1-1-2010

Responses to Tax Treaty Shopping: A Comparative Evaluation

David G. Duff
Allard School of Law at the University of British Columbia, duff@allard.ubc.ca

Citation Details
David G Duff, "Responses to Tax Treaty Shopping: A Comparative Evaluation" (2010) [unpublished].

Responses to Tax Treaty Shopping: A Comparative Evaluation

David G. Duff [*]

[*] Professor, Associate Dean, and Co-Director of the National Centre for Business Law, Faculty of Law, University of British Columbia; International Research Fellow, Oxford University Centre for Business Taxation; Research Fellow, Monash University Taxation Law and Policy Research Institute.

I. INTRODUCTION

In the years since the OECD adopted its first draft tax treaty in 1963,[1] the world has experienced exponential growth in international trade and investment,[2] and in the number of tax treaties based on the OECD Model Convention, which now number roughly 3,000.[3] As the globalization of economic activity has greatly increased opportunities for tax avoidance and evasion,[4] so too has the expansion of the international tax treaty network increased opportunities for taxpayers to take advantage of domestic tax rules and bilateral tax treaties by arranging their affairs in ways that reduce taxes otherwise owing or eliminate them altogether.[5] Regarding many of these arrangements as abusive treaty shopping, the OECD and several member jurisdictions have adopted various responses to this phenomenon, involving the interpretation of treaties as the well as the introduction and application of anti-avoidance rules in domestic law and tax treaties. In Canada, which has one of the largest tax treaty networks among developed countries,[6] recent tax cases and legislative initiatives illustrate both approaches.

This paper reviews and evaluates these responses to treaty shopping, comparing recent developments in Canada with developments in other jurisdictions. Part II discusses the concept of treaty shopping, defining this term for the purposes of this analysis, providing a few examples for illustrative purposes, and explaining why treaty shopping is problematic on policy grounds. Part III considers interpretive responses to abusive treaty shopping, examining recent cases and commentary on the concepts of "residence" and "beneficial ownership" as well as the existence of an anti-abuse principle inherent in tax treaties and international law. Part IV addresses specific and general anti-avoidance rules, both domestic rules and their relationship to tax treaties as well as anti-avoidance rules contained in tax treaties themselves. Based on this analysis, Part V provides general conclusions.

---

[1] OECD, *Draft Double Taxation Convention on Income and Capital*, (Paris: OECD, 1963).

[2] See, e.g., Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies" (2000-2001), 54 *Tax L. Rev.* 261; and Michael J. Graetz and Itai Grinberg, "Taxing International Portfolio Income" (2002-2003), 56 *Tax L. Rev.* 537.

[3] OECD Centre for Tax Policy and Administration, *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles,* (Paris: OECD, 2009) at 11.

[4] V. Tanzi, "Globalization and the Work of Fiscal Termites" *IMF Working Paper*, WP/00/ 181 (November 2000).

[5] Brian Arnold, "Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model" (June 2004), *Bulletin for International Fiscal Documentation* 244 at 244.

[6] Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage,* (Ottawa: Department of Finance, 2008) at 71 [hereafter "Canadian Advisory Panel Final Report"]. At the time of writing, Canada has 87 treaties in force, has signed another 5 treaties that are not yet in force, and is negotiating treaties with another 5 countries. Department of Finance Canada, "Notices of Tax Treaty Developments" available at http://www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp#status (last accessed 23 May 2009).

II. TREATY SHOPPING

Treaty shopping, broadly defined, connotes "a premeditated effort to take advantage of the international tax treaty network, and careful selection of the most favorable treaty for a specific purpose."[7] As bilateral tax treaties apply only to "persons who are residents of one or both of the Contracting States,"[8] treaty shopping necessarily involves deliberate measures by individuals and entities to affect their residence for treaty purposes.

While tax residence for individuals generally turns on the location of a permanent home and the focus of their social and economic relations (centre of vital interests),[9] tax residence for corporations and other entities typically depends on the place of their effective management or their incorporation in the case of corporations.[10] As a result, while individuals must establish a real social and economic presence in a state in order to become a resident of the state for tax purposes, the tax residence of a corporation or other entity can be established with little or no economic presence in the relevant state. For this reason, concerns about treaty shopping generally and abusive treaty shopping in particular are usually directed at corporations and other entities rather than individuals.[11]

---

[7] H. David Rosenbloom, "Tax Treaty Abuse: Policies and Issues" (1983), 15 *Law & Policy in International Business* 763 at 766. For a useful discussion of treaty shopping in the Canadian context, see Geoffrey T. Loomer, "Tax Treaty Abuse: Is Canada Responding Effectively?" Oxford University Centre for Business Taxation, Working Paper 09/05.

[8] OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital (Paris: OECD, 2009), Art. 1 [hereafter "OECD Model"]. This language appears in all of Canada's tax treaties. See, e.g., Canada-US Income Tax Convention (1980), Art. I [hereafter "Canada-US treaty]; and Canada-UK Income Tax Convention (1978), Art. 1 [hereafter "Canada-UK treaty"].

[9] OECD Model, Art. 4(2). See also Canada-US treaty, Art. IV(2) and Canada-UK treaty, Art. 4(2). Similar tests for individual residence exist under domestic law, although these are often supplemented by special rules deeming individuals to be resident in specific circumstances. In Canada, see *Thomson v. M.N.R.*, [1946] C.T.C. 51, 2 D.T.C. 812 (S.C.C.), *per* Kerwin J. (concluding that individual residence is "chiefly a matter of the degree to which a person in mind and fact settles into or maintains or centralizes his ordinary mode of living with its accessories in social relations, interests and conveniences at or in the place in question"); and subsection 250(1) of the federal *Income Tax Act*, R.S.C. 1985, c.1 (as amended) [hereafter "ITA"] (deeming individuals to have been resident in Canada throughout a taxation year in various circumstances).

[10] OECD Model, Art. 4(3) (effective management); Canada-US treaty, Art. IV(3) (incorporation or continuance for corporations) and Canada-UK treaty, Art. 4(2) (determination by competent authorities by reference to place of effective management, incorporation, and other relevant factors). As with individuals, similar tests exist under domestic law. See, e.g., *De Beers Consolidated Mines Limited v. Howe*, [1906] A.C. 455 at 458, *per* Lord Loreburn L.C. (concluding that "a company resides for the purposes of income tax where … central management and control actually abides"); and ITA, s. 250(4)(a) (deeming corporations to be resident in Canada throughout a taxation year where they were incorporated in Canada after 26 April 1965).

[11] See, e.g., OECD Commentary 2003, Art. 1, para. 8 (stating that "the extension of double taxation conventions increases the risk of abuse by facilitating the use of artificial legal constructions aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in double tax conventions") and para. 9 (explaining that "[t[his would be the case … if a person … acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly'). Notwithstanding this emphasis on legal entities, the OECD also appears to regards tax-motivated emigration by individuals as a form of abusive treaty-shopping. *Ibid*. Art. 1, para. 9 (discussing

Since tax treaties invariably reduce source country taxation, lowering or eliminating withholding taxes on dividends, interest and royalties paid to beneficial owners resident in the other contracting state,[12] and limiting source country taxation of capital gains,[13] treaty shopping generally involves the reduction of source country taxation through inbound investments that are structured in order to access more advantageous treaty provisions than would otherwise be available.[14] In a typical "direct conduit" structure, for example, an investor who is resident in one state (the residence state) who wishes to invest in another state (the source state) uses a legal entity that is resident in a third state (the conduit state) with which the source state has entered into a tax treaty that provides more generous tax relief than would be available for investments made directly from the residence state.[15]

As the tax advantages of this structure would be lost if the conduit state imposed significant tax on income received from the source state or income paid to the residence state, treaty shopping also depends on domestic tax rules in the conduit state as well as treaty provisions governing payments from the conduit state to the residence state. For this reason, countries with territorial tax systems and little or no withholding tax on income distributed by resident entities are particularly attractive as conduit states.[16] Alternatively, where the conduit state would otherwise levy tax on income received from foreign sources, it may be possible to minimize this tax through a "stepping-stone" structure in which the legal entity in the conduit state makes deductible payments to another legal entity established in a second conduit state which imposes little or no tax on these payments and little or no withholding tax on payments to the residence state.[17] In this way, treaty shopping can also reduce taxation in conduit states.

Although these examples involve inbound investment, treaty shopping may also take place for outbound investment. For example, where a residence state with a participation exemption does not grant this exemption to dividends from subsidiaries resident in a low-tax source state, this rule may be circumvented by redirecting the outbound investment through a subsidiary in a conduit state affording a more generous participation exemption on dividends originating in the source state.[18] In addition to

tax-motivated emigration by individuals to escape capital gains tax on a substantial shareholding). This view has been criticized by at lease one commentator: Luc de Broe, "The Transfer of Residence by Individuals" (2002), 87B *Cahiers de droit fiscale international* 65-68. In this author's view, tax-motivated emigration is rightly regarded as a form of treaty shopping, but is less likely to be abusive given the requirement of a real social and economic presence for individual tax residence.

[12] OECD Model, Arts. 10, 11, and 12.

[13] *Ibid*., Art. 13.

[14] Luc de Broe, *International Tax Planning and Prevention of Abuse: A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, (Amsterdam: IBFD, 2008) at 7.

[15] OECD Committee on Fiscal Affairs, *Double Taxation Conventions and the Use of Conduit Companies*, (Paris: OECD, 1986), para. 4 [hereafter "OECD Conduit Companies Report"].

[16] See de Broe, *supra* note 14 at 17 and 19-20.

[17] OECD Conduit Companies Report, *supra* note 15 at para. 4.

[18] de Broe, *supra* note 14 at 8.

reductions in source and conduit state taxation, therefore, treaty shopping may also reduce taxation in residence jurisdictions.

While treaty shopping might be dismissed as an acceptable form of tax planning,[19] there are several reasons why it is problematic on policy grounds. First, to the extent that treaty shopping enables persons who are not residents of the contracting states to access treaty benefits in a manner that the contracting parties had not anticipated or intended, it upsets the reciprocal “balance of sacrifices” that underlies the mutual relinquishment of tax jurisdiction by each contracting state,[20] calling into question the fairness of the treaty bargain entered into by the contracting states.[21] Second, since treaty shopping effectively extends the benefits of one tax treaty to persons who are resident in third-party states, the distinction between negotiated treaty provisions and unilateral tax changes loses much of its meaning,[22] thereby reducing the incentive for states to enter into tax treaties at all. Correspondingly, since residents of third-party states are able to access treaty benefits from other states in the absence of any treaties between them, third-party states have little incentive to enter into tax treaties with these states.[23] Finally, and perhaps most importantly, treaty shopping facilitates international tax avoidance and evasion, as income from international investment may face little or no taxation in a manner that is neither anticipated nor intended by the contracting states.[24] As a result, treaty shopping can undermine basic tax principles of economic efficiency and horizontal equity, as investment decisions are distorted by tax considerations and tax burdens are shifted to less internationally mobile activities.

For these reasons, it is not surprising that the OECD and its member jurisdictions have devoted increasing attention to treaty shopping over the last several years and have taken various measures in response to this phenomenon. The remainder of this paper reviews and evaluates these responses, looking first at the interpretation of tax treaties and then at anti-avoidance rules contained in domestic law and tax treaties themselves.

III. TREATY INTERPRETATION

One response to treaty shopping turns on the interpretation of tax treaty provisions, either individually or as a whole. Since treaties apply only between persons who are residents of one or both of the contracting states, for example, the interpretation of tax residence for treaty purposes represents one strategy to challenge treaty shopping. Similarly, where treaty benefits require a resident of a contracting state to be the beneficial owner of a payment received from a resident of the other contracting state, treaty shopping can be challenged through the interpretation of beneficial ownership for

[19] See, e.g., Canadian Advisory Panel Final Report at 72 (concluding that “businesses should be able to organize their affairs to obtain access to treaty benefits”).
[20] OECD Conduit Companies Report, *supra* note 15 at para. 7(a).
[21] Rosenbloom, *supra* note 7 at 774.
[22] *Ibid*. at 775.
[23] OECD Conduit Companies Report, *supra* note 15 at para. 7(c).
[24] *Ibid*., at para. 7(b).

tax treaty purposes. More generally, treaty shopping has been attacked on the basis that tax treaties include an inherent anti-abuse principle, which is often claimed to flow from principles of international law regarding the interpretation of treaties as well as the object and purpose of tax treaties in general. This part of the paper examines each of these interpretive responses to treaty shopping.

1. RESIDENCE

According to Article 4(1) of the OECD Model Convention, "the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature …."[25] According to Article 4(3), where a person other than an individual is a resident of both contracting states under the provisions of Article 4(1), "it shall be deemed to be resident only of the State in which its place of effective management is situated."[26] Similar or identical language appears in most of Canada's tax treaties, as well as the tax treaties of other countries.[27]

In order to challenge treaty shopping on the basis of treaty residence, therefore, these provisions suggest two possible arguments: either that the taxpayer is not liable to tax in the contracting state by reason of domicile, residence, place of management or any other criterion of a similar nature, or that its place of effective management is not situated in the contracting state from which the treaty benefit is derived. Judicial decisions in Canada and other jurisdictions have addressed each of these issues.

1.1. Liable to Tax by Reason of Domicile, Residence, Place of Management or Any other Criterion of a Similar Nature

Beginning with the concept of residence in Article 4(1), judicial decisions disclose two challenges to treaty shopping – on the basis that the taxpayer is not in fact "liable to tax" in the contracting state from which the treaty benefit is sought, or that the taxpayer is not liable to tax "by reason of" one of the listed criteria or a criterion of a similar nature.

The first approach is apparent in two decisions of the Authority for Advance Ruling (AAR) of India. In *Abdul Razak A. Meman*,[28] for example, the AAR held that an individual who was a citizen of and resident in the United Arab Emirates (UAE) was not eligible for treaty benefits under the India–UAE treaty on the grounds that he was not "liable to tax within the meaning of the treaty" because the UAE does not impose income

---

[25] OECD Model, Art. 4(1).
[26] *Ibid*., Art. 4(3).
[27] See, e.g., Canada-UK treaty, Art. 4(1) (identical language) and Art. 4(3) (requiring determination by the competent authorities of the contracting states "having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors).
[28] A.A.R. No. 637, 638 and 640 of 2004, (2004) 276 I.T.R. 306 (AAR), at p. 22 (online at http://rulings.co.in/it-rulings/uploads/pdf/1250758926_637,638,640,.pdf).

tax on its citizens.[29] Similarly, in *General Electric Pension Trust*,[30] the AAR held that the taxpayer was not resident in the United States for the purposes of the India-US treaty on the basis that the Trust which was tax-exempt was not "subject to tax" in the United States.[31]

The second approach is apparent in *The Queen v. Crown Forest Industries Ltd.*,[32] in which the Supreme Court of Canada concluded that a company ("Norsk") incorporated in the Bahamas with its only office and place of business in the United States was not a resident of the United States for the purposes of the Canada-US treaty on the basis that it was not liable to tax in the United States by reason of its "domicile, residence, place of management, place of incorporation or any other criterion of a similar nature" as required by Article IV(1) of the treaty. Rejecting the taxpayer's argument that the company was liable to tax in the United States either by reason of its place of management or by reason of another criterion of a similar nature, the Court held that the location of the company's head office made it liable to tax in the United States only on the basis that it was "engaged in a trade or a business" in the United States,[33] and that this source-based tax jurisdiction was not "of a similar nature" to the other criteria in Article IV(1) which constitute grounds for the most "comprehensive … tax liability as is imposed by a state."[34] More generally, Iacobucci J. declared:

> The goal of the *Convention* is not to permit companies incorporated in a third party country (the Bahamas) to benefit from a reduced tax liability on source income merely by virtue of dealing with a Canadian company through an office situated in the United States.… There is no reason to assume that, in the context of this case, Canada entered into a treaty with the United States with a view to ceding its taxing authority to a jurisdiction that is a stranger to the Convention, namely the Bahamas…. It seems to me that both Norsk and the respondent are seeking to minimize their tax liability by picking and choosing the international tax regimes most immediately beneficial to them. Although there is nothing improper with such behaviour, I certainly believe that it is not to be encouraged or promoted by judicial interpretation of existing agreements.[35]

As a result, the Court suggested, treaty shopping should not be "encouraged or promoted" by the interpretation of tax treaties.

While the first approach might be used to attack instances of abusive treaty shopping, it is questionable to the extent that it makes treaty benefits subject to actual tax liability in the contracting state, which is ultimately a matter of each state's fiscal sovereignty. As the Commentary to the OECD Model Convention states:

---

[29] For a brief discussion of this case, see Anna A. Kornikova, "Solving the Problem of Tax-Treaty Shopping Through the Use of Limitation on Benefits Provisions" (2008), 8:2 *Richmond Journal of Global Law & Business* 249 at 269.
[30] A.A.R. No. 659 of 2005, (2005) 280 I.T.R. 425 (AAR) at p. 14 (online at http://rulings.co.in/it-rulings/uploads/pdf/1250757507_659.pdf).
[31] For a brief discussion of this case, see Kornikova, *supra* note 29 at 270.
[32] [1995] 2 SCR 802.
[33] *Ibid*. at paras. 32-37.
[34] *Ibid*. at para. 47.
[35] *Ibid*. at para. 55.

> In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organizations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemptions specified in the tax laws. They are, thus, subject to the tax laws of a Contracting State.[36]

As well, the Commentary explains, although the "wording and spirit" of the treaty definition of residence might exclude "foreign-held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies," this interpretation has "inherent difficulties and limitations" and must be understood restrictively "because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended."[37]

Perhaps not surprisingly, therefore, the approach of the Indian AAR to the interpretation of the words "liable to tax" has proven quite controversial and has been rejected by the Indian Income Tax Appellate Tribunal (ITAT) and the Supreme Court of India. In *Assistant Director of Income Tax v. Green Emirate Shipping and Travels*,[38] for example, the ITAT held that treaty benefits under the India-UAE treaty do not depend on actual taxation in the UAE to the extent that the treaty vests an exclusive right on the UAE to levy tax under specific circumstances, whether this right is exercised or not.[39] Similarly in *India v. Azadi Bachao Andolan*,[40] the Supreme Court of India held that Foreign Institutional Investors (FIIs) incorporated in Mauritius but managed and controlled by third-party residents of India were exempt from Indian capital gains tax under the India-Mauritius treaty on the grounds that they were subject to Mauritius tax laws even though Mauritius does not generally impose tax on capital gains.[41] Interestingly, however, the India-UAE treaty was subsequently amended to include a Limitation on Benefits (LOB) provision,[42] and the Indian Government has recently announced that it will amend the India-Mauritius treaty to "prevent its misuse for avoiding taxes."[43]

---

[36] OECD Commentary 2003, Art. 4, para. 8.2.
[37] *Ibid*., Art. 4, para. 8.See also OECD Conduit Companies Report, *supra* note 15 at para. 14(a).
[38] [2006] 286 I.T.R. 60 (A.T.).
[39] See the brief discussion of this case in Akil Hirani, "Recent Developments in International Taxation: India" (2007) International Bar Association (Singapore) Current Report, at p. 8 (online at http://www.ebalawyers.com.au/system/files/download/o44/SIN26.pdf).
[40] (2003), 263 I.T.R. 706 (India).
[41] For a brief discussion of this case, see Kornikova, *supra* note 29 at 268-69.
[42] Hirani, *supra* note 39 at 9, referring to new Art. 29 of the India-UAE treaty, which denies treaty benefits to an entity "if the main purpose or one of the main purposes of the creation of such entity was to obtain the benefits under the DTAA."
[43] "India to amend Indo-Mauritius tax treaty" (August 4, 2009) indianexpress.com (online at http://www.indianexpress.com/news/india-to-amend-indomauritius-tax-treaty/497939/).

In contrast to the first approach, the second approach is conceptually sound and consistent with the Commentary to the OECD Model Convention,[44] but wholly inadequate to prevent abusive treaty shopping. While the interpretation of criteria for assessing residence under tax treaties can prevent the unwarranted extension of treaty benefits to taxpayers who are liable to tax in a contracting state solely on the basis of source tax jurisdiction, it cannot preclude access to treaty benefits by conduit entities that are subject to comprehensive tax liability by a contracting state that does not in fact impose tax on these residents. For this reason, it follows that any effective response to abusive treaty shopping must depend on another approach.

1.2. Place of Effective Management

Where a person other than an individual is resident in both contracting states under the definition in Article 4(1) of the OECD Model Convention, Article 4(3) deems the person to be a resident "only of the State in which its place of effective management is situated." In this circumstance, therefore, application of this tie-breaker rule can be another way to prevent abusive treaty shopping. According to the Commentary to the OECD Model Convention, for example:

> … in some cases, claims to treaty benefits by subsidiary companies, in particular companies established in tax havens or benefiting from harmful preferential regimes, may be refused where careful consideration of the facts and circumstances of a case shows that the place of effective management of the subsidiary does not lie in its alleged state of residence but, rather, lies in the state of residence of the parent company so as to make it a resident of that latter state for domestic law and treaty purposes ….[45]

In addition to its application to challenge the treaty residence of subsidiary companies, this provision may also be used to counteract treaty shopping involving the use of trusts.

A good example of this response to treaty shopping is the decision of the UK Special Commissioners in *Smallwood v. Commissioners for Revenue & Customs,*[46] in which the taxpayer sought to avoid capital gains tax on the sale of shares held by the taxpayer's family trust by changing the trustee to a Mauritius corporation for a short period of time coinciding with the sale. Concluding that low-level decisions were made by the trustees in Mauritius but that "key" decisions were made in the United Kingdom,[47] the Special Commissioners held that the trust was resident in the United Kingdom under Article 4(3) of the UK-Mauritius treaty on the basis that "effective management" of the trust was located in the United Kingdom.

---

[44] OECD Commentary 2003, Art. 4, para. 8, explaining that the definition of a "resident of a Contracting State" in Article 4(1) "aims at covering the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax)" as well "cases where a person is deemed, according to the taxation laws of a State, to be a resident of that State and on account thereof is fully liable to tax therein (e.g. diplomats or other persons in government service)."
[45] *Ibid*., Art. 4, para. 10.1.
[46] [2008] STC (SCD) 629, rev'd on other grounds [2009] EWHC 777 (Ch.) [hereafter *Smallwood*].
[47] *Ibid*. at para. 140.

Similarly, in its recent decision in *Garron Family Trust v. The Queen*,[48] where the taxpayer trusts argued that they were exempt from Canadian tax on capital gains under the Canada-Barbados treaty,[49] the Tax Court of Canada held that the trusts were taxable in Canada on the basis that they were, in fact, managed by their Canadian beneficiaries, not the trustee.[50] Although the decision turns on the concept of trust residence under domestic law,[51] rather than the tie-breaker rule in the Canada-Barbados treaty,[52] the effect of the decision is identical to that of the Special Commissioners in *Smallwood*, and the domestic test of "central management and control" is substantively the same as the treaty test of "effective management".[53]

Although the application of domestic and treaty-based tests of residence based on the place of effective management may forestall abusive treaty shopping in some circumstances, the effectiveness of this response is highly limited. As illustrated by the English Court of Appeal decision in *Wood v. Holden*,[54] the extent of decision-making that is necessary to constitute effective management is generally quite low and subject to manipulation with considerable ease. Notwithstanding that the managing director of the company at issue acted wholly in accordance with a preconceived plan devised by the taxpayer's professional advisors in order to facilitate avoidance of capital gains tax in the United Kingdom, the Court held that central management and control of the company was in the Netherlands on the grounds that representatives of the director "signed or executed documents" prepared by the taxpayer's professional advisors and "must, in fact, have decided to do so."[55] As a result, even where the directors of a corporation make decisions solely on the advice of other persons and "without proper information or

[48] 2009 D.T.C. 1568 (T.C.C.) [hereafter *Garron Family Trust*].
[49] *Agreement between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to taxes on Income and on Capital* (1980). According to Article XIV(4) of this treaty, "[g]ains from the alienation of property other than those mentioned in paragraphs 1, 2 and 3 may be taxes only in the Contracting State of which the alienator is a resident."
[50] *Garron Family Trust*, *supra* note 48 at paras. 187-267.
[51] Rejecting the taxpayers' argument that the residence of the trusts depended solely on the residence of their corporate trustee, the Court held that the residence of a trust should be determined according to the same "central management and control test" that the UK courts developed for corporate residence. *Ibid*. at paras. 157-62. In so deciding, the case reverses an earlier Canadian decision in *Thibodeau Family Trust v. The Queen* (1978), 78 D.T.C. 6376 (F.C.T.D.), in which the Court held that a trust was a resident of Bermuda on the grounds that two of three trustees were resident in Bermuda and the trust document permitted a majority decision on all matters within the discretion of the trustees.
[52] Article IV(3) of the Canada-Barbados treaty does not contain a tie-breaker rule based on the taxpayer's place of effective management, but provides instead that where a person other than an individual is a resident of both contracting states under Article IV(1) of the treaty, "the competent authorities of the Contracting States shall by mutual agreement endeavour to settle the question and to determine the mode of application of this Agreement to such person." According to the Court, the competent authorities had agreed not to engage the residence tie-breaker provision. *Garron Family Trust*, *supra* note 48 at para. 108.
[53] See, e.g., *Wood v. Holden*, 2006] EWCA Civ. 26, [2006] S.T.C. 443 (Eng. C.A.) at para. 6, suggesting that the effective management test in Article 4(3) of the UK-Netherlands treaty does not differ 'in substance" from the domestic law test for corporate residence set out in *De Beers Consolidated Mines Ltd. v. Howe*, *supra* note 10.
[54] *Ibid*.
[55] *Ibid*. at para. 40.

consideration," these decisions may be sufficient to constitute "effective" management for the purpose of assessing corporate residence.[56]

2. BENEFICIAL OWNERSHIP

A second interpretive approach to challenge abusive treaty shopping involves the concept of "beneficial ownership" which determines the eligibility of residents of contracting states to the reduction or elimination of source country withholding taxes on dividends, interests and royalties under Articles 10, 11 and 12 of the OECD Model Convention and comparable provisions of bilateral tax treaties.[57]

Introduced into the OECD Model in 1977, following its earlier use in the 1966 Protocol to the UK – US treaty,[58] these words are generally understood to exclude intermediaries such as nominees, agents and mandataries, who might be interposed between the payer and the ultimate beneficiary.[59] For common law jurisdictions, which distinguish between legal owners who hold title to property and beneficial owners who "ultimately exercise the rights of ownership in the property,"[60] this interpretation is consistent with Article 3(2) of the OECD Model Convention and comparable provisions in bilateral tax treaties which stipulate that a term that is not defined in the treaty "shall, unless the context otherwise requires, have the meaning it has at that time under the law of that State for the purposes of the taxes to which the Convention applies."[61] For civil law jurisdictions, however, the meaning of beneficial ownership is less certain, since civil law systems do not distinguish between legal and beneficial ownership.[62]

In addition to its common law meaning, moreover, the 2003 Commentary to the OECD Model states that the term "beneficial owner" is "not used in a narrow technical sense" but "should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion

---

[56] *Ibid*. at paras. 42-43.
[57] OECD Model, Art. 10(2) (reducing the withholding tax rate on dividends paid to beneficial owners who are resident in the other contracting state); Art. 11(2) (reducing the withholding tax rate on interest paid to beneficial owners who are resident in the other contracting state); and Art. 12(1) (prohibiting source country taxation of royalties that are beneficially owned by a resident of the other contracting state).
[58] J.F. Avery Jones and others, "The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States" [2006] BTR 695 at 753-54.
[59] OECD Commentary 1977, Art. 10, para. 12, explaining that the "the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State."
[60] *Jodrey Estate v. Nova Scotia (Minister of Finance)*, [1980] 2 S.C.R. 774 at 784, citing *Cowan v. Nova Scotia (Minister of Finance)*, [1977] C.T.C. 230 (N.S.T.D.), para. 46.
[61] OECD Model, Art. 3(2).
[62] As a country with common law and civil law jurisdictions, the meaning of beneficial ownership is particularly uncertain in the Canadian context. For this reason, among others, a recent Advisory Panel on Canada's System of International Taxation suggested in its April 2008 Consultation Paper (at para. 3.23) that the term "beneficial owner" might be specifically defined for the purpose of Canadian domestic law. In its Final Report, however, the Advisory Panel concluded (at para. 5.66) that "it might be best to wait for a globally agreed definition before taking unilateral action in this regard."

and avoidance."[63] On this basis, it concludes, "a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties."[64] As a result, as Philip Baker suggests, it is arguable that the concept of beneficial ownership has an "international fiscal meaning" distinct from the domestic law of specific contracting states.[65]

In interpreting the concept of beneficial ownership, recent judicial decisions in the United Kingdom and France appear to have preferred the OECD's "international fiscal meaning" to the more narrow common law meaning. In *Indofood International Finance Ltd. v. JP Morgan Chase Bank NA London*,[66] for example, where the English Court of Appeal had to rule on the viability of a proposed structure in order to resolve a commercial dispute,[67] the Court held that the interposition of a Dutch company between an Indonesian borrower and lenders resident in other jurisdictions would not enable the borrower to access a reduced withholding tax rate under the Indonesia-Netherlands treaty because the Dutch company would not constitute the beneficial owner for the purpose of the treaty. Explaining that "the concept of beneficial ownership is incompatible with that of the formal owner who does not have 'full privilege to directly benefit from the income',"[68] the Court also stated that the meaning of beneficial ownership should be interpreted not in a "legal and technical" sense, but according to "the substance of the matter."[69] On these grounds, it concluded that the Dutch company would not be the beneficial owner under the proposed structure since its sole function, both legally and in "commercial and practical terms", would be to receive interest income from the Indonesian borrower and pay this interest to the noteholders.[70]

Similarly, in *Bank of Scotland v. Ministre de l'Economie, des Finances et de l"Industrie*,[71] the French *Conseil d'Etat* (Supreme Administrative Court) relied on a broad concept of beneficial ownership to conclude that treaty benefits under the France-UK treaty were not available to a UK bank which received dividends of 270 million francs from a French company on preference shares that it has acquired from the

---

[63] OECD Commentary 2003, Art. 10, para. 12; Art. 11, para. 9; and Art. 12, para. 4.
[64] *Ibid*., Art. 10, para. 12.1; Art. 11, para. 10; and Art. 12, para. 4.1, citing the OECD Conduit Companies Report (1986), *supra* note 15 at para. 14(b). According to the Commentary, "it would be … inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned."
[65] Philip Baker, *Double Taxation Conventions*, (London: Sweet & Maxwell, 2007) [10B]-[14].
[66] [2006] B.T.C. 8003 (C.A.) [hereafter *Indofoods*].
[67] The facts of the case involved an Indonesian borrower which invoked an early redemption clause to redeem notes that had been issued by a Mauritian subsidiary after Indonesia terminated its tax treaty with Mauritius. The lenders argued that the early redemption was prohibited on the basis that the borrower could take "reasonable measures" to access the same 10% withholding tax rate that had been available under the Indonesia-Mauritius treaty.
[68] *Ibid*. at para. 42, citing a circular letter issued by the Director of General Taxes (DTG) in Indonesia.
[69] *Ibid*. at para. 44.
[70] *Ibid*. at paras. 43 and 44.
[71] *Conseil d'Etat*, Case 283314 (29 December 2006) [hereafter *Bank of Scotland*].

company's US parent for 267 million francs under a usufruct arrangement lasting three years.[72] According to the *Conseil d'Etat*, "[a]n analysis of these arrangements reveals that the beneficial owner of the dividends under the dispute was the American company" which, as the Commissaire du Gouvernement explained, "conceded the apparent benefit to the Bank of Scotland only for the reimbursement of its debts by a mechanism reducing its burden to the detriment of the French public treasury."[73]

In contrast, Canadian courts appear to have adopted a narrower concept of beneficial ownership, interpreting this term by reference to its domestic common law meaning as well as the 1977 OECD Commentary as "the person who receives [property] for his or her own use and enjoyment and assumes the risk and control of the [property] he or she received."[74] On this basis, the Tax Court of Canada decision in *Prévost Car Inc. v. The Queen* held that a Dutch holding company was entitled to a reduced withholding tax rate under the Canada-Netherlands treaty as the beneficial owner of dividends paid by a Canadian operating company, notwithstanding that it had no employees in the Netherlands and no investments other than shares of the Canadian operating company, and that a shareholder's agreement between its English and Swedish parents provided that not less than 80 percent of its net profits would be distributed to the parent companies.[75] According to the Court:

> It is the true owner of the property who is the beneficial owner of the property. Where an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatary is acting or for whom the nominee has lent his or her name. When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it, for example, a stockbroker [your typo? If theirs, add *sic*] who is the registered owner of the shares it holds for clients.[76]

Because the holding company was not obligated to pay dividends to its parent companies and was not party to the shareholder's agreement, the Court concluded that it was the beneficial owner of the dividends and not a pure conduit for its parent companies.[77]

Although the concept of beneficial ownership in *Prévost Car* appears to be narrower than the interpretation adopted in *Indofoods* and the *Bank of Scotland* case, the decisions themselves may be reconciled to the extent that the holding company *Prévost*

---

[72] If successful, the claim for treaty benefits would also have entitled the UK bank to repayment of *avoir fiscal* resulting in an additional 74.25 million francs, resulting in a combined profit of 77.25 million on the bank's investment in the usufruct.
[73] Cited in David A. Ward, *Access to Tax Treaty Benefits*, Research Report Prepared for the Advisory Panel on Canada's System of International Taxation (September 2008) at 21-22, online at www.apcsit-gcfcfi.ca.
[74] *Prévost Car Inc. v. The Queen*, [2008] 5 C.T.C. 2306, 2008 D.T.C. 3080 (T.C.C.), at para. 100 [hereafter *Prévost Car*]; aff'd [2009] 3 C.T.C. 160, 2009 D.T.C. 5053 (F.C.A.).
[75] *Ibid*. at paras. 12, 14, 25 and 26.
[76] *Ibid*. at para. 100.
[77] *Ibid*. at paras. 102-105.

Car was not obligated to funnel the dividends that it received to its parent companies, whereas the recipients of interest and dividends in *Indofoods* and *Bank of Scotland* appear to have had little or no discretion regarding the use or application of these funds and functioned as pure conduits for the ultimate recipients. Indeed, where funds are flowed through a conduit in a "predetermined and automatic" manner, the judgment in *Prévost Car* indicates that the conduit would not be regarded as the beneficial owner under Canadian law.[78] For this reason, the Canada Revenue Agency is continuing to challenge treaty shopping arrangements involving conduit companies on the basis that the conduit is not the beneficial owner of funds within the meaning of the applicable tax treaty.[79]

Notwithstanding this risk, however, sophisticated taxpayers can easily avoid characterization as a conduit through careful planning to ensure that the recipient of dividends, interest or royalties has sufficient "discretion as to the use or application of funds" to constitute their beneficial owner. For this reason, as with interpretive approaches to the concept of treaty residence, interpretations of beneficial ownership represent a limited and inadequate response to the problem of abusive treaty shopping.

3. INHERENT ANTI-ABUSE PRINCIPLE

A final interpretive response to treaty shopping involves the assertion of an inherent anti-abuse principle based on the *pacta sunt servanda* principle of international law, according to which treaties are to be performed and interpreted "in good faith".[80] According to Klaus Vogel, for example

> … if a contracting State need not tolerate a circumvention of a treaty by the other contracting State, it would be absurd for it to be committed to tolerate circumvention by a private person and to apply the treaty in a strictly formal way notwithstanding such circumvention. Consequently, [tax treaties] are subject to a general 'substance v. form proviso' based on international law. That proviso restricts the treaty's binding effect under international law and thus also its binding effect under domestic law, since only so much of the treaty's contents can become domestic law as is applicable by virtue of international law.[81]

Frank Engelen makes a similar argument, concluding that it would be "against the object and purpose of the treaty" if contracting states were required to fulfil their treaty obligations "in cases where the conditions laid down for obtaining the benefits are

---

[78] *Ibid*. at para. 102.
[79] See, e.g., *Velcro Canada Inc. v. The Queen*, currently held in abeyance in the Tax Court of Canada.
[80] Vienna Convention on the Law of Treaties, Art. 26 and 31(1). For a useful discussion, see David A. Ward, "Abuse of Tax Treaties" in H.H. Alpert and K. Van Raad, eds., *Essays on International Taxation in Honour of Sidney L. Roberts*, (London: Kluwer, 1993) 397.
[81] *Klaus Vogel on Double Taxation Conventions*, 2nd ed. (London: Kluwer, 1990), Introduction at para. 121. In a subsequent edition Vogel emphasized that "application of a double taxation convention in accordance with its substance rather than in accordance with its form should continue to be an *exception* and that the threshold for allowing such application should be fixed at a high level rather than a low one." *Klaus Vogel on Double Taxation Conventions*, 3rd ed. (London: Kluwer, 1996), Art. 1 at para. 95.

created by means of wholly artificial arrangements only set up for the purpose of avoiding tax."[82]

In contrast, other commentators contend that the *pacta sunt servanda* principle cannot support an inherent anti-abuse principle since it applies only between contracting states and not to taxpayers who are third parties to these agreements.[83] On this basis, in fact, the 1986 OECD Conduit Companies Report concluded that the *pacta sunt servanda* principle requires contracting states to grant treaty benefits "even if considered to be improper" absent the existence of an explicit anti-avoidance rule within the treaty itself.[84]

With the 2003 revisions to the OECD Commentary, however, the OECD Committee on Fiscal Affairs appears to have abandoned this approach, affirming instead the conclusion that international law and the object and purpose of tax treaties support an inherent anti-abuse principle. Asserting that a purpose of tax treaties is "to prevent tax avoidance and evasion,"[85] the 2003 Commentary explains that the object and purpose of tax conventions and the obligation to interpret them in good faith justify the view of some States that "a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions."[86] More generally, the Commentary concludes, "the benefits of a double tax convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions."[87]

In addition to the 2003 Commentary, the idea of an inherent anti-abuse principle has also been affirmed in two judicial decisions by the Swiss Federal Court and the District Court of Tel Aviv in Israel. In *A Holdings ApS v. Federal Tax Administration*,[88] the Federal Court of Switzerland relied on an inherent anti-abuse principle to deny a reduced withholding tax rate under the Switzerland-Denmark treaty on dividends paid to a Danish holding company whose sole shareholder was a Guernsey corporation whose sole shareholder was a corporation resident in Bermuda. According to the Court, "[b]ecause the prohibition of abuses is part of the principle of good faith … the prohibition of an abuse of rights as regards conventions is ... recognized … without being necessary to adopt an explicit provision in the respective convention."[89]

---

[82] F.A. Engelen, *On Values and Norms: The Principle of Good Faith in the Law of Treaties and the Law of Tax Treaties in Particular*, (London: Kluwer, 2006) at 36.
[83] See, e.g., Stef van Weeghel, *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and the United States*, (London: Kluwer, 1998) at 116; and Nathalie Goyette, *Countering Tax Treaty Abuses: A Canadian Perspective on an International Issue*, (Toronto: Canadian Tax Foundation, 1999) at 10-12.
[84] OECD Conduit Companies Report (1986), *supra* note 15 at para. 43.
[85] OECD Commentary 2003, Art. 1, para. 7.
[86] *Ibid*., Art. 1, para. 9.3.
[87] *Ibid*., Art. 1, para. 9.5.
[88] (2005) 8 ITLR 536.
[89] *Ibid*. at para. 3.4.2.

Likewise, in *Yanko-Weiss Holdings (1996) Ltd. v. Holon Assessing Office*,[90] the District Court of Tel Aviv affirmed an inherent anti-abuse principle in order to deny treaty benefits to a company which was originally incorporated in Israel but subsequently changed its place of management to Belgium and registered as a Belgian company in order to access benefits under the Israel-Belgium treaty. According to the Court:

> Tax treaties were not designed, nor can it be said that any such intent existed, whether they include express provisions or not, for use that will be made of them in a manner which is not in good faith and in an acceptable manner, or that can be made of them which constitutes improper use of provisions set forth and the benefits which they grant.[91]

On the contrary, the Court concluded, "treaties for the prevention of double taxation to which Israel is a party are to be read as if they contain limitation on benefit provisions in cases where it is proven that there exists improper use of a tax treaty, according to standards of domestic law and international law."[92]

In contrast to these decisions, the Tax Court of Canada judgment in *MIL (Investments) SA v. The Queen*,[93] concluded that the Canada-Luxembourg treaty contained no inherent anti-abuse principle on the grounds that the 2003 OECD Commentary could not apply to a treaty concluded in 1990,[94] and that the treaty did not include a specific anti-avoidance rule.[95] On this basis, it held that the taxpayer, which had continued into Luxembourg from the Cayman Islands shortly before selling shares that would otherwise have been subject to tax in Canada, were exempt from Canadian tax under Article XIII of the Canada-Luxembourg treaty.[96]

Although one might question the reasoning in *MIL Investments*, for predicating the existence of an *inherent* anti-abuse principle on an explicit reference to anti-avoidance rules within the relevant treaty,[97] the decision is consistent with the conclusion of the 1986 OECD Conduit Companies Report that contracting states are obliged to grant treaty benefits "even if considered to be improper" absent the existence of an explicit anti-avoidance rule within the treaty itself.[98] While a more recent Canadian case affirms

---

[90] (207) 10 ITLR 254.
[91] *Ibid*., cited in Ward, *Access to Tax Treaty Benefits, supra* note 73 at 22.
[92] *Ibid*. at 23. According to the Court: "This approach is consistent with the interpretation of the OECD of recent years (since 2003) from its model convention, although in my opinion, it should have been included even earlier in light of the language of the provisions of the Vienna convention and the doctrine of good faith …."
[93] [2006] 5 C.T.C. 2552, 2006 D.T.C. 3307 (T.C.C.) [hereafter *MIL Investments*].
[94] *Ibid*. at para. 86. According to the Court: "one can only consult the OECD commentary in existence at the time the Treaty was negotiated without reference to subsequent revisions."
[95] *Ibid*. at para. 87.
[96] Because the cost of the shares was stepped up to their fair market value when the taxpayer continued into Luxembourg, the gain was also not taxable in Luxembourg.
[97] If an anti-abuse principle is truly *inherent* to every tax treaty, and based on the principle that treaties are to be performed and interpreted in good faith, it presumably requires no explicit affirmation in the treaty itself.
[98] *Supra* note 84 and accompanying text.

that courts may consider subsequent Commentaries to interpret previously concluded treaties, it cautions that this consideration should occur only where the subsequent Commentaries represent "a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time a specific treaty was entered."[99] Since references to tax avoidance and anti-abuse principles in the 2003 OECD Commentary constitute a clear departure from the 1986 OECD Conduit Companies Report and the 1977 OECD Commentary,[100] it follows that judicial reliance on these statements to interpret treaties concluded before 2003 is questionable. As a result, while one might disagree with the Court's analysis in *MIL Investments*, it is impossible to conclude that it was clearly mistaken in its conclusion that the Canada-Luxembourg treaty did not include an inherent anti-abuse principle.

Nonetheless, since the OECD Model Commentaries constitute a recognized guide to the interpretation of tax treaties,[101] and an important contextual reference for interpreting tax treaties concluded in light of the prevailing Commentary at the time, it follows that courts in Canada and other countries are more likely to recognize an inherent anti-abuse principle in tax treaties that are concluded or renegotiated after the 2003 OECD Commentary. For this reason, the decision in *MIL Investments* may have limited application over time as new treaties are concluded and old treaties are renegotiated.

At the same time, it is questionable whether references to an inherent anti-abuse principle represent the most fair and effective way to respond to abusive treaty shopping. On the contrary, to the extent that the object and purpose of tax treaties and specific treaty provisions are unclear, the application of an inherent anti-abuse principle is necessarily uncertain and difficult for courts to apply and taxpayers to follow. For this reason, and in order to provide better guidance to courts and taxpayers on the meaning of tax treaty abuse, it is useful to rely on explicit anti-avoidance rules in addition to interpretive principles.

IV. ANTI-AVOIDANCE RULES

In addition to the interpretation of tax treaties, a second response to treaty shopping involves the application of anti-avoidances rules, both domestic rules and rules contained in tax treaties themselves. This part of the paper examines the application of anti-avoidance rules to the phenomenon of treaty shopping, considering anti-avoidance rules in domestic law as well as anti-avoidance rules in tax treaties.

[99] *Prévost Car Inc. v. The Queen*, [2009] 3 C.T.C. 160, 2009 D.T.C. 5053 (F.C.A.) at para. 11.
[100] See, e.g., Arnold, *supra* note 5 at 259-60; and Michael Lang and Florian Brugger, "The Role of the OECD Commentary in tax treaty interpretation" (2008), 23 *Australian Tax Forum* 95 at 101-06.
[101] *Crown Forest*, *supra* note 32 at para. 64.

1. DOMESTIC RULES

In most contracting states, the tax implications of international transactions may be affected by domestic anti-avoidance rules, such as judicial business purpose or substance-over-form tests in the United States or statutory general anti-avoidance rules (GAARs) as in Australia, Canada, and New Zealand. While it might be argued that the application of these domestic anti-avoidance rules to limit treaty benefits contravenes the obligations to perform and interpret tax treaties in good faith,[102] it is also arguable that domestic anti-avoidance rules are fully consistent with treaty obligations to the extent that they determine the characterization of legal relationships and transactions that result in tax liability.[103] Although the 1977 OECD Commentary appears to have taken the former view, suggesting that states that are concerned to prevent abusive tax avoidance should explicitly "preserve the application" of the domestic anti-avoidance rules in their tax treaties,[104] the 2003 OECD Commentary adopts the latter view, concluding that domestic anti-avoidance rules "are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability," and are therefore "not addressed in tax treaties and … not affected by them."[105]

In Canada, courts have taken differing positions on the relationship between domestic anti-avoidance rules and tax treaties, finding no conflict in one case and questioning this conclusion in another case. In *RMM Canadian Enterprises Inc. and Equilease Corporation v. The Queen*,[106] the Tax Court of Canada held that a domestic anti-avoidance rule deeming capital gains to be dividends subject to non-resident withholding tax was fully consistent with the Canada–US treaty – although it is important to acknowledge that the decision depended in part on the treaty definition of dividends to include "income that is subjected to the same treatment as income from shares under the laws of the State in which the payer is a resident."[107] Most significantly, the Court declared:

> It would be a surprising conclusion that Canada, or indeed any of the other countries with which it has tax treaties, including the United States, had intentionally or inadvertently bargained away its right to deal with tax avoidance or evasion by residents of treaty countries in its own domestic tax laws. It would be equally

[102] Jinyan Li, Art Cockfield, and J. Scott Wilkie, *International Taxation in Canada*, (Markham, Lexis-Nexis, 2006) at 292.
[103] Arnold, *supra* note 5 at 250, finding support for this conclusion in Article 3(2) of the OECD Model Convention and bilateral tax treaties, which stipulate that a term that is undefined in the treaty "shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."
[104] OECD Commentary 1977, Art. 1, para. 7.
[105] OECD Commentary 2003, Art. 1, para. 9.2. See also *ibid*., Art. 1, para. 22.1, explaining that where domestic anti-avoidance rules result in "a recharacterization 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."
[106] [1998] 1 C.T.C. 2300 (T.C.C.).
[107] Canada-US Tax treaty, Art. X(3).

> surprising if tax avoidance schemes that are susceptible of attack under either general anti-avoidance provisions or specific anti-avoidance rules, if carried out by Canadian residents, could be perpetrated with impunity by nonresidents under the protection of a treaty. That is not what treaties are for.[108]

In *Garron Family Trust*,[109] on the other hand, the Court questioned this statement on the basis, among others, that it conflicted with the 1977 OECD Commentary.[110]

Regardless of the status of domestic anti-avoidance rules in international law, US courts have not shied away from applying a business purpose test to deny treaty benefits. In *Johansson v. United States*,[111] for example, where a Swedish boxer incorporated a Swiss corporation to which US source income was paid, the Fifth Circuit denied treaty benefits under the US-Switzerland treaty on the basis that the Swiss corporation had no business purpose. Similarly, in *Aiken Industries Inc. v. Commissioner*,[112] where a company resident in Ecuador incorporated a subsidiary in Honduras in order to loan funds to a US subsidiary, the court denied treaty benefits under the US-Honduras treaty on the basis that the Honduran company was a conduit with no business purpose.

In Canada, which introduced a statutory general anti-avoidance rule (GAAR) in 1988,[113] the application of this provision to tax treaties was made explicit by a 2005 amendment retroactive to the introduction of the GAAR in 1988.[114] According to this amendment, the GAAR applies, among other things, where a transaction can reasonably be considered to result in a misuse of the provisions of domestic tax legislation or a tax treaty or an abuse having regard to these provisions read as a whole. Correspondingly, the *Income Tax Conventions Interpretation Act*,[115] to which domestic legislation implementing tax treaties is subject, was amended to specify that the GAAR "applies to any benefit provided under … [a tax] convention" notwithstanding the provisions of the convention or the legislation giving the convention the force of law in Canada.[116] As a result, although courts might question the retroactive nature of these amendments,[117] it is clear that the Canadian GAAR can apply to tax treaties.[118]

Notwithstanding its potential application to tax treaties, however, Canadian courts have generally been reluctant to apply the GAAR to treaty shopping. In *MIL Investments*,[119] for example, where the taxpayer continued into Luxembourg from the Cayman Islands before realizing substantial capital gains that were exempt from

---

[108] *Ibid*. at para. 56.
[109] *Supra* note 48.
[110] *Ibid*. at paras. 374-75.
[111] 336 F.2d 809 (5th Cir. 1964).
[112] 56 T.C. 925 (1971).
[113] *Income Tax Act*, R.S.C. 1985, c. 1 (as amended), s. 245 [hereafter ITA].
[114] S.C. 2005, c. 19, s. 52(2), amending ITA, s. 245(4).
[115] R.S.C. 1985, c. I-4 [as amended].
[116] *Ibid*., s. 4.1.
[117] See, e.g., *MIL Investments*, *supra* note 93 at para. 30.
[118] *Antle v. The Queen*, 2009 D.T.C. 1732 (T.C.C.) at paras. 85-87.
[119] *MIL Investments*, *supra* note 93.

Canadian tax under the Canada-Luxembourg treaty and exempt from domestic tax in Luxembourg, the Tax Court of Canada rejected the revenue department's argument that the taxpayer's continuation into Luxembourg was abusive, concluding instead that "the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive."[120] On appeal, the Federal Court of Appeal affirmed the Tax Court of Canada decision on the grounds that it was unable to find an object or purpose whose abuse could justify the Court departing from the plain words of the treaty provision exempting the taxpayer from capital gains tax in Canada.[121]

Likewise in *Garron Family Trust*,[122] where the taxpayer trusts argued unsuccessfully that they were resident in Barbados,[123] the Tax Court of Canada held that their creation would not have resulted in an abuse of the Canada-Barbados treaty if they had been found to be resident in Barbados, since it is impossible to abuse a tax treaty if the treaty criteria for residence are satisfied.[124] Rejecting the revenue department's argument that treaty benefits would not have been "intended to apply to the Trusts because they had very little connection with Barbados,"[125] the Court concluded that this approach would "result in a selective application of the Treaty to residents of Barbados, depending on criteria other than residence … contrary to the object and spirit of the Treaty."[126]

In *Antle v. The Queen*,[127] however, where the taxpayer purported to transfer shares on a tax-deferred basis to a spousal trust resident in Barbados which realized a substantial capital gain on their subsequent disposition, the Tax Court of Canada held that the series of transactions would have resulted in an abuse of the Canada-Barbados treaty had the taxpayer properly established the trust. According to the Court:

> The *Income Tax Act* and the Canada-Barbados Treaty contemplate payment by Canadian residents of Canadian income tax on the gain arising on the sale of property held by the Canadian marital unit. They do not contemplate, figuratively, running property through Barbados and returning it to the Canadian marital unit for the sole purpose of escaping that Canadian payment of tax. It is an abuse of the *Act*, of the Treaty and of the joint operation of both.[128]

---

[120] *Ibid*. at para. 72. See also *ibid*. at para. 74: "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 section 245, should seek recourse by attempting to renegotiate selected tax treaties."
[121] *The Queen v. MIL (Investments) S.A.*, [2007] 4 C.T.C. 235, 2007 D.T.C. 5437 (F.C.A.), at para. 6.
[122] *Supra* note 48.
[123] *Supra*, notes 49-53 and accompanying text.
[124] *Garron Family Trust*, *supra* note 48 at para. 383: "If the Trusts are resident only in Barbados under these principles, then the *Treaty* contemplates that Article XIV(4) will apply to them. It does not matter that the Trusts have few connections with Barbados."
[125] *Ibid*. at para. 380.
[126] *Ibid*. at para. 381.
[127] *Supra* note 118.
[128] *Ibid*. at para. 120.

As a result, it seems, treaty shopping may be successfully challenged under the Canadian GAAR, provided that it contradicts the purpose of the relevant treaty provisions.

As the Canadian decisions illustrate, however, reliance on a statutory GAAR like the Canadian GAAR represents a problematic response to treaty shopping, since its application depends on the existence of a misuse or abuse of a tax treaty, which may be difficult to establish where the taxpayer is able to establish residence for treaty purposes. For this reason, as with the concept of an inherent anti-abuse principle, it is best to rely on domestic general anti-avoidance rules as residual responses to treaty shopping that supplement more specific anti-avoidance rules contained within tax treaties themselves.

2. TREATY RULES

A final response to treaty shopping involves the inclusion of anti-avoidance rules in tax treaties themselves. As the 1986 OECD Conduit Companies Report explains, specific anti-avoidance rules relating to conduit companies include "look-through" rules that "pierce the corporate veil" of conduit companies (the "look-through" approach),[129] rules excluding specified entities from access to treaty benefits (the exclusion approach),[130] rules limiting treaty benefits to income that is actually subject to tax in the residence state (the subject-to-tax approach),[131] and rules denying treaty benefits to income that is used mainly to satisfy claims of persons resident in third-party states (the channel approach).[132] Other anti-avoidance rules include purpose tests denying treaty benefits where a main purpose of the creation or assignment of rights was to obtain treaty benefits,[133] and more detailed limitation of benefit (LOB) provisions limiting treaty benefits to residents with a substantial economic presence in one of the contracting states.[134] Specific anti-avoidance rules and LOB provisions are often accompanied by specific provisions excluding from their application entities that are established and maintained primarily for *bona fide* purposes other than the pursuit of tax benefits under the tax treaty.[135]

Until recently, Canada has generally not included these kinds of anti-avoidance rules in its tax treaties, except to exclude specific entities in a few states from benefits otherwise available under tax treaties with these states.[136] According to one

[129] OECD Conduit Companies Report, *supra* note 15 at paras. 23-25.
[130] *Ibid*. at paras. 26-28.
[131] *Ibid*. at paras. 29-36.
[132] *Ibid*. at paras. 37-41.
[133] OECD Commentary 2003, Art. 1, para. 21.4.
[134] *Ibid*., Art. 1, para. 20.
[135] See, e.g., OECD Conduit Companies Report, *supra* note 15 at para. 42; OECD Commentary 2003, Art. 1, para. 19.
[136] See, e.g., Art. XXX(3) of the Canada-Barbados treaty (excluding "companies entitled to any special tax benefit under the Barbados International Business Companies (Exemption from Income Tax) Act, Cap. 77 or to companies entitled to any special tax benefit under any similar law enacted by Barbados in addition to or in place of that law"); and Art. 28(3) of the Canada-Luxembourg treaty (excluding "holding companies within the meaning of the special Luxembourg laws (currently the Act of July 31, 1929 and the Grand Duchy Order of December 17, 1938) or any other similar law enacted in Luxembourg after the signature of

commentator, this approach reflected a broad consistency among treaty provisions, particularly regarding withholding tax rates for dividends, interest, and royalties.[137] However, as treaty shopping is increasingly recognized as a policy concern and Canada has negotiated different withholding tax rates in different tax treaties,[138] anti-avoidance rules have become an increasing feature of Canada's tax treaties.

Since 1992, for example, purpose tests have been included in tax treaties with Nigeria (1992), Ukraine (1997), Kazakhstan (1997), Uzbekistan (2000), Lebanon (2000), Peru (2001), Oman (2005) and Mexico (2006).[139] Many other treaties negotiated since the late 1990s include narrow LOB provisions denying treaty benefits to a resident entity that is beneficially owned or controlled by residents of other countries if the tax imposed on the entity is substantially lower than it would have been if the entity were owned or controlled by residents of the state in which the entity resides.[140] Most recently, Canada adopted a detailed LOB provision in the Fifth Protocol to the Canada-US Tax Convention (1980), which became effective 15 December 2008.[141] According to this provision, treaty benefits are limited to "qualifying persons",[142] income from the active conduct of a trade or business received by residents who are not qualifying persons but are engaged in the active conduct of a trade or business in Canada or the United States,[143] and dividends, interest and royalties received by companies that are substantially owned by persons resident in states with withholding tax rates as low as the rate applicable under the Canada-US treaty.[144] A further provision stipulates that a person who is not

---

the Convention, nor to companies subjected to similar fiscal laws in Luxembourg"). An exception to this pattern is the purpose tests that were added to Articles 10 (Dividends), 11 (Interest) and 12 (Royalties) of the Canada-UK treaty in 1980 – stipulating that the provisions of these articles do not apply if it was "the main purpose or one of the main purposes" of any person concerned with the creation or assignment of the rights in respect of which the relevant income is paid to "take advantage" of the Article "by means of that creation or assignment." The addition of this test appears to have been at the insistence of the United Kingdom, which developed the test and includes it in many of its tax treaties with other countries.

[137] Brian Arnold, *Reforming Canada's International Tax System: Toward Coherence and Simplicity*, (Toronto: Canadian Tax Foundation, 2009) at 358.

[138] The most significant change in recent years is the elimination of withholding tax for arm's length and non-arm's length interest payments under the Fifth Protocol to the Canada-US treaty, which came into effect on 15 December 2008.

[139] Arnold, *supra* note 137 at 358 (noting that the scope of these purpose tests varies from treaty to treaty, applying to dividends, interest and royalties in some treaties and interest and royalties alone in other treaties).

[140] See, e.g., Art. 26(3) of the Convention Between Canada and Finland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Helsinki on 20 July 2006. Similar provisions are included in approximately 35 of Canada's tax treaties.

[141] Canada-US Income Tax Convention (1980), Art. XXIXA [added by Art. 25 of the Fifth Protocol to the Convention, effective 15 December 2008].

[142] *Ibid*., Art. XXIXA(1)(a) and Art. XXIXA(2) (defining a "qualifying person" as a resident that is, among other things a natural person, a company or trust whose principal class of shares or units is primarily and regularly traded on one or more recognized stock exchanges in Canada or the United States, a company that is owned primarily by five or fewer companies or trusts with shares or units traded on a recognized stock exchange in Canada or the United States, and a company that is not primarily owned by persons other than qualifying persons and does not pay 50% or more of its gross income to persons other than qualifying persons in the form of deductible expenses).

[143] *Ibid*., Art.XXIXA(3).

[144] *Ibid*., Art. XXIXA(4).

entitled to treaty benefits under these provisions may be granted benefits if its "creation and existence did not have as a principal purpose the obtaining of benefits under this Convention that would not otherwise be available" or "[i]t would not be appropriate, having regard to the purposes of this Article, to deny the benefits of this Convention to that person."[145]

At present, none of these anti-avoidance rules has been subject to judicial interpretation in Canada. As a result, it is difficult to assess how effective they may be to prevent abusive treaty shopping. Like domestic anti-avoidance rules, however, the effectiveness of these treaty-based anti-avoidance rules may depend as much on their deterrent effect as it does on their actual implementation. Nonetheless, the effectiveness of these rules may be limited to the extent that Canadian tax treaties lack a consistent approach to treaty shopping – including purpose tests in some treaties, narrow LOB provisions in other treaties, and a detailed LOB provision in the Canada-US treaty.[146] For this reason, and in order to promote increased certainty regarding the line between acceptable and abusive treaty shopping, it would be desirable for Canada to adopt a more consistent approach to anti-treaty-shopping provisions, including the introduction of detailed LOB provisions in all its treaties and subject-to-tax provisions where Canada cedes the right to tax amounts (such as capital gains) to states that do not tax these amounts.[147]

V. CONCLUSION

Over the last few decades the globalization of trade and investment and the exponential growth in bilateral tax treaties have greatly increased opportunities for taxpayers to engage in abusive treaty shopping that is neither intended nor contemplated by the contracting states. This conduct upsets the balance of sacrifices associated with the negotiation of tax treaties, undermines incentives to enter into tax treaties, and facilitates international tax avoidance and evasion. In response to this phenomenon, the OECD and several countries have adopted various strategies, including the interpretation of tax treaties and the application of anti-avoidance rules in domestic law and tax treaties themselves. This paper has reviewed and evaluated these responses – examining cases and commentary on the concepts of residence and beneficial ownership, the existence of an anti-abuse principle inherent in tax treaties, domestic anti-avoidance rules and treaty-based anti-avoidance rules.

While each of these responses has a role to play in preventing abusive treaty shopping, this paper questions whether the interpretation of residence and beneficial ownership can prevent abusive treaty shopping, and the extent to which references to an

---

[145] *Ibid*., Art.XXIX(6).
[146] See, e.g, Arnold, *supra* note 137 at 361, concluding that "[t]here is scant evidence that the government can point to in order to demonstrate that treaty-shopping is abusive, especially in light of the fact that anti-treaty-shopping rules are included in only some treaties, and even in those treaties they are applicable to only some types of income."
[147] *Ibid*.at 362-63.

inherent anti-abuse principle and/or domestic general anti-avoidance rules represent a fair and effective response, given uncertainty over the line between acceptable tax planning and abusive treaty shopping. For this reason, it concludes that the best response to treaty shopping involves the inclusion of detailed LOB and subject-to-tax provisions in tax treaties. Although Canada has shown some willingness to move in this direction in recent years, much more is required to ensure a coherent and consistent approach to treaty shopping.[148]

[148] For this reason, the author cannot accept the conclusion of Advisory Panel on Canada's System of International Taxation that "Canada has adequate resources and tools in its tax treaties and domestic law and in international jurisprudence to police treaty shopping." Canadian Advisory Panel Final Report, *supra* note 6 at para. 5.68.