
Chapter 4

A New Approach

4.1. Introduction

In order to design a treaty framework that is conceptually sound, it is necessary to start from the fundamental principles underlying treaties. First and foremost of these is that the imposition of tax is a matter of domestic law; it is domestic law that determines in each state when and how income is taxable, in whose hands it is taxed and whether it is taxable at all. The primary function of a tax treaty in this respect is to resolve the double taxation that occurs when these domestic systems overlap with the result that two (or more) states wish to tax the same income. The solution employed by treaties is to allocate the taxing rights over the income between the two states that have concluded a treaty.¹⁹³

The new approach that will be suggested here takes these fundamental principles as its starting point, and seeks only to regulate the minimum that is necessary to make the allocation rules of the treaty work. Nevertheless, if this approach is applied rigorously it does lead to some structural changes in the way that treaties are drafted. It also requires a number of policy decisions to be made, either by states individually or, preferably, by consensus through the OECD and the UN; these policy issues are highlighted throughout this chapter as the explanation of the new approach progresses.

The following subsection provides a brief outline of the steps involved and the rest of 4. examines the proposed new approach to determining the entitlement to treaty benefits in more detail. The explanation in this chapter is given in a rather theoretical way, and 5. considers the application of the new approach in a number of concrete situations, many of them cases decided by the courts of various countries.

193. Some multilateral treaties have been concluded in respect of income taxation, but the number is so small that they are not considered further here. A multilateral treaty does make it easier to resolve some of the triangular problems that will be discussed later in this section among the signatory states to the treaty, but the same also applies to the current treaty framework.

4.1.1. The new approach in outline

The starting point of the new approach is the autonomy of states in deciding when, whether and how to impose liability to tax on income, and on which person to impose that liability. It is therefore the imposition of a tax liability in respect of a specific item of income under domestic law that constitutes the first step towards entitlement to the benefit of a treaty. In most cases both states would impose their tax liability on the same person, but this is not a condition for the granting of treaty protection. Section 4.7. considers situations in which two states attribute income to different persons.

Once a liability to tax in respect of the income has been established on a residence basis in one or both contracting states to a treaty, a state that is asked to grant treaty benefits would first consider whether the tax liability in the other state is a sufficient basis on which to grant treaty benefits. This determination is intended to test whether the tax liability of the other state is within the margins considered acceptable by the state making the determination, as it will not wish to give treaty benefits on the basis of a liability that it considers unjustified or insufficient.

In order to make this determination, a state would look at various factors supporting the tax liability in the other state. If the state asked to grant treaty benefits is the source state,¹⁹⁴ two of the factors that it is likely to consider reflect current treaty practice, namely whether the connection between the income and the person claiming treaty benefits is substantial enough; and whether that person has a factual connection with the other contracting state that is substantial enough. The source state may also wish to investigate whether the tax liability imposed in the residence state is sufficient as a basis for treaty benefits; this aspect is particularly important in respect of conduit structures, as will be discussed in 4.9.

If a state wishes to impose a tax liability in respect of the income on a person that it regards as a resident, its concern would be twofold. The initial concern would arise if the other contracting state also wishes to impose a tax liability in respect of the income on a residence basis. The liability in the other contracting state could be imposed because the other contracting state regards the same person as a resident; in this case the treaty would resolve the matter in a manner similar to the current tiebreaker rules. It is also possible that the liability in the other state is imposed in respect of the

194. It is assumed here that there is no dispute as to the geographical source of the income.

same income but on a different person, and in that case the treaty would determine which liability takes precedence; this issue is discussed further in 4.7.

If the treaty does not grant the exclusive taxing right to the residence state, the second consideration is whether it is required to grant double tax relief in respect of the tax imposed in the other contracting state. The factors that it would consider in this respect would focus on the nature of the tax liability and, if the liability is imposed on a specific person, the substantive connection between the income and that person. This issue is considered further in 4.6. and 4.7.

As the starting point for entitlement to treaty benefits would be liability to tax in respect of a specific item of income, the basic rules of the treaty would not extend its protection to persons that are exempt from tax, such as pension funds in some countries, or to income that is not taxable in one or both states. The contracting states could, however, add specific provisions granting treaty protection to these persons or income if they so wished. The factors that would be used in defining the scope of this extension of treaty protection would probably be similar to the factors that would be used to support a regular claim to treaty benefits. This issue is discussed further in 4.5.

The difference between the new approach and the current framework lies in the route to determining entitlement to treaty benefits. Making the claim for treaty protection is a different issue; essentially this is just a question of mechanics and, as in the current framework, the person who actually makes the claim could be different from the person whose tax liability gives rise to the treaty entitlement. The OECD Commentary,¹⁹⁵ for example, includes a suggested provision that would allow a collective investment vehicle (CIV) to claim treaty benefits on behalf of its investors. The scope of this provision is limited to investors who are resident in the state in which the CIV is established, although the subsequent text of the Commentary considers the possibility of extending its scope to investors resident in other states. This suggestion has already been taken up in practice by the Netherlands, which has concluded a mutual agreement with some treaty partners allowing certain investment funds established in the Netherlands to claim treaty benefits on behalf of their investors, even if the investors are resident in other states and therefore entitled to the benefit of a treaty other than the treaty between

195. OECD Commentary on Art. 1, Para. 6.28. See also: OECD Committee on Fiscal Affairs, note 13, Paras. 36-40.

the Netherlands and the source state.¹⁹⁶ There is no reason why a similar facility could not be provided under the new approach.

4.1.2. Supporting factors – margins of discretion

As explained in the previous subsection, the new approach would take a liability to tax in respect of a specific item of income as the starting point for entitlement to treaty benefits, but would allow the contracting states to a treaty to test the justification for giving treaty protection on that basis by reference to various substantive factors. The precise choice and definition of those factors would be a matter for negotiation between the two states, and would reflect their domestic law to a certain extent, but the factors should be named in the treaty and, ideally, would also reflect a general consensus among states.

The reason for considering these supporting factors is to determine whether the liability imposed by the other contracting state is sufficient as a basis for granting treaty benefits. But it is not the intention of the new approach that a state would recognize a tax liability in the other state for treaty purposes only if that liability is imposed in exactly the same conditions as its own. The point is not that the supporting factors are an exact match of those of the state applying the treaty, but only that they are acceptable to it. In order to achieve the aim of treaties, states should not take an excessively narrow view of what is acceptable in this respect, although the margin of discretion allowed to them under a treaty might vary from one factor to another.

A similar issue already arises in the current treaty framework in connection with the residence requirement of the OECD Model. The OECD Commentary on Art. 4 states¹⁹⁷ that treaties “do not lay down standards which the provisions of the domestic laws on ‘residence’ have to fulfil in order that claims for full tax liability can be accepted between the Contracting States.” It is submitted, however, that this statement is manifestly wrong, as Art. 4 does set a standard by defining residence by reference to a liability to tax that is imposed according to a person’s “domicile, residence, place of management or any other criterion of a similar nature”.

196. De Bruin, M., et al., “Dutch closed mutual fund may apply for tax treaty benefits on behalf of its investors”, 12 *Tax Planning International: European Tax Service* 6 (2010), pp. 10-11. Mutual Agreement No. IFZ2010/534M of 25 August 2010 with the United Kingdom, for example, is available at <https://zoek.officielebekendmakingen.nl/stcrt-2010-13491.html>.

197. In Para. 4.

Aside from this discrepancy, there must in any event be some limit on how far states are obliged to accept another state's residence definition for treaty purposes. Imagine, for example, that the Netherlands adopts legislation which deems every individual whose family name begins with an "N" to be resident in the Netherlands for tax purposes. Why would the source state of income that is owned by a Mr Nicholls, who lives in the United Kingdom and who has no substantive connection whatsoever with the Netherlands, be obliged to grant benefits under its treaty with the Netherlands? There is no reason to oblige source states to respect such an absurd rule. In fact a less extreme example is already found in current treaty practice, as most treaty partners of the United States are not willing to extend treaty protection to non-resident citizens, even though those citizens are liable to tax in the United States in respect of their worldwide income.¹⁹⁸

Another fundamental element in the application of many treaty articles is the determination of the source of income. Again, states determine under their domestic law how they define the source of income, but the OECD Model contains implicit source rules which restrict the ability of states to determine the source of income for treaty purposes to a rather narrow margin. In this way they avoid the double taxation that could otherwise ensue if states disagreed about the source of income and the residence state refused to grant double tax relief in respect of income that it regarded as having a domestic source. States also have a discretion in deciding why they impose a liability to tax in respect of income and in selecting the person on whom they impose that liability, and domestic law on these points can vary considerably from one state to another, as demonstrated by Appendix II.¹⁹⁹

One of the benefits of the new approach is that it focuses attention on these policy decisions, which are at the core of determining entitlement to treaty benefits. It also gives the contracting states to a treaty the possibility of finding that a tax liability of the other state is not acceptable as a basis for granting treaty benefits. This is a possibility which they do not have in the current framework, and this gap has had to be compensated by the use of other considerations, leading to some of the problems outlined in 2. and 3. The margin that should be left to states in respect of these issues is the subject of much of the rest of 4.

198. The author is grateful to Dan Berman, Boston University School of Law for pointing this out to her.

199. See also Wheeler, note 1.

4.2. The treaty claimant

4.2.1. In general

The introduction to the new approach in the previous subsection discussed treaty entitlement in terms of the application of treaties to persons, as does much of the rest of this thesis. The focus in the current treaty structure on persons creates problems, however, as discussed in 2.2. Two of the primary examples of this problem are the entity classification issue and the separate ownership and taxpaying capacity of a trustee; indeed, a professional trustee may have hundreds of separate taxpaying capacities, and in this case the focus of the OECD Model on the person is clearly inaccurate. The obvious solution is that treaties should apply to each taxpaying capacity separately, and this solution would be the natural result of applying the new approach. The rest of this thesis generally refers to persons who are entitled to treaty benefits in the interest of readability, but it should be borne in mind that it is intended to refer to the specific taxable capacity of the person or unit that bears the liability to tax.

More importantly, the new approach is more objective in this respect than the current OECD Model, which means that the problem of identifying the treaty-entitled person becomes much less acute.²⁰⁰ This difference also brings the new approach closer to the fundamental aim of the distributive rules of tax treaties, namely to resolve overlapping claims to taxing jurisdiction by states.

Entitlement to treaty benefits is predicated on a substantive connection between the destination of the income and one or both of the contracting states to the treaty, and the current treaty framework identifies the destination of the income through the person who owns the income. The current path to treaty entitlement looks for two connections: a residence connection between a person and the tax system of a contracting state; and an ownership connection between the income and the person. The person is

200. Danon also recommends that treaties take a more objective approach than at present, although he does not go as far as the new approach suggested here. He argues that "... the concept of international double taxation contained in the OECD Commentary should preferably be refined so as to focus more on the allocation of taxing claims between the parties and on their exercise of taxing jurisdiction over the latter, rather than on the so-called 'identity of subject' requirement inherent to juridical double taxation." Danon, note 155, at p. 365. See also Danon, note 80. Prebble has also considered a more substantive interpretation of the current treaty framework, but rejected it because the text of the OECD Model so clearly deals with persons, rather than income: Prebble, note 10, at p. 198.

the pivotal point that brings these two connections together, and it is for this reason that the identification of the person has acquired paramount importance in current treaty law.

But using the person as the pivotal point is also what causes many of the difficulties in current treaty law because, as argued in 3.4., the two connections that have to be made in order to establish entitlement to treaty benefits do not join up properly. There is a tension between them that manifests itself at the pivotal point where they are supposed to join, namely the person. This was the problem of the Canadian court in the *TD Securities* case,²⁰¹ where the court felt instinctively that the treaty should apply but had difficulty in squeezing the facts within the text of the treaty. Many of the problems discussed by Couzin in respect of the residence definition in the current treaty framework²⁰² also stem from the focus on the person and the huge range of possibilities in which liability to tax in respect of income can be imposed, or not imposed, on a person.

The new approach removes this tension by starting from the most direct connection between an item of income and a state's tax system, namely the imposition of liability to tax in respect of the income. The taxable unit, or taxable capacity, on which the liability is imposed is a matter for the state to determine, and the new approach accepts this determination as a consequence of its starting point.

In order to ensure that there is a minimum substantive connection between the destination of the income and at least one of the contracting states, further conditions would have to be fulfilled to support the claim to treaty benefits. Those conditions relate to the ownership of the income and to the residence of the person or capacity on whom the liability is imposed, but they take a more objective approach than the current framework. Provided all the supporting elements are found within one state, it would be clear that the treaties concluded by that state apply, even if the supporting elements do not join together in one person. If the supporting elements are found in different states, policy choices would have to be made as to which treaty applies, or whether any treaty applies at all; this issue is discussed in 4.8.

201. Note 121.

202. Couzin, note 31, Sec. 3.1.1.

4.2.2. Permanent establishments

As something of an aside to the previous subsection, because this point is not the focus of this thesis, the new approach also offers a way to resolve a particular problem related to permanent establishments. That problem is that the current focus of treaty law on the person who is entitled to treaty benefits means that, when an enterprise resident in one state receives passive income from another state through a permanent establishment that it maintains in a third state, the limitation of the source state tax is governed by the wrong treaty in economic terms.²⁰³

The new approach could solve this problem by recognizing the tax liability of the enterprise in respect of its permanent establishment as a liability imposed on it in a taxpaying capacity distinct from the taxpaying capacity of the enterprise as a whole. The permanent establishment would, in other words, be regarded as capable of having a “treaty capacity” and therefore be capable of claiming the benefit of the treaties concluded by the state in which it is situated. This suggestion is not new; it has already been made by Avery Jones²⁰⁴ and by Vann,²⁰⁵ who states that “there is a policy basis for such a result” but who sees problems with the application of bilateral nature of treaties to the triangular situations in which this solution would be applied.

Indeed, a number of qualifications have to be made to this solution, but they all reinforce the basic philosophy of the new approach. One is that this approach would be necessary only to the extent that the enterprise is liable to tax in the state of the permanent establishment in respect of income from worldwide sources derived through the permanent establishment.²⁰⁶

Rather more importantly, this solution is not appropriate for all types of permanent establishment. As Schön has noted,²⁰⁷ the OECD has been tak-

203. Avery Jones, J. and Bobbett, C., “Triangular treaty problems: a summary of the discussion in Seminar E at the IFA congress in London”, 53 *Bulletin for International Taxation* 1 (1999), pp. 16-20.

204. Avery Jones, J.F., “The David Tillinghast Lecture: Are Tax Treaties Necessary?”, 53 *Tax Law Review* 1 (1999), pp. 1-38 at p. 27.

205. Vann, note 16, at pp. 248-50.

206. There seems to be no universal consensus on this point: Baker, P., and Collier, R.S., General Report, at p. 42 in: International Fiscal Association, *Cahiers de droit fiscal international*, Vol. 91b (Amersfoort, the Netherlands: Sdu Fiscale & Financiële Uitgevers, 2006), pp. 21-67.

207. Schön, W., “Attribution of Profits to PEs and the OECD 2006 Report”, 46 *Tax Notes International* 10 (2007), pp. 1059-72.

ing the concept of a permanent establishment in two directions in the past decade or so. One direction is the lowering of the threshold for finding that a permanent establishment exists.²⁰⁸ The other is increasing the notional independence of a permanent establishment in order to determine the profit attributable to it. The first direction diminishes the separate identity of a permanent establishment, whereas the second direction reinforces it. Schön has therefore suggested the introduction of two definitions in the OECD Model: a low threshold for source state taxation; and a high threshold for the computation of profit according to a full notionally separate entity approach.²⁰⁹ In the new approach, recognizing the status of a treaty-entitled person would be suitable only for permanent establishments that exceed the higher threshold.

As regards triangular situations, the treaty entitlement of a permanent establishment would be in addition to the treaty entitlement of the enterprise as a whole, but it would have to take priority over the entitlement of the whole enterprise in respect of the income attributable to the permanent establishment. The relationship between the permanent establishment and the enterprise as a whole would also still have to be regulated by treaty. Both of these requirements could be achieved in a manner similar to that proposed in 4.8. in respect of double residence state attributions of income; a high-threshold permanent establishment does, after all, have many features of a resident taxpayer.²¹⁰

Subject to some brief discussion in 4.4.3. and 4.7.4., this thesis will not, however, go into an extended discussion of the merits or otherwise of treating permanent establishments as taxable capacities capable of being entitled to treaty benefits; the issue is mentioned only because it is a logical consequence of the new approach that is proposed.

208. In this respect, see also: van Raad, C., “New sources of tax revenue for transit countries: can a (rail) road qualify as a permanent establishment?” in: Baker and Bobbett, note 65, pp. 125-30.

209. Schön, W., “Persons and territories: on the international allocation of taxing rights”, *British Tax Review* 6 (2010), pp. 554-62 at p. 560.

210. Vann, R., “Reflections on business profits and the arm’s-length principle”, in: Arnold, B.J., Sasseville, J., and Zolt, E. (eds), *The taxation of business profits under tax treaties* (Toronto: Canadian Tax Foundation, 2003), pp. 133-69, especially at pp. 142-8.

4.3. Liability to tax

4.3.1. The basic principle

The central feature of the new approach is that the starting point for determining whether treaty benefits are available in respect of an item of income is the imposition of a liability to tax on that income under domestic law. Unlike the current treaty framework, therefore, a person who owns income, but who is not liable to tax in respect of that income under the tax system of a state, would not be able to claim the benefits of treaties concluded by that state. So if, for example, a trustee is not liable to tax in respect of trust income, because the income is paid directly to the beneficiary and the only liability is imposed directly on the beneficiary,²¹¹ the trustee would not be entitled to treaty protection in respect of that income. The beneficiary would, of course, be entitled to claim treaty benefits, subject to the conditions discussed in the remainder of 4. Similarly, if a state uses the remittance basis in respect of certain types of income, no entitlement to the benefit of treaties concluded by that state would arise until the income is actually remitted and becomes subject to a tax liability there.

This thesis focuses on the application of treaties to overlapping tax claims in a source and a residence state, or in two residence states, but under the new approach there is no conceptual reason that prevents treaties from also dealing with double claims to source taxation. A treaty could include a hierarchical list of the factors that underlie state claims to tax on a source basis, and provide that a factor higher in the list takes priority over a factor lower down on the list. As liability to tax on the income forms the entry requirement to treaty entitlement, a person who is resident in neither state would still be able to claim the benefit of such a provision in order to resolve competing claims to source taxation. This possibility is not pursued here any further, however, as the aim of this thesis is to propose a solution for the structural problem in respect of entitlement to treaty benefits that besets the existing treaty framework. It is therefore assumed in the remainder of this

211. This could be the case, for example, in Australia and New Zealand, as their domestic law distinguishes between “beneficiary income” and “trustee income” and imposes a tax liability on trustees only in respect of trustee income. It could also happen in the United Kingdom, if a beneficiary has an immediate right to the income as it arises and the trustees mandate payment of the income directly to the beneficiary. See: Gillies, P., *Australia - Trusts* sec. 4.3., Tomlinson, P., Morrison, K., and Alston, A., *New Zealand - Trusts* sec.4.3. and Hardy, A., *United Kingdom - Trusts* sec. 4.3., Topical Analyses IBFD (accessed 3 March 2011). The application of the new approach to trusts is discussed in detail in 5.4.

discussion that only residents of one or both contracting states are entitled to treaty benefits.

The reliance of the new approach on a liability to tax in respect of an item of income would invoke the same distinction between “liable to tax” and “subject to tax” that is made in the current treaty framework. So there would be a liability to tax in respect of income even if no tax is immediately payable in respect of the income, for example because the payment enters into a net profit computation that results in a loss or because it falls within the tax-free income band of an individual. This aspect of the new approach may seem, at first sight, to reintroduce all the “liable to tax” problems of the current treaty framework, but that is not so.

The difference is that in the new approach the “liable to tax” concept applies to a specific item of income, not to a person. There are so many variations in the mixtures of liability and non-liability that can be imposed on a person that it is hardly possible to treat this requirement in respect of a person as a simple yes/no question.²¹² Single items of income, by contrast, are not subject to the same mixtures of liability and non-liability. In respect of one item of income, it is usually clear whether or not it falls within the scope of a state’s tax system and therefore a yes/no answer is readily found. There might be a question about the sufficiency of the tax liability as a basis for treaty benefits, however, and that issue is discussed in 4.3.2.

It is unlikely that states would be prepared to accept the imposition of tax liability by other states without question, and so further conditions would be necessary. In respect of the tax liability in a residence state, these concerns would be addressed by the conditions relating to the tax liability discussed in the remainder of 4.3. and the ownership and residence conditions discussed in 4.4. These conditions would take over many of the functions currently fulfilled by limitation-on-benefits provisions in the current treaty framework and serve to demonstrate the economic nexus between the income and the residence state. By separating out the various elements required to substantiate a claim to treaty benefits, however, they make the underlying issues clearer than in the current limitation-on-benefits provisions. These substantive elements would also be integrated into the basic approach to granting treaty benefits, rather than being added on

212. On this point, see: Couzin, note 31, Sec. 3.1.1; and Nikolakakis, note 11, pp. 255-63.

as anti-avoidance provisions after the route to treaty entitlement is defined or brought into the treaty through its interpretation.²¹³

The decision as to whether a specific tax liability of another state justifies entitlement to treaty benefits is the mirror image of the decision that states have to make when shaping their own taxing policy. States have to make many decisions as to when and on whom to impose tax and some states may go much further than others in imposing tax on a person who has only a remote connection with the income. Section 3.3.3. discussed some examples of states imposing tax in circumstances which might be regarded as too extreme by other states. In the current treaty framework, a person who is subject to such a tax liability might well be refused treaty benefits on the basis that he does not “derive” the income or is not the beneficial owner. But this approach disguises the real issue to a certain extent, if the underlying problem is that another state finds the liability in these circumstances too extreme. If another state does, indeed, disagree as to the policy justification for imposing such a tax liability, there seems to be no reason why it should be obliged to grant treaty benefits on the basis of that liability.

Anti-avoidance legislation is not the only situation in which this issue may arise. Grundy, for example, has argued in the context of the current treaty framework that²¹⁴ “[t]here seems no reason in principle why a person who is a ‘resident of the United Kingdom’ should be denied the benefit of the tax treaties to which the United Kingdom is a party because he is a trustee,

213. Two recent pleas for an integral approach have been made in: Lang, et al. (eds), note 34. Duff (Duff, D.G., “Responses to Treaty Shopping: A Comparative Evaluation”, Sec. 5), for example, writes “While each of these responses has a role to play in preventing abusive treaty shopping, this paper questions whether the interpretation of residence and beneficial ownership can prevent abusive treaty shopping, and the extent to which references to an inherent anti-abuse principle and/or domestic general anti-avoidance rules represent a fair and effective response, given uncertainty over the line between acceptable tax planning and abusive treaty shopping. For this reason, it concludes that the best response to treaty shopping involves the inclusion of detailed LOB and subject-to-tax provisions in tax treaties.” Bammens and De Broe (Bammens and De Broe, Sec. 6) consider the economic perspective on treaty entitlement and conclude that “the objective component of most anti-avoidance mechanisms hinges on the question whether there is an economic justification for granting the taxpayer the relevant tax benefits. ... The question thus arises whether there is a universal threshold that must be met in order for tax treaty benefits to be available. In other words, is it possible to formulate an economic-substance test to replace the beneficial-ownership requirement, LOB provisions, etc.? Assuming that tax treaties should only be applied to situations that further the economic objective sought by the treaty, this test could be seen as an implicit anti-abuse mechanism, inherent in all tax treaties and intended to confine treaty application to situation where a sufficient economic nexus warrants it.”

214. Grundy, M., “The Uses of Trusts”, IX *GITC Review* 3 (2010), p. 13 et seq., at p. 17.

unless the relevant treaty so provides, or unless he is a mere nominee or has a beneficiary with an interest in possession. But the effect is anomalous: it can indirectly confer the benefit of the tax treaty on individuals who – one would think – have no business enjoying it.” If there is an anomaly in this situation, however, it does not lie in the treaty entitlement of the trustees but rather in the tax liability that is imposed on them in the first place. To put it another way, if the source state does indeed think that the residence state has no business taxing trustees, why should it be obliged to grant them treaty benefits?²¹⁵

The basic principle should be that, if it is justifiable to impose a tax liability on an item of income, it is also justifiable to grant treaty protection in respect of that income. Of course states may disagree as to whether the liability is justifiable, and this disagreement may lead to specific formulations of the elements that have to be demonstrated in order to support a claim to treaty entitlement. Possibly a treaty could also include provisions that deny treaty benefits in respect of certain specified types of liability under the domestic law of one state that are not acceptable to the other state. In any event, a disagreement of this sort would ideally be made explicit, so that it is clear why a particular type of tax liability does not lead to treaty entitlement.

4.3.2. The sufficiency of the tax liability

As it is the tax liability imposed by a state that is the key to treaty protection, the treaty partners of that state may also wish to lay down certain standards that the tax liability must meet in order to give entitlement to treaty benefits. For a source state, this would mean that it is not obliged to grant treaty benefits if the liability in the residence state is not sufficient. For the residence state this would mean that treaty exemptions do not apply or that they are replaced by a credit.

In many cases the state granting treaty benefits may be content simply to rely on the other state’s tax system to impose a sufficient amount of tax, but there may also be situations in which states find it necessary to specify further conditions about the tax liability. One simple condition could refer to the nominal rate of tax, but this is often not representative of the amount of tax that is actually collected. The alternative is to look at the effective rate of tax, although in that case it would be necessary to determine how to

215. The application of the new approach to trusts is considered in detail in 5.4.

compute the effective rate on a single item of income that forms part of a larger basket of taxable income in the residence state.

A common concern in this respect is base erosion, and as Rosenbloom writes in respect of limitation-on-benefits provisions in the current treaty framework, “[b]ase erosion provisions attempt to ensure that the country of asserted residence collects an amount of tax that is not substantially lower than the normal or expected amount because deductions are used to reduce the local tax base in favor of persons resident elsewhere. What happens, however, if the residence country employs credits, rather than deductions, as a means of reducing its tax?”²¹⁶ A general test of the sufficiency of the tax liability in the residence state that looks at the effective rate of tax could indeed deal with the use of tax credits to lower the effective rate. Base erosion is considered in more detail in 4.9.

Another possibility is that a tax levied in the residence state is the subject of a refundable credit in the hands of another person within the same state. This may happen, for example, with trust income; in some systems income received by a trustee is taxable in the hands of the trustee, and a beneficiary who receives a trust distribution is able to credit the tax paid by the trustees and obtain a refund of any excess above his own personal tax liability. The point here is not that the refund may reduce the final amount of tax, but that the trustee’s liability is not sufficient because it is not permanent. The credit mechanism, in effect, shifts the tax liability from the trustee to the beneficiary, and for that reason only the beneficiary would be entitled to claim treaty benefits. This issue is discussed further in 5.4.2.3.

4.3.3. Fragmented and dislocated tax liability

A liability to tax on a specific item of income is usually clearly imposed by domestic law on one person, but occasionally the liability is fragmented, in that the amount of tax is computed by reference to the characteristics and circumstances of one person, but the legal liability to pay the tax is imposed on a different person. Both Australia and the United Kingdom, for example, in some circumstances impose a tax liability on trustees in respect of trust income, but compute the amount of tax by reference to the circumstances of the beneficiary.²¹⁷ Holmes notes in respect of Australia that this legisla-

216. Rosenbloom, D, “Limiting Treaty Benefits: Base Erosion, Intermediate Owners, Equivalent Beneficiaries”, 58 *Tax Notes International* 8 (2010), pp. 649-52, at p. 650.

217. In Australia: Sec. 98 Income Tax Assessment Act 1936. In the United Kingdom: Secs. 23-45 Finance Act 2005. A similar mechanism applies in the United Kingdom in

tion causes difficulties in determining which person is entitled to claim treaty benefits in respect of the income.²¹⁸ The UK legislation sometimes also achieves a comparable result but in a different way; in some circumstances the legislation imposes a tax liability on a trust settlor in respect of trust income, but grants the settlor the right to recover the tax so charged from the trustees.²¹⁹

It seems hardly likely that a tax liability would be fragmented across the borders of a state and it is assumed here that, if a tax liability is fragmented in this way, the fragments are all found within the same state. Under the new approach, these fragments could be aggregated in order to fulfil the initial condition for claiming the benefits of the treaties concluded by that state. Nevertheless, it might be important to identify a person in respect of the treaty claim if, for example, the income in question is a dividend.

It is submitted that in this case the treaty protection should be based on the person whose characteristics and circumstances determine the amount of tax, as this is the aspect of the tax liability that has the more substantive connection with the state's tax system. Some support for this proposition can be found in the OECD Partnership Report, which also finds this feature the determinative one in the identification of the person to whom a treaty applies.²²⁰ In the context of the new approach this is, however, a policy decision rather than a "systemic" one, and states could choose the person who bears the obligation to pay the tax.

A rather different possibility is that the design of the tax charge dislocates the liability to tax from the income. One of the best examples of this phenomenon is the Netherlands system for taxing the passive income of individuals, known as the "Box 3" system.²²¹ Under this system, individuals are not taxable in respect of their actual income from assets but rather on a deemed rate of return on the investment assets they own. Although there are many arguments that this charge is a wealth tax, rather than an

certain cases on a change of ownership of company, when the tax authority is permitted to assess certain persons connected with the company to any unpaid tax due from the company, but gives that person a right of indemnity against the company: Secs. 710-8 Corporation Tax Act 2010.

218. Holmes, K., *International tax policy and double tax treaties: an introduction to principles and application* (Amsterdam: IBFD, 2007), at p. 117.

219. Chap. 5, Part 5, Income Tax (Trading and Other Income) Act 2005, in particular Secs. 622, 624, 629 and 646.

220. OECD Committee on Fiscal Affairs, note 2, Para. 40.

221. Arts. 5.1 to 5.3 Wet inkomstenbelasting 2001.

income tax,²²² it is generally covered by the treaties concluded by the Netherlands. Another example is the corporate loan relationships scheme of the United Kingdom,²²³ which creates a scheme of taxation based on notional payments. When this scheme applies, the amounts taxed as income in the hands of a company do not necessarily coincide with the amounts of income that are actually paid, and the legal and economic ownership of sums actually paid are only indirect factors in determining the tax liabilities of the parties.²²⁴

Cases such as these cause the same difficulty under the new approach as in the current treaty framework: that a liability to tax is imposed on something that does not correspond with a payment recognized as an income payment by the other contracting state to a treaty. One solution is that the contracting states agree to regard the tax liability as being equivalent to a liability on the income that is actually paid, although this solution raises issues about matching the tax liability to actual income payments. Alternatively, under the new approach, treaty protection could be granted on the same basis as would be used in respect of exempt persons, which is discussed in 4.5. Under the new approach there is, in effect, no difference between the two, as in both cases treaty benefits would be granted to a person in respect of income even though that person is not liable to tax in respect of that exact item of income.

4.4. The supporting factors in the residence state

Once a liability to tax on an item of income has been established in a residence state, the next step under the new approach is to determine whether or not that liability is acceptable as a basis for access to treaty benefits. One part of that determination would focus on the connection between the income and the person on whom the liability is imposed; the second part would focus on the connection between the person and the residence state. In applying the conditions explained below, the source state is testing whether the residence state is justified in levying tax on the item of income

222. An overview of these arguments, with references to the relevant literature, is given in Sillevius, L.W. and van Kempen, M.L.M., *Cursus Belastingrecht (Inkomstenbelasting)* (Deventer: Gouda Quint, loose-leaf), Sec. 5.0.6.A.d. (March 2010). In the opinion of the current author, the most persuasive argument, which is not given in this overview, is that, if an asset is subject to a usufruct, the bare owner is liable to a Box 3 charge even though the bare owner, by definition, is not entitled to the income.

223. Now found primarily in Parts 5 and 6 Corporation Tax Act 2009.

224. An example of how this scheme works is given in Appendix II, Sec. 3.2.3.2.

so that, as a corollary, it is justifiable to grant treaty benefits in respect of the income.

This testing has two aspects. One aspect is whether the tax liability in the residence state is acceptable of itself; this aspect raises issues about whether the residence state steps outside an acceptable margin in imposing tax on persons who have only a remote connection with the income or with the state. The other aspect is whether the person claiming treaty benefits has manipulated the circumstances in order to fall within a state's tax system in order to be able to claim the treaty benefits. These are two sides of the same coin, and the side that receives attention will depend on the circumstances of the case.

This section focuses on these questions in respect of one person; 4.8. deals with the situation when different attributes of treaty entitlement are divided among two or more persons. States may also wish to grant treaty protection to certain persons or to certain items of income in the absence of a tax liability. In this case they would probably rely on factors similar to those that would support a treaty claim via the normal route. This possibility is considered in 4.5.

4.4.1. The connection between the income and the person

The first element that would have to be demonstrated in order to support a claim to treaty protection would be a sufficient connection between the income and the person claiming protection. The two most obvious connections are either that the person has ownership of the income or that the person derives the income from carrying on an activity. The issue is not that simple, however, as both factors can be found in respect of active income, not necessarily in the hands of the same person, and the ownership connection can be divided into a number of different aspects. This section considers whether one specific connection between income and a person is sufficient to give entitlement to treaty protection; 4.8. considers the issues that may arise when different persons have different connections.

In respect of active income, the primary connection would be with the person that carries on the activity in respect of which the income is paid. Indeed, in respect of certain types of active income derived by an individual, it is possible that this connection is the only one that is recognized for treaty purposes; this may be the case with employment income or remuneration for services that have a highly individual character. In respect of a

business, it may not always be easy to pinpoint the person who is carrying on the business,²²⁵ but this would again undoubtedly be the primary connection in this case. Some specific considerations that apply to business receipts are discussed in 4.4.3.

The ownership connection is likely to be more problematic, particularly in respect of passive income, as is already the case in the current treaty framework. Ownership has many attributes,²²⁶ and there is therefore a policy decision to be made as to how much ownership is needed in order to claim treaty benefits, or which ownership attributes are sufficient. The two main factors that are likely to play a role in this respect are economic entitlement to income and control over the application of the income. The ownership connection could, in the alternative or in addition, be defined in a negative way to exclude persons whose only connection with the income is their legal entitlement and/or the simple receipt of income.

Note, however, that the positive factors would not, of themselves, lead to entitlement to treaty protection. A *bewind* in the Netherlands, for example, is a legal figure in which a *bewindvoerder* is appointed to deal with the financial affairs of another person, such as an individual under an incapacity. The *bewindvoerder* has control over the application of that person's income, but this control would not lead to treaty entitlement as the *bewindvoerder* is not liable to tax in respect of the income.

The ownership condition in the new approach would be less fraught than the beneficial ownership requirement in the current framework because it would have to carry much less of an anti-avoidance burden. As will be discussed in 4.9., the current problem with conduit structures would be solved primarily at the initial stage of evaluating the tax liability that gives entitlement to treaty benefits. The further condition, discussed below, as to the connection between the treaty-entitled person and the state would provide further safeguards.

On the other side of the coin, the law of some states may raise a question when it attributes income to a person who has rather a remote connection with the income. This question would apply, for example, to anti-avoidance measures such as those described in 3.3.3. It might also be raised by source states in connection with attribution rules that are often regarded as more basic, such as those of many common-law states that attribute the income

225. See Appendix II, in particular Section 4.2.

226. See Appendix II, in particular Section 3.

of a trust to the settlor on the basis of factors such as the settlor's ability to recover the trust property. For states in the position of source state, the policy issue here is whether they are prepared to accept this type of tax liability as a good basis for granting treaty benefits. Residence states would also have to make a policy decision as to whether they wish to include specific provisions in their treaties in this respect; maybe in some cases they would not do so, in order to maintain the deterrent effect of anti-avoidance rules.

Clearly, the choice of connecting factors would be an important policy decision. No doubt a large degree of consensus could be achieved on the most usual factors, which could be expressed in the OECD Model. The advantage of the new approach is that, unlike the current treaty framework, it requires that this aspect is explicitly addressed.

As a subsidiary point, it is questionable whether the income categories defined in the distributive provisions of the current OECD Model are the most appropriate for this purpose. Probably the best example is Art. 11, which applies to all payments of interest, regardless of whether the interest is received as a receipt of an active business, as a return on a multimillion corporate financing deal or as the investment income of a small private investor.²²⁷ Redefining the categories of income in the OECD Model would not only make it easier to define suitable connecting factors; it would also make it easier to define suitable thresholds for source state taxation. This issue is not discussed further here, however, as the suggestion has already been made elsewhere in a different context²²⁸ and a consideration of the current income categories in the OECD Model is beyond the scope of this thesis.

4.4.2. The connection between the person and the state

The second element that would have to be demonstrated in order to support a claim for treaty benefits is a sufficient connection between the person on whom the tax liability is imposed and the state from which treaty protection is claimed, or in other words a residence connection. The conditions in this respect would relate to the taxable capacity in which the tax liability is borne, as discussed in 4.2.1., so the residence of a trustee, for example, could be different from the residence of the person who happens to fulfil

227. Although the Commentary on Art. 11 does recognize this issue to a certain extent in Paras. 7.1 to 7.9.

228. Vogel, K., "The schedular structure of tax treaties", 56 *Bulletin for International Taxation* 6 (2002), pp. 260-1.

the role of trustee. Unlike the current OECD Model, this test would not look for a general, or unlimited, liability to tax, but rather at the substantive factors that connect a person with a state. It would probably contain a number of alternative factors, each of which are accepted by the contracting states to a treaty as a sufficient basis on which to claim the protection of treaties concluded by that state.

For individuals this test would probably name various elements similar to those now used in the first two paragraphs of the tiebreaker provision in Art. 4(2) OECD Model, although the precise elements named in each treaty would reflect the residence connections used by the contracting states in their domestic law. Policy decisions would have to be made as to the acceptability of more formal connecting factors, such as an individual's registration in a state's civil registry. If a state imposes an extended liability to tax for a period after an individual ceases to be resident in the state, a policy decision would also be required as to whether the existence of a substantial connection in the past is acceptable as a basis for granting treaty benefits.

In respect of companies, the basic idea behind the test would be the same, but here the matter is complicated by the clash between the domestic and treaty policies of many states that already causes problems in the current treaty framework. On the one hand, most states regard a company as resident if it is incorporated under the state's domestic law and accordingly impose taxation on the company's worldwide income. On the other hand, states are increasingly reluctant to grant treaty benefits to a company on the sole basis of its incorporation under the domestic law of a treaty partner state.

This difficulty is compounded by the thinness of the concept of a company as a legal person. A company can be used for an extremely limited purpose, in which case there may be almost no substance with which to test its personal connection with a state. This problem is illustrated by the UK case of *Wood v. Holden*,²²⁹ in which a company simply played a role in a scheme that had been designed in advance. Its role was solely to buy shares and then sell them, and all that it was required to do was to make the decisions to buy and sell. The residence of the company was not the crux of the decision, but the Court of Appeal stated that if it had had to decide this point it

229. *Wood and another v. Holden (Inspector of Taxes)* [2006] STC 443, United Kingdom: CA, 26 January 2006, Tax Treaty Case Law IBFD. In this case the Court of Appeal held that the determination of a shell company's residence could be based on the small number of decisions that were required to implement a scheme that had been designed in advance.

would have had to look at those two decisions alone, as there was nothing else in the company to manage.

In the current treaty framework, the policy clash in respect of the place of incorporation as a connecting factor has led to the adoption of limitation-on-benefits provisions in an increasing number of treaties. These provisions usually contain a mix of conditions; shareholder tests relate to the company's ownership, active-business tests relate to the activity that generates the income and base erosion provisions relate to the substance of the tax burden on specific items of income in the claimed residence state. In a recent critique of the limitation-on-benefits provisions in US treaties, Rosenbloom has described them as "convoluted and formulaic" and largely ineffective.²³⁰ It is submitted that part of the problem here is that limitation-on-benefits provisions have to deal with too many things at the same time. The mix of tests they employ reflects the indirect route to determining residence that is taken by the current OECD Model, and their defensive character does little to clarify what it is precisely that does give entitlement to treaty protection.

One of the advantages of the new approach is that it separates out the various elements that are required in order to substantiate a claim to treaty benefits, and so allows the discussion to focus on one element at a time. The liability to tax in respect of a specific item of income is the basic condition for obtaining treaty protection and there is, therefore, no need to build this aspect into the residence definition. The residence definition would, rather, look at the substantive, non-tax factors connecting a company with a state that are found to justify granting treaty benefits. This is, of course, an extremely important policy question.

The problems in this respect in the current treaty framework have already led various commentators to suggest alternatives. At one end of the scale, Van Weeghel has argued that the "place of effective management" concept is no longer useful as a tiebreaker rule and should be replaced by a more formal test, such as place of incorporation, possibly backed up by an anti-abuse provision.²³¹ At the other end of the scale, Vann has argued for

230. Rosenbloom, note 216, at p. 652.

231. Van Weeghel, S., "The tie-breaker revisited: towards a formal criterion?", in: *A vision of taxes within and outside European borders: Festschrift in honor of Prof. Dr. Frans Vanistendael* (Alphen aan den Rijn, the Netherlands: Kluwer, 2008), pp. 961-9. See also: van Weeghel, S., "Article 4(3) of the OECD Model Convention: An inconvenient truth" in: Maisto (ed.), "Residence of Companies under Tax Treaties and EC Law", note 16, pp. 303-7.

a much more substantive test to determine the treaty entitlement of companies, arguing that “a substantial argument can be mounted that a PE test is appropriate for granting treaty benefits in place of or in addition to a residence test for companies”.²³² In respect of this latter suggestion it is interesting to note a point made by Couzin²³³ in his analysis of the *De Beers* case;²³⁴ the statutory background to the case meant that “it was not open to the courts to decide that ‘residing’ should mean, ‘carrying on business in the jurisdiction’, although such a meaning might otherwise have been acceptable.” The “management and control” test enunciated in that case, which has dominated so much thinking about corporate residence, was chosen because the statute seemed to require an analogy with individual residence.

Although this background suggests that states might choose a different test of residence if they could start afresh from a clean slate, it remains necessary to apply the new approach to treaty entitlement in the existing world. The criteria that would be named in a treaty as acceptable connections between a company and a state would probably reflect the connections used in domestic law, and/or might resemble the factors named in the 2003 OECD discussion draft²³⁵ on a possible revision of the corporate tiebreaker rule.

Of course the most controversial policy decision remains whether or not incorporation in a state is a sufficient connection as a basis for treaty protection. If the incorporation connection is not accepted, states may wish to include a derivative benefits provision for a company that cannot demonstrate any of the named connections with the claimed residence state, but is nevertheless liable to tax on the income due to its incorporation there. Under this test, the company would be able to claim treaty protection to the extent that its shareholders would be able to do so if the income in question were paid to them directly. If the shareholders are resident in the company’s incorporation state, it is obvious which treaty applies.

If the shareholders are resident in a different state from the company, there is a policy decision to be made as to whether they would have to be entitled

232. Vann, note 16, at p. 269.

233. Couzin, note 31, Sec. 2.1.

234. *De Beers Consolidated Mines, Limited v. Howe (Surveyor of Taxes)* 5 TC 198; [1906] A.C. 455.

235. OECD Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits, *Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention* (Paris: 2003), available at <http://www.oecd.org/dataoecd/24/17/2956428.pdf>.

to the benefit of the actual treaty with their residence state if the income were paid to them directly, or whether the treaty with the company's residence state should be used for the purpose of applying this test. If the treaty with their actual residence state is used, there is then a question as to which treaty applies to determine the extent of the benefits granted. As the entitlement to treaty protection in this case is formed, in effect, by aggregating the partial entitlements of the company and the shareholders, it would usually be the less favourable treaty that applies, as the aggregation should take the treaty protection only to the limit of the lesser part. Derivative benefits given in this way would have to be granted on a proportional basis according to the shareholders' interests. These computations might become very complex, but if the company has a large number of shareholders it is likely to be managed in the state where it is incorporated and be able to demonstrate its residence on that basis. Furthermore, this basis for granting treaty benefits is a last-resort measure, and it would have to be accepted that, the more tenuous a company's connection with a state becomes, the more difficult it becomes to demonstrate the required residence connection.

It would still be necessary to include a residence tiebreaker provision in treaties, as the risk of one person being resident in both contracting states for treaty purposes would still be present. The tiebreaker provision could give a hierarchy of connecting factors; if the hierarchy used the same connecting factors that are used to demonstrate the residence connection in the first place, there would be no danger of the tiebreaker pointing to a third state, as can happen under the current OECD Model in respect of companies.²³⁶

Unlike the current OECD Model, the residence tiebreaker would not automatically be applied every time a person has a residence connection with both states. It would be necessary to resolve cases in which both states wish to tax the same person on a residence basis, as in the current treaty framework. It would not, however, be necessary to apply it if both states wish to tax the same item of income on a residence basis, but in the hands of different persons, even if one or both persons has a residence connection with both states.²³⁷

236. OECD Business Profits Technical Advisory Group, *The impact of the communications revolution on the application of "place of effective management" as a tie breaker rule* (Paris: 2001), available at <http://www.oecd.org/dataoecd/46/27/1923328.pdf> at p. 9.

237. An example of the latter situation is the *Smallwood* case discussed in 5.2.4.