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Abuse of tax treaties and treaty shopping*

Summary

The expansion of the network of tax treaties has increased State concerns about their potential abusive use, inducing States to develop anti-abuse measures to restrict illegitimate and improper access to tax treaties by individuals and entities not resident in the contracting States.

Hence there is a need to formulate some general criteria regarding measures of action and reaction against the abuse of tax treaties and to include such criteria in the commentaries on the articles of the model conventions, making sure that they are in harmony with the theory of international treaties and the limitations on the use of domestic measures to react to fraud and tax evasion. In relation to treaty abuse, however, a distinction must be drawn between a reaction to excessive use of the advantages that result from combining treaty provisions with the tax benefits granted by the other contracting State and a reaction to the schemes of persons deliberately seeking to abuse the treaty.

In most cases, the reaction to treaty abuse is to apply domestic mechanisms to prevent tax evasion. Any such response, however, must take due account of the primacy of treaties, the *pacta sunt servanda* principle and the prohibition against unilateral modification of treaty obligations, and that conclusion in turn necessitates a look at the specific conditions under which the treaty is interpreted and integrated with the domestic tax legislation of the contracting States. In order to ensure that domestic anti-abuse legislation can be applied, it is advisable to include a safeguard clause in the treaty.

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Another approach is to specify in the treaty itself what constitutes abuse, although such provisions will need to be complemented by domestic provisions. The definition may be partial and take the form of a variety of mechanisms limiting the effects of the treaty, or it may be comprehensive and take the form of a limitation-of-benefits clause. Any such clause included in the treaty, however, must be consistent with the premises underlying the tax and budgetary policy of each State and with the principle of legal certainty and will sometimes prove to be incompatible with the requirements of reciprocity when it comes to actual implementation.

Contents

I. Introduction

1. Concern about the improper use of tax treaties has increased as the network of such treaties has expanded in an effort to provide tax stability for international investment. The chief aim of tax treaties is to promote the exchange of goods and services and the flow of capital by eliminating international double taxation, one of the main obstacles to international trade.

2. However, as the network of bilateral treaties becomes denser, tax treaties do more than bring tax stability to international economic relations; they also increase the methods and opportunities for structuring international business arrangements in such a way as to reduce the overall tax burden on international operations, which may give them an advantage over purely domestic operations (see paragraph 8 of the commentary on article 1 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Cooperation and Development ("OECD Model Convention"), which is reproduced in the United Nations Model Double Taxation Convention between Developed and Developing Countries ("United Nations Model Convention")).

3. In an attempt to restore the balance, many States, as well as these international organizations, have taken a position that refines and expands upon the chief aim of tax treaties as follows:

(a) On the one hand, tax treaties are still considered the most effective normative instruments for eliminating international double taxation and promoting flows of transnational investments thanks to tax stability;

(b) On the other hand, there is agreement on the need to limit the effects of tax treaties to prevent illegitimate and abusive use thereof by persons who do not appear to be the ultimate recipients of the benefits provided by the respective tax treaties.

4. The proliferation of tax treaties that include such anti-avoidance mechanisms makes it advisable to review the arguments — pro and con — for concluding tax treaties, taking into account not only the reciprocal advantages to be derived from the conclusion of a bilateral tax treaty but also, at a deeper level, the multilateral effects of signing such an agreement and of combining and integrating the tax treaty with the domestic legislation and treaty obligations of the contracting States, analysing the implications of its bilateral scope and the subjective and objective conditions for its application.

5. The Ad Hoc Group of Experts on International Cooperation in Tax Matters examined abuse of tax treaties on two occasions in the past, at its second meeting in 1983 and at its fourth meeting in 1987. At the latter meeting, it arrived at some important conclusion that form the basis for the present review and update.[1] On that occasion, the Group of Experts identified the main types of abuse of double taxation conventions, considered possible treaty solutions to the problem and examined a number of abusive situations and possible solutions to them. It did not, however, embody these considerations in the update of the United Nations Model Convention in 2001.

6. A number of factors, taken together, make it advisable to review the thinking on abuse of tax treaties, among them:

(a) The new treatment of the topic of improper use of tax conventions in the 2003 update of the OECD Model Convention;

(b) Harmful tax competition among States, as it relates to the self-interested and abusive use of double taxation treaties;

(c) The inclusion of new anti-abuse clauses in treaties and increased experience with their application;

(d) The influence of regional and international sets of rules, such as those to be found in Community law, on the concept of abuse of tax laws;

(e) Lastly, the new international framework in which the Group of Experts carries out its work, resulting from the adoption of the Monterrey Consensus, which added an instrumental dimension to the treatment of national and international tax problems with the aim of ensuring the efficacy and effectiveness of the proposed measures by requiring practical implementation of the decisions taken.[2]

II. The concept of abuse of tax treaties

A. Preliminary considerations: difficulty in arriving at a uniform, internationally applicable definition

7. In international tax circles there is considerable debate about what constitutes abuse of a tax treaty. Although there have been some attempts at a formulation of the concept, including the one adopted by the Group of Experts at its meeting in 1987, it has proved difficult to arrive at a definition that is valid and acceptable for all international actors, including States and economic agents. Nonetheless, the phenomenon of treaty abuse is recognized, despite the lack of a uniform, internationally valid definition. In other words, it is recognized that treaty abuse occurs, even though the specific elements that make it up have not been clearly delineated.

8. To begin with, it can be contrasted with the straightforward and correct use of a treaty. Treaty abuse implies, then, an “incorrect” use of a treaty, without, however, necessarily involving an illegal act or a formal breach of the treaty. Hence, it is sometimes referred to instead as “improper use” of a treaty. The reference to the improper use of a treaty implies a use of the treaty that is contrary to its spirit, object and purpose. However, the term “abuse of tax treaties” can refer to a variety of situations requiring differentiation, since each has its own particular set of characteristics and calls for a different, specific legal response.

9. The first aspect to consider is who is abusing the tax treaty. In this regard, a distinction can be drawn between (a) abuse of the agreed terms of the tax treaty by one of the contracting Parties, that is, a State, and (b) abuse of the treaty provisions by persons (natural or juridical), who may or may not be the intended beneficiaries of the treaty, in order to gain advantages greater than would otherwise result from the context and intent of the tax treaty.

10. This distinction derives from the dual nature of tax treaties, which are international agreements between States but are intended to affect the tax liability of the individuals and entities subject to it, and it is an important one to make in order to identify the factors that lead to such abuse, the conditions that determine the

existence of an abuse and the response mechanisms that are legally acceptable from the standpoint of the international law of treaties.

11. The distinction is recognized in the OECD Model Convention in the commentary on article 1, paragraph 17, formerly paragraph 19, and has been strengthened in the 2003 update of the OECD Model Convention by new paragraphs 21 to 21.5 of the same section, particularly in the cases contemplated in paragraph 21.5.

B. Abuse by one of the contracting States

12. State abuse of a tax treaty refers to situations in which one of the contracting States, through the subsequent exercise of its domestic powers of taxation, modifies the obligations previously assumed by that State with other States and upsets the balance in the division of taxing powers expressed in the concluded tax treaty. By so doing, it fosters the development of abusive situations involving from the improper use of the double taxation treaties signed by that State and causing significant injury to the legitimate financial interests of the other contracting State.

13. The determination that an abuse has occurred and the means of sanctioning it must be strictly consistent with public international treaty law, in particular article 26 of the Vienna Convention on the Law of Treaties of 1969, which requires the parties to a treaty to perform it in good faith, and article 38 of the Statute of the International Court of Justice, which states that the Court shall apply the general principles of law recognized by civilized nations. It follows that the adjustment and resolution of such situations must be subject to and decided in accordance with the rules of international law on the basis of treaty provisions between the parties, before or after the fact, which means that the treaty balance may not be restored by the unilateral action of the other contracting State.

14. State abuse of a tax treaty may occur in the following situations:

(a) It may result from the post-treaty amendment of a domestic tax law that must be taken in conjunction with a tax treaty in order to be interpreted and actually applied. The process may result in the concession of exceptional or excessive advantages to a certain number of persons or beneficiaries of the treaty that are not derived solely from the text of the treaty but from the treaty provisions in combination with the domestic tax legislation of the State in question. Such situations, however, are sometimes lumped together with other forms of "treaty shopping".[3]

(b) Treaty abuse may be the consequence of an administrative practice of one of the contracting States. State abuse may result, not from the subsequent amendment of tax legislation by a contracting State, but from an administrative practice used to apply it that has the effect of permitting the relinquishment of one of the objects and purposes of the treaty by defining the conditions for treaty access by persons who were not originally intended to benefit from it.

15. Verification of State abuse of a tax treaty faces serious obstacles, since as a public international law concept it is difficult to apply to the realm of tax treaties, bearing in mind the *pacta sunt servanda* principle, which governs the actions of the contracting States. Some of those obstacles are:

(a) The lack of a concept of minimum taxation of transnational income or of an obligation to tax such income, which could be inferred from double taxation treaties so that situations of double exemption from tax could be seen as abusive;

(b) The lack of an agreed verification procedure that would make it possible to settle cases of abuse of a tax treaty; in such cases it is left to the respective domestic authorities to apply and interpret the rules, there being no provision for recourse to international courts of justice to adjudicate the existence of such an abuse, although the potential for resorting to an amicable proceeding in such cases should be explored;

(c) The lack of any means of dealing with the consequences of such a determination under public treaty law, which provides for a response only in the case of material breaches of a treaty (article 60 of the Vienna Convention on the Law of Treaties).

16. In the light of the above, the response to State abuse of the tax treaty needs to be spelled out in the treaty itself, which should include rules governing the application of its provisions in conjunction with domestic laws and regulations of either of the contracting States that could cause an injury considered inadmissible to the financial interests of the other State, setting forth the conditions of application and the extent of their effects. In such cases, contracting States should not be allowed to react unilaterally outside the scope of the treaty and contrary to the rules of the Vienna Convention in a way that would undermine the primacy of the tax treaty.

III. Abuse of tax treaties by individuals and entities

A. Definition of treaty abuse

17. The term “treaty abuse” as it is used in the field of tax treaty law basically refers to the incorrect or improper use of treaty provisions by persons, resulting in an injury to the financial interests of one of the signatory States — or even to a third State.

18. More narrowly, the term refers only to situations in which a person who is not intended to be a beneficiary of the treaty does benefit from its provisions by obtaining an illicit tax saving through the application of the treaty. This is how it was described in general terms by the Group of Experts at its fourth meeting, which defined abuse of tax treaties as “the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits the treaties were not designed to give them”.[4] This differs, then, from a situation in which the treaty is used as a pretext to justify the abuse of a domestic provision of a State signatory to the treaty.

19. Looked at another way, however, the term comprises only subjective abuses, referred to as “treaty shopping”. However, the term “treaty shopping” — in other words, searching for a more favourable treaty — should not be equated with treaty abuse. The conclusion that a situation is abusive — or that an individual is benefiting from the application of a double taxation treaty in an abusive fashion — requires and implies verification of the occurrence of an indirect, rather than a direct, breach of a provision through a violation of its object, spirit or purpose, something that is difficult to determine a priori.

B. Identifying treaty abuse: application of the concept and domestic anti-abuse mechanisms to verify it

20. Identifying abuse of a tax treaty by persons requires consideration of the purpose of the treaty, how it is applied and integrated with domestic legislation and how its provisions are interpreted in the light of the context of the treaty. Because of these varying characteristics, such a determination is arrived at according to the terms that define abuse in the domestic tax legislation of the given State and is made by the authorities — administrative or judicial — of that State.

21. From this general observation, some important consequences can be inferred:

(a) Abuse presupposes a violation of the legitimate financial or revenue interests of the contracting State that uncovers the abuse;

(b) Verification is done independently by the domestic authorities of each of the contracting States, since each is fully competent to apply the treaty;

(c) The occurrence of abuse is inferred through the application of domestic mechanisms existing in each contracting State to counter the abuse of tax laws or of specific rules regarding abuse of tax treaties;

(d) It is not requisite or necessary that both contracting States should identify the abuse;

(e) Hence it is impossible to formulate a uniform, internationally acceptable concept of abuse of tax treaties by persons. Even if one were to be elaborated on the basis of some minimum basic elements, in an individual case the definition would ultimately depend on the legal and judicial rules and the administrative and judicial practice that make up each tax system, with which tax treaties must be integrated in order to determine how they will affect the persons that might claim their benefits.

22. This wide variation in the process of identifying and responding to treaty abuse needs to be expressly recognized in the commentaries on the articles of the United Nations Model Convention, which must do more than merely cite certain doctrines or formulas (such as the "substance-over-form" rule).

23. Moreover, the process of treaty interpretation is of the utmost importance in determining what is material and critical to the object and purpose of the system and of the treaty and in confirming that the requirements of treaty primacy are safeguarded, even in those cases in which the treaty as such is ignored in favour of objective a priori yardsticks that beg the question, such as intent or will to defraud, artificiality of arrangements, or lack of sound business reasons to justify a transaction.

C. Defence of the special nature of treaties in formulating a definition of abuse: primacy and context

24. In establishing the occurrence of treaty abuse, even in the most basic manner, and determining the applicable means of restitution, it is important to keep in mind the special nature of tax treaties deriving from their ranking, their position in the system of sources of law and their relation to and integration with domestic laws. While it is true that such issues must be resolved by the judges and administrators of

a country in accordance with domestic constitutional criteria, nonetheless the solution must respect the special position of tax treaties under the rules of public international law. In particular, the use of national mechanisms to identify and combat tax treaty abuse must be consistent with the *pacta sunt servanda* principle set out in article 26 of the Vienna Convention on the Law of Treaties. Moreover, according to article 27 of that Convention, a party may not invoke the provisions of its internal law — in this case its domestic anti-abuse tax rules — as justification for its failure to perform a treaty. Even if such constitutional precautions are valid and legitimate from a domestic standpoint, from the standpoint of public international law that is not sufficient reason for according validity to an attempt to apply domestic anti-abuse rules in all cases in the face of the tax treaty provisions as a means of combating abuse of the treaty provisions. This is the rationale for the efforts of some countries to provide specific treaty justification for the responses of domestic — and international — tax systems to cases of treaty abuse, even though a response through purely domestic anti-abuse mechanisms might have constitutional legitimacy.

25. In verifying abuse, it is particularly important to determine the implications of the context of the treaty and to interpret its terms in good faith. It will be useful, then, to analyse some of these contextual implications.

(a) First, in many tax treaties it cannot be assumed that elimination of cases of international double exemption from tax is an objective of the treaty. And while this is not an outcome sought by the tax treaty, neither can it be firmly concluded that it is contrary to some tax treaties, since the situation does not depend solely on the effects of the treaty but rather on the treaty taken in conjunction with the laws of the two contracting States. Therefore, States that wish to confront the dangers that these observations imply must either include express saving provisions in their treaties or apply domestic saving provisions, provided they do not contravene the terms of the treaty.

(b) Second, it should be recognized that the response to an alleged treaty abuse is relative rather than absolute. In arriving at an assessment of context that would make it possible to decide whether the object or purpose of the treaty has been violated, the factors to be taken into account include the domestic laws of each of the States, the existing balance among the rules governing division of powers and the methods allowed or contemplated by the treaty for eliminating international double taxation. It may also depend on the model convention that served as a reference for the particular tax treaty, even though the model conventions do not specify what role and relevancy the models and their commentaries should have in the interpretative process.

(c) Lastly, whether or not it is considered abusive if an individual or an entity — normally a company — is set up in a third State to benefit from the tax treaties signed by the third State will depend on how the contracting States understand the implications of the bilateral nature of the treaty and how much discretion each of the contracting States has in defining what is meant by residents of that State to whom the provisions of the treaty apply, which entails delineating the scope of the persons and situations covered by the treaty (persons covered).

IV. Reaction to tax treaty abuse: measures to counter abuse of a tax treaty

A. Domestic anti-abuse measures and tax treaties

26. The logical reaction to treaty abuse begins with an attempt to apply the domestic rules designed to prevent or address cases of tax law abuse harmful to the financial interests of States. As we have said above, the usual meaning of the term "abuse of tax treaties" relates to cases of abuse by individuals or entities of a tax provision — either in a treaty or in domestic law, but relating to taxation — in order to obtain a tax saving that is illicit, improper or not available in the ordinary way.

27. It is apparent from cases examined in a variety of jurisdictions that, on occasion, such attempts achieve practical success, quite apart from theoretical considerations as to their legal validity. The national authorities responsible for investigating them are bound by the requirements of their own tax systems, rather than by more general considerations relating to the special status of the treaty rule that has been abused or evaded.

28. However, as the above analysis shows, this outcome is likely to undermine the primacy of double taxation treaties over domestic tax legislation to be inferred from international public law and thus to breach the State's obligations under an international treaty instrument. The application of domestic anti-abuse rules in the face of the treaty should depend on the conclusion reached by examining the factors relevant to the identification of treaty abuse, namely:

(a) The criteria governing the interpretation and application of the treaty and in particular the logical requirements arising from its context;

(b) The conditions under which the treaty rule — supposedly being abused — is integrated with the domestic tax laws in question;

(c) The requirements to be inferred from the prohibition against unilateral modification of treaty obligations, as set forth in article 27 of the Vienna Convention on the Law of Treaties.

29. If the application of the domestic anti-abuse rule leads to a reconsideration of the facts to which the tax rule — in this case the treaty rule — applies, it is difficult to argue that the domestic rule constitutes a breach of treaty obligations, regardless of the validity of the reconstructive mechanisms of proof employed.

30. If, on the other hand, the application of the domestic anti-abuse rule leads to a legal recharacterization of the situation or arrangement devised in order to commit treaty abuse, whether or not there is a unilateral breach of treaty obligations — with reference to the beneficiaries of the treaty — will depend on the impact of the recharacterization on the conditions governing the application and interpretation of the treaty. If the exemptions issue relates to the domestic tax rule, it cannot be argued that there are insuperable obstacles to the application of the recharacterizing domestic tax rule. However, if the recharacterization occurs first and gives rise to the application of a different treaty rule with different effects, the increased tax liability of the individual could be seen as a unilateral modification of the conditions governing the application of the treaty, thus contravening the *pacta sunt servanda* principle. In that event, the attempt by States to make domestic anti-abuse rule

prevail over particular treaty obligations might succeed through the inclusion in the tax treaty itself of a safeguard clause authorizing the application of domestic tax rules.

31. The Group of Experts should analyse from this standpoint the following aspects, in regard to which the conclusions presented in the 2003 update of the OECD Model Convention are highly relevant:

(a) A technical aspect relating to the systematization of the treatment of the topic, incorporating the principles contained in paragraphs 9.2 to 9.6, and in paragraphs 22 to 26 of the commentary on article 1 of the OECD Model Convention.

(b) A substantive aspect relating to the validity of the general OECD proposals that can be inferred from paragraphs 9.4 and 22.2 of the commentary on article 1 of the OECD Model Convention. Paragraph 9.4 states that “it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the Convention have been entered into”; and paragraph 22.2 states that “whilst these [domestic] rules do not conflict with tax conventions, there is agreement that Member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused”. The inclusion of these concepts seems to imply acceptance — through international consensus — of the possibility that States may apply their domestic anti-abuse rules to address cases of international tax evasion, even if that means overriding the primacy of tax treaties, and that such a measure does not conflict with international law where there is clear evidence that the treaty has been abused. However, OECD establishes a guiding principle for determining whether treaty abuse has occurred, which entails verifying that the person’s “main purpose” was to benefit from the more favourable tax position provided by the application of the abused treaty.

32. In view of the foregoing, the Group of Experts should be asked to consider whether it agrees that that consensus should be introduced into the United Nations Model Convention; whether there is a “general principle of law recognized by civilized nations” that would allow States to take action against individuals and entities that set up arrangements and carry out operations that constitute treaty abuse; what in that event would be the criteria or elements that would prove useful in defining such a general principle (in a manner similar to paragraph 9.5 of the commentary on article 1 of the OECD Model Convention; and whether such legal conclusions should be qualified by the requirements of the Vienna Convention on the Law of Treaties.

33. One way of avoiding doubts about interpretation and application that arise from the relationship between anti-abuse laws and tax treaties is to introduce into such treaties an explicit safeguard clause allowing for the application of such laws as against the treaty. This practice is becoming common, and many States have decided to insert in their treaties — usually through protocols — explicit authorizations, of varying scope and content, for the application of domestic anti-abuse laws, thereby altering presumptions about the interpretation and application of the terms of the treaty. From a practical standpoint, this approach has the advantage of being easy to apply and avoids legal problems caused by a departure from treaty primacy.

34. It should be noted, however, that the use of such “authorizing” clauses does not automatically prejudge whether or not it is possible to apply domestic anti-abuse laws in cases where there is no such clause. In such cases the issue will be decided according to the criteria discussed above.

B. Treaty measures for avoiding treaty abuse

35. As a response to treaty abuse, safeguard clauses authorizing the application of domestic anti-abuse laws should be distinguished from specific treaty provisions spelling out forms of abuse and their consequences and effects. In the latter case, the treaty contains not a mere authorization but a specific definition of the treaty abuse, although, a corresponding development of domestic law allowing for verification and ensuring effectiveness might be advisable. In such cases only a specific treaty reference determines when an individual is not eligible to claim the benefit of a tax treaty, treaty shopping as an abuse and the response to it being defined internationally.

36. This finding has important implications:

(a) There is a further delimitation of the individuals and entities who can claim the benefit of the treaty or one or more of its provisions, redefining the persons covered by the treaty or by some of its provisions.

(b) Tax and budgetary policy considerations determine that further delimitation, which should, however, be in keeping with the practical implications of the fact that tax treaties are concluded as means of promoting international trade, as part of the process of economic internationalization. Such considerations are discussed in the 1987 United Nations report, which goes so far as to state, in paragraph 27, that, “even if the transactions have been entered into with the express intention of taking advantage of the relevant treaties it does not necessarily follow that this is objectionable.”[5] The Group of Experts should consider whether this assertion continues to be valid as a point of departure for the treatment of treaty shopping.

(c) Often, the nature of the contemplated response is mixed. Action is taken not only against the conduct or activities of an individual, company or entity, but also against the other contracting State, which is attempting to take advantage of the integration of treaty provisions with its own legal system, in a response clearly demonstrative of distrust towards the other contracting State. Such a response therefore tries to restrict the bilateral view of the treaty, which is at odds with the recognition that the treaty has effects on third parties, as discussed in the model conventions, with regard, for example, to triangular arrangements and artiste-companies, and hence to limit the discretionary power of a State to determine, under the provisions of article 4, paragraph 1, in conjunction with article 1 of the model conventions, which persons may benefit from the treaty vis-à-vis the other contracting State.

(d) Unless the treaty so specifies, it cannot be concluded that treaty shopping is contrary to the object and purpose of the treaty. In other words, treaty shopping constitutes improper use of a treaty only when it can be legally defined as an abuse of law by a State or by persons through internationally accepted mechanisms and with due regard for the requirements of international public law, or when it is expressly so characterized in a treaty clause. In this regard, the thinking being done in some regional contexts, notably in the European Union about the possibility of using such specific anti-abuse mechanisms — along with other more general mechanisms incorporated in domestic tax law — in situations where, for example, Community law prevails, undoubtedly deserves attention.

(e) Among the general criticisms that could be levelled at that approach is the loss of a consistent position as to the scope of the benefits of the treaty provisions, which constitute only a partial approach to treaty shopping and, so far from reducing or eliminating it, may even exacerbate it or increase the complexity of applying the treaties, necessitating a revision of the practical mechanisms for implementing and monitoring them. The effectiveness of such clauses largely depends on the response of the other contracting Party and on its cooperation in preventing illicit or improper interposition of individuals or entities.

C. The position of the United Nations Model Double Taxation Convention between Developed and Developing Countries and commentary on addressing treaty abuse through treaty measures

37. The United Nations Model Convention begins its discussion of treaty measures to counter treaty abuse with the comments made by OECD in its Model Convention. Accordingly, in considering a possible update of the United Nations Model Convention, we will start with the additions and changes to the OECD Model Convention.

38. We should first, however, review the process by which the views expressed in the commentary on the OECD Model Convention have been assimilated into the most recent published version of the commentary on the United Nations Model Convention.

39. According to paragraphs 28 and 29 of the “Draft report of the Focus Group of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on its second meeting”,[6] paragraphs 7 to 10 of the commentary on article 1 of the OECD Model Convention should be inserted into the United Nations Model Convention, and the discussion in the OECD commentary on treaty abuse issues (paragraphs 22 to 26 in the version of the OECD Model Convention current at that time) could usefully be incorporated in the United Nations Model Convention.

40. However, the material finally inserted differed considerably from this suggestion, although no reason for the omissions emerged in the debate in the Group of Experts. Former paragraph 12 of the OECD commentary on article 1, which contains general considerations to be borne in mind in adopting one approach or another was not inserted. Moreover, the paragraphs enumerating the advantages and disadvantages of adopting each particular approach were omitted (paragraphs 14, 16, 18 and 20). Even conceding that such a wholesale borrowing was unnecessary, the failure to reflect in the United Nations Model Convention the views discussed and noted in the Group of Experts’ own 1987 report is difficult to understand. The “channel” clause, an effective mechanism for dealing with “stepping-stone” devices (paragraphs 19 and 20), was not adopted, either, even though the 1987 report discussed that approach.[7] Consideration should be given to correcting these

omissions and to incorporating, with some adjustments, the changes made to the OECD Model Convention in its 2003 update.

V. Analysis of proposed treaty clauses to deal with treaty abuse: limitation-of-benefits clauses

41. Since the United States of America included such a clause in its Model Income Tax Convention of 20 September 1996, "limitation-of-benefits" or "LOB" clauses have increasingly been used to set limits on who may benefit from some or all of the clauses of a tax treaty.

42. Limitation-of-benefits clauses are a general mechanism involving a closed or semi-closed definition of the persons (individuals and entities) with access to the treaty. Rather than a negative delineation of the conditions that would exclude some or all the effects or provisions of the treaty, such clauses provide a positive definition of the criteria that beneficiaries of the treaty must meet in order to be able to claim and apply its benefits in both States. They imply greater intervention and exercise of discretion on the part of tax administrations than are implied by the partial clauses recommended in the OECD and United Nations model conventions up to now.

43. Thus they constitute a shift in the powers traditionally allocated in the model conventions to the contracting States when acting in the capacity of State of residence to determine the scope of application of the definition of persons covered by the treaty, as given in article 4, paragraph 1, of both model conventions. With the introduction of a limitation-of-benefits clause, that determination becomes part of the text of the treaty and is no longer a matter for the other contracting State, so that the source State of the income may verify compliance, thus preventing persons to which the provisions of the treaty do not apply from benefiting from it contrary to the intent of the signatory States.

44. A comprehensive positive definition of the ultimate beneficiaries of the tax treaty provisions therefore constitutes an anti-abuse mechanism broader in scope and content and different from other subjective-definition anti-abuse methods previously accepted and included in the model conventions.

45. The concept of "beneficial owner" incorporated in articles 10 to 12 of the United Nations Model Convention has the same purpose and intent, which is to prevent the tax treaty from benefiting individuals or entities set up as intermediaries merely to take advantage of the treaty. However, the two methods differ in some essential respects:

(a) First, the exclusion or inclusion effect of a beneficial-owner clause is partial. Only limitation-of-benefits clauses offer a comprehensive response to a potential subjective abusive use of a treaty. The beneficial-owner clause, in contrast, as an anti-abuse mechanism, is limited to preventing reduced taxation at the source when persons in a different — third — State are involved who are not the recipients of the income generated in the source country.

(b) Second, the term "beneficial owner" is not usually expressly defined in the treaty. Although the term is widely used, few domestic tax systems specify what is meant by "beneficial owner", so that to interpret it in accordance with article 3, paragraph 2, of the Model Convention is feasible only in terms of how it is used in the context of the treaty. This solution, however, turns out to be unsatisfactory in many cases, so that some States are opting for the inclusion of a specific definition of the concept in their tax treaties.

46. Moreover, limitation-of-benefits clauses differ from the anti-abuse clause dealing with artiste-companies to be found in article 17, paragraph 2, of the Model Convention, because the latter is an example of a clause that merely authorizes a domestic anti-abuse tax rule.

47. There are a number of general points to be made about the inclusion of limitation-of-benefits clauses in the text of tax treaties, before discussing what they specifically stipulate.

48. First, such clauses give rise to a dual link between individuals or entities and the tax treaty. To begin with, there is the general applicability of the treaty to all taxpaying residents of either (or both) of the contracting States, which can clearly be inferred from articles 24, 25 and 27 of the Model Convention. In addition, a special category of "qualified residents" is created, consisting of those residents who, since they fulfil the specific treaty requirements for linkage, are entitled to invoke, claim and apply the provisions of the tax treaty that bring them a tax benefit.

49. Second, the comprehensive approach to treaty abuse does not distinguish between situations in which the negative effects on one contracting State are the result of a reaction by the other contracting State and those in which the effect is brought about by the abusive activities or structural arrangements of persons, a distinction that, as we have shown, must be taken into account in discussing the validity of the anti-abuse mechanisms provided in the treaty.

50. Third, application of such clauses requires a complementary domestic tax law mechanism and the development of channels of administrative cooperation to obtain tax-related information from other countries. In the absence of these necessary complements, there is a risk that the demands of one of the contracting States related to subjective abuse of the tax treaty will simply be accepted, with the result that assumptions about application of the treaty based on the principle of reciprocity will break down.

51. Fourth, there is no uniform or standard wording for such a clause. A variety of factors, including the progressive development of the clause in an attempt to counter the most advanced types of improper use of tax treaties, the lack of a model clause in the internationally accepted model conventions, the negative reaction to the clause on the part of many States and the need to harmonize its requirements with other requirements imposed by supranational systems such as the North American Free Trade Agreement or European Community law, have resulted in a varied, diverse and complex set of anti-abuse rules that do not lend themselves to methodical arrangement or uniform explanation. Moreover, far from standardizing the subjective criteria for access to treaty benefits in order to restrict the opportunities for persons to set up conduit companies and other entities to obtain undue benefits from a tax treaty, such clauses generate a multitude of particular, specific treaty situations, resulting in privileges for some and not for others, a situation scarcely compatible with the principle of non-discrimination. To take only one example, a comparison of the tax treaties concluded between the United States and various countries of the European Union, within which the fundamental rights

of freedom of movement and establishment prevail, shows that some of those treaties do not include a limitation-of-benefits clause, others do include such a clause, although the particular criteria differ, and yet others have such a clause supplemented by a derivative-benefits clause to overcome its incompatibility with the supranational requirements of Community law, giving rise to the new concept of "equivalent beneficiary". The existence of different standards of treaty access allows for a choice of jurisdictions for entry to or exit from the European Union, notwithstanding the fact that in other cases the mechanisms established to implement the limitation-of-benefits clauses do not allow for a detailed verification of each of these criteria.

52. Therefore, the inclusion of a standard clause in the model conventions (the 2003 update of the OECD Model Convention already contains a standard limitation-of-benefits clause in paragraph 20 of the commentary on article 1) might contribute to a more uniform and internationally harmonized understanding. The criticism could be made, however, that the OECD Model Convention merely presents the clause without offering a general discussion and explanation of the criteria for applying and interpreting it and its advantages and disadvantages. Nonetheless, the Group of Experts should decide whether to include such a clause in the commentary on the United Nations Model Convention and, if so, what its scope and content should be.

A. Structure of limitation-of-benefits clauses

53. Despite its complexity, on the version that appears in the United States Model Income Tax Convention of 1996 and some specific clauses that appear in tax treaties concluded by the United States, the limitation-of-benefits clause can be divided into the following sections, which specify the eligibility requirements for access to treaty benefits: provisions regarding individuals, governmental entities, companies listed on a stock exchange, non-profit organizations and other non-listed companies and entities; a provision allowing for partial application of the treaty; and a saving provision allowing the administrative authorities of the contracting States to make the determination whether to apply the treaty.

54. The purpose of this division of beneficiaries of the tax treaty into categories is to define for each the criteria that would demonstrate a sufficient link with the territory of a contracting State or a genuine commercial motive. The link is different for the different categories of beneficiaries, so that different objective tests or criteria are applied: the stock-exchange test, the ownership test, the base-erosion test, the derivative-benefits test, the business-activity test. However, the application of different objective tests may result in discrimination with regard to the access to tax treaties available to different types of taxpayers, discrimination that should be analysed for its impact on the incentives to companies to do business internationally and the need of developing countries to attract capital.

B. Application of the treaty to individuals

55. With regard to individuals (that is, natural persons), limitation-of-benefits clauses rely completely on the legislation of the State of residence to establish what it considers an appropriate criteria for demonstrating a link with that State. To deal

with the problem of the interposition of agents or nominees, the usual beneficial-owner clauses found in most tax treaties are considered a sufficient anti-abuse mechanism.

C. Application of the treaty to governmental entities

56. The treaty protection provided by the contracting States is obviously needed to ensure that they can carry out their functions with the least possible tax burden in the other State. Inclusion of such a clause makes it necessary to define or list the various entities that qualify, based on the particular characteristics of the contracting States.

D. Application of the treaty to companies listed on a stock exchange

57. Treaty benefits apply to such companies if they pass the tests of listing on a recognized stock exchange and regular and active trading of their shares. However, listed companies do not need to pass the ownership test or, more significantly, the base-erosion test, one of the most effective mechanisms to be found in limitation-of-benefit clauses against so-called “stepping-stone” arrangements, or even the general business-activity test. This may result in a difference in treatment between listed and unlisted companies that is difficult to justify, making it harder for the latter to access treaty benefits. From the perspective of developing countries, this may mean that small and medium-sized enterprises are at a disadvantage compared with multinationals. The situation is aggravated by the fact that access to treaty benefits on the stock-exchange basis is not limited to the listed companies who themselves meet these criteria but also extends to their subsidiaries, including indirectly controlled subsidiaries, subject to certain conditions, and to trusts controlled by such listed companies with treaty access, in both cases by-passing the tests of ownership and base erosion.

58. As a general rule, leaving aside for the moment the special provisions that do exist in many treaties, a company is deemed to be listed on a recognized stock exchange if the principal class of its shares — all of them — is actively and regularly traded on a recognized stock exchange. As an additional mechanism, access to treaty benefits is accorded when the principal class of shares representing the majority (more than 50 per cent) of the voting power and value of the company is owned by five or fewer companies that meet the foregoing requirements.

E. Application of the treaty to non-profit entities and pension funds and plans

59. For this category, access to treaty benefits is granted to non-profit entities of a religious, charitable, scientific, literary or educational nature in view of the public purposes or general interests such entities serve, as recognized by the domestic legislation governing them, and to pension plans and funds in view of the social welfare purposes they are intended to fulfil. In the case of pension plans and funds, however, access to treaty benefits is subject to an ownership test: more than 50 per cent of the beneficiaries, members or participants must be individuals resident in either contracting State.

F. Application of the treaty to other entities and companies

60. For other companies for which no special rule applies, access to treaty benefits depends on satisfying both the ownership test and the base-erosion test.

61. The ownership test requires that the majority (more than 50 per cent) of the aggregate vote and value of the shares or other beneficial interests is owned for the greater part of the fiscal year by other individuals or entities who are qualified residents, except in the case of subsidiaries of companies listed on a stock exchange.

62. The aim of the base-erosion test is to discourage stepping-stone arrangements whereby the income attributed to an intermediary is transferred, directly or indirectly, to entities resident in other States in the form of payments abroad that are deductible and reduce by more than 50 per cent the gross income of the intermediary company. The precise meaning of the terms "payments that are deductible" and "gross income" is determined in accordance with the domestic legislation of the contracting States.

G. Partial application of the treaty benefits under the business-activity test

63. Application of the treaty benefits in this case is based on the existence of an effective economic link with the residence State, independent of the existence of a sufficient subjective link. The requirement is satisfied, in relation to each type of income, when the recipient of the income is carrying on business in the residence State, the income derived from the source State is derived in connection with, or is incidental to, that business and the resident satisfies the other conditions of the treaty for the obtaining of the treaty benefits. It is also a requirement that the business activity in the residence State should be substantial in relation to the activity carried out in the source State of the income.

64. Unlike the other criteria, this test is very difficult to apply automatically and cannot be considered self-executing, since it requires a ruling on an application and the procurement of the relevant evidence. The provision proposed in the OECD Model Convention is worded solely from the standpoint of the residence State, although there is no reason why application of the provision could not be claimed and required in the source State of the income.

H. Saving clause: application of treaty benefits by the authorities of either of the contracting States

65. **Limitation-of-benefits clauses in many tax treaties, like the one proposed in the commentary on the OECD Model Convention, conclude by authorizing either of the competent tax authorities of the contracting States to grant the benefit of some provisions of the tax treaty to certain entities or companies that do not meet any of the above criteria or tests. The according of such discretionary power to either of the contracting States' authorities needs to be examined closely from the standpoint of the principles of reciprocity, *pacta sunt servanda* and legal certainty, contravened in this case by the wide scope for**

discretion allowed to either of the two States unilaterally — acting either as source State or residence State — to decide whether to apply the terms of the treaty. It would seem more consistent with the requirements of international treaty law to include a bona fide provision to allow access to treaty benefits to persons who are not engaged in abusive activity and can demonstrate it.

Notes

[1] See United Nations, *Contributions to International Cooperation in Tax Matters: Treaty Shopping, Thin Capitalization, Cooperation between Tax Authorities, Resolving International Tax Disputes* (United Nations publication, Sales No. E.88.XVI.1).

[2] *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (United Nations publication, Sales No. E.02.11.A.7, chap. I, resolution 1, annex, para. 64).

[3] *Contributions to International Cooperation in Tax Matters*, para. 24.

[4] Ibid., para. 8.

[5] Ibid., para. 27.

[6] "Draft report of the Focus Group of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on its second meeting" (English only) (ST/SG/AC.8/1999/CRP.6).

[7] *Contributions to International Cooperation in Tax Matters*, paras. 68-72.