TREATY SHOPPING AND THE ABUSE OF INCOME TAX CONVENTIONS;

Luiza Brindusa Cruceru, Institute of Comparative Law, Faculty of Law, McGill University, Montreal;

July, 2005;

A thesis submitted to McGill University in partial fulfillment of the requirements of the degree of Masters of Laws, LL.M.;

Your file Votre référence
ISBN: 978-0-494-22688-9
Our file Notre référence
ISBN: 978-0-494-22688-9

TABLE OF CONTENTS

ABSTRACT

This study proposes to analyze the phenomenon of tax treaty abuse and the use of tax treaties as tools to avoid or minimize the taxation by residents doing business in a foreign jurisdiction. This study analyses a particular strategy using tax treaties known as "treaty shopping." This paper will argue that treaty shopping constitutes an abuse of the tax treaty regime. However, this study rejects the traditional arguments against treaty shopping and proposes a different basis to challenge the legitimacy of this practice and to explain why this strategy constitutes an improper use of tax treaties.

Cette étude propose d'analyser le phénomène d'abus de traité fiscal et de l'emploi de traités fiscaux comme les outils pour éviter ou minimiser la taxation de revenu gagné par les résidents dans une juridiction etrangere. Cette étude analyse une stratégie particulière en utilisant des traités fiscaux connu comme "la course au traités." Ce papier arguera que cette stratégie constituent un abus du "régime de traité." Pourtant, cette étude rejette les arguments traditionnels contre la course au traités et propose une base différente pour défier la légitimité de la pratique et expliquer pourquoi cette stratégie constitue un emploi impropre de traités fiscaux.

ACKNOWLEDGMENTS

I would like to thank my co-supervisors Professors Wendy A. Adams of the Faculty of Law at McGill University and David G. Duff of the Faculty of Law at the University of Toronto for their very helpful comments on the previous drafts of the thesis.

Chapter 1: Introduction

International tax planning and the decision of where and how to structure commercial transactions and where to locate corporate entities or conduct corporate/economic activities, are influenced to a large extent by the tax benefits conferred under bilateral tax conventions. In response to concerns about aggressive tax avoidance practices, the tax literature has focused on the measures that states may or have adopted to counter avoidance practices that are perceived to result in an abuse of tax conventions.[1] The abuse of tax treaties has been loosely defined as the use of tax treaties by persons whom the treaties were not designed to benefit, and or to acquire benefits that the treaties were not designed to confer.[2]

To counter treaty abuse, countries have either resorted to doctrinal methods such as a theory of abuse of rights grounded in international law, judicial anti-avoidance principles, and/or domestic legislation such as general or specific anti-avoidance rules, to deny treaty benefits, or have implemented specific anti-avoidance provisions in tax treaties to limit the scope of their application. For example, the "abuse of rights" doctrine, in most civil law jurisdictions, and the "substance over form" or "business purpose" test or principle in common law countries, is applied to re-characterize a taxpayer's legal arrangements for tax purposes, denying the tax relief or benefits sought by a taxpayer, in circumstances where the taxpayer acts with the intention and the result

[1] See Stef van Weeghel, *The Weeghel: With Particular Reference to the Netherlands and the United States* (London; Boston: Kluwer Law International, 1998). [Weeghel]; Nathalie Goyette *Goyette: A Canadian Perspective on an International Issue*, (Toronto: Canadian Tax Foundation, 1999). [Goyette].

[2] The United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters: Fourth Meeting, Geneva, 30 November-11 December 1987, *Prevention of abuse of tax treaties* (New York: United Nations Secretariat, 1987) at 3.

of circumventing the object and spirit of a particular tax rule.[3] Legislative anti-avoidance rules like the general anti-avoidance rule under section 245 of the Canadian *Income Tax Act*, permit revenue authorities to deny tax benefits resulting from transactions that are primarily tax motivated and result directly or indirectly in a misuse of a provision or set of provisions under the *Act* or an abuse of the legislation read as a whole.[4] Tax treaties do not generally include provisions to this effect, expressly stating that treaty benefits shall be denied in cases where the treaty instrument is misused or abused. One of a narrow category of exceptions is Article 12 of the Netherlands-UK Tax Convention, which deals with royalty income.[5] It provides:

> "The provision of this Article shall not apply if the right or property giving rise to the royalties was created or assigned mainly for the purpose of taking advantage of this Article and not fore bona fide commercial reasons."

Anti-treaty abuse provisions generally function to restrict the scope and application of a treaty instrument in circumstances that are considered abusive by the contracting states concerned.[6] An example of such a provision is Article 11 under the Denmark-UK Tax Convention which limits treaty relief in respect of dividend payments issued in one treaty state to a resident of the other treaty jurisdiction in circumstances where the actual

---

[3] See Weeghel, *supra* note 1at 101-3 & 163-190.

[4] *Income Tax Act*, R.S.C. 1985 (5th Supp.) c.1, 31st ed., 2002 s. 245. [*Income Tax Act*]. The relevant provisions under s. 245 of the *Act* are as follows: ss.245 (2)---Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction; ss.245(4)—For greater certainty, subsection (2) does not apply to a transaction where it may reasonable be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

[5] Ned Shelton, *Interpretation and Application of Tax Treaties* (London: Lexis Nexis, 2004) at 419. [Shelton]. Royalty income refers to the income accruing to the owner of an intellectual property right under a license agreement, granting another party the right to use the rights.

[6] The relevant section of the provision provides as follows: The provisions of paragraph 1 of this Article shall not apply, where the beneficial owner of the interest is a company other than a quoted company, unless the company shows that it isn't controlled by a person, or two or more associated or connected persons together, who or any of whom would not have been entitled to relief under paragraph 1 of this Article if he had been the beneficial owner of the interest." *Ibid.* at 419. The concept of a beneficial owner will be discussed in chapter 4 dealing with treaty shopping.

beneficiary of the dividend income is resident in one treaty state.[7] Another example of an anti-treaty abuse provision is a limitation of benefits provision. As an illustration, Article XXIX-A of the Canada-US Tax Convention expressly limits the application of the convention by the United States to natural persons who are resident in Canada and to certain designated entities.[8] As a result, the application of a principle of abuse or anti-abuse measure, whether it constitutes a legislative, judicial or unwritten norm, and whether it is included in a treaty, necessitates a determination of the object and purpose of the relevant tax treaty provision or instrument.

In Canada, the proposed legislative amendment to the general anti-avoidance provision (GAAR) under the *Income Tax Act*, which operates to deny tax benefits in cases where there is a misuse of the provisions of the Act, incorporates a reference to "treaty abuse." In order for the GAAR to apply it is necessary to identify either a misuse of a domestic legislative provision or in the alternative, a misuse of a treaty policy or provision.[9] In light of the content of this proposed provision the issue, it is necessary to determine what in fact constitutes an abuse of a tax treaty and what type of tax avoidance practices can be said to run afoul of the object and purpose or content of a tax treaty convention.

This is a study of the phenomenon of tax treaty abuse, focusing on a particular tax avoidance strategy, known as "treaty shopping." Treaty shopping involves the practice of

[7] *Ibid.*
[8] Convention between Canada and the United States of America with respect to taxes on income and on capital, September 26, 1980, (as amended by the Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995 and July 29, 1997.).
[9] The proposed amendment to subsection 245(4) of the general anti-avoidance provision under the *Income Tax Act* provides as follows: That, for greater certainty, subsection 245(4) of the *Act* has operated from its inception to exclude a transaction from the operation of subsection 245(2) of the *Act* only where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the *Income Tax Act,...*, or a tax treaty, or in an abuse having regard to those provisions, read as a whole. Federal budget, Notice of Ways and Means Motion, March 23, 2004

establishing a minimal presence in a jurisdiction in order to benefit from the jurisdiction's treaty network with other countries, without any real connection between the jurisdiction and the taxpayer or the taxpayer's economic activities.[10] I will evaluate the general and specific principles of treaty abuse that scholars have proposed and the soundness or legitimacy of the arguments that scholars have proposed, branding "treaty shopping" an improper treaty practice.[11] Another purpose of this study is to provide a response to Stef van Weeghel's treatise on improper tax treaty uses, and in particular, a response to Weeghel's approach to the analysis of improper tax treaty uses, and the general conclusions he draws on the subject of treaty abuse. Weeghel judges the legitimacy of tax avoidance strategies with sole reference to the tax treaty policies of the respective contracting states, as reflected under the terms of the treaties employed or by various communiqués or documents released by the relevant state fiscal authorities. Weeghel disregards general propositions or theories regarding the legitimate or illegitimate uses of tax treaties, or general depictions regarding the characteristics of illegitimate tax avoidance practices in determining whether a particular tax planning strategy constitutes an improper use of a tax convention.

This work does not offer a comprehensive study of the improper use of tax conventions or a study of the measures that may be adopted to counter tax treaty abuse. However some reference will be made to domestic and treaty anti-abuse measures where appropriate as a complement to the discussion of treaty shopping.

The Organization on Economic Cooperation and Development (OECD) and the majority of OECD member states regard treaty shopping as an abuse of the tax treaty

[10] See Goyette, *supra* note 1 at 5.
[11] See Weeghel, *supra* note 1 at 121-123.

regime. However, the arguments that have been proposed to explain why treaty shopping is abusive have not been properly defended with reference to the rationale and principles underpinning the bilateral tax treaty regime.

I will argue that treaty shopping violates the economic rationale governing the allocation of taxing rights between states under a bilateral tax treaty. Tax treaties are abused in circumstances where transactions lacking economic substance are structured to trigger the application of a particular treaty instrument or treaty provision. Furthermore, the failure to refer to the principles of the treaty regime in evaluating the legitimacy of tax planning transactions presents the risk of branding as improper tax avoidance practices that are otherwise legitimate or that do not infringe treaty principles or policies.

The first step in coming to terms with a notion of treaty abuse is to understand the principles and rationale underpinning the bilateral tax treaty regime and the logic and justification for the principal tax treaty rules. Chapter 2 will be devoted to discussing the role of tax treaties, as well as the rationale and principles underpinning the bilateral tax treaty regime or model and other relevant principles of international taxation. Chapter 3 will provide an analysis of the general notions of tax treaty abuse that have been proposed in the tax literature. Chapter 4 will provide a summary and critique of the traditional arguments against treaty shopping and my analysis explaining why treaty shopping constitutes an abuse of the bilateral tax convention.

Another commonly perceived misuse of tax conventions that will not be studied in this paper, includes "rule shopping."[12] Rule shopping refers to the strategy employed by taxpayers, who are otherwise properly entitled to the benefits under a treaty, to trigger the application of a more favorable treaty provision or set of provisions than that or those

[12] See Goyette, *supra* note 1 at 5.

which would otherwise apply. It is hoped that further studies on the subject of treaty abuse will consider the legitimacy of rule shopping strategies.

Several references will also be made in this work to the inherent limitations of the bilateral tax treaty system in coordinating the international tax policies of treaty states. It is hoped that this analysis will encourage a more thorough approach to the analysis of tax planning in the treaty context and encourage lawmakers to draw a principled distinction between tax planning practices that result in the exploitation of the tax treaty regime and the legitimate planning activities that arise as a result of the limited scope or the gaps inherent in the bilateral tax treaty system.

It is hoped that this work will also appeal to administrators to develop more effective measures to combat abusive tax practices.

Chapter 2:The structure and principles underpinning the bilateral tax treaty regime

I. Introduction

As a prelude to the study of tax treaty abuse it is necessary to explore the objectives of the tax treaty regime, the treaty principles and the rationale underpinning the framework of treaty rules. Only in this way will is it possible to appreciate how tax avoidance strategies affect the treaty regime, and whether the application of tax treaties in particular cases will give rise to legitimate results, consistent with the logic and the principles of the bilateral tax treaty system. These considerations will in turn afford a thorough understanding of the breadth of the tax treaty regime as well as its practical limitations. Such an analysis will also permit a distinction to be drawn between tax avoidance structures that arise as a result of the gaps inherent in a bilateral treaty system and its limited scope from those practices that result in treaty abuse, or contravene treaty rules and principles.

This chapter explores the general objectives of bilateral tax treaties, the principal treaty rules, and the principles upon which the structure and rules of the treaty regime are based. The chapter will begin with an overview of the historical development of the bilateral tax treaty regime before proceeding with an in-depth analysis of the general aims and the structure of tax treaties. The treaty principles of residence and source are the pillars of the treaty system and dictate the manner in which taxing rights are shared between treaty states to avoid the incidence or minimize the risk of double taxation. This chapter also analyses the rationale underpinning the general framework of treaty rules under the regime and the compromise struck between treaty states governing the exercise of their taxing powers over foreign income and foreign residents. This chapter will also address the policies under the treaty regime concerning international tax avoidance. An appreciation of the general aims and the structural character of the tax treaty regime will permit a more informed analysis of the prevailing notions of tax treaty abuse that will be explored in the next chapter.

II. Background to tax treaties

The latest version of the OECD Model Income Tax Convention,[1] the product of the work of the Fiscal Committee of the Organization of Economic Cooperation and Development (OECD), reflects the basic structure of bilateral tax treaties and serves as the primary tool in their negotiation.[2] The alternative to the OECD Model and one that has been designed to address the interests of developing countries is the United Nations Model Double Taxation Convention between Developed and Developing countries, released in 1980.[3] This chapter focuses on the treaty structure under the OECD model tax convention with only occasional references to the competing UN treaty model. The revisions to the OECD Model convention introduced since 1992 were intended to take account of more complex cross-border transactions, facilitated by technological innovation, more expansive trade relations between states, with fewer non-tax barriers to

---

[1] The most recent revisions to the *OECD Model Tax Convention on Income and Capital* was released in 2002. In this work, references are made to the provisions of the condensed version of the OECD Model Tax Convention, released in January of 2003. The first version of *the OECD Model Convention*, based on a report entitled "Draft Double Taxation Convention on Income and Capital, produced in 1963, was released in 1977. From 1992, with the introduction of a loose-leaf, no new comprehensive revision of the Model has been produced. There are rather, ongoing revisions introduced to the various provisions of the Conventions and additions or updates to the treaty commentaries.

[2] The Supreme Court of Canada in *The Queen v. Crown Forest Industries Ltd.* described the OECD Model Convention as an instrument recognized worldwide as " a basic document of reference in the negotiation, application and interpretation of multi-lateral and bi-lateral tax conventions." See *The Queen* v. *Crown Forest Industries Ltd.*, [1995] 95 DTC (SCC) 5389 at 5396. [Crown Forest].

[3] United Nations, *United Nations Model Double Taxation Convention between Developed and Developing Countries*, 2nd ed. (New York: UN, 2001).

capital movements, and the emergence of more sophisticated forms of tax avoidance and evasion.

A series of model income tax treaties was developed under the auspices of the various committees of the League of Nations following the First World War [4], and subsequently by the Fiscal Committee of the Organization for Economic Cooperation and Development. These conventions were proposed to reduce tax distortions and tax barriers to international investment, an important objective given the growth in trade relations and the increasing economic interdependence between members of the Organization for European Economic Co-operation (OEEC) and later the OECD.[5] The reduction in trade barriers would be accomplished under the tax treaty regime through the elimination or reduction of double taxation (the taxation of the same tax subject in respect of the same item of income, in more than one jurisdiction), and the elimination of discriminatory tax practices as between residents and non-residents of a treaty country. [6]

---

[4] The work commissioned by the League of Nations led to the first draft model convention issued in 1928 and the subsequent Mexico and London drafts issued in 1943 and 1946 respectively. Many of the principles in these latter two documents were later adopted under the *OECD Model Conventions*, first issued in 1963. See also the introduction to the latest condensed version of the treaty, OECD, *The Condensed version of the Model Tax Convention on Income and on Capital* (Paris: OECD, 2003) for a brief historical account of the evolution of the tax treaty regime. [*OECD Model Convention*].

[5] For an in-depth discussion on the relationship between domestic anti-avoidance legislation and tax treaties see Jinyan Li & Daniel Sandler, *Materials on Canadian Income Tax*, 12th ed. (Toronto: Carswell, 2000) at 896. It is noted in the text that the" primary objective of the OECD model is to remove impediments to cross-border trade and investment." See also Stef van Weeghel, *The Weeghel: With Particular Reference to the Netherlands and the United States* (London; Boston: Kluwer Law International, 1998) at 37-42. [Weeghel].

[6] The tax treaty regime addresses juridical double taxation and does not deal with what has been termed "economic double taxation" (the taxation of more than one individual or entity in respect of the same income source.) This is a matter that has been left to be resolved either through bilateral negotiations or through the unilateral adoption by countries of partial or comprehensive tax integration regimes. To combat one form of economic double taxation, states administer either full or partial integration systems, conferring dividend tax credits to resident shareholders, to reflect the taxes or partial taxes paid at the corporate level in the other contracting state. The utility of the tax treaty regime is compromised somewhat when states administer partial integration measures. The treaty system was designed on the premise that states administer the classical system of taxation, where no measures are adopted to alleviate economic double taxation. The withholding taxes imposed on dividend payments do not take account of the tax rates imposed at a corporate level and the extent to which such taxes at the corporate level are integrated with

On a more fundamental level the model tax conventions were designed to harmonize and therefore simplify the tax regime governing the taxation of residents' foreign sourced income as well as the domestic income of non-residents, by promoting the adoption of uniform definitions, principles and rules and through agreement on the interpretation of the individual treaty instruments. Any term not defined under a treaty instrument may be and generally is interpreted in accordance with the laws of the contracting states. Article 3(2) of the *Canada-US Tax Convention* provides that it is the laws of the state whose taxes are in question that may be applied to interpret a term under the convention. The interpretation and application of tax conventions is governed by the *Vienna Convention on the Law of Treaties*, assuming the treaty states are signatories to the convention.[7] In any event, the principles reflected under the *Vienna Convention* are considered part of customary international law, binding on all jurisdictions.[8] The general binding prescription is that tax treaties are to be interpreted in a broad and liberal manner in accordance with their object and purpose, with view to implementing the intention of the contracting states. The OECD model convention serves as an interpretive tool, in accordance with Articles 31 and 32 of the *Vienna Convention*.[9] Nonetheless, there can be

---

taxes levied at the shareholder level. See Peggy B. Musgrave, *Tax policy in the Global Economy,* (Cheltenham, UK; Northampton, MA, USA: Edward Elgar Publishing Ltd., 2002) at 362. [Musgrave].

[7] *Vienna Convention on the Law of Treaties* 23 May 1969, U.N.T.S. vol. 1155 at 331. [*Vienna Convention*] See also Ned Shelton, *Interpretation and Application of Tax Treaties* (London: Lexis Nexis, 2004) at 155-156. [Shelton].

[8] Klaus Vogel, Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD-UN and US Model Conventions for the Avoidance of Double Taxation of Income & Capital with Particular Reference to German Treaty Practice (London; The Hague; Boston: Kluwer Law International, 1997) at 36-40. [Vogel].

[9] Article 31(1) of the *Vienna Convention* provides: A treaty shall be interpreted in good faith in accordance wit the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. Article3(2) provides: "the context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes: a)any agreement relation to the treat which was made between all the parties in connexion wit the conclusion of the treaty; b) any instrument...made by one or more parties...and accepted by the other parties...Article 3(3) provides: "There shall be taken into account, together with the context: a) any subsequent agreement between the

significant differences in the manner in which tax treaties are interpreted and applied by the treaty states. These differences in turn can present a number of tax avoidance opportunities which are explored in subsequent chapters.

While the model tax conventions present a source of recommendations for structuring tax treaty relations between countries, they are not a set of binding international principles.[10] Although the architects of the OECD model treaties had hoped for the multilateral adoption of the tax treaty principles that were proposed, the model conventions were never fully implemented in this form. What did emerge was a more extensive bilateral tax treaty regime, encompassing similar aims but also discrepancies or differences in bilateral treaty practices.[11] The proposed bilateral tax arrangements and the tax treaties that emerged were also intended to reflect, to the extent possible, the economic ties between the tax subjects concerned and the states with the ultimate jurisdiction to levy taxation, a notion that will be explored in this Chapter.

---

parties regarding the interpretation of the treaty or the application of its provisions; b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation; c) any relevant rules of international law applicable in the relations between the parties." Article 32 of the Convention provides: Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting form the application of Article31, or to determine the meaning when the interpretation according to Article 31: a) leaves the meaning ambiguous or obscure; or b) leads to a result which is manifestly absurd or unreasonable. See *Vienna Convention, supra* note 7.

[10] Ronald Durand & Timothy R. Hughes, "Comparing OECD Treaty Policy and Canadian Treaty Policy," in *International Fiscal Association: Special Seminar on Canadian Tax Treaties: Policy and Practice*, May 15-15, 2000 Toronto, Text of Seminar Papers (Toronto: International Fiscal Association, 2000) at 8:3.

[11] Reference will also be made to the provisions of the *Canada-US Income Tax Convention* where necessary to provide an illustration of the content of specific treaty provisions and to highlight the differences between the tax treaty policy of Canada and that of the OECD. In what is considered obiter dicta, the Supreme Court in *Crown Forest* describes the *OECD Model Convention* as founding the basis of the *Canada-US Tax Convention* and as highly persuasive in defining the parameters of the convention. See Crown Forest, supra note 2 at 5398. In *Cudd Pressure Control Inc v. The Queen* the Supreme Court of Canada remarked that as a member of the OECD "Canada is expected to conform to the OECD Convention in negotiating and interpreting its bilateral tax treaties." See *Cudd Pressure Control Inc. v. The Queen*, [1998] 98 DTC 6630 (FCA) at 5396. At the same time it is acknowledged that Canada's treaties do depart from the prescriptions of the OECD model treaty and the related commentaries. *Ibid.* note 11 at 8:6.

III. The basic aims and function of tax treaties

The preamble to most bilateral tax conventions provides that the objective of the tax treaty is to avoid or eliminate double taxation as well as to prevent tax evasion.[12] A few tax conventions also make reference to the aim of combating tax avoidance.[13] Double taxation has always been considered a major barrier to international trade and investment, as well as unfair and contrary to the principle of horizontal equity, requiring the equitable tax treatment of both foreign and domestic income sources. To avoid double taxation, bilateral tax treaties provide a mechanism for assigning taxing rights over income and capital, accruing to residents of one or both contracting states, between the treaty partners in cases where both jurisdictions have a legitimate claim to taxation. The bilateral tax treaty regime, however, is not necessary to deal with this problem. Countries can administer unilateral measures to prevent double taxation, such as foreign tax credits recognizing the taxes paid in foreign jurisdictions, and need not resort to a bilateral tax

---

[12] See the introductory notes to the *Canada-US Income Tax Convention on Income and on Capital* (1980). Convention between Canada and the United States of America with respect to taxes on income and on capital, September 26, 1980, (as amended by the Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995 and July 29, 1997). [*Canada-US Tax Convention*].
Paragraph 7 of the Commentary to Article 1 of the *OECD Model Convention* provides that the purpose of tax conventions, in addition to promoting the exchanges of goods and services and the movement of capital and persons (by eliminating international double taxation), is to prevent tax avoidance and evasion. The basic structure of the *OECD Model Convention* consists of the following: Chapter 1, which depicts the scope of the convention; Chapter 2, which provides a set of definitions; Chapter 3, 5 setting out the extent to which each treaty state may tax capital and the various income categories {as defined in Chapter 2}, in order to relieve or prevent juridical double taxation; Chapter 4 which define the notion of a treaty resident; Chapter 6 which contains special provisions, including the non-discrimination clause, the mutual agreement procedure for the resolution of disputes arising under the treaty and a clause governing the exchange of information between the treaty states; which will be discussed in this Chapter; and Chapter 7 which provides the clauses governing the terms for the entry into force and the termination of a treaty instrument. See Vogel, *supra* note 8 at 4.
Article I of the *Canada-US Tax Convention* provides: "This convention is generally applicable to persons who are residents of one or both of the Contracting States." The term "resident" is defined under Article IV of the Convention, which provides that: the term" resident of a Contracting State" means any person, that, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, citizenship, placed of management, place of incorporation or any other criterion of a similar nature. A criterion of a similar nature excludes persons who are liable to tax as a result of income generated in a treaty state. See also Crown Forest, *supra* note 2.
[13] See the introductory commentary to the *OECD Model Tax Convention on Income and on Capital* (Condensed Version, 28 January, 2003) at 14-20. [*OECD Model Convention*].

treaty system.[14] Academics have applied game theory to analyze the tax policies that countries would administer in the absence of a tax treaty regime, concluding that states would unilaterally adopt optimal policies for avoiding double taxation.[15]

As a complement to domestically administered double tax relief policies, tax treaties introduce a measure of uniformity in the tax treatment of income generated in one jurisdiction by residents in another treaty state, and establish a set of rules that lead to predictable results and are simple to apply.[16] It is through the assignment of taxing rights that the tax treaty regime coordinates the interaction of domestic tax regimes to avoid the overlap between divergent or conflicting domestic tax rules.

i. Double taxation and the principles of residence and source

The principal treaty framework for the allocation of taxing rights addresses the most common cause of double taxation: the concurrent application of residence and source based taxation. All countries tax income from economic activities occurring in their jurisdiction. The vast majority of countries impose taxation on their residents' worldwide income.[17] By contrast, a minority of states administer a territorial system of taxation, and impose taxation only in respect of a resident's income sources situated in

---

[14] In addition to foreign tax credits, other unilateral state measures for relieving double taxation include deductions from income, reflecting the foreign taxes paid on income sources in other jurisdictions, and exemptions, sparing the income taxed abroad from further taxation under the domestic tax regime.
[15] See Dagan Tsilly, " The Tax Treaties Myth," (2002) 32 N.Y.U.J. & Pol. 939.
[16] *Ibid.*
[17] Canada, Germany, the United States, Japan and the Netherlands (among other nations) tax their residents on their worldwide income. This principle of global income taxation is applied with "varying degrees of comprehensiveness with respect to foreign source income, " with some states excluding certain foreign income sources from the tax base. France, Italy and Brazil only tax the income generated within their borders, which results in the exemption of foreign income sources. See Peggy B. Musgrave "International tax differentials for multinational corporations: equity and efficiency considerations," in S.S. Shoup, *The Impact of Multinational corporations on Development and on International Regulations, Technical Papers: Taxation, Department of Economic and Social Affairs* (New York: United Nations, 1974) at 43-57. See also Musgrave, *supra* note 6 at 104.

the jurisdiction.[18] If all countries administered a territorial basis of taxation, the potential for double taxation would not present a grave concern.[19] Under a worldwide system of taxation, the income generated in a foreign jurisdiction by the resident of one state, is subject to tax in the state of residence as well as in the jurisdiction where the economic activities are carried out, i.e. the country of source. In response, tax treaties either confer exclusive or concurrent taxing rights to the contracting states. If the taxing rights are shared between the two jurisdictions, the treaty mechanism compels the residence jurisdiction, as the state with residual taxing powers, to account for the taxes levied in the source state, by conferring either a credit or an exemption.[20] The tax treaty regime permits states to adopt either a credit or an exemption regime. Each country has plenary jurisdiction under the treaty regime to design and implement its own tax relief mechanism.[21]

Tax treaties recognize the different income categories that are adopted under domestic tax law, and allocate taxing rights based on the character of the income source. The residence state normally enjoys more extensive taxing rights in respect of income generated from movable and intangible property, as well in respect of passive or portfolio investment income. The source state is assigned primary taxing rights over the business

---

[18] Musgrave, *ibid.*

[19] Double taxation could still arise as a result of differences in the tax rules administered by states for determining the source of income. The same income item may be sourced and taxed by more than one jurisdiction.

[20] Articles 23A & 23B of the *OECD Model Convention* describe the exemption and the credit mechanism, respectively, for the elimination of double taxation. See *OECD Model Convention, supra* note 13.

[21] Article XXIV of the *Canada-US Tax Convention*, a very lengthy and detailed provision, deals with the policies for the elimination of double taxation applied by each country with respect to each category of income. Each country must confer a credit on "income tax paid or accrued "to the other contracting state, on profits, income or gains arising in the other contracting state. The credit cannot exceed the taxes that would otherwise have been paid in the first mentioned state. See *Canada-US Tax Convention, supra* note 12.

income generated by a non-resident, if a certain threshold is met and primary taxing rights over the income from and the capital from the sale of immovable property.[22]

Tax treaties authorize the source or host jurisdiction to tax business income only to the extent of the income attributable to the activities of a permanent establishment in that state. The concept of a permanent establishment denotes an affiliate or a branch of the non-resident parent corporation with a commercial presence in the foreign market. The definition of the concept, which differs from one treaty instrument to another, generally excludes subsidiary income generating activities which are not directly or principally connected with the commercial activities of the parent corporation.[23] As s result, source-based taxation of a foreign entity or investor is only intended to arise under the treaty regime if there are strong economic ties between the entity and the source jurisdiction. The residence country in turn exercises residual taxation rights but must administer tax relief to avoid double taxation. If the foreign entity or taxpayer does not operate a permanent establishment in the source state, the residence jurisdiction is assigned exclusive taxing rights over the foreign business income.[24]

The permanent establishment concept was intended to achieve uniformity in the bilateral allocation of taxing rights.[25] Outside the tax treaty regime, states apply different

---

[22] The commentary to the definition of the permanent establishment concept under Article 5 of the *OECD Model Convention*, excludes services that are "ancillary" or "antecedent to the actual realization of profits by the parent corporation, including services which are of "an intermittent or casual nature." See *OECD Model Convention, supra* note 13.

[23] See commentary to Article 12 of the *OECD Model Convention*, and the taxation of business income. The provision provides that activities which are ancillary or intermittent nature are not included. *Ibid.*

[24] By contrast, the subsidiary of a parent corporation, an entity incorporated in the source state, in states where residency is determined by the place of incorporation, is taxed in the same manner as a domestic entity. The incorporated entity will be taxed. The country of residence can only tax income that is remitted to shareholder in the form of dividends. In other states, corporate residency is determined based on an entity's centre of management and control, irrespective of its place of incorporation. See Peggy B. Musgrave, International Tax Differentials for Multinational Corporations: Equity and Efficiency Considerations, " in Musgrave, *supra* note 6 at 105.

[25] See Vogel, *supra* note 8 at 280-1, 282-285.

standards for source taxation and generally tax non-residents on the basis of a less demanding criterion. The minimum requirement in some states is the generation of income within that state by the non-resident, within the meaning attributed under domestic law. In Canada, non-resident persons are taxable under domestic legislation if they carry on a business in Canada, denoting a lower tax threshold.[26] Double taxation of income would arise to the extent that countries source and tax the same income by administering different source rules of taxation. The treaty regime, nonetheless, does not achieve full harmonization, in so far as treaty states apply different definitions of the permanent establishment concept. Due to these prevailing discrepancies, some double taxation can still arise under two or more treaty instruments.[27]

ii. Withholding tax rate limits: reducing source taxation under the treaty regime

Tax treaties also impose reciprocal limitations on the withholding tax rates levied by the source country on payments of passive income sources to a non-resident, in the form of royalties, interest or dividends. It has been quite difficult to reach agreement on a mechanism for the assignment of rights over these categories of income. The bilateral allocation of taxing rights in these cases, has been described as a "balanced arrangement based on reciprocal concessions" between treaty countries.[28] As a result, the limitations application on domestic withholding tax rate regimes varies from one treaty to another, with some treaties implementing different rates depending on the category of income concerned. The OECD model tax treaty does not envision a withholding tax on royalties,

---

[26] See, Li & Sandler, *supra* note 5 at 890-6.
[27] See Brian J. Arnold "Threshold Requirements for Taxing Business Profits," in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties*, (Toronto: Canadian Tax Foundation, 2003) 55.
[28] See Weeghel, *supra* note 5 at 32.

allocating taxation to the country of residence Other states, including Canada, impose uniform rate caps in respect of royalties and interest, supported in part by an objective to limit certain tax avoidance practices, aimed at exploiting the boundaries of the various income categories. Although each treaty can set different withholding tax policies, the withholding tax rates have nonetheless converged to relatively uniform levels over the course of the last twenty years.

iii. The principles of non-discrimination and reciprocity

Another function of tax treaties is to prevent discriminatory tax practices. The principle of non-discrimination governing bilateral treaty relations prevents the imposition of a larger or smaller tax burden on income attributable to a non-resident. The principle of reciprocity ensures that the treaty-based withholding tax measures are applied equally by both treaty partners. [29]

The UN model treaty guidelines propose that the principle of reciprocity be applied to both corporate and withholding taxes. Peggy Musgrave presents the complementary proposal that the principle of non-discrimination also be applied to all major taxes to ensure an equitable distribution of the tax burden between foreign and

[29] Peggy Musgrave is of the view that the non-discrimination principle should be applied broadly and not simply prescribe that foreign investors be taxed at the same rates or in the same manner as domestic investors, but that taxes be applied in a non-arbitrary and predictable fashion. See Peggy B. Musgrave, "Taxation and American investment abroad: the interests of workers and investors," in Musgrave, *supra* note 6 at 108. In a separate article Peggy Musgrave argues that treaty states should address the tax treatment of foreign investments on a "tax by tax basis" taking account of both home and foreign country taxes as well as withholding taxes. Such a policy is concerned with the effective tax rate applied on foreign investors and not just with equalizing tax rates on limited categories of income. See Peggy B. Musgrave, "The OECD Model Tax Treaty: Problems and Prospects, " in Musgrave, *supra* note 6 at 363-4. The objective here is two fold, on one hand the desire to address issues of inter-state equity, to achieve a more equitable distribution of the international tax base between capital importing and capital exporting countries, and primarily between developed and developing countries, and secondly to ensure the foreign investors are taxed fairly with regard to all income sources generated in the source state. These proposals for reform of the tax treaty regime are based on premise that the aims of the treaty regime should be expanded to include inter-state tax equity issues.

domestic taxable interests. Under Canada's tax treaties, the principle of non-discrimination applies to all forms of taxation that may be imposed on non-residents.[30]

iv. Policies against tax evasion and tax avoidance

With regard to combating tax evasion and tax avoidance, tax treaties have traditionally played a secondary role to the aim of eliminating tax barriers to trade and simplifying the international tax regime. The draft model conventions address the problem of tax evasion and or tax avoidance by promoting a framework for the mutual exchange of information and the mutual enforcement and collection of taxes. Treaty partners are obligated to monitor and impart information regarding the economic affairs of the residents of the other treaty country, and in the rarer cases, enforce the tax obligations of a treaty subject in the other treaty jurisdiction. The Canada US Income Tax Convention adopts both policies. These bilateral arrangements allow each country to better administer its own tax laws and measures and policies for combating harmful tax practices.

Specific anti-avoidance or anti-abuse measures, which will be considered in subsequent chapters, were gradually adopted under tax treaties to deal with the emergence of more sophisticated forms of tax avoidance. This development was due in part to the reduction of non-tax and tax barriers to international trade and investment which permitted corporations or unincorporated entities to expand their operations in many jurisdictions, taking advantage of more preferential tax regimes. In addition, increased opportunities for tax avoidance have arisen since the publication of the first OECD model convention in 1963, with the advent of more complex business

[30] See Article XXV under the *Canada-US Tax Convention*. See *Canada-US Tax Convention, supra* note 12.

organizations and cross-border transactions that are classified or characterized and or taxed differently in different countries. The increasing use of anti-tax avoidance measures, in the absence of specific guidelines from the OECD, has in turn compromised the uniformity of bilateral tax treaties, contributing to a growing divergence in treaty practices.[31]

Despite the lack of uniformity in treaty practices, the treaty rules and principles governing the allocation and exercise of taxing rights has greatly simplified international taxation, and has introduced some measure of clarity and certainty with respect to the tax treatment accorded to residents of one treaty jurisdiction, in another treaty state. At the same time, tax treaties play a significant role in circumscribing the scope of each jurisdiction's taxing powers, and function to limit the tax burden levied in the host state, reducing the source jurisdiction's share of the international income base. As a result, the bilateral treaty model functions primarily to reduce the administrative and compliance burden faced by tax subjects with residency or economic ties in more than one treaty country. The treaty regime also has a limited scope and cannot address all the tax related complications that arise when the laws of two jurisdictions overlap or converge. The implications of the treaty regime's bilateral scope and the absence of a multilateral system for the allocation of taxing rights are important in evaluating the prevailing notions of tax treaty abuse and the legitimacy of the tax avoidance practices that will be explored in chapter 4.

[31] See Weeghel, *supra* note 5 at 22. The next chapters will briefly discuss tax avoidance practices designed to interfere with a state's information gathering policies in cooperation with other treaty countries.

v. A complementary note on double taxation

Tax treaties also address the problem of double taxation in the rarer cases where a tax subject is a resident under the laws of both contracting states, and would as such be subject to taxation on worldwide income in both jurisdictions. Tax treaties deem a dual resident entity or taxpayer resident in a single treaty state for purposes of administering the treaty instrument, under prescriptions similar in content to Article 4 of the draft model convention.[32] The taxpayer will be taxed as a resident in one of the contracting states, in accordance with the allocation of taxing rights under the bilateral tax treaty. Individuals are deemed resident in the jurisdiction where their vital economic interests are centered, while corporations are deemed resident in the state where the central management and control is carried out. Tie breaker rules determine residency in accordance with the strength of the economic affiliations of the tax subjects concerned, such that a treaty subject will not attract the plenary taxing powers of both states, incurring a double tax burden.

Overlapping source rules can also give rise to double taxation. Different states may allocate or attribute different income levels in respect of foreign operations. Tax treaties are designed to prevent double taxation in such cases by prescribing that the residence jurisdiction shall provide a credit or exemption in respect of the income sources in a foreign jurisdiction, in accordance with the laws of the source state. Due to the variety in the wording of treaty provisions, and the different manner in which states will interpret

---

[32] Article 4 of the *OECD Model Convention* provides: For this purposes of this Convention, the term "residents of a Contracting State" means any person who, under the laws of the State, is liable to tax therein by reason of,..., residence, place of management or any other criterion of a similar nature.... This term, however, does not include any person who is liable to tax in that State, in respect only of income from sources in that State and capital situated therein. See *OECD Model Convention, supra* note 13.

the obligations under a tax convention, domestic tax authorities may conclude that the state is not bound to accept the income attribution method employed in the source state. As a result, the potential for double taxation in such cases may still arise despite the application of a bilateral tax treaty.

Double taxation may also occur where the income generated in one treaty state, by a resident of another treaty state, is attributable to the operations of a permanent establishment situated in a third jurisdiction; this is typically the case with royalty income attributable to a permanent establishment, but generated under a license agreement administered in another jurisdiction.[33] Article 21 of the OECD model tax convention addresses these cases, ensuring that miscellaneous income sources, not otherwise dealt with under other provisions of the Convention, including income arising in a third or fourth state, are attributed to the treaty state of the permanent establishment.[34]

These are some examples of the shortcomings of a bilateral treaty regime and the absence of a multilateral approach to govern the allocation of taxing rights between states. The tax treaty regime, as a system governing the bilateral allocation of taxing rights, cannot eliminate the potential tax distortions, or the opportunities for tax avoidance, created by the overlapping tax rules of three or more jurisdictions. Tax planning structures of multinational corporations, with a significant presence in two or

[33] This example is reproduced from Stef van Weeghel's text . See Weeghel, *supra* note 5 at 13.

[34] Article 21 of the *OECD Model Convention* provides: (1) Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shale be taxable only in that State. (2) The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income paid is effectively connected with such permanent establishment. In such a case the provisions of Article 7 shall apply." See *OECD Model Convention, supra* note 13. A similar specification is included under Article 7 of the *Canada-US Tax Convention*, which prescribes the general rules for the taxation of business income attributable to a permanent establishment. See *Canada-US Tax Convention, supra* note 12.

more jurisdictions, are designed to exploit the interaction of domestic tax laws, as well as the inherent gaps in the treaty regime, to secure a very low tax burden or no taxation. Examples of this kind will be explored in subsequent chapters.

IV. The economic rationale for the allocation of taxing rights under bilateral tax treaties

Based on this explanation of the general structure of tax treaties and their historical development, it is possible to address in considerable detail how the substance of the treaty rules was developed and the rationale that was adopted as the basis for the general framework of treaty rules. Two fundamental questions that had to be resolved by the architects of the treaty regime concerned the determination of when and on what basis a country should cede taxing jurisdiction to another country in respect of the income generated from cross-border transactions. The architects of the model tax conventions, the various committees under the League of Nations, and the various economic studies that were commissioned were focused on identifying or developing a set of principles to govern the allocation of taxing rights between states. The Financial Committee or the fiscal arm of the League of Nations commissioned four economists in the 1920's to study the consequences of double taxation and the international principles governing the exercise of taxing powers. [35] The product of the study, a report issued in 1923, proposed that the international allocation of tax rights or the tax base should be based or should reflect the economic allegiance[36] or the strength of the economic ties of the tax subjects to the state exercising taxing powers. The other issue addressed in the report concerned

[35] The report is entitled " *Report on Double Taxation*, authored by Professors Bruins, L. Einaudi, E.R.A. Seligman and J. Stamp prepared for the Economic and Financial Committee of the League of Nations (Geneva, 1923).

[36] Economic allegiance denotes the bundle of factors that have contributed a role in the creation of and the right to the enjoyment of income or wealth. *Ibid.*

the measures of fiscal nexus that should be adopted to coordinate bilateral or multilateral state relations in matters of taxation.

The concept of economic allegiance turned on the 1) the geographical or economic location of the income producing activities (source); 2) the jurisdiction where the wealth or income originating from the economic activity is situated (situs)[37]; 3) the source of the property or ownership rights and the enforcement powers exercised over the wealth produced; and finally, 4) the domicile/residence of the property rights holder or the income generating entity (or the location where "the wealth is (ultimately) consumed or otherwise disposed of."[38] It was proposed that, based on the concept of economic allegiance, taxing rights to income and wealth would have to be partitioned between the various jurisdictions in accordance with these four factors. Different types of taxes would also be administered depending on what factor of economic allegiance was applied to distribute the income.[39] The report acknowledged, however that such a model would not be feasible in practice, recommending instead that the allocation of taxing rights be based on the principles of residence and source. The concepts of residence and source were accepted as the strongest determinants of economic nexus.[40] It was also concluded that the country or residence had a stronger claim to the income tax base of its residents than the country of source, but that the source jurisdiction should exercise a first claim to taxation over business profits.[41]

---

[37] Richard A. Musgrave & Peggy B. Musgrave, "Inter-nation equity" in Musgrave, *supra* note 6 at 159, 161.
[38] See Weeghel, *supra* note 5 at 28.
[39] See Musgrave, *supra* note 37 at 161.
[40] *Ibid.*
[41] *Ibid.*

The report also recommended how the various categories of income should be allocated between the country of residence of the investor or taxable entity and the country of source.[42] The income sources from immovable property would be taxed in the jurisdiction where the property was situated, while the various categories of income from movable and intangible property would be taxed by the country of residence.[43] The various income classifications, denoting a dominant feature of domestic tax regimes, were accepted principally for pragmatic rather than economic reasons: to implement an administrable regime that countries would find mutually advantageous.[44] This practical model for allocating taxing rights could not take full account of economic allegiance, but would allow for an expedient and relatively easy solution to the problem of coordinating taxing jurisdictions. As a result, pragmatic considerations, and the objectives of organizing and simplifying the international tax regime were balanced against the economic rationale that was intended to govern the allocation of taxing rights. For this reason Peggy Musgrave has remarked that the residency and source rule are "essentially legal concepts," lacking "a clear economic content."[45]

Residence and source-based taxation under the tax treaty regime does have a strong economic rationale under the benefit principle of taxation, even though the provision of

---

[42] Sol Piciotto, *International business taxation: A study in the internationalization of business regulation* (London: Weindenfeld & Nicholson, 1992) at 19-58. [Piciotto].
[43] *Ibid.*
[44] The Committee of Technical Experts acknowledged that the income characterization policies were based on "purely pragmatic purposes and that no inference in regard to economic theory or doctrine should be drawn from this fact." See Niv Tadmore, "Further discussions on income characterization, "(2004) 52 Can.Tax.J.124 at 132. [Tadmore, "Further discussions on income characterization " This quote is reproduced from a report issued by the Technical Experts committee set up by the League of Nations. See *League of Nations, Double Taxation and Tax Evasion: Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations* document no. F.212 (Geneva: League of Nations, February 7, 1925) at 15; United States, Joint Committee on Internal Revenue, Legislative History of United States & Joint Committee on Internal Revenue, *Legislative history of the United States Tax Conventions*, vol. 4 (Washington, DC: US Government Printing Office, 1962) at 4057-4105.
[45] See Musgrave, *supra* note 37 at 168.

benefits cannot be measured precisely and a pure benefit system of taxation cannot be administered.[46] The source state is justified to levy taxation for the regulatory, communications and transportation infrastructure it provides along with other private or public services that create the essential conditions for conducting business. [47] The residence jurisdiction, on the other hand, has a potentially deeper rationale for exercising taxation powers, due to the privileges afforded to resident subjects as a result of their membership in the relevant political community, regardless of the nature and situs of their foreign activities. Other benefits supplied by the residence jurisdiction may include public and private capital resources applied towards the development of a resident person or entity's income generating capabilities, including the benefits that residency status confers on tax subjects with business operations in foreign markets, and particularly with regard to the consular services and the like available to subjects situated abroad.[48]

Nonetheless, it is true that a static method for the allocation of taxing rights between the countries of residence and source, based as it is on predetermined criteria, cannot properly account for the economic affiliations of particular tax subjects in all cases. The hallmark of any system based on the application of a preordained set of rules, bypassing the need to tailor solutions as dictated by the particular and potentially unique facts under by a case by case approach, is the potential for arbitrary results. This is particularly the case with regard to the allocation of taxing rights over intellectual

---

[46] The relevance of the concepts of residence and source, (due to their limited measure of economic allegiance) have been especially challenged in the e-commerce context. See Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003) at 47. [Li].

[47] Benefits in the form of the provision of capital resources or production inputs for operations are measured by value added taxes. Corporate taxes are not consistent with a benefit system of taxation and are not a good proxy for benefits conferred to a tax subject. Li & Sandler, *supra* note 5 at 23.

[48] Michael J. Graetz, *Foundations of International Income Taxation* (New York: Thomson West, 2003) at 20-1 [Graetz].

property income in the rapidly changing business climate of the 21st Century. The advent of electronic commerce challenges traditional notions of how economic links to a particular jurisdiction are forged and how they may be identified.[49] Regardless of the shortcomings of the treaty based principles of taxation, there is an undisputable economic rationale underlying the treaty rules governing the allocation of taxing rights.

On the basis of the notions presented in the first economic report of the League of Nations, and reaffirmed in subsequent studies sponsored by the League, [50] the model treaty rules were designed to confer greater taxing rights to the residence jurisdiction. The only refinements that were later adopted were the permanent establishment concept, conferring primary but limited taxing powers to the source country' [51] and the withholding tax rate regime which granted a share to the source state over other income sources allocated to non-residents.[52] The work of the League of Nations led to the first comprehensive model conventions, the Mexico and London drafts, in 1943 and 1946 respectively, which served as the basis for the work of the Fiscal Committee and the first OECD model income tax treaty issued in 1963.

---

[49] Authors have challenged the relevance of the traditional principle of a permanent establishment in the new economy as reflected by outdated criteria for establishing source-based taxation under most tax treaties. See Reuven S. Avi Yonah, "International Taxation of Electronic Commerce," (1997) 52 Tax L.Rev. 507. [Avi Yonah, "International Taxation of Electronic Commerce"].

[50] The second study was produced by the Committee of Technical Experts, also established by the fiscal arm of the League of Nations. The study recommended measures to achieve a more equitable assignment of taxing rights with the similar aim of preventing double taxation and tax evasion. It confirmed the findings in the earlier economic report but recommended more extensive taxation at source. Concerns were raised about granting too many taxing rights in favor of the residence jurisdiction and the negative impact this would have on countries who were capital importers of capital, and who would consequently generate a lower share of the international tax base. See Piciotto, *supra* note 42 at 18.

[51] The permanent establishment principle was introduced in a report issued in 1929. See Musgrave, *supra* note 37 at 161.

[52] The withholding tax rate regime was adopted under the first *OECD Model Convention* of 1963. See Piciotto, *supra* note 42 at 23.

Challenging the rationale for differences in withholding tax treaty policies

Interest, dividends and royalties are taxed on a gross basis, in accordance with the withholding tax rate cap limits prescribed under tax treaties. Royalties[53] and other income sources that are attributable to the activities of a permanent establishment are taxed on a net basis in accordance with Articles 7 and 12 of the *OECD Model Convention.*[54] The *OECD Model Convention* recommends a zero withholding rate policy in respect of royalties, with different rate standards applicable for interest and dividends. Nonetheless, OECD member countries have departed from such an approach. The rationale for the OECD policy rests on the premise that royalties do not reflect a sufficient economic connection to the source state to trigger source taxation; a conclusion that is highly disputed, particularly in the electronic commerce context.[55] As a departure from these recommendations, treaty states do administer the highest withholding tax rates on royalty and interest income. Proponents of this approach argue that the taxation of royalties and other income sources derived from intellectual property is justified under the benefit and entitlement theories of taxation. [56]

[53] The term royalties is used here as an umbrella term to refer to the fees rendered for the use of intellectual property by a licensee, including patents, copyrights (in respect of software etc.) and trademarks. The distinction between the provisions of services versus the sale of intellectual property will be considered when analyzing tax planning structures in subsequent chapters. See Tadmore, "Further Discussions on Income Characterizations," *supra* note 44.
[54] See paragraphs 1 & 3 of the commentary to Article 12 of the 2003 updated version of the *OECD Model Convention. OECD Model Convention, supra* note 4.
[55] See Reuven S. Avi-Yonah "International Taxation of Electronic Commerce" (1997) 52 Tax L. Rev. 507. As an example, from a commercial perspective, there is little that distinguishes the sale of software over the internet, which results in regular business income and the use of online databases that charge a fee, which gives rise to royalty income. If both businesses are branches of a foreign parent, the first operation will be subject to withholding taxes on any fees issued to the parent, while the second operation, which generates royalty income, will not, in the absence, that is, of a permanent establishment in the jurisdiction.
[56] See Tadmore, "Further Discussions on Income Characterization," *supra* note 44 at 135-6. "Intellectual property derives its value form the right of the owner to exclude others from their use and as such the benefits of their use." The non-resident holder or beneficiary of the intellectual property rights (the recipient of the royalty income), benefits from the source jurisdiction's legal regime which functions to exclude others from use of the rights in question. The enforcement of license agreements which govern the

The prevailing view among many academics and tax policy analysts, particularly in the e-commerce context, is that there is no rationale for drawing a distinction between and imposing different tax treatment in respect of different categories of income.[57] The treaty regime in its own right does not provide guidance or criteria to distinguish between regular business income, and royalty income (or other income derived from the application of intellectual property rights).[58] As another example, it is unclear what distinguishes income from the provision of professional consulting services in a treaty state, and the income that is derived from conferring specialized knowledge protected by an intellectual property right, which includes the application of the knowledge or know-how. The first income category is not taxed in the source state unless the income is attributable the operations of a permanent establishment in that state. The second income item is subject to withholding taxes under most tax treaties. The income sources do not display any compelling dissimilarities to warrant a different treatment under the treaty regime. One author has remarked that the only distinction that continues to make sense for treaty purposes, resulting in the application of different tax policies, is that between portfolio (investment) and active business income.[59] Dividends arising from portfolio investments, income which has greater potential to escape taxation in both the residence and source states, is generally subject to a more rigorous treaty policy, than dividends

---

use by non-owners and the benefits that may be derived from intellectual property rights by the non-owner, likewise, depends on the laws of the source state.

[57] Nid Tadmore argues that e-commerce renders royalties more similar to business profits than is the case in more traditional industries, justifying the same tax treatment and tax allocation rules for both. Jinyan Li recommends that in general the different income categories should be eliminated, but that a distinction between active business income and royalties should be maintained. No real rationale is suggested for the distinction; the implication is that the differentiation is acceptable for practical and administrative feasibility purposes. *Ibid.*

[58] See *Issues in International Taxation: 2002 Reports Related to the OECD Model Tax Convention No. 8* (Paris: Organization for Economic Co-operation and Development (OECD), 2003).

[59] Tadmore, "Further Discussions on Income Characterizations, *supra* note 44 at 132.

from active business income, which, due to the nature of the operations concerned and the nature of the economic ties exhibited in the source state, does not present the same challenges.[60]

The various calls for treaty reform reflect the general consensus or recognition that the allocation of tax rights under the bilateral treaty regime has always been based on the theory of economic allegiance, and that there is a shared belief that the treaty system may no longer be capable of striking a reasonable balance between the competing economic interests of the treaty countries. The proposals for reform are also consistent with the notion of economic allegiance in the first economic report issued by the Fiscal Committee of the League of Nations. The economic report had recognized that "the creation of value can be based upon demand"[61] and that the jurisdiction that provides the consumer base or a market for the consumption of a good or service should be entitled to a portion of the income tax base. In the electronic commerce context the presence of a consumer market is promoted as a basis to trigger source taxation in the absence of a permanent establishment as it has traditionally been defined.[62] The deficiencies or limitations of traditional tax treaty rules in the new global context, provides many opportunities for tax avoidance. Some of the tax planning examples to follow will denote the shortcomings and limitations of the tax treaty regime considered in this chapter. As noted earlier and acknowledged in a previous study on treaty abuse, before the issue of

---

[60] Due to the mobility of capital, taxpayers can shield portfolio income from taxation in the source or residence states, by shifting income streams from high to low tax jurisdictions, through the use of various flow through entities. A sensible tax policy for countries to protect their revenue base is to levy taxation at source. See Graetz, *supra* note 48 at 124-127. States administer low withholding taxes on dividends generated from active business income as a measure to lower the risk or impact of economic double taxation, and to encourage foreign capital investments. A dividend rate cap of 15% applies to portfolio dividends as opposed to 10% in all other cases, as reflected in Article 10 of the *OECD Model Convention.*
[61] See Tadmore, "Further Discussions on Income Characterization," *supra* note 44 at 134.
[62] See Li, *supra* note 46 at 24-50.

the improper use of tax treaties can be addressed, it is necessary to understand the gaps and inherent flaws of the tax treaty regime, how treaties are applied, and the circumstances where their application will lead to inappropriate results or results that are inconsistent with the objectives and rationale of the regime.[63]

V. Other principles governing treaty relations: the single tax principle

Some academics accept that the corollary of the principle against double taxation is that income must be taxed at least once pursuant to the bilateral allocation of taxing powers under the tax treaty regime.[64] This is what has been termed the "single tax principle." Stated differently, some academics accept that the objective of eliminating double taxation also reflects the understanding or expectation that income falling within the taxing powers of one or both treaty countries will be taxed once.[65] Ideally, the first economic report issued by the Fiscal Committee of the League of Nations proposed that the coordination of domestic taxing powers should indeed ensure that tax subjects are taxed in accordance with their relative economic interests in each jurisdiction, and that they will accordingly be taxed at least once.[66] If we accept this principle, then any tax planning strategy that is designed to escape taxation in both treaty countries through the application of a treaty instrument would constitute an improper use of a tax treaty.

Nonetheless, whatever the motivation or expectations of the contracting states may have been in entering into treaty relations, the structure of the tax treaty regime does not implement or promote such a principle of single taxation.

---

[63] See Weeghel, *supra* note 5 at 37.
[64] See Reuven S. Avi Yonah, "Commentary" (2000) 53 Tax L.Rev. 167.
[65] See Li, *supra* note 46.
[66] The reference is taken from an OECD Report on Double Taxation. See Weeghel. *supra* note 5 at 28.

The tax treaty regime clearly leaves open the possibility that income may not ultimately be taxed in either state. The division of the revenue from cross-border transactions requires that double tax claims be resolved in favor of the country of source or the residence state, but does not require taxation in one country or the other. The tax treaty regime is merely a mechanism for allocating taxing rights between the treaty states and does not purport to control the exercise of domestic taxing rights, apart from the obligation not to impose discriminatory tax treatment on non-residents and the obligation to abide by the withholding tax rate limits imposed under the applicable tax treaty instruments. When a treaty country has the jurisdiction to levy taxation under a tax treaty, it will administer tax liability in conformity with its own domestic tax rules and policies. Tax treaties do not impose taxes, nor do they impose an obligation on treaty states to levy taxes.

As a general rule, countries confer tax exemptions if the foreign source income is subject to comparable rates of taxation in the source country (comparable to those administered domestically). Regardless of this general policy, states that have adopted an exemption tax regime have also accepted the risk that the income entitled to a tax exemption may not be taxed in the source state.[67]

---

[67] The commentary to Articles 23a and 23b of the *OECD Model Convention* acknowledges that the application of a tax exemption regime can lead to instances where the income generated by a resident of a treaty state in another treaty country will not be taxed in either state. To avoid double non taxation the commentary to the *OECD Model Convention* encourages countries to adopt specific provisions in their tax treaties. It is a matter of discretion for each state under their tax laws to determine the circumstances when a tax exemption will be granted. See *OECD Model Convention, supra* note 13. See also Vogel, *supra* note 8 at 13-17

If treaty countries deliberately exempt income that is not taxed in the other jurisdiction, or offer a tax holiday to foreign interests that are exempt from tax in the residence state, they would not stand in violation of any treaty principle or rule.
The bilateral tax treaty regime preserves state sovereignty with regard to the design of their tax regimes and the levying of taxation.

Chapter 4 will evaluate the legitimacy of a number of tax planning strategies using tax treaties, and consider whether the tax treaties concerned are applied in a manner that is consistent with the assumptions and principles underpinning the bilateral tax treaty regime. The category of tax avoidance strategies that constitute an abuse of tax treaties may also be distinguished from tax avoidance opportunities that arise as a result of the inherent gaps in the treaty regime and the lack of coordination between the overlapping tax laws of two or more countries. This latter challenge is beyond the scope of this paper. Nonetheless, it is hoped that in light of the treaty principles and limitations of the tax treaty regime discussed in this chapter, this task will be attempted in further studies on tax treaty abuse.

Chapter 3: The improper use of tax treaties: general principles

I. Introduction

There is a consensus among countries as to existence of the phenomenon of tax treaty abuse.[1] The Commentary to Article 1 of the OECD Model Convention provides that states are not required to provide the benefits under a tax treaty if the arrangements entered into by the treaty subject concerned constitute an abuse of the provisions of the treaty.[2] The basic precept is that the use or application of a tax treaty that is contrary to the intentions of the treaty partners constitutes a misuse of the treaty instrument.[3] Nonetheless, states may disagree with regard to the specific cases that result in an improper application or abuse of a tax convention.[4] Domestic authorities have adopted different conclusions in particular tax avoidance cases regarding the legitimacy of taxpayers' conduct or legal arrangements and divergent views on the issue whether taxpayers have engaged in abusive tax practices.[5]

Academics have attempted to identify in abstract terms certain general principles that may be relied upon to construct or deduce a notion of treaty abuse, focusing on the nature and purpose of tax treaties, the status of the treaty regime in the international legal order and the expectations of the treaty states.[6] Any study that purports to evaluate the legitimacy of tax planning strategies and articulate a principle of tax treaty abuse must

---

[1] See Stef Van Weeghel, *The Improper Use of Tax Treaties: With Particular Reference to the Netherlands and the United States* (London; Boston: Kluwer Law International, 1998). [Weeghel].
[2] This is according to paragraph 9.4 of the commentary to Article 1of the 2003 updated version of the OECD model convention. See Ned Shelton, *Interpretation and application of tax treaties* (London: Lexis Nexis, 2004) at 142. [Shelton].
[3] See Weeghel, *supra* note 1.
[4] As reflected in Stef van Weeghel's account of tax avoidance practices in the treaty context in his treatise on the improper use of tax treaties. *Ibid.* at 163-190.
[5] *Ibid.* The application of tax treaties to facilitate tax evasion is not discussed in this paper.
[6] Weeghel conducts a similar analysis in chapter 7 of his text, *Ibid.* at 95-117.

also provide an account of what academics have written on the subject. This chapter provides a summary and critique of the prevailing general notions of tax treaty abuse. The main issue considered in this chapter is whether these prevailing principles or concepts of abuse offer a constructive basis to evaluate or challenge the legitimacy of the treaty shopping strategies that are considered in the next chapter.[7]

Through this treatise and its critique of the various notions and approaches to the study of treaty abuse that academics have proposed, one may appreciate the extent to which these notions have shaped the arguments and conclusions on treaty abuse presented in this paper. This chapter also reveals the weaknesses of other theories or other potential avenues of discourse on the subject which were not pursued in this study. The chapter starts with a description of the characteristics and elements of the tax treaty regime that academics have relied upon or have considered as a basis for constructing a general theory of treaty abuse.

Tax treaties do not include general anti-abuse provisions as is typically found in domestic legislation of most OECD countries. Academics have grappled with the question whether there is a general theory of treaty abuse grounded in international law, based in part on the domestic tax policies of the treaty states that may be applied to interpretation and application of tax treaties.[8] This has proved an elusive challenge. This chapter demonstrates that there is insufficient evidence to articulate a substantive principle of international law on treaty abuse. The principles that have been proposed carry little substance and consequently, will not be very helpful in evaluating the

---

[7] For a definition of treaty shopping see Nathalie Goyette, *Countering Tax Treaty Abuses: A Canadian Perspective on an International Issue* (Toronto: Canadian Tax Foundation, 1999) at 5. [Goyette].

[8] Stef van Weeghel, Klaus Vogel, and Nathalie Goyette are some of the writers that have tackled the question.

legitimacy of specific tax avoidance practices. It is more correct to suggest that the tax treaties permit states to rely on domestic principles of abuse in construing and applying the provisions under a tax convention.

The OECD Committee on fiscal affairs argues that the general tax avoidance schemes employing artificial legal maneuvers, devoid of economic substance constitute an abuse of tax conventions.[9] This paper endorses the OECD's view on treaty abuse but argues that the proposition has not been fully explained or adequately supported with reference to treaty principles. I propose that the rationale underpinning the structure of the bilateral tax treaty regime, and the allocation of taxing rights between treaty states, provides a foundation to challenge the legitimacy of certain treaty uses. The next chapter relies on this rationale to challenge the legitimacy of transactions lacking economic substance and employed to derive benefits under the treaty regime.

Stef van Weeghel, who has written the most recent and comprehensive treatise on improper tax treaty uses, rejects the notion of a meta principle of tax treaty abuse or the notion that there are particular tax avoidance strategies that are illegitimate as a general rule, arguing that whether a tax avoidance strategy constitutes a misuse of a tax treaty, depends on the terms of each treaty instrument and the treaty policies of the respective treaty partners and what the states consider to constitute improper or illegitimate tax practices In other words, whether the treaty shopping or other tax avoidance strategies under the tax treaty regime are abusive depends on whether the practice is sanctioned by the terms of the treaty instrument or by the contracting states. Weeghel identifies the treaty policies and practices of the states concerned, relying on the interpretation of the

[9] See paragraphs 8 & 9 of the commentary to Article 1of the *OECD Model Tax Convention* in OECD Committee on Fiscal Affairs, *The Condensed version of the Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 2003). [*OECD Model Convention*].

relevant treaty provisions, in accordance with the terms of the Vienna Convention on the Law of Treaties, and any public statements and documents released by government officials denoting a treaty state's stance on the legitimacy of particular tax or anti-avoidance practices in the international or bilateral context.

This chapter also provides an introduction to what various authors have stated regarding the potential role that notions of equity, as well as considerations regarding the moral character of taxpayers' conduct, may play in evaluating the legitimacy of individual avoidance strategies under the treaty regime. These notions are introduced as potential areas for further study. *This paper does not rely on equity, moral principles, or ethical considerations to scrutinize the legitimacy of tax avoidance practices in the treaty context, and determine whether the application of a particular treaty instrument or provision is abusive[repetitive].* While some of the tax avoidance strategies that are evaluated in this chapter may raise ethical considerations, the legitimacy of tax avoidance practices in this paper is ultimately evaluated with reference to the content of individual treaty provisions and the principles underpinning the tax treaty regime. In other words, the scope of this study is limited, but it seeks to acknowledge that such issues may be raised. It is hoped that these issues will be explored in future studies.

There are two principal works on tax treaty abuse that this paper will refer to in addressing the subject of improper tax treaty practices; the first is the work of Stef van Weeghel, entitled The Improper Use of Tax Treaties; the other is a publication by Klaus Vogel, a comprehensive collection of commentaries to the articles of the OECD model income tax convention.[10]

[10] See Weeghel, *supra* note 1 & Klaus Vogel, *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD-UN and US Model Conventions for the Avoidance of Double Taxation of*

II Tax treaties as tax planning tools: legitimate versus illegitimate treaty uses

The tax treaty network inadvertently increases the opportunities available to taxpayers to minimize their tax burden by taking advantage of the discrepancies between domestic tax regimes, while also permitting taxpayers to benefit from the differences between treaty instruments by targeting the most advantageous treaty benefits.[11] Taxpayers also have more liberty under the treaty regime to employ artificial legal maneuvers to derive certain treaty benefits that would not otherwise be available.[12]

Despite the tax planning opportunities available to taxpayers under the tax treaty system the commentary to Article 1 of the OECD model tax convention provides that tax treaties were not designed with the purpose of facilitating either tax evasion or tax avoidance.[13] The 2003 revised model commentaries include a stronger statement to the effect that a purpose of tax treaties includes the prevention of tax avoidance.[14] At the same time, the aim of combating tax avoidance is not generally included as part of the preamble to most tax conventions, alongside the objectives of preventing double taxation and tax evasion.[15] Despite this omission there is a general consensus among OECD member states that even tax avoidance strategies employing treaties, which may not interfere with a treaty's express aims, may offend the purpose of a treaty provision or set

---

Income & Capital with Particular Reference to German Treaty Practice (London; The Hague; Boston: Kluwer Law International, 1997). [Vogel].

[11] See OECD Committee on Fiscal Affairs, *International Tax Avoidance and Evasion: Four Related Studies* (Paris: OECD, 1987) at 60. [OECD]. The next chapter examines the nuances of a particular tax avoidance strategy employing tax treaties.

[12] *Ibid.*

[13] See paragraph 7 of the commentary to Article 1 of the 1997 version of the *OECD Model Convention.* Vogel, *supra,* note 10 at 11. *The* complete reference stipulates that tax treaties were not designed to facilitate tax evasion and tax avoidance.

[14] This is stipulated in paragraph 7 of the commentary to Article 1. See *OECD Model Convention, supra* note 9.

[15]See Weeghel, s*upra note* 1 at 97. See Goyette, *supra* note 7 at 9-10.

of provisions, resulting in the improper use of a convention.[16] This brings forth the issue what constitutes abusive tax avoidance in the treaty context and how one may identify the abusive tax practices under the treaty regime?

i. the commentary to the OECD model tax treaty

The commentary to Article 1 of the OECD model convention also provides that the tax treaty network "increases the risk of treaty abuse by facilitating the use of artificial legal constructions," to derive benefits under the treaty regime that would not otherwise be obtained.[17] I raise the question whether the OECD model tax commentary carries sufficient authority as a source to confirm the existence of a principle of treaty abuse to challenge the legitimacy of treaty tactics employing artificial maneuvers. The commentaries are intended as an aid to the interpretation of treaty provisions but were not designed to be annexed to a treaty instrument concluded between two countries.[18] The commentaries were drafted by experts appointed to the Committee on Fiscal Affairs by the governments of the member countries.[19] However, the Committee is not represented by members from all the OECD member states. As a result, it is incorrect to suggest that the OECD treaty policy reflects the policy endorsed by all treaty countries, without referring to the provisions and the commentaries under the treaty instruments of the states concerned.

Whether it is legitimate to rely on the model commentaries as an aid in construing the provisions of a tax treaty, in so far as the treaty states have designed their treaties based on the model provisions and the treaty states have not included any reservations to

---

[16] See OECD, *supra* note 11 at 101.
[17] See paragraph 9.5 of the commentary to Article 1. *OECD Model Convention*, supra note 9.
[18] See the introduction to the condensed version of the *OECD Model Convention. Ibid* at 12.
[19] *Ibid.*

the model commentaries or any observations signaling a departure from the interpretations of the model provisions, is an issue that remains a subject of debate.[20] The *OECD Model Convention* typically serves as a document of reference during bilateral negotiations. Nonetheless, even tax treaties based on the model treaty depart in some respects from the model instrument.[21] The relevance and legitimacy of the model commentaries is especially brought into question where there is a difference in timing between the drafting of tax treaty provisions and the introduction of amendments to the model commentaries.[22] Nonetheless, there is a general consensus among OECD member states that any subsequent amendments or additions to the model commentaries constitute a legitimate aid in the interpretation and application of tax conventions, except in cases where the OECD Model treaty is changed substantively as a result.[23] This is the general policy on tax treaty construction included in the introduction to the OECD Model Commentaries.[24]

The model treaty and commentaries have been described as an ancillary tool, a document subordinate to tax treaties, which constitute the only authoritative and binding instruments, a broadly accepted proposition among treaty states.[25] The real debate among academics concerns how much weight should be attributed to the model convention as a tool to delineate the substance or scope of prevailing state bilateral tax treaty policies. This discussion, which is based on the provisions of the Vienna *Convention on the Law of*

[20] Observations to the model commentaries have also been inserted in the model treaty at the request of some states, reflecting the extent to which states depart from the interpretation given to particular provisions under the model convention. *Ibid.* at 15-20.
[21] The *Canada-US Tax Convention* is one example of a convention that departs from the general provisions of the model convention. In addition, Canada's tax treaties with other countries do not include a general reference to the abusive character of artificial maneuvers employed to derive benefits under the convention.
[22] See Shelton, *supra* note 2 at 30-33.
[23] *Ibid.*
[24] *Ibid.*
[25] See Vogel, *supra* note 10 at 10-3.

Treaties,[26] will be explored in the next chapter dealing with treaty shopping, or, in other words, tax planning employed by the residents of a state that is not a party to a particular tax convention, to trigger the benefits under the instrument.[27]

Regardless of the degree of weight to be attributed to the OECD model commentaries as an interpretative tool, the commentaries provide only a vague indication of what may constitute an improper use of a tax convention and do not prescribe criteria do determine what may or may not constitute artificial and abusive tax planning. The OECD has not yet developed any specific or comprehensive guidelines to assist in delineating improper treaty uses and nor has it provided guidelines denoting measures that may be adopted to combat abusive tax avoidance practices.[28]

Nonetheless, the treaty states do, by and large, accept the general principle that the use of artificial constructs to acquire benefits under a tax treaty constitutes an abuse of the treaty regime.[29] Klaus Vogel argues that the policy against the use of artificial arrangements constitutes a concrete example of a relatively common principle as reflected in the tax regimes of most developed states, noting that most countries will disregard for tax purposes "artificial arrangements motivated primarily or solely by tax considerations, in the absence of a reasonable business purpose."[30] This reference denotes the substance over form doctrine, or business purpose test, in common law countries, or

---

[26] *Vienna Convention on the Law of Treaties*, 23 May 1969, U.N.T.S. vol. 1155 at 331. [*Vienna Convention*].

[27] The next chapter discusses the role of the *OECD Model Convention* in construing the provisions of a treaty instrument and in identifying the polices of the contracting states with respect to treaty shopping. The discussion is carried out in the process of critiquing Weeghel approach to the analysis of improper tax treaty uses, who makes reference to the principles underpinning the *OECD Model Convention.*

[28] The OECD has encouraged states to design their own anti treaty abuse measures. See OECD, *supra* note 11 at 95-101. Examples of model anti-abuse provisions will be looked at in the next chapter.

[29] See OECD, *supra* note 11at 88-91. This section depicts the activities that states consider to be abusive but the treaty states' assessment of individual cases will generally differ. The report notes however, that OECD member states are generally in agreement as to the range of abusive tax avoidance practices and that they have no problems identifying them. *Ibid.* at 16.

[30] See Vogel, *supra* note 10.

the doctrine of fraus legis or abuse of rights doctrine in civil law jurisdictions. The doctrines are applied to re-characterize a taxpayer's transactions for tax purposes to reflect the economic substance of the arrangements as opposed to their legal form.[31] Nonetheless, academics continue to question whether the general practices of states and domestic principles of fiscal law across states denote a sufficient level of commonality to support the existence or emergence of a customary international norm to guide the interpretation and application of tax conventions.

ii. The domestic practice of treaty states and the source for a principle of abuse at international law

Various attempts have been made to articulate a general principle of abuse of rights or anti-abuse doctrine at international law based on the domestic practices of states in fiscal matters or other legal domains.[32] Indeed, states have followed a relatively similar course in the fiscal law and policy context, as reflected by the enactment by domestic legislatures and the development by courts of anti-tax avoidance and anti-abuse principles or doctrines and the adoption by states of treaty provisions enacted to restrict or sanction certain commonly known treaty uses.[33] Treaty states generally agree that treaty shopping, which involves the use of conduit entities in a treaty state by a non-treaty resident to obtain benefits under the treaty regime, is not a practice that the treaty regime

---

[31] See Weeghel, *supra* note 1 at 95-105. See also Goyette, *supra* note 7 at 4-5, 7-15. Most OECD countries also recognize that taxpayers are entitled to arrange their economic affairs in the manner that will attract the minimum tax liability. See OECD, *supra* note 11 at 16. See also Weeghel at 97. States that do not administer a general anti-avoidance principle or doctrines of abuse of law will accept as legitimate any transactions that are arranged in accordance with the letter of the law, irrespective of the intent or result of the arrangement.

[32] See Weeghel, *ibid.* at 98-103.

[33] *Ibid.* at 108-116, 160-190. The Supreme Court of Canada has held that a general anti-abuse doctrine in the fiscal law domain does not exist in Canada. See *Stubart Investments Ltd v. The Queen* [1984] 1 SCR 536 at 557, 573-4, and 580, where the Supreme Court, in a judgment delivered by Estey J., rejected the notion of a business purpose test in Canadian tax law, to challenge the legitimacy of legal arrangements employed by commercial actors, designed solely for the purpose of minimizing taxation. See also Goyette, *supra* note 7 at 7.

was designed or intended to facilitate.[34] Other perceived improper practices include certain rule shopping cases, which involve planning by taxpayers who are legitimately entitled to the benefits under a treaty, to trigger the application of more beneficial treaty provisions.[35] The common general practices of states or general legal principles recognized by civilized nations can constitute a source of customary international law, in accordance with Article 38(1)(c) of the *Statute of the International Court of justice*.[36]

Nonetheless, academics like Natalie Goyette and Stef van Weeghel have rejected the notion of an anti-abuse doctrine at international law applicable to tax conventions, arguing that there is little to document the emergence of such a principle of law.[37] Both authors argue that while the International Court of Justice has embraced the abuse of rights doctrine on a number of occasions with respect to the interpretation of international conventions, generally, the relevant judgments have stemmed from a single source, the concurring or dissenting opinions of Justice Alvarez, an enthusiastic proponent of the doctrine.[38] According to Goyette and Weeghel these judgments do not present a sufficiently credible source to document the existence of an international abuse of rights doctrine.

Weeghel also considers whether an international principle of treaty abuse can be discerned from the doctrines of abuse, developed in a non-tax context, in most civil law

---

[34] See OECD, *supra* note 11 at 88-92 for a general description of tax strategies by residents in one state, employing corporations resident in a treaty state.

[35] *Ibid.* See also Goyette, *supra* note 7 at 8. Tax treaty strategies involving rule shopping will not be examined in this study.

[36] *Statute of the International Court of justice,* June 26, 1945, Department of State Publications 2353, Conference Series No. 74. See also Goyette, *ibid.* at 12-13.

[37] *Ibid.* at 13. See also *Improper use of tax treaties, supra* note 1 at 99, 98-100.

[38] The citations for the relevant judgments are noted here. All judgments are non-tax related. (See *Fisheries*, 1951 I.C.J. 116; *Competence of the General Assembly for the Admission of a State to the United Nations*, 1950 I.C.J. 4: *Anglo-Iranian Oil Co.*, 1952 I.C.J. 93; See also, *Nottebohm*, 1955 I.C.J. 4 (Judge Read dissenting) and *Norwegian Loans*, 1957 I.C.J. 9. See also Bin Cheng, *General Principles of Law as applied by International Courts and Tribunals*, (Grotius Publications, Cambridge University Press, Cambridge, Melbourne, New York 1994) at 121.

countries.[39] He rejects the proposition arguing that the principles of law that have developed in other legal fields are not transferable to the tax law domain. Weeghel discusses the concept of abuse that has been applied and developed in the property law context in many civil countries. The abuse of rights discourse in this context refers to the exercise of property rights by one party, which results in the commission of a tort against another party.[40] The abuse of rights doctrine as it is applied in this area of the law is focused on striking a balance between the opposing interests of parties with the aim of preventing a disproportionate harm to one party as a result of exercise of rights by another. Weeghel notes that in the tax law context, actions by taxpayers to minimize taxation will result in a proportionate loss but not a disproportionate harm to fiscal or other societal interests.[41] As a result, he reasonably concludes that the context in which the doctrine of abuse of rights has developed in this legal field is not at all helpful in construing a general principle of tax treaty abuse.[42]

Weeghel also rejects the notion that the substance over form doctrine, applied and developed by countries in the tax law domain, sets a foundation for an international abuse principle.[43] This, according to Weeghel, is the result of the fact that the doctrine has developed differently in many jurisdictions as a result of the diversity between domestic legal regimes and traditions. Weeghel notes in particular that "the substance over form

---

[39] See Weeghel, *supra* note 1 at 98-99.
[40] *Ibid.*
[41] *Ibid.* at 99.
[42] Both Weeghel and Goyette adopt the proposition that there is no clear indication that a doctrine of abuse of rights exists at positive law. See Goyette, *supra* note 7 at 13 & Weeghel, *ibid.* at 99,116-7. They both rely on an excerpt from a general and authoritative text on Public International law, authored by Ian Brownlie where it is noted that the prevailing concepts of abuse may be employed as a useful guide for the progressive development of the law, but that a doctrine of abuse of rights does not exist as a general principal of positive law. See Weeghel, *ibid.* at 99. Goyete refers to the text in a footnote. See also Ian Brownlie, *Principles of Public International Law*, (Clarendon Press, Oxford 1990) at 446.
[43] Weeghel, *ibid.*

doctrine has developed in different countries in different forms and with different thresholds for its application," and generally without regard to the application of the doctrine in other states.[44] Natalie Goyette also concludes that there is a sufficient lack of uniformity between state practices in combating tax planning practices that presumably lack substance, to defeat any attempt to construe an international principle of law that is sufficiently precise to be applied."[45] It is indeed evident that there are notable variations between domestic anti-abuse principles and practices among OECD member countries which will stand to frustrate attempts to articulate the scope and ambit of a substance over form doctrine at international law. Evidence of the variations in domestic legal approaches is provided in part through Weeghel's account of the tax laws and jurisprudence in various countries, and his account of the manner in which general tax abuse principles have been applied in different countries.[46] Weeghel's account provides strong support for the claim that no such international legal doctrine has emerged and perhaps also explains why no progress has been made in articulating the scope of a common general principle of law or doctrine of abuse that treaty countries may have recourse to in construing their tax treaties. David Ward and John Avery Jones also adopt the conclusion that a substance over form doctrine does not exist at international law, stating that while there is certainly a discernible trend internationally in the application of abuse of rights principles and business purpose doctrines in many countries, it is not

---

[44] See Weeghel, *ibid.* at 102.
[45] See Goyette, *supra* note 7 at 13.
[46] Weeghel, *supra,* note 1 at 163-190. Weeghel discusses the substance over form doctrine has been applied in the US the Netherlands and Germany, among other countries. See also Goyette, *ibid.* at 4. Goyette notes that" the term "abuse of rights" the concept that exists in civil law countries differs from the concept of "tax avoidance" found in common law countries." She does not elaborate on this point but makes reference to the following sources: Stefan N. Frommel, "United Kingdom Tax Law and Abuse of Rights" (1991) 2 Intertax 54 at 55-61, 79; David A. Ward et al,. "The Business Purpose Test and Abuse of Rights" [1985] 2 British Tax Rev. 68.

possible, based on these state practices, to define the substantive content of a general principle or doctrine of abuse.[47] I also conclude, based on the lack of affirmation by domestic fiscal authorities to the effect that no international fiscal principle of abuse at international law has yet emerged which may be applied in the tax treaty context. General statements challenging avoidance practices employing artificial legal maneuvers lack substance. Moreover, vague pronouncements, lacking criteria for identifying abusive conduct or circumstances offer little practical utility.[48]" This leaves no other alternative for states but to continue to rely on domestic anti-abuse rules or domestic concepts of abuse. As such, the more pertinent question that should be posed is whether treaty countries may have recourse to domestic anti-abuse principles to guide the interpretation and application of the provisions under a tax treaty.

iii. The application of domestic anti-abuse principles under the tax treaty regime

The commentary to the 1992 Model Convention confirms that OECD member states are entitled to resort to domestic concepts of abuse in determining whether tax subjects have complied with the conditions for the conferral of treaty relief, in the absence of an express treaty provision condoning such an approach.[49] Paragraph 24 of the commentary to Article 1 of the 1995 version of the OECD model treaty provides "it is the view of the wide majority of states that domestic substance over form rules and the underlying

[47] The substance over form doctrine will be discussed in greater detail at a latter stage in this chapter.
[48] See Goyette, *supra* note 7 at 13. See also Henry Torrione, in International Fiscal Association, *How Domestic Anti-avoidance rules affect domestic taxation conventions, a seminar of the 48th Congress of the International Fiscal Association, held in Toronto, Canada in 1994*, vol. 19c (The Hague: Kluwer Law International, 1995) at 8. cited in *ibid.* He proposes that "the absence of criteria it so significant that it is impossible to say that there is an international anti-abuse principle on which treaty partners may rely on as a basis to limit treaty benefits."
[49] See Vogel, *supra* note 10 at 124. This remains a valid approach in so far as the relevant tax treaty does not contain a treaty provision forbidding or otherwise limiting the application of domestic anti-abuse rules.

principles do not have to be confirmed in the text of the convention to be applicable." [50] The question that arises, as a result, is whether these domestic rules are consistent or compatible with treaty principles. Vogel notes in his commentaries to the OECD Model Convention that a subject's entitlement to treaty benefits are appropriately judged according to the substance as opposed to the form of the taxpayer's arrangements to be determined with reference to both domestic private law and treaty law.[51] As an example, a condition for the conferral of treaty benefits, the application of limits on withholding tax rates on a particular income item, is that the income remitted by a resident in the source state is "received by" a person resident in the other treaty jurisdiction.[52] Domestic rules, including the substance over form doctrine and domestic anti-abuse provisions, are applied to determine who should be regarded as the actual recipient of the income for treaty purposes.

Vogel argues that the manner in which taxpayers' arrangements should be construed or the determination of "which facts give rise to a tax liability"[53] is not a matter addressed under the provisions of a tax convention and that, as a result, nothing in principle can prevent states from resorting to general domestic tax concepts and rules to do so. The consensus among treaty states is that domestic authorities may legitimately determine whether the domestic tax law will be applied to the legal form or the economic substance of a tax subject's transactions or legal arrangements.[54] The application of

---

[50] *Ibid.* See also *OECD, supra* note 11 at 70.

[51] *Ibid.* See also Vogel, *ibid.* at 122-23. General domestic anti-abuse principles like substance over form are applied for purposes of the provisions of domestic substantive law of the state concerned. Once the taxpayer's legal arrangements are construed for purposes of domestic law, the relevant transactions are considered for purposes of applying the provisions of a treaty instrument.

[52] Treaty provisions of this kind will be discussed in the next chapter dealing with treaty shopping.

[53] This is also the view endorsed by the OECD in its report on international tax avoidance and evasion. See OECD, *supra* note 11 at 70.

[54] See Shelton, *supra* note 2 at 142.

domestic anti-tax abuse doctrines are applied to determine whether taxpayers have complied with the conditions for seeking relief under the provisions of a tax convention. In this way artificial transactions or transactions lacking economic substance can be invalidated or disregarded for both domestic and tax treaty purposes. In this manner an improper use or what the treaty states may regard as an abusive application of a treaty provision can generally be avoided. Examples of this kind will be discussed in the next chapter on treaty shopping.

III. Relevant treaty-based precepts: constructing a theory of treaty abuse

i. Article 26 of the Vienna Convention and the pacta sunt servanda principle

As a basis to articulate a principle against treaty abuse, academics have also relied on Article 26 of the *Vienna Convention*, and the pacta sunt servanda principle, a precept binding countries under the treaty regime to perform their obligations under a treaty instrument in good faith.[55] The OECD has noted that this precept imposes an obligation on treaty states to implement the provisions under their tax conventions and to make certain that a domestic legal regime does not interfere with the performance by states of their treaty responsibilities, as denoted by a broad and purposeful construction of the relevant treaty provisions.[56] Based on these precepts, academics have argued that taxpayers are also bound by the obligation not to abuse the tax treaty regime and to apply the provisions of a tax treaty and the domestic law of the contracting states correctly in

[55] Article 26 and the pacta sunt servanda principle provides: "Every treaty in force is binding upon the parties to it and must be performed by them in good faith." See *Vienna Convention on the Law of Treaties*, 23 May 1969, U.N.T.S. vol. 1155 at 331.
[56] See OECD, *supra* note 11 at 7. Treaty provisions must be construed a bona fide construction.

accordance with the normal treaty and domestic rules of interpretation.[57] Even though tax treaties and the pacta sunt servanda principle bind states, as the parties to a Convention, and not their residents or citizens, academics have argued that taxpayers cannot derive rights under a tax convention that are greater than those which the treaty states have agreed to confer.[58] Nathalie Goyette in her text on measures to counter tax treaty abuse argues that if the *Vienna Convention* constitutes a codification of customary international law, as it is generally accepted, it can be concluded that taxpayers are directly bound by the principles under the convention, even though they are not signatories to the treaty or a tax convention. This proposition is not without controversy. Ned Sheldon in his text on the interpretation and application of tax treaties questions whether the *Vienna Convention* can be properly regarded as an accurate codification of customary international law. He doubts the proposition that states can possess unanimous views on such a complex issue as treaty construction which denotes, as he ventures to discuss in his text, "many varied facets."[59]

If taxpayers are bound by the pacta sunt servanda principle, this leads to the proposition that an improper treaty use is any use that is contrary to the intentions of the contracting states under the treaty instrument. The challenge remains to properly construe the intentions of the treaty states with reference to the provisions of the treaty, its object and purpose as reflected in the preamble, and the related commentaries.[60] Nonetheless, this pronouncement is not helpful to the task of construing a theory or notion of treaty abuse.

---

[57] See Weeghel, *supra* note 1 at 97. The rules of treaty construction are found under Articles 31 and 32of the *Vienna Convention*. These provisions will be discussed in detail in the next chapter.
[58] See Goyette, *supra* note 7 at 10-2.
[59] See Shelton, *supra* note 2 at 157.
[60] The general rules of treaty construction are discussed in Chapter 2.

ii. The preamble to tax treaties as the source of anti-abuse principle

Academics have also considered whether the preamble to tax treaties can serve as the foundation for an anti-abuse principle that fiscal authorities can invoke to deny treaty relief *in* cases of abuse. Nathalie Goyette, in her treatise on measures to counter abusive treaty practices, rejects this notion. The preamble to tax treaties lays out the principal aims of a treaty instrument which normally includes the aims of preventing double taxation and tax evasion. Very few treaties include an express reference to the objective of combating tax avoidance. Goyette argues that since the treaty network does not itself levy taxation, that it cannot be claimed that the tax treaty regime functions to prevent harmful tax practices [61] She specifically notes that "the tax treaty does not in any way limit tax abatements, exemptions or other tax relief afforded to taxpayers," but simply permits states to determine whether tax should be imposed in one treaty state or the other.[62] Goyette argues further that the OECD Committee on Fiscal Affairs, as the principal architect of the tax treaty regime, has confirmed that the preamble is not a source for an anti-abuse principle of this kind. According to Goyette, this is reflected by the OECD's policy instructing that treaty benefits have to be granted unless an anti-abuse treaty provision is inserted under a convention to restrict the conferral of treaty benefits under a particular set of circumstances.[63] However, this debate is not relevant to the task of delineating the substance and scope of a principle against treaty abuse, or construing a notion of treaty abuse. Rather, this debate addresses the issue whether the preamble can be invoked to deny the conferral of treaty benefits in circumstances that, in the view of the treaty states, has resulted in an abusive application of the convention. The availability

[61] See Goyette, *supra* note 7 at 8-9.
[62] *Ibid.*
[63] See OECD, *supra* note 11 at 12.

of countermeasures to prevent the conferral of treaty benefits in cases of abuse is not the focus of this paper.

The discussions in this chapter thus far have shown that there has been no success in articulating a substantive general theory of treaty abuse or criteria to determine which practices constitute abuse of a tax convention. As a result, the general precepts that have been proposed and analyzed in this chapter will not be very helpful in evaluating the legitimacy of concrete cases of tax avoidance employing tax treaties in the next chapter. It is interesting to observe that perhaps the various attempts to articulate a principle of abuse, considered in this chapter, have laid the foundation for Stef van Weeghel's analytical approach to the study of improper treaty uses.

iii. Weeghel's theory of treaty abuse and its refinement

Stef van Weeghel, in his treatise on improper tax treaty, departs from any attempt to articulate a universal general doctrine or abstract theory of treaty abuse.[64] He proposes that whether or not a particular tax practice results in an improper use of a tax treaty will depend on the treaty policy of the states concerned and what the states are prepared to accept as legitimate; in turn the policies that states administer may not necessarily or generally be informed by principle or doctrine.[65] According to Weeghel, treaty abuse arises in cases where tax treaties are used in a manner that departs from the intentions of the treaty partners and where the primary purpose of the tax avoidance is to secure a benefit under a tax convention.[66] Accepting these general precepts, I focus primarily on the principles and rationale of the treaty system and its rules, and whether particular tax

[64] *Ibid.* See also Weeghel, *supra* note 1 at 98-100.
[65] Weeghel asserts that the treaty policy of contracting states is frequently a product of political compromise or caprice. Weeghel, *ibid.* at 99.
[66] See Weeghel, *supra* note 1 at 117.

avoidance practices are consistent with the logic of the treaty instrument and where relevant, the provisions and framework of rules under the OECD Model Convention.

I will evaluate the general or perceived cases of treaty abuse against the general structure and aims of the tax treaty regime explored in Chapter 1. States have, by and large, structured their fiscal treaty relations with other countries in reliance on the OECD model tax treaty framework, and its bilateral system for the division of taxing rights between countries. Stef van Weeghel evaluates the legitimacy of some tax avoidance practices with reference to the general treaty principles denoted under the OECD model treaty. Nonetheless, some of the conclusions that Weeghel draws on the issue of treaty abuse will be challenged in the next chapter.

I will argue that a tax treaty is misused if treaty benefits are conferred in circumstances that do not accord with the rationale for the bilateral tax treaty mechanism and the resulting tax concessions that states are obligated to assume under the treaty regime. The legitimacy of a tax plan depends on whether the economic interests of the treaty subject in a particular treaty jurisdiction are sufficient to trigger the treaty relief sought. This basis for challenging avoidance strategies is generally overlooked, particularly in the treaty shopping context. I rely on the proposition that the allocation of taxing rights under the treaty system is based on the notion of economic allegiance and the existence of certain economic ties between the taxing jurisdiction and the treaty subject concerned.[67] In the majority of tax planning cases considered in this paper, the transactions employed to secure treaty benefits are either artificial or lack economic substance.

---

[67] This transcends into an economic interest in the income base and its taxation. See the discussion regarding the economic rationale for the allocation of tax rights under the treaty regime in chapter 2.

IV. Equity and Neutrality: judging abusive tax practices.

A question that further studies of tax treaty abuse may pursue relate to whether and to what extent equity and considerations of "the moral attributes" of a tax avoidance scheme should play a role in evaluating the legitimacy of various treaty practices. This chapter serves to introduce the views that have already been presented on this subject. Klaus Vogel has remarked that there are limits to tax planning beyond which tax avoidance practices can no longer be tolerated by legal regimes conforming to principles of justice.[68] Vogel refers to both treaty shopping and rule shopping in this excerpt. While this view is disputed in the next chapter, Vogel's reference to principles of justice does raise the question whether an analysis of issues of justice or morality should be incorporated in these discussions. The OECD report on tax avoidance and evasion characterizes certain categories of tax avoidance and treaty practices as an affront to principles of equity, and as barriers to the administration of an equitable and neutral international tax regime. The report also provides that the tax treaty regime was never intended to suppress national sovereignty in matters of fiscal governance and to interfere with state efforts to safeguard the integrity of their fiscal regimes.[69]

Nonetheless, the literature on tax treaty abuse generally departs from judgments based on notions of equity and does not include debates concerning the ethics or morality of tax planning practices.[70] Vogel argues, in a slightly different context, that discussions of equitable principles are not sufficiently developed and tend to give rise to vague

[68] See Vogel, *supra* note 10 at 14.
[69] See OECD, *supra* note 11 at 11
[70] See Weeghel, *supra* note 1 at 97.

recommendations.[71] What is for certain is that this remark is but an invitation to engage in debate and not a final and decisive pronouncement on the subject of the role of equity in such discussions.

Weeghel makes the affirmation that taxpayers need not be expected to be "excessively correct in conduct" or "vigorously moral," referring to taxpayers' sole obligation in fiscal matters to comply with both the letter of the law and the law's object and purpose. An extract from a 1980 report by the Committee on Fiscal Affairs provides that, "while moral attitudes may indeed be taken towards tax avoidance, it is not appropriate for tax authorities to do so."[72] In combating tax avoidance the tax authorities, in their official capacity, are simply administering the law in accordance with what they understand to have been the intention of the legislature.[73] The same reasoning may be applied in the tax treaty context, considering that the main object for fiscal authorities is not to assess the morality of a tax plan but to judge whether a treaty was applied in a manner that is consistent with the object and purpose of the relevant treaty provisions and the intentions of the contracting states. The key question, of course, is whether taxpayers are properly entitled to the tax benefits under the law and under the provisions of a tax treaty and how a consideration of equitable principles as well as moral or ethical notions will impact this determination. This is a subject that is left for future study.

V. Concluding remarks

The next chapter will evaluate the legitimacy of treaty shopping practices. While the general theories discussed in this chapter will not be helpful to the analysis of the

---

[71] *Ibid.* In this part of his commentary Vogel refers to the concepts of inter-state and inter-taxpayer equity, The role of the tax treaty system in promoting an equitable international tax regime is beyond the scope of this study.
[72] See OECD, *supra* note 11 at 16.
[73] *Ibid.*

alleged cases of treaty abuse, the analytical method adopted in the next chapter confirms and provides greater substance to the general proposition that the use of artificial maneuvers to garner benefits under the treaty regime is abusive.

Chapter 4: An Analysis of Treaty Shopping: the improper use of tax treaties

I. Introduction

Treaty shopping involves interposing an intermediary in a treaty jurisdiction, to serve as a conduit through which economic activities or investments are carried out in another treaty jurisdiction by a person resident in a third state. The use of conduit entities as income channeling devices by residents of a third or non-treaty state will trigger the application of the benefits under the treaty instrument between the country of residence of the entity and the source state. This chapter will look at treaty shopping and the issue whether it constitutes a misuse of income tax treaties.

A treaty shopper can employ more than one conduit entity, potentially situated in different treaty jurisdictions. The income accumulated in a conduit entity from the activities carried out in a treaty state may be channeled through several intermediary countries passing through different interposed entities it reaches the state of the treaty shopper. The income may also change character several times as it is transferred from one jurisdiction to another.[1] A common characteristic of treaty shopping cases is the

---

[1] See Simone M. Haug, "The United States Policy of Stringent Anti-Treaty Shopping Provisions: A Comparative Analysis" (1996) 29 Vand. J. Transnat'l L. 191 at 195-220. [Haug]. See also Michael J. Graetz, *Foundations of International Income Taxation*, (New York: Thomson West, 2003) at 138. [Graetz]. Treaty shopping has also been described as a practice that employs *artificial* entities in a treaty state to channel income for the main or sole purpose of obtaining treaty benefits that can not be obtained directly by the treaty shopper. See, Helmut Becker, & Felix J. Wurm, eds., *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (Deventer; Boston: Kluwer Law and Taxation Publishers, 1988) at 1-30. [Becker & Wurm].

absence of a real economic contact with or presence in the jurisdiction of the interposed entity as will be observed in the treaty shopping cases in this chapter.[2]

This chapter raises the issue whether treaty shopping is a legitimate strategy employed by residents in non-treaty states to circumvent the limited reach of the bilateral tax treaty regime, or whether the practice is abusive, violating the object and purpose of the tax treaty framework or the principles underpinning the system of treaty rules.

The OECD report on tax avoidance and evasion in reference to treaty shopping, provides that a common example of treaty abuse occurs where a company situated in a treaty country acts as a conduit for channeling income economically accruing to a person resident in another state and who is thereby able to improperly take advantage of the benefits provided under a tax treaty.[3] However, this pronouncement begs the question what specific treaty rule or principle may be breached in such cases or how the operation of the treaty regime may be adversely affected. This chapter looks at a number treaty shopping examples and the traditional arguments that have been proposed, embraced by the OECD and the majority of OECD member states, to explain why treaty shopping constitutes an improper use of tax treaties.[4] I will also present the perspectives other academics or commentators have brought to the debate and my critique of the alternative viewpoints that have been raised to evaluate the legitimacy of treaty shopping practices.

---

[2] The treaty shopping examples considered in this chapter are, by and large, reproduced from Stef van Weeghel's treatise on the improper use of tax treaties, Klaus Vogel's commentary to the provisions of the OECD model tax convention, as well as a study by the OECD study on tax avoidance in the tax treaty context. See Stef van Weeghel, *The Weeghel: With Particular Reference to the Netherlands and the United States* (London; Boston: Kluwer Law International, 1998) [Weeghel]; Klaus Vogel, *Klaus Vogel on Double Taxation Conventions, a commentary to the OECD-, UN-and US Model Conventions for the avoidance of Double Taxation and Income and Capital with Particular Reference to German Treaty Practice*, 3rd ed. (the Hague; London; Boston: Kluwer Law International, 1997) [Vogel]; OECD Committee on Fiscal Affairs, *Issues in International Taxation No. 1. International tax avoidance and evasion: Four Related Studies* (Paris: OECD, 1987). [OECD].

[3] OECD, *ibid.* at 88.

[4] The traditional arguments against treaty shopping are reproduced from the OECD study on tax avoidance practices. OECD, *ibid.* at 90-1.

Another purpose for this chapter is to provide a response to Stef van Weeghel's analysis of treaty shopping, who has published the most comprehensive and the most recent critique of the traditional arguments against treaty shopping in his treatise on improper tax treaty uses. [5]

This chapter argues that the traditional arguments against treaty shopping are not well supported and are based on certain erroneous conceptions about the role of the treaty regime and the principles underpinning it. The main opposition to treaty shopping has always been based on the premise that the conferral of treaty benefits to residents of a third state violates the treaty principle of reciprocity and what is erroneously perceived as a corollary of the principle against double taxation, the single tax principle. These notions are discussed and critiqued at length in this chapter.

I accept the proposition that treaty shopping constitutes an improper use of tax treaties but argue that this argument must be supported with reference to the principles underpinning the tax treaty regime and the treaties based on the OECD Model Tax Convention. Treaty shopping is abusive because the use by treaty shoppers of conduit entities, (lacking a real economic purpose or presence in a treaty state), to obtain benefits under the tax treaty regime, violates the economic rationale governing the allocation of taxing rights under a bilateral tax treaty. Weeghel, on the other hand, rejects the general proposition that treaty shopping is abusive, arguing that the legitimacy of the practice can only be determined on a case by case basis, with reference to the provisions of treaty instrument concerned and the intentions of the treaty partners. I critique Weeghel's analytical approach and argue that he places too much emphasis on construing the

[5] See Weeghel, *supra* note 2 at 119-23.

intentions of the treaty states: an approach that departs from the textual approach to treaty construction and the general principles mandated under the *Vienna Convention on the Law of Treaties*.[6]

To prevent the conferral of treaty benefits in treaty shopping schemes states have adopted a variety of anti-treaty shopping clauses. Anti-abuse clauses may, nonetheless, present loopholes or gaps that treaty shoppers can exploit. Another issue this chapter will consider in evaluating the traditional arguments against treaty shopping, is whether tax planning strategies aimed at avoiding the application of such a treaty provision, which would otherwise deny taxpayers the benefits under a tax treaty, is abusive.

At the other extreme, there is a minority of countries who either consider treaty shopping a legitimate tax planning strategy or which administer domestic tax policies that condone the practice.[7] No principled justification has been offered for such measures. Klaus Vogel has argued that all tax avoidance practices, including treaty shopping, are legitimate in principle but that there are limits beyond which such practices can no longer be accepted in a jurisdiction that conforms to principles of justice.[8] However, it is difficult to conceive how domestic regimes can reconcile treaty shopping and traditional notions of inter-taxpayer equity, considering that international entities can significantly reduce their tax liability by exploiting such opportunities while domestic subjects

---

[6] *Vienna Convention on the Law of Treaties*, 23 May 1969, U.N.T.S. vol. 1155 at 331 [*Vienna Convention*]. The relevant provisions under this convention will be discussed in this Chapter.

[7] Finland condones treaty shopping. See Treaty Shopping, *supra* note 1 at 110. The Netherlands condones the use of conduit entities by treaty shoppers through the preferential tax policies it administers. The Dutch Ministry of Finance has expressly encouraged the use of the country's treaty network for the benefit of public and private multinationals with operations in the Netherlands, as well as for the benefit of third country residents. See Weeghel, *supra* note 5 at 109 & 108-111.

[8] See Vogel, *supra* note 2 at 65. Concerns regarding the equitable division of the tax base does not only arise between tax subjects but also between states, referred to as inter-state equity. The latter does not be discussed in this work. See Vogel, *ibid.* at 14.

cannot.[9] Pro-treaty shopping policies are typically adopted for political reasons to attract foreign investment and to discourage other countries from pursuing anti-treaty shopping measures that will prevent a country's own residents from employing similar tax planning strategies in other states.[10]

II. The mechanics of treaty shopping

Treaty shopping involves either the use of a direct conduit or a stepping stone strategy.[11] In the case of a direct conduit strategy a company resident in state A, wholly owned by a resident of a third jurisdiction, state C, receives income from state B. The income is exempt or partially exempt from withholding taxes in state B under the tax treaty between states A and B.[12] The conduit entity is usually a corporation but may also be a partnership, a trust or other legal entity. This strategy may involve the transfer by the resident of state C, (the state of residence of the treaty shopper) of ownership rights in income producing assets, to the conduit corporation, which are in turn employed to generate income in state B (the source state). The strategy may also involve the issuance of a loan or an equity investment in the new entity by the non-resident, funds which are in turn reinvested by the conduit corporation in the source state. The income remitted to the entity in state A, from the income activities in state B, will either be in the form of dividends, interest or royalties. The entity in state A will in turn remit income in the form desired to the treaty shopper in state C. As a result, even though the conduit entity is the direct recipient of the tax treaty benefits, economically, the treaty benefits are granted to

---

[9] See Nathalie Goyette, *Countering Tax Treaty Abuses: A Canadian Perspective on an International Issue* (Toronto: Canadian Tax Foundation, 1999) at 2. [Goyette].
[10] *Ibid.*
[11] Weeghel, *supra* note 2 at 120.
[12] *Ibid.*

persons who are not otherwise entitled to the treaty relief. In order to ensure that the benefits under the treaty instrument accrue to the treaty shopper, the intermediary entity must be set up in a jurisdiction that administers low withholding taxes on payments made by the conduit entity to the non-resident taxpayer and low tax rates on any income retained in the conduit entity.

A stepping stone structure, on the other hand, is employed in cases where the intermediary entity is resident in a high tax jurisdiction, to avoid incurring a high tax rate on any income items received from state B. In order to reduce the taxable income in state A the intermediary entity pays high service or commission fees to a second conduit operation or entity established in a third jurisdiction, state D.[13] The payments which are deducted in state A are typically tax-exempt or subject to a very low tax cost in state D. The income received in state D is ultimately remitted to the resident in state C, and subject to a low withholding tax rate.

Treaty shopping may be employed by residents in non-treaty jurisdictions or existing treaty states, the latter seeking to benefit under more favorable treaty arrangements that the source jurisdictions may have with other countries. Treaty shopping may trigger the application of multiple tax treaties as income is channeled through a number of intermediaries located in different jurisdictions. A concrete example of this will be shown in this chapter.

---

[13] *Ibid.* States administer transfer pricing guidelines to ensure that related companies do not charge exorbitant fees that deviate from the fair market value of services rendered between the non-arm's length or related parties concerned. Related parties include entities, which are owned or controlled by the same shareholder or group of shareholders. Transfer pricing guidelines are not discussed in this chapter since they are administered by states and not under the bilateral tax treaty regime. Article 9 of the *OECD Model Convention* prescribes that states shall structure their transfer pricing policies based on the arm's length principle. The transfer pricing provision applies with regard to prices charged for goods and services and with regard to the expenses allocated between related parties. Nonetheless, the arm's length standard may not be sufficient to prevent artificial income shifting activities between related entities. See OECD, *supra* note 2 at 29-31.

III. The safeguards provided against treaty shopping under the tax treaty regime

There are a number of tax treaty provisions that function to minimize the opportunities available to treaty shoppers.[14] Nonetheless, some of these treaty provisions were adopted for different purposes and may not have been envisioned to promote an anti-tax avoidance objective.

i. Tax avoidance and the residency criteria under tax treaties

Article 1, which delineates the scope of the treaty, operates to limit the opportunities available to taxpayers to engage in treaty shopping. The general definition of the term "resident of a contracting state" under Article 4(1) of the OECD model tax treaty provides that "any person who, under the laws of the State, is liable to tax therein by reason of this domicile, residence, place of management or any other criterion of a similar nature."[15] Paragraph 1 of Article 4 of the OECD model convention excludes from the term "resident of a contracting state" and hence from the ambit of the treaty, any person who is "liable to tax in a contracting state only in respect of income from sources "or capital situated in that state.[16] Not all treaty states have included this residency restriction under their tax treaties: this includes Canada and the US as reflected under Article IV of the Canada-US tax convention.[17] Nonetheless, the Supreme Court of

---

[14] The provisions dealing with improper uses under the *OECD Model Convention* are scarce. The conditions for triggering tax treaty relief under the model treaty ensure in some respects that the provisions will be applied in a legitimate manner. See Weeghel, *supra* note 2 at 211. This chapter will evaluate some of these provisions.

[15] OECD Committee on Fiscal Affairs, *The Condensed version of the Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 2003) [*OECD Model Convention*].

[16] *Ibid.*

[17] Convention between Canada and the United States of America with respect to taxes on income and on capital signed on September 26, 1980, (Canada-United States Tax Convention, 1980), as amended by the Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995 and July 29, 1997. [*Canada-US Tax Convention*].

Canada in *The Queen v. Crown Forest Industries Ltd.*, has incorporated this restriction in its interpretation of the residency requirements under the provision.[18]

The primary purpose of the residency conditions under a tax treaty is to exclude non-resident entities or individuals who engage in income earning activities in a contracting state, from the benefits under the treaty regime. More precisely, the residency provisions aim to limit the scope of the treaty to those entities which are subject to the plenary taxing powers of a treaty state or full taxation in a treaty state, or to limit the application of the convention to the residents of a treaty state who are subject to taxation on their worldwide income. This policy is consistent with the treaty objective of eliminating double taxation, since only these entities bear the veritable risk of double taxation.[19] However, the OECD warns states to take measures to exclude from this policy the minority of countries who tax residents under a territorial tax regime; these countries only tax their residents on income earned domestically, foregoing taxation on income sources generated abroad.

In the case of countries that tax their residents on their worldwide income, this restriction excludes from the ambit of the treaty any entity resident in a contracting state (in accordance with the laws of that state), that is taxed in a similar manner as a non-resident. As a result, by excluding these entities from the treaty regime, the effect of the condition is to prevent the use of these entities by non-residents for treaty shopping purposes.[20] However, this provision does not necessarily exclude from the ambit of a tax

[18] See Chapter 2 for a description of the residency criteria under the *Canada-US Tax Convention. Canada-US Tax Convention, supra* note 17. See also *The Queen* v. *Crown Forest Industries Ltd.*, [1995] 95 DTC (SCC) 5389 at 5396. [Crown Forest].
[19] See Richard L. Reinhold, " What is Treaty Abuse? (Is Treaty Shopping an Outdated Concept" in *Foundations of international income taxation, supra* note 1 at 143.
[20] Based on the interpretation of the term "resident" in Article IV of the *Canada-US Tax Convention*, the Canadian courts have concluded that the convention was not intended to benefit conduit entities that are

treaty all entities resident in a treaty jurisdiction that are subject to special tax privileges under the domestic regime, and which non-residents may be tempted to utilize as conduit entities.[21] Countries have sought to adopt more stringent domestic based residency conditions to deny residency status to entities lacking substantial links to their jurisdiction.[22] This is an attempt to limit the application of treaties to entities that exhibit economic ties to the jurisdiction, which in effect deprive treaty shoppers of the opportunity to use corporations as mere income channeling devices.

Article 1 has been invoked in support of the proposition that an abuse of a tax convention occurs in all cases where treaty benefits are directly or indirectly conferred to a person that is not a resident of a treaty state under the applicable treaty instrument. This is a position that the UN Committee on fiscal affairs has endorsed.[23] The counter-argument is that the conferral of treaty relief to a entity resident in the other treaty state, is consistent with Article 1, whether or not the entity is employed as a treaty shopping device. Residency under the treaty instrument is determined in accordance with the

---

employed for treaty shopping purposes. See Crown Forest, supra note 18. Goyette accepts that the *Crown Forest*, decision introduces "a presumption in the interpretation of tax treaties against treaty shopping and other international schemes designed to reduce tax liability." See Goyette, *supra note* 10 at 16. In support of this proposition Goyette refers to an article by François Vincent, "Crown Forest Industries: The OECD Model Tax Convention as an Interpretative Tool For Canada's Tax Conventions" (1996) 44 Can Tax. J. 38 at 58.

[21] A detailed analysis of the residency requirements and their susceptibility to abuse is beyond the scope of this analysis. Richard Reinhard argues that the fact of an entity's compliance with the definition of "resident" under a tax treaty is a mere formality that does not prevent residents in a third state from engaging in treaty shopping. For a critique of the residency test under the tax treaty regime See *Foundations of international income taxation*, *ibid* note 20 at 141-44.

[22] Treaty states may also incorporate a treaty provision to exclude certain classes of entities, which are as a result of their special legal status, partially or fully exempt from taxation. In the alternative, treaties may include a "subject to tax" provision, which deprives all persons of treaty relief who are not subject to tax liability under domestic law. These options are explored in the section dealing with anti-treaty shopping clauses later in this chapter. By contrast, some states grant tax privileges to certain entities or alternatively to foreign residents in order to attract conduit entities, and consequently, to attract foreign investment. Conduit entities in The Netherlands are subject to preferential tax treatment. See Weeghel, *supra* note 2 at 108-111.

[23] The official name of the committee is the Ad Hoc Group of Experts on International Cooperation on Tax Matters. *Ibid.*

domestic law of the contracting states. This latter pronouncement may very well, overlook the object and purpose of the said provision under the liberal rules of construction mandated under the Vienna Convention. In any event, it is not clear based on the wording of the provision, whether treaty shopping constitutes an abuse of the object and purpose of article 1 or whether it falls outside the scope of the treaty regime.[24] In the absence of a general anti-abuse or anti-treaty shopping provision, the legitimacy of treaty shopping in this study is evaluated with reference to the framework of treaty rules as a whole, and not with regard to the contents of a single provision.

ii. The beneficial owner concept

Articles 10 to 12 of the *OECD Model Convention* provide that the withholding tax limits levied on dividend, interest and royalty income, respectively, apply only if the beneficial owner of the income is a resident in the other contracting state.[25] The concept of a beneficial owner was introduced in the 1977 version of the *OECD Model Convention* to combat treaty abuse, and particularly, to prevent residents of a non-treaty state from claiming treaty benefits on income from investments in a contracting state, by channeling the income through an agent or nominee resident in the conduit state.[26] The qualification ensures that the protection under the treaty is extended in cases where the economic interest or the real title to the income, as opposed to the formal title, is vested in a resident of a treaty state.

---

[24] See *OECD Model Convention, supra* note 15 and accompanying text.

[25] See Vogel, *supra* note 2 at 561. The commentaries to Articles 10-12 (par. 12 of Art. 10, par 8. of Art.11, & par 4 of Art. 12) of the *OECD Model Convention*, also adopt the terminology of agent and nominee, (terms undefined under the convention), and provide that treaty benefits shall not be made available in circumstances when a third person, such as an agent or nominee, is interposed between the payer and the beneficiary of the income. In ascribing a definition to the terms agent and nominee contracting states are permitted to refer to their internal laws in accordance with Article 3(2) of the *OECD Model Convention. Ibid.*

[26] *OECD Model Convention*, *ibid.*

According to Vogel's commentaries to the model convention, the beneficial owner is the person who has a virtual or absolute economic claim to the income, and is "free to decide whether or not the capital or other assets should be used or made available to others, and/or how the yield from the income should be utilized.[27] As a result, a commitment or a legally enforceable obligation to remit an income receipt to a third party, a non-resident subject, will generally run afoul of the beneficial ownership condition, depriving the paying entity of the benefit of the withholding tax relief provisions under the treaty. [28]

Nonetheless, despite these restrictions, the beneficial owner condition does not constitute an anti-treaty shopping measure. In so far as an entity is vested with full ownership rights over an income item, and is not under a legal obligation to remit the income to a non-resident person, the entity can be used as a treaty shopping device. Vogel also notes in his commentaries to Articles 10, 11 & 12 of the OECD model convention, that an entity may benefit from treaty relief in respect of dividends, interest or royalties, even if it is obliged to distribute all of its profits to its shareholders.[29]

Nonetheless, whether or not the beneficial owner requirement is met will depend on how the beneficial owner concept is interpreted and applied by a state authority in view of the particular facts concerned.[30] Countries will typically resort to domestic

---

[27] *Ibid.*

[28] *Ibid.* This is how the beneficial owner restriction has been construed in the Netherlands. In the case of an individual, the beneficial owner is one whose powers over or power of disposition of the income are not restricted or controlled in any fashion. As an example, the owner of shares is not the beneficial owner of dividend income if the rights to the dividend payments are vested in another party who is resident in a third state.

[29] Vogel, *supra* note 2 at 562-3 Vogel makes reference to paragraphs par 12, 12, and 7 of the commentary to Art's 10, 11, & 12 respectively of the 1997 revised version of the *OECD Model Tax Convention.*

[30] *Ibid.* at 16. There is an ongoing debate as to whether the concept of a beneficial owner should be interpreted exclusively with reference to the internal law of the source jurisdiction, or with reference to the context of the treaty as a whole and particularly with view to the purpose of the beneficial owner restriction under the tax treaty regime. Vogel places greater emphasis on a definition based on the context of the treaty instrument as opposed to a definition that is derived based on domestic law principles. He argues that none of the national tax regimes can provide a precise definition of the term. Weeghel disagrees with this method

notions of substance over form in applying the beneficial owner concept, and will focus on the substance of the taxpayers' arrangements as opposed to their legal character to determine if the conditions for granting treaty relief are satisfied. Domestic authorities may conclude that certain entities vested with beneficial ownership rights in law may not, as a practical matter, be capable of exercising a sufficient level of control over their income resources.[31] As a result, according to some domestic authorities the beneficial owner condition will be violated if there is evidence that the subsidiary's management is not in a position to make decisions independent of the direction of the controlling non-resident shareholder, and particularly decisions with regard to the transfer and distribution of income-generating assets and their income yield.[32]

The beneficial owner criterion certainly limits the opportunities to employ conduit entities for treaty shopping purposes, but it does not eliminate the risk of treaty shopping. Some countries have built in anti-treaty shopping device under the treaty relief provisions, to supplement to the beneficial owner requirement for triggering treaty benefits.[33] The commentary to the OECD model convention encourages states to

---

of construction arguing that domestic legal concepts have had a significant role to play in the development of treaty principles. Weeghel traces the evolution of the beneficial owner concept under the jurisprudence of the English courts. See Weeghel *supra* note 2 at 78-83. In any event, states are permitted to refer to domestic legal principles to construe terms that are not defined under a tax treaty in accordance with the principles of construction under the *Vienna Convention* discussed later in this chapter. See *Vienna Convention*, supra note 6.

[31] See Vogel, *supra* note 2 at 561-2.

[32] Treaty relief is not denied if the beneficial owner of the income interest is a resident of a treaty state, but the formal recipient of the income or the holder of the formal title to the income is a non-resident. *Ibid.* at 563.

[33] As an example see Article 9(2)(a)(i) of the 1951 *Netherlands-Switzerland Tax Convention*, which prescribes the conditions for generating a refund for dividend withholding taxes. The provision reads: "if the recipient of the dividends is an entity whose capital wholly or partly consists of shares and which owns at least 25% of the capital of the company paying the dividends, *provided the relation between the two entities has not been constituted or maintained primarily for purposes of assuring receipt of the total refund*." (*italics* added) Reproduced from Weeghel, *supra* note 2 at 219-20. The treaty relief provisions are typically very complex. Article 10(6) of the 1980 *Netherlands-United Kingdom Tax Convention*, is regarded as both an anti-treaty shopping and anti-rule shopping measure. The provision reads, in part: "if the beneficial owner of the dividends being a resident of one of the States, owns x% or more of the class of

consider separate measures or policies for targeting treaty shopping, and particularly the adoption of specifically tailored anti-treaty shopping provisions under their tax conventions.[34]

iii. Anti-treaty shopping clauses

The OECD report on tax avoidance and evasion evaluates and make recommendations regarding model treaty provisions for curbing treaty shopping and other perceived treaty abuses.[35] These recommendations are nonetheless intended as benchmarks for treaty negotiators who are in turn encouraged to devise their own solutions, which are also consistent with or similar in design to the domestic anti-abuse measures administered by the treaty states. In the absence of an anti-treaty shopping clause treaty relief must be granted if the conditions for triggering the application of the relevant provisions are met. The general consensus is that this result is mandated by the *pacta sunt servanda* principle under Article 26 of the *Vienna Convention on the Law of Treaties* which reflects the international legal duty assumed by states under their tax conventions to apply the provisions of a tax instrument in good faith.[36]

The model provisions reflect a concern with economic substance, and are drafted to limit treaty protection to persons with a substantial economic presence in a treaty

---

shares in respect of which the dividends are paid and does not suffer tax thereon in that State, then paragraph 2, or as the case may be paragraph 3, of this Article shall not apply to the dividends to the extent that they can have been paid out of the profits which the company paid the dividends earned....*This paragraph shall apply only if the shares were acquired primarily for the purpose of securing the benefit of this Article and not for bona fide commercial reasons.*" [*italics* added] See *ibid.* at 219.

[34] See OECD, *supra* note 2 at 94-101.

[35] *Ibid.*

[36] Article 26 entitled "Pacta sunt servanda, " under Part III of the *Vienna Convention* provides: Every treaty in force is binding upon the parties to it and must be performed by them in good faith. As it was argued in the previous chapter, there is also some scope for treaty states to resort to domestic anti-abuse principles, such as substance over form, to determine whether the conditions for granting treaty benefits have been met or not and to deny the conferral of treaty benefits if the legal form of the taxpayer's arrangements are not consistent with the substance of the arrangements. See *Vienna Convention, supra* note 6.

jurisdiction, and which demonstrate a real economic interest in taxing the income items concerned. The OECD report on tax avoidance and evasion also cautions states, in devising and applying anti-avoidance measures, not to deny the benefits of the treaty regime to persons or entities that carry on bona fide economic activities in a treaty jurisdiction.

A look-through provision represents a very aggressive response to the treaty shopping dilemma. Such a provision disregards stacks of intermediary companies or conduit entities, or pierces the corporate veil, regardless of an entity's residency status, if the separate legal entities are owned or controlled by a non-resident. These intermediary entities are consequently disentitled from relief under the relevant treaty provisions. Such a provision will run afoul of domestic legal rules or the legal principle that recognize the separate legal status of entities, and may very well be rejected by the treaty partners as too draconian in design. This is indeed an extreme measure that will deprive all foreign owned resident entities of treaty benefits, even if they are not used for treaty shopping purposes. The OECD confirms that such a measure will normally require the inclusion of a number of safeguards to protect legitimate economic operations and warns that these additional requirements will normally result in provisions that are very complicated and burdensome to administer.[37] Nonetheless, the OECD recommends such an approach if the contracting state concerned is a low tax jurisdiction that supports very little substantive business activities. A provision of this kind may include the following criteria:

> "A company which is a resident of a Contracting State shall be entitled under this Convention to relief from taxation in the other Contracting State with respect to any item of income, gains or profits, only to the extent that it is not owned directly

[37] See OECD, *supra* note 2 at 96.

> or through one or more companies, wherever resident, by persons who are not residents of the first mentioned State."[38]

The OECD report also recommends a channeling strategy, a similar but a more precisely tailored anti-treaty shopping measure. A treaty provision of this kind also denies treaty benefits to entities that are substantially owned and controlled by a non-treaty resident but only in circumstances where the entity remits a certain percentage of its income base to non-residents. A model provision of this kind prescribes the following general conditions:

> "Where income arising in a Contracting State is received by a company resident in the other contracting state and one or more persons not resident in that other Contracting State: i) Have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such a company,..., and ii) Exercise directly or indirectly, alone or together, the management and control of such a company,
> any provision of this Convention conferring an exemption from, or a reduction of tax shall not apply if more than 50 % of such income is used to satisfy claims by such persons, (including interest, royalties, ...(business related) expenses,...,etc,)."

This limitation of benefits provision is similar in design to Article 22 of the US model tax convention; which renders many treaty shopping strategies involving a direct conduit or stepping stone structure invalid. Under the limitation of benefits provision in tax treaties concluded by the US with other countries, an entity is not considered a real resident for treaty purposes if their income base is eroded by deductible payments remitted to a non-resident party. The 1981 version of the limitation of benefits provision under the US Model Convention provides as follows:

> "A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless (a) more than 75 % of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and (b) the income of such person is not used in substantial part,

---

[38] *Ibid.*

directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a state other than a contracting state and who are not citizens of the US."[39]

The United States administers the strictest anti-treaty shopping policies and is a strong proponent of the use of limitation on benefits clauses in tax conventions.[40] US tax treaties include anti-treaty shopping provisions of this kind.[41] US policy makers also favor depriving entities of relief from source taxes if they are wholly or substantially owned by non-resident shareholders.[42] Exceptions are granted under some tax treaties for entities which conduct significant economic activities in the jurisdiction and for entities which are the headquarters of multinational corporations.[43]

The OECD prefers these particular approaches as opposed to a treaty policy that excludes specific types or categories of companies enjoying certain tax privileges under domestic law, from the ambit of the treaty. This would constitute a stricter policy than the residency conditions imposed under the OECD model convention examined earlier in this chapter.

The OECD does not look favorably upon the alternative policy of denying treaty benefits unless the respective income is taxed in the state of conduit entity, which is generally referred to as the "subject- to- tax policy."[44] These latter approaches are considered too broad-based, focused as they are on the character of domestic tax

---

[39] Reproduced from Vogel, *supra* note 2 at 129. The limitation of benefits provision under the 1996 US Model Convention is extraordinarily complex. See Graetz, *supra* note 1 at 141. See also, *Weeghel, supra* note 2 at 227-240 for an explanatory note on the content and scope of the model provision.
[40] See Ned Shelton, *Interpretation and Application of Tax Treaties* (London: Lexis Nexis, 2004) at 417. [Shelton].
[41] *Ibid.*
[42] See Graetz, *supra* note 1 at 141-144.
[43] *Ibid.*
[44] A subject to tax approach could also potentially exclude charitable organizations, pension funds and similar institutions as well as companies receiving tax incentives designed to stimulate development in a particular industry. The policy would also exclude from treaty benefits companies used to accumulate income and defer taxation in the state of the parent corporation. See OECD, *supra* note 2 at 99.

legislation, rather than on identifying instances where conduit entities are deliberately employed to exploit the tax treaty regime.[45] The OECD has expressed the concern that such measures will have an unjustifiable adverse impact on entities with legitimate economic activities.[46] The same adverse results arise from treaty measures prescribing foreign ownership criteria targeting entities that are heavily dependent on foreign equity investment, and that are not necessarily employed for treaty shopping purposes.

The anti-treaty shopping clauses that states adopt under their tax treaties are typically very detailed and complex.[47] This is particularly the case with regard to the limitation of benefits provisions adopted by the United States under its tax conventions.[48] The detailed nature of these provisions, or the challenges associated with their implementation, compromises their effectiveness, leaving gaps or loopholes that treaty shoppers can exploit.[49] This in turn encourages states to negotiate more elaborate versions of the provisions to plug some of the inherent loopholes.[50] An analysis of the loopholes inherent in such provisions and their adverse impact on anti-treaty shopping measures is beyond the scope of this study.

III. Treaty shopping examples

The following are some concrete examples of treaty shopping, partly based on the illustrations provided in the OECD's study on tax avoidance and evasion.[51] These cases

---

[45] *Ibid.*
[46] *Ibid.*
[47] See Weeghel, *supra* note 2 at 219-224 for a description of limitations of benefits provision under various tax conventions.
[48] See OECD, *supra* note 2 at 96.
[49] *Ibid.*
[50] See Graetz, *supra* note 1 at 142.
[51] *Ibid.*

are perceived as resulting in an improper use of the treaty being shopped.[52] The treaty shopper may or may not have a treaty with the state of source, or the jurisdiction where the income earning activities are situated. In each of these cases the entities interposed by the treaty shopper have no independent economic purpose, and are employed solely in order to trigger the application of a tax convention between the state of residence of the entity and the source jurisdiction. The examples also denote the range of tax benefits that treaty shoppers may derive under the treaty regime and under the domestic tax regimes of the relevant treaty states.

> 1. A person X, resident of a state which has not concluded any tax treaties, derives interest income from bonds issued in a number of jurisdictions, which is subject to withholding taxes under the domestic laws of each state. X transfers the bonds to a company set up in State A, which has an extended network of tax treaties. Under State A's tax treaties the company claims exemption from or a reduction of withholding taxes in the states where the interest arises. The interest flowing to the company is subject to no or very little taxation in state A as a result of the preferential tax treatment afforded to conduit companies of that kind or as a result of a low tax regime. The interest received by the company in State is A is remitted to X in the form of a loan or a dividend, which is subject to a low withholding tax rate under domestic law.
>
> 2. A company Y resident in State O has developed a patent and intends to enter into several license agreements with licensees in a number of countries. Y transfers the patent rights to a company set up in State A. State O has a tax treaty with State A, but not with the other jurisdictions. Under State A's treaty network, a reduction or exemption of withholding taxes applies on any royalty income generated in those states and remitted to a resident of State A. As an alternative to transferring the patent rights, Y can license the rights to the newly established company, who will subsequently sublicense the rights to residents in the other states.[53] As in the example noted above the income is subject to no or very little taxation in State A. The royalties may subsequently be transferred to Y in the form of a dividend, subject to a low withholding tax under the applicable tax treaty between states O and A. The dividends may in turn be exempted from tax as an inter-corporate dividend payment or under a participation exemption under State O's tax law.

[52] This is the view of the OECD Committee on Fiscal Affairs and of the majority of OECD member states. See OECD, *supra* note 2 at 88-103.

[53] A license agreement grants the licensee the right to use intellectual property rights of the licensor subject to the conditions under the agreement.

3. A company Z is a parent company with wholly-owned subsidiaries in states C1, C2, C3. The state of residence of Z has no treaties with either of CI, C2 or C3. Z transfers its shareholding interest in the wholly owned subsidiaries to a company resident in state A. Under state A's tax treaties with states C1, C2 and C3 there are no withholding tax rates on dividend payments issued by the subsidiaries in C1, C2, and C3. The dividends received by the newly established entity in state A are also not subject to tax in that state as a result of a participation exemption. The income is either remitted to company Z or is invested in the jurisdictions of the parent's company's choosing.

The strategy noted in the third example may also be employed to accumulate income in a low tax jurisdiction, in what is known as a base company, in order to defer taxation in a high tax jurisdiction.[54] The strategy is generally employed to shelter the income generated from activities carried out in multiple jurisdictions.[55] Treaty shopping is but an auxiliary strategy in these cases to ensure that the income generated in a foreign state, is taxed favorably as it is remitted from a (treaty) jurisdiction to the jurisdiction where the base company is situated. The income earned in a jurisdiction can be channeled through a number of jurisdictions before it reaches the state of the base company, taking advantage of the treaty network to eliminate or reduce the potential high withholding taxes administered in the source state. Treaty shopping may also be employed to transfer the income from the base company to the state of residence of the shareholder, to benefit from lower withholding taxes, and any potential treaty based tax exemptions for certain income categories. A related and sometimes complementary strategy in such cases includes secondary sheltering; this involves remitting the income from the base company to another entity, in a different form, in order to take advantage of a tax exemption under domestic law or under a tax treaty.[56]

---

[54] See OECD, *supra* note 2 at 37.
[55] *Ibid.*
[56] *Ibid.*

Strategies employing base companies are generally regarded as abusive by the OECD and most OECD member countries.[57] However, an analysis of strategies employing base companies is not directly relevant to the study of treaty shopping and whether treaty shopping constitutes an abuse of tax conventions. Base companies are employed by residents to escape domestic taxation on foreign source income in countries that administer taxation on their residents' worldwide income, and do not, as a result, directly concern the tax advantages that may be properly or improperly secured under the tax treaty regime. As a result the various uses of base companies, both legitimate and illegitimate, will not be explored further in this chapter.

Treaty shopping may also make use of a tax haven entity as depicted in the fourth example below.

> 4. A tax haven company plans to invest funds by means of a loan in a high tax state, State A. The tax haven company may in turn be set up by a company resident in a high tax jurisdiction. The funds are channeled through a company set up for this purpose in another high tax state, State B. In other words, the tax haven company lends the funds to the State B entity. The company in turn lends the funds to a corporation it has set up in State A and receives interest from State A. It pays interest to the tax haven company at a close to equivalent rate. State A levies a withholding tax on interest which is reduced to zero under the tax convention between States A and B. State B does not levy withholding taxes on interest under its domestic law. The company resident in State B is also subject to an insignificant tax liability (the result of tax levied on the small portion of the income remaining). This is an example of both a back to back loan and a stepping stone structure. As a variation of this example, assuming State B is not a high tax state, the intermediary corporation in State B, may issue a dividend of a virtually similar monetary value, to the non-resident parent corporation, in order to take advantage of more favorable tax benefits. The dividend income may be exempt from taxation in the non-treaty state, in addition to being subject to a low withholding tax rate under the domestic law of State B.

---

[57] Base companies, situated in non-treaty jurisdictions may also be employed to obscure the character of income-related transactions, as a result of the fact that information regarding the entity's affairs may be difficult to obtain, in the absence of a treaty based exchange of information mechanism. For a discussion of legitimate and illegitimate tax avoidance strategies employing base companies. See *ibid.* at 62-66.

In order to prevent the erosion of the corporate income base, some countries have implemented thin capitalization rules under their tax treaties or under domestic law to protect their tax base and limit the extent to which interest deductions will be permitted in respect of payments made by a corporate or non-corporate entity to a non-resident person.[58]

Treaty shoppers may also generate a double tax exemption by exploiting the interaction of treaty rules under a tax convention and the domestic tax laws in each treaty jurisdiction and the discrepancies between state tax regimes. I turn to an example from Weeghel's treatise on improper tax treaty uses as an illustration.[59] The case concerns a finance company resident in a third state, which sets up a conglomerate structure in the Netherlands to trigger the application and benefit of the Netherlands-US tax convention in the form of a withholding tax exemption on interest income. The tax planning arrangements also take advantage of the different corporate tax laws applicable in the Netherlands and the US in order to avoid the application of an anti-treaty shopping or limitation of benefits provision under the convention. The object of the anti-treaty abuse provision is to prevent the stripping of an entity's income base as a strategy designed to avoid taxation in the treaty state. This is an example of a back-to-back loan scheme, which is, as a general practice, sanctioned by OECD countries.

5. A finance company (the foreign parent), resident State X, conducts its financing operations in the US through an intermediary structure, comprised of a two entities, both resident in the Netherlands. The intermediary structure (or two tier structure) is comprised of two entities organized as follows: The first entity is set up by the foreign parent, a resident of state X, with a debt investment. The newly established entity (first-tier entity) creates a wholly

[58] A detailed description of the measures employed to prevent income stripping is beyond the scope of this analysis .For an example of domestic and treaty-based anti-avoidance measures to prevent thin capitalization or the stripping of an entity's income base. See Shelton, *supra* note 37 at 528-530.
[59] See Weeghel, *supra note* 2 at 130.

owned company (the second entity), financed with equity. The second entity carries out an investment business in the US. It loans funds to the US subsidiary, collects interest payments, and issues dividends of an equal or substantially equivalent amount to the first-tier entity. The first conduit entity remits interest income to the foreign parent (the treaty shopper). The interest income generated in the US and paid to the second conduit is exempt from withholding tax under the Netherlands-US tax convention. The limitation of benefits provision under the convention does not apply to deny the withholding tax exemption because the second-tier company is not under a legal obligation to remit income (generated in the other treaty state) to an entity or person resident in a third state.[60] The conglomerate structure is known as a "fiscal unity" under Netherlands law and is taxed as a single entity; the interest income received by the second entity is set off against the interest payments issued by the first conduit to the foreign parent or treaty shopper to generate a double tax exemption.

Weeghel refers to this case as a disguised back to back loan scheme, created by interposing a second conduit entity or what he refers to as "an equity wall" between the conduit entity, carrying out operations in the source state, and the foreign parent. Had the first tier entity loaned the funds directly to the US subsidiary the limitation of benefits provision would have applied to deny the conferral of interest relief on the income payments under the treaty.[61] Weeghel notes that while there may be valid business reasons for setting up a finance company in the Netherlands that the use of the two-tier entity is primarily tax driven, designed to avoid the payment of US withholding taxes.[62]

[60] A limitation of benefits provision under the treaty denies the withholding tax exemption on interest income if the income is remitted to an entity or person resident in the other treaty state, unless the person or entity exercises "complete dominion and control" over the income item. This condition is breached if the income recipient is legally obligated to remit interest under a back-to-back loan or stepping stone arrangement to a non-resident person. *Ibid.*
Another method that might be employed to avoid the application of the limitation of benefits provision above, is to issue a hybrid debt instrument that mimics an equity investment tool but that preserves the standard characteristics of a debt instrument, resulting in the periodic payment of income to the non-resident. The use of derivative instruments will not be explored in this paper. *Ibid.* at 149-151 for an example employing hybrid debt instruments, also referred to as a type of derivative instrument. The payments of interest on this type of debt instrument would be contingent on the profit of the subsidiary and would function to reduce the potential dividend distributions.
[61] *Ibid.* at 130.
[62] *Ibid.*

A resident of a treaty jurisdiction may also employ treaty shopping to avoid the disclosure of information pursuant to a provision under the tax treaty between the state of residence of the treaty shopper and the source jurisdiction. Both treaty instruments (i.e. the treaty between the state of source and the state of residence of the conduit, and the treaty between the state of residence of the treaty shopper and the source jurisdiction) may, in such cases, offer equal protection. The treaty shopper is ensuring that the disclosure of information relating to the economic activities undertaken in the source state is governed by the treaty between the state of the conduit entity and the source state, depriving the state of residence of information that may be required to properly assess the tax liability in respect of the resident's foreign source income.

In addition, a treaty shopper may employ a conduit entity for the primary or sole purpose of transforming an income item into another (i.e. transforming interest into dividend income), and obtaining a tax exemption or incurring low taxation in the taxpayer's state of residence once the income is remitted to the treaty shopper. As an illustration, an entity resident in a treaty state that generates interest income may remit a dividend payment to a conduit entity set up by the treaty shopper and resident in another treaty jurisdiction. The jurisdiction in which the income generating activities are situated does not have a treaty with the state of the treaty shopper. The first mentioned entity is a wholly owned subsidiary of the conduit corporation, established by means of an equity investment. The dividend payment remitted is subject to a low or a zero withholding tax rate under the applicable tax convention between the two states. The conduit entity may then issue a dividend to the treaty shopper, which is subject to a low withholding tax rate under domestic law or as a result of the application of the tax treaty between the state of the conduit and the state of the treaty shopper. The treaty shopper may also be resident in a jurisdiction that exempts dividend income from taxation.

In analyzing the above noted examples the OECD report cautions that any income accruing from bona fide activities or transactions should receive protection under the applicable tax conventions.[63] The report gives the example of an operating subsidiary, resident in treaty state A, that develops a patent in connection with its production activities in treaty state B. The subsidiary's parent company is resident in State X, a non-treaty jurisdiction. The report notes that a tax exemption under the treaty between states A & B, in respect of any income generated in state B by the operating subsidiary, from the licensing of patent rights (i.e. royalty income), should not be denied because the subsidiary's parent company is resident in a non-treaty jurisdiction. In any event, this is not an example of a treaty shopping case, which would involve the use of conduit entities, lacking an economic purpose, for the sole or main purpose of securing benefits under the tax treaty regime.

IV The case against treaty shopping

i. The traditional case against treaty shopping and its shortcomings

The rationale for the anti-treaty shopping position of the OECD Committee on Fiscal Affairs, and OECD member states, consists of three arguments, reproduced from the OECD's study on tax avoidance and evasion. The OECD relies primarily on the

[63] This reference excludes example 5, which is reproduced from Weeghel's text on improper treaty uses. See Weeghel, *supra* note 2 at 130.

general propositions noted below to argue that treaty shopping constitutes an improper use of tax treaties. [64] Treaty shopping is considered undesirable on the grounds that:

1. The treaty benefits negotiated between the two treaty states are extended to persons resident in a third state in a manner unintended by the contracting states, in violation of the treaty notion of reciprocity;[65]

2. Little or no taxation of income may result, contrary to the intentions of the contracting states; and finally

3. The state of residence of the treaty shopper will be discouraged from negotiating a treaty with the source country, as a result of the opportunity to derive benefits under the prevailing treaty regime.

These concerns, on their own or taken together, are either invalid or insufficient to conclude that treaty shopping constitutes an improper treaty use. Weeghel also rejects these general principles. He argues that treaty abuse occurs if treaty shopping is contrary to the intentions, general expectations and policy objectives of the treaty states and the primary object of the tax plan was to secure treaty relief.[66] The shortcomings of Weeghel's analysis and his response to the traditional case against treaty shopping are also explored in this section.

A. A breach of the reciprocity principle

The first argument claims that treaty shopping constitutes a breach of the treaty principle of reciprocity, resulting in a different balance of sacrifices by the treaty states then the respective states have agreed to assume under their tax treaties. I do not accept

---

[64] The OECD Committee on Fiscal Affairs regards these concerns as highly relevant in determining the circumstances in which treaty benefits should be denied and which provisions should be included in bilateral treaties or recommended in amendments to the OECD model tax convention. See OECD, *supra* note 2 at 90.

[65] It is expressly noted in the report of the OECD Committee on Fiscal Affairs elaborates that the principle of reciprocity is breached because "the treaty benefits negotiated between two states are economically extended to persons resident in a third state in a way unintended by the contracting states." *Ibid.*

[66] The tax minimization objective, both in the treaty shopping context and in other tax planning cases is always presumed by domestic tax authorities, based on the character and nature of the taxpayer's legal arrangements. See Weeghel, *supra* note 2 at 117.

that treaty shopping constitutes a breach of the reciprocity principle in the manner proposed by the OECD Committee on Fiscal Affairs in their report. The reciprocity principle has a bilateral scope and reflects the treaty obligations assumed between the treaty partners under a tax treaty. The principle reflects the agreement between the treaty partners that the benefits under a tax convention will be conferred to residents of both treaty states in equal measure and on equal terms, or as a result of the application of equivalent standards.

Treaty shopping, on the other hand, secures treaty benefits for residents of a third state, but does not affect the allocation of taxing rights and the obligation assumed under a tax convention between the treaty partners. The legitimacy of this tax avoidance practice is challenged because the jurisdiction of the treaty shopper does not assume any reciprocal obligations towards the treaty states and their residents in exchange for the benefits secured by its residents.[67] But based on what has already been stated, this criticism does not directly concern the treaty notion of reciprocity. The reciprocity principle can only be breached in cases where the state of residence of the treaty shopper has a treaty with the source jurisdiction. Only in these cases can it be argued that the balance of treaty benefits and concessions secured between the source jurisdiction and the state of the treaty shopper is breached, as residents in the latter state derive greater benefits under the treaty being shopped, without assuming further obligations under the treaty regime.

However, in defense of the traditional proposition, it may also be argued that reciprocity is breached in the treaty shopping context, because the concessions granted

[67] Nonetheless, Weeghel argues in his work that residents in the source state may also derive benefit under the treaty regime in the state of residence of the treaty shopper.

for the benefit of the treaty shopper are borne exclusively by the source state and are not shared equally between the treaty states. The weakness with this argument is that both treaty partners make concessions on source based taxes under the treaty regime on income earned in the jurisdiction and issued to foreign entities, or on investments channeled through a conduit entity resident in the other treaty state. As a result, both treaty partners are susceptible to the risks posed by treaty shoppers. As a result, I draw the conclusion that only treaty shopping carried out by entities in treaty countries violates the treaty principle of reciprocity.

By contrast, Weeghel accepts the general proposition that treaty shopping violates the treaty norm of reciprocity, but argues that the principle will not be breached in every case. He proposes that residents in the source state may also engage in treaty shopping and benefit under a treaty between the other treaty jurisdiction and the treaty shopping state or rather, the state of residence of the treaty shopper. This assumes that such a treaty exists and that it does not sanction the practice under an anti-treaty shopping provision. On the other hand, if the country of residence of the corporation does not have treaty relations with the third state, the investors may potentially benefit from lower withholding tax rates under domestic law.

As an illustration, Weeghel refers to the opportunities available to a US resident to carry out investments in the state of residence of the treaty shopper via conduit entities set up in the Netherlands.[68] It is assumed as well that the Netherlands is a desirable

[68] See Weeghel, *supra* note 2 at 122. For greater certainty, consider the case of a resident in state C who sets up a corporation in the Netherlands, which in turn conducts operations in the US through a subsidiary. This is the case of the primary treaty shopper who seeks the benefit of the US Netherlands tax convention. In the opposite direction, US residents set up a corporation in the Netherlands to trigger the application of the tax treaty between the Netherlands and state C, benefiting from the treaty based withholding tax regime on any income generated in that state and remitted to the treaty shopper.

jurisdiction to invest in for the residents concerned. While this will not always be the case, US residents may use the same strategy to carry out operations in other countries and benefit under the tax treaties between the Netherlands and the other jurisdictions.

The intermediary corporation may also be used as a vehicle to accumulate income generated in other jurisdictions, allowing the taxpayer the advantage of any unused foreign tax credits if the home state permits the averaging of the tax rates incurred in other countries.[69]

Weeghel also concludes that treaty shopping can constitute a legitimate alternative to a multilateral tax convention, as a tool to circumvent the limited reach and scope of the bilateral treaty regime. He regards treaty shopping as a potential self-help measure for taxpayers with legitimate economic interests in non-treaty countries to avoid double taxation and the distortions in investment flows, created by the dissimilarities between national tax systems.[70] Treaty shopping between existing treaty states also has the effect of extending the application of treaty practice or policies that treaty residents consider more beneficial, a result that could only be achieved under a multilateral tax treaty. The problem with this view is that it cannot be presumed that the treaty states themselves desire to conclude treaties with countries which their residents find desirable to invest in, or, in the alternative, prefer a multilateral to a bilateral treaty solution. Furthermore, treaty shopping results in severe revenue losses for both the residence and the source state. As a result, countries will, as a general rule, be reluctant to conclude

[69] Under a tax credit regime, residents are only permitted to credit against domestic taxes the foreign tax paid, in so far as the foreign taxes do not exceed the domestic tax liability on the income. If tax rates are higher in a foreign country, the resident will not receive a refund of the taxes paid. Under the Internal Revenue Code, a US resident can average together the foreign tax rate levels from different countries, enabling the taxpayer to use up any potential foreign tax credit limits. See Graetz, *supra* note 1 at 137-139.
[70] See Weeghel, *supra* note 2 at 122-23.

treaties in order to extend uniform tax relief measures to all countries, a result that a multilateral treaty solution would impose.[71] Some states could also be reluctant to negotiate treaties with certain low tax jurisdictions, which could facilitate the cross-border flight of taxable income sources.[72] While states do conclude tax treaties with countries that condone treaty shopping through the conferral of preferential tax treatment to conduit entities, the treaties may include provisions to limit the application of the tax relief provisions to exclude the beneficiaries of preferential tax policies.[73]

Weeghel also argues that treaty partners may tolerate treaty shopping even if it results in an imbalance of sacrifices.[74] He is suggesting rather, that contracting states may agree not to be bound by the treaty norm of reciprocity in all cases or with respect to certain tax treaty practices. In other words, some states may tacitly permit third state residents to derive benefits under that country's tax treaty network. Moreover, while the source state may not have been cognizant of the opportunities available to treaty shoppers when the treaty was concluded, it may have developed an active interest in condoning the practice in an effort to encourage foreign investment. Some jurisdictions may also tolerate treaty shopping under their tax treaties, so as not to encourage other treaty states to adopt anti-abuse measures that would limit the opportunities available to its own residents to engage in similar practices while pursuing income earning activities in foreign markets. In this respect, Weeghel is essentially reiterating his principal argument that treaty shopping cannot constitute an improper treaty use if both treaty states tolerate

---

[71] Simone M. Haug, "The United States Policy of Stringent Anti-Treaty Shopping: a comparative analysis" (1996) 29 Vand. J. Transnat'l L. 191, 195-220 (1996) at 139.
[72] See OECD, *supra* note 2 at 94-5.
[73] *Ibid.*
[74] See Weeghel, *supra* note 2 at 123.

the practice. If we accept this proposition, the only task that remains is to properly construe the intentions of the treaty partners and determine whether the treaty states do in fact condone certain tax planning practices.

I criticize Weeghel's approach for failing to distinguish between the general principles binding states under a tax treaty, and the general expectations of the treaty states, and the policies that states are willing to pursue outside the context of the treaty regime. States may very well pursue treaty policies that are contrary to their obligations or the principles reflected under the provisions of a tax convention with other countries. As a result, the practices that treaty states may or may not tolerate can be irrelevant to the issue whether a particular treaty use is abusive or contrary to the principles binding on states under a convention. In any event, I conclude that the principle of reciprocity has a very narrow scope and cannot be relied on to support the general conclusion that treaty shopping involving non-treaty states is an illegitimate practice.

B. Evading the normal taxing powers of the treaty state.

Another negative aspect associated with treaty shopping is the potential outcome that the income remitted to the treaty shopper may not be taxed in either treaty state, or be taxed at a very low rate, escaping the normal tax jurisdiction of the states concerned. Example five in part III of this chapter described a treaty shopping scenario that results in a double tax exemption. As noted in the OECD report on tax avoidance and evasion that "the income flowing internationally may be exempted from taxation altogether. The report also claims that the income may be subject to inadequate taxation in a way unintended by the contracting states.[75] Treaty shopping engaged for these purposes is

[75] See OECD, *supra* note 2 at 90.

perceived as an improper treaty use.[76] It is argued further in the OECD report that the granting by countries of treaty benefits is based, except in special circumstances, on the fact that the respective income is taxed in the other state or that it falls under the normal tax regime of the other treaty jurisdiction.[77] This perspective embraces the notion of a single tax principle which has also been depicted as a corollary of the principle against double taxation.[78] This is also a proposition that I have rejected in Chapter 1.[79]

It is fair to say that countries generally agree to cede tax jurisdiction under a tax treaty, on the expectation that the income will be taxed in the other treaty state, and further, that it will be taxed at rates comparable to those administered domestically. Nonetheless, it is not an objective of tax treaties to ensure that income exempted from tax in one treaty state is taxed in the other treaty jurisdiction. As a result, countries may legitimately exempt from taxation income they are exclusively entitled to tax under a tax convention. The decision to tax or to tax at an incentive rate remains the prerogative of states under the treaty regime.[80]

Weeghel also argues that there is a general assumption underpinning all tax treaties based on the OECD model tax convention, that income will be taxed once.

---

[76] *Ibid.*

[77] *Ibid.* This proposition has been depicted as the rationale for Canada's anti-treaty shopping position. In reference to treaty shopping under the Canada-US tax treaty Justice Iacobucci, delivering the judgment of the Supreme Court of Canada in *Crown Forest* states: "enterprises could route their income through particular states in order to avail themselves of benefits that were designed to be given only to residents of the contracting states. This result would be patently contrary to the basis on which Canada ceded it jurisdiction to tax as the source country, namely that the US as the resident country would tax the income." See *Crown Forest*, *supra* note 20 at 48.

[78] See Reuven Avi Yonah, "Commentary" (2000) 53 Tax L.Rev. 167.

[79] The nature of the bilateral treaty regime and the framework of treaty rules do not support the notion of a single tax principle. Please turn to Part V in Chapter 2 for a discussion of the single tax principle.

[80] As I argue in Chapter 2, a party to a convention that implements a tax exemption regime, has also accepted the possibility that any income item exempted may not be taxed in the other treaty country. This flows from the structure of the treaty regime which does not levy taxation and does not impose an obligation on a treaty states to tax income exempted in the other jurisdiction. See also Weeghel, *supra* note 2 at 107.

However, Weeghel concludes that a taxpayer, who takes advantage of tax laws under a tax regime to secure a double tax exemption under a tax convention, may not necessarily be engaging in an improper treaty use, depending whether or not the practice is sanctioned by the treaty countries.[81] Weeghel was able to conclude in his analysis that the tax planning scheme examined in example 5 in Part III of this chapter, which resulted in a double tax exemption, did not violate a treaty principle or result in a misuse of the treaty instrument. As such, Weeghel departs from the more forceful pronouncement that the notion of single taxation is a treaty principle, on the same par as the principle against double taxation.

This traditional objection against treaty shopping also refers to tax results that are not in accordance with the normal laws of the treaty states. This seems to suggest that treaty shopping can interfere with the normal exercise of states' tax powers, or the application of normal rates of taxation in a treaty state. This implication is faulty. The tax treaty regime might limit but it does not govern the exercise of tax rights; the regime merely prescribes how tax rights will be shared between the treaty partners.

In the treaty shopping context, whether an item of income remitted to a non-resident is deductible or otherwise taxable in the treaty state is a matter determined in accordance with domestic law. In cases where taxpayers resort to abusive tax practices to avoid taxation under domestic law, whether or not taxpayers achieve the tax results sought will also be determined in accordance with domestic legal rules or principles. As an example, some states may apply thin capitalization rules to limit the deductions that may be claimed on interest income remitted by a conduit entity to a non-resident entity, and avoid the stripping of the entity's income base. In an effort to avoid this restriction,

[81] *Ibid.*

the income may be channeled in various forms through a series of intermediary entities to disguise the identity of the ultimate recipient and avoid the applicable deduction limits. If the taxpayer's scheme is judged to be abusive under domestic law, the tax treatment sought may be denied and the income taxed in the treaty state.[82] Some states may not apply a general anti-avoidance rule or principle and will, as a result, regard as legitimate any tax plan that complies with the letter of the law. However, it cannot be concluded under either scenario that the tax planner's affairs were not dealt with in accordance with the normal tax laws of the treaty state concerned. The proposition that treaty shopping constitutes an improper treaty use, cannot as such, be based on the absence of taxation or the nature of the tax liability incurred in a treaty state.

In many cases, the manner in which the taxpayer's legal arrangements are construed by domestic authorities will determine whether the tax plan satisfies the conditions for triggering relief under the applicable tax convention. Ironically, the application of domestic anti-abuse rules, or substance over form rule will generally result in the denial of treaty relief, avoiding a misapplication of the benefits provision under the treaty concerned. A judgment rendered by the US Tax Court in *Aiken Industries* provides a good illustration.[83] The facts of the case concerned money loaned by an Ecuador company to a Honduras company which loaned an equivalent or substantially equal amount to a US corporation. There is no tax treaty between Ecuador and the US. As a result, the Ecuadorian shareholder sought to trigger treaty relief under the US Honduras

---

[82] The domestic regime may apply a substance over form doctrine or apply a principle of abuse of rights to disregard particular steps in a series of transactions, deemed artificial or lacking a business purpose. In such cases the taxpayer's arrangements will be re-characterized for tax purposes to correspond with their economic substance. In the case at bar, fiscal authorities may conclude that the income was in substance received by the non-resident and administer the appropriate deduction limits. See Goyette, *supra* note 9 at 11-13. The manner in which domestic authorities characterize taxpayers' legal arrangements also applies for tax treaty purposes. For a brief discussion of domestic abuse principles turn to Part II of Chapter 3.
[83] See *Aiken Industries v. Commissioner*, (1971) 56 T.C. 925. See also Vogel, *supra* note 2 at 123-4.

tax convention. The issue was whether the tax convention applied to limit source taxation in the US on interest payments remitted to the Honduran entity. The US Tax Court, employing a substance over form interpretation of the relevant treaty provision, held that the income was in substance "received by" the Ecuadorian and not the Honduran company, disregarding the legal form of the taxpayer's arrangements and denying the treaty benefits.[84] As a result, the application of domestic anti-abuse principles may very well preclude or prevent an abuse of the applicable treaty instrument.

C. The impact of treat shopping on the negotiation and the renegotiation of tax treaties.

A third criticism levied against treaty shopping is that it jeopardizes the expansion of the bilateral tax treaty regime. Countries will be reluctant to conclude treaties with other states and grant tax concessions in exchange for benefits that its residents can secure through treaty shopping. The view expressed by the OECD is that the state of residence of the ultimate income beneficiary has little incentive to enter into a treaty with the country of source, if the residents of that state can indirectly receive treaty benefits in the other jurisdiction without the need to provide reciprocal benefits.[85] Despite the disincentive treaty shopping might pose, many countries have agreed to conclude treaties with other treaty countries in an effort to establish closer diplomatic ties and for the purpose of administering an exchange of information arrangement with a view to combating tax evasion. In addition, as previously stated, it cannot be assumed that

[84] The relevant treaty provision is Article IX of the US-Honduras tax treaty provides: " Interest on bonds, securities, ..., or any other form of indebtedness from sources within one of the contracting states *received by* a resident, corporation or other entity of the other contracting state not having a permanent establishment within the former State, ..., which such interest is received, shall be exempt from tax by such former state." See Weeghel, *supra* note 2 at 60, 59-61.
[85] See OECD, *supra* note 2 at 90.

existing treaty states want to conclude tax treaties with all countries or, alternatively that that states want to conclude tax treaties, based on the OECD model convention, with all states. The OECD model was designed for countries and by representatives from countries with comparable tax regimes, similar fiscal policies and foreign investment objectives.[86] As a result, it is reasonable that countries which have adopted tax treaties based on the OECD model convention, may not want to extend the same treaty benefits, available for residents with economic interests in other OECD member states, under existing tax treaties, to residents from other countries. Indeed, tax treaties are concluded between high tax jurisdictions and certain tax havens, or between countries with disparate tax regimes but such treaties are likely to incorporate different provisions and treaty policies and may be implemented for different main purposes, such as combating tax evasion.[87]

In reality treaty shopping may create a stronger disincentive for existing treaty states to renegotiate tax treaties with the jurisdictions targeted by treaty shoppers resident in the former state.[88] As an alternative, states may have the option of inserting anti-treaty shopping clauses under tax treaties that are or may be employed by treaty shoppers.

Stef van Weeghel also emphasis in his text that the counter measures to treaty shopping may jeopardize the uniformity of tax conventions, with states adopting anti-treaty shopping provisions that depart from the model language of the OECD tax

[86] See Shelton, *supra* note 40 at 109-110.
[87] Countries have concluded tax treaties with some tax haven jurisdictions for the main purpose of implementing exchange of information, tax collection and law enforcement arrangements. As to the concept of a tax haven, it is a relative one; any state can garner the label depending on the tax policies they administer. Countries which offer preferential tax policies for a limited number of tax subjects or with respect to particular industry segments are referred to as states administering preferential tax regimes as opposed to tax havens, although the impact posed on capital flows and the tax revenue base of high tax jurisdictions, may be similar. See OECD, *supra* note 2 at 94-95.
[88] See Weeghel, *supra* note 2 at 123.

convention.[89] States may also be prompted to end treaty relations while refraining from concluding other treaties, limiting the reach and expansion of the tax treaty network, in an effort to reduce the risk of treaty shopping.[90] Weeghel also notes that although treaty shopping may not constitute an improper treaty practice, ironically, the threat posed to the existence and uniformity of tax treaties regime may interfere with the rationale for the avoidance of double taxation, to promote the international exchange of goods and capital.[91] The impact that treaty shopping may have on the conclusion of new or the breadth of the existing treaty network is indeed, a tenuous basis to conclude that treaty shopping may violate a principal purpose of the treaty regime.[92] In any event these considerations fail to offer an explanation why treaty shopping constitutes a misuse of tax conventions or how and why it results in the improper application of a tax treaty. As a result, the debate in this context is not very helpful in unraveling a concept of tax treaty abuse.

ii. Treaty shopping violates the rationale for the allocation of taxing rights under a tax treaty.

There is a more fundamental basis to argue that treaty shopping constitutes an abuse of the tax treaty regime. I contend that tax treaties are misused in cases where the conduit entity employed by the treaty shopper does not have a real economic presence in the treaty state where it was created. As a practical matter, differences in opinion between treaty states, with regard to the legitimacy of particular treaty uses in the tax planning context, usually revolve around different opinions regarding the presence or absence of a

---

[89] *Ibid.*
[90] *Ibid.* at 123.
[91] *Ibid.*
[92] *Ibid.*

legitimate economic rationale for the subject's treaty arrangements.[93] The absence of an economic presence, a prevailing feature of most of the treaty shopping examples considered in this chapter, violates the rationale for the assignment of taxing rights under the tax treaty regime. As I argued in Chapter I the assignment of tax jurisdiction under the bilateral tax treaty regime is intended to reflect the treaty subject's economic allegiance or economic connection to the taxing jurisdiction.[94] This remains the case even if the treaty regime is not capable of fully reflecting a treaty subject's economic affiliations, due in part to the limited measures of economic nexus denoted by the principles of residence and source.

The tax treaty regime grants more extensive taxing rights to the state of residence on the premise that residents have stronger economic ties to their home jurisdictions, despite the commercial activities carried out in other treaty jurisdictions.[95] One rationale for this is that the public or private infrastructure in the state of the investing entity has developed or contributed to the resources invested in the source state. At the same time, it should not be overlooked that another rationale for the implementation of the bilateral tax treaty framework is to simplify the international tax system and to minimize the administrative and compliance burden borne by foreign investors. [96] Nonetheless, states

---

[93] *Ibid* at 163-190.

[94] A US Appeal Circuit Court adopted a similar approach in resolving a dispute over the conferral of treaty benefits under the US-Switzerland tax treaty. The Court comments that the basic treaty mechanism involves establishing standards to determine the single most appropriate locus for the taxation of any given transaction. While the Court acknowledges that some treaty provisions are inevitably the result of political compromise, it accepted that the dominant criterion for determining the appropriate taxing locus is economic impact. The treaty rule that was applied to resolve the dispute concerned the taxation of income from services in the jurisdiction where the services are rendered. See *United States v. Johansson*, (1964) (5th Cir.) 336 F.2d 809.

[95] Please turn to Chapter 2 for a discussion of the structural character of the tax treaty regime and its objectives.

[96] Withholding taxes are reduced to minimize the administrative and tax burden on foreign residents conducting business in the source state. Please refer to chapter 2 for a more thorough discussion of the economic rationale governing the allocation of taxing rights under the treaty regime.

also concede tax rights on the premise that a treaty subject has stronger economic ties in the other treaty state and that accordingly the other jurisdiction has a stronger claim to the treaty subject's income.[97] This rationale provides a justification for the general view shared by states and reflected under the commentary to the OECD model convention that the use of artificial legal entities or constructions solely for the purpose of acquiring treaty benefits is inappropriate.[98] From this basis it can be argued further that all the activities conducted in a treaty jurisdiction should have an economic or business purpose or rationale to legitimately entitle a treaty subject to the benefits of the treaty regime. This is particularly so if all the steps or maneuvers employed are essential to entitle a subject to benefits pursuant to the conditions under a tax convention.

To better illustrate these propositions, I will return to the treaty shopping case examined earlier, involving a financing conglomerate in the Netherlands with investment operations in the United States.[99] In this example, the interest income generated in the US was exempted from taxation under the relevant provision of the US-Netherlands tax treaty. [100] A principal reason for locating the financing operations in the Netherlands was to take advantage of the withholding tax reductions on interest income under the applicable tax convention. The strategy also enabled the foreign parent to avoid the application of the limitation of benefits provision under the convention, which would otherwise have disentitled the US subsidiary from claiming interest relief under the

[97] Peggy B. Musgrave, *Tax policy in the Global Economy* (Cheltenham, UK; Northampton, MA, USA: Edward Elgar Publishing Ltd., 2002) at 363-4. [Musgrave].
[98] See OECD, *supra* note 2 at 20-1.
[99] This case is discussed in example 5 in part III of this chapter at pages 21-3. See also Weeghel, *supra* note 2 at 130.
[100] If we recall, the Netherlands intermediary structure was comprised of an entity funded by the third state parent company with debt, and a second entity, set up by the first intermediary company, and funded with equity. The second entity loaned the funds to the US subsidiary, supporting the investments business in the US. The second tier entity then collected interest payments and issued a dividend of a substantially equivalent amount to the first-tier entity, which in turn remitted interest income to the foreign parent. *Ibid.*

treaty.[101] This tax planning scenario was not regarded by US fiscal authorities as giving rise to an improper use of the US-Netherlands tax convention.

According to the economic substance analysis above, the conglomerate should have a legitimate economic presence in the jurisdiction, and in this case, be shown to conduct legitimate financing operations in the Netherlands, to benefit from any reduction of taxes under the treaty. A legitimate business purpose for setting up an operation in the Netherlands is to take advantage of a more liberal financial regulatory regime. It is difficult to conclude on the facts of this case that there were no legitimate financial operations conducted in the Netherlands. The foreign parent company was an investment company with active business interests in other markets, while the two Netherlands corporations were legitimate finance companies capable of carrying out independent operations domestically or abroad.[102] While a principal rationale for situating the financing operations in the Netherlands was to trigger the application of a favorable tax convention, the case does not run contrary to the economic rationale justifying the allocation of taxing rights and the conferral of tax benefits in favor of the residence state under a tax convention.

As a practical matter domestic fiscal authorities, in determining whether tax treaty benefits are properly conferred, consider, as a matter of course, whether a conduit entity has a sufficient economic presence in the relevant treaty jurisdiction. US tax authorities, for example, will consider whether there is a sufficient business or economic purpose to overcome the conduit nature of a transaction or series of transactions to properly entitle a

[101] The treaty subject also generated a double exemption as a result of the fiscal unity rules under Netherlands tax law and their interaction with the relevant provisions under the tax treaty. *Ibid.*
[102] *Ibid.*

conduit to relief under the applicable convention.[103] If there is not, US authorities apply the substance over form doctrine, disregarding the taxpayer's legal arrangements for both domestic tax and tax treaty purposes.[104] Some countries have shown a tendency to regard a minimal economic contact as sufficient to legitimately entitle a subject to benefits under both domestic law and under the treaty regime.[105] This raises the issue how significant an economic presence an entity must establish in a treaty state, or rather what constitutes a sufficient economic presence in a treaty jurisdiction for an entity to be legitimately entitled to the benefits under a tax convention. Judging from the tax planning examples considered in this study, it can be relatively easy for foreign subjects to establish some economic ties in a treaty jurisdiction or to demonstrate a commercial purpose for their arrangements in another treaty state.[106] Many entities employed for treaty shopping purposes will generally have some economic presence in the relevant treaty jurisdiction.[107]

Tax treaties do not address this issue directly. The tax treaty regime is primarily concerned with the allocation of tax rights in favor of jurisdictions that have the stronger economic claim to income. On this basis, it may be argued that if a resident of a treaty state does not have more extensive economic ties in the state of residence, that there is no longer a legitimate basis for the source state to concede tax rights on the particular facts

[103]As an example of the application of the economic purpose standard by fiscal authorities in the US, consider the case involving Eurobond and real estate investments carried out in the US via a conduit entity located in the Netherlands-Antilles, set up to trigger the benefits under the former US-Netherlands Antilles tax treaty [no longer in force]. The US fiscal authorities had determined that the conduit entities employed for this purpose lacked a sufficient and independent economic purpose and where as a result not property entitled to withholding tax relief under the treaty. See Weeghel, *supra* note 2 at 114-15.

[104] *Ibid* at 163-172. This part of Weeghel's text discuses the application by states of the doctrine of substance over form, in evaluating whether tax subjects are legitimately entitled to claim relief under a tax convention.

[105] *Ibid* at 178-190.

[106] *Ibid* at 125-140.

[107] *Ibid* at 108-116

concerned. Nonetheless, this proposition does not help us identify the criteria that could be applied to determine which jurisdiction has a stronger claim to income in a particular case. In addition, none of the sources and reports of the League of Nations organizations or of the OECD, considered in this study are very helpful in addressing this issue. As a result, this remains a determination for domestic authorities to make with exclusive reference to domestic legal principles. The experience of countries with the application of the substance over form doctrines or anti-abuse principles has shown that the determination of what constitutes a sufficient economic presence in a treaty state, is an arbitrary one.[108] Therefore, as a practical matter, it is to be expected that domestic authorities in different states will apply different standards and reach different conclusions on this point. While this reality may not be satisfactory for those who favor certainty for taxpayers in the resolution of fiscal matters irrespective of the jurisdiction in which the income generating activities are situated, the tax treaty regime was not introduced to replace or harmonize domestic fiscal laws, or to ensure predictability of fiscal results, but rather to offer a model that states can adopt and adapt to simplify the taxation of international income and the taxation of non-residents and to avoid or alleviate the tax burden placed on economic actors as a result of overlapping domestic tax jurisdictions.[109]

Planning to circumvent the application of anti-treaty shopping provisions

A principal issue raised on the facts this tax planning case is whether the use of the two tier corporate structure, to avoid the application of the anti-treaty shopping provision leads to an improper application of the convention. This is despite the entities'

---

[108] *Ibid.*

[109] See *OECD Tax Convention*, supra note 15 at 14.

legitimate commercial presence in the jurisdiction. The limitation of benefits provision provides that treaty relief will only be granted to entities that exercise "complete dominion and control" over income received from an entity resident in the source state.[110] The treaty instrument was intended to deny treaty relief for entities employed in a stepping stone strategy or a back to back loan scheme resulting in the stripping of an intermediary entity's income base.[111] But for the presence of the second tier company, as an independent legal entity, the limitation of benefits provision under the convention would have disentitled the Netherlands' intermediary company from the reduction of US withholding taxes in respect of the entity's US lending activities. It can be argued that, in effect, such a scheme nullifies the utility of the limitation of benefits provision, considering that other foreign corporations can adopt a similar strategy to avoid its application and that, accordingly, this cannot be consistent with the spirit of the provision and the intentions of the contracting states. Nonetheless, the fiscal authorities in the jurisdiction impacted by the strategy concluded that this tax planning strategy did not result in a misuse of the limitation of benefits provision or of the treaty instrument.

The US authorities, applying a substance over form analysis, focused on the second conduit company, and determined that, devoid of any debt obligations, the entity had the capacity to exercise "complete control" over its income resources, and that, as a result, it was entitled to claim the interest exemption under the tax treaty.[112] US law respects the separate legal status of all entities for tax purposes and does not consolidate the income

---

[110] Please turn to the discussion in Part III of this chapter.

[111] See Part II of this chapter and the mechanics of treaty shopping for a description of the stepping stone strategy.

[112] The US fiscal authorities may have reached the opposite conclusion had the second tier entity been indebted to the first corporation. See Weeghel, *supra* note 2 at 178-188 for a description of cases involving the application of the substance over form doctrine in the United States.

and expenses of related companies, unlike the legal approach adopted in the Netherlands. It is interesting to note that if a similar structure had been employed in the US, to reduce an entity's tax burden in the Netherlands, the Holland authorities would have denied relief under the treaty. The Holland authorities would treat the two entities as a single entity for tax purposes and conclude that the limitation of benefits provision disentitled the conglomerate from claiming an exemption under the treaty, as a result of the indebtedness of the conglomerate to a foreign entity.[113] As it was argued in the previous chapter, countries are legitimately entitled to apply domestic legal principles and anti-abuse principles to construe taxpayers' legal arrangements in administering the tax treaty regime.[114] This approach is consistent with Article 3(2) of the OECD model convention, which provides that any term that is not defined under the treaty shall be construed with reference to domestic law. The approach is also consistent with Article 31(4) of the *Vienna Convention* which permits states to have recourse to domestic law for purpose of construing a specialized term or a term with a meaning specific to fiscal law, that is not otherwise defined under a treaty.[115] As a result, the treaty regime does not purport to regulate all matters, and does leave gaps that states must in turn address with reference to and through the application of domestic legal standards. In applying domestic legal principles to construe a taxpayer's legal arrangements, individual states will determine whether a tax subject is legitimately entitled to claim benefits under domestic law and under the provisions of a tax convention, resulting in a reduction of source taxes.[116] It is

---

[113] This is evident based on Weeghel's description of the fiscal policies employed in the Netherlands. *Ibid.* at 108-111.
[114] See discussion in chapter 3, part iii, pages 12-3.
[115] This provision of the *Vienna Convention* is discussed in Part IV of this Chapter. See also Shelton, *supra* note 40 at 103-7.
[116] See discussion in Part II of chapter 3 at pages 43-7.

reasonable to conclude as a result, that the treaty regime, in effect, delegates to state authorities the task of determining whether a particular tax planning scheme designed to acquire benefits under the treaty regime is legitimate or whether it aims to misuse the benefit provisions under a treaty instrument. If a treaty state concludes that a foreign taxpayer, conducting income earning activities in its jurisdiction, has met the conditions for claiming tax treaty relief and accordingly reduces the subject's source tax liability, it cannot also be concluded that the treaty instrument was misused.[117]

Weeghel also draws the conclusion that the tax plan is legitimate. He argues, based on his analysis of the tax policies in both countries, that treaty shopping, employing direct conduits and stepping stone structures, is consistent with the fundamental and enduring expectation and policy objectives of both countries.[118] Weeghel notes in particular that the US and the Netherlands condone the benefits arising from the interaction of domestic tax law and the tax treaty regime and the fact that the Netherlands has not enacted laws to limit the use of two tier conduit structures as a treaty-shopping tool.[119] I also conclude that the US fiscal authorities did not intend for the limitation of benefits provision to deprive multinational corporations with legitimate or with the capacity to undertake commercial operations in the jurisdiction, of the benefits of the tax treaty regime. Such a strategy would run contrary to the economic measures pursued by the United States, which has been active in employing tax reduction measures or incentives for the benefit of particular corporations or industry segments and to

---

[117] It is also interesting to note that the application of substance over form doctrine to construe taxpayers' legal transactions is consistent with the approach to treaty construction mandated under the *Vienna Convention* which requires a broad and purposeful construction of treaty terms and provisions. The limitation of benefits provision considered in this section required that the treaty subject demonstrate "complete dominion and control" over an income receipt in order to qualify for treaty benefits. See *Vienna Convention, supra* note 6.
[118] Weeghel, *supra* note 2 at 108-111.
[119] *Ibid.* at 130.

encourage certain economic activities.[120] This is also confirmed by the structure and scope of the anti-tax avoidance measures under the US Model Tax Convention, which where designed to safeguard legitimate commercial interests and economic operations in the jurisdiction. The US employs the US Model Tax Convention, as opposed to the OECD Model Convention, as a primary tool for treaty negotiations with other countries.[121]

iii. A critique of Weeghel's approach to treaty analysis and treaty interpretation

In analyzing the standard treaty shopping cases Weeghel reiterates the general precept that the application of a treaty instrument must be consistent with the intentions of the treaty partners. According to Weeghel, if both treaty partners condone treaty shopping it is not necessary to consider or refer to the principles underpinning the OECD model tax treaty, to conclude that the practice is legitimate. Weeghel relies on the general expectations and policy objectives of the treaty partners as a basis to discern their treaty policies. He rejects the traditional objections raised towards treaty shopping as a result of what he perceives as a lack of consistency in the treaty policies and practices of the treaty states. Nonetheless, while both treaty partners may implicitly condone treaty shopping, the bilateral tax treaty regime was not designed to facilitate the practice. I have argued in this chapter that treaty shopping is contrary to the rationale underpinning the bilateral tax treaty network. Absent an affirmation by the treaty states, reflecting an express or implied agreement between the parties to the contrary, treaty shopping cannot be considered to be

[120] *Ibid.* at 108-119.
[121] See Part IV of this chapter and the discussion of anti-treaty shopping provisions under the *US Model Convention*. See also Graetz, *supra* note 1 at 141-144.

consistent with the object and purpose of a treaty instrument.[122] This is accordance with the provisions of the *Vienna Convention on the Law of Treaties*[123] which are reproduced and discussed later in this chapter.

The potential problem with Weeghel's approach in attempting to identify cases of treaty abuse is the degree of relevance he places on the intentions of the treaty states and the method he adopts in construing these intentions. Weeghel notes in his analysis that "tax treaties reflect the tax policy, and more specifically, the treaty policy in each state at the time a convention is concluded, and further that "elements of a country's tax treaty policy may be discerned from the content of the reservations to the provisions of the OECD model convention." [124] Weeghel implies, as a result, that the policies of the treaty partners evolve and that they probably cannot be discerned with strict or exclusive reference to the terms of the treaty instrument. He notes as well that the policy motives behind a tax convention are highly relevant in identifying cases of treaty abuse and relies on the external sources to construe these motives. However, a state's motives for concluding a treaty may bear no relationship to the nature and substance of the agreement between the contracting states or the content of the instrument's provisions. Weeghel's pronouncements confirm a departure from the prescriptions under the provisions of the *Vienna Convention* which denote the weight to be attributed to the treaty text and which govern precisely the external sources and the circumstances under which they may be consulted in construing the provisions of a treaty document and the intentions of the

[122]This is not to suggest that both states will reach the same conclusions with regard to the legitimacy of individual treaty uses. Each state has full autonomy to evaluate, based on the application of their own laws, the legitimacy of taxpayers' arrangements, and accordingly, to determine whether taxpayers merit tax concessions under the domestic regime as conferred under the provisions of a treaty instrument.
[123] See *Vienna Convention, supra* note 6.
[124] See Weeghel, *supra* note 2 at 107.

treaty states. It appears from the text of the *Vienna Convention* that the intentions of the contracting states are to be construed with strict reference to the provisions of a treaty instrument, with only a few limited exceptions.

A. The approach to treaty construction prescribed by the Vienna Convention

According to Article 31(1) of the *Vienna Convention* the text of the treaty is of primary importance in the interpretative process, which requires that treaties be interpreted in good faith, in accordance with the ordinary meaning of its terms and in light of its object and purpose.[125] Article 31(1) also provides that the ordinary meaning of a treaty term must be construed with reference to the context of the treaty as a whole. According to this provision under the *Vienna Convention* the intentions of the treaty partners are only important to the extent that they are expressed in the text of the treaty and in any documents or agreements made in connection with the conclusion of the treaty. Article 31(2) under the *Vienna Convention* provides that a treaty may be construed in reliance on any instrument concluded by one and accepted by both treaty states and denoting some aspect of their treaty relations. In particular, the provision stipulates that "the context for the purpose of treaty construction shall comprise, in addition to the text, its preamble and annexes, any agreement between the treaty partners which was made in connection with the conclusion of the treaty, or any instrument made in the same circumstances by both partiers or by one treaty state and subsequently accepted by the other state. Such an instrument or agreement may denote the intentions of the states concerned with regard to the scope of their bilateral dealings with one another, including any potential policies the states may wish to administer under the bilateral

[125] Also see Vogel's discussion of the rules of treaty construction. Vogel, *supra* note 2 at 37.

treaty with regard to residents in other treaty or non-treaty jurisdictions. Of importance as well is Article 31(3), which provides that there, shall be taken into account, together with the context of the treaty, any subsequent agreement made between the parties regarding the interpretation of the treaty or the application of its provisions. The rules of construction prescribed under this provision also take into account any "subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation." As alluded to above, fiscal authorities may turn to model conventions prepared by the other treaty jurisdiction, as a reflection of the states' treaty policies and as an interpretative aid in construing the provisions of a tax convention.[126]

The International Law Commission's commentary on the draft of Article 31 notes that the text of the treaty must be presumed to reflect the intentions of the contracting states and that, consequently, the starting point of interpretation is to discern the meaning of the text, as opposed to giving "too large a place to the intentions of the parties as an independent basis of interpretation."[127] Klaus Vogel affirms this proposition, noting in his commentaries to the OECD model convention that the object and purpose of a treaty instrument is "not synonymous with the subjective intention of the treaty states but refers to the goal of the treaty as reflected objectively" with reference to the provisions of the instrument as a whole.[128] Relying on these and other sources, Daniel Sandler argues that there is sufficient evidence to conclude that "the textual approach to treaty construction

[126] The discussion in the previous section made reference to the provisions of the US model tax treaty which have influenced to a large extent, as a reflection of the bargaining power of the US, the substance of the treaty relations between the US and other countries. The document is frequently referred to as an aid in the construction of treaty provisions by fiscal authorities in other countries. See Weeghel, *supra* note 2 at 108-119.

[127] See Daniel Sandler, *Tax Treaties and controlled foreign legislation: pushing the boundaries*, 2nd ed. (The Hague; London; Boston: Kluwer Law International, 1998) at 57. [Sandler].

[128] This is according to Vogel's interpretation of Article 31(2) of the *Vienna Convention*. See Vogel, *supra* note 2 at 37.

constitutes established law,"[129] and that accordingly any external sources that may be consulted must be consistent with the text of the treaty and cannot be relied upon to inject meaning into the text of a treaty that cannot be inferred.[130] These are sensible conclusions in light of the provisions under the *Vienna Convention* but I would emphasize, in reference to Sandler's comments, that there are potential gaps in the text of the treaty which may necessitate recourse to external documents, in accordance with the prescriptions under Article 31(3), as described above.

Weeghel departs from the general precepts under the *Vienna Convention* as a result of his extensive reliance on external sources in attempting to construe the intentions of the treaty partners. While Weeghel begins his analysis with the provisions of the treaty instrument and the related documents, he relies to a large extent on the general tax practices of the states concerned, any relevant judicial decisions, and domestic anti-tax avoidance legislation targeting cross-border transactions, as evidence of a state's treaty policy. He also relies on state communiqués or publications or any pronouncements from finance state department officials regarding foreign policies, the content of which may not necessarily be confirmed by the other treaty state in a manner consistent with the provisions of Articles 31(2) and (3) of the *Vienna Convention.*[131]

---

[129] Sandler, *supra* note 127 at 20.

[130] Sandler relies on the jurisprudence of the International Court of Justice, paraphrasing an excerpt from a 1971 decision, stating that "the court has more than once stressed that it is not the function of interpretation to....read into them [treaties] what they do not, expressly or by implication contain. The cite for the judgment is omitted. See Sandler, *supra* note 127 at 233. This position also appears to be endorsed by the International Law Institute which has noted that the text of an international instrument, with rare exceptions, provides the only and the most recent expression of the intentions of the parties. The actual excerpt provides: " le texte signe est, sauf de rare exceptions, la seule et la plus récente expression de la volonté commune des parties." See L'annuaire de l'Institut de droit international (1952), vol. 44, at 199.) noted in footnote 94. See Weeghel, *supra* note 2 at 57.

[131] See Weeghel, *ibid.* at 109 & 108-111.

B. The role of the OECD model convention

Weeghel's also makes reference in a number of cases to principles under the OECD model convention and considers whether the tax planning practices at issue are consistent with such principles.[132] I will consider the arguments that academics and other relevant authorities have proposed regarding the weight that should be attributed to the OECD model treaty as an interpretative tool. There is some dispute as to which provision or provisions of the *Vienna Convention* apply to the OECD model convention.

The view expressed by Canadian courts is that the OECD model treaty constitutes a primary interpretative aid to the extent that the treaty states have complied with the provisions of the model instrument.[133] The Supreme Court of Canada in *The Queen v. Crown Forest* held that recourse to the model treaty is justified as part of the context for the interpretation of the treaty instrument in accordance with Articles 31(1) and (2) of the Convention.[134] This view is endorsed by the International Law Commission which argues that the Model Convention is a supplementary document that can be consulted to aid an interpretation governed by the principles in Article 31 and not only in cases where the

[132] In another section of his work, unrelated to treaty shopping, Weeghel turns to the provisions of the *OECD Model Convention* as an interpretive aid, after concluding that the principles adopted under the tax treaty are consistent with the principles under the *OECD Model Convention*. Weeghel discusses the interaction of the *Netherlands-Belgium Tax Convention* and the rules of taxation applicable to parent and subsidiary companies under Netherlands tax law. The application of the tax treaty resulted in a double tax exemption in both treaty states. The case concerns the income attributable to a permanent establishment, consisting of a parent and subsidiary, which is normally taxed in the source jurisdiction. The parent and subsidiary were treated as a single entity for tax purposes. Weeghel concludes that the treaty states are only prepared to exempt income attributable to a permanent establishment if all prior losses of the conglomerate are recaptured, under Article 24(2)(5) of the *Netherlands-Belgium Tax Convention*. This according to Weeghel is also consistent with the principle adopted by the OECD under Article 23A of the *OECD Model Convention*, which describes a typical tax credit regime. Weeghel concludes that the use of the conglomerate, the parent and the subsidiary, resulted in an improper conferral of treaty benefits. *Ibid.* at 129.

[133] See Crown Forest, *supra* note 18.

[134] *Ibid.*

interpretative rules in Article 31 fail to disclose a clear or reasonable meaning.[135] This perspective has been disputed by academics like Daniel Sandler who argue that the model convention does not fit the description of the "context" of the treaty under Article 31(2) which refers to the treaty text, its preamble and annexes, and "any agreement" relating to the treaty between the parties or "any instrument made by one or both parties in connexion with the conclusion of the treaty, and accepted by the other parties as an instrument created to the treaty." It is clear, as such, that the model convention does not represent an agreement or instrument as described under the provision. As a result, Sandler goes on to suggest that a reference to the model treaty is only permitted under Article 32 of the Vienna Convention which provides that recourse to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, is only appropriate in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning of an interpretation under Article 31, where the interpretation under the provision results in an absurd or unreasonable result.[136] While I accept the restrictions under Article 31(2), I do disagree with Sandler's conclusion regarding the potential relevance of the model convention, as an interpretative aid. The provision that is overlooked is Article 31(3), which refers to "any subsequent practice by the states in the application of the treaty and its provisions" which establishes an agreement between the parties regarding the instrument's interpretation. The practices of the treaty states, and whether and the extent

[135] See Shelton, *supra* note 40 at 59.
[136] The precise wording of Article 32 is as follows: "Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, but only in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to article 31: a) leaves the meaning ambiguous according to article 31; or b) leads to a result which is manifestly absurd or unreasonable." *See Vienna Convention, supra* note 6.

to which they rely on the OECD model convention as an aid in construing the scope and ambit of the treaty instrument, will confirm whether the states regard or accept the OECD model treaty or other model conventions, as a primary tool of interpretation. At a result, it is possible that the model treaty and the related commentaries may, in accordance with the practices of the treaty states, form a part of the "context" of the treaty instrument for the purpose of its interpretation.

With regard to the construction of individual treaty terms, as Hugh Ault has acknowledged, a reference to the model treaty may be permitted under Article 31(4) which provides that "a special meaning shall be given to a treaty term if the parties so intended."[137] He argues that this is appropriate "to establish the intent of the parties to use a term in a special manner," despite the lack of ambiguity based on the restricted Article 31 material.[138] Nonetheless, regardless of the weight that will be attributed to the model convention as a tool of construction in individual cases, it is reasonable to conclude, as a practical matter, that the model treaty should be consulted in the beginning stages of the interpretative process, and not simply in cases were there is ambiguity in the language of a treaty provision. Such an approach will allow tax authorities or courts to confront any potential difficulties in construing the text and avoid or resolve any potential ambiguities in the text of the instrument. I also propose that to the extent that the treaty partners have embraced the OECD model treaty provisions, it is also sensible to conclude that they concur with the commentaries accompanying the model provisions and have incorporated or assimilated the principles underpinning the model treaty and its

---

[137] See Vogel, *supra* note 2 at 65.
[138] *Ibid.*

framework of treaty rules, subject, of course, to any reservations under the relevant treaty or any observations by one of the treaty state included in the OECD model convention.

Even in cases where the treaty provisions are not worded in an identical fashion as the model provisions or in cases where the OECD model treaty does not constitute a primary tool of interpretation, I still propose that in abiding by the bilateral model for the allocation of taxing rights, states have accepted its underlying principles and its basic rationale, which is reflected in the economic studies conducted by the League of Nations and the OECD.[139] Klaus Vogel notes in his commentaries to the model convention that the OECD model tax treaty and the related commentaries have, indeed had an important role to play in contributing to the development of an international tax language, a claim that has not been disputed.[140]

C. The treaty scheme for the allocation of taxing rights according to Weeghel

Weeghel acknowledges that an important goal for states under a tax treaty is to achieve a favorable allocation of tax rights. However he does not explore the rationale for the tax arrangements promoted under the treaty regime and the division of taxing rights between the residence and source states.[141] Weeghel does make the observation, in a separate part of his analysis, that while there may be a logical basis for the division of taxing rights between the state of residence and source over the various income items, that the treaty arrangements themselves may be arbitrary in some cases. He argues that the treaty rules governing the allocation of tax rights may simply reflect the practical challenges of constructing a workable bilateral treaty solution, as the product of an

---

[139] See discussion in Part III in chapter 2.

[140] See Vogel, *supra* note 2 at 37 where he quotes the High Court of Australia in *Thiel v. FCT* (1990) 21 ATR 531 at 537.

[141] See Weeghel, *supra* note 2 at 100.

unpredictable negotiation process.[142] While certain treaty rules may fail to denote a clear principle or rationale, there are clear principles underpinning the general treaty framework that deserve mention, as confirmed by the various economic studies carried out by the various OECD bodies, and which should be considered in analyzing the alleged cases of treaty abuse.[143]

D. A final note on Weeghel's analytical approach

Weeghel's analysis does not always result in a definitive conclusion regarding the legitimacy of certain tax planning schemes. The sources Weeghel consults may not always reveal a state's treaty policy towards certain tax planning schemes or may provide evidence of conflicting treaty practices. In such cases Weeghel is not able to conclude whether the use of the treaty by a taxpayer for the specific purpose concerned is improper or legitimate.[144] In addition, by adopting an unorthodox method of treaty construction Weeghel draws conclusions that do not appear to take into account relevant treaty principles or the structural character of the tax treaty regime. As an example, Weeghel posits the question whether the use of a tax treaty by a taxpayer that is contrary to the treaty policy of one state but not contrary to the policy of the other jurisdiction can be labeled an improper treaty use. This is a rather odd consideration. As it was argued earlier in this chapter, the treaty regime and its framework of rules, confers to each treaty state the plenary authority to construe the provisions of a tax convention treaty to

---

[142] Weeghel argues that "it would not be illogical to grant the source state a limited right to tax capital gains (from the sale of an income generating asset situated in the source state) where it also has a limited right to tax dividends (in respect of the income generating activities in that state)." The brackets are my own. It is remarked further that "the Committee on Fiscal Affairs may see a practical difficulty in dividing the taxing right in respect of the capital and the capital gain between the source state and the state of residence, a difficulty important enough to assign the exclusive right to tax the capital and the capital gain to the state of residence." *Ibid.* at 141.

[143] See the discussion in Part III of Chapter 2.

[144] See Weeghel, *supra* note 2 at 124 -160 for Weeghel's case by case analyses.

determine whether a tax subject is legitimately entitled to claim treaty relief, resulting in a lower tax revenue share for the state applying the convention. Such a procedure involves the application of both domestic legal principles and the broad principles of treaty construction mandated under the *Vienna Convention.* If the treaty state, in determining an entity's fiscal burden under its tax laws, concludes that a subject's transactions are legitimate, and that the subject is entitled to claim tax relief pursuant to the provisions under the applicable convention, this settles the question regarding the propriety of the conferral of tax treaty benefits, regardless if the other treaty state would have denied tax treaty relief under similar circumstances on the basis that applicable tax treaty relief provisions were applied in an improper or abusive manner.

VI. Concluding Remarks

In evaluating the legitimacy of treaty shopping as a tax planning strategy this paper has attempted to focus on the principles underpinning the tax treaty regime. The question that has been addressed in analyzing this practice and the alleged cases of treaty abuse presented in this chapter is whether the tax planning practices were consistent with the economic rationale governing the allocation of taxing rights under the treaty regime. This chapter has also offered a critique of the traditional arguments that have been proposed against treaty shopping, which have generally failed to properly relate to or consider the structural character of the regime and the relevant treaty principles. It is hoped that this analysis will encourage a more comprehensive evaluation of tax planning strategies in future studies and that a similar analytical approach will be applied to the study of other perceived tax treaty abuses.

Chapter 5: Conclusion

This study has focused primarily on the use of tax treaties in the treaty shopping context, and the issue whether treaty shopping constitutes an abuse of the bilateral tax treaty regime. Treaty shopping involves the channeling of income through a conduit entity resident in a treaty jurisdiction by non-treaty residents, in an attempt to derive benefits under the tax treaty between the source state, the jurisdiction where the investments are carried out, and the state of residence of the conduit entity.

I have proposed that the bilateral tax treaty regime, modeled after the OECD model convention, lays the foundation for a principle of abuse, or anti-abuse rule that treaty states may invoke to challenge the legitimacy of the tax avoidance practices employing tax treaties. The paper concludes that treaty shopping, as a general proposition, constitutes an abuse of the tax treaty regime and that the practice violates the economic rationale underpinning the division of tax rights between treaty states under the bilateral tax treaty system. This is the result of the use of conduit devices that lack an independent economic rationale or a sufficient economic presence in a treaty jurisdiction to be legitimately entitled to claim treaty relief under a convention. This analysis supports and lends credence to the general proposition expressed by the OECD and OECD member states, that the use of artificial legal maneuvers to derive benefits under a tax treaty constitutes is an abusive practice. This paper has also served as a response to Stef van Weeghel's approach to the analysis of improper tax treaty uses and his conclusions regarding the legitimacy of treaty shopping, as a tax avoidance strategy.[1]

[1] Stef van Weeghel, *The Improper Use of Tax Treaties: With Particular Reference to the Netherlands and the United States* (London; Boston: Kluwer Law International, 1998). [Weeghel].

Chapter 2 has discussed the purpose and the principles underpinning the bilateral tax treaty regime and the economic rationale for the bilateral allocation of tax rights between the treaty states. The object of the bilateral tax treaty regime is to simplify the international tax regime and to reduce the tax compliance costs borne by economic actors operating in other treaty jurisdictions. The principal purpose of tax conventions reflected in the preamble to the instruments is to eliminate or reduce the incidence of double taxation and prevent fiscal evasion. While only a minority of tax treaties make reference to the objective of combating international tax avoidance, the tax treaty regime was not intended or designed to facilitate international tax avoidance.

The design of the tax treaty system was inspired by and based on a number of economic studies sponsored or conducted by the various fiscal bodies of the League of Nations and the finance committees of the OECD, the Organization of Economic Cooperation and Development. As a general principle, the OECD tax treaty model and the alternative bilateral tax treaty model proposed by the fiscal body of the United Nations, is designed to allocate tax rights in respect of the various income categories to the jurisdiction that has the strongest economic claim to its taxation.

Chapter 3 has presented a summary and critique of the general principles of tax treaty abuse that other academics and writers have proposed. Academics have sought to construct or identify certain general principles of treaty abuse under international law, that may be applied to the interpretation and application of tax treaties. There is nonetheless, an insufficient evidence for the existence or emergence of an international norm of customary international law, or international concept of abuse that applies to the tax treaty regime. The chapter concludes that the principles of treaty abuse that have been proposed generally lack substance, and that, accordingly they are not helpful in evaluating the legitimacy of the alleged individual cases of treaty abuse. Chapter 4 presents an analysis of treaty shopping, with reference to principles considered in previous chapters. The chapter also presents a number of treaty shopping examples and critiques the arguments that have been proposed to challenge the legitimacy of the practice.

As such, this study highlights two separate and contrasting approaches to the analysis of tax treaty abuse. The first approach attempts to identify certain abstract notions of treaty abuse. The second approach serves to evaluate each individual case in question and determine, with reference to the provisions of the relevant treaty instrument and the intentions of the treaty states, whether it constitutes a misuse of a tax treaty.[2] This is the method that Stef van Weeghel adopts in his treatise on improper tax treaty uses. This paper serves to analyze both of these approaches.

This paper also encourages a study of the potential role that equitable notions or principles and considerations regarding the moral character of taxpayers' conduct may play in evaluating the legitimacy of tax planning strategies. These issues are beyond the scope of this analysis which has focused on identifying the rationale and the principles underpinning the treaty regime and whether certain alleged cases of treaty abuse violate these principles. These alternative considerations are presented as a potential area for further study.

This paper has not considered tax planning strategies involving rule shopping or other perceived improper tax treaty uses. Rule shopping refers to planning by treaty subjects, who are otherwise entitled to benefits under the treaty, to trigger the application

[2] *Ibid.*

of more beneficial treaty provisions.[3] It is hoped that this work will encourage a study of other tax avoidance strategies employing treaties, with a view to drawing a distinction between the legitimate and illegitimate tax planning opportunities that are aided by the tax treaty regime.

The discussion in chapter 2 of this work has shown that the tax treaty regime was not designed or intended to address all taxation conflicts or the anomalous results that may arise as result of the differences between domestic tax regimes and any overlapping or conflicting tax rules. A task for a future study might be to distinguish the tax planning opportunities, arising as a result of the inherent gaps in the bilateral tax treaty regime, and the absence of a multilateral treaty solution, and those that result due to the misapplication of tax conventions. It is also hoped that such further studies will inform the debate whether a multilateral tax treaty solution should be preferred as an alternative to the current bilateral treaty system, as a basis to maintain an equitable and neutral international tax regime.

[3] See Nathalie Goyette, *Countering Tax Treaty Abuses: A Canadian Perspective on an International Issue* (Toronto: Canadian Tax Foundation, 1999) at 5. [Goyette].

BIBLIOGRAPHY

SECONDARY MATERIAL:

Adams, J.D.R. , & Whalley, J., *The International Taxation of Multinational Enterprises in Developed Countries* (London: Associated Business Programmes for the Institute for Fiscal Studies, 1977).

Arnold, Brian J., "Threshold Requirements for Taxing Business Profits," in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties* (Toronto: Canadian Tax Foundation, 2003). 55.

Arnold, Brian J. & Jacques Sasseville, "Source rules for taxing business profits," in Brian J. Arnold, Jacques Sasseville and Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties* (Toronto: Canadian Tax Foundation, 2003). 109.

Atlas, Michael L., *Canadian taxation of non-residents*, 2nd ed. (Toronto: CCH Canadian Limited, 2002).

Avery Jones, John F., "Permanent Establishment: Historical Evolution and Contemporary Relevance," in *Report of Proceedings of the First World Tax Conference: Taxes Without Borders* (Toronto: Canadian Tax Foundation, 2000).

Becker, Helmut, & Wurm, Felix J., eds., *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (Deventer; Boston: Kluwer Law and Taxation Publishers, 1988).

Brownlie, Ian, *Principles of Public International Law* (Clarendon Press, Oxford 1990)

Carter, Kenneth Le M., & Canadian Royal Commission on Taxation, *Report of the Royal Commission on Taxation*, vol. 4. & 6 (Ottawa: R. Duhamel, Queen's Printer, 1966).

Cheng, Bin, *General Principles of Law as applied by International Courts and Tribunals* (Grotius Publications, Cambridge University Press, Cambridge, Melbourne, New York 1994)

Li, Jinyan & Sandler, Daniel, *Materials on Canadian Income Tax*, 12th ed. (Toronto: Carswell, 2000).

Ginsberg, Anthony, *International Tax Planning: Offshore Finance Centres and the European Community.* (Deventer, The Netherlands; Boston, USA; Kluwer Law and Taxation Publishers, 1994).

Goyette, Nathalie, *Countering Tax Treaty Abuses: A Canadian Perspective on an International Issue* (Toronto: Canadian Tax Foundation, 1999).

Graetz, Michael J., ed., *Foundations of International Income Taxation* (New York: Thomson West, 2003).

Knoester, Anthonie, ed., *Taxation in the United States and Europe: Theory and Practice: Proceedings of a Conference held by the Confederation of European Economic Associations at Amsterdam, the Netherlands, 1991* (New York: Saint Martins Press, 1993).

Krishna, Vern, ***Canadian International Taxation***, looseleaf (Scarborough: Carswell, 1995).

Kroft, Edwin G., "Tax Avoidance in the 21St Century: A Canadian Perspective," in *Report of Proceedings of the First World Tax Conference: Taxes Without Borders* (Toronto: Canadian Tax Foundation, 2000).

Lang, Michael, ed., *Tax Treaty Interpretation* (The Hague; London; Boston: Kluwer Law International, 2002).

Levine, Pierre, *La Lutte Contre L'evasion Fisclale de Caractere International en L'absence et En Presence de Conventions Internationales* (Paris: Librairie Generale de Droit et de Jurisprudence, 1988).

Li, Jinyan, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003).

Lymer, Andrew, ed., *The International Taxation System* (Boston: Kluwer Academic Publishers, 2002).

Martha ,Rutsel Silvestre J., *The Jurisdiction to Tax in International Law: Theory and Practice of Legislative Fiscal Jurisdiction*, (Series on international taxation. No.9.) (Deventer, The Netherlands; Boston, USA: Kluwer Law and Taxation Publishers, 1989).

Messere, K.C., *Tax Policy in OECD Countries: Choices and Conflicts* (Amsterdam: IBFD Publications BV, 1993).

Musgrave, Peggy B., *Tax policy in the Global Economy* (Cheltenham, UK; Northampton, Ma, USA: Edward Elgar Publishing Ltd., 2002).

OECD Committee on Fiscal Affairs, *International Tax Avoidance and Evasion: Four Related Studies* (Paris: OECD, 1987).

OECD, *The OECD Model Convention, 1998 and beyond: The Concept of Beneficial Ownership in Tax Treaties; Proceedings of a Seminar held in London in 1998 during the 52nd Congress of the International Fiscal Association* (The Hague; London: Kluwer Law International, 2000).

OECD, *Issues in International Taxation: 2002 Reports Related to the OECD Model Tax Convention*, Series No. 8 (Paris: OECD, 2003).

OECD, *Treaty Override* (Paris: OECD, 1989).

OECD, "Triangular Report" in *Model Tax Convention: Four Related Studies* (Paris:OECD,1992).

Ogley, Adrian, *The Principles of International Tax: A Multinational Perspective* (London: Interfisc Publishing, 1993).

Picciotto, Sol, *International Business Taxation: A Study in the Internationalization of Business Regulation* (London: Weidenfeld & Nicholson, 1992).

Pires, Manuel, *International Juridical Double Taxation of Income*, (Series on International Taxation No. 11.) (Deventer, The Netherlands; Boston, USA: Kluwer Law and Taxation Publishers, 1998).

Raad, Kees Van, "International Divergence in Tax Treaty Interpretation and Application," in *Report of Proceedings of the First World Tax Conference: Taxes Without Borders* (Toronto: Canadian Tax Foundation, 2000).

Sandler, Daniel, *Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries*, 2nd ed. (Boston; The Hague; London: Kluwer Law International, 1998).

Sassville, Jacques, "The Future of the Treaty Rules," *Report of Proceedings of the First World Tax Conference: Taxes Without Borders* (Toronto: Canadian Tax Foundation, 2000).

Self, Heather, "Double Tax Relief Systems: A Current and Future Perspective, "in *Report of Proceedings of the First World Tax Conference: Taxes Without Borders* (Toronto: Canadian Tax Foundation, 2000).

Shelton, Ned, *Interpretation and Application of Tax Treaties* (London: Lexis Nexis, 2004).

Skaar, Arvid A., *Permanent Establishment: Erosion of a Tax Treaty Principle* (Deventer: Kluwer Law and Taxation, 1991).

Spitz, Barry, *International Tax Planning*, 2nd ed. (London; Toronto: Butterworks, 1983).

Vogel, Klaus, *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD-UN and US Model Conventions for the Avoidance of Double Taxation of Income & Capital with Particular Reference to German Treaty Practice* (London; The Hague; Boston: Kluwer Law International, 1997).

Ward, David A., "Abuse of Tax Treaties, in Alpert, Herbert H., Raad, Kees Van, in *Essays of International Taxation* (Series on International Taxation No. 15), (Deventer; Boston: Kluwer Law International, 1993) 397.

Weeghel, Stef Van, *The Improper Use of Tax Treaties: With Particular Reference to the Netherlands and the United States* (London; Boston: Kluwer Law International, 1998).

Westin, Richard A., *International Taxation of Electronic Commerce* (The Hague; Boston: Kluwer Law International, 2000).

SECONDARY MATERIAL: ARTICLES

Avery Jones, John F., "Are Tax Treaties Necessary" (1999) 53 Tax. L. Rev. 1.

Avi-Yonah, Reuven, S., "Commentary" (2000) 53 Tax L.Rev. 167.

Avi-Yonah, Reuven, S., "International Taxation of Electronic Commerce" (1997) 52 Tax L. Rev., 507.

Edgar, Tim "Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage" (2003) 51 Canadian Tax J., 1079.

Graetz, Micael J., "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies " (2001) 54 Tax L. Rev. 261.

Leblanc, Stuart, " International Double Non-Taxation" (1998) 80 Tax Notes 2.

Goyette, Nathalie, *"Tax Treaty Abuse: A Second Look"* (2003) 51 Can.Tax J. 764.

Haug, Simone M., "The United States Policy of Stringent Anti-Treaty Shopping Provisions: A Comparative Analysis" (1996) 29 Vand. J. Transnat'l L. 191.

Li, Jinyan, "Policy Forum: Comments on International Taxation in the Age of Electronic Commerce: a comparative Study" (2004) 51 Canadian Tax J. 106.

Reinhold, Richard L., "What is Treaty Abuse? (Is Treaty Shopping an Outdated Concept" (2000) 53 Tax L. Rev. 663.

Ring, Diane, M. "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage" (2002) 44 Boston Col. L. Rev. 79.

Rosenbloom, H. David, "International Tax Arbitrage and the International Tax System" (2000) 53 Tax L. Rev. 167.

Sawyer, Adrian J. "Electronic Commerce: International Policy Implications for Revenue Authorities and Governments" (1999) 19 Va. Tax. Rev. 73.

Tadmore, Niv, "Further discussions on income characterization" (2004) 52 Can Tax. J. 124.

Vincent, Fanrcois, "Crown Forest Industries: The OECD Model Tax Convention as an Interpretative Tool For Canada's Tax Conventions" (1996) 44 Can Tax. J. 38.

JURISPRUDENCE:

Aiken Industries v. Commissioner, (1971) 56 T.C. 925.

Cudd Pressure Control Inc. v. The Queen, [1998] 98 DTC 6630 (FCA).

The Queen v. *Crown Forest Industries Ltd.*, [1995] 95 DTC (SCC) 5389

United States v. Johansson, (1964) 336 F.2d 809 (5th Cir.)

LEGISLATION:

The Income Tax Act, R.S.C. 1985 (5th Supp.), c. 1.

OTHER MATERIALS:

Convention between Canada and the United States of America with respect to taxes on income and on capital, September 26, 1980, (as amended by the Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995 and July 29, 1997).

Department of International Economic and Social Affairs, United Nations, *Contributions to International Co-operation in Tax Matters: Treaty Shopping, Thin Capitalization, Co-operation Between Tax Authorities, Resolving International Tax Disputes,* (New York: UN, 1988).

Durand, Ronald & Hughes, Timothy R., "Comparing OECD Treaty Policy and Canadian Treaty Policy," in *International Fiscal Association: Special Seminar on Canadian Tax Treaties: Policy and Practice*, May 15-15, 2000 Toronto, Text of Seminar Papers, (Toronto: International Fiscal Association, 2000).

International Fiscal Association, *Recourse to Tax Havens Use and Abuse: Proceedings) of a Seminar held in Paris in 1980 during the 34th Congress of the International Fiscal Association*, (Paris: International Fiscal Association, 1981).

International Fiscal Association, *Seminar on Recent International Developments to Counter Tax Avoidance and Evasion,* (Toronto: Richard De Boo Publishers, 1982).

OECD Committee on Fiscal Affairs, *The Condensed version of the Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 2003)

OECD Committee on Fiscal Affairs, *Model Double Taxation Convention on Income and on Capital*, Report of the OECD Committee on Fiscal Affairs, (Paris: OECD, 1992).

United Nations, *United Nations Model Double Taxation Convention between Developed and Developing Countries*, 1st ed., (New York: United Nations Publications, 1980).
United Nations, *United Nations Model Double Taxation Convention between Developed and Developing Countries*, 2nd ed., (New York: United Nations Publications, 2001).

Vienna Convention on the Law of Treaties, 23 May 1969, U.N.T.S. vol. 1155 at 331.

Statute of the International Court of justice, June 26, 1945, Department of State Publications 2353, Conference Series No. 74.