Introduction
This document is dedicated to clarifying the legal issues arising from the Application of Domestic General Anti-Abuse Rules (GAARs) under Double Taxation Agreements (DTAs).

Taking into account the widespread application of tax avoidance schemes involving DTAs, many countries are willing to expand their GAARs’ scope to DTAs. Consequently, the question these countries must consider is whether the application of their GAARs is in harmony with their DTAs.

The OECD approach
The current OECD practice with regard to the relationship between domestic anti-abuse rules and DTAs has been followed since the 2003 update to the Commentary on the OECD Model. The OECD argues that two fundamental questions must be answered in order to decide whether or not domestic anti-abuse measures can be applied under DTAs.1

First, it must be decided whether or not the benefits of DTAs must be granted in regard to abusive transactions involving DTAs. Not surprisingly, the OECD declares that the “benefits of conventions should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions” (“guiding principle”).2

The second question raised by the OECD is whether domestic anti-abuse measures conflict with DTAs. The OECD’s answer to this question is that in countries in which abuse of a DTA is defined as abuse of domestic law, to the extent such domestic anti-avoidance measures are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are, therefore, not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of DTAs.3

There are, however, some concerns if the reasoning of the OECD is followed in resolving the two issues outlined above. These concerns will be addressed in the following sections.

The objective and purpose of the abusive arrangements and of the DTAs
The OECD authorizes the application of domestic anti-abuse rules in DTA situations if the application of such rules is not based on lightly assumed abuse.

1 Para. 9.1 OECD Model: Commentary on Article 1 [2010].
2 Para. 9.5 OECD Model: Commentary on Article 1 [2010].
3 Para. 9.2 OECD Model: Commentary on Article 1 [2010].
The Application of Domestic General Anti-Abuse Rules under Double Tax Agreements

When deciding whether or not a transaction is abusive, it must be assessed, according to the OECD’s guiding principle, whether or not:

a) a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax treatment; and

b) the more favourable treatment would be contrary to the object and purpose of the provisions.

Based on these provisions, tax authorities can only apply a GAAR in a treaty situation if it is decided, on a case-by-case basis, that the attainment of the actual advantage deriving from the abusive tax arrangement would be contrary to the objective of the DTA concerned.

In order to establish whether or not a tax avoidance scheme or the attainment of the benefit deriving from the tax avoidance scheme runs counter to the aim of a DTA, the objectives of DTAs must first be determined.

In this respect, reference should obviously be made to the aim of preventing tax avoidance. Since 2003, specific reference to the prevention of tax avoidance and evasion as an objective of DTAs can be found in the Commentary on the OECD Model (2010). The application of GAARs cannot, however, be justified simply on the basis that an abusive transaction conflicts with the aim of counteracting abuse, as this would be a “circular argument”.

Consequently, countries are expected to examine whether other objectives of DTAs have been violated by the favourable tax position arising from an abusive tax arrangement.4

With regard to other objectives, the most important one is the prevention of double taxation. Consequently, what must be examined is whether or not the attainment of a favourable tax treatment deriving from a tax avoidance scheme violates the objective of the prevention of double taxation. This would be difficult to envisage, as tax avoidance, almost by definition, rules out double taxation.

Similarly, the question arises whether or not the application of a GAAR can be prevented if it results in double taxation. If one considers that the main aim of a DTA is to prevent double taxation, one should answer this question in the affirmative. In contrast, paragraph 22.2 of the Commentary on Article 1 of the OECD Model (2010) declares that the aim of a DTA to relieve double taxation can be set aside where there is clear evidence of abuse.

Criticism can, however, be levelled at the approach taken in paragraph 22.2.

Firstly, the OECD is inconsistent in applying this approach. For example, if a transfer pricing adjustment is carried out in a contracting state (for whatever reason, including abusive practices), the OECD Model (2010) suggests that a corresponding adjustment shall still be made in the other contracting state, so as to relieve double taxation, irrespective of the reason for the primary adjustment.5 The same approach is not

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5 Art. 9(2) OECD Model (2010). The absence of provisions differentiating between adjustments made on the basis of abusive practices and adjustments made on the basis of bona fide dealings has led to a few reservations on article 9. On this point, see, for example, para. 16 OECD Model: Commentary on Article 9 [2010].
followed for adjustments made according to domestic anti-abuse measures, and the obligation to relieve double taxation can be disregarded if a contracting state unilaterally detects abuse under its GAAR.

Secondly, countries, in their residence state capacity, shall relieve double taxation in a treaty situation if taxation has taken place in the other contracting state in accordance with the applicable DTA. If, for example, the source state does not regard a treaty situation as abusive, and does grant a favourable tax benefit (such as a lower withholding tax rate), the residence country cannot deny the double taxation relief simply because it regards the transaction as abusive under its domestic law. Even though, in this example, the residence state – as a result of the application of its domestic anti-abuse rule – would apply provisions of the treaty different from those that the source state has applied, the former must still grant double tax relief.

As the Commentary on Articles 23A and 23B of the OECD Model (2010) states, the residence state only avails itself of the right to deny double tax relief if it considers that the conflict arises from the different interpretations of the provisions of the DTA but not if the conflict arises from different provisions of domestic law.⁶

The situation is different if the source state grants a treaty benefit even though the treaty includes an anti-abuse provision, under which the taxpayer’s arrangement should not have been tolerated. In this case, the residence state may refuse to grant relief, as its treaty interpretation differs from the interpretation upheld by the source state.

From a source state perspective, a clash of the two objectives (prevention of tax avoidance and relief from double taxation) does not arise. Where the source state simply does not grant the treaty benefit due to abuse, the residence state must relieve double taxation, if the taxation in the source state – including the application of the source state’s anti-abuse rules – is in accordance with the DTA.⁷

In conclusion, before a GAAR is applied in a situation concerning DTAs, it must be examined whether or not the objectives of the DTA (articles) concerned have been frustrated by the targeted tax avoidance scheme. If this is the case, subsequent application of a GAAR would be acceptable.

**Determining which facts give rise to a tax liability**

With regard to its second question, mentioned above, the OECD seems to suggest that if the “guiding principle” test has been met, there is no limit on the manner in which domestic law counteracts abusive transactions.⁸ Accordingly, anti-abuse measures can re-characterize or re-determine the (source of the) income, the taxpayer or the timing of taxation.⁹

In order to verify whether this reasoning is correct, one must examine how GAARs operate.

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⁶ Paras. 32.3 and 32.5 OECD Model: Commentary on Articles 23A and 23B (2010).
⁸ De Broe, supra n. 7, sec. 157.
⁹ Para. 22.1 OECD Model: Commentary on Article 1 (2010).
General anti-avoidance measures can generally be divided into two categories based on the way they counteract abuse.\[^{10}\]

The first category consists of anti-avoidance rules under which tax authorities are authorized to re-determine, and change the facts of a case, re-characterize income and the timing of taxation.

The second group of anti-avoidance measures, after interpreting the facts, simply denies the tax benefits that would have arisen had the fact pattern not constituted or indicated abuse. Tax benefits under DTAs include, for example, a lower withholding tax rate on certain income streams or the application of an exemption.

The two categories of anti-avoidance measures may imply two different concerns.

In regard to the first category, the OECD's straightforward assertion that the anti-abuse measures determine (change, re-characterize, etc.) which facts give rise to a tax liability, and that subsequently the "convention will be applied taking into account these changes" is questionable. The reason for this is that this approach disregards the fact that domestic law (including anti-abuse measures) and the classification under domestic law must be applied in accordance with the applicable DTA. If, for example, a DTA contains its own definition of what constitutes a dividend, the role of the domestic law is (severely) limited. It is limited in the sense that a definition under domestic law can only be invoked if a term is not defined by the applicable DTA.\[^{11}\]

The problem arising from the application of the second group of anti-avoidance measures is somewhat different. If, for example, a GAAR is applied to a given set of facts to deny tax benefits under a DTA that would have been granted if no abuse were present - the question becomes whether the simple denial of the DTA's benefits by the tax authorities amounts to "determining the facts". Under the OECD's approach, the GAAR must be used to determine which facts give rise to a tax liability. If the GAAR is not applied for this purpose, the GAAR cannot be used. With this consideration in mind, can it be stated that a determination of the right legal consequences of a fact pattern is the same as the determination of the facts?

In conclusion, based on the previous paragraphs, it must be pointed out that:

a) when a GAAR is used to re-characterize payments or re-determine facts, the overall limit to the application of the GAAR will be the relevant DTA itself. In other words, the application of the GAAR cannot frustrate the application of the relevant DTA; and

b) when a GAAR is used to simply deny the treaty benefits applicable to a fact pattern, are the facts being determined by the GAAR or are the tax authorities attaching new legal (tax) consequences to a previously determined fact pattern?

The shared expectations of the treaty partners, and the reciprocity of treaties

The Netherlands, Ireland, Luxembourg and Switzerland made observations on the Commentary on Article 1 of the OECD Model (2010) regarding the application of domestic anti-abuse provisions under DTAs.\[^{12}\]

\[^{10}\] De Broe, supra n. 7, sec. 157.

\[^{11}\] Art. 3(2) OECD Model (2010).

\[^{12}\] Paras. 27.5 - 27.9 OECD Model: Commentary on Article 1 (2010).
The listed countries, as well as certain academic scholars, believe that the application of domestic anti-abuse provisions under DTAs cannot be tolerated in every case. The reason for this is that the application of the domestic rules could go against the shared expectations of the treaty partners and the principle of reciprocity, which is considered to be a fundamental principle of tax treaties.

In its observation, the Netherlands clarifies that the automatic application of domestic anti-abuse provisions under treaty situations without any further examination of the domestic and treaty provisions, their interrelationship and objectives is not acceptable.

Ireland points out the simplicity of the OECD’s approach, and the importance of the legal and constitutional relationship between domestic law and international agreements in individual Member countries.

Switzerland explicitly states, in its observation, that the “domestic tax rules on abuse of tax conventions must conform to the general provisions of tax conventions, especially where the convention itself includes provisions intended to prevent its abuse”. As certain DTAs signed by Switzerland include special anti-avoidance provisions (for example, anti-conduit provisions in articles 10, 11 and 12 of the United Kingdom-Switzerland Income Tax Treaty (1977)) it is questionable whether or not the unilateral application of a domestic GAAR by its treaty partner would be acceptable to Switzerland in light of its observation.

Switzerland has also clarified that it does not accept the view that DTAs have the special objective of preventing tax avoidance and evasion. Accordingly, Switzerland is not expected to invoke its treaties to counteract tax avoidance, and based on reciprocity, taxpayers might expect the same approach from its treaty partners.

Luxembourg makes the application of domestic anti-avoidance rules conditional on whether or not a Mutual Agreement Procedure (MAP) will be initiated.

These countries made their comments in light of the 2003 changes to the Commentary. This reveals that some countries do not share the view taken by many OECD Member countries that the 2003 changes only clarified the pre-2003 approach.

It is not debated in the observations mentioned above that the application of anti-abuse provisions that do not target legitimate tax avoidance could be necessary in treaty situations. However, it is suggested that a thorough analysis or recourse to a MAP may be needed before such anti-abuse measures are applied unilaterally by one of the parties.

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13 De Broe, supra n. 7, sec. 160.
14 Para. 27.7 OECD Model: Commentary on Article 1 (2010).
15 Para. 27.5 OECD Model: Commentary on Article 1 (2010).
16 Para. 27.9 OECD Model: Commentary on Article 1 (2010).
17 Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Income (8 Dec. 1977) (as amended through 2009), Treaties IBFD.
18 Para. 27.9 OECD Model: Commentary on Article 1 (2010).
19 Arnold, supra n. 4, at p. 248, sec. 5.
20 Para. 27.6 OECD Model: Commentary on Article 1 (2010).
In conclusion, taking into account the observations of the above-mentioned countries, the following recommendations can be made to countries which support the OECD’s approach and the unilateral application of GAARs under DTAs:

a) the countries concerned could re-negotiate their treaties, especially with the countries which do not accept the OECD’s approach, to stipulate provisions authorizing the parties to apply their anti-abuse measures (GAARs) under the treaty concerned.

b) however, taking into account the procedure for re-negotiating treaties, it is recommended that the countries which wish to apply their GAARs explicitly stipulate in their legislation implementing a GAAR that the application of the GAAR under DTAs also depends on the position of the treaty partner. The treaty partner’s position, in turn, is determined, among other things, by its approach to the OECD Model (2010) (and Commentary thereon), and should be taken into account during a MAP.

**Conclusion: GAARs and DTAs**

Concerning the compliance of GAARs with DTAs, the OECD’s approach, which is that domestic anti-abuse rules are compatible with DTAs, is not without potential legal pitfalls. Although countries’ need for GAARs, in general, is understandable, certain concerns must be addressed by the tax authorities before a GAAR is implemented.

First of all, before applying a GAAR in treaty situations, countries must examine if the objectives of the treaty (articles) concerned would be frustrated by the targeted tax avoidance scheme. If this is not the case, subsequent application of a GAAR might raise legal concerns.

Secondly, if a GAAR is used to re-characterize payments or re-determine which facts give rise to a tax liability, the overall limit of the application of the GAAR will be the relevant DTA itself. In other words, the application of the GAAR cannot frustrate the application of the relevant DTA. If, however, after the interpretation of the facts, a GAAR is used to simply deny the treaty benefits applicable to a particular fact pattern, it is not clear whether or not the GAAR is being used to determine the facts, or whether tax authorities are attaching new legal (tax) consequences to an already determined fact pattern.

Finally, countries could renegotiate their treaties with those treaty partners that have made observations regarding the application of GAARs in the Commentary on the OECD Model (2010), to include provisions authorizing the parties to apply their anti-abuse measures (GAAR) under the treaty concerned. As an alternative, countries could also include in their GAARs a provision stating that the application of the GAAR under DTAs also depends on the position of the other contracting state. The treaty partner’s position, in turn, is determined, among other things, by its approach to the OECD Model (2010) (and Commentary thereon), and should be taken into account during a MAP.

**IBFD welcomes your feedback as follows:**

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