Eivind Furuseth

The Interpretation of Tax Treaties in Relation to Domestic GAARs

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The Interpretation of Tax Treaties in Relation to Domestic GAARs

Why this book?
There are more than 3,000 tax treaties in the world, and an important question is whether these tax treaties limit a state's ability to curb undesirable tax planning by the use of domestic general anti-avoidance rules (GAARs). Many large multinational companies use essentially legitimate methods to reduce taxes. Meanwhile, governments increasingly focus on the part of this tax planning that they view as undesirable; for example, tax planning schemes where income is shifted from one classification to another and/or shifted from one taxpayer to another. Although these transactions may be legitimate in principle, tax authorities may find that the tax planning scheme "stretches" the rules and thus wish to apply their domestic anti-avoidance rules.

In order to decide whether a treaty restricts the use of domestic GAARs, the treaty must be interpreted. A basic principle in tax treaty law is that if the national rules are contrary to the treaty, the tax treaty prevails. A typical example is withholding tax on dividends: If the tax treaty provides for a lower withholding tax than what follows from domestic law, the treaty withholding tax rate prevails. A question that arises, however, is whether it is of any relevance, in terms of the relationship between tax treaties and domestic law, that the domestic tax rate is determined after the application of a domestic GAAR. This book argues that when State A and State B have agreed between themselves on how the taxation between these two countries should be shared, one of the contracting states may not, after the taxing right is shared, apply the domestic GAAR to override the tax treaty.

Both domestic law and tax treaty law are under constant development. An important question is to what extent these developments affect the tax authorities' ability to counter undesirable tax planning. Is it true that tax agreements signed in recent years increasingly allow the tax authorities to apply their domestic anti-avoidance rules? This book demonstrates that it is of great importance when the tax treaty was signed for determining whether the tax authorities are restricted from using their domestic anti-avoidance rule to deny undesirable tax planning.

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Preface

This book is an updated version of my doctoral thesis, *The relationship between domestic anti-avoidance rules and tax treaties*, which I defended on 9 June 2016 at the University of Oslo to obtain the degree of *Philosophiae Doctor*.

Many people helped me to write this thesis, each in their own way. In particular, I would like to thank Prof. emeritus Frederik Zimmer for being an inspiring and encouraging supervisor and for the many hours he spent reading, commenting on and discussing the draft manuscripts.

Before I started working on my PhD at the University of Oslo, I had the pleasure to study for an advanced LLM at the International Tax Centre in Leiden, the Netherlands, with Prof. Kees van Raad. During my stay in Leiden, I had some of the best lectures in international tax and I had the pleasure of having Prof. Pasquale Pistone as supervisor for my LLM paper. I owe Prof. Pistone a great deal of thanks not only for supervising me on the LLM paper but also for encouraging me to undertake a PhD thesis and supporting me all the way through the process of writing it.

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Before I started working on my PhD, I had the pleasure to work at the Central Office for Large Enterprises (the tax authorities) and, after that, as a tax lawyer at KPMG Law. I owe them both many thanks. Both places gave me extensive insight into national and international tax and great friends for life. The experience I gained from working on “both sides of the table” has been very useful for the work on my PhD.

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I owe the last word of thanks to my family. Above all, I would like to thank my wife, Kaja, for being such a supportive and encouraging life companion. Her love and assistance made it all possible.

Eivind Furuseth
Oslo, 21 December 2017

Sample Content

Setting the Scene

1.1. The relationship between domestic anti-avoidance rules and tax treaties

A long-lasting, and ongoing, discussion about abuse of tax treaties has been taking place in the tax and legal world. This issue was being discussed as early as 1986, in the OECD Report entitled "Double Taxation Conventions and the Use of Conduit Companies", which stated that "the problem has become more acute over recent years".[1] A question related to the abuse-of-treaty issue is the applicability of domestic anti-avoidance rules in a tax treaty situation.[2] This issue has also been under discussion over a period of years. For example, it was the topic of an IFA seminar held at the IFA Congress in Toronto in 1994. Furthermore, the relationship between domestic anti-avoidance rules and tax treaties was one of the main subjects of the IFA Congress in Rome in 2010,[3] as well as one of the questions discussed at the EATLP Congress in Munich in 2016.[4]

The main research question of this book is the relationship between domestic anti-avoidance rules and tax treaties and to what extent a tax treaty restricts the application of domestic anti-avoidance rules. Domestic anti-avoidance rules may take the form of general (GAAR) and specific (SAAR) anti-avoidance rules. As explained in chapter 2, this book will, as indicated in its title, mainly focus on the relationship between domestic GAARs and tax treaties. The research questions are further elucidated in chapter 3. Recently, it has further been common to mention a third group (in addition to GAARs and SAARs) of anti-avoidance rules. This group is referred to as "targeted anti-avoidance rules" (TAARs). A TAAR is something of a middle ground

1. *See* OECD R(6) para. 16.
2. The nature and the scope of domestic anti-avoidance rules vary considerably. They range from general anti-avoidance rules (GAARs) to rules regarding shams, legally ineffective transactions, substance over form, abuse of law and *fraus legis*. IFA (2010) p. 78. However, although the names of the domestic anti-avoidance rules are different, there is not necessarily a major difference in the content of such rules.
3. The topic has not been touched upon by Norwegian scholars to a great extent. Zimmer has written an article in *Festschrift to Nils Mattsson*, Zimmer (2005a), at pp. 572-574, where he analyses the issue, and Banoun in Banoun (2006), at p. 895, points out and discusses some of the most relevant issues.
4. Available at http://www.eatlp.org/index.php/congresses/pastcongresses1/269-munich-2016 (last visited 12 Oct. 2017).

between a GAAR and a SAAR. It may share many of the characteristics of a GAAR regime but is limited to a specific set or type of transactions. Because a TAAR is something in between a GAAR and a SAAR, is relatively new, and GAARs and SAARs are well-established terms, the book will mainly refer to GAARs and SAARs, and only rarely to TAARs.

Most tax treaties include one or more SAARs, and, further, in the BEPS Action 6 2015 Final Report,[5] it is proposed to amend the OECD Model Tax Convention on Income and on Capital (OECD MC)[6] to include a GAAR.[7] In the "Draft Contents of the 2017 Update to the OECD Model Tax Convention",[8] released on 11 July 2017, Working Party 1 of the OECD Committee on Fiscal Affairs proposes to include a GAAR in article 29(9) of the OECD MC. The 2017 Update was approved by the Committee on Fiscal Affairs on 28 September 2017 and by the OECD Council on 21 November 2017.[9] The proposed changes in the 2017 draft update to the OECD MC and the Commentary on the OECD MC (OECD Comm.) relevant for the analysis of the relationship between domestic anti-avoidance rules and tax treaties are carried forward without changes in the 2017 OECD MC and the 2017 OECD Comm.

The GAAR is also included in article 6 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI).[10] Hence, for the question of the applicability of domestic anti-avoidance rules, it is relevant to analyse whether the fact that the tax treaty itself includes a GAAR and/or a SAAR influences the answer to the question of the applicability of domestic anti-avoidance rules in a tax treaty situation.

Because the use of cross-border transactions is becoming more and more common as part of international trade, but also as a method for reducing a potential tax liability, the question of the applicability of domestic

5. OECD, BEPS Action 6: 2015 Final Report.
6. OECD *Model Tax Convention on Income and on Capital: Condensed Version 2014*.
7. *See* below for some brief information about the BEPS Project.
8. *See* http://www.oecd.org/ctp/beps/oecd-releases-draft-contents-2017-update-model-tax-convention.htm (last visited 12 Oct. 2017).
9. *See* https://online-ibfd-org.ezproxy.library.bi.no/collections/ttmodel/pdf/tt_o2_02_eng_2017_mo.pdf (last visited 18 Dec. 2017).
10. *See* http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm (last visited 12 Oct. 2017).

anti-avoidance rules in a tax treaty situation is also becoming increasingly relevant.[11]

It seems to be an international trend that more and more countries are introducing domestic anti-avoidance rules. Whether this is a consequence of the increased frequency of cross-border transactions is uncertain, but, in the author's view, it is likely that this is an important factor. The United Kingdom, for example, introduced GAARs in 2013.[12] Another example of a jurisdiction which has relatively recently introduced domestic GAARs is Ireland, which introduced a domestic GAAR effective as of 23 October 2014.

In 2013, the OECD started an initiative called the Base Erosion and Profit Shifting (BEPS) Project.[13] The work was initiated by the G-20.[14] One of the overall aims of the BEPS Project is to "effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it".[15] To counter base erosion and profit shifting, the study lists various tools that the tax authorities may apply to reduce the tax benefit of such transactions.[16] Further, the BEPS Reports lists a number of suggested actions to counter BEPS related to anti-avoidance rules – both for domestic legislation and for tax treaties.[17] OECD BEPS Action 6 deals especially with abuse of tax treaties and the applicability of domestic anti-avoidance rules in a tax treaty situation.[18] To the extent countries follow the recommendation of the OECD

11. At the IFA Congress in Oslo in 2002 one of the main topics was "Form and substance in tax law". For all countries reporting that they had domestic anti-avoidance rules, which was the situation for a majority of the 27 national reports, the national reporters stated that the domestic anti-avoidance rule was applicable in cross-border situations. *See* IFA (2002) p. 60. *See also* IFA (2010) p. 22, where the General Reporter, Van Weeghel, confirms Zimmer's findings in IFA (2002).
12. The UK GAAR came into force on 17 July 2013.
13. For further information about the BEPS Project, *see* http://www.oecd.org/tax/beps/ (last visited 12 Oct. 2017).
14. *See* OECD, G-20.
15. *See* http://www.oecd.org/ctp/BEPSActionPlan.pdf., chapter 3 (last visited 12 Oct. 2017).
16. In this study, the OECD found that some multinationals use strategies that allow them to pay as little as 5% in corporate taxes while smaller businesses are paying up to 30%. The study also shows that some small jurisdictions act as conduits and receive disproportionately large amounts of foreign direct investment compared to large industrialized countries. Furthermore, these small jurisdictions are investing disproportionately large amounts in major developed and emerging economies. Global solutions are needed to ensure that tax systems do not unduly favour multinational enterprises, leaving citizens and small businesses with bigger tax bills. *See* OECD Press release of 12 February 2013.
17. *See* http://www.oecd.org/tax/beps.htm (last visited 12 Oct. 2017).
18. *See* http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm (last visited 12 Oct. 2017).

and include more domestic anti-avoidance rules to counter BEPS, the issue of the applicability of domestic anti-avoidance rules in a tax treaty situation will be even more relevant than it is today.[19]

19. Design of new domestic anti-avoidance rules may result from the work of, for example, OECD, BEPS Action 2: 2015 Final Report, BEPS Action 3: 2015 Final Report, BEPS Action 4: 2015 Final Report and BEPS Actions 8-10: 2015 Final Report.

Chapter 20

Conclusions

20.1. Introduction

The analysis above has proved that there is no straightforward answer regarding the relationship between domestic anti-avoidance rules and tax treaties. At an IFA Seminar in 1994, Stanley Katz drew the following conclusion on the question of when, and in what circumstances, it is legitimate to apply a domestically based anti-avoidance or form of substance rule when applying a treaty:

> The general conclusion I would draw is that there is no single yes or no answer to whether a particular anti abuse rule or type of rule may apply under a treaty. It depends on the rule, on the issue, on the context, and on the treaty.[525]

More than 20 years later there is still no single "yes" or "no" to that same question. Neither the OECD MC nor the OECD Comm. has managed to resolve the issue properly (although both the 2011 version of the UN Comm. and the 2017 version of the OECD Comm. are steps in the right direction).

Due to its importance as regards the issue and the uncertainty it creates, there has been surprisingly little attention paid by the OECD, UN, scholars and domestic tax authorities to it. However, in the past years, the focus has shifted considerably. In 2011, an updated version of the UN Comm. was released, and, in relation to UN MC Art. 1, the UN Comm. takes a more detailed and nuanced view on the relationship between domestic anti-avoidance rules and tax treaties than the OECD Comm. does. Also, the BEPS Project initiated by the G20,[526] which began in 2013 (whereby one of the action plans is devoted to treaty abuse (Action 6)), and which has resulted in the 2017 OECD Comm., with an increased focus on the abuse of tax treaties and domestic anti-avoidance rules, shows that the abuse of treaties, including the potential use of domestic anti-avoidance rules to avoid treaty abuse, is now on the agenda.

As described in chapter 2, some jurisdictions have taken an approach to the question of the relationship between domestic anti-avoidance rules and tax treaties without taking into account the interplay of domestic anti-avoidance

525. IFA1994 (1995) p. 13.
526. *See* OECD, G-20.

rules and tax treaties. The author does not find this solution correct, because such an approach does not take into account the obligations which follow from the tax treaty. A contracting state is bound by the provisions in the tax treaty and may not disregard these simply by referring to domestic rules or by referring to the *lex* rules.

In the author's view, the correct approach is to resolve the question of the applicability of domestic anti-avoidance rules by way of interpreting the tax treaty. Under the interpretation of the tax treaty, however, it is important to take into account the "guiding principle" in 2017 OECD Comm. Art. 1 para. 61 and the PPT rule in 2017 OECD MC Art. 29(9). Only to the extent that there is no conflict between the application of the domestic anti-avoidance rule and the tax treaty may the domestic anti-avoidance rule be applied unhindered by the tax treaty.

In situations where the scope of a domestic anti-avoidance rule falls within the scope of the tax treaty, there is no conflict with domestic anti-avoidance rules; this means that the tax treaty does not restrict the application of the domestic anti-avoidance rule. Where the scope of the domestic anti-avoidance rules is wider than the guiding principle/the PPT rule, the tax treaty restricts the application of the part of the domestic anti-avoidance rule which goes further than the guiding principle/PPT rule. However, to the extent that the domestic anti-avoidance rule is within the scope of the tax treaty and the treaty benefit is denied because of the domestic anti-avoidance rules, the same result could most likely have been achieved by an interpretation of the tax treaty itself (i.e. there is an abuse of the treaty and under the guiding principle and the PPT rule the taxpayer is not entitled to the treaty benefit). The relevance and scope of the guiding principle are analysed in chapter 11.

As explained in section 3.1., the author finds it appropriate to divide the analysis of the question of the relationship between domestic anti-avoidance rules and tax treaties into two main situations:

(1) use of domestic legislation to circumvent domestic legislation without benefiting from a tax treaty (*see* chapter 14); and
(2) where the benefit from the transaction/arrangement follows from the tax treaty:
    (i) use of domestic legislation as a tool to circumvent tax treaties (*see* section 15.2.); and
    (ii) use of a tax treaty as a tool to circumvent domestic legislation (*see* section 15.3.).

The analyses in chapters 14 and 15 have proven that the question of the applicability of domestic anti-avoidance rules in a tax treaty situation must be answered differently depending on whether there use of domestic legislation to circumvent domestic legislation without benefiting from a tax treaty or whether the benefit from the transaction/arrangement follows from the tax treaty, respectively.

20.2. Use of domestic legislation to circumvent domestic legislation without benefiting from a tax treaty

Chapter 14 of this book analysed whether a tax treaty restricts the application of domestic anti-avoidance rules where the taxpayer has used domestic legislation as a tool to circumvent domestic legislation without benefiting from the tax treaty. In this analysis, it is assumed that the benefit from the transaction/arrangement does not follow from the tax treaty (but from domestic legislation).

Application of domestic anti-avoidance rules in a situation where the taxpayer has used domestic rules to circumvent domestic legislation will typically result in either (i) a redetermination of the taxpayer; or (ii) a recharacterization of the transaction.

The analyses in chapter 14 have demonstrated that the tax treaty does not restrict the applicability of domestic anti-avoidance rules where domestic rules are used to circumvent domestic legislation without benefiting from the tax treaty. This applies both for the situation where there is a question about a redetermination of the taxpayer or a recharacterization of the transaction. In neither of the situations has the taxpayer benefited from the tax treaty, and as long as the taxpayer has not benefited from the tax treaty (although there is a tax treaty in force between the contracting states involved in the transaction/arrangement), the tax treaty does not restrict the application of domestic anti-avoidance rules in such a situation.

20.3. The benefit from the transaction/arrangement follows from the tax treaty

20.3.1. Introduction

The second main situation where the question of the relationship between domestic anti-avoidance rules and tax treaties arises is where the taxpayer's benefit from the transaction/arrangement stems from the tax treaty. This may be the case both where the taxpayer has used domestic legislation to circumvent a tax treaty and where the taxpayer has used a tax treaty to circumvent domestic legislation.

20.3.2. Use of domestic legislation as a tool to circumvent tax treaties

In the analysis of the applicability of domestic anti-avoidance rules where domestic legislation is used to circumvent a tax treaty, it is necessary to distinguish between (i) a situation where a term in the tax treaty *is defined* and the transaction at stake falls under this definition; and (ii) a situation where there is *no definition* of the term in the tax treaty which covers the classification and recharacterization of the transaction under the domestic anti-avoidance provision.

First, where there is a definition in the tax treaty that covers the transaction, the analysis in section 15.2.2. has demonstrated that a recharacterization of a transaction under domestic anti-avoidance rules as the main rule may not be given effect for treaty purposes. However, to the extent that the domestic recharacterization is in accordance with the object and purpose of the tax treaty or does not expand the taxing rights of the contracting state applying its domestic anti-avoidance rules in conflict with the tax treaty (compared to the situation before the recharacterization), the domestic recharacterization may be given effect for treaty purposes.

Second, where domestic legislation is used to circumvent a tax treaty and there is no definition in the tax treaty that covers the transaction, the question arises whether the tax treaty prohibits the application of domestic anti-avoidance rules or whether there are no restrictions. In the author's view, it is more difficult to conclude on this question than the question of the applicability of domestic anti-avoidance rules in a tax treaty situation where there is definition in the tax treaty covering the transaction.

Where there is no definition in the tax treaty covering the transaction and the tax treaty included a provision similar to OECD MC Art. 3(2), the analysis above (*see* section 15.2.3.) has demonstrated that most of the relevant sources of law point in the direction that a domestic definition, as a general rule, may not be applicable for tax treaty purposes where the domestic definition is determined after the application of domestic anti-avoidance rules. However, if the application of the domestic anti-avoidance rules is compatible with the context of the treaty, the tax treaty does not restrict the application of domestic anti-avoidance. In other words, this means that, for the changes in domestic legislation to be applicable for treaty purposes, they may not be contrary to the object and purpose of the tax treaty.

20.3.3. Use of a tax treaty as a tool to circumvent domestic legislation

As analysed in section 15.3., the second group of situations where the issue of the applicability of domestic anti-avoidance rules in a tax treaty situation arises is where the taxpayer has used the tax treaty to circumvent domestic legislation. Further, the application of domestic anti-avoidance rules in these situations may typically entail (i) a redetermination of the counterpart of a transaction; and/or (ii) a recharacterization of the transaction.

In the situation where the application of domestic anti-avoidance rule has entailed a redetermination of the counterpart of a transaction, a distinction may be made between inbound and outbound situations. In an outbound situation, the application of domestic anti-avoidance rules that redetermine the recipient of the income will more easily result in double taxation than in an inbound situation. The answer to the question of the applicability of domestic anti-avoidance rules that redetermine the recipient of an income in a tax treaty situation, however, depends on whether the redetermination of the counterpart of the transaction promotes or restricts the object and purpose of the treaty in accordance with the guiding principle in 2017 OECD Comm. Art. 1 para. 61. It is thus not decisive whether the situation may be classified as an inbound or outbound situation.

The above analysis has demonstrated that both the OECD Comm. and domestic case law are arguments in favour of holding that domestic anti-avoidance rules redetermining the counterpart of a transaction may be applied in a tax treaty situation, provided that the scope of the domestic anti-avoidance rule is in accordance with the guiding principle. Although the object and purpose is a counter-argument to accepting the application

of domestic anti-avoidance rules in these situations, the fact that the domestic anti-avoidance rule must be in conformity with the guiding principle reduces the risk of double taxation.

Where the application of domestic anti-avoidance rules has entailed a recharacterization of the transaction, the issue is whether a domestic recharacterization overrules the definition in the tax treaty, if any. The analysis of this issue is similar to the analysis and conclusions in section 20.3.2. Hence, it is necessary to distinguish between the situation where there is a definition in the tax treaty covering the transaction and the situation where there is no definition in the tax treaty covering the transaction.

First, where there is a definition in the tax treaty covering the transaction, application of domestic anti-avoidance rules which result in a reclassification of the transaction does not prevail over the definition in the tax treaty. Second, where there is no definition in the tax treaty covering the transaction, a domestic anti-avoidance rule that entails a reclassification of a transaction is not restricted by the tax treaty if the application of the domestic anti-avoidance rules is compatible with the context of the treaty.

20.4. The relevance of tax treaty GAARs and/or SAARs for the application of domestic anti-avoidance rules

In chapter 18, the author analysed the relevance of a tax treaty GAAR for the application of domestic anti-avoidance rules. In the author's view, it is difficult to give a clear-cut answer on the relevance of including a GAAR in the tax treaty when it comes to the question of the applicability of domestic GAARs. As the analysis in chapter 18 demonstrates, the answer depends on the facts and circumstances. However, in the author's opinion, to the extent that there are no indications by the contracting states as to how to resolve this issue, the principle of *pacta sunt servanda* in VCLT Art. 26 and the object and purpose of the tax treaty to avoid double taxation are strong arguments in favour of holding that, where a tax treaty has included a GAAR, domestic GAARs may only be applied, provided that the domestic GAAR is within the scope of the tax treaty GAAR.

Further, in chapter 19, the author analysed the relevance of a tax treaty SAAR for the application of domestic anti-avoidance rules. It is the author's opinion that a tax treaty SAAR does not exclude the applicability of domestic GAARs. SAARs such as the tax treaty concept of beneficial owner, for example, do not deal with all issues related to whether treaty shopping is

abusive, and, according to the OECD Comm., the beneficial owner concept may therefore not be considered to restrict any other anti-avoidance rules that may be applicable in such cases. However, there is one very important limitation to this, and that is that the application of the domestic anti-avoidance rule in the specific situation may not be contrary to the object and purpose of the tax treaty, both in general and in relation to the specific treaty provision at stake.[527] In most situations, this entails that if the transaction passes the tax treaty SAAR, it is only in extraordinary situations that the domestic GAAR may "stop" the transaction from receiving treaty benefits.

527. *See* sec. 10.2. for more on the object and purpose of the tax treaty and OECD MC Art. 10.

Notes

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