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The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties in the Post-BEPS and Digitalized World

In its analysis, this article distinguishes between domestic anti-avoidance rules that counteract treaty abuse and those that thwart abuse of domestic law. The authors conclude that conflicts could arise with tax treaties. States should employ a provision that authorizes the application of these rules to prevent this situation arising.

1. Addressing the Interaction Issue: Two Types of Domestic Anti-Avoidance Rules

In order to discuss the interaction of domestic anti-abuse rules with tax treaties, the authors classify domestic anti-avoidance rules in two categories. These categories are as follows.

The first category consists of domestic anti-abuse rules that counteract treaty abuse,[1] i.e. rules which seek to deny benefits that flow from tax treaties. This category includes, for instance, when a taxpayer engages in a treaty shopping scheme and the tax administration applies domestic anti-abuse rules, such as judicial anti-abuse rules (for example, sham and/or simulation, substance over form, economic substance,[2] step transactions doctrine,[3] business purpose tests[4] or other doctrines),[5] domestic statutory general anti-avoidance rules (GAARs),[6] or statutory specific anti-avoidance rules (SAARs, for instance, anti-treaty shopping rules).[7] The treaty benefit could, for example, be a lower and/or nil rate for dividends or interest (article 10 or 11 of the OECD Model) or non-taxation of capital gains (article 13(5)) by the investee state. Other schemes which fit into this category, but which are not analysed in this article, relate to rule shopping, splitting contracts and/or activities to avoid permanent establishment (PE) status, the international hiring out of labour and so on.

The second category consists of domestic anti-avoidance rules that counteract abuse of domestic law and where the tax treaty is used to neutralize the application of the domestic anti-abuse rule.[8] For example, the taxpayer of a state may enter into income deferral strategies and its state could apply a GAAR or a controlled foreign company (CFC) rule to impute income in the hands of a resident taxpayer. A similar imputation effect could be achieved by the income inclusion rule that is being considered in the context of Pillar Two of the digital economy. Another example pertains to a situation wherein a resident taxpayer of a state enters into base erosion strategies through interest payments and the local tax administration applies an anti-base erosion rule, such as a thin capitalization rule. A similar denial of deduction effect could be achieved by the base eroding payments rule that is being considered in the context of Pillar Two. Under both examples, the taxpayer then invokes the provisions of the tax treaty to argue that the domestic anti-abuse rule is not applicable.

The analysis in our article will undertake to consider national anti-avoidance rules, court judgements from around the world, scholarly literature and the pre- and post-BEPS material published by the OECD, such as the OECD Models as well as the Commentaries on the OECD Models (various versions),[9] the reports of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project and the "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (the

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A draft of this article was presented at the interdisciplinary conference "Tax Treaty Interpretation after BEPS" held in Lausanne from 19 to 20 December 2019 and organized by the Max Planck Institute for Tax Law and Public Finance and the Tax Policy Center of the University of Lausanne.

1. The object of abuse in these situations is the provisions of the tax treaty. *See* L. De Broe & J. Luts, *BEPS Action 6: Tax Treaty Abuse*, 43 Intertax 2, p. 125 (2015).
2. V. Chand, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties* sec. 3.2.2. (Schulthess 2017).
3. Id., at sec. 3.2.3.
4. Id., at sec. 3.2.4.
5. Id., at secs. 3.2.5. and 3.2.6.
6. Id., at sec. 3.3.
7. Id., at sec. 3.4.2.1.
8. The object of abuse in these situations are the provisions of the domestic law. The treaty is used subsequently to neutralize the application of the domestic anti-avoidance rule. *See* De Broe & Luts, *supra* n. 1, at p. 126.
9. *OECD Model Tax Convention on Income and on Capital* (11 Apr. 1977), Treaties & Models; *OECD Model Tax Convention on Income and on Capital* (1 Sept. 1992), Treaties & Models; *OECD Model Tax Convention on Income and on Capital* (28 Jan. 2003), Treaties & Models; *OECD Model Tax Convention on Income and on Capital* (26 July 2014), Treaties & Models; and *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Treaties & Models and *OECD Model Tax Convention on Income and on Capital: Commentaries* (11 Apr. 1977), Treaties & Models; *OECD Model Tax Convention on Income and on Capital: Commentaries* (1 Sept. 1992), Treaties & Models; *OECD Model Tax Convention on Income and on Capital: Commentaries* (28 Jan. 2003), Treaties & Models; *OECD Model Tax Convention on Income and on Capital: Commentaries* (26 July 2014), Treaties & Models; and *OECD Model Tax Convention on Income and on Capital: Commentaries* (21 Nov. 2017), Treaties & Models.

MLI or the "Multilateral Instrument").[10] The analysis also takes into consideration the ongoing work at the OECD with regard to Pillar Two.[11]

2. Domestic Anti-Avoidance Rules Denying Benefits Flowing from Tax Treaties

2.1. Treaty shopping and four associated questions

Treaty shopping broadly refers to the situation in which a:

> person who is not entitled to the benefits of a tax treaty makes use – in the widest meaning of the word – of an individual or legal person in order to obtain those treaty benefits that are not available directly.[12]

The most prevalent way through which a taxpayer engages in treaty shopping is by setting up an intermediary entity (company or other entities similar to a company) in an intermediary jurisdiction.[13] To illustrate, on the assumption that a tax treaty does not exist between State R and State S, a tax resident of State R may prefer not to invest (via equity) directly in State S because the income derived from the investment may be subject to high taxes in State S and immediate taxation in State R. Accordingly, on the further assumption that a tax treaty exists between State T and State S, the State R tax resident may prefer to set up a company in State T. This company will receive the income from the investment in State S. The tax advantage of setting up the company in State T is that the tax resident of State R gets access to the State T–State S Tax Treaty.[14] This kind of "treaty shopping" aims at the reduction of taxes in State S through the benefits provided to residents of State T investing in State S.

In section 2.2., the authors will only analyse the interaction of domestic anti-avoidance rules as applied from a State S perspective to treaty shopping transactions. They will not analyse the impact of the principal purpose test (PPT) to such transactions. That rule has been extensively analysed by them in other contributions.[15]

The authors propose that in an examination of the application of an anti-avoidance rule (in particular, judicial rules and statutory GAARs) to a treaty shopping situation, or a cross-border investment involving the application of a tax treaty, there are four key questions that require addressing. The order in which they are addressed is not particularly important, although there is, in the view of the authors, some logic to that followed in this article (*see* sections 2.2. to 2.5.).

2.2. First question: Is the transaction a sham or simulated transaction?

Naturally, tax treaties should apply to real facts of a case. In this regard, the late Professor John Tiley (1987) remarked that in an anatomy of a tax case a court is required to "determine the facts, interpret the law and apply that interpretation to the facts". In his opinion, the sham doctrine (at least, as applied in the UK context) is relevant in determining the facts of a tax case because this doctrine assists in determining whether the facts stated by the taxpayer should be given the appropriate private law classification. However, his opinion was that the business purpose test,as applied in the United States, is relevant in interpreting the law as it reads into the tax law a requirement that the particular provision should apply only where there is some business (or other non-tax) purpose. Similarly, he suggested that the US economic substance doctrine assists in interpreting the law and applying that interpretation to the facts.[16] Other commentators have also identified this issue. They comment that domestic judicial doctrines (with the exception of the narrow sham or simulation doctrine) are interpretive principles, under which the domestic tax law applies only to transactions with economic substance or business purpose and such doctrines are not fact-finding rules.[17]

Some Indian courts have held that treaty benefits should be extended to taxpayers (in treaty shopping cases) as long as the transactions are not shams. For example, *see* the decisions of the Supreme Court of India (SCI) in the *Azadi Bachao Andolan* (2003)[18] and *Vodafone* (2012)[19] cases as well as the recent decision of the Bombay High Court (BHC) in *Indostar* (2019).[20] Interestingly, the question arises whether there is a common universal understand-

10. OECD/G20, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (7 June 2017), Treaties & Models IBFD [hereinafter the MLI or the "*Multilateral Instrument*"].
11. For a recent update, *see* OECD/G20 Base Erosion and Profit Shifting Project, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy As approved by the OECD/G20 Inclusive Framework on BEPS on 29-30 January 2020*, pp. 27-29 (OECD 2020), available at www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf.
12. S. van Weeghel, *The Improper Use of Tax Treaties* p. 119 (Kluwer L. Intl. 1998). De Broe (2008) also provides a similar definition. *See* L. De Broe, *International Tax Planning and Prevention of Abuse*, IBFD Doctoral Series Vol. 14, sec. 1.1, p. 10 (IBFD 2008), Books IBFD.
13. A.J. Martín Jiménez, *Domestic Anti-Abuse Rules and Double Taxation Treaties: a Spanish Perspective – Part I*, 56 Bull Intl. Fiscal Docn. 11, sec. 2 (2002), Journal Articles & Papers IBFD.
14. Article 1(1) of the *OECD Model* (2017) provides that a tax treaty applies to "persons" who are "residents" of a state. A company can be regarded as a "person" when article 3(1)(a) of the *OECD Model* (2017) is read in conjunction with article 3(1)(b). Moreover, a company can be regarded as a "resident" for the purpose of article 4(1) of the *OECD Model* (2017), as it is liable to tax in a state because it is either incorporated or its place of effective management (POEM) is located in that state. Accordingly, a company qualifies for treaty benefits. *See* Martín Jiménez, *supra* n. 13, at sec. 2.2.
15. *See* V. Chand, *The Principal Purpose Test in the Multilateral Convention: An in-depth Analysis*, 46 Intertax 1, pp. 18-44 (2018). *See also* C. Elliffe, *The Meaning of the Principal Purpose Test: One Ring to Bind Them All?*, 11 World Tax J. 1 (2019), Journal Articles & Papers IBFD.
16. J. Tiley, *Judicial anti-avoidance doctrines: the US alternatives - Part 1*, Brit. Tax Rev. 5, pp. 190-196 (1987).
17. B.J. Arnold, *Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary on the OECD Model*, 58 (2004) Bull. Intl. Fiscal Docn. 6, sec. 7.1. (2004), Journal Articles & Papers IBFD.
18. IN: SCI, 7 Oct. 2003, *Union of India and another v. Azadi Bachao Andolan and another*, 2003-(263)-ITR-0706-SC 132 Taxman 373 (SC), pp. 233-291, Case Law IBFD.
19. IN: SCI, 20 Jan. 2012, *Vodafone International Holdings B.V. v. Union of India*, Civil Appeal No. 733 of 2012 (arising out of S.L.P. (C) No. 26529 of 2010), Case Law IBFD.
20. IN: BHC, 26 Apr. 2019, *Indostar Capital v. ACIT, Writ Petition No. 3296 of 2018*. *See* https://indiankanoon.org/doc/88095597/.

ing of the concept of sham and/or simulation? In this relation, it should be noted that in some common law as well as civil law countries there is a high degree of convergence with regard to understanding these concepts, in particular, with regard to the presence of an element of "falsity" or "deceit" or "lies".

For instance, in the United Kingdom, the definition of sham can be traced to the case of *Snook* (1967),[21] where Lord Diplock (on behalf of the UK House of Lords, UKHL) held that a sham:

> means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create.[22]

This formulation provides that for a sham to exist two conditions need to be satisfied. First, the parties to a transaction must have the intention of creating dissimilar rights and obligations from those emerging from the relevant documentation. Second, the parties must have intended to give a false impression of those rights and obligations to third parties such as the tax authorities or courts. Consequently, a legal document will be a sham when the rights between the transacting parties evidenced on the face of the document were in fact never meant to be effective or to be acted upon. If the doctrine applies then the tax treatment will be determined in accordance with the correct legal facts as opposed to the fabricated facts set out in documents.[23] In the United Kingdom, the sham doctrine deals only with transactions in terms of their legal form and not with their business purpose or economic substance.[24] Accordingly, this doctrine is considered to be narrow in terms of its application and is not usually invoked for tax avoidance schemes as in such schemes the parties normally comply with all legal aspects, and the documents that carry out the scheme are legally effective, but act against the intention or "spirit" of the legislation.[25]

Similarly, in Canadian tax law, a sham transaction is a transaction in which the documents or acts of the parties attempt to give the appearance of creating legal results that are different from the actual legal rights and obligations.[26] The Supreme Court of Canada (SCC) has confirmed this position on several occasions.[27] To elaborate, in the case *Cameron* (1972),[28] the SCC relied on the definition of a sham as provided by Lord Diplock in *Snook* to give a meaning to the concept of a sham. Thereafter, this position was confirmed in the landmark case of *Stubart Investments* (1984).[29] The SCC reiterated *Snook* and held that a sham transaction is:

> a transaction conducted with an element of deceit so as to create an illusion calculated to lead the tax collector away from the taxpayer or the true nature of the transaction or simple deception whereby the taxpayer creates a facade of reality quite different from the disguised reality.[30]

Subsequently, in the case of *Mcclurg* (1990),[31] by relying on *Stubart Investments*, the SCC once again held that a transaction is a sham if it is undertaken to "create a false impression in the eyes of a third party, specifically the taxing authority".[32] If the doctrine applies then the tax treatment will be determined in accordance with the correct legal facts as opposed to those set out in documents.[33] Therefore, from these decisions it can be ascertained that a "sham" should be intentional (the parties to the sham must jointly intend to create the appearance of legal rights or a relationship that differs from the actual rights or relationship) and should be undertaken to deceive a third party. The element of deceit, i.e. the presence of a common intention to create the appearance of a legal result that is different from the actual legal result, is therefore necessary for a transaction to qualify as a sham. It should be noted that the Canadian concept of a sham is independent of the business purpose test.[34] Justice Wilson has confirmed this in *Stubart Investments*, in which it was held that the business purpose test and the sham test are two distinct tests.[35] It should also be noted that the sham doctrine does not look into the economic substance of the transaction. Accordingly, it has been opined that this concept has a very narrow and limited application in tax avoidance cases.[36] Moreover, a reading of the recent cases of the Tax Court of Canada (TCC) of *Lee* (2018)[37] and *Cameco* (2018)[38] indicate that the threshold for determining sham is quite high for legally effective arrangements.

In *Cameco*, Justice Owens also referred to the approach of the courts in New Zealand, especially the approach of the Supreme Court of New Zealand (SCNZ) in the case of *Ben Nevis* (2008).[39] In that case, the SCNZ also referred to the English and Welsh case of *Snook*. The following definition of sham was provided:

21. UK: UKHL, 17 Jan. 1967, *Snook v. London & West Riding Investments Ltd*, 1 All ER 518, p. 528.
22. V. Thuronyi, *Comparative Tax Law* p. 157 (Kluwer L. Intl. 2003).
23. M.R. Ballard & P.E.M. Davison, *United Kingdom*, in *Form and substance in tax law*, International Fiscal Association (IFA) *Cahiers de Droit Fiscal International*, vol. 87a, sec. 2. (IBFD 2002), Books IBFD.
24. D. Korb & A. Banarjee, *Analysis – Comparing US and UK anti-avoidance approaches*, Tax J. 1040, pp. 22-24 (Aug. 2010). *See* https://www.taxjournal.com/articles/comparing-us-and-uk-anti-avoidance-approaches.
25. S. Frommel, *United Kingdom Tax Law and Abuse of Rights*, Intertax 2, p. 60 (1991).
26. C. Sprysak, *From Sham to Reality: Should a Wrong be Taxed as a Right*, 55 McGill L. J. 1, p. 131 (2010) and W. Mitchell, *A Period of Interest*, 58 Can. Tax J. (Supp), pp. 304-305 (2010).
27. H. Kellough, *Tax Avoidance: 1945-1955*, 43 Can. Tax J. 5, p. 1836 (1995).
28. CA: SCC, 29 June 1972, *Minister of National Revenue v. Cameron*, [1974] SCR 1062, pp. 1068-1069.
29. CA: SCC, 7 June 1984, *Stubart Investments Ltd v. Her Majesty, the Queen*, 1 SCR 536.
30. Id., at pp. 545-546.
31. CA: SCC, 20 Dec. 1990, *Mcclurg v. Canada*, [1990] 3 SCR 1020.
32. Kellough, *supra* n. 27.
33. B. Beswick & A. Nijhawan, *Canada*, in *Anti-avoidance measures of general nature and scope – GAAR and other rules*, IFA *Cahiers de Droit Fiscal International* vol. 103, sec. 2.3. (IBFD 2018), Books IBFD.
34. Mitchell, *supra* n. 26, at p. 306.
35. *Stubart* (1984), *supra* n. 29, at pp. 539-540.
36. R. Federico, *From Westminster to Lipson: What Canada Has Done for Eighty Years to Counteract Tax Avoidance*, *Diritto e Pratica Tributaria Internazionale* 3, pp. 1205-1262 (Mar. 2009), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1563573, pp. 1-42, at p. 5 (accessed 24 Mar. 2020).
37. CA: TCC, 15 Nov. 2018, *Lee v. The Queen*, 2018 TCC 230, paras. 48-73.
38. CA: TCC, 26 Sept. 2018, *Cameco Corporation v. Her Majesty, the Queen*, 2018 TCC 195, paras. 582-670, Case Law IBFD.
39. NZ: SCNZ, 19 Dec. 2008, *Ben Nevis Forestry Ventures Limited and Ors; Accent Management Limited and Ors v. Commissioner of Inland Revenue*, [2008] NZSC 115.

> In essence, a sham is a pretence. It is possible to derive the following propositions from the leading authorities. *A document will be a sham when it does not evidence the true common intention of the parties.* They either intend to create different rights and obligations from those evidenced by the document or they do not intend to create any rights or obligations, whether of the kind evidenced by the document or at all. A document which originally records the true common intention of the parties may become a sham if the parties later agree to change their arrangement but leave the original document standing and continue to represent it as an accurate reflection of their arrangement. *A sham in the taxation context is designed to lead the taxation authorities to view the documentation as representing what the parties have agreed when it does not record their true agreement.* The purpose is to obtain a more favourable taxation outcome than that which would have eventuated if documents reflecting the true nature of the parties' transaction had been submitted to the Revenue authorities...It is important to keep firmly in mind the difference between sham and avoidance. A sham exists *when documents do not reflect the true nature of what the parties have agreed.* Avoidance occurs, even though the documents may accurately reflect the transaction which the parties intend to implement, when, for reasons to be discussed more fully below, the arrangement entered into gives a tax advantage which Parliament regards as unacceptable. (Emphasis added)

In India, in the case of *Azadi Bachao Andolan*,[40] the SCI also referred to the definition of a sham as provided by Lord Diplock in *Snook* to discuss the meaning of a sham transaction. The SCI ruled that:

> If the Court finds that notwithstanding a series of legal steps taken by an assessee, the intended legal result has not been achieved, the Court might be justified in overlooking the intermediate steps, but it would not be permissible for the Court to treat the intervening legal steps as non-est based upon some hypothetical assessment of the "real motive" of the assessee. In our view, the court must deal with what is tangible in an objective manner and cannot afford to chase a will-o'-the-wisp.

Accordingly, this judgement indicates that the concept of sham is narrow, i.e. if the taxpayer carries out all the relevant legal steps to give effect to a transaction, then that transaction cannot be treated as a sham.

In the Netherlands, relationships among the parties are ascertained on the basis of what has been agreed as opposed to what has been showcased to third parties (including tax authorities). Therefore, simulation exists when the parties to a transaction show a set of documents to evidence a specific contract or transaction while agreeing amongst them to enter into a different contract or transaction. If the doctrine applies then the tax authorities are required to determine the actual relationships between the parties. Taxes will then be levied on the basis of actual relationships as opposed to simulated relationships.[41]

Similarly, in Switzerland, the concept of simulation is derived from article 18(1) of the *Loi fédérale complétant le Code civil suisse* (*Livre cinquième: Droit des obligations*) [Code of Obligations, SCO] of 1911.[42] The SCO provides that:

> When assessing the form and terms of a contract, the true and common intention of the parties must be ascertained without dwelling on any inexact expressions or designations they may have used either in error or by way of disguising the true nature of the agreement.

Therefore, where there is a conflict between the real intentions and the intention expressed in a contract, a person who receives such contract and knows that it does not express the real intentions of the parties, normally has to follow the real intentions and ignore what was expressed in the contract. It should also be noted that this doctrine does not look into the economic substance and/or the business purpose of a transaction. Accordingly, it has a very narrow and limited application in tax avoidance transactions because, in such transactions, the parties usually intend to give the arrangements the desired legal effect.[43]

In contrast to the aforementioned jurisdictions, in some jurisdictions the difference between using the sham doctrine to ascertain facts or using the sham doctrine to deter legal tax avoidance is blurred.

For instance, in the United States, the sham doctrine is widely applied. A sham can either be a sham in fact or a sham in substance.[44] A factual sham arises where the transactions reported by the taxpayer never occurred or were only created on paper but never actually took place.[45] If the doctrine applies then the transactions reported by the taxpayer will be considered to be non-existent for tax purposes.[46] On the other hand, a sham in substance (or economic sham) arises when the purported transaction does not have any underlying economic substance and is undertaken solely for achieving a reduction in tax.[47] The leading case that deals with the sham in substance doctrine is that of *Knetsch* (1960).[48] In this case, the taxpayer had borrowed money at a high interest rate from an insurance company in order to invest in deferred annuity bonds offered by the same company that in turn provided a lower rate of return. The rationale for borrowing at a high interest rate and investing that amount in a low interest rate investment product was that the US tax law at the time provided that the taxpayer could deduct the interest expense completely against his taxable income while being subject to a lower rate of tax on the interest earned.[49] Accordingly, the taxpayer executed the transactions with the sole intention of generating interest deductions. The US Supreme Court (USSC) held that the transaction undertaken by the taxpayer was a "sham", deprived of genuine economic results, because "there was nothing of substance to be realized by [the taxpayer] beyond a tax deduction".[50] Consequently, the sham in substance doctrine provides that in the United States a transaction will be respected for tax purposes and will not be considered as

40. *Azadi Bachao Andolan* (2003), *supra* n. 18.
41. R.L.H. IJzerman, *Netherlands*, in IFA, *supra* n. 23, at sec. 2; M.F. de Wilde & C. Wisman, *Netherlands*, in *Tax Avoidance Revisited in the EU BEPS Context* sec. 19.2.1.1.2 (A.P. Dourado ed., IBFD 2017), Books IBFD; and R. Kok & I.M. Valderrama, *Netherlands*, in IFA, *supra* n. 33, at sec. 1.2.
42. CH: Loi fédérale complétant le Code civil Suisse (Livre cinquième: Droit des obligations), (Code of Obligations, SCO) of 1911. *See* https://www.admin.ch/opc/fr/classified-compilation/19110009/index.html#a1.
43. *See* Chand, *supra* n. 2, at sec. 3.2.1.
44. H. Lee & C. Turner, *United States*, in IFA, *supra* n. 33, sec. 2.1., at (b) and (a) and (b).
45. Thuronyi, *supra* n. 22, at p. 157.
46. P.W. Streng & D.L. Yoder, *United States*, in IFA, *supra* n. 23, at sec. 2.
47. Id.
48. US: USSC, 14 Nov. 1960, *Knetsch v. United States*, 364 US 361 (1960).
49. Thuronyi, *supra* n. 22, at p. 163.
50. Streng & Yoder, *supra* n. 46.

a sham if it has underlying economic substance.[51] It should be noted that even though the court used the word "sham" on several occasions, the USSC did not indicate as to how it should be measured.[52] Moreover, it is widely regarded that *Knetsch* and the other US court cases that have dealt with this judicial doctrine have not clearly articulated the doctrine, and, therefore, commentators have proposed that it be disregarded or subsumed within the other judicial anti-avoidance doctrines.[53]

In light of this discussion, even though several commonalities exist among countries with regard to understanding the meaning of these concepts, there is no common universal definition of sham and/or simulation. Given the diversity in the approach taken by different jurisdictions to the question of sham, it seems a logical first step in the application of the anti-avoidance rules to treaties. Many jurisdictions will not regard a tax avoidance arrangement or scheme which has real and genuine legal obligations as a sham but others take a different approach. That said, the authors believe that until the extent these doctrines are used to determine the real facts of a transaction, a conflict will not arise with tax treaties. In other words, in the pre-BEPS or post-BEPS world, if a transaction is considered to be sham or simulated (or even legally ineffective) then that transaction should not be respected for domestic tax law purposes. Logically, such rules cannot be considered to violate the provisions of a tax treaty, as these rules determine the true facts to which the taxing provisions apply.

2.3. Second question: Is the domestic anti-avoidance rule applicable to tax treaties?

The second question is equally as fundamental as the first, and again indicates the difference in approach in different jurisdictions. In particular, it illustrates the way in which international law is incorporated into domestic law in different legal systems.

In some countries, in particular states that follow the monistic doctrine,[54] domestic GAARs are not applicable at the level of a tax treaty. For example, in the Netherlands, the *Hoge Raad der Nederlanden* (Supreme Court of the Netherlands, HR)[55] has held that the "*fraus legis*" doctrine does not apply at the level of the tax treaty. Some commentators have also remarked that the doctrine hardly applies at the treaty level unless a specific provision authorizes its application.[56]

Similarly, in Switzerland, the *Bundesverwaltungsgericht/Tribunal administratif fédéral* (Federal Administrative Court, Bvwg/Taf)[57] has held that article 21(2) of the Swiss *Bundesgesetz über die Verrechnungssteuer* (Federal Withholding Tax Law, VStG),[58] which is a general anti-abuse provision with regard to abusive tax refunds,[59] is not applicable at the tax treaty level.[60] This said, some commentators have argued that the Swiss tax avoidance doctrine, i.e. *Steuerumgehungsdoktrin* (judicial anti-abuse rule) could be applied in a treaty context,[61] although this position is highly controversial. Also, it should be noted that Swiss courts apply an inherent anti-abuse rule to tax treaties and interpret the "beneficial ownership" clause in a broad manner.[62]

Remarkably, the tax administrations of the aforementioned jurisdictions along with the tax administrations of other jurisdictions (for example, Luxembourg) had recorded observations to paragraphs 9.1 to 9.2 read in conjunction with paragraphs 22 to 22.2 of the Commentary on Article 1 of the OECD Model (2003),[63] which provided that domestic anti-abuse rules do not conflict with tax treaties i.e. they are compatible with tax treaties. Specifically, the Netherlands observed that the answer to the issue at stake would depend on the wording of the specific tax law provision, the wording and purpose of the relevant treaty article and the relationship between international and domestic law as applicable in a state.[64] Switzerland observed in relation to paragraph 22.1 that domestic tax rules must conform to the general provisions of tax conventions, especially when the tax treaty in question contains measures to prevent abuse. Luxembourg rejected the application of paragraphs 9.2 and 22.1 and observed that in the absence of any express provision in a tax treaty, domestic anti-abuse rules can only be applied by a state after recourse to a mutual agreement procedure (MAP).[65]

Interesting issues arise with regard to the observations made by these states to the Commentaries on the OECD Model. First, the question arises as to the legal status of such observations? Second, the question arises whether the state making the observation (observing state) is bound to interpret a tax treaty in accordance with its observation

51. Id., at sec. 5.7.4.
52. Thuronyi, *supra* n. 22, at p. 163.
53. R. Tooma, *Legislating Against Tax Avoidance* sec 3.1., p. 43 (IBFD 2008), Books IBFD and Lee & Turner, *supra* n. 44.
54. Under the monistic theory, national and international law (treaties) are two parts of a single legal system. In such systems, as soon as international law becomes valid, it is automatically considered to be valid domestically. Put differently, after a treaty enters into effect at the international level, it spontaneously takes legal effect in a state. Therefore, tax treaties in monistic states, are self-executing and directly become a part of the domestic law when they are ratified. This is the case, for instance, in the Netherlands and Switzerland. *See* Chand, *supra* n. 2, at sec. 4.2.2.
55. NL: HR, 15 Mar. 1995, Case No. 29.531, Case law IBFD. In this respect, it should be noted that the HR has reiterated its opinion in a case that had a similar fact pattern. *See also* NL: HR, 6 Dec. 2002, Case No. 36.773, Case Law IBFD. The authors did not manage to get translations of these cases. Therefore, reliance was made on the summary of the case as available in the IBFD Case Law collection. *See also* De Broe, *supra* n. 12, at pp. 407-411.
56. Kok & Valderrama, *supra* n. 41.
57. CH: Bvwg/Taf, 23 Mar. 2010, Case A-2744/2008 (2010), para. 3.3.
58. CH: *Bundesgesetz über die Verrechnungssteuer* (Federal Withholding Tax Law, VStG).
59. M.R. Jung, *Switzerland*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, IFA *Cahiers de Droit Fiscal International* vol. 95a, sec. 1.3. (IFA 2010), Books IBFD and *Art. 15 of the Switzerland-EC Savings Tax Agreement: Measures Equivalent to Those in the EC Parent-Subsidiary and the Interest and Royalties Directives – A Swiss Perspective*, in 46 Eur. Taxn. 3, sec. 2.1.3. (2006), Journal Articles & Papers IBFD.
60. *See* Jung, *Switzerland*, *supra* n. 59, at sec. 1.4.3.
61. N. Kunz-Schenk, *Switzerland*, in IFA, *supra* n. 33, at sec. 1.2.2.
62. For a detailed discussion, *see* R. Danon & H. Salome, *The BEPS Multilateral Instrument*, *IFF Forum Für Steuerrecht*, pp. 197-247 (2017).
63. Paragraphs 9.1 to 9.2 read together with paragraphs 22 to 22.1 *OECD Model: Commentary on Article 1* (2003).
64. Id., at para. 27.7.
65. Id., at para. 27.6.

to the OECD Commentaries? Third, the question arises whether the non-observing state is bound by the interpretation advocated by the observing state. An answer to these questions is essential, as it would assess the impact of the observations made on the Commentary on Article 1 of the OECD Model (2003).

At the outset, the authors believe that observations cannot be considered to be unilateral interpretative declarations under general international law. This is because they are made in response to an international recommendation by the OECD, i.e. to the Commentaries on the OECD Model and are not formulated in connection with a concluded tax treaty.[66] In our opinion, the legal status of observations to the OECD Commentaries depends on the legal status attributed to the Commentaries on the OECD Model themselves.[67] The position adopted in this article is that the OECD Commentaries is not a legally binding instrument. Logically, observations as such should not be legally binding statements.

However, this does not mean that a state entering an observation can interpret its treaties differently from what it has proposed in the observation. By making an observation, the observing state has given a clear indication about the way in which it will interpret the Commentaries on the OECD Model. The Commentaries on the OECD Model (2017) also provide that:

> member countries... should follow these Commentaries... as modified from time to time and subject to their observations thereon, when applying and interpreting the provisions of their bilateral tax convention.[68]

Therefore, even if observations are not legally binding statements, it could be argued that the observing state should interpret a tax treaty in accordance with its observation to the OECD Commentaries.[69] This is because the observation creates a legitimate expectation as to how a tax administration interprets and applies tax treaties on principles of tax treaty interpretation.

This conclusion, of course, does not imply that the non-observing state has to interpret a tax treaty in accordance with the observing state's observation. This is because observations, as stated previously, are not legally binding. Accordingly, the non-observing state (if it resorts to the OECD Commentary) will interpret a tax treaty in accordance with the interpretation laid down in the OECD Commentaries.[70] This being established, the authors would like to comment on the observations made to the Commentary on Article 1 of the OECD Model (2003).

The Luxembourg and Swiss observations indicate that domestic anti-abuse rules cannot be applied in a treaty context, unless a specific provision is inserted in a tax treaty. Do these observations mean that Luxembourg and Switzerland cannot apply their domestic anti-abuse rules to treaty situations, unless a specific provision towards that extent is present in a tax treaty? In our opinion, the answer to the question is in the affirmative. Accordingly, the tax authorities of Switzerland and Luxembourg are required to interpret tax treaties in such a way that absent a specific provision in a tax treaty, Switzerland and Luxembourg cannot apply their domestic anti-avoidance rules to tax treaties. This is because the observations reflect Luxembourg's and Switzerland's intention towards treaty interpretation. The conclusion applies to tax treaties entered into by these countries prior to and following the amendments to Commentary on Article 1 of the OECD Model (2003).[71]

The next question arises whether the treaty partners (non-observing states) of Luxembourg and Switzerland are obliged to accept the latter states' position? In our opinion, the answer to the question is in the negative. It can be argued that as the non-observing state had knowledge about the observing state's observation, the former country should abide by the position of the latter country.[72] It can also be argued that as the principle of common interpretation requires that a treaty should be interpreted in the same way, domestic anti-abuse rules cannot be applied to a treaty situation in the absence of a specific provision in the treaty.[73] However, as stated earlier, observations are not legally binding statements. They express the way in which one state approaches the issue of treaty interpretation and that approach is not binding on another state. Therefore, the treaty partners of Luxembourg and Switzerland are not bound by the latter states' observations.[74] That said, these states have been put "on notice" by the observations as to the likely approach to interpretation by Luxembourg and Switzerland (at least at an administrative level).

Interestingly, these observations have been deleted in the Commentary on Article 1 of the OECD Model (2017). Accordingly, the question arises whether the tax administrations of these countries will start applying the domestic general anti-abuse rules to tax treaties? Does this represent a change in policy by the tax administrations in these jurisdictions? If yes, how will courts react? In this regard, it should be noted that if courts in a jurisdiction (typically, a monistic state) have already held that domestic GAARs do not apply to tax treaties then that conclusion should continue to apply in the post-BEPS world.

66. G. Maisto, *The Observations on the OECD Commentaries in the Interpretation of Tax Treaties*, 59 Bull. Intl. Fiscal Docn. 1, sec. 3. (2005), Journal Articles & Papers IBFD.
67. Id.
68. Para. 3, Introduction *OECD Model: Commentaries* (2017).
69. One commentator reaches a similar conclusion but argues that observations to the *OECD Model: Commentaries* may constitute unilateral interpretative declarations under general international law. Nevertheless, the commentator provides that there may be departures from this general conclusion given the nature of the observation, for example, if a state reserves its right to propose an alternate interpretation in the course of negotiating and/or concluding tax treaties with other OECD member countries rather than making a clear and conclusive observation. *See* Maisto, *supra* n. 66, at sec. 5.
70. A commentator reaches a similar conclusion. Maisto, *supra* n. 66, at sec. 5.
71. Arnold, *supra* n. 17, at sec. 9.1. and De Broe, *supra* n. 12, at sec 4.1.3., p. 402.
72. De Broe, *supra* n. 12, at p. 402.
73. Arnold, *supra* n. 17, at sec. 9.1.
74. Concurring, *see* Arnold, *supra* n. 17, at sec. 9.1. Dissenting, *see* L. De Broe, *supra* n. 12, at pp. 402-403.

In many other countries, domestic anti-avoidance rules have been applied at the level of the tax treaty. In fact, in some dualistic states,[75] the legislation expressly authorizes the tax administration to apply their national GAARs to tax treaties. By their very nature, dualistic states have an inherent ability to enact domestic law which can, at the domestic level, override their treaty obligations. Since the treaties entered into by dualistic states have legal force through the operation of domestic law, subsequent domestic law, which is expressly designed to conflict will take precedence. On this point, it should be noted that although treaty overrides may be possible at the domestic law level, such overrides could conflict with international law provisions. This latter point will not be discussed in this article.

Accordingly, the domestic GAAR may specifically authorize the application of the anti-avoidance provisions to a tax treaty. This has been the approach in many common law jurisdictions, where, for example, Australia,[76] Canada,[77] the United Kingdom[78] and, most recently, New Zealand,[79] have adopted laws that make it clear that their domestic GAARs can be applied to tax treaties. Even without such a specific authorization, many countries will take the view that their domestic anti-avoidance rules apply to tax treaties in most circumstances (the OECD terminology is to say that the GAAR will apply "in the vast majority of cases").[80]

One reason for this is that many provisions in the tax treaty depend on the domestic law characterization which the tax treaty then applies to.[81] The Commentaries on the OECD Model point to provisions in article 4 of the OECD Model, dealing with residence, article 6, determining immovable property and article 10, involving dividends as examples, and also reflects that article 3(2) imports the domestic law meaning of terms into the treaty. This means the treaty provisions apply to this characterization (or recharacterization after the application of the anti-avoidance rules) rather than produce conflicting results. One of the best examples of this phenomenon is provided in paragraph [73] of the Commentary on Article 1 of the OECD Model (2017),[82] where the sale of shares is recharacterized by an anti-abuse rule as a dividend. The treaty applies using the dividend recharacterization (article 10 of the OECD Model), rather than the alienation of property (article 13).[83] This said, the example can indeed be challenged under treaty interpretation rules.

Where the application of the provisions of domestic law and those of tax treaties produce conflicting results,[84] the provisions of tax treaties are intended to prevail.[85] This reflects the legal principle "*pacta sunt servanda*" incorporated in article 26 of the Vienna Convention on the Law of Treaties (the "Vienna Convention") (1969).[86] The OECD discusses such a situation in paragraph [74] of the Commentary on Article 1 of the OECD Model,[87] giving an example where specific anti-abuse domestic rules are designed to prevent temporary changes of residence for tax purposes and deeming someone a resident for domestic law purposes,[88] opining that the provisions of article 13(5) of the OECD Model would apply conflicting with and overriding the domestic law gloss. They conclude that the treaty would prevent the application of the domestic rule "unless the PPT[89] or the guiding principle prevent the benefit of exemption from source state tax".[90]

The third question (*see* section 2.4.) that then arises is whether all the steps that are required to trigger the application of the national anti-abuse rule (such as a judicial rule or GAAR) have been fulfilled or not?

2.4. Third question: Are all the steps for applying the domestic anti-avoidance rule fulfilled?

To reiterate, in many countries, the judicial or statutory GAAR applies to tax treaties. This said, there have been situations in which the conditions outlined in the GAAR have not been satisfied. To illustrate this point, a reference is made to the Canadian GAAR and the various treaty shopping cases analysed under the GAAR.

The Canadian GAAR provisions, which were introduced in 1987, are found in the Canadian Income Tax Act (CITA).[91] In order for the GAAR provision[92] to apply to a transaction (or a series of transactions) the SCC, in

75. Under the dualistic theory, national and international law (treaties) are considered to be separate. Consequently, in such systems, a specific instrument of domestic legislation is required to transform international law (treaties) into national law. It is for this reason that treaties cannot be implemented directly within the legal system of such a state. Therefore, treaties (including tax treaties) in dualistic states are given an indirect effect i.e. specific legislative steps are required to enact treaty provisions in domestic law. Canada, Germany, India and the United Kingdom are some of the states that have a dualistic system. *See* Chand, *supra* n. 2, at sec. 4.2.3 and C. Elliffe, *The Lesser of Two Evils: Double Tax Treaty Override or Treaty Abuse*, Brit. Tax Rev. 1, pp. 62-88 (2016), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2745612 (accessed 24 Mar. 2020)
76. AU: International Tax Agreements Act 1953 (Cth), sec. 4(2), as amended in 1995.
77. CA: Income Tax Act (CITA), sec. 245(4) and CA: Income Tax Convention's Interpretation Act, RSC 1985, sec. 4.1.
78. UK: Finance Act 2013, Pt. 5, sec. 212.
79. NZ: Income Tax Act 2007, sec. BH 1(4): amended, on 30 March 2017, by NZ: Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act 2017 (2017 No. 14), sec. 6(2).
80. Paras. 76-77 *OECD Model: Commentary on Article 1* (2017).
81. Id., at para. 73.
82. Para. 73 *OECD Model: Commentary on Article 1* (2017).
83. Paragraph 28 of the *OECD Model: Commentary on Article 10* (2017), which states that: "payments regarded as dividends may include not only distribution of profits…, but also other benefits in money or money's worth, such as … disguised distributions of profits".
84. Presumably, in the "small minority" of cases where they will arise. "Small minority" being the antithesis of the "vast majority" referred to by paragraph [77] of the *OECD Model: Commentary on Article 1* (2017), where there will be no conflict at all.
85. Para. 70 *OECD Model: Commentary on Article 1* (2017).
86. *UN Vienna Convention on the Law of Treaties* (the "*Vienna Convention*") (23 May 1969), Treaties & Models IBFD.
87. Para. [74] *OECD Model: Commentary on Article 1* (2017).
88. Deeming a resident taxable on gains from the alienation of property in a third state if the person was resident in the state when the property was acquired and for at least seven of the ten years preceding the alienation.
89. Whether or not that is introduced by article 7 of the MLI or article 29 (9) of the *OECD Model* (2017).
90. Due to the application of article 13(5) of the *OECD Model* (2017).
91. Sec. 245 CITA.
92. Id., at sec. 245(2).

the case of *Canada Trust Co* (2005),[93] has laid down three steps.[94] The first step is to determine whether there is a "tax benefit"[95] arising from a "transaction".[96] The second step is to determine whether the transaction is an "avoidance transaction"[97] in the sense of not being arranged essentially for bona fide purposes other than to obtain tax benefits. The third step is to determine whether the avoidance transaction is "abusive".[98] The burden is on the taxpayer to prove that there is no "tax benefit" or no "avoidance transaction" and it is for the tax authorities to establish that there is "abusive" tax avoidance.[99] With regard to the third step, in order to determine whether a transaction is "abusive" a two-stage analysis has to be undertaken. In the first stage, a unified textual, contextual and purposive analysis of the provisions conferring the tax benefit has to be undertaken in order to determine the object, spirit or the purpose of the provision at stake. Thereafter, in the second stage of the abuse analysis, it has to be determined whether the avoidance transactions respect or defeat the object, spirit or purpose of the provisions at stake. If these requirements are met, then the GAAR provisions can be invoked to deny a tax benefit that is conferred on the taxpayer pursuant to the domestic law or through the provisions of a tax treaty.[100] For the latter point, it should be noted that when the GAAR provisions were enacted there were doubts as to whether the GAAR provisions applied to misuse or abuse of tax treaties. However, in 2005, the Canadian government ended this controversy by amending the GAAR provisions retrospectively (from 1988) by including misuse or abuse of tax treaties within the scope of the GAAR.[101]

The Canadian GAAR was applied in the case of *Mil Investments* (2006 and 2007).[102] This case dealt with a treaty shopping structure that was implemented to benefit from the provisions of the Canada-Luxembourg Income and Capital Tax Treaty (1989).[103] In this case, Mr Boulle, a tax resident of Monaco, owned more than 10% of the equity in a Canadian listed resident company, i.e. DFR, a company engaged in the mining business. The shares of DFR were owned by Mr Boulle via his wholly owned Cayman Island Company, i.e. Mil (the "taxpayer"). As DFR had explored a blockbuster mining property, another Canadian mining company, i.e. Inco wished to acquire DFR. In order to achieve the acquisition, Inco approached several shareholders, among them, Mr Boulle in order to acquire their shareholding in DFR. Thereafter, Mr Boulle agreed to alienate his shareholdings as he needed to improve his cash position in order to focus on his African operations and repay outstanding debts (it is important to note that all shareholders of DFR sold their shares and that there were sound commercial reasons for doing so). Therefore, Mr Boulle entered into the following series of transactions. First, he had Mil exchange shares in DFR for shares of Inco, so that Mil's shareholding in DFR fell below 10%. This transaction was tax neutral for Canadian tax purposes due to a specific provision in the CITA. Second, he had Mil move to Luxembourg so that the company became a tax resident therein. The move was also tax neutral for Canadian tax purposes. Third, Mil sold the shares in Inco and DFR and realized a huge capital gain. The gains made on these transactions were not subject to tax in Canada as article 13(4)(b) read in conjunction with article 13(5) of the Canada-Luxembourg Income and Capital Tax Treaty (1989) allocated taxing rights over capital gains to Luxembourg. Also, as Luxembourg did not tax these gains, the transactions led to double non-taxation.[104] The Canadian tax authorities invoked the statutory GAAR to deny the benefit (exemption) claimed by Mil under the Canada-Luxembourg Income and Capital Tax Treaty (1989), as they considered the transaction to be an abusive tax avoidance transaction.

After a thorough analysis of the facts of the case, the TCC held that the conditions to invoke the GAAR (step 2 of the GAAR) was not satisfied as to the circumstances surrounding the case clearly indicated that there were many

93. CA: SCC, 19 Oct. 2005, *Canada Trust Co Mortgage Co v. Canada*, 8 ITLR 276, pp. 276-305.
94. *See Canada Trust Co* (2005), *supra* n. 93, at para. 17 and Beswick & Nijhawan, *supra* n. 33, at sec. 1.1.
95. Sec. 245(1) CITA.
96. Id., at section 245(1), read together with section 248(10).
97. Id., at sec. 245(3).
98. According to the SCC: "The third requirement for application of the GAAR is that the avoidance transaction giving rise to a tax benefit be abusive. The mere existence of an avoidance transaction is not enough to permit the GAAR to be applied. The transaction must also be shown to be abusive under s 245(4)". *Canada Trust Co* (2005), *supra* n. 93, at para. 36. Section 245(4) of the CITA provides that the GAAR provisions will apply to a transaction: "only if it may reasonably be considered that the transaction (a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of (i) this Act,(ii) the Income Tax Regulations, (iii) the Income Tax Application Rules, (iv) a tax treaty, or (v) any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in determining any amount that is relevant for the purposes of that computation; or (b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole".
99. *Canada Trust Co* (2005), *supra* n. 93, at para. 66. *See also* N. Goyette & P.D. Halvorson, *Canada*, in IFA, *supra* n. 59, at sec. 1.2.2.2.1.
100. *Canada Trust Co* (2005), *supra* n. 93, at 55. *See also* Goyette & Halvorson, *supra* n. 99, at sec. 1.2.2.2.1.
101. Goyette & Halvorson, *supra* n. 99, at sec. 1.2.2.
102. CA: TCC, 18 August 2006, *Mil Investments S.A. v. Her Majesty the Queen*, 2004-3354(IT)G, 9 ITLR 25, pp. 25-88, Case Law IBFD. Followed by the decision of the Canadian Federal Court of Appeal (CFCA) in CA: CFCA, 13 June 2007, *Mil Investments S.A. v. Her Majesty the Queen*, A-416-06, 9 ITLR 1111, pp. 1111-1113, Case Law IBFD.
103. *Convention between Canada and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* (17 Jan. 1989), Treaties & Models IBFD [hereinafter the *Can.-Lux. Income and Capital Tax Treaty* (1989)].
104. Article 13(4) of the *Can.-Lux. Income and Capital Tax Treaty* (1989) provided that: "Gains derived by a resident of a Contracting State from the alienation of: a) shares forming part of a substantial interest in the capital stock of a company which is a resident of the other Contracting State the value of which shares is derived principally from immovable property situated in that other State; or b) an interest in a partnership, trust or estate, the value of which is derived principally from immovable property situated in that other State, may be taxed in that other State. For the purposes of this paragraph, the term "immovable property" includes the shares of a company the value of which shares is derived principally from immovable property or an interest in a partnership, trust or estate referred to in sub-paragraph (b), but does not include property (other than rental property) in which the business of the company, partnership, trust or estate was carried on; and a substantial interest exists when the resident and persons related thereto own 10% or more of the shares of any class of the capital stock of a company." Art. 13(5) provides that "Gains from the alienation of any property other than that mentioned in paragraphs 1 to 4 shall be taxable only in the Contracting State of which the alienator is a resident".

bonafide business reasons for undertaking the aforementioned steps.[105] Courts in other countries have also held that their GAARs (judicial doctrines or statutory GAARs) were not applicable in situations (fact patterns dealing with treaty shopping) wherein the taxpayers transactions had commercial purpose and/or economic substance. For example, this was the verdict of the US Tax Court (USTC) in the case of *Northern Indiana Public Service* (1997)[106] as well as the decision of the Supreme Court of South Korea (SCSK) the case of *Carrefour Korea* (2014).[107]

Coming back to *Mil Investments*, while delivering its verdict, the TCC also analysed the question as to whether the transactions could be considered as "abusive" avoidance transactions for the purpose of the Canada-Luxembourg Income and Capital Tax Treaty (1989) (the third step of the GAAR). With regard to Mil moving into Luxembourg, the TCC stated that:

> the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the use of the selected treaty that must be examined".[108]

Further, the TCC examined article 13(5) and (4) of the Canada-Luxembourg Income and Capital Tax Treaty (1989) and held that:

> The general rule, contained in art 13(5) of the treaty, is that capital gains are taxable only in the country in which the taxpayer is resident (Luxembourg). An exception is made for the taxation of immovable property situated in the other state (Canada). Exempt from Canada's right to tax the capital gain on immovable property are two further restrictions found in art 13(4). These are the right to tax immoveable property from which a business is carried on and the right to tax immovable property in which the taxpayer owns less than a substantial interest (less than 10%).[109]

The TCC went on to say that:

> The two exemptions found in art 13(4) are not found in the OECD model convention upon which the treaty is based. In drafting those exemptions it must be presumed that Canada had a valid reason to allow Luxembourg to retain the right to tax capital gains in those specific circumstances, for example, the desire to encourage foreign investment in Canadian property. The appellant's reliance upon a treaty provision as agreed upon by both Canada and Luxembourg cannot be viewed as being a misuse or abuse. Canada, if concerned with the preferable tax rates of any of its treaty partners, instead of applying s 245, should seek recourse by attempting to renegotiate selected tax treaties.[110]

To summarize, the TCC seems to have held that the object and purpose of the relevant distributive rules are to allocate taxing rights. As Canada had forgone taxing rights in favour of Luxembourg with regard to capital gains and as Mil was always a non-resident for Canadian tax purposes, the fact that Mil moved into Luxembourg and alienated the shares of DFR and Inco could not be considered to be abusive for the purpose of the Canada-Luxembourg Income and Capital Tax Treaty (1989).[111]

The TCC in the case of *Alta Energy* (2018)[112] had to once again decide on the application of the Canadian GAAR to a tax treaty situation. The treaty shopping case dealt with a situation wherein a direct shareholding held by a US entity in a Canadian entity was restructured with the effect that a new Luxembourg Company (taxpayer) held the shares of the Canadian entity. The restructuring was mainly driven for tax purposes. The taxpayer then sold the shares of the Canadian entity (which owned immoveable property) and derived a capital gain. It then tried to argue that the capital gains were exempt from tax by relying on the specific provisions of article 13(4) read in conjunction with article 13(5) of the Canada-Luxembourg Income and Capital Tax Treaty (1999).[113] The taxpayer conceded that the first and second steps of the GAAR were satisfied. However, the third step was not. The TCC agreed with the taxpayer and put forward the following analysis.

As a starting point, when analysing the question of whether the transactions were "abusive" tax avoidance transactions, the TCC referred to the preamble and remarked that:

> The preamble of the Treaty states that the two governments desired "to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital." While indicative of the general purpose of the Treaty, this statement remains vague regarding the application of specific articles of the Treaty. Under the GAAR analysis, the Court must identify the rationale underlying Article 1, 4 and 13, not a vague policy supporting a general approach to the interpretation of the Treaty as a whole.[114]

The TCC's reference to the preamble is in accordance with article 31(2) of the Vienna Convention (1969). However, as the TCC considered the preamble to be vague, it focussed more on interpreting the concrete provisions of the treaty, i.e. the residence provision and the distributive rules at stake.

In this regard, the TCC held that the taxpayer was a resident of Luxembourg under article 4 of the Canada-Luxembourg Income and Capital Tax Treaty (1999).[115]

With regard to the distributive rules, the TCC held that:

> When the Treaty was negotiated, the Canadian treaty negotiators were aware of the fact that Luxembourg allowed its resi-

105. TCC, *Mil Investments* (2006), *supra* n. 102, at paras. 43-69.
106. US: USTC, 6 Nov. 1995, *Northern Indiana Public Service Company v. Commissioner of Internal Revenue*, Docket No. 24468-91 105 TC 341, Case Law IBFD. Followed by decision of the US Court of Appeals (USCA) for Seventh Circuit in US: USCA, 6 June 1997, *Northern Indiana Public Service Company v. Commissioner of Internal Revenue*, Docket No. 96-1659, 115 F3d 506, Case Law IBFD.
107. KR: SCSK, 10 July 2014, Case 2012, No. 16466 (*Carrefour Korea*), Case Law IBFD. The SCSK ruled that a Dutch BV that invested in Korea was not a conduit company as it had economic substance, held the shares of the Korean company for a long period of time and it had discretionary authority over the purchase and sale of the Korean company. *See* B. Kim & H. Park, *Republic of Korea*, in IFA, *supra* n. 33, at sec. 2.2.3.
108. TCC, *Mil Investments* (2006), *supra* n. 102, at para. 72.
109. Id., at para. 72.
110. Id., at paras. 73-74.
111. De Broe, *supra* n. 12, at sec. 4.2.6., p. 437.
112. CA: TCC, 22 Aug. 2018, *Alta Energy Luxembourg S.A.R.L. v. The Queen*, 2018 TCC 152 (CanLII), Case Law IBFD.
113. *Convention between the Government of Canada and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* (10 Sept. 1999), Treaties & Models IBFD.
114. TCC, *Alta Energy* (2018), *supra* n. 112, at para. 77.
115. Id., at para. 80.

> dent to avoid Luxembourg income tax on gains arising from the sale of shares of foreign corporations in broad circumstances. In this light, if Canada wished to curtail the benefits of the Treaty to potential situations of double taxation, Canada could have insisted that the exemption provided for under Article 13(5) be made available only in the circumstance where the capital gain was otherwise taxable in Luxembourg. Canada and Luxembourg did not choose this option. It is certainly not the role of the Court to disturb their bargain in this regard.[116]

The TCC, once again, seems to have taken the position that the object and purpose of the distributive rules is to allocate taxing rights and as the taxpayer had satisfied that objective the transaction was not abusive for the purpose of the GAAR.

In the end, the TCC held that:

> The Minister argues that the Restructuration constitutes an abuse of Articles 1, 4 and 13, because, absent the Restructuration, the gain would have been taxable in Canada. I do not find this result contrary to the rationale underlying Articles 1, 4 and 13. The rationale underlying the carve-out is to exempt residents of Luxembourg from Canadian taxation where there is an investment in immovable property used in a business. The significant investments of the Appellant to de-risk the Duvernay shale constitute an investment in immovable property used in a business. Therefore, I conclude that the GAAR does not apply to preclude the Appellant from claiming the exemption provided for under Article 13(5) of the Treaty.[117]

Recently, on appeal, the Canadian Federal Court of Appeal (CFCA) ruled in favour of the taxpayer in the case of *Alta Energy* (2020).[118] The Court, by relying on the reasoning developed in *Mil Investments*, held that:

> the object, spirit and purpose of the relevant provisions of the Luxembourg Convention is reflected in the words as chosen by Canada and Luxembourg. Since the provisions operated as they were intended to operate, there was no abuse.[119]

In the post-BEPS world, one may also raise the question as to what is the potential impact of the new preamble contained in article 6(1) of the MLI on the third step of the Canadian GAAR?

The question is also relevant for other jurisdictions where the GAAR refers to the object and purpose of the relevant provisions. For example, with regard to the abuse of rights doctrine applied in the European Union, abuse arises when the economic operator exercises its right to free movement with the sole intention (or principal, essential or predominant intention)[120] of obtaining benefits through artificial schemes and granting the benefits would be contrary to the "object and purpose of the relevant provisions" of EU law (primary or secondary law). The doctrine has been codified in article 6(1) of the Anti-Tax Avoidance Directive (ATAD) (2016/1164),[121] which states that the GAAR applies when an arrangement or a series of arrangements has been put into place for "the main purpose or one of the main purposes" of obtaining a tax advantage (subjective element) and that "defeats the object or purpose of the applicable tax law" (objective element), and, therefore, are not genuine having regard to all of the relevant facts and circumstances.

New Zealand is also an example of a jurisdiction where the courts will carefully consider the object and purpose of the New Zealand GAAR in its application, whether that be to purely domestic legislation or a tax treaty.[122] The SCNZ in its important judgement in the case of *Ben Nevis*[123] decided that the purpose of the GAAR was not just to ensure that the substantive "black letter" law provisions were being read fairly in order to discern the intention of Parliament. The majority judgement goes further and seeks to describe the relationship between the specific provisions and the GAAR by contextualizing in their respective roles. The general anti-avoidance regime is the principal vehicle to address tax avoidance. That is its purpose, so that:

> ... the general anti-avoidance regime is designed for that purpose, whereas individual specific provisions have a focus which is determined primarily by their ordinary meaning, as established through their text in the light of their specific purpose. In short, the purpose of specific provisions must be distinguished from that of the general anti-avoidance provision.[124]

The SCNZ framed the essential test for the application of the New Zealand GAAR as a two-step approach, i.e. the taxpayer must demonstrate to the court's satisfaction that:

(1) the use made of the specific provision is within its intended scope; and
(2) it has not used the provision, viewed in the light of the arrangement as a whole, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision.[125]

Statement (2) was based on a purposive interpretation of the GAAR. When looking at the application of the domestic GAAR to a tax treaty, a court, like the SCNZ will consider factors such as these indicia of tax avoidance (which will vary in persuasiveness depending on the particular facts) to provide some more concrete guidance to taxpay-

116. Id., at para. 85.
117. Id., at para. 100.
118. CA: CFCA, 12 Feb. 2020, *Alta Energy Luxembourg S.A.R.L. v. the Queen*, 2020 FCA 43, Case Law IBFD.
119. Id., at para. 80.
120. For a detailed discussion on such terminological differences, *see* C. Öner, *Is Tax Avoidance the Theory of Everything in Tax Law? A Terminological Analysis of EU Legislation and Case Law*, 27 EC Tax Rev. 2, pp. 105-107 (2018).
121. Council Directive (EU) 2016/1164 of 12 July 2016 Laying Down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, OJ L 193 (2016), Primary Sources IBFD [hereinafter the Anti-Tax Avoidance Directive (ATAD) (2016/1164)].
122. New Zealand has a long history and familiarity with GAARs having used them for more than 140 years. Much of the law developed around the use of the anti-avoidance provisions is judge-made notwithstanding the statutory provisions of the legislation. For a discussion, *see* C. Elliffe, *Policy Forum: New Zealand's General Anti-Avoidance Rule – A Triumph of Flexibility over Certainty*, 62 Can. Tax J./*Revue Fiscale Canadienne* (2014) 1, pp. 147-164 and C. Elliffe & J. Cameron, *The Test for Tax Avoidance in New Zealand: A Judicial Sea Change*, 16 N.Z. Bus. L. Q. 16, pp. 440-460 (2010), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1625604 (accessed 25 Mar. 2020). The application of the New Zealand GAAR to tax treaties is beyond doubt due to the amendments made to the legislation in 2017, although the extent of its retrospectivity has been justifiably questioned. *See* C. Burnett, *General Anti-avoidance Rules and Double Tax Agreements: Issues of Design, Timing and Penalty*, 24 N.Z. J. Tax L. 4, p. 337 (2018).
123. *Ben Nevis* (2008), *supra* n. 39.
124. Id., at [103].
125. Id., at [107].

ers as to how the Court is likely to apply the conceptual test of Parliamentary contemplation. These factors include:

- the manner in which the arrangement is carried out;
- the role of all relevant parties and any relationship they may have with the taxpayer;
- the economic and commercial effect of documents and transactions;
- the duration of the arrangement;
- the nature and extent of the financial consequences that it will have for the taxpayer; and
- the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way ("a classic indicator of a use that is outside Parliamentary contemplation").[126]

In other words, in these jurisdictions, will courts interpret the object and purpose of the relevant distributive rules (which also form a part of tax law) by giving considerable weight to the purpose of the GAAR. They may also consider, certainly in the interpretation of the PPT, but also in the broader context of the application of the domestic anti-avoidance rules to provisions that have been introduced by the MLI, i.e. the new preamble, which reads:

> Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions).

Two key possibilities emerge, among others, which the authors highlight below.

On the one hand, courts, in line with *Alta Energy* (2018 and 2020), may once again be inclined to state that the new preamble is vague. The addition of the new language to the preamble does not change the fact that higher importance should be given to the concrete provisions of the tax treaty, i.e. the residence provision and the distributive rules at stake. If the taxpayer complies with these provisions, then there is no abuse.

On the other hand, by referring to the new preamble, courts may state that the objectives of tax treaties are: (1) allocating taxing rights and eliminating double taxation with a view to promoting cross border flows (such as investments); (2) the prevention of tax evasion; and (3) prevention of tax avoidance (in particular, treaty shopping).[127] The addition of the tax avoidance objective will ensure that:

> tax conventions apply in accordance with the purpose for which they were entered into, i.e. to provide benefits in respect of *bona fide* exchanges of goods and services, and movements of capital and persons.[128] (Emphasis added)

Therefore, the object and purpose of the "relevant provisions", i.e. articles 1, 4 and 13 of the OECD Model, have to be read in light of the object and purpose of the entire tax treaty. Such an analysis will lead to the conclusion that the "purposive" (or object and purpose) element of the GAAR will be satisfied in treaty shopping cases and, hence, the treaty benefit is denied.

2.5. Fourth question: What is the effect of applying the domestic anti-avoidance rule?

2.5.1. Re-determination of the taxpayer, income re-allocation and possible conflict

In many countries, the requirements for applying the domestic anti-avoidance rule were fulfilled by re-determining the taxpayer and allocating income to another person or entity. To illustrate, US courts have applied domestic judicial anti-avoidance rules (such as substance over form or step transactions doctrine) in the following cases: *Aiken Industries* (1971),[129] *Teong-Chan Gaw* (1995)[130] and *Del Commercial* (2001).[131] Similarly, Austrian courts have upheld the application of the Austrian domestic statutory GAAR to treaty shopping cases such as in Case No. 93/13/0185 (1997)[132] and the case of *N AG* (2000)[133] as well as the *EU Directive Shopping* (2014) case.[134] Likewise, Korean courts have upheld the application of their national statutory GAAR in the cases of *Winia Mando* (2012),[135] *Lone Star Fund III* (2012)[136] and *La Salle Asia Recovery* (2012).[137] In the same vein, French courts have applied their domestic abuse of law concept in the case of *Bank of Scotland* (2006)[138] and a specific anti-avoidance rule in *Aznavour* (2008).[139] In all of these cases, the immediate income recipient was discarded by the state applying the domestic anti-avoidance rule and the income was

126. Id., at [108]-[109].
127. Paras. 16.1-16.2 *OECD Model: Commentaries, Introduction* (2017).
128. OECD, *Action 6 Final Report 2015 – Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* para. 26 (OECD 2015), Primary Sources IBFD and para. 174 *OECD Model: Commentary on Article 29* (2017)).
129. US: USTC, 5 Aug. 1971, *Aiken Industries, Inc v. Commissioner of Internal Revenue*, 56 TC 925, Case Law IBFD.
130. US: USTC, 9 Nov. 1995, *Anthony Teong-Chan Gaw as Transferee of Radcliffe Investment Ltd v. Commissioner of Internal Revenue*, 17906-92 and 18268-92, TC Memo 1995-531, Case Law IBFD.
131. US: USTC, 20 Dec. 1999, *Del Commercial Properties, Inc. v. Commissioner of Internal Revenue*, Docket No. 1887-98, TC Memo 1999-411, Case Law IBFD. Followed by US: USCA for District of Columbia Circuit, 8 June 2001, *Del Commercial Properties, Inc. v. Commissioner of Internal Revenue*, Docket No. 00-1313 251 F.3d 210, Case Law IBFD.
132. *See* the decision of the Austrian *Verwaltungsgerichtshof* (Supreme Administrative Court, Vwgh), in AU: Vwgh, 10 Dec. 1997, Case No. 93/13/0185, Case Law IBFD. The authors did not manage to get a translation of this case. So, reliance was placed on the summary of the case as available in the IBFD Case Law collection.
133. AU: Vwgh, 26 July 2000, *N AG v Regional Tax Office for Upper Austria*, 2 ITLR 884.
134. For a discussion of this case, *see* S. Bergmann & M. Lehner, *Austria*, in IFA, *supra* n. 33, at sec. 2.2.4.
135. Kim & Park, *supra* n. 107, at sec. 2.2.2.
136. KR: SCSK, 27 Jan. 2012, *Lone Star Fund III (U.S.) L.P. and Lone Star Fund III (Bermuda) L.P. v. Head of Yeoksam District Office of National Tax Service & other*, 2015du2611, 14 ITLR 953, pp. 953-966, Case Law IBFD.
137. KR: SCSK, 26 Apr. 2012, *La Salle Asia Recovery International LLP and another v Director of the Jongro District Tax Office*, 2010 du 11948, 15 ITLR 1, pp.1-17, Case Law IBFD.
138. The decision of the French *Conseil d'État* (Supreme Administrative Court) in FR: CE, 29 Dec. 2006, Case No. 283314, *Société Bank of Scotland v. Ministre de l'Economie, des Finances et de l'Industrie*, 9 ITLR 683, pp. 683-714, Case Law IBFD. *See also* A. Calloud, *France*, in IFA, *supra* n. 33, at sec. 2.2.2.
139. FR: CE, 28 Mar. 2008, Case No. 271366, *M. Aznavour v. Ministre de l'Economie, des Finances et de l'Industrie*, Case Law IBFD. The authors did not manage to get a translation of this case. Therefore, reliance was made on the summary of the case as available in the IBFD Case Law collection.

reallocated to a resident of another state. The question that then arises is how does this effect (income re-allocation) interact with the provisions of the tax treaty in question?

The Commentary on Article 1 of the OECD Model (2003),[140] whose history can be traced back to the majority view in the OECD Base Companies Report of 1986[141] as well as the OECD Commentary on Article 1 of the OECD Model (1992),[142] provided that:

> Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including "substance-over-form", "economic substance" and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties… …Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict. For example, to the extent that the application of the rules referred to in paragraph 22 results in a recharacterisation of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes.[143]

The Commentaries on Article 1 of the OECD Models (2014)[144] and (2017)[145] also express the similar position.

Moreover, the Commentaries on Article 17(2) of the OECD Model (2014) discuss this position. Specifically, the OECD Commentary on Article 17 (2014), in the context of countering "rent-a-star-arrangements", provides that:

> the Convention would not prevent the application of general anti-avoidance rules of the domestic law of the State of source which would allow that State to tax either the entertainer/sportsperson or the star-company in abusive cases, as is recognised in paragraphs 22 and 22.1 of the Commentary on Article 1.[146]

The Commentary on Article 17 of the OECD Model (2017) contains similar language.[147] Accordingly, a conflict with treaty provisions does not arise if a domestic anti-avoidance rule re-allocates the income derived by an intermediary entity to the artist or sportsman. Essentially, the OECD's view is that the provisions of a tax treaty will be applied only after a domestic anti-avoidance rule redetermines the relevant taxpayer. But is this position correct?

As a starting point, it should be noted that domestic tax law, including the use of domestic anti-avoidance rules, governs attribution of income to a taxpayer. A state can indeed decide as to what the taxable event is, what the taxable amount is and who the taxpayer is. Accordingly, the state of source (State S), in a treaty shopping situation, can indeed re-allocate the income to a third-state resident (State R) under its domestic anti-avoidance rules and not the immediate income recipient (State T), even if State R and State T consider the immediate income recipient to be the real income recipient for tax purposes. Consequently, the attribution of income by each state should be seen independently as tax treaties do not interfere with such decisions. This said, once the domestic law attributes income to a taxpayer – a tax treaty, indeed, applies. Therefore, income attribution decisions, once triggered by the domestic law, are indeed affected by tax treaties. If a state has entered into a tax treaty, then the provisions of that tax treaty have to be analysed in order to understand if the state imposing the tax can be restricted from taxing the income.[148]

Article 1(1) of the OECD Model (2017) provides that a tax treaty applies to "persons" who are "residents" of one of the contracting states. Accordingly, once a taxpayer qualifies as a "person" in accordance with article 3(1)(a) of the OECD Model (2017) and a "resident" as under article 4(1), primarily by reference to unlimited and/or full tax liability criteria,[149] then – in principle – the tax treaty can be applied. The next condition, even though this has not been expressly provided in the tax treaty, is that the income should be attributed to the resident person in order to apply the distributive rules.[150] In other words, in order to claim treaty benefits, there has to be a connection between a tax subject (resident person) and the tax object (income or gains).[151] This condition can be deduced from the distributive rules of tax treaties[152] that use different terms such as "derived by", "of", "from", "paid to", etc. Put differently, these terms represent a connection that is required between the resident person and the tax object so that the resident person can claim treaty benefits with regard to the tax object. Accordingly, in order to apply the distrib-

140. The extent to which the *OECD Model: Commentaries* can be used in the interpretation of tax treaties has been the subject matter of extensive debate and there seems to be no consensus regarding its legal status. Specifically, the issue arises with regard to the relationship between the interpretation rules of the *Vienna Convention* (1969) and the *OECD Model: Commentaries*, i.e. is the practice of considering the *OECD Model: Commentaries* permitted by the rules of the *Vienna Convention* (1969)? Our position is that the *OECD Model: Commentaries* existing at the time of conclusion of a tax treaty is not a legally binding instrument, but, nevertheless, plays an important role in the tax treaty interpretation process. Moreover, subsequent versions of the *OECD Model: Commentaries* can be considered, only if, the revision to the relevant *OECD Model: Commentaries* is in the nature of a clarification. Consequently, if the revised *OECD Model: Commentaries* represents a fundamental change or if the *OECD Model: Commentaries* reverses or contradicts previous versions, then that *OECD Model: Commentaries* should be disregarded and should not be taken into the tax treaty interpretation process. For a discussion on this issue, *see* Chand, *supra* n. 2, at sec. 6. *See also* C. Elliffe, *Cross Border Tax Avoidance: Applying the 2003 OECD Commentary to Pre-2003 Treaties*, Brit. Tax Rev. 3, pp. 307-333 (2012), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2120834.
141. OECD, *Double Taxation Conventions and the Use of Base Companies (adopted by the OECD Council on 27 November 1986)* paras. 39 and 40 (OECD 1986), Primary Sources IBFD [hereinafter OECD, *Base Companies* (1986)].
142. Paras. 22-24 *OECD Model: Commentary on Article 1* (1992).
143. Paras. 22-22.1 *OECD Model: Commentary on Article 1* (2003).
144. Paras. 22, 22.1, 9.2 and 9.5 *OECD Model: Commentary on Article 1* (2014).
145. Paras. 76 and 77 *OECD Model: Commentary on Article 1* (2017).
146. Para. 11.2 *OECD Model: Commentary on Article 17* (2014).
147. Para. 11.3 *OECD Model: Commentary on Article 17* (2017).
148. De Broe, *supra* n. 12, at sec. 6.3.4, p. 605.
149. Para. 8 *OECD Model: Commentary on Article 4* (2014).
150. R. Danon, *Switzerland's Direct and International Taxation of Private Express Trusts* vol. 1, *Droit Fiscal Suisse et international* (Schulthess 2004).
151. J.C. Wheeler, *General Report*, in *Conflicts in the attribution of income to a person*, IFA *Cahiers de Droit Fiscal International* vol. 92b, sec. 1.1.2. (IBFD 2007), Books IBFD.
152. R. Danon, *Conflicts of attribution of income involving Trusts under the OECD Model Convention: The Possible Impact of the OECD Partnership Report*, 32 Intertax 5, p. 211 (2004).

utive rules, the income and/or gain that originates in the state of source has to be received by a resident person of the other state. Therefore, it needs to be checked if there is a resident recipient of the income (the test of beneficial ownership[153] as provided in articles 10 to 12 of the OECD Model (2017) should be considered separately). In the case at hand, from the perspective of State S, a State T resident does not receive the income, whereas from the perspective of State T the income is indeed received by a State T resident. Therefore, a conflict of income attribution arises. Accordingly, the question as to whether the source state's income attribution criteria are controlling or the residence state's income attribution criteria are controlling in order to obtain treaty entitlement needs to be answered.

The expressions used in the distributive rules, such as "derived by", "of", "from", "paid to",etc., are undefined treaty terms. Accordingly, reference should be made to the domestic tax law of the source state pursuant to article 3(2) of the OECD Model (2017) to understand the meaning of these terms subject to the "context" requiring otherwise. The state of source could argue that, from its perspective, a resident of the other state (State T) does not receive the income and/or gains. As a result, the State T-State S Tax Treaty should not apply and the State R-State S Tax Treaty (to the extent it exists is applicable). For instance, the courts have adopted this approach, for example, in the *Del Commercial, Bank of Scotland, Aznavour, Lone Star Fund III* and *La Salle Asia Recovery* cases, in which the attribution rules applicable in the intermediary state were not taken into consideration and the source state's (State S) attribution was upheld. One commentator also supports the position that the source state's attribution criteria are to be endorsed. This has the clear advantage of simplicity as the source state's tax administration applies its own attribution rules and, therefore, its tax treaties.[154]

Conversely, another commentator states that a "contextual" interpretation of the connecting terms in the distributive rules needs to be undertaken.[155] In his opinion, reference can be made to the principles of the 1999 OECD Partnership Report[156] to understand the contextual meaning of the connecting terms, especially, the expressions "derived by" and "paid to". The general recommendation proposed by the Report to resolve conflicts regarding attribution of income in the context of partnerships, is that the state of source should consider that an item of income is "derived by" and/or "paid to" a resident of the other state if the latter state attributes the income to that resident person for tax purposes.[157] The view has been incorporated in the Commentary on Article 1 of the OECD Model (2000),[158] in which it is stated that:

> the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident.[159]

Furthermore, illustration 8 of the 1999 OECD Partnership Report can be used to shed light on the case study at hand.[160] The example deals with a situation where two partners, residents of State R, own interests in a partnership (P) that is a resident in State P and the income source (dividend) emanates from State S. All states treat the partnership as a taxable entity. In such a situation, the report provides that State S should follow the residence state's attribution criteria to check the treaty entitlement of the partners or the partnership. The report concludes that the partners should not be entitled to treaty benefits as they are not "liable to tax" on the dividends for the purposes of applying the equivalent of article 4(1) of the OECD Model. On the other hand, the partnership should be entitled to treaty benefits as it is "liable to tax" on the dividends for the purposes of applying that provision. In summary, the report states that the attribution criteria of State S do not matter (in this situation). If that logic is followed then the applicable treaty in our treaty shopping case is the State T-State S Tax Treaty as opposed to the State R-State S Tax Treaty. Consequently, State S should be restricted from taxing the dividends, interest, royalties or capital gains. Applying this logic, the redetermination effect of the domestic anti-avoidance rule will be curtailed as a conflict arises with the treaty provisions.[161]

The argument becomes stronger if the State T-State S Tax Treaty has an anti-hybrid clause that is proposed in the context of BEPS Action Plan 2 to prevent hybrid mismatches. The clause which codifies the principles of the 1999 OECD Partnership Report states that:

> For the purposes of this Convention, income derived by or through an entity or *arrangement* that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.[162] (Emphasis added)

This provision, which states may opt to apply to their Covered Tax Agreements (CTA),[163] is also reflected in article 3(1) of the MLI,[164] which states that:

> For the purposes of a Covered Tax Agreement, income *derived by* or through *an entity or arrangement* that is treated as *wholly or partly fiscally transparent* under the tax law of either Contracting

153. For an analysis of this concept, *see* Danon, *supra* n. 150, at pp. 326-350.
154. M. Lang, *The Application of the OECD Model Tax Convention to Partnerships, A Critical Analysis of the Report Prepared by the OECD* 3rd edn., p. 38 (Kluwer L. Intl.2000).
155. Danon, *supra* n. 150, at pp. 314-323.
156. OECD, *The Application of the OECD Model Tax Convention to Partnerships – Report: adopted on 20 January 1999* (OECD 1999), Primary Sources IBFD [hereinafter OECD, *Partnership Report* (1999)].
157. Danon, *supra* n. 150, at p. 217.
158. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* (29 Apr. 2000), Treaties & Models IBFD.
159. Para. 6.3 *OECD Model: Commentary on Article 1* (2014).
160. OECD, *Partnership Report* (1999), *supra* n. 156, at paras. 71-72.
161. M. Steindl & M. Stiastny, *The Impact of the OECD Partnership Report (1999) on Tax Avoidance in Outbound Cases*, 68 Bull. Intl. Taxn. 2 (2014), Journal Articles & Papers IBFD.
162. OECD, *Action 2 Final Report 2015 – Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project ch. 14 (OECD 2015), Primary Sources IBFD [hereinafter OECD, *Action 2 Final Report* (2015)].
163. It should be noted that this clause is an optional clause that states may wish to apply to their CTAs. *See Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, paras. 46-47 (7 June 2017), Treaties & Models IBFD [hereinafter *Explanatory Statement*].
164. Art. 3(1) MLI.

> Jurisdiction shall be considered to be income of a resident of a Contracting Jurisdiction but only to the extent that the income is treated, for purposes of taxation by that Contracting Jurisdiction, as the income of a resident of that Contracting Jurisdiction. (Emphasis added)

The Commentary on this provision provides that:

> The reference to "income derived by or through an entity or arrangement" has a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each Contracting State as to who derives that income for domestic tax purposes.[165]

Therefore, if State S, by applying its domestic anti-avoidance rule, treats the taxpayers "entity" or "arrangement" as fiscally transparent (by allocating the income to State R), it will still be restricted by the State T-State S Tax Treaty as State T would attribute the income to its own resident company and would tax that company on it. Consequently, the application of the 1999 OECD Partnership Report principles leads to an effect which is contrary to that intended by the application of the domestic anti-avoidance rules.

It could be argued that the principles of the 1999 OECD Partnership Report and the anti-hybrid clause should be restricted only to partnerships and hybrid entities (such as trusts). Accordingly, they should not be extended to other situations, especially, when domestic anti-avoidance rules are applied. Such an approach was upheld in a recent case decided by the Swiss *Bundesgericht/Tribunal fédéral* (Federal Supreme Court, Bg/Tf).[166] Contrary to the analysis here, the domestic rule was applied by the state of residence (State R) and not the state of source (State S). To elaborate, an Austrian taxpayer had invested into Switzerland through a chain of entities established in Liechtenstein, Panama and the British Virgin Islands (foundations and companies). The Austrian tax administration looked through the intermediaries and imputed their income in the hands of the Austrian taxpayer pursuant to the Austrian GAAR. The Austrian taxpayer then argued for the application of the lower rates on dividends as provided in the Austria-Switzerland Income and Capital Tax Treaty (1974).[167] However, the Bg/Tf held that, from a Swiss perspective, the principles contained in the partnership report cannot be applied, as the present case deals with foundations and companies and not partnerships.[168]

Keeping aside this judgement, on the other hand, it could also be argued that the principles should be extended to all situations that involve residence, being source conflicts of income attribution (a residence – source conflict of income attribution arises when the residence state and source state attribute the same income to different taxpayers), as they represent a correct interpretation of the connecting terms used in the OECD Model.[169] Consequently, in our view, this is one area wherein the taxpayers may argue for a potential conflict to arise, especially when the domestic anti-avoidance rule is applied by State S.

2.5.2. Alternate benefits under domestic law

If taxpayers do not succeed in making the argument advanced at the end of section 2.5.1. on a potential conflict, can they request for alternate benefits till the extent it exists (for example, a lower rate on dividends or interest under the State R-State S Tax Treaty)? In fact, some countries' national rules provide for alternate benefits under domestic law mechanisms (seen from the perspective of State S). For example, the United States seems to adopt this approach in conduit financing cases wherein the transactions are re-characterized.[170] Similarly, alternate benefits could be available in South Korea under its GAAR.[171] Likewise, this should be the case in Austria under its national GAAR.[172] The situation in Switzerland seems to be mixed. In 2010, the Bvwg/Taf[173] seems to have applied the tax treaty to the new (fictitious) fact pattern.[174] On the other hand, in a case which dealt with conduit companies (in particular, the beneficial ownership requirement), the Swiss Bg/Tf seems to have denied alternate benefits on procedural grounds.[175] This said, commentators have opined that alternate benefits should indeed be available[176] (assuming the judicial anti-abuse rule applies to treaties). With regard to transactions that can be considered to be abusive within the European Union, the Court of Justice of the European Union (ECJ) in *Halifax* (Case C-255/02) has ruled that:

> transactions involved in an abusive practice must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice.[177]

165. OECD, *Action 2 Final Report* (2015), *supra* n. 162, at para. 435 (*Commentary*, para. 26.8).
166. CH: Bg/Tf, 4 Feb. 2020, Case No. 2C_344/2018.
167. *Convention between the Swiss Confederation and the Republic of Austria for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (30 Jan. 1974) (as amended through 2009), Treaties & Models IBFD.
168. Case No. 2C_344/2018 (2020), *supra* n. 166, at paras. 3.4.5-3.5.
169. Danon, *supra* n. 150, at p. 323. OECD, *Partnership Report* (1999), *supra* n. 156 also provides that the principles of the report can be applied to other situations. *See* OECD, *Partnership Report* (1999), *supra* n. 156, at para. 1.
170. The United States also seems to adopt a similar approach in conduit financing cases wherein the transactions are re-characterized. *See* US: Treasury Regulations, 1.881-3 (effect of income tax treaties).
171. Kim & Park, *supra* n. 107, at secs. 1.4.2.3.-1.4.2.4.
172. Bergmann & Lehner, *supra* n. 134, at sec. 2.2.4.
173. CH: Bvwg/Taf, 23v Mar. 2010, Decision A-2744/2008. *See also* Kunz-Schenk, *supra* n. 61, at sec. 1.5.1.-15.2.
174. Kunz-Schenk, *supra* n. 61, at sec. 2.3.2.
175. CH: Bg/Tf, 27 Nov. 2015, Decision 2C_752/2014, para. 7, Case Law IBFD.
176. For a detailed discussion, *see* Danon & Salome, *supra* n. 62, at pp. 197-247.
177. UK: ECJ, 21 Feb. 2006, Case C-255/02, *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v. Commissioners of Customs & Excise, BUPA Hospitals Ltd, Goldsborough Developments Ltd v. Commissioners of Customs and Excise and University of Huddersfield Higher Education Corporation v. Commissioners of Customs and Excise*, paras. 93-94, Case Law IBFD. *See also* UK: ECJ, 13 Mar. 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, paras. 80-83, Case Law IBFD. In *Test Claimants in the Thin Cap Group Litigation* (C-524/04), *supra*, the ECJ held that even if abuse arises, the UK domestic thin capitalization rules should not adjust the profits of the borrower beyond that mandated by the arm's length standard.

Advocate-General Bobek has expressed a similar position in *Cussens* (Case C-251/16),[178] in addition to the ECJ.[179]

3. Domestic Anti-Avoidance Rules That Deny Benefits Flowing from Domestic Tax Law

3.1. Income inclusion rules applicable from a residence state's perspective

Income imputation rules can trigger compatibility issues with tax treaty law, in particular, article 7 of the OECD Model, which deals with business income, article 10(5), pertaining to taxation of undistributed profits, as well as article 21, which deals with other income. These compatibility related issues have been discussed extensively in literature.[180] The position of the OECD and the UN is that such rules, in particular, CFC rules do not conflict with treaty obligations. The position has been expressed in the 1986 Base Companies Report (majority view),[181] the Commentary on Article 1 of the OECD Model (1992) (majority view),[182] the Commentaries on Articles 1, 7 and 10 of the OECD Model (2003),[183] the Commentaries on Articles 1, 7 and 10 of the OECD Model(2017)[184] and the Commentaries on Articles 1, 7 and 10 of the OECD Model (2017).[185]

In several jurisdictions, courts have also held that CFC rules are compatible with tax treaties when they were applied by the state of the residence to its resident taxpayer. For instance, *see* the decisions in the United Kingdom's *Bricom Holding* (1996 and 1997),[186] Finland's *Re A Oyj Abp* (2002),[187] Sweden's *X AB* (2008)[188] and Japan's *Glaxo Kabushiki* (2009).[189] Courts in some jurisdictions have also upheld the application of the same imputation effect pursuant to a domestic GAAR, for example, in Austria.[190]

That said, some courts have held that CFC rules are contrary to tax treaties. for example, in France.[191]

One additional area that merits investigation is whether such rules conflict with article 9 of the OECD Model, especially, when the rules apply to genuine operating entities in which the CFC "controls" keys risks or carries out development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE) related activities. Although an analysis of this issue is beyond the scope of this article, in the BEPS Action 3 report, the OECD provides that transfer pricing rules and CFC rules can coexist with each other.[192] Moreover, several countries which include the equivalent of article 9 of the OECD Model in their tax treaties already apply CFC rules.[193]

It should also be noted that the OECD Model (2017) contains a saving clause in article 1(3). This clause states that:

> This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23, 24 and 25 and 28.

It is obvious that if this clause exists in tax treaties, it would not be possible to argue that a state is restricted from applying its CFC rule.[194] This is because that clause reserves a state's right to tax its residents under the rules provided in the domestic laws, notwithstanding any provisions of the tax treaty.[195] Moreover, it should be noted that article 9(1) of the OECD Model is not listed as an exception in the saving clause. Accordingly, the domestic CFC rule could apply notwithstanding a possible and/or potential conflict with article 9(1) of the OECD Model.[196] Moreover, the Commentary on Article 1 of the OECD Model (2017)[197] and the UN Model (2017)[198] make it absolutely clear that, even if a tax treaty does not have a saving clause, then this does not mean that a state is restricted from applying its CFC rule.

The OECD in the context of Pillar Two of the debate on the Digital Economy[199] has put forward an income inclusion rule that may either be based on a worldwide blending, a jurisdictional blending or an entity-by-entity blending approach.[200] While discussing the policy rationale and the scope of this rule is also beyond the scope of this article, one of the authors to this contribution has a preference for a worldwide blending approach given its simplici-

178. IE: Opinion of Advocate General Bobek, 7 Sept. 2017, Case C-251/16, *Edward Cussens, John Jennings, Vincent Kingston v. T.G. Brosnan*, paras. 109-116, Case Law IBFD.
179. IE: ECJ, 22 Nov. 2017, Case C-251/16, *Edward Cussens, John Jennings, Vincent Kingston v. T.G. Brosnan*, Paras. 45-51, Case Law IBFD.
180. For a detailed analysis, *see* Chand, *supra* n. 2, at sec. 18.
181. OECD, *Base Companies* (1986), *supra* n. 141, at paras. 39-51.
182. Paras. 22-26 *OECD Model: Commentary on Article 1* (1992).
183. Para. 22.1 *OECD Model: Commentary on Article 1* (2003); para. 10.1 *OECD Model: Commentary on Article 7* (2003); and paras. 37-39 *OECD Model: Commentary on Article 10* (2003).
184. Para. 81 *OECD Model: Commentary on Article 1* (2017); para. 14 *OECD Model: Commentary on Article 7* (2017); and para. 37 *OECD Model: Commentary on Article 10* (2017).
185. *UN Model Double Taxation Convention between Developed and Developing Countries: Commentary on Article 1*, para. 40 (1 Jan. 2017), Treaties & Models IBFD; para. 8 *UN Model: Commentary on Article 7* (2017); and para. 16 *UN Model: Commentary on Article 10* (2017).
186. *See* the decision of the UK High Court (UKHC) in UK: UKHC, 3 Apr. 1996, *Bricom Holdings Ltd v. Commissioners of Inland Revenue*, [1996] STC (SCD) 228, followed by UK: UKCA, 25 June 1997, *Bricom Holdings Limited v. Commissioners of Inland Revenue*, Appeal No. OOTRF 96/1522/B, 1 oflr ITLR 365, pp. 366-379, Case Law IBFD.
187. *See* the decision of the Finnish *Korkein Hallinto-oikeus* (Supreme Administrative Court, KHO) in FI: KHO, 20 Mar. 2002, *Re A Oyj Abp*, 20.03.02/596; KHO: 2002:26, 4 ITLR 1009, pp. 1009-1076, Case Law IBFD.
188. *See* the decision of the Swedish Supreme Administrative Court (*Regeringsrätten*, RR), in SE: RR, 3 Apr. 2008, *X AB v. Swedish Tax Agency*, Case No. 2695-05, 12 ITLR 311, pp. 311-342.
189. *See* the decision of the Japanese *Saikō-saibansho* (Supreme Court, Ss) in JP: Ss, 29 Oct. 2009, *Glaxo Kabushiki Kaisha v. Director of Kojimachi Tax Office*, Case No. 2008 (*Gyou Hi*), 12 ITLR 644, pp. 644-657, Case Law IBFD.
190. AU: Vwgh, 9 Dec. 2004, Case No. 2002/14/0074, Case Law IBFD.
191. FR: CE, 28 June 2002, *Re Societe Schneider Electric*, Appeal No. 232276, 4 ITLR 1077, pp. 1106-1129.
192. OECD, *Action 3 Final Report 2015 – Designing Effective Controlled Foreign Company Rules*, OECD/G20 Base Erosion and Profit Shifting Project paras. 8-9 (OECD 2015), Primary Sources IBFD.
193. For an analysis of CFC rules, *see* B.J. Arnold, *The Evolution of Controlled Foreign Corporation Rules and Beyond*, 73 Bull. Intl. Taxn. 12, sec. 4. (2019), Journal Articles & Papers IBFD.
194. G. Kofler, *Some Reflections on the "Saving Clause"*, 44 Intertax 8/9, pp. 582-584 (2016).
195. *US Model Income Tax Convention: Technical Explanation to Article 1(4)* (15 Nov. 2006), Treaties & Models IBFD.
196. Kofler, *supra* n. 194, at pp. 586-588.
197. Paras. 17-18 *OECD Model: Commentary on Article 1* (2017).
198. Para. 8 *UN Model: Commentary on Article 1* (2017).
199. OECD, *Global Anti-Base Erosion Proposal ("GloBE") - Pillar Two, Public consultation document, 8 November – 2 December 2019* (OECD 2019) [hereinafter OECD, *Global Anti-Base Erosion Proposal*].
200. Id., at para. 55.

ty.[201] Nevertheless, the question arises whether these rules conflict with treaty provisions when applied by the state of the controlling shareholder of a multinational enterprise (MNE). In light of the discussion made in the context of CFCs, our initial opinion is that such a rule will not conflict with tax treaties.[202]

3.2. Switchover clauses applicable from a residence state's perspective

Another rule that is being contemplated in the Pillar Two debate is a switchover clause. It is our understanding that this rule will apply on a separate entity basis (establishment-by-establishment basis) as opposed to a worldwide blending approach which is contemplated under the aforementioned income inclusion rule.

Consider the following situation. X, a tax resident of State R operates through a PE in State T (a low tax country). The PE derives passive income (such as interest) from loans provided to State T companies. If the State R-State T Tax Treaty is based on the OECD Model (which follows the exemption method), the income will not be taxable in State R. This is because article 23(A)(1) of the OECD Model provides that:

> Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State..., the first-mentioned State shall... exempt such income or capital from tax.

Accordingly, when X derives income from a PE in State T that maybe taxed in that state, State R should exempt such income from further taxation. Assume that State R introduces a domestic switch over rule that denies the exemption to X and considers the income to be subject to normal tax rules (it switches over to the credit mechanism). The question then arises as to whether the State R-State T Tax Treaty precludes the application of such a rule? Ideally, this rule should have been analysed under the first type of domestic anti-abuse rule as it denies benefits that flow from tax treaties. However, given the context in which it is proposed, the authors analyse the rule here.

In our opinion, domestic law and treaty law are two completely different legal spheres. If a taxpayer derives income from foreign PEs then that taxpayer should be given treaty benefits. Barring treaty benefits on the basis of a domestic anti-avoidance rule, such as a switchover SAAR clearly conflicts with the provisions of tax treaties. This is because the domestic law provision does not square with the provisions of the tax treaty. To elaborate, the equivalent of article 23A of the OECD Model in the State R-State T Tax Treaty requires State R to exempt income from taxation which in accordance with the treaty "may be" taxed in the other state. The relief has to be provided by State R, irrespective of whether the income is actually taxed, lowly taxed or is not taxed at all in State T. This issue has been debated in Germany.[203]

Germany, under its longstanding treaty policy, provides for the exemption method with regard to several items of income.[204] Typically, the exemption is provided for income attributable to a PE.[205] Some tax treaties exempt the PE's income without any conditions,[206] whereas in other treaties the PE's income is exempt only if it is considered to be "active", in the sense that the income derived is from active operations (such as manufacturing, producing, processing, exploration and extraction of natural resources, banking and insurance, etc.)[207] and not passive sources (where the PE derives only income from holding shares).[208]

Due to these clauses, it was beneficial for taxpayers to operate with foreign PEs in low tax jurisdictions.[209] Accordingly, to counteract such schemes (as well as other schemes), the German legislature introduced a domestic switchover clause that is currently found in section 20(2) of the German *Aussensteuergesetz* (Foreign Tax Law, AStG).[210] The rules provide that the exemption method will be replaced by the credit method where the PE's income is derived from passive sources that are low taxed.[211] Accordingly, the question arises whether the switchover clause can be used to deny the exemption method for the income derived from the foreign PE without disrupting the treaty provisions. It has been argued in German tax literature that such a domestic provision conflicts with treaties that provide for the exemption method to be applied unconditionally (in this sense, the national rules constitute a treaty override).[212] The authors agree with this position. Therefore, in order to negate a conflict a treaty provision which authorizes the application of the domestic rule will need to be developed. This rule would need to be in the tax treaty itself for monistic countries but dualistic countries could incorporate it in their domestic legislation (on the basis that it is anti-avoidance legislation overriding the

201. *See* L. De Broe, R. Danon & V. Chand, *Public comments on OECD Global Anti-Base Erosion Proposal*, pp. 1-24, at 8, Institute of Tax Law at KU Leuven and Tax Policy Center (2 Dec. 2019), available at www.dropbox.com/s/bbykwyz39gosgbf/oecd-public-comments-globe-proposal-pillar-two-december-2019.zip?dl=0.
202. Id., at pp. 10-11. Furthermore, if the income inclusion rule is built on the basis of a global blending approach then the chances of potential conflicts with EU law reduce in comparison to the entity-by-entity or jurisdictional approach.
203. J. (Jürgen) Lüdicke, *Exemption and Tax Credit in German Tax Treaties – Policy and Reality*, 64 Bull. Intl. Taxn. 12, sec. 4.5., p. 619 (2010), Journal Articles & Papers IBFD.
204. Id., at sec. 3.2., p. 612.
205. A. Linn, *Germany*, in IFA, *supra* n. 59, at Summary and conclusions.
206. For instance, *see Agreement between New Zealand and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Certain Other Taxes*, art. 23(2) (20 Oct. 1978), Treaties & Models IBFD. For a list of other treaties, refer to Linn, *supra* n. 205, at sec. 2.4.1.
207. M. Lipp, *Germany's Tax Treaty Negotiation Policy*, 54 Eur. Taxn. 7, sec. 4.4. (2014), Journal Articles & Papers IBFD.
208. For instance, *see Agreement between Canada and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and Certain Other Taxes, The Prevention of Fiscal Evasion and the Assistance in Tax Matters*, art. 23(2)(c) (19 Apr. 2001), Treaties & Models IBFD. For a list of other treaties, refer to Linn, *supra* n. 205, at sec. 2.4.1. and Lüdicke, *supra* n. 203, sec. 3.2., p. 615.
209. Lüdicke, *supra* n. 203, sec. 3.2.4., p. 619.
210. DE: *Aussensteuergesetz* (Foreign Tax Law, AStG).
211. Lüdicke, *supra* n. 203, sec. 4.5.
212. Linn, *supra* n. 205, at sec. 1.5.3.2., pp. 344-345.

treaty).[213] As an alternate, states can sign up to Option C which is reflected in article 5 of the MLI.[214]

3.3. Base-eroding rules from a payor state's perspective and a possible rethink: Reverse CFC or extension to all tax-exempt entities?

Anti-base eroding measures such as thin capitalization rules also trigger compatibility issues with tax treaty law. These compatibility related issues have been discussed extensively in literature.[215] Essentially, if the rule denies a deduction to the payor only for payments made to non-residents, then depending on the scope of the rule, compatibility issues could arise with tax treaty law. Specifically, thin capitalization rules that are based on fixed debt:equity ratios could conflict with article 9(1) of the OECD Model. Furthermore, such rules could conflict with the non-discrimination provisions,[216] i.e. article 24(4) of the OECD Model, which deals with deduction non-discrimination,[217] and article 24(5), which deals with ownership non-discrimination.[218] In several jurisdictions, courts have also confirmed this position, that is, potential conflicts could arise between such rules and tax treaties. For example, the French courts in the *Société Andritz* (2003)[219] and the Spanish courts in the *Hero Espana* (2011)[220] have held that conflicts can arise.

The question arises whether such a conflict be neutralized if the treaty has a saving clause? In this regard, it should be noted that, as article 9(1) of the OECD Model is not listed as an exception in the saving clause, it could be argued that the tax treaty should not affect the taxation by State S (the state applying the thin capitalization rule) of its own resident. Accordingly, the rule could apply notwithstanding the conflict with article 9(1) of the OECD Model.[221] The authors agree with this position.[222] Nevertheless, if the treaty contains the equivalent of article 24(4) or (5) of the OECD Model and that rules applies to non-residents, then an argument cannot be made that the saving clause protects the application of the thin capitalization rule. This is because that clause lists article 24 of the OECD Model as an exception.[223]

The OECD in the context of Pillar Two of the debate on the Digital Economy[224] has also put forward the idea of applying a base eroding payments rule. That rule, if applicable only for payments made by residents to non-residents could, indeed, conflict with tax treaties (especially, non-discrimination) provisions.[225] Furthermore, conflicts could arise with EU law.[226] Therefore, this rule poses a significant challenge from a compatibility standpoint as opposed to the income inclusion rule.

In order to overcome the conflict hurdle, one possibility which could be explored would be to drop the base-eroding payments rules and introduce a reverse CFC rule. The reverse CFC rule would apply when the income inclusion rule is not applied at the level of the MNE's parent. Consider the following example. Company S of State S makes a payment to related Company T of State T. State T is a low-tax jurisdiction. Company T is owned by Company R of State R, another related company. Company R is also the parent of the MNE group. The payment made by Company S to Company T will be allowed as a deduction for Company S. However, if State R does not apply its income inclusion rule, then State S would apply its reverse CFC rule and allocate the income of Company T to Company S (or a part of the deemed income that was supposed to be taxed by State R in the hands of Company R, but was actually not taxed). Specifically, the income which had been paid out to a low-tax jurisdiction would be re-allocated back to the payor state's resident. The question then arises as to whether the re-allocation of this income back to State S conflicts with tax treaties?

If one applies the principles of the partnership report, then a conflict does not arise. Example 16 of the partnership report deals with a situation where two partners (A – a resident of State P and B – a resident of State R) own interests in a partnership (P) that is a resident in State P and the income source (royalty) emanates from State P. State P treats the partnership as a taxable entity, whereas State R treats the partnership as a transparent entity. In such a situation, the report provides that a conflict does not arise with treaty provisions as State R and State P are taxing their own residents.[227] This conclusion was reflected in the Commentaries on the OECD Model (2000) onwards, which now provides that:

> Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State's right to tax the partnership on its income do not apply to restrict that other State's right to tax the partners who are its own residents on their share of the income of the partnership.[228]

213. *See* the discussion on permissible treaty overrides in abuse situations in Elliffe, *supra* n. 75. Although, the authors believe that this is not a preferable option as domestic law overrides could conflict with international law provisions, i.e. arts. 26 and 27 of the *Vienna Convention* (1969).
214. States that apply the exemption method can now switch to the credit method pursuant to the MLI, in particular, Option C as reflected in article 5. It should be noted that this clause is an optional clause that states may wish to apply to their CTAs. *See* para. 60 of the *Explanatory Statement*.
215. *See* Chand, *supra* n. 2, at sec. 18.
216. For an extensive discussion of this matter, *see* Chand, *supra* n. 2, at pp. 314-360.
217. Para. 74 *OECD Model: Commentary on Article 24* (2017).
218. Id., at para. 79.
219. FR: CE, 30 Dec. 2003, *Re Société Andritz Sprout Bauer*, 6 ITLR 604, pp. 605-641.
220. *See* the decision of the Spanish *Tribunal Supremo* (Supreme Court, TS) in ES: TS, 17 Mar. 2011, *Hero Espana SA v. Direccion General de Tributos*, Case No. 5871/2006, Case Law IBFD. The original text of the case is in Spanish and the authors did not manage to obtain a translation of this case in English. Accordingly, the summary of the case as reported in the IBFD Case Law collection was referred to.
221. Kofler, *supra* n. 194, at pp. 586-588.
222. J. Sasseville, *A Tax Treaty Perspective: Special Issues*, in *Tax Treaties and Domestic Law*, pp. 53-54 (G. Maisto ed., IBFD 2006), Books IBFD.
223. Art. 11(1)(e) MLI.
224. OECD, *Global Anti-Base Erosion Proposal*, *supra* n. 199.
225. De Broe, Danon & Chand, *supra* n. 201, at pp. 10-11.
226. Id., at pp. 20-24.
227. *See* OECD, *Partnership Report* (1999), *supra* n. 156, at paras. 127-129.
228. Para. 6.1 *OECD Model: Commentary on Article 1* (2014).

Also, to reiterate, the Commentaries on Article 1(2) of the OECD Model[229] and the UN Model[230] make it absolutely clear that a tax treaty does not prevent a state from taxing its own residents. However, commentators have been quite critical of such a conclusion, especially, in a partnership and trust context.[231]

An alternate to the reverse CFC would be to extend the base-eroding payment provisions to domestic situations, especially when payments are being made to local tax-exempt entities. Like this, an argument can be made that there is no discrimination as the rule applies when payments are made to low-taxed non-residents as well as tax-exempt residents. For example, consider the situation when Company S of State S makes a payment to related Company T of State T (a low-tax jurisdiction) and a payment to a charitable organization in State S (or in another state) that is tax exempt. Under both situations, the payment will be denied as a deduction for Company S. In fact, such an approach was followed by the United States with regard to section 163(j) of the US Internal Revenue Code (IRC),[232] which contains earnings-stripping provisions. Some commentators argue that this approach conflicts with treaties, whereas some others argue that conflicts do not arise.[233]

Both approaches, the reverse CFC rule and the extension of the base-eroding rule to tax-exempt entities, are not bulletproof from a treaty compatibility standpoint. Therefore, it will be prudent for states to insert a provision in their tax treaties which authorizes the application of such rules as commented on in the conclusions in section 4.

229. Paras. 15-16 *OECD Model: Commentary on Article 1* (2017).
230. Paras. 15-16 *UN Model: Commentary on Article 1* (2017).
231. For instance, *see* Danon, *supra* n. 152, at pp. 218-220.
232. US: Internal Revenue Code (IRC).
233. For a discussion on this matter, *see* N. Bammens, *The Principle of Non-Discrimination in International and European Tax Law*, IBFD Doctoral Series, vol. 24, sec. 8.2., pp. 340-344 (IBFD 2012), Books IBFD. *See also* New York State Bar Association Tax Section, *Report on Certain Legislative Proposals Relating to the Section 163(j) Earnings Stripping Rules* pp. 41-51 (2003), available at https://nysba.org/NYSBA/Sections/Tax/Tax%20Section%20Reports/Tax%20Reports%202003/1037%20Report.pdf.

3.4. Subject-to-tax rule applicable from a payor state's perspective

Another rule that is being contemplated is a subject-to-tax rule for payments made to non-residents. Essentially, the rule will deny treaty benefits for outbound payments made to low-tax jurisdictions. In contrast to the base-eroding payment rule, it is our understanding that this rule will be proposed at a treaty level and not at a domestic law level. Therefore, compatibility issues, in principle, should not arise with domestic law.

4. Conclusions: Treaty Policy: One Answer for States to Ensure That a Conflict Does not Arise

To conclude, the answer to the question of whether domestic anti-avoidance rules conflict with a treaty provision or not depends on the scope of the domestic anti-avoidance rule and the relevant treaty provisions. The article showcases that conflicts can indeed arise. Nevertheless, if states wish to end the debate on potential conflicts, they could adopt the safeguard clauses which authorize the application of domestic anti-avoidance rules taking into consideration their approach towards incorporation of treaties in national law, i.e. monistic versus dualistic approach. Once again, separate clauses will need to be designed for the two categories of anti-avoidance rules discussed in this contribution.[234] Such clauses could also be built into the MLI for swift implementation or in a new multilateral treaty (which could be considered to implement the Pillar Two proposals).

234. For a detailed analysis of such rules, *see* Chand, *supra* n. 2, at secs. 23 and 24.