SECRETARIAT NOTE: AS FINALISED BY THE UN TAX COMMITTEE BY WRITTEN PROCEDURE FOR INCLUSION IN THE NEXT VERSION OF THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES - JUNE 2009

IMPROPER USE OF TAX TREATIES*

Summary

At its fourth session held from 20 to 24 October 2008, the Committee of Experts on International Cooperation in Tax Matters examined the report of the subcommittee on Improper Use of Treaties and agreed that the report was finalised, subject to the following minor changes:

- In paragraph 8 of the Introduction: it was agreed that the amended version of paragraph 5 of Article 13 proposed in that paragraph would be modified to ensure that paragraph 5 does not affect the application of paragraph 4 as regards relief of double taxation and to replace the reference to "that state" by "that other state";
- In paragraph 103 of the proposed new section of the Commentary on Article 1: it was agreed to remove the square bracketed text and the phrase "combined with arbitration to deal with cases that competent authorities cannot resolve" in the last sentence of paragraph 103 [this triggered minor consequential changes to the rest of the sentence].

This revised version of the report incorporates these final changes. As noted by the Chairperson during the meeting, the finalization of this report concludes the work of the subcommittee on Improper Use of Treaties.

* This document has been prepared by the subcommittee on Improper Use of Treaties (Coordinator: Mr. Lee). The views and opinions expressed are those of the author and do not necessarily represent those of the United Nations.

Contents

INTRODUCTION

1. At its first session held on 5-9 December 2005, the Committee of Experts on International Cooperation in Tax Matters ("the Committee of Experts") decided that:

> (a) The issue of treaty abuse needed to be dealt within the United Nations Model Convention and that this might be addressed in the Commentary as well as in the Convention itself. The Commentary on article 1 of the OECD Model Convention, which addresses methods of combating treaty abuse, would be helpful in this regard. However, it is important to ensure that, in considering the issue of treaty abuse, there is a balance between the need to provide certainty for investors and the need for tax administrations to combat such abuse;
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> (b) Further consideration needs to be given to addressing methods that might be used to combat specific treaty abuse issues. A sub-committee was appointed, to be coordinated by Mr. Lee and to include Mr. Silitonga, Mr. Lara Yaffar, Mr. Zhang, Mr. Garcia Prats and Mr. Sasseville.[1]

2. A draft report was presented at the second session of the Committee held on 30 October – 3 November 2006. After discussion, the Committee decided that Mr. Arrindell (Barbados) and Mr. Liao (China, replacing Mr. Zhang) should join the sub-committee. It also revised the mandate of the sub-committee as follows:[2]

> It was decided that the subcommittee should continue its work according to the following mandate: drafting a new Commentary on Article 1 of the Model that would include both practical examples and possible wording of anti-abuse clauses focusing on improper use by taxpayers. It was suggested that in choosing the examples particular reference should be made to misuses affecting developing countries and to responses which would be feasible for such countries. Attention should also be paid to the relationship between treaties and domestic anti-abuse rules. To better reflect its work, the sub-committee would henceforth be referred to as the subcommittee on improper use of treaties.

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[1] Paragraph 37 of the Record on the first session (E/2005/45).

[2] Paragraph 19 of the Report on the second session (E/2006/45).

3. In accordance with this revised mandate, a meeting of the subcommittee was held in Beijing from 5 to 7 April 2007. That meeting was attended by Mr. Lee, Mr. Liao, Mr. Arrindell and Mr. Sasseville of the subcommittee as well as Mr. Ji, State Administration of Taxation (People's Republic of China) and Mr. Ohyama of the Secretariat. Incorporating comments received from Prof. Garcia Prats, Mr. Silitonga and Mr. Lara Yaffar, the subcommittee prepared a draft new section for the Commentary on Article 1 of the UN Model Convention which focussed on the various approaches available to deal with the improper use of tax treaties and included a number of examples illustrating the application of these approaches.

4. That draft new section was included in the report (note E/C.18/2007/CRP.2) that the subcommittee presented at the third session of the Committee held from 29 October to 2 November 2007. As a result of the detailed discussion of the note that took place during the meeting, it was agreed to make a number of drafting changes and the subcommittee was requested to finalize its report for presentation at the Fourth Session of the Committee.

5. A revised version of the report of the subcommittee that incorporated the agreed changes was presented to the Committee for approval at its fourth session, held from 20 to 24 October 2008. At that meeting, the Committee examined the report of the subcommittee on Improper Use of Treaties and agreed that the report was finalised, subject to a few minor changes. This final version of the report incorporates these changes.

6. In the course of its work, the subcommittee did not examine situations where one of the Contracting States makes changes to its domestic law for purposes of circumventing the intended effect of the provisions of a tax treaty or where a State, in order to attract certain taxpayers or activities, introduces preferential regimes that give unintended treaty benefits (such cases are discussed in paragraphs 21 to 21.5 of the Commentary on Article 1 of the OECD Model). These two situations have sometimes been referred to as "treaty abuse by a State" but the first issue is also related to the issue of treaty overrides. The subcommittee considered that these issues were outside the mandate that was given to it by the Committee since they did not relate to the improper use of tax treaties by taxpayers.

7. Whilst this report includes the draft new section that the subcommittee has prepared for inclusion in the Commentary on Article 1 of theUN Model, the subcommittee raised two other issues related to the improper use of tax treaties which resulted in decisions by the Committee. These are dealt with in the following paragraphs 8 to 11.

Change to paragraph 5 of Article 13 of the UN Model

8. A previous version of this report dealt with avoidance strategies intended to circumvent paragraph 5 of Article 13 of the UN Model. The subcommittee, noting the risk that taxpayers could attempt to divide the transfer of a substantial shareholding through a number of transfers of smaller shareholdings, invited the Committee to consider amending paragraph 5 of Article 13. Two different options were put forward for that purpose. After discussion, the Committee decided that the paragraph should be amended on the basis of the second option. At its fourth session, it discussed a draft amendment prepared by the subcommittee and concluded that it should be modified to ensure that paragraph 5 does not affect the application of paragraph 4 as regards relief of double taxation and to replace the reference to "that state" by "that other state". In accordance with these decisions, paragraph 5 of Article 13 of the UN Model should therefore be replaced by the following:

> Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting Statefrom the alienation of shares of a company which is a resident of the other Contracting State, may be taxed

in that other State if the alienator, at any time during the 12 month period preceding such alienation, held directly or indirectly at least _____ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.

9. Whilst this new formulation will not prevent all risks of improper use of paragraph 5 of Article 13, the subcommittee believes that it will address the most blatant avoidance strategies involving that paragraph.

Extending the concept of beneficial ownership to other Articles of the UN Model

10. A previous version of this report indicated that the interpretation of the concept of "beneficial owner" might be relevant in dealing with cases of improper use of tax treaties such as those involving conduit arrangements. The Committee was invited to consider whether and how work on the clarification of the concept of "beneficial ownership" should be carried on and whether the application of the concept of beneficial ownership should be extended to other Articles of the Model Convention.

11. These issues were discussed at the fourth session of the Committee on the basis of a consultant's report. As indicated in the report on that meeting, there was only limited support for inserting beneficial ownership in Article 13 or 21 or any other articles, or for a general beneficial ownership provision. It was also concluded that there was a need to refine (fine tune) the beneficial ownership and that the practical application of the beneficial ownership concept, including how to certify the beneficial ownership, should be recommended to the membership of the next Committee as a subject worthy of its consideration, and could be elaborated on in the Manual.

DRAFT NEW SECTION ON THE IMPROPER USE OF TAX TREATIES

12. The following is the new section that was drafted by the subcommittee to replace paragraphs 8 to 11 of the Commentary on Article 1 of the UN Model:

Improper use of tax treaties

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

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

1. Approaches to prevent the improper use of tax treaties

10. There are a number of different approaches used by countries to prevent and address the improper use of tax treaties. These include:

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

11. These various approaches are examined in the following sections.

Specific legislative anti-abuse rules found in domestic law

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

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

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

15. Generally, where the application of provisions of domestic law and of those of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of "*pacta sunt servanda*" which is incorporated in Article 26 of the *Vienna Convention on the Law of Treaties*. Thus, if the application of these rules had the effect of increasing the tax liability of a taxpayer beyond what is allowed by a tax treaty, this would conflict with the provisions of the treaty and these provisions should prevail under public international law.

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

17. First, a treaty may specifically allow the application of certain types of specific domestic anti-abuse rules. For example, Article 9 of the Convention specifically authorizes the application of domestic transfer pricing rules in the circumstances defined by that Article. Also, many treaties include specific

provisions clarifying that there is no conflict (or, even if there is a conflict, allowing the application of the domestic rules) in the case, for example, of thin capitalization rules, CFC rules or departure tax rules or, more generally, domestic rules aimed at preventing the avoidance of tax.

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

19. Third, the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied on a proper interpretation of the treaty. In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both the interpretation of the treaty and the domestic specific anti-abuse rules. Domestic specific anti-abuse rules, however, are often drafted by reference to objective facts, such as the existence of a certain level of shareholding or a certain debt-equity ratio. While this greatly facilitates their application, it will sometimes result in the application of these rules to transactions that do not constitute abuses. In such cases, of course, a proper interpretation of the treaty provisions that would disregard abusive transactions only will not allow the application of the domestic rules if they conflict with provisions of the treaty.

General legislative anti-abuse rules found in domestic law

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

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

> ‘22. Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including "substance-over-form", "economic substance" and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties […]
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> 22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict. […]”

22. Having concluded that the approach of relying on such anti-abuse rules does not, as a general rule, conflict with tax treaties, the OECD was therefore able to conclude that “[…] States do not have to grant

the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into."[3]

23. That conclusion leads logically to the question of what is an abuse of a tax treaty. The OECD did not attempt to provide a comprehensive reply to that question, which would have been difficult given the different approaches of its Member countries. Nevertheless, the OECD presented the following general guidance, which was referred to as a "guiding principle":[4]

> "A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions."

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

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

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

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

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

Judicial doctrines that are part of domestic law

28. In the process of determining how domestic tax law applies to tax avoidance transactions, the courts of many countries have developed different judicial doctrines that have the effect of preventing domestic law abuses. These include the business purpose, substance over form, economic substance, step transaction, abuse of law and *fraus legis* approaches. The particular conditions under which such judicial

3 Paragraph 9.4 of the Commentary on Article 1 of the OECD Model.

4 Paragraph 9.5 of the Commentary on Article 1 of the OECD Model.

doctrines apply often vary from country to country and evolve over time based on refinements or changes resulting from subsequent court decisions.

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

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

Specific anti-abuse rules found in tax treaties

31. Some forms of treaty abuses can be addressed through specific treaty provisions. A number of such rules are already included in the UN Model; these include, in particular, the reference to the agent who maintains a stock of goods for delivery purposes (subparagraph 5 b of Article 5), the concept of "beneficial owner" (in Articles 10, 11, and 12), the “special relationship” rule applicable to interest and royalties (paragraph 6 of Article 11 and paragraph 6 of Article 12), the rule on alienation of shares of immovable property companies (paragraph 4 of Article 13) and the rule on “star-companies” (paragraph 2 of Article 17). Another example would be the modified version of the limited force-of-attraction rule of paragraph 1 of Article 7 that is found in some tax treaties and that applies only to avoidance cases.

32. Clearly, such specific treaty anti-abuse rules provide more certainty to taxpayers. This is acknowledged in paragraph 9.6 of the Commentary of the OECD Commentary, which explains that such rules can usefully supplement general anti-avoidance rules or judicial approaches.[5]

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

5 “9.6 The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy […].”

General anti-abuse rules found in tax treaties

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

> A competent authority of a Contracting State may deny the benefits of this Convention to any person, or with respect to any transaction, if in its opinion the granting of those benefits would constitute an abuse of the Convention according to its purpose. Notice of the application of this provision will be given by the competent authority of the Contracting State concerned to the competent authority of the other Contracting State.

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

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

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

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

When considering such a provision, some countries may prefer to replace the phrase "a main purpose" by "the main purpose" to make it clear that the provision should only apply to transactions that are, without any doubt, purely tax-motivated. Other countries, however, may consider that, based on their experience with similar general anti-abuse rules found in domestic law, words such as "the main purpose" would impose an unrealistically high threshold that would require tax administrations to establish that obtaining tax benefits is objectively more important than the combination of all other alleged purposes, which would risk rendering the provision ineffective. A State that wishes to include a general anti-abuse rule in its treaties will therefore need to adapt the wording to its own circumstances, particularly as regards the approach that its courts have adopted with respect to tax avoidance.

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

use of such a provision would probably be considered primarily by countries that have found it difficult to counter improper uses of tax treaties through other approaches.

The interpretation of tax treaty provisions

38. Another approach that has been used to counter improper uses of treaties has been to consider that there can be abuses of the treaty itself and to disregard abusive transactions under a proper interpretation of the relevant treaty provisions that takes account of their context, the treaty's object and purpose as well as the obligation to interpret these provisions in good faith.[6] As already noted, a number of countries have long used a process of legal interpretation to counteract abuses of their domestic tax laws and it seems entirely appropriate to similarly interpret tax treaty provisions to counteract tax treaty abuses. As noted in paragraph 9.3 of the Commentary on Article 1 of the OECD Model Tax Convention:

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

39. Paragraphs 23 to 27 above provide guidance as to what should be considered to be a tax treaty abuse. That guidance would obviously be relevant for the purposes of the application of this approach.

2. Examples of improper uses of tax treaties

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

Dual residence and transfer of residence

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

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

6 As prescribed by Article 31 of the *Vienna Convention on the Law of Treaties*.

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

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

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

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

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

44. Countries have also dealt with such cases through the use of so-called "departure tax" or "exit charge" provisions, under which the change of residence triggers the realization of certain types of income, e.g. capital gains on shares. In order to avoid a conflict with the provisions of a tax treaty, such

domestic rules may deem the realization of the income to take place immediately before the change of residence; they may also be combined with treaty provisions allowing for their application.

45. A proper interpretation of the provisions of paragraphs 2 and 3 of Article 4 may also be useful in dealing with cases similar to these examples. Concepts such as “centre of vital interests” and “place of effective management” require a strong relationship between a taxpayer and a country. The fact that a taxpayer has a home available to him in a country where he sojourns frequently is not enough to claim that that country is his centre of vital interests; likewise, the mere fact that meetings of a board of directors of a company take place in a country is not sufficient to conclude that this is where the company is effectively managed. Also, some countries have replaced paragraph 3 of Article 4, which deals with cases of dual residence of legal persons on the basis of their place of effective management, by a rule that leaves such cases of dual residence to be decided under the mutual agreement procedure. An example of such a provision is found in paragraph 3 of Article 4 of the treaty signed in 2004 by Mexico and Russia, which reads as follows:

> Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall by mutual agreement endeavour to settle the question and to determine the mode of application of the Agreement to such person. In the absence of such agreement, such person shall be considered to be outside the scope of this Agreement, except for the Article "Exchange of information".

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

> 26.1 Under the domestic law of some States, persons who qualify as residents but who do not have what is considered to be a permanent link with the State (sometimes referred to as domicile) are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. Such persons are not, therefore, subject to potential double taxation to the extent that foreign income is not remitted to their State of residence and it may be considered inappropriate to give them the benefit of the provisions of the Convention on such income. Contracting States which agree to restrict the application of the provisions of the Convention to income that is effectively taxed in the hands of these persons may do so by adding the following provision to the Convention:
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> > "Where under any provision of this Convention income arising in a Contracting State is relieved in whole or in part from tax in that State and under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then any relief provided by the provisions of this Convention shall apply only to so much of the income as is taxed in the other Contracting State."
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> In some States, the application of that provision could create administrative difficulties if a substantial amount of time elapsed between the time the income arose in a Contracting State and the time it were taxed by the other Contracting State in the hands of a resident of that other State. States concerned by these difficulties could subject the rule in the last part of the above provision, i.e. that the income in question will be entitled to benefits in

the first-mentioned State only when taxed in the other State, to the condition that the income must be so taxed in that other State within a specified period of time from the time the income arises in the first-mentioned State.

Treaty shopping

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

48. A treaty shopping arrangement may take the form of a "direct conduit" or that of a "stepping stone conduit", as illustrated below.[7]

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

50. The basic structure of a stepping stone conduit is similar. In that case, however, the income of company X is fully taxable in State A and, in order to eliminate the tax that would be payable in that country, company X pays high interest, commissions, service fees or similar deductible expenses to a second related conduit company Z, a resident of State D. These payments, which are deductible in State A, are tax-exempt in State D by virtue of a special tax regime available in that State.[8] The shareholder resident of State C is therefore seeking to access the benefits of the tax treaty between States A and B by using company X as a stepping stone.

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

52. For instance, specific anti-abuse rules have been included in the domestic law of some countries to deal with such arrangements. One example is that of the US regulations dealing with financing arrangements. For the purposes of these regulations, a financing arrangement is a series of transactions by which the financing entity advances money or other property to the financed entity, provided that the

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

8 *Id.*

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

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

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

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

56. Some countries, however, consider that the most effective approach to deal with treaty shopping is to include in their tax treaties specific anti-abuse rules dealing with that issue. Paragraphs 13 to 21.4 of the Commentary on Article 1 of the OECD Model Convention, which are reproduced below, include various examples of such rules. The Committee considers that these examples are helpful in dealing with treaty shopping concerns that may arise with respect to treaties between developing and developed countries.

Conduit company cases

13. Many countries have attempted to deal with the issue of conduit companies and various approaches have been designed for that purpose. One solution would be to disallow treaty benefits to a company not owned, directly or indirectly, by residents of the State of which the company is a resident. For example, such a "look-through" provision might have the following wording:

> "A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State."

Contracting States wishing to adopt such a provision may also want, in their bilateral negotiations, to determine the criteria according to which a company would be considered as owned or controlled by non-residents.

14. The "look-through approach" underlying the above provision seems an adequate basis for treaties with countries that have no or very low taxation and where little substantive business activities would normally be carried on. Even in these cases it might be necessary to alter the provision or to substitute for it another one to safeguard bona fide business activities.

15. General subject-to-tax provisions provide that treaty benefits in the State of source are granted only if the income in question is subject to tax in the State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the Model Convention does not recommend such a general provision. Whilst this seems adequate with respect to a normal international relationship, a subject-to-tax approach might well be adopted in a typical conduit situation. A safeguarding provision of this kind could have the following wording:

> "Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State
>
> a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or
>
> b) exercise directly or indirectly, alone or together, the management or control of such company,
>
> any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last-mentioned State under the ordinary rules of its tax law."

The concept of "substantial interest" may be further specified when drafting a bilateral convention. Contracting States may express it, for instance, as a percentage of the capital or of the voting rights of the company.

16. The subject-to-tax approach seems to have certain merits. It may be used in the case of States with a well-developed economic structure and a complex tax law. It will, however, be necessary to supplement this provision by inserting bona fide provisions in the treaty to provide for the necessary flexibility (cf. paragraph 19 below); moreover, such an approach does not offer adequate protection against advanced tax avoidance schemes such as "stepping-stone strategies".

17. The approaches referred to above are in many ways unsatisfactory. They refer to the changing and complex tax laws of the Contracting States and not to the arrangements giving rise to the improper use of conventions. It has been suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision that would single out cases of improper use with reference to the conduit arrangements themselves (the channel approach). Such a provision might have the following wording:

> "Where income arising in a Contracting State is received by a company that is a resident of the other Contracting State and one or more persons who are not residents of that other Contracting State

a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or

b) exercise directly or indirectly, alone or together, the management or control of such company

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on immaterial goods and processes)."

18. A provision of this kind appears to be the only effective way of combatting "stepping-stone" devices. It is found in bilateral treaties entered into by Switzerland and the United States and its principle also seems to underlie the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies. States that consider including a clause of this kind in their convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a bona fide clause.

19. The solutions described above are of a general nature and they need to be accompanied by specific provisions to ensure that treaty benefits will be granted in bona fide cases. Such provisions could have the following wording:

a) General bona fide provision

"The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention."

b) Activity provision

"The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income that is connected with such operations."

c) Amount of tax provision

"The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident."

d) Stock exchange provision

"The foregoing provisions shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned — directly or through one or more companies each of which is a resident of the first-mentioned State — by a company which is a resident of the first-mentioned State and the principal class of whose shares is so registered."

e) Alternative relief provision

In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that the term "shall not be deemed to include residents of third States that have

income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention."

These provisions illustrate possible approaches. The specific wording of the provisions to be included in a particular treaty depends on the general approach taken in that treaty and should be determined on a bilateral basis. Also, where the competent authorities of the Contracting States have the power to apply discretionary provisions, it may be considered appropriate to include an additional rule that would give the competent authority of the source country the discretion to allow the benefits of the Convention to a resident of the other State even if the resident fails to pass any of the tests described above.

20. Whilst the preceding paragraphs identify different approaches to deal with conduit situations, each of them deals with a particular aspect of the problem commonly referred to as "treaty shopping". States wishing to address the issue in a comprehensive way may want to consider the following example of detailed limitation-of-benefits provisions aimed at preventing persons who are not resident of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of these States, keeping in mind that adaptations may be necessary and that many States prefer other approaches to deal with treaty shopping:

"1. Except as otherwise provided in this Article, a resident of a Contracting State who derives income from the other Contracting State shall be entitled to all the benefits of this Convention otherwise accorded to residents of a Contracting State only if such resident is a "qualified person" as defined in paragraph 2 and meets the other conditions of this Convention for the obtaining of such benefits.

2. A resident of a Contracting State is a qualified person for a fiscal year only if such resident is either:

a) an individual;

b) a qualified governmental entity;

c) a company, if

(*i*) the principal class of its shares is listed on a recognised stock exchange specified in subparagraph *a*) or *b*) of paragraph 6 and is regularly traded on one or more recognized stock exchanges, or

(*ii*) at least 50 per cent of the aggregate vote and value of the shares in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subdivision *i*) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;

d) a charity or other tax-exempt entity, provided that, in the case of a pension trust or any other organization that is established exclusively to provide pension or other similar benefits, more than 50 per cent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; or

e) a person other than an individual, if:

(*i*) on at least half the days of the fiscal year persons that are qualified persons by reason of subparagraph a), b) or d) or subdivision c) i) of this paragraph own, directly or indirectly, at least 50 per cent of the aggregate vote and value of the shares or other beneficial interests in the person, and

(*ii*) less than 50 per cent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not residents of either

Contracting State in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank, provided that where such a bank is not a resident of a Contracting State such payment is attributable to a permanent establishment of that bank located in one of the Contracting States).

3. *a*) A resident of a Contracting State will be entitled to benefits of the Convention with respect to an item of income, derived from the other State, regardless of whether the resident is a qualified person, if the resident is actively carrying on business in the first-mentioned State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer), the income derived from the other Contracting State is derived in connection with, or is incidental to, that business and that resident satisfies the other conditions of this Convention for the obtaining of such benefits.

b) If the resident or any of its associated enterprises carries on a business activity in the other Contracting State which gives rise to an item of income, subparagraph a) shall apply to such item only if the business activity in the first-mentioned State is substantial in relation to business carried on in the other State. Whether a business activity is substantial for purposes of this paragraph will be determined based on all the facts and circumstances.

c) In determining whether a person is actively carrying on business in a Contracting State under subparagraph a), activities conducted by a partnership in which that person is a partner and activities conducted by persons connected to such person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) or another person possesses, directly or indirectly, at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) in each person. In any case, a person shall be considered to be connected to another if, based on all the facts and circumstances, one has control of the other or both are under the control of the same person or persons.

4. Notwithstanding the preceding provisions of this Article, if a company that is a resident of a Contracting State, or a company that controls such a company, has outstanding a class of shares

a) which is subject to terms or other arrangements which entitle its holders to a portion of the income of the company derived from the other Contracting State that is larger than the portion such holders would receive absent such terms or arrangements ("the disproportionate part of the income"); and

b) 50 per cent or more of the voting power and value of which is owned by persons who are not qualified persons

the benefits of this Convention shall not apply to the disproportionate part of the income.

5. A resident of a Contracting State that is neither a qualified person pursuant to the provisions of paragraph 2 or entitled to benefits under paragraph 3 or 4 shall, nevertheless, be granted benefits of the Convention if the competent authority of that other Contracting State determines that the establishment, acquisition or maintenance of such person and the

conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention.

6. For the purposes of this Article the term "recognized stock exchange" means:

a) in State A ……..;

b) in State B ……..; and

c) any other stock exchange which the competent authorities agree to recognize for the purposes of this Article."

Provisions which are aimed at entities benefiting from preferential tax regimes

21. Specific types of companies enjoying tax privileges in their State of residence facilitate conduit arrangements and raise the issue of harmful tax practices. Where tax-exempt (or nearly tax-exempt) companies may be distinguished by special legal characteristics, the improper use of tax treaties may be avoided by denying the tax treaty benefits to these companies (the exclusion approach). As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause which would apply to the income received or paid by such companies and which could be drafted along the following lines:

> "No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under section ... of the ... Act, or under any similar provision enacted by ... after the signature of the Convention."

The scope of this provision could be limited by referring only to specific types of income, such as dividends, interest, capital gains, or directors' fees. Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information).

21.1 Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State that has created special privileges in its tax law may prevent those privileges from being used in connection with the improper use of tax treaties concluded by that State.

21.2 Where it is not possible or appropriate to identify the companies enjoying tax privileges by reference to their special legal characteristics, a more general formulation will be necessary. The following provision aims at denying the benefits of the Convention to entities which would otherwise qualify as residents of a Contracting State but which enjoy, in that State, a preferential tax regime restricted to foreign-held entities (i.e. not available to entities that belong to residents of that State):

> "Any company, trust or partnership that is a resident of a Contracting State and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that State shall not be entitled to the benefits of this Convention if the amount of the tax imposed on the income or capital of the company, trust or partnership by that State (after taking into account any reduction or offset of the amount of tax in any manner,

including a refund, reimbursement, contribution, credit or allowance to the company, trust or partnership, or to any other person) is substantially lower than the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or partnership, as the case may be, were beneficially owned by one or more residents of that State."

Provisions which are aimed at particular types of income

21.3 The following provision aims at denying the benefits of the Convention with respect to income that is subject to low or no tax under a preferential tax regime:

"1. The benefits of this Convention shall not apply to income which may, in accordance with the other provisions of the Convention, be taxed in a Contracting State and which is derived from activities the performance of which do not require substantial presence in that State, including:

a) such activities involving banking, shipping, financing, insurance or electronic commerce activities; or

b) activities involving headquarter or coordination centre or similar arrangements providing company or group administration, financing or other support; or

c) activities which give rise to passive income, such as dividends, interest and royalties

where, under the laws or administrative practices of that State, such income is preferentially taxed and, in relation thereto, information is accorded confidential treatment that prevents the effective exchange of information.

2. For the purposes of paragraph 1, income is preferentially taxed in a Contracting State if, other than by reason of the preceding Articles of this Agreement, an item of income:

a) is exempt from tax; or

b) is taxable in the hands of a taxpayer but that is subject to a rate of tax that is lower than the rate applicable to an equivalent item that is taxable in the hands of similar taxpayers who are residents of that State; or

c) benefits from a credit, rebate or other concession or benefit that is provided directly or indirectly in relation to that item of income, other than a credit for foreign tax paid."

Anti-abuse rules dealing with source taxation of specific types of income

21.4 The following provision has the effect of denying the benefits of specific Articles of the convention that restrict source taxation where transactions have been entered into for the main purpose of obtaining these benefits. The Articles concerned are 10, 11, 12 and 21; the provision should be slightly modified as indicated below to deal with the specific type of income covered by each of these Articles:

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

57. When considering these examples, countries should take account of their ability to administer the various approaches that are proposed. For many developing countries, it may be difficult to apply very detailed rules that require access to substantial information about foreign entities. These countries might consider that a more general approach, such as the one proposed in paragraph 21.4, might be more adapted to their own circumstances.

Triangular Cases

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

— dividends, interest or royalties are derived from State S by a resident of State R, which is an exemption country;
— that income is attributable to a permanent establishment established in State P, a low-tax jurisdiction where that income will not be taxed.[9]

59. Under the State R-State S tax treaty, State S has to apply the benefits of the treaty to such dividends, interests or royalties because these are derived by a resident of State R, even though they are not taxed in that State by reason of the exemption system applied by that State.

60. Paragraph 53 of the Commentary on Article 24 of the OECD Model Tax Convention, which is reproduced in the Commentary on Article 24 below, discusses this situation and suggests that it may be dealt with through the inclusion of a specific provision in the treaty between States R and S:

> … If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment.

61. A few treaties include a provision based on that suggestion.[10] If, however, similar provisions are not systematically included in the treaties that have been concluded by the State of source of such dividends, interest or royalties with countries that have an exemption system, there is a risk that the relevant assets will be transferred to associated enterprises that are residents of countries that do not have that type of provision in their treaty with the State of source.

Attributing Profits or Income to a Specific Person or Entity

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

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9 Triangular Cases", in volume II of the loose-leaf version of the *OECD Model Tax Convention*, OECD, R(11)-3, at paragraph 53.

10 See for example, paragraph 5 of Article 30 of the France-United States treaty.

shopping and the use of permanent establishments in low-tax countries) have already been discussed. The following discusses other income shifting scenarios.

i) Non arm's length transfer prices

63. It has long been recognized that profits can be shifted between associated enterprises through the use of non arm's length prices and the tax legislation of most countries now include transfer pricing rules that address such cases. These rules are specifically authorized by Article 9 of the UN and OECD Model Tax Conventions. This, however, is a complex area, as shown by the extensive guidance produced by the OECD[11] as to how these rules should operate.

ii) Thin capitalisation

64. In almost all countries, interest is a deductible expense whereas dividends, being a distribution of profits, are not deductible. A foreign company that wants to provide financing to a wholly-owned subsidiary may therefore find it beneficial, for tax purposes, to provide that financing through debt rather than share capital, depending on the overall tax on the interest paid. A subsidiary may therefore end up with almost all of its financing being provided in the form of debt rather than share capital, a practice known as "thin capitalisation".

65. According to the OECD report on Thin Capitalisation,[12] countries have developed different approaches to deal with this issue. These approaches may be broadly divided between those that are based on the application of a general anti-abuse rules or the arm's length principle and those that involve the use of fixed debt-equity ratios.

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

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

68. To the extent that a country's thin capitalisation rule applies to payments of interest to non-residents but not to similar payments that would be made to residents, it could be in violation of paragraph 4 of Article 24, which provides that "interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State". There is a specific exception to that rule, however, where paragraph 1 of Article 9, which deals with transfer pricing adjustments, applies. For that reason, as indicated in the Commentary on paragraph 4 of Article 24:[13]

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11 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 1995 (as updated)

12 "Thin Capitalisation", in volume II of the loose-leaf version of the *OECD Model Tax Convention,* R(4)-1.

13 Paragraph 56 of the Commentary on Article 24 of the OECD Model Tax Convention, which is reproduced under

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

69. Paragraph 3 of the OECD Commentary on Article 9, which is reproduced under paragraph 6 of the Commentary on the same provision of this Model, clarifies that paragraph 1 of Article 9 allows the application of domestic rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation. While this would typically be the case of thin capitalisation rules that are based on the arm's length principle, a country that has adopted thin capitalisation rules based on a fixed ratio approach would, however, typically find it difficult to establish that its thin capitalisation rule, which does not refer to what independent parties would have done, satisfies that requirement.

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

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

iii) The use of base companies

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

72. Various approaches have been used to deal with such arrangements. For example, a company that is a mere shell with no employee and no substantial economic activity could, in some countries, be disregarded for tax purposes pursuant to general anti-abuse rules or judicial doctrines. It could also be possible to consider that a base company that is effectively managed by shareholders who are residents of another State has its residence or a permanent establishment in that State. The first approach is described by paragraph 10.1 of the Commentary on Article 1 of the OECD Model Tax Convention, according to which claims to treaty benefits

> […] may be refused where careful consideration of the facts and circumstances of a case shows that the place of effective management of a subsidiary does not lie in its alleged state of residence but, rather, lies in the state of residence of the parent company so as to make it a resident of that latter state for domestic law and treaty purposes (this will be relevant where the domestic law of a state uses the place of management of a legal person, or a similar criterion, to determine its residence).

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paragraph 5 of the Commentary on Article 24 of this Model.

73. The second approach is described in paragraph 10.2 of that Commentary, which reads as follows

> Careful consideration of the facts and circumstances of a case may also show that a subsidiary was managed in the state of residence of its parent in such a way that the subsidiary had a permanent establishment (e.g. by having a place of management) in that state to which all or a substantial part of its profits were properly attributable.

74. These approaches, however, might not be successful in dealing with arrangements involving companies that have substantial management and economic activities in the countries where they have been established. One of the most effective approaches to dealing with such cases is the inclusion, in domestic legislation, of controlled foreign corporation (CFC) legislation. While the view has sometimes be expressed that such legislation could violate certain provisions of tax treaties, the Committee considers that this would not be the case of typical CFC rules, as indicated in paragraph 23 if the Commentary on Article 1 of the OECD Model Tax Convention (and as further explained in paragraphs 10.1 of the Commentary on Article 7 and 37 of the Commentary on Article 10 of that Model):

> 23. The use of base companies may also be addressed through controlled foreign companies provisions. A significant number of Member and non-member countries have now adopted such legislation. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of controlled foreign companies legislation conflicted with these provisions. For the reasons explained in paragraphs 10.1 of the Commentary on Article 7 and 37 of the Commentary on Article 10, that interpretation does not accord with the text of the provisions. It also does not hold when these provisions are read in their context. Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign companies legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention.

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

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

and an official in a top-level managerial position of company C and arrange for most of his remuneration to be attributed to these functions.

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

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

77. According to paragraph 13 of the Commentary on Article 11, countries may agree during bilateral negotiations to include in their treaties an exemption for interest of the following categories:[14]

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

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

79. While it could be argued that an easy solution would be to avoid including such exemptions in a tax treaty, it is important to note that these are included for valid policy purposes, taking into account that source taxation on gross payments of interest will frequently act as a tariff and be borne by the borrower. Also, as long as a country has agreed to include such exemptions in one of its treaties, it becomes difficult to refrain from granting these in treaty negotiations with other similar countries.

80. Many of the approaches referred to above in the case of treaty shopping may be relevant to deal with back-to-back arrangements aimed at accessing the benefits of these exemptions. Also, cases where the consideration provided for in a mixed contract has been improperly attributed to interest payments can be challenged using specific domestic anti-abuse rules applicable to such

14 Many treaties additionally exempt from source taxation interest paid to financial institutions, interest on sales on credit or interest paid to tax-exempt entities such as pension funds (see paragraphs 7.7-7.12 of the Commentary on Article 11 of the OECD Model Tax Convention).

cases, general domestic anti-abuse rules or doctrines or a proper interpretation of the treaty provisions. Where the overall consideration is divided among related parties, paragraph 6 of Article 11 and paragraph 1 of Article 9 may also be relevant to ensure that the benefit of the treaty exemption only applies to the proper amount of interest. Finally, some states have included specific anti-abuse rules in their treaties to deal with such back-to-back arrangements. An example of such a rule is found in paragraph b) of Article 7 of the Protocol to the treaty signed in 2002 by Australia and Mexico, which reads as follows:

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

Hiring out of Labour

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

Artistes and sportspersons

82. A number of older tax treaties do not include paragraph 2 of Article 17 (Artistes and sportspersons), which deals with the use of so-called “star-companies”. In order to avoid the possible application of provisions based on paragraph 1 of that Article, residents of countries that have concluded such treaties may be tempted to arrange for the income derived from their activities as artistes or sportspersons, or part thereof, to be paid to a company set up for that purpose.

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

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

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

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

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

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

Transactions that modify the treaty classification of income

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

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

(i) Conversion of dividends into interest

88. Converting dividends into interest will be advantageous under a treaty that provides for source taxation of dividends but not of interest payments. Assume that X, a resident of State R, owns all the shares of company A, which is a resident of State S. In contemplation of the payment

of an important dividend, X arranges for the creation of holding company B, which will also be a resident of State S; X is the only shareholder of company B. X then sells the shares of company A to company B in return for interest-bearing notes (State R and State S allow that transfer to be carried out free of tax). The payment of interest from company B to company X will be made possible by the payment of dividends by company A to company B, which will escape tax in State S under a participation exemption or similar regime or because of the deduction of interest payments on the notes issued to X; X will thus indirectly receive the dividend paid by company A in the form of interest payments on the notes issued by company B and will avoid source taxation in State S.

(ii) Allocation of price under a mixed contract

89. A mixed contract covers different considerations, such as the provision of goods, services, know-how and the licensing of intangibles. These generate different types of income for treaty purposes. In many cases, the acquirer will be indifferent to the allocation of the price between the various considerations and the provider may therefore wish, in the relevant contract, to allocate a disproportionate part of the price to items of income that will be exempt in the State of source. For instance, a franchising contract may involve the transfer of goods to be sold, the provision of various services, the provision of know-how and royalties for the use of intellectual property (e.g. trademarks and trade names). To the extent that the non-resident franchisor does not have a permanent establishment in the State of residence of the franchisee, Article 7 would not allow that State to tax the business profits attributable to the provision of inventory goods and services but Article 12 would allow the taxation of the royalties and the payments related to know-how. Since all of these payments would normally be deductible for the franchisee, it may not care about how the overall price is allocated. The contract may therefore be drafted so as to increase the price for the provision of the goods and services and reduce the royalties and the price for the provision of know-how.

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

(iii) Conversion of royalties into capital gains

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

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

The term "royalties" as used in this Article means:

a) payments of any kind received as a consideration for the use of, or the right to use, any copyright […] *including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof* … [emphasis added]

(iv) Use of derivative transactions

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

Transactions that seek to circumvent thresholds found in treaty provisions

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

95. Taxpayers may enter into arrangements in order to obtain the benefits of such provisions in unintended circumstances. For instance, a non-resident shareholder who owns less than 10% of the capital of a resident company could, in contemplation of the payment of a dividend, arrange for his shares to be temporarily transferred to a resident company or non-resident company in the hands of which the dividends would be exempt or taxed at the lower rate. Such a transfer could be structured in such a way that the value of the expected dividend would be transformed into a capital gain exempt from tax in the source State. As noted in the Commentary on Article 10, which reproduces paragraph 17 of the OECD Commentary on that Article:

The reduction envisaged in subparagraph a) of paragraph 2 should not be granted in cases of abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction. To counteract such manoeuvres Contracting States may find it appropriate to add to subparagraph a) a provision along the following lines:

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

The following are other examples of arrangements intended to circumvent various thresholds found in the Convention.

Time limit for certain permanent establishments

96. Article 5(3) of the Convention includes a rule according to which, in certain circumstances, the furnishing of services by a foreign enterprise during a certain period under the same or connected projects will constitute a permanent establishment. Taxpayers may be tempted to circumvent the application of that provision by splitting a single project between associated enterprises or by dividing a single contract into different ones so as to argue that these contracts cover different projects. Paragraphs 11 and 12 of the Commentary on Article 5 deal with such arrangements.

Thresholds for the source taxation of capital gains on shares

97. Paragraph 4 of Article 13 allows a State to tax capital gains on shares of a company (and on interests in certain other entities) the property of which consists principally of immovable property situated in that State. For the purposes of that provision, the property of such an entity is considered to consist principally of immovable property situated in a State if the value of such immovable property exceeds 50% of the value of all assets of the entity.

98. One could attempt to circumvent that provision by diluting the percentage of the value of an entity that derives from immovable property situated in a given State in contemplation of the alienation of shares or interests in that entity. In the case of a company, that could be done by injecting a substantial amount of cash in the company in exchange for bonds or preferred shares the conditions of which would provide that such bonds or shares would be redeemed shortly after the alienation of the shares or interests.

99. Where the facts establish that assets have been transferred to an entity for the purpose of avoiding the application of paragraph 4 of Article 13 to a prospective alienation of shares or interests in that entity, a country's general anti-abuse rules or judicial doctrines may well be applicable. Some countries, however, may wish to provide expressly in their treaties that paragraph 4 will apply in these circumstances. This could be done by adding to Article 13 a provision along the following lines:

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

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

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

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

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

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