaction even where the transaction is not contrary to the underlying object and purpose of the tax legislation. Taxpayers can be expected to strongly oppose the adoption of such a GAAR, and most countries have rejected this type of GAAR.

Most statutory GAARs do not apply to all transactions or arrangements that are carried out for the main purpose or one of the main purposes of obtaining a tax benefit. Most contain an exception, saving provision or additional condition under which some transactions that meet the purpose test are not subject to the GAAR if they are consistent with or not contrary to the object and purpose of the tax legislation.

3.6.2 An exception or saving provision or an additional condition

An exception or saving provision can be drafted as an added condition for the application of the GAAR, or as an exception to the main rule. An example of an exception or saving provision that is drafted as an exception is the general anti-abuse rule in Article 29(9) that was added to the United Nations and OECD Model Conventions in 2017. Article 29(9) applies if one of the principal purposes of a transaction is obtaining a treaty benefit "unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention." However, in the guiding principle in the Commentaries on Article 1 of both Model Conventions on which Article 29(9) is based, the exception in Article 29(9) is drafted as an additional condition for the application of the guiding principle. Thus, the guiding principle applies if one of the principal purposes of a transaction is to obtain a treaty benefit **and** obtaining that benefit is contrary to the object and purpose of the treaty.

The Canadian GAAR contains an exception to the main rule; it applies only if a transaction can reasonably be considered to result in a "misuse" of the relevant provision or in an "abuse" of the provisions of the statute read as a whole (see Canadian GAAR section 245(4)). In contrast, one aspect of the South African GAAR is structured as an additional condition: a transaction is covered if its sole or main purpose is to obtain a tax benefit and it "would result directly or indirectly in the misuse or abuse of the provisions of this Act" (see South African GAAR section 80A(c)); however, the other aspects of the South African GAAR require other conditions in addition to a purpose test for the application of the GAAR (see section 80A(a) and (b)).

3.6.3 Drafting an exception or saving provision or an additional condition

There are three basic options for drafting an exception or saving provision to the charging rule of a GAAR or an additional condition for the application of the charging rule. The basic difficulties in this regard are designing the exception or additional condition with sufficient specificity and avoiding duplication with the purpose test. For example, if a GAAR applies to transactions with a main purpose of avoiding tax, it does not make sense to exempt transactions whose main purpose is a business or commercial one.

First, an exception could be designed as a list of specific transactions, such as business or corporate reorganizations, that are not subject to the GAAR even if the main purpose or one of the main purposes test is met. There are many difficulties with this approach including the identification of exempt transactions with reference to objective criteria to allow taxpayers and tax officials to apply the exemption with reasonable certainty. The most serious problem with this approach is that, if any legitimate transactions that should be exempt are not listed in the exemption (which is not just possible but likely), an inappropriate negative implication will be created that such unlisted transactions are subject to the GAAR.

Second, an exception or additional condition could take the form of a generally worded description of transactions by reference to objective criteria other than their purpose. For example, the Indian and South African GAARs apply to transaction whose main purpose

is to avoid tax and that are carried out in an abnormal manner, lack commercial substance or create rights or obligations that would not ordinarily be created between arm's length parties (Indian GAAR, section 96 and South African GAAR section 80A).

Third, an exception or additional condition could be drafted as an interpretive rule similar to the general anti-abuse rule in Article 29(9) of the United Nations and OECD Model Conventions, which applies to transactions if one of purposes is to obtain a treaty benefit and obtaining that benefit would be contrary to the object and purpose of the treaty. Several countries use an exception or additional condition designed in this fashion. The major difficulty with this approach is how to draft an exception or additional condition in a manner that can be applied reasonably by taxpayers, tax authorities and the courts. The South African, Indian, Irish and Canadian GAARs use the concepts of misuse and abuse. (See the South African GAAR section 80A(c), the Indian GAAR section 96, the Irish GAAR, section 811(3)(a)(ii) and the Canadian GAAR section 245(4)). These concepts of misuse and abuse have been interpreted by Canadian courts to mean transactions that frustrate, defeat or contravene the object and purpose of the tax legislation. This meaning is explicit in the exception in the general anti-abuse rule in the United Nations and OECD Model Conventions; Article 29(9) applies "unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention." Similarly, the United Kingdom GAAR contains an additional condition for the application of the GAAR that is explicitly based on the determination of the purpose of the tax legislation. A tax arrangement is abusive if it "cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances, including:

a) whether the substantive results of the arrangements are consistent with any principles on which those provisions are based (whether express or implied) and the policy objectives of those provisions" (United Kingdom GAAR section 207(2)).

b) whether the means of achieving those results includes one or more contrived or abnormal steps, and

c) whether the arrangements are intended to exploit any shortcomings in those provisions.

This type of exception or saving provision in a GAAR is effectively a rule of interpretation — the relevant provisions of the tax legislation (or the treaty in the case of Article 29(9)) must be interpreted to determine their object and purpose, and then the transaction or arrangement in question must be assessed to determine whether it is in accordance with or contrary to that object or purpose. If the transaction or arrangement is found to be contrary to the object and purpose of the legislation, the GAAR will apply to deny the tax benefits that would otherwise result.

This type of interpretive approach may be difficult to apply depending on the nature of a country's tax legislation, the approach of the country's courts to statutory interpretation generally, and the interpretation of tax statutes in particular. Some countries' courts have a long tradition of interpreting tax legislation literally. For these countries, the application of a purposive approach to determine whether a transaction or arrangement is abusive for purposes of the GAAR will be an unusual exercise for which the tax authorities and the courts may not be adequately prepared. Moreover, if the tax authorities and the courts interpret the provisions of the tax legislation (other than GAAR) literally, then it would be logically impossible to consider any transaction or arrangement that complies with the literal wording of those provisions to be contrary to any of those provisions considered separately and all of them considered as a whole.

If the GAAR is a provision of last resort, it means that the GAAR is relevant only if a transaction or arrangement complies with all the provisions of the tax legislation other than the GAAR. Therefore, if the GAAR provides an exception for a transaction or arrangement that is consistent with the object and purpose of the relevant provisions of the tax legislation other than the GAAR, and the object and purpose of those provisions is determined by reference to their literal meaning, then any transaction or arrangement that is consistent with the literal meaning of the provisions of the tax legislation other than the GAAR will inevitably be within the exception, and, as a result, the GAAR will be rendered meaningless.

The difficulties with applying an interpretive exception based on the identification of the underlying object and purpose of the tax legislation has led some countries to use alternative exceptions based on more objective factors. For example, the Indian and South African

GAARs apply in certain situations if the sole or primary purpose of an arrangement is to obtain a tax benefit and the arrangement:

a) is carried out by abnormal means, or
b) lacks commercial substance, or
c) creates rights or obligations that would not normally be created between arm's length persons. (Indian GAAR section 96(a), (b) and (c) and South African GAAR section 80A(a), (b) and (c)(i)).

Although detailed rules are provided for determining whether an arrangement lacks commercial substance (Indian GAAR sections 97 and South African GAAR sections 80C-80F), no rules are provided as to the meaning of abnormal means of carrying out arrangements or abnormal rights. To determine whether something is abnormal presumably requires a determination of what is normal, which may produce difficulties in this context. For example, if a particular type of tax avoidance is used extensively before the tax authorities identify and attack it using the GAAR, taxpayers have an argument that such transactions have become normal. Conversely, if a taxpayer carries out a novel transaction that is not abusive and is consistent with the underlying purpose of the tax legislation, there is nevertheless a risk that the transaction could be subject to the GAAR because it is abnormal.

Another method for providing more guidance with respect to an exception from or an additional condition for the application of a GAAR based on whether a transaction or arrangement contravenes the object and purpose of the tax legislation is for the legislation to specify certain factors that the tax authorities and the courts must consider in making that determination. These factors may include the economic substance of the transaction, the manner in which the transaction was carried out, the presence of contrived or abnormal steps in a series of transactions (see the United Kingdom GAAR section 207(2)(b)), whether the arrangements are intended to exploit shortcomings in the legislation (the United Kingdom GAAR section 207(2)(c)) and timing aspects of the transaction.[18] Some of these factors can be used

[18] The timing aspects of transactions might include, for example, the length of time that a taxpayer holds an investment. A taxpayer who acquires property (for example, shares of a corporation) and then disposes of it shortly

to determine the primary purpose of a transaction, as is the case with the Australian GAAR section 177D(b) (8 factors), the Hong Kong GAAR section 61A(1)(a)-(g) (7 factors), and the Irish GAAR section 811(3)(b) (4 factors). However, some of these factors are equally relevant for purposes of determining whether a transaction abuses, defeats, frustrates or contravenes the object and purpose of the tax legislation.

3.7 The role of economic substance

In many cases, the most important factor that should be considered in determining whether a transaction is abusive for purposes of a GAAR is its economic substance. As a general observation, it seems clear that income tax should be imposed on the economic substance of transactions. However, in all income tax systems, the legal form of transactions (for example, the treatment of corporations as taxable entities separate from their shareholders) is respected at least to a certain extent. For tax systems that adhere generally to the legal form of transactions, tax avoidance is relatively easy for taxpayers and their advisers through the manipulation of the legal form of transactions and arrangements. For purposes of the application of a GAAR, it is important for the tax authorities and the courts to be able to consider the economic substance of the transactions in question. For example, where a taxpayer transfers property with the right to reacquire the property in a short time and at a pre-determined price, in substance the taxpayer has effectively maintained ownership of the property. Although the meaning of economic substance may be imprecise, in general terms it means a consideration of the non-tax economic and financial consequences of the relevant transactions. For example, a transaction that does not result in any pre-tax profit for a taxpayer or that does not provide a taxpayer with any risk (or only a limited risk) of loss or possibility of profit indicates that the principal purpose or one of the principal purposes of the transaction was the expected tax benefits. Another relevant factor is the presence of parties to a transaction that are indifferent to tax consequences.

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thereafter (for example, after a dividend has been paid), might be considered to have done so for the purpose of receiving the dividend without making a real investment in the corporation.

Although the Canadian and Chinese GAARs do not refer explicitly to the concept of economic substance in the GAAR, economic substance is intended to play an important role in the application of the GAAR in both countries. The explanatory notes to the Canadian GAAR provide that the GAAR "recognizes that the provisions of the [Income Tax] Act are intended to apply to transactions with real economic substance."[19] The Chinese GAAR applies to business arrangements without a reasonable business purpose. Arrangements without economic substance or arrangements whose economic substance is inconsistent with their legal form are considered to lack a reasonable business purpose.[20] The administrative guidance with respect to the GAAR identifies some key factors in determining whether an intermediary entity lacks economic substance.[21] The IMF sample GAAR refers explicitly to the substance of a scheme for purposes of determining whether the sole or dominant purpose of the scheme was to reduce or avoid tax (section 1(c)). However, it does not refer to "economic substance" or provide any guidance as to how the substance of a scheme should be determined. Similarly, the Australian, Hong Kong and Irish GAARs refer to the "substance" of a transaction or scheme and the Australian and Hong Kong GAARs also refer to changes in the "financial position" of the taxpayer but do not refer to economic substance. The United Kingdom GAAR refers only to the "substantive results" of arrangements (section 207(2)(a)).

The South African and Indian GAARs contain explicit and detailed rules with respect to the role of "commercial substance" in the application of the GAAR. Under one of the operative rules of the GAAR, an arrangement is an impermissible avoidance arrangement if its sole or main purpose is to obtain a tax benefit and it lacks "commercial substance" (South African GAAR section 80A(a)(ii) and Indian

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[19] Canada, Department of Finance, Explanatory Notes to Legislation Relating to Income Tax (June, 1988) clause 186. See Zimmer, supra note ; Jinyan Li, " 'Economic Substance': Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance" (2006) vol. 54, no. 1 *Canadian Tax Journal* 23-56.

[20] See Li, *International Taxation in China*, supra note 17, at 479.

[21] Ibid., at 483-84. The factors include whether the entity has sufficient employees, assets and revenue to carry out business activities and whether the entity's existence is transitory.

GAAR section 96(1)(c)). Further, an arrangement is deemed to lack commercial substance if it has no significant effect on a person's business risks or its net cash flows and several additional factors are listed as indicating a lack of commercial substance (South African GAAR section 80C and Indian GAAR section 97).

3.8 Determination of the tax consequences

A GAAR should specify how the tax consequences should be determined where the GAAR applies to a transaction or arrangement. Some GAARs take a relatively simplistic approach to the determination of the tax consequences where the GAAR applies. For example, Article 29(9), the treaty general anti-abuse rule, provides simply that an abusive treaty benefit may be denied; the EU ant-tax avoidance directive provides that an EU member state "shall ignore" an abusive arrangement or series of arrangements and the New Zealand GAAR similarly provides that an avoidance arrangement is "void" against the Commissioner and allows the Commissioner to counteract any tax advantage derived from the arrangement (section BG 1(1) and (2)).

The other GAARs reproduced in the Appendix provide more detailed rules for the determination of the tax consequences where the GAAR applies. In general, these GAARs have a general provision that authorizes the tax authorities to determine the tax consequences to deny the tax benefit in a "reasonable" or "appropriate" manner and also provide more detailed supplementary rules with respect to the specific actions that the tax authorities may take. The Canadian GAAR allows the tax consequences to be determined for any person "as is reasonable in the circumstances" and then provides a variety of specific adjustments that may be made for this purpose (Canadian GAAR section 245(2) and (5)). The IMF sample GAAR allows the tax authorities to determine the tax liability of the person who obtained a tax benefit as if the transaction had not been entered into or a reasonable alternative transaction had been entered into. The South African GAAR allows the tax authorities to determine the tax consequences of any person who participates in a transaction by taking specified actions, including treating the transaction "in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit" (South

African GAAR section 80B(1)). The Indian GAAR is similar (section 98). The Irish GAAR authorizes the tax authorities to make any adjustments and take all "just and reasonable" actions so that the tax advantage is denied (section 811(5)(a)). The United Kingdom GAAR requires the tax advantage to be counteracted through "just and reasonable" adjustments (section 209).

Most of these GAARs also require the tax authorities to make "relieving adjustments" to the tax consequences of persons other than the taxpayers who have claimed tax benefits. Such adjustments are sometimes necessary to ensure that all the persons affected by the determination of the tax consequences of an avoidance transaction are treated consistently. Thus, for example, where a taxpayer is denied the tax benefit of a tax-free transfer of property as a result of being treated as having sold the property to a related person for its fair market value, the related person who acquires the property should be treated as having acquired the property at a cost equal to its fair market value. See the Australian GAAR section 177F(3)-(5), the Canadian GAAR section 245(6), the Irish GAAR section 811(7)-(9), the South African GAAR section 80B(2), United Kingdom GAAR section 210 and the IMF sample GAAR section 2.

Difficulties may be encountered where a tax avoidance transaction results in an increase in an amount, such as the cost of property or a loss that will affect the taxpayer's income in subsequent tax years. For example, if a transaction results in an increase in the cost of depreciable property but the taxpayer does not claim any depreciation (assuming that the amount of depreciation claimed by a taxpayer is within the taxpayer's discretion), the GAAR should contain provisions giving the tax authorities the authority to apply the GAAR and determine the tax consequences by reducing the cost of the depreciable property in the year that the transaction occurs or perhaps alternatively in the year that the tax benefit is claimed or both.

All these provisions are clearly intended to ensure that where the GAAR applies, the tax consequences should be determined reasonably to deny the tax benefit that would otherwise result and to make relieving adjustments in appropriate circumstances for the taxpayer and any other person affected by the application of the GAAR.

Chapter 4

Sample GAARs with Explanatory Notes

4.1 Introduction

This chapter provides two sample GAARs with explanatory notes. A GAAR can take many different forms as shown by the selected GAARs included in the Appendix. Any country adopting a GAAR should adapt the provisions of the sample GAARs to the country's particular circumstances including its legal and tax system, the attitude of taxpayers to aggressive tax avoidance, the role of the courts in controlling abusive tax avoidance and other factors.

Section 4.2 contains a simplified GAAR, which is limited to the essential aspects of a GAAR. This simplified GAAR may be an attractive option for some developing countries that are concerned about their capacity to administer a more detailed provision and want to maximize their discretion in applying a GAAR. However, a simplified GAAR involves significant uncertainty for taxpayers, tax officials and the courts. The simplified GAAR in section 4.2 is similar to the general anti-abuse rule in Article 29(9) of the United Nations and OECD Model Convention and in Article 6 of the EU Anti-Abuse Directive.

The more detailed sample GAAR presented in section 4.3 below draws features and wording from several of the selected GAARs included in the Appendix; however, it is impossible to point to a direct connection between a provision in the sample GAAR and a provision in an actual GAAR. The sample GAAR occasionally contains alternative provisions, which are shown in square brackets. However, even where no alternatives are shown, it must be emphasized that the provisions of a GAAR can be worded in many different ways to express the same underlying policy. The sample GAAR does not contain provisions dealing with the administrative aspects of the application of

the GAAR, such as special assessment or appeal procedures, notice requirements and the effective date or coming-into-force provision, because these aspects are heavily dependent on the procedural and administrative aspects of the domestic law of each particular country.

Both sample GAARs have been drafted to adhere as closely as possible to the underlying tax policy principles set out in Chapter 2 and also to be consistent with a treaty GAAR similar to Article 29(9) of the United Nations and OECD Model Convention.

THE SAMPLE GAARs IN THIS SECTION ARE NOT INTENDED TO BE INCLUDED IN ANY COUNTRY'S DOMESTIC LAW AS IS. THEY ARE PROVIDED FOR GUIDANCE ONLY.

4.2 Simplified Sample GAAR

4.2.1 General anti-avoidance rule

Section X

(1) Where one of the main purposes [the main purposes] of a transaction is to obtain a tax benefit and, having regard to all the circumstances, that tax benefit would be contrary to the object and purpose of the tax law, the tax authorities shall determine the tax consequences to any person so as to deny the tax benefit.

(2) For the purpose of section (1):

"transaction" includes an event, agreement, arrangement, course of conduct, undertaking, scheme or series of transactions; and

"tax benefit" includes any reduction, avoidance or postponement of tax payable [under this Act].

4.2.2 Explanatory Notes

Introduction

Section X is a general anti-avoidance rule intended to protect the tax system from abusive tax avoidance transactions. The tax system

is designed to raise tax revenues to fund public goods and services. Abusive tax avoidance transactions reduce tax revenues inappropriately and effectively shift the tax burden to other taxpayers. Although taxpayers have the right under the law to arrange their affairs to pay the minimum amount of tax allowable under the law, the general anti-avoidance rule limits taxpayers' rights to engage in tax planning.

The general anti-avoidance rule involves a two-step analysis. First, it must be determined if one of the main purpose [the main purpose] for a particular transaction was to get a tax benefit, which is broadly defined in section X(2). Second, it must be determined whether the tax benefit resulting from the transaction is in accordance with or contrary to the underlying policy of the relevant provisions of the income tax legislation; only tax benefits that are contrary to the object and purpose of the tax law are subject to the general anti-avoidance rule.

Section X(1)

Section X(1) sets out the basic charging provision of the general anti-avoidance rule. It authorizes the tax authorities to deny a tax benefit resulting from a transaction if two conditions are met:

1. one of the main purposes [the main purpose] of the transaction was to obtain a tax benefit as defined in section X(2); and
2. the tax benefit is contrary to the object and purpose of the tax law having regard to all the circumstances.

Section (1) allows the tax authorities to determine the tax consequences of any person, not just the taxpayer or taxpayers who derive a tax benefit from the transaction.

Section X(2)

Section X(2) provides definitions of two key terms used in section X(1).

"Transaction" is defined broadly to include "an event, agreement, arrangement, course of conduct, undertaking, scheme or series of transactions." The definition is broadly worded and intended to include all actions that might result in a tax benefit. The definition includes an arrangement, course of conduct, scheme and series

of transactions. These terms are intended to include tax avoidance arrangements consisting of multiple steps or transactions because sophisticated tax avoidance transactions often involve arrangements with multiple steps. Multiple transactions are intended to be part of an arrangement, course of conduct, scheme or series if the transactions are related or connected, directly or indirectly, whether expressly or impliedly and whether legally enforceable or not.

The definition of "transaction" also includes events such as meetings of shareholders and directors, the expiry of an option, changes in the use or location of property or persons, etc. which might not be considered to be within the ordinary meaning of a transaction.

Where a transaction is part of a series of transactions, section X(1) can apply to either the transaction by itself, the series of transactions as a whole or both.

"Tax benefit" is defined broadly to include any reduction, avoidance or postponement of tax payable. Thus, any deduction, allowance or exclusion in computing income and any credit against tax payable would clearly be a tax benefit. Similarly, any postponement of tax, such as a tax-deferred rollover for a transfer of property, would clearly be a tax benefit. Because the definition is inclusive other types of tax benefits, such as a reduction in interest or penalty or an increase in a tax refund would also be subject to the general anti-avoidance rule. A reduction, avoidance or deferral of domestic tax pursuant to the application of the provisions of a tax treaty is intended to be included in the definition of a tax benefit.

4.3 Detailed Sample GAAR

4.3.1 General anti-avoidance rule

Section X

(1) The tax consequences of any tax avoidance transaction for any person shall be determined as is reasonable in the circumstances in order to deny any tax benefit that would otherwise result from the tax avoidance transaction.

(2) A transaction or a series of transactions is a tax avoidance transaction if, it may reasonably be considered having regard to all of the relevant facts and circumstances, that the transaction or the series of transactions:
  (a) (i) results, directly or indirectly, in a tax benefit; and
    (ii) one of the main purposes [the main purpose] of the transaction or the series of transactions was to obtain a tax benefit.

(3) For the purposes of section (2) and without limiting the generality of section (2), the following factors shall be considered in determining the main purpose[22] of a transaction or a series of transactions:
  (a) Any changes in the financial position of the persons carrying out or participating in the transaction or series of transactions, or any person related to such persons;
  (b) The manner in which the transaction or series of transactions was entered into or carried out;
  (c) The economic substance of the transaction or series of transactions; and
  (d) Whether the transaction or series of transactions created rights or obligations that would not have been created by persons dealing at arm's length with one another.

(4) Section (1) shall not apply to any tax avoidance transaction if it is established by the person claiming the tax benefit that the transaction is in accordance with and not contrary to the object and purpose of the relevant provisions of this Act [refer to the relevant Act or Acts] or a tax treaty or the provisions of this Act read as a whole.

(5) For the purposes of section (4),
  (a) the object and purpose of the relevant provisions of this Act or the provisions of this Act read as a whole shall be determined by reference to the wording of the provisions, any relevant extrinsic evidence including

[22] This provision is probably unnecessary if section (2) use a one of the main purposes test.

any explanatory material issued by [the tax authorities or the Ministry of Finance] and any other relevant information; and

(b) the following factors shall be considered in determining whether a tax avoidance transaction is in accordance with or contrary to the object and purpose of the relevant provisions of this Act [refer to the relevant Act or Acts] or a tax treaty or the provisions of this Act read as a whole:

(i) the manner in which the transaction or series of transactions was entered into or carried out;

(ii) the economic substance of the transaction or series of transactions;

(iii) whether the transaction or series of transactions created rights or obligations that would not have been created by persons dealing at arm's length with one another; and.

(iv) whether the transaction or series of transactions is artificial or abnormal or involves artificial or abnormal steps.

(6) For the purposes of section (1), in determining the tax consequences for any person, the tax authority may take any action that is reasonable in the circumstances including without limiting the foregoing:

(a) Allowing or disallowing any deduction, allowance, relief, credit, exemption, or exclusion [in computing gross income, taxable income or tax payable] in whole or in part;

(b) Allocating or reallocating any income, loss, deduction, allowance, relief, credit, exemption, or exclusion to any person in whole or in part;

(c) Recharacterizing the nature of any income, loss, payment, expenditure or other amount;

(d) Ignoring or disregarding any transaction or series of transactions that is or is part of a tax avoidance transaction;

(e) Ignoring, disregarding or combining one or more

transactions that form part of a series of transactions; and

(f) Considering any two or more persons to be related [connected, associated or not dealing at arm's length] or to be the same person.

(7) Any person, other than a person who has received an assessment involving the application of section (1), may request, within 12 months of the date of the issuance of an assessment under section (1) with respect to a particular tax avoidance transaction, the tax authorities to make consequential adjustments to that person's liability to tax as a result of that assessment as are reasonable in the circumstances.

(8) Where the tax authorities deny a person's request for consequential adjustments under section (7), the tax authorities shall notify the person of the decision within __ months of the receipt of the request and the person shall be entitled to appeal the decision [to the applicable court in accordance with the normal rules governing appeals].

(9) Definitions:

(a) "tax benefit" means any reduction, avoidance or postponement of tax payable [or any interest, penalty or other amount payable] under this Act, an increase in any tax refund under this Act and includes any benefit derived from the application of the provisions of a tax treaty;

(b) "tax" means any tax [imposed under the following Acts] [administered by the Commissioner];

(c) "transaction" means any transaction, event, action, course of action, course of conduct, scheme, plan, proposal, agreement, arrangement, understanding, promise or undertaking whether express or implied and whether enforceable or not; and

(d) "series of transaction" means two or more transactions that are connected or related, directly or indirectly, whether express or implied and whether enforceable or not and includes any transaction that is carried out because of prior or subsequent transactions.

4.4 Explanatory Notes

Introduction

Section X is a general anti-avoidance rule intended to protect the tax system from abusive tax avoidance transactions. The tax system is designed to raise tax revenues to fund public goods and services. Abusive tax avoidance transactions reduce tax revenues in appropriately and effectively shift the tax burden to other taxpayers. Although taxpayers have the right under the law to arrange their affairs to pay the minimum amount of tax allowable under the law, the general anti-abuse rule places a legal obligation on taxpayers not to engage in abusive tax avoidance transactions, which limits taxpayers' rights to engage in tax planning.

The general anti-avoidance rule involves a three-step analysis. First, it must be determined if a particular transaction or series of transaction results in a tax benefit, which is broadly defined in section X(9). Second, it must be determined whether one of the main purposes [the main purpose] of the transaction was to obtain the tax benefit. Third, if a transaction is a tax avoidance transaction because it meets the first two steps, under section X(4) it must be determined whether the transaction is in accordance with or contrary to the underlying policy of the relevant provisions of the income tax legislation; tax avoidance transactions that are contrary to the object and purpose of the tax law are subject to the general anti-avoidance rule.

Section X(1)

Section (1) sets out the basic charging provision of the general anti-avoidance rule. It authorizes the tax authorities to determine the tax consequences for any person with respect to a tax avoidance transaction, which is defined in section (9). The tax consequences of a tax avoidance transaction must be determined in a reasonable manner to deny any tax benefit that would have resulted from the transaction in the absence of the application of section (1). Section (1) allows the tax authorities to determine the tax consequences of any person, not just the taxpayer or taxpayers who would derive a tax benefit from the transaction in the absence of section X.

Section X(2)

Section X(2) applies to determine whether a transaction is a tax avoidance transaction subject to section X(1). For this purpose, a tax avoidance transaction must be a transaction or a series of transactions as defined in section X(9). A transaction or series of transactions will be a tax avoidance transaction if the transaction or series:

1. results, directly or indirectly, in a tax benefit as defined in section X(9), and
2. one of the main purposes [the main purpose] of the transaction or series was to obtain the tax benefit.

A tax benefit is broadly defined in section X(9) to mean any reduction, avoidance or deferral of tax payable or other amount payable under the tax law. A transaction or series results directly in a tax benefit if, for example, it results in a deduction, allowance, credit or loss that is deductible for tax purposes or results in revenue being diverted to another person. A transaction or series results in a tax benefit indirectly if, for example, it produces or increases a tax attribute that may be claimed by the taxpayer in the future. For example, a transaction or series of transactions that generates an increase in the stated or paid-in capital of shares of a corporation results in a tax benefit even though the benefit may not be realized until sometime in the future when the corporation makes a tax-free return of capital to its shareholders.

A transaction or series of transactions is an avoidance transaction only if one of the main purposes of the transaction or series is to obtain the tax benefit. This purpose test must be determined reasonably in accordance with all the relevant facts and circumstances as expressly provided in section X(2). Thus, section X(2) requires the purpose test to be applied on the basis of objective facts not just on the basis of the taxpayer's subjective intention. Although the taxpayer's subjective intention may be a relevant consideration, it will not be determinative and all relevant facts and circumstances must be considered. Section X(3) provides that, in determining if one of the main purposes of a transaction or series is to obtain a tax benefit, four especially relevant factors must be taken into account.

For the purposes of section X(2), a main purpose is a purpose that is a major motivating reason for the transaction or series and not

an incidental or ancillary reason. It is not necessary for purposes of section X(2) for a main purpose to be the main purpose for the transaction or series. The main purpose for a transaction or series must be more important than any other purpose. However, under section X(2) it is sufficient if one of the main purposes of a transaction or series is to obtain a tax benefit. A transaction or series may have several main purposes. For example, transactions will often be undertaken for both commercial or legal objectives and tax benefits. As long as obtaining a tax benefit is one of the main purposes of a transaction or series and not just an incidental or ancillary purpose, the transaction or series will be a tax avoidance transaction under section X(2).

Under section X(2), either a transaction or a series of transactions as defined in section X(9) may be a tax avoidance transaction. Where a transaction is part of a series of transactions, section X(2) can apply to either each transaction that is part of the series or the series as a whole or both. Thus, a transaction that is part of a series of transactions may be a tax avoidance transaction if it results in a tax benefit and one of its main purposes is to obtain that benefit even though none of the main purposes of the series as a whole is to obtain a tax benefit. Alternatively, a series may be a tax avoidance transaction if it results in a tax benefit and one of its main purposes is to obtain that benefit even though none of the transactions in the series is a tax avoidance transaction.

There is nothing in section X that prevents the tax authorities from taking the position that a transaction that is part of a series is a tax avoidance transaction, the series as a whole is a tax avoidance transaction or both are tax avoidance transactions under section X(2).

Section X(3)

[Note: section X(3) is probably unnecessary if section X(2) uses a main purpose test rather than a one of the main purposes test. The following explanatory notes assume that the purpose test in section X(2) is a main purpose test.]

Section X(3) sets out four factors that must be considered in determining the main purpose of a transaction or series of transactions for purposes of section X(2). However, the fact that these four factors are mentioned expressly does not detract from the need to

determine the main purpose of a transaction or series on the basis of all relevant circumstances.

Section X(3)(a) requires consideration of the changes in the financial positions of any parties to the relevant transaction or series of transactions or any persons related to those parties. If there is no significant change in the financial positions of the parties or related persons, it is more likely that the main purpose of the transaction or series was to obtain tax benefits. This is especially the case where a series of transactions involves a circular flow of funds. On the other hand, if the transaction or series results in significant changes in the financial positions of the parties or related persons, it suggests that commercial or other non-tax considerations were the main reason for the transaction or series.

Section X(3)(b) requires consideration of the manner in which a transaction or series of transactions is carried out in determining the main purpose of the transaction or series. Certain aspects of the manner in which a transaction or series is carried out may indicate that it was not carried out primarily for a non-tax purpose. For example, a transaction may be carried out with one or more tax-indifferent parties, such as tax-exempt entities, in order to reduce or avoid tax. Also, if a transaction or series of transactions features a condition of confidentiality, fees or payments that are contingent on the tax benefits or savings from the transaction or series or a tax indemnity, this may be a strong indicator that the main purpose of the transaction or series was to get a tax benefit.

Section X(3)(c) requires consideration of the economic substance of the transaction or series. The reference to economic substance is used in contrast to the legal form of a transaction or series. If the economic substance of a transaction or series differs significantly from its legal form, this may be an indication that the legal form was used to obtain tax benefits that would not be available if the transaction or series was taxable in accordance with its economic substance. Tax avoidance transactions often involve manipulation of the legal form of transactions to obtain tax benefits. Consideration of the economic substance of the transactions may indicate that the transactions were carried for the main purpose of getting tax benefits. For example, a company may issue a debt obligation with terms that entitle the holder to interest only

if the company makes profits rather than issuing shares in order to get a deduction for the interest. In effect, the economic substance of the debt obligation in this situation is an equity interest in the company and the interest paid on the debt obligation is in reality a share of the profits of the company or a dividend, which should not be deductible.

Section X(3)(d) requires consideration of whether a transaction or series of transactions results in the creation of rights or obligations that would not be created between persons dealing at arm's length. Transactions between arm's length persons generally reflect real commercial considerations unless one of the parties is tax-indifferent (see section X(3)(a)). Therefore, where related or non-arm's length persons engage in transactions that arm's length persons would not engage in, this may indicate that the main purpose of the transactions was to obtain tax benefits. For example, an owner of a company or other entity would not give up control of the entity in the absence of a sale of an equity interest in the entity for its fair market value. Therefore, if the owner sells control of an entity in circumstances other than an arm's length sale, it may indicate that the main purpose of the transaction was to obtain a tax benefit.

Section X(4)

Section X(4) provides an exception for tax avoidance transactions that are established by the taxpayer to be in accordance with the underlying policy of the relevant provisions of the tax law. Tax avoidance transactions are not subject to section X(1) if they are consistent with the object and purpose of the relevant provisions.

Section X(4) is based on the principle that not all transactions or series of transactions one of the main purposes of which is to obtain a tax benefit are necessarily abusive. Some transactions may represent legitimate or acceptable tax planning despite the fact that they are partly driven by tax considerations. The exception in section X(4) places the burden on the person claiming the tax benefit to establish that the tax avoidance transaction is not contrary to the object and purpose of the tax laws.

Section X(4) requires a two-step analysis. First, the object and purpose of the relevant provisions of the tax law must be determined. The object and purpose of the relevant provisions of the tax

law is a reference to the underlying tax policy of those provisions. In general, the relevant provisions will be the provisions that the taxpayer has relied on for the tax benefit; however, in certain circumstances it may be necessary to consider the object and purpose of the tax law as a whole. Where a tax benefit results from the provisions of a tax treaty, the object and purpose of the provisions of the treaty must be determined. As expressly provided in section X(5)(a), the object and purpose must be determined based on the words of the relevant provisions and any official guidance concerning the object and purpose of the legislation, such as explanatory notes or administrative guidance issued in connection with the legislation or other extrinsic evidence.

Second, once the object and purpose of the legislation has been determined, the issue is whether the tax avoidance transaction is contrary to, is inconsistent with, frustrates, defeats or abuses that object and purpose or is in accordance with and consistent with that object and purpose.

Section X(5)

Section X(5)(a) sets out guidance with respect to the material that tax officials and courts should consider for the purpose of determining the object and purpose of the tax laws. Section X(5)(a) requires the words of the relevant provisions and any official guidance concerning the object and purpose of the legislation as well as any other relevant information, such as scholarly articles, to be considered in determining the object and purpose of the relevant provisions. Where the tax benefit resulting from the tax avoidance transaction is a benefit under a tax treaty, the provisions of the United Nations Model Double Taxation Convention Between Developed and Developing Countries and the Commentary and the OECD Model Tax Convention on Income and on Capital and the Commentary should be considered in determining the object and purpose of the provisions of the treaty.

[This provision may be necessary for countries in which the courts and tax officials do not have extensive experience in interpreting tax statutes in accordance with the purpose of the relevant provisions of those statutes. If a country's courts would consider this material for purposes of applying the general anti-avoidance rule without the need for a provision like section X(5)(a), then section X(5) could be omitted.]

Section X(5)(b) sets out four factors that must be considered in determining whether a transaction or series of transactions is in accordance with or contrary to the object and purpose of the relevant provisions of the tax law for purposes of section X(4). However, the fact that these four factors are mentioned expressly is not intended to limit the considerations that can or should be taken into account for this purpose.

Section X(5)(b)(i) requires consideration of the manner in which a transaction or series of transactions is carried out in determining whether a transaction or series is in accordance with or contrary to the object and purpose of the relevant provisions of the tax law. Certain aspects of the manner in which a transaction or series is carried out may indicate that it was not carried out primarily for a non-tax purpose.

Section X(5)(b)(ii) requires consideration of the economic substance of the transaction or series. The reference to economic substance is used in contrast to the legal form of a transaction or series. If the economic substance of a transaction or series differs significantly from its legal form, this may be an indication that the legal form was manipulated to obtain tax benefits that would not be available if the transaction or series was taxable in accordance with its economic substance. Consideration of the economic substance of the transactions may indicate that the tax benefits of the transaction or series are contrary to the object and purpose of the tax law. For example, a company may issue preferred shares with a fixed term, fixed dividends and no voting rights to a unrelated company in order for the holder of the shares to get the benefit of an exemption for intercorporate dividends. In substance, these shares represent debt owed to the holder and the amounts paid on the shares are in substance interest, which should be txable to the holder. Allowing an exemption for intercorporate dividends with respect to these shares may be contrary to the object and purpose of the exemption.

Section X(5)(b)(iii) requires consideration of whether a transaction or series of transactions results in the creation of rights or obligations that would not be created between persons dealing at arm's length. Where related or non-arm's length persons engage in transactions that arm's length persons would not engage in, this may indicate

that the transactions are contrary to the object and purpose of the relevant provisions of the tax law. For example, an owner of property would not enter into a transaction with an arm's length party to dispose of the property for less than its fair market value; therefore, if the owner does enter into such a transaction, it may indicate that the transaction is contrary to the object and purpose of the tax law.

Seection X(5)(b)(iv) requires consideration of any transaction that is artifical or abnormal. In general, the provisions of a country's tax law are not intended to apply to transactions that are artificial or abnormal. Therefore, if a transaction is artificial or unrealistic or creates abnormal rights or obligations that would not be created between arm's length parties, the artificiality or abnormality of the transaction may indicate that the transaction is contrary to the object and purpose of the tax law.

Section X(6)

Section X(6) gives the tax authorities broad discretion to determine the tax consequences for any person in order to deny the tax benefits that would result from the tax avoidance transaction if the general anti-avoidance rule did not apply. Because tax avoidance transactions vary widely, it is impossible to provide specific rules governing the appropriate tax consequences resulting from the application of section X(1) to a tax avoidance transaction. The basic purpose of section X(1) is to deny the tax benefit that would otherwise result from an tax avoidance transaction. However, this must be done in a manner that is reasonable in the circumstances. Therefore, for example, if income is attributed to a person other than the person who actually received the income, the other person's income should be reduced by the income attributed to the first person.

Section X(1) and (6) authorize the tax authorities to determine the tax consequences for any person involved in or affected by the tax avoidance transaction, including the person or persons claiming a tax benefit from the transaction, the parties to the tax avoidance transaction and other persons.

Although section X(6) allows the tax authorities to take any reasonable action in determining the tax consequences of a person, it also lists examples of the actions that they might take in this regard.

These actions include:

- allowing or disallowing deductions, allowances, reliefs, credits exemptions or exclusions in whole or in part;
- allocating or reallocating any income, loss, deductions, allowances, reliefs, credits, exemptions or exclusions in whole or in part;
- recharacterizing the nature of any income, loss, payment, expenditure or other amount;
- ignoring or disregarding any transaction or series of transactions that is or is part of a tax avoidance arrangement;
- ignoring, disregarding or combining one or more transactions that form part of a series of transactions; and
- considering any persons to be related [connected, associated or not dealing at arm's length] or to be the same person.

These examples are not intended to limit the actions that the tax authorities can take in determining the tax consequences for any person if the general anti-avoidance rule applies.

Section X(7)

Section X(1) and (6) allow the tax authorities to determine the tax consequences for persons other than those persons who claim a tax benefit from a tax avoidance transaction. Where the tax authorities apply the general anti-avoidance rule in section X to persons who claim a tax benefit from a tax avoidance transaction, typically those persons will receive an assessment of tax payable as a result of the application of section X. However, persons who do not claim a tax benefit with respect to the particular tax avoidance transaction may be adversely affected by the application of section X to other persons. For example, a person who acquires property pursuant to a transaction that is disregarded by the tax authorities under section X, may not be assessed under section X as having received a tax benefit, but still owns or holds that property under the law. Therefore, that person may wish to have the tax authorities establish the cost or nature of the property for tax purposes.

Section X(7) allows persons who are not assessed under section X(1) with respect to a tax avoidance transaction to request the tax authorities to make relieving adjustments to their liability to tax as

are reasonable in the circumstances. Any such request must be made within 12 months of the date that an assessment with respect to the particular tax avoidance transaction is made. Unlike persons who are assessed under the general anti-avoidance rule, other persons who are adversely affected but not assessed will not receive any notice from the tax authorities that section X has been applied to the particular tax avoidance transaction. Accordingly, such persons are given an extended period of 12 months from the date that an assessment with respect to the particular tax avoidance transaction is issued to make the request for relief. The request must be made in writing, but does not have to be made in any particular format.

Section X(8)

Section X(8) places an obligation on the tax authorities to notify a person who makes a request in accordance with section X(7) within __ months of the receipt of the request whether the request has been granted or denied. If the request is denied, the person has the right to appeal the denial to the court in the same manner as a tax assessment.

Section X(9)

Section X(9) provides definitions of several key terms used in section X.

In section X(9)(a), a "tax benefit" is defined to mean any reduction, avoidance or postponement of tax [or other amount payable] under the tax law, any increase in the amount of a tax refund and any benefit derived under the provisions of a tax treaty. The definition of a tax benefit is intended to be broad and includes any reduction, avoidance or deferral of tax. Thus, any deduction, allowance or exclusion in computing income and any credit against tax payable would clearly be a tax benefit. Similarly, any postponement of tax, such as a tax-deferred rollover for a transfer of property, and any benefit derived from the application of the provisions of a tax treaty would clearly be a tax benefit.

Section X(9)(b) defines "tax" to be the tax imposed under the relevant legislation.

Section X(9)(c) defines "transaction" broadly to mean any transaction, event, action, course of action, course of conduct, scheme,

plan, proposal, agreement, arrangement, understanding, promise or undertaking. The listed items, such as a scheme, plan, proposal, understanding, promise or undertaking, are transactions whether they are express or implied or legally enforceable. The definition is as broad as possible to include all actions that might result in a tax benefit. It also includes events such as meetings of shareholders and directors, the expiry of an option, changes in the use or location of property or persons, etc. which might not be considered to be transactions.

Section X(9)(d) defines "series of transactions" to mean two or more transactions as defined in section X(9)(c) that are connected or related directly or indirectly. Thus, a transfer of property by a person to another person on the condition or understanding that the property will be transferred to a third person would be a series of transactions consisting of the first and second transfers of the property. Like the definition of "transaction," the definition of "series of transactions" is not limited to transactions that must be carried out because of a legal obligation or that are legally enforceable. The definition of "series of transactions" includes any transaction as defined in section X(9)(c) that is carried out because of prior or subsequent transactions. In effect, the definition of a series of transactions is not limited to a transaction and related or connected transactions occurring after that first transaction; it extends to related or connected transaction occurring before or after another transaction.

4.5 Case Studies

4.5.1 Introduction

This section presents case studies to illustrate how a GAAR might be interpreted and applied. The case studies are based on simplified facts in order to highlight the key issues in the application of a GAAR. Rather than focus on any particular country's GAAR, the provisions of the detailed sample GAAR in section 4.3 above are applied in the case studies.

The application of a GAAR is always intimately related to the provisions of domestic law and any relevant tax treaty. The case studies set out certain simplified assumptions concerning the relevant

provisions of domestic law or tax treaties to illustrate how a GAAR that involves the object and purpose of the provisions of domestic law or a tax treaty should be applied. Actual cases will usually involve more complex facts, and as a result the application of the GAAR will be more difficult and uncertain.

4.5.2 Case Study 1

X, a resident of Country X, started a small business of roasting coffee beans and selling them to local independent coffee shops. The business has been quite successful and now has several employees, significant assets, and annual sales of 1 million. X has been advised by his accountant that he should establish a corporation under the laws of Country X and transfer the business to the corporation to obtain limited liability and certain tax advantages (small corporations are subject to a lower rate of tax than the top marginal rate applicable to individuals). Consequently, X establishes a corporation and transfers all the assets and liabilities of his sole proprietorship to the company in exchange for all the common shares of the company. Under the domestic law of Country X, transfers of the assets and liabilities of a sole proprietorship to a corporation in exchange for shares qualify for a tax-deferred rollover, with the result that no tax is imposed on any accrued gain at the time of the transfer to the corporation; instead, the tax is deferred until the assets are sold by the corporation or the shares in the corporation are sold.

The first step in the application of the GAAR to this case study is to determine whether there is a transaction or series of transactions that results in a tax benefit. On the facts of this case study, the incorporation of the company and the transfer of the business to the company in exchange for shares constitute a series of transactions. The two transactions are related, because otherwise, incorporating the company without transferring the business to the company would not make any sense. Therefore, section X(2) can apply to the transfer of the business as a transaction or as part of a series consisting of the incorporation of the company and the transfer of the business to the company. Both the transaction and the series of transactions result in a tax benefit. (The incorporation of the company by itself does not result in a tax benefit.) The transaction results in a tax benefit, in the

form of a deferral of tax on the transfer of the assets to the company (although to the extent that there are accrued losses in respect of the transferred assets, there would be no tax benefit). The series of transactions also results in a tax benefit, in the form of the lower rate of tax on the income of small business corporations as compared to the rate of tax on the income of sole proprietorships.

The second step in the application of the GAAR is to determine whether one of the main purposes or the main purpose of the transaction or series of transactions was to obtain the tax benefit. On the facts of this case study, it appears clear that the tax benefits (the deferral of tax on the transfer of the assets of the sole proprietorship and the lower rate of tax) were the main reasons (and therefore one of the main reasons) for the transaction and the series. The taxpayer might argue that obtaining limited liability was the main reason for the transfer of the business to the company; however, this argument is not convincing. Therefore, both the transfer of the business to the corporation and the series are tax avoidance transactions under section X(2).

The third step in the application of the GAAR is to determine whether the tax avoidance transaction (either the transfer or the series) is contrary to the object and purpose of the tax law under Article X(4) taking into account the factors listed in section X(5)(b). In this situation, the tax law of Country X explicitly provides a lower tax rate for small business corporations and does not contain any restrictions on the transfer of the business of a sole proprietorship to a corporation. Furthermore, the tax law explicitly provides a tax-deferred rollover to facilitate the transfer of property to a corporation. Finally, the transfer of the business of a sole proprietorship to a company is the typical, normal manner in which businesses grow. Therefore, it is reasonably clear that the underlying policy of Country X's domestic tax legislation is to provide a lower rate of tax on business income earned by small business corporations and to facilitate transfers of property to such corporations, including the transfer of a business carried on as a sole proprietorship. In this situation, the transaction and the series of transactions simply accomplish what Country X's domestic tax law provides, allows, and even encourages. Thus, they are consistent with and not contrary to the object and purpose of the tax law, and the general anti-avoidance rule should not apply.

4.5.3 Case Study 2

ACo owns all the shares of BCo, which has accumulated losses of 1 million and has ceased to carry on business. ACo carries on a cyclical business and does not anticipate generating profits for several years.

Under the domestic tax law of Country A, in which ACo and BCo are resident, any losses incurred by a company are deductible against its profits and can be carried forward for 5 years. In addition, losses of a controlled subsidiary can be deducted by its parent corporation after the liquidation of the subsidiary or after a merger of the parent and subsidiary. However, a company cannot deduct losses after control of the company has changed, except to the extent of profits from the same business that gave rise to the losses. For purposes of the restrictions on the deduction of losses, control means direct or indirect control. Therefore, although Country A's domestic tax law allows BCo to be liquidated or merged with ACo and allows BCo's losses to offset the profits of ACo after the liquidation or merger, ACo has no profits to absorb BCo's losses.

In order to use BCo's losses before they expire, ACo carries out the following transactions:

1) XCo, a company resident in Country A, is a profitable company engaged in a business that is unrelated to the business carried on by ACo and BCo. XCo is controlled by Mr. X, who is a longtime friend of Mr. A, who controls ACo.
2) XCo issues preferred shares to ACo
   - The preferred shares are redeemable at the option of the holder and retractable at the option of the company for 1,000.
   - The preferred shares have voting rights that allow the holder of those shares to elect a majority of the board of directors of XCo. As a result, the preferred shares are issued, ACo controls XCo so that when XCo acquires the shares of BCo, as described below, ACo still controls BCo indirectly.
   - The common shares of XCo have a fair market value of 10 million.
3) Mr. X and Mr. A enter into a shareholders' agreement under which they agree that all decisions of the board of directors

of XCo require the agreement of Mr. X and Mr. A.

4) Mr. A agrees to indemnify XCo and Mr. X for all costs they incur in connection with the transactions if the transactions are not successful in reducing XCo's tax.
5) XCo acquires the shares of BCo for 50,000, or 5 percent of the amount of BCo's losses.
6) BCo is liquidated into YCo.
7) XCo deducts the losses of BCo against XCo's profits.
8) Once the losses of BCo have been completely used up to offset XCo's profits, the preferred shares held by ACo are redeemed for 1,000.

All these transactions constitute a series of transactions within the definition in section X(9)(d). They are related or connected transactions that form part of an overall scheme to utilize the losses of BCo to reduce the profits of XCo. The series results in a tax benefit, as required by section X(2), because the tax payable by XCo on its profits is reduced as a result of the losses. Further, one of the main purposes (and indeed, the main purpose) of the series was to allow XCo to deduct the losses of BCo. In fact, there is no other commercial purpose for the series of transactions, since BCo has ceased to carry on business. Therefore, the series of transactions is a tax avoidance transaction under section X(2).

This conclusion is supported by reference to the factors listed in section X(3). The only changes in the financial positions of ACo and XCo are attributable to the payment by XCo of 50,000 to ACo for the shares of BCo, representing 5 percent of BCo's losses, and the costs of the transactions. The economic substance of the series of transactions is that XCo has acquired the losses of BCo, which, if XCo had acquired the shares of BCo, would not have been deductible because control of BCo would have been acquired and its losses would no longer have been deductible. The series of transactions, and in particular the issuance of the voting preferred shares carrying control of XCo, attempt to avoid any change in control of BCo, so that the restriction on the deduction of BCo's losses does not apply even though the preferred shares give ACo only formal control of XCo.

Further, the issue of the preferred shares by XCo to ACo, which give control of XCo to ACo for a nominal amount, is not a commercial

transaction that arm's length persons would enter into; owners of a company worth 10 million do not sell control of the company to other persons for a nominal amount. This conclusion is supported by other facts, such as the redemption of the preferred shares as soon as the losses are completely deducted against XCo's profits, the tax indemnity, and the shareholders' agreement, which prevents ACo from actually exercising control of XCo's affairs. Therefore, the series of transactions is clearly a tax avoidance transaction under section X(2).

The final issue is whether the series of transactions is contrary to the object and purpose of the tax legislation of Country A under section X(4). The tax legislation expressly prohibits the deduction of losses of a company where control of the company changes, except to the extent of the profits of the business that produced the loss.

In this situation, ACo and XCo have employed a highly artificial series of transactions, including the issue of non-commercial preferred shares, to avoid a change in control of BCo when its shares are acquired by XCo. If the statutory restriction on the deduction of losses where there is a change of control of a company can be avoided through such an artificial, non-commercial series of transactions, the statutory restriction would be rendered meaningless. The factors listed in section X(5)(b) support the conclusion that the series of transactions is contrary to the object and purpose of the relevant provisions of Country A's tax law. The preferred shares have artificial, non-arm's length terms and are issued on the understanding that XCo will not actually exercise the voting rights attached to the shares. The economic substance of the series is that ACo has sold the losses of BCo to XCo for 5 percent of the amount of the losses, which is directly contrary to the restrictions on the sale of losses in Country A's law.

Therefore, it is reasonable to conclude that this series of transactions is contrary to the object and purpose of the restriction on the deduction of losses after a change in control of a company, and the general anti-avoidance rule should apply.

4.5.4 Case Study 3

ACo owns 8 percent of the shares of BCo. Under the tax law of Country A, in which ACo and BCo are resident, dividends received by one

resident corporation from another resident corporation are exempt from tax if the recipient owns 10 percent or more of the value and voting rights of all the shares of the payer corporation. Other dividends received by resident corporations are subject to tax at a rate of 15 percent.

In order to take advantage of the exemption for intercorporate dividends, ACo acquires an additional 2 percent of the voting common shares of BCo in an arm's length transaction for the fair market value of the shares. This acquisition gives ACo 10 percent of the votes and value of the shares of BCo.

On these facts, it is clear that one of the main purposes for the acquisition of an additional 2 percent of the shares of BCo is to get the benefit of the exemption for intercorporate dividends. However, it is not clear that getting that tax benefit is the main purpose of the acquisition. An argument can be made on these facts that the main purpose of the acquisition was to make an additional investment in the shares of BCo with the opportunity to profit from dividends and the appreciation in the value of the shares. If ACo had acquired 10 percent of the shares of BCo at the outset, this argument would be even more persuasive. The general anti-avoidance rule is not intended to require taxpayers to ignore tax considerations in planning their affairs. However, even where 10 percent of the shares of BCo is acquired in one transaction, one of the main purposes of the acquisition would likely be the tax benefit of the exemption for intercorporate dividends.

Assuming that the purpose test in section X(2) is satisfied, the acquisition of an additional 2 percent of the shares of BCo would be a tax avoidance transaction unless ACo can establish that the acquisition is in accordance with, and not contrary to, the object and purpose of the exemption for intercorporate dividends under section X(4) taking into account the factors listed in section X(5)(b). Under Country A's domestic law, the exemption for intercorporate dividends is available if the recipient owns 10 percent or more of the shares of the payer corporation. There is nothing in the tax legislation to indicate that the exemption is available only if a corporation acquires 10 percent or more of another corporation in a single transaction, rather than in stages over time. It is also notable that ACo acquired the additional 2 percent of the shares in an ordinary commercial transaction.

The economic substance of the acquisition of an additional 2 percent of the shares of BCo is exactly the same as its legal form — an acquisition of all the risks and rewards of ownership of those shares. Therefore, once ACo owns 10 percent or more of the shares of BCo, ACo should be entitled to the exemption for intercorporate dividends.

However, if, as part of the acquisition of the additional 2 percent of the shares of BCo, ACo had entered into an agreement with the seller of the shares to transfer the shares back to the seller shortly after the dividend is received, that series of transactions would be contrary to the object and purpose of the exemption for intercorporate dividends. The exemption is intended for dividends where the recipient corporation owns 10 percent or more of the shares of the payer corporation. For this purpose, the ownership of the requisite percentage of the shares of the payer corporation does not mean temporary ownership — if it did, the 10 percent ownership requirement would be rendered meaningless. Therefore, transactions that do not involve a real acquisition of shares for their fair market value are contrary to the purpose of the ownership threshold for the intercorporate dividends exemption, and the general anti-avoidance rule should apply to such transactions.

4.5.5 Case Study 4

ACo is a large corporation that carries on extensive business operations in Country A. ACo requires financing for its ongoing operations in the amount of 100 million. Instead of borrowing 100 million in Country A currency, for which the annual interest rate is 5 percent, ACo borrows 150 million of Country X dollars, a weaker currency, at an annual interest rate of 8 percent for 5 years. ACo enters into a forward foreign exchange contract (a swap arrangement) with a bank, under which the bank provides ACo with 100 million of Country A currency in exchange for 150 million of Country X currency; ACo agrees to provide the bank with sufficient Country A currency on each interest payment date so that the bank can acquire Country X currency to pay the interest; and ACo agrees to provide the bank with sufficient Country A currency on the maturity of the loan on the maturity of the loan in 5 years for the bank to repay the loan in Country X dollars. Because future forward exchange rates between two currencies are a function of current interest rates for the two currencies, on the maturity of the

loan, ACo is required to provide the bank with 85 million of Country A currency in order for the bank to repay the loan with 150 million of Country X dollars. The amount necessary to repay the loan is fixed at the time the arrangement between ACo and the bank is entered into.

Under the domestic tax law of Country A, interest is deductible in computing a taxpayer's income if the borrowed money is used for the purpose of earning business profits. The interest paid by ACo clearly satisfies the test for the deduction of the interest, since the borrowed funds are actually used in its business. The issue is whether all or part of the interest deduction should be disallowed as a result of the application of the general anti-avoidance rule in section X.

For financial accounting purposes, the 15 million gain realized on the maturity of the loan (the liability is settled for 15 million less than its cost) must be amortized over the 5-year term of the loan and netted against the interest at 8 percent. Thus, in effect, ACo is entitled to claim a current expense of only 5 percent, which is the applicable rate for a similar borrowing of Country A currency.

The series of transactions—the borrowing and the payments pursuant to the forward foreign exchange agreement—clearly result in a tax benefit in the form of interest deductions. In addition, one of the main purposes of the series is clearly to obtain the benefit of the interest deductions. However, it questionable whether the main purpose of the series of transactions is to obtain interest deductions. The taxpayer can argue that the main purpose of the series is to obtain financing for its business operations. This argument is less persuasive with respect to the swap payments, since the only reason for those payments was to get Country A currency, and those payments were necessitated by ACo's decision to borrow in a currency that it could not use. However, the currency of a loan is only one term of the loan and is unlikely to be treated as a separate transaction for purposes of section X. Therefore, there is a risk that a court might conclude that the main purpose of the series of transactions, and each step in the series, was not to obtain a tax benefit, in which case the general anti-avoidance rule would not apply because the series of transactions would not be an avoidance transaction under section X(2).

Reference to the factors listed in section X(3) may support the argument that the main purpose of the transactions is to obtain a tax

benefit. The manner in which the transactions are carried out suggests that they were driven mainly by tax considerations — in the absence of tax considerations, commercial enterprises would not borrow funds in a currency that they don't want and can't use at a higher interest rate than they would be required to pay to borrow the same amount on the same terms in the currency that they do want. Similarly, the economic substance of the series of transactions, as illustrated by the treatment of the series for financial accounting purposes, is simply a synthetic loan in Country A currency. The higher interest rate over the term of the loan is offset by the gain on the repayment of the loan at maturity. In substance, the higher interest rate represents a portion of the principal amount of the loan, as shown by the gain on the repayment of the loan. If a deduction is allowed for the interest payments in excess of 5 percent, the rate on an equivalent loan in Country A currency, in effect, a deduction will be allowed for part of the principal amount of the loan.

Assuming that the purpose test in section X(2) is satisfied, the issue becomes whether the series of transactions is in accordance with or contrary to the object and purpose of Country A's tax legislation under section X(4) taking into account the factors in section X(5)(b). Country A's tax laws allow a deduction for interest on money borrowed for use in a business. On the facts, the borrowed money was clearly used in ACo's business. The crucial question is whether the periodic payments made by ACo are really interest or are in part repayments of principal. Country A's tax laws do not allow a deduction for all or any part of the principal amount of a loan. As explained above, the effect of the series of transactions and its economic substance is to convert part of the principal amount of a loan into interest, contrary to the purpose of the tax legislation. Moreover, more principal will be converted into interest to the extent that the currency of the borrowing is weaker than the currency that the taxpayer needs. It is unlikely that the legislature of Country A would have intended the interest deduction provision in the law to encourage residents of Country A to borrow the weakest currencies available and then swap those currencies at added costs into Country A currency. Also, the manner in which the series of transactions was carried out and the artificiality of the transactions supports a finding that the series is contrary to the object and purpose of the tax law. Borrowing funds in a currency that a taxpayer does not

want and cannot use is not a commercial transaction that taxpayers would carry out unless the transaction resulted in tax benefits significantly in excess of the tax benefits of borrowing in the currency that the taxpayer wants and needs.

Therefore, ACo is unlikely to be able to establish that a weak currency borrowing that converts non-deductible principal into deductible interest is consistent with the object and purpose of Country A's tax law, and the general anti-avoidance rule should apply to deny the higher interest deductions claimed.

4.5.6 Case Study 5

ACo, a company resident in Country A, owns all of the shares of BCo, a company resident in Country B. BCo has recently ceased to carry on business and has sold all its business assets; as a result, BCo's assets consist exclusively of cash and near-cash assets. ACo sells the shares of BCo to XCo, another company resident in Country B that is unrelated to ACo, for their fair market value, less a small discount. The fair market value of the shares of BCo is equal to the value of BCo's cash and near-cash assets. The purchase price of the shares is satisfied by XCo issuing a note to ACo for the entire amount. After the sale, XCo causes BCo to be liquidated and all its assets are distributed to XCo. XCo then uses the funds to repay its note payable to ACo.

Under the tax law of Country B, withholding tax of 20 percent is imposed on payments of dividends by corporations resident in Country B to non-residents. Further, on the liquidation of a resident corporation and on a redemption of its shares (and other similar transactions), the corporation is deemed to have paid a dividend to its shareholders equal to the fair market value of its assets in excess of the stated capital of its shares. (Assume that the stated capital of the shares of BCo is a nominal amount.) Country B imposes tax on capital gains realized by residents and non-residents with respect to the disposition of shares of corporations resident in Country B, but the tax is imposed at a preferential rate of 10 percent of the gain.

Country A and Country B have concluded a tax treaty with provisions identical to those of the United Nations Model Convention, except that the treaty does not contain Article 13(5) or a general

anti-abuse rule like Article 29(9). Under Article 10 of the treaty, the withholding tax on dividends is reduced to 10 percent for dividends paid by a corporation resident in Country B to a corporation resident in Country A that owns 25 percent or more of the shares of the payer corporation.

This series of transactions clearly results in a tax benefit. If BCo had been liquidated and its assets distributed to ACo, ACo would have been liable to pay withholding tax on a deemed dividend equal to the fair market value of BCo's assets. The withholding tax would have been imposed at a rate of 20 percent under Country B's domestic law but would have been reduced to 10 percent under Article 10 of the tax treaty. Instead, the series of transactions converts this dividend into a capital gain on the sale of the shares of BCo to XCo and, under Article 13 of the treaty between Country A and Country B, the capital gain is exempt from tax by Country B. The exemption provided by Article 13 of the treaty is clearly a tax benefit under the definition in section X(9)(a), which expressly includes treaty benefits. Even in the absence of the treaty, there would be a tax benefit because Country B's tax on the capital gain is less than its withholding tax on the deemed dividend.

One of the main purposes of the series of transactions is to obtain a tax benefit in the form of the exemption of the capital gain from tax by Country B. Similarly, it also seems clear that this tax benefit was the main purpose of the series. The commercial purpose of the series — the distribution of the assets of BCo to ACo — could have been accomplished more directly if BCo had simply paid a dividend to ACo or if BCo had been liquidated and distributed its assets to ACo. However, these alternatives would have resulted in withholding tax on the distributions. The taxpayer might argue that the main purpose of the series of transactions was for ACo to get access to the assets of BCo and that the tax considerations were secondary.

Consideration of the factors listed in section X(3) confirms that the main purpose of the series of transactions was to obtain the benefit of the exemption for capital gains under the tax treaty. There are no significant changes in the financial positions of the parties. After the transactions, ACo has the assets that were previously in BCo. Instead of receiving these assets as a distribution from ACo, ACo has received the same amount (less the fee paid to XCo) in the form of the purchase

price of the shares of BCo. XCo has nothing other than its fee (the discount on the purchase price of the shares of BCo) for participating in the transactions. Other than its fee, XCo has no real interest in the transactions; it is simply an accommodation party. Furthermore, the economic substance of the transactions is simply that ACo has received a distribution of the assets of BCo.

Therefore, this series of transactions was carried out for the main purpose of deriving a tax benefit. If necessary, the tax authorities could focus only on the sale of the shares to XCo rather than the entire series of transactions. This sale has no commercial purpose because XCo borrowed the purchase price from ACo and repaid that loan with the assets of BCo. XCo was not acquiring a business; it was merely acquiring cash for the purpose of passing that cash on to ACo.

The most important issue is whether under section X(4) the series of transactions is contrary to the object and purpose of Country B's tax legislation or the tax treaty between Country A and Country B taking into account the factors listed in section X(5)(b). The purpose of the relevant provisions of Country B's tax law is to tax distributions on the liquidation of a corporation as dividends rather than as capital gains and to impose withholding tax on such deemed dividends where the shareholders are non-residents. However, where non-residents sell shares of corporations resident in Country B, those sales result in the realization of a capital gain or loss that is taxed differently than a distribution. This capital gain treatment is intended for real sales, not disguised or artificial sales to accommodation parties. On these facts, there was no valid commercial reason for ACo to sell, or for XCo to purchase, a corporation with assets consisting exclusively of cash and near-cash. The sale of the shares of ACo to XCo was not a genuine commercial transaction and it would be contrary to the object and purpose of the capital gains provisions of Country B's tax law to treat such a sale as resulting in a capital gain so as to avoid withholding tax on dividends.

Moreover, the transactions are inconsistent with the object and purpose of the provisions of Country B's tax law. Under Country B's tax law, dividends and capital gains are taxed differently. Dividends paid by corporations resident in Country A to non-residents are subject to withholding tax of 20 percent on the gross amount paid. Capital gains, measured as the difference between the proceeds of disposal and the

cost of the property, are also taxable, but at a preferential rate of 10 percent of the gain. For purposes of Country B's tax law, a dividend includes not only formal dividends to shareholders, but also distributions to shareholders by way of redemptions of shares (and similar transactions) and on the liquidation of a corporation. Although the distributions on the redemption of shares of a corporation occur by way of a disposal of the shares of the corporation, they are deemed to be dividends under Country B's tax law.

Therefore, the underlying policy of Country B's tax system is to treat most distributions by corporations to their shareholders as dividends even if in some circumstances those distributions occur as a result of a disposal of the shares of the corporation. Further, distributions by resident corporations to non-resident shareholders are intended to be subject to withholding tax on the gross amount of the distribution.

The series of transactions in this case results in a distribution of BCo's assets by means of an artificial disguised sale of the shares of BCo to an accommodation party in an attempt to avoid Country B's withholding tax. The avoidance of withholding tax in this manner is contrary to the object and purpose of the provisions of Country B's tax law dealing with distributions by resident corporations and the imposition of withholding tax on dividends paid by resident corporations to non-residents. If withholding tax on liquidating distributions can be avoided through such artificial sales of shares to accommodation parties, the withholding tax would be rendered meaningless, contrary to its purpose, for liquidations of resident corporations with non-resident shareholders.

The series of transactions is also contrary to the object and purpose of the provisions of the tax treaty between Country A and Country B. Although that treaty does not contain a general anti-abuse rule, there is nothing in the treaty that would prevent Country B from applying its general anti-avoidance rule, and the Commentary on Article 1 of the United Nations and OECD Model Conventions confirms this result. On a proper interpretation of the treaty, there is no conflict between the treaty and Country B's domestic law. Under Country B's domestic law, the sale of the shares of BCo results in a dividend which, in accordance with Article 10 of the treaty, Country B

is entitled to tax at a maximum rate of 10 percent. Also, since Country B does not impose any tax on the gain from the sale of the shares of BCo, Article 13 of the treaty, which would prevent Country B from taxing any gain from the sale of the shares, is irrelevant.

If a court concludes that the provisions of the treaty prevent the application of Country B's general anti-avoidance rule, there is a strong argument that the tax treaty itself should be interpreted to deny the benefits of the treaty with respect to this series of transactions. The guiding principle in paragraph 22 of the Commentary on Article 1 of the United Nations Model Convention (and paragraph 61 of the Commentary on Article 1 of the OECD Model Convention) provides that treaty benefits should be denied where one of the principal purposes of a transaction or arrangement is to obtain treaty benefits and granting those treaty benefits in the circumstances would be contrary to the object and purpose of the relevant provisions of thes treaty. On the facts of this case study, it is obvious that one of the principal purposes of the series of transactions is to obtain the benefit of avoiding Country B's withholding tax on dividends and its tax on capital gains. Also, granting the benefits of the exemption for capital gains in Article 13 would be contrary to the object and purpose of that exemption, which is intended to apply only to genuine alienations of property, not to artificial sales to an accommodation party in order to avoid withholding tax on dividends.

In summary, the above analysis of the underlying policy of Country B's domestic law and Articles 10 and 13 of the tax treaty between Country A and Country B establishes convincingly that tax benefits resulting from the transactions should be denied under Country B's general anti-avoidance rule or under a proper interpretation of the treaty. Under Country B's general anti-avoidance rule, it would be reasonable for the tax authorities to ignore the sale to XCo and treat the transactions as a payment of dividends by BCo to ACo subject to withholding tax, which is reduced to 10 percent pursuant to Article 10(2) of the treaty. If the treaty prevents the application of Country B's general anti-avoidance rule, applying a proper interpretation of the treaty, the tax authorities of Country B could deny the exemption in Article 13 and either tax the transactions as resulting in a dividend subject to withholding tax at a rate of 10 percent or in a capital gain subject to Country B's capital gains tax.

Chapter 5

Negotiating A Treaty GAAR

The decision to include a GAAR in a country's tax treaties involves three major steps.

First, the country's tax policy officials working in conjunction with the country's tax treaty negotiators must decide whether it is desirable or necessary for a GAAR to be added to the country's tax treaties. The OECD/G20 BEPS Action 6 Final Report concluded that countries should add a general anti-abuse rule to their bilateral treaties and proposed a treaty GAAR that has since been added to both the United Nations and OECD Model Conventions. Ideally, once a decision has been made to include a GAAR in one tax treaty, that decision should also apply to all of the country's tax treaties although it may be difficult to achieve that result quickly.

Those countries that have signed the MLI and agreed to modify their tax treaties to add a general anti-abuse rule the same as or similar to Article 29(9) of the United Nations and OECD Model Conventions, have effectively made the decision to include a GAAR in their treaties. Therefore, any tax treaties that are not covered by the MLI should be renegotiated to include a GAAR although this may take several years depending on the size of the country's tax treaty network.

For those developing countries that already have a GAAR in their domestic law, it would seem to be quite obvious that a similar GAAR should be added to the country's tax treaties to prevent those treaties from being used to reduce or avoid domestic tax inappropriately.

Those countries that do not have a domestic GAAR or a GAAR in any of their tax treaties should carefully consider the need for both GAARs using the guidance provided in this Portfolio and in light of the fact that many countries have adopted a domestic GAAR and that

both the United Nations and OECD Model Conventions include a treaty GAAR.

Second, once a country decides that it wants to add a GAAR to its tax treaties, it needs to decide how that GAAR should be worded. This step is relatively simple given the addition of Article 29(9) to the United Nations and OECD Model Conventions in 2017. Article 29(9) reflects a consensus of OECD and G20 member countries and the members of the United Nations Committee of Experts. In addition, it will be included in many bilateral tax treaties through the mechanism of the MLI. Consequently, it will be difficult for any developing country to persuade its potential treaty partners to adopt a treaty GAAR that is significantly different from Article 29(9) and probably not worth the effort. However, a country may identify aspects of Article 29(9) that it would prefer to change or clarify and raise those issues during treaty negotiations. If the other country raises issues about the wording of a treaty GAAR, then it may be possible for the two countries to reach agreement on a treaty GAAR that is different from Article 29(9). In this case, the guidance in the United Nations and OECD Commentaries on Article 29(9) might not be applicable to a differently worded GAAR.

Third, the potential treaty partners must agree during the negotiations to include a GAAR in the treaty and must agree on the wording of the GAAR. As discussed above, negotiating for the inclusion of a treaty GAAR that is the same as Article 29(9) should be straightforward. The onus should fall on any country that does not want to include a GAAR in its tax treaties or wants to include a GAAR that is worded substantially differently from Article 29(9) to justify its position especially since Article 29(9) is included in both the United Nations and OECD Model Conventions. Any country that has decided that it wants to include a GAAR in its treaties should carefully consider its negotiating position with respect to any potential treaty partner that refuses to agree to include a GAAR in its tax treaties. For example, a country may decide that it will accept not to include a GAAR if the other country makes certain other concessions with respect other provisions of the treaty or that it will not enter into a tax treaty without a GAAR.

Part 4

Administrative Aspects of a GAAR

Chapter 1

4.1 Organization of a special aggressive tax avoidance unit

Countries with a GAAR or considering adopting a GAAR should think about establishing a special unit within the tax administration to deal with tax avoidance including the application of the GAAR. Such a special unit would allow the tax authorities to create a group of tax officials that would acquire specialized knowledge over time about sophisticated tax avoidance transactions.

Aggressive tax avoidance is usually carried out by large corporations and high net worth individuals; moreover, the amount of tax at risk with respect to the tax avoidance transactions is generally much greater with respect to the transactions carried out by large corporations and high net worth individuals. Although all tax officials dealing with these taxpayers need to be able to identify abusive tax avoidance transactions and to be familiar with the GAAR, it may be more effective for transactions potentially subject to the GAAR to be referred to a special tax avoidance unit for a final decision as to whether the GAAR should be applied to the transactions. Such a special unit could help ensure that the GAAR is applied consistently. Obviously, it is necessary for effective lines of communication to be established between the special tax avoidance unit and tax officials dealing with large corporations and wealthy individuals.

4.2 Identifying Abusive Tax Avoidance Transactions

The effective application of a GAAR requires the identification of the transactions to which the GAAR might potentially apply. Unless the tax authorities are able to identify these transactions, they will not be in a position to analyze whether they are subject to the GAAR. Although it is possible for tax officials to discover avoidance transactions from an audit of a taxpayer's tax return, financial statements, and relevant documents,

that task is difficult, intensive and time consuming. For many developing countries, the audit activities that are necessary to identify tax avoidance transactions may beyond the capacity of the tax authorities. Therefore, it is important especially for developing countries to require taxpayers to provide specific information about any potentially abusive transactions carried out in a particular year. These mandatory disclosure rules are discussed in Part 2, chapter 2, section 2.4.2.

4.3 Assessment Procedures

A GAAR is a provision of last resort and, like any anti-avoidance rule, it must be applied by the tax authorities rather than by the taxpayer, even in a self-assessment system. (Taxpayers cannot reasonably be expected to apply a GAAR to their detriment.) The application of the GAAR by the tax authorities must be in accordance with the general assessment procedures of each country's tax system; however, some special provisions may be necessary or appropriate with respect to an assessment based on the GAAR. For example, it may be necessary to provide specifically that an assessment may be made on persons other than the taxpayer who enters into or carries out the transaction, and, in this case, the tax authorities should be required to give notice to any person affected by a GAAR assessment. Also, persons other than the taxpayer should be entitled to request the tax authorities to make an assessment and relieving adjustments. For example, if the GAAR is applied to include an amount in a taxpayer's income that was received by another person, that person should be entitled to request that the tax authorities to remove that amount from its income. In addition, an extended period (statute of limitations) for making a GAAR assessment may be appropriate, especially if the tax authorities adopt a special internal procedure for the application of the GAAR, as discussed below, since such a procedure may take considerable time. For example, if a country's basic limitation period for assessing a taxpayer's tax return for a year is, say, three years, the assessment period for the application of the GAAR could be extended to four or five years.

The tax authorities should be entitled to use the GAAR as either the sole or primary basis of assessment or as a secondary basis of assessment. In many cases, the issue will be whether a specific statutory

provision can be interpreted to negate the effects of a tax avoidance scheme and, if not, whether the GAAR applies. In such a situation, the specific provisions would usually be the primary basis for the assessment and the GAAR would be the secondary basis.

4.4 Application of a GAAR by the tax authorities

A broad GAAR is a potentially powerful tool for tax officials to use in combating tax avoidance and, as a result, taxpayers and their advisers are usually concerned that a GAAR might be applied indiscriminately and used as a threat to impose more tax than is properly owed. In the discussion of the underlying tax policy principles for designing a GAAR in Part 3, chapter 2, section 2.6 above, it was suggested that a GAAR should be a provision of last resort that is applied only after all the other provisions of a country's tax legislation. It follows that a GAAR should be applied relatively infrequently and not used as a regular assessment tool. However, this may not be sufficient to allay taxpayers' concerns that the tax authorities will apply the GAAR fairly, cautiously and consistently. In response, several countries have adopted special administrative measures with respect to their GAARs. These special administrative measures are especially important at the time a GAAR is first enacted.

There are several types of special measures that might be established for the administration of a GAAR. First, it makes sense for the tax authorities to provide guidance concerning the interpretation and application of the GAAR for the benefit of both tax officials and taxpayers; it would be desirable for this guidance to include examples illustrating the circumstances in which the tax authorities will and will not apply the GAAR and the supporting reasons. Several countries with GAARs have issued this type of administrative guidance.

Second, the application of the GAAR in particular cases could be subject to some type of approval process. For example, the application of the GAAR could be subject to the approval of a committee of senior officials from the tax administration, the ministry of finance (officials responsible for tax policy) and officials responsible for litigating tax cases. Under such an approval process, an auditor wanting to apply the GAAR to a particular transaction carried out by a taxpayer would be required to refer the case (a detailed description of the transaction and

a discussion of the reasons why the GAAR should apply) to the GAAR approval committee; only if the committee approved the application of the GAAR in a particular case would an assessment based on the GAAR be issued. Such a process would provide some confidence to taxpayers that a GAAR would be applied reasonably and consistently.

An administrative approval process can be either formal or informal. An informal process has the advantage of flexibility; it could be modified as necessary and even withdrawn completely if the application of the GAAR becomes relatively clear. In contrast, a formal process, which requires legislative authority, would provide greater certainty to taxpayers, but at the cost of a loss of flexibility.

The Canadian GAAR Committee provides an example of an informal approval process.[23] The Canadian GAAR committee is an informal administrative creation of the Canada Revenue Agency; it is not authorized by legislation. The Committee is a head-office Committee composed of officials from the Canada Revenue Agency, the Ministry of Finance and the Department of Justice. The Committee must approve the application of the GAAR in most cases although once the application of the GAAR to particular types of transactions becomes well established then tax auditors can apply the GAAR in accordance with that well established practice without the approval of the GAAR Committee. The Committee meets regularly but its proceedings are not public. Taxpayers are not entitled to be present or to make direct submissions to the committee although submissions can be made to the tax officials handling the audit of the taxpayer's case who present evidence to the GAAR Committee.

In contrast, the United Kingdom approval process for the application of the GAAR is authorized by statute.[24] The United Kingdom

[23] W. Adams, "The General Anti-Avoidance Rule (GAAR) Committee" in Report of the Proceedings of the Forty-Seventh Tax Conference, 1995 Conference Report (Toronto: Canadian Tax Foundation 1996) 54:1 – 9 and P. Boyle et al., "The GAAR Committee: Myth and Reality," in Report of the Proceedings of the Fifty-Fourth Tax Conference, 2002 Conference Report (Toronto: Canadian Tax Foundation 2003) 10:1 - 20.

[24] United Kingdom, Finance Bill 2013-14, Part 5, Schedule 43: General Anti-Abuse Rule: Procedural Requirements. For more details concerning the GAAR Advisory Panel see https://www.gov.uk/government/uploads/system/

introduced a "GAAR Advisory Panel" in conjunction with the adoption of its GAAR. The members of the Advisory Panel are appointed by the Commissioner of HMRC from the private sector.

If a United Kingdom tax official considers that the GAAR should apply to counteract a benefit derived by a taxpayer from an abusive tax arrangement, the official must give written notice to the taxpayer stating the reasons for the application of the GAAR and the proposed consequences. The taxpayer has 45 days to make written submissions in response to the notice. If, after considering the taxpayer's submissions, the tax official still thinks the GAAR should apply, the case must be referred to the Advisory Panel and notice of the referral must be given to the taxpayer. The taxpayer has another opportunity to make submissions, this time to the Advisory Panel. A sub-panel of three members of the Advisory Panel must provide an opinion (each member may provide a separate opinion) to the taxpayer and the tax official as to whether the transaction is reasonable or not, or whether it is impossible to render such an opinion. The tax official is required to consider the opinion of the Advisory Panel before issuing an assessment, but is not bound by that opinion. In addition, any court dealing with the potential application of the GAAR must consider the opinion of the Advisory Panel (and HMRC's guidance on the GAAR that has been approved by the Panel, as noted below).

The GAAR Advisory Panel also has a role in approving HMRC's administrative guidance on the GAAR. HMRC is required to provide its draft guidance to the Advisory Panel for review and recommendations for change. HMRC does not require the Advisory Panel's approval before releasing the guidance to the public, but in practice it seems likely that only guidance that has received the approval of the Advisory Panel will be issued.

The United Kingdom process for the application of the GAAR is very elaborate, and perhaps even more elaborate than necessary. However, it does provide a model of an approval process that is designed to allay taxpayers' fears about the indiscriminate application of a GAAR. Such an elaborate process is probably beyond the

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uploads/attachment_data/file/402183/GAAR_Advisory_Panel_-_Terms_of_Reference.pdf and https://www.gov.uk/government/groups/general-anti-abuse-rule-advisory-panel.

administrative capacity of most developing countries.

Consideration might be given to allowing private-sector tax professionals to participate in the approval process, as is the case in the United Kingdom, although concerns about taxpayer confidentiality and conflicts of interest may make such participation undesirable.

Many ancillary issues must be resolved if a country decides to adopt some type of formal or informal approval process for the application of the GAAR, including:

- Should the taxpayer be entitled to make written or oral representations to the committee?
- Should the decisions of the committee (in redacted form to protect taxpayer confidentiality) be made available to the public?
- Some mechanism should be adopted to communicate the decisions of the committee and the reasons for those decisions to tax auditors so that they can understand how to apply the GAAR properly.
- Decisions of the GAAR approval committee should not be subject to any further internal administrative review or appeal process. However, the decisions of the committee should not have any adverse effect on a taxpayer's right to appeal the application of the GAAR to the courts.
- Should the committee be required to provide written reasons for its decisions? If written reasons are required, the GAAR approval process is likely to be less flexible and efficient.

4.5 A rulings process

An advance income tax rulings process could be adopted to deal with the application of a GAAR to proposed transactions. An advance rulings process, which is sometimes referred to as a "clearance" procedure, allows taxpayers to obtain a binding ruling from the tax authorities as to the tax consequences of proposed transactions. One of the most important differences between an administrative GAAR approval committee, as discussed above, and an advance rulings process is that the GAAR approval committee is initiated and controlled exclusively by the tax administration, whereas an advance rulings process is initiated by the taxpayer.

If a country has an advance rulings process, it is relatively easy to make that process available with respect to the application of the GAAR. The main issue is whether it is desirable to provide rulings to taxpayers concerning the application of the GAAR to proposed transactions as discussed below. If a country adopting a GAAR does not have an advance rulings process, it probably does not make sense for it to introduce a rulings process only with respect to the application of the GAAR. The best case for a rulings process relates to legitimate commercial transactions for which the tax consequences may not be certain, not for potentially abusive transactions. The establishment of a rulings process is costly and requires a significant commitment of specialized human resources, which may be beyond the capacity of many developing countries.

An advance rulings process that includes the application of the GAAR would allow taxpayers to learn whether the tax authorities would apply the GAAR to a proposed transaction before carrying out the transaction. The ruling would not prevent the taxpayer from carrying out the proposed transaction and then contesting the application of the GAAR in the courts; however, it would give the taxpayer the opportunity to abandon the transaction or modify it to make it more acceptable. An advance rulings process with respect to the application of the GAAR would help to ensure the consistent application of the GAAR to proposed transactions, but only to those proposed transactions for which taxpayers request rulings. Therefore, if taxpayers choose not to request advance rulings that involve the possible application of the GAAR, the advance rulings process may not be effective in ensuring the reasonable and consistent application of the GAAR. Another issue is whether it is desirable for the tax authorities to provide advance rulings with respect to proposed transactions that potentially involve abusive tax avoidance. Some tax authorities may consider it preferable to impose all the risk as to the possible application of the GAAR to proposed transactions on taxpayers, with the expectation that the uncertainty will deter taxpayers from undertaking risky transactions.

4.6 Penalty

One of the most controversial issues with respect to the adoption of a GAAR is whether a financial penalty should be imposed when the

GAAR applies to a taxpayer's transaction. Tax practitioners usually argue that the imposition of a penalty is inappropriate because the application of a GAAR in any particular case usually involves considerable uncertainty and taxpayers should not be penalized because a court determines after the fact that the transaction is unacceptable. Admittedly, there is sometimes a fine line between abusive tax avoidance and acceptable tax planning. However, one of the purposes of a GAAR is to discourage taxpayers from engaging in aggressive tax planning transactions in the hope that the tax authorities will not discover those transactions and even if they do, the courts will not conclude that they are subject to the GAAR. For many taxpayers, tax avoidance is a matter of a risk/reward analysis: they will carry out avoidance transactions if the tax saving from a transaction outweighs the costs – namely, the tax consequences if the transaction turns out to be ineffective. The costs incurred by a taxpayer if a transaction is found to be subject to the GAAR include the tax payable, interest on the unpaid tax (the cost is reduced if the interest is deductible) and any penalty (as well as any transactions costs). If a penalty is not imposed, the only costs incurred by the taxpayer would be the tax payable (which would have been payable even if the taxpayer had not carried out the avoidance transaction) and interest on the unpaid tax (which the taxpayer might be able to offset – for example, by investing the amount of the unpaid tax).

The imposition of a penalty in connection with the application of a GAAR can be justified as reasonable and necessary for the effectiveness of the GAAR. A penalty would serve to reinforce the role of a GAAR as a deterrent for abusive transactions. Abusive tax avoidance imposes serious costs on a country's tax system in terms of the resources devoted to combating abusive tax avoidance, and, if unchecked, the tax revenue lost must be borne by other taxpayers. The GAAR penalty could be imposed as a percentage of the tax that was sought to be avoided or could be left to the discretion of the judges.

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