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Tax Treaty Abuse and the Principal Purpose Test - Part I

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INTERNATIONAL TAX PLANNING

Co-Editors: Ken Bутtenham and Ian Bradley*

TAX TREATY ABUSE AND THE PRINCIPAL PURPOSE TEST — PART 1

*David G. Duff***

The Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting came into force on July 1, 2018, and has been signed by more than 80 jurisdictions, including Canada. This multilateral instrument (MLI) has been described as “an historical turning point in the area of international taxation”; it introduces a third layer of rules for the taxation of cross-border transactions, in addition to domestic tax law and bilateral tax treaties. Of the many provisions of the MLI, the most important are the preamble text in article 6(1) and the general anti-avoidance provision—the so-called principal purpose test (PPT)—in article 7(1). Both of these provisions have been adopted by all signatories to the MLI in order to satisfy the OECD’s minimum standard on tax treaty abuse under BEPS action 6. This two-part article considers the structure and potential application of the PPT in the context of pre-BEPS responses to perceived tax treaty abuses, the OECD’s work on BEPS action 6, and other provisions of the MLI, including the preamble text in article 6(1). The first part of the article reviews pre-BEPS responses to perceived tax treaty abuses, providing necessary background and context for understanding BEPS action 6, the MLI, and the PPT. The second part examines the PPT in light of this background and in the context of BEPS action 6 and other provisions of the MLI, considering the structure of this provision and the kinds of transactions or arrangements to which it might apply.

KEYWORDS: TREATY SHOPPING ■ OECD ■ BEPS ■ MULTILATERAL INSTRUMENT (MLI) ■ PURPOSE ■ ANTI-ABUSE

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INTRODUCTION

The Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting¹ has been described as “an historical turning point in the area of international taxation”² in that it introduces a third layer of rules for the taxation of cross-border transactions, in addition to domestic tax law and bilateral tax treaties. Developed, as the title suggests, to facilitate the implementation of tax treaty measures proposed by the Organisation for Economic Co-operation and Development (OECD) as part of its project on base erosion and profit shifting (BEPS),³ this multilateral instrument (MLI) is designed to modify specific provisions of covered tax agreements (CTAs) that are designated by contracting jurisdictions to those agreements.⁴

1 Organisation for Economic Co-operation and Development, Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting, released on November 24, 2016 (www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.pdf) (herein referred to as “the MLI”).

2 Robert J. Danon and Hugues Salomé, “The BEPS Multilateral Instrument: General Overview and Focus on Treaty Abuse” [2017] no. 3 *IFF Forum für Steuerrecht* 197-247, at 199.

3 The proposed treaty-based measures were developed in BEPS action 2 (neutralizing the effect of hybrid mismatch arrangements), action 6 (preventing the granting of treaty benefits in inappropriate circumstances), action 7 (preventing the artificial avoidance of permanent establishment status), and action 14 (making dispute resolution mechanisms more effective), and appear in part II (articles 3 through 5), part III (articles 6 through 11), part IV (articles 12 through 15), and part V (articles 16 and 17) of the MLI. Part I of the MLI (articles 1 and 2) addresses the scope of the convention and the interpretation of terms; part VII (articles 27 through 39) deals with matters such as signature, ratification, entry into force, and withdrawal; and part VI (articles 18 through 26) contains measures for binding arbitration that emerged in the process of developing the MLI.

4 The MLI applies to a tax treaty only where all parties to the treaty are signatories to the MLI and designate the treaty as a CTA. In addition, provisions of the MLI generally modify these tax treaties only where all parties to the CTA choose to apply the provision either by selecting an option afforded by the MLI or by not reserving the right for the provision not to apply. On the mechanics of the MLI and the positions taken by the initial signatories, see Danon and Salomé, *supra* note 2, at 200-13.

The MLI has been signed, to date, by more than 80 jurisdictions, including Canada,⁵ and came into force on July 1, 2018.⁶ Before the MLI can come into effect for a particular CTA, however, all contracting jurisdictions to the CTA must deposit their instruments of ratification, acceptance, or approval with the OECD.⁷ As a result, although the MLI will only modify CTAs selected by contracting jurisdictions and will not modify those CTAs until at least three months after all contracting states have deposited their instruments of ratification, acceptance, or approval with the OECD, the MLI will begin to modify the CTAs of some states beginning in 2019.⁸

Of the many provisions of the MLI, the most important are the preamble text in article 6(1) and the so-called principal purpose test (PPT) in article 7(1); both of these provisions have been adopted by all signatories to the MLI in order to satisfy the OECD's minimum standard on tax treaty abuse under BEPS action 6.⁹ The preamble text in article 6(1) applies in the place of or in the absence of preamble

5 Organisation for Economic Co-operation and Development, "Signatories and Parties to the Multilateral Convention To Implement Tax Treaty Measures To Prevent Base Erosion and Profit Shifting: Status as of 23 July 2018" (www.oecd.org/tax/treaties/beps-ml-signatories-and-parties.pdf).

6 According to article 34(1) of the MLI, the convention shall enter into force on "the first day of the month following the expiration of a period of three calendar months beginning on the date of deposit of the fifth instrument of ratification, acceptance or approval." Slovenia became the fifth jurisdiction to deposit its instrument of ratification, acceptance, or approval, on March 22, 2018 (joining Austria, Jersey, the Isle of Man, and Poland); accordingly, the MLI entered into force on July 1, 2018. For other signatories, article 34(2) of the MLI stipulates that the convention enters into force for each other signatory on the first day of the month after the expiration of three months from the date when the signatory deposited its instrument of ratification, acceptance, or approval with the OECD.

7 According to article 35(1) of the MLI, the convention comes into effect for non-resident withholding taxes on the first day of the next calendar year beginning on or after the latest of the dates on which the MLI comes into force for each of the contracting jurisdictions to the CTA, and otherwise generally for taxation years commencing six months after the latest of the dates on which the convention comes into force for each of the contracting jurisdictions to the CTA.

8 Although Canada has signed the MLI, it has yet to ratify the convention. It has, however, tabled legislation to ratify the convention, and this legislation is likely to be approved by the end of 2018. See Canada, Department of Finance, "Canada Takes Next Step in Fight Against Aggressive International Tax Avoidance," *News Release*, May 28, 2018 (www.fin.gc.ca/n18/18-037-eng.asp). As a result, although it is uncertain whether Canada will deposit its instrument of ratification, acceptance, or approval with the OECD in time for the MLI to apply to non-resident withholding taxes in 2019, it can be expected to begin modifying at least some of Canada's tax treaties as they apply to taxation years commencing later in 2019.

9 According to the final report on BEPS action 6, countries must satisfy this minimum standard by amending bilateral tax treaties to include "an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements" and adopting either (1) a PPT, (2) a PPT and "a specific anti-abuse rule based on the limitation-on-benefits provisions included in treaties concluded by the United States and a few other countries," or (3) a limitation-on-benefits (LOB) provision and "a mechanism (such as a treaty rule that might take the form of a PPT rule restricted to conduit arrangements or domestic

language in a CTA, declaring that the CTA is intended to eliminate double taxation with respect to the taxes covered by the 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).”¹⁰ The PPT in article 7(1) applies in place of or in the absence of principal purpose requirements in a CTA, and stipulates that

[n]otwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.¹¹

Based on a “guiding principle” in the commentary on the OECD model tax treaty,¹² and similar in structure to Canada’s general anti-avoidance rule (GAAR),¹³ this provision adds a general anti-avoidance or anti-abuse rule to CTAs.

anti-abuse rules or judicial doctrines that would achieve a similar result) that would deal with conduit arrangements not already dealt with in tax treaties.” Organisation for Economic Co-operation and Development, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Paris: OECD, October 5, 2015) (herein referred to as “the final report on BEPS action 6”), at paragraphs 19 and 22 (www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm). Of the 83 states that had signed the MLI as of July 23, 2018, 62 indicated that they would adopt the PPT as a stand-alone anti-abuse provision; 13 indicated that they would adopt the PPT and the simplified LOB (SLOB) provisions in articles 7(8)-(13) of the MLI; and 8, including Canada, indicated that they would adopt the PPT alone as an interim measure while intending, where possible, to adopt LOB provisions in addition to or as a replacement for the PPT through bilateral negotiation. Figures compiled by the author from the positions of the signatories, available at OECD, *supra* note 5.

10 MLI articles 6(1) and (2).

11 MLI article 7(1).

12 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (Paris: OECD, November 2017) (herein referred to as “the OECD model convention”), at paragraph 61 of the commentary on article 1, stating that “[a] guiding principle is that the benefits of a double taxation 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.” According to the commentary, this principle “applies independently” of the PPT in new article 29(9) of the OECD model convention, “which merely confirm[s] it” (*ibid.*).

13 Section 245 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended. Like the PPT, this provision applies to deny a tax benefit where three requirements are satisfied: (1) a transaction or a series of transactions of which the transaction is a part would otherwise result directly or

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PRE-BEPS RESPONSES TO PERCEIVED TAX TREATY ABUSES

Although BEPS action 6 and the MLI represent major developments in the OECD's efforts to prevent what it calls "the granting of treaty benefits in inappropriate circumstances,"¹⁴ these initiatives cannot be properly understood in isolation, since they expand on pre-BEPS responses to perceived tax treaty abuses, which the OECD and signatories to the MLI presumably consider to be inadequate or insufficient. The discussion that follows reviews these pre-BEPS responses to perceived treaty abuses, considering measures to address tax treaty shopping as well as other perceived abuses of tax treaties.

TAX TREATY SHOPPING

Tax treaty shopping, broadly understood, has been defined as "a premeditated effort to take advantage of the international tax treaty network, and careful selection of the most favorable treaty for a specific purpose."¹⁵ Since bilateral tax treaties apply only to residents of one or both of the contracting states,¹⁶ tax treaty shopping necessarily involves deliberate measures either to become a resident of a contracting state in order to obtain treaty benefits that are available under one or more of

indirectly in a tax benefit; (2) the transaction may not reasonably be considered to have been undertaken or arranged primarily for a bona fide purpose other than to obtain the tax benefit; and (3) it may reasonably be considered that the transaction would otherwise result in a misuse of provisions of the Income Tax Act or other relevant enactments or an abuse having regard to those provisions read as a whole.

14 Final report on BEPS action 6, *supra* note 9, at paragraph 15.

15 H. David Rosenbloom, "Tax Treaty Abuse: Policies and Issues" (1983) 15:3 *Law and Policy in International Business* 763-831, at 766. The final report on BEPS action 6 defines the concept of tax treaty shopping more narrowly, stating that these arrangements "typically involve persons who are residents of third States attempting to access indirectly the benefits of a treaty between two Contracting States." Final report on BEPS action 6, *supra* note 9, at paragraph 17. I return to this distinction later in this article, suggesting that the OECD's emphasis on indirect access to treaty benefits by residents of third jurisdictions may support a possible distinction between abusive and non-abusive tax treaty shopping.

16 Article 1 of the OECD model convention.

its tax treaties with other states, or to access these treaty benefits indirectly by means of a legal entity that is resident in the contracting state. Examples include a tax-motivated change of residence shortly before the disposition of property in order to obtain a treaty exemption on the taxation of capital gains,¹⁷ and conduit arrangements whereby a resident of one state directs an investment through a legal entity in a third state in order to obtain treaty benefits under that state's tax treaty with the ultimate source state.¹⁸

Objections to tax treaty shopping have traditionally emphasized its impact on the reciprocal "balance of sacrifices" accepted by each contracting state in negotiating a tax treaty.¹⁹ If a treaty can be accessed by residents of another state, the fairness of the treaty bargain may be undermined and the incentive for states to enter into tax treaties in the first place may be reduced.²⁰ As the final report on BEPS action 6 explains,

[a]llowing persons who are not directly entitled to treaty benefits (such as the reduction or elimination of withholding taxes on dividends, interest or royalties) to obtain these benefits indirectly through treaty shopping would frustrate the bilateral and reciprocal nature of tax treaties. If, for instance, a State knows that its residents can indirectly access the benefits of treaties concluded by another State, it may have little interest in granting reciprocal benefits to residents of that other State through the conclusion of a tax treaty.²¹

As the number of tax treaties has grown over the last several decades, increasing opportunities to take advantage of the tax treaty network to reduce or eliminate

17 See, for example, paragraph 56 of the commentary on article 1 of the OECD model convention (transfer of permanent home by an individual); and *MIL Investments (SA) v. The Queen*, 2006 TCC 460 (transfer of corporate residence).

18 See, for example, Organisation for Economic Co-operation and Development, "Double Taxation Conventions and the Use of Conduit Companies," in *International Tax Avoidance and Evasion: Four Related Studies*, Issues in International Taxation no. 1 (Paris: OECD, 1987), 87-106 (herein referred to as "the OECD conduit companies report"). For a useful discussion of conduit arrangements and tax treaty shopping, see 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*, IBFD Doctoral Series vol. 14 (Amsterdam: International Bureau of Fiscal Documentation, 2008). De Broe discusses (ibid., at 5-20) direct conduits in which a person who expects to derive dividends, interest, or royalties sourced in another state establishes an entity in a third state in order to access more advantageous treaty benefits in respect of the income, and "stepping-stone" structures in which the conduit is fully subject to tax in the third state but reduces its tax in that state through the deduction of interest, royalties, service fees, or other expenses paid either to the person in the residence state or to another entity controlled by that person.

19 OECD conduit companies report, supra note 18, at 90.

20 Rosenbloom, supra note 15, at 774-75.

21 Final report on BEPS action 6, supra note 9, at 22. This text was subsequently incorporated into paragraph 4 of the commentary on article 29 of the OECD model convention.

taxation, tax treaty shopping has also been challenged on the ground that it can produce unintended tax benefits resulting in reduced taxation or non-taxation.²² As the final report on BEPS action 6 states,

in such a case, the benefits that would be indirectly obtained may not be appropriate given the nature of the tax system of the former State [that is, the ultimate state of residence]; if, for instance, that State does not levy an income tax on a certain type of income, it would be inappropriate for its residents to benefit from the provisions of a tax treaty concluded between two other States that grant a reduction or elimination of source taxation for that type of income and that were designed on the assumption that the two Contracting States would tax such income.²³

Before BEPS action 6 and the MLI, several jurisdictions adopted various domestic and treaty-based provisions to discourage tax treaty shopping, on which their tax authorities have relied with varying degrees of success. In order to discourage tax-motivated emigration, for example, several jurisdictions impose exit or departure taxes that apply to accrued pension rights and/or capital gains.²⁴ Other domestic anti-avoidance rules that may discourage tax-motivated expatriation include controlled foreign corporation rules and non-resident trust provisions that attribute the income of non-resident legal entities to resident shareholders and beneficiaries.²⁵

In order to discourage conduit arrangements, the United States adopted domestic anti-conduit regulations allowing the Internal Revenue Service to disregard an intermediate entity's participation in a financing arrangement where one of the principal purposes of this participation is the avoidance of US withholding tax.²⁶ For the same reason, Germany enacted an anti-treaty-shopping provision denying treaty benefits to a foreign company to the extent that the company's shareholders would not be entitled to these benefits if they had received the income directly,

22 See, for example, United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Treaty Abuse and Treaty Shopping*, United Nations document E/C.18/2006/2 (New York: United Nations, October 16, 2006), at paragraph 18 (www.un.org/esa/ffd/tax/documents/bgrd_model_ta.htm).

23 Final report on BEPS action 6, *supra* note 9, at 22. This text was subsequently incorporated into paragraph 4 of the commentary on article 29 of the OECD model convention.

24 These provisions are discussed in the final report on BEPS action 6, *supra* note 9, at paragraphs 65-67, and are mentioned in revised paragraph 69 of the commentary on article 1 of the OECD model convention. Because Canada levies withholding tax on pension income under domestic law and tax treaties, it does not impose an exit tax on accrued pension rights; however, because Canada generally exempts capital gains from the alienation of property by non-residents, it imposes an exit tax on accrued capital gains under subsection 128.1(4) of the Income Tax Act.

25 See, for example, sections 91 and 94 of the Income Tax Act. These provisions are discussed in the final report on BEPS action 6, *supra* note 9, at paragraph 59, and are incorporated into revised paragraph 81 of the commentary on article 1 of the OECD model convention.

26 For a detailed discussion of these provisions and their potential application, see Peter M. Daub, "The Conduit Regulations Revisited" (2015) 147:4 *Tax Notes* 409-26.

unless the income is derived from the company's own economic activity or unless there are sound economic or other non-tax reasons for interposing the company and the company participates in general commerce through an appropriately equipped business establishment.²⁷

Long before the development of these anti-conduit rules in the mid-1990s, Switzerland adopted a unilateral anti-abuse decree in 1962, which was designed, among other things, to protect treaty partners against the use of Swiss conduit arrangements by denying treaty benefits where more than 50 percent of treaty-protected income was used to satisfy claims in third countries.²⁸ More recently, Canada introduced domestic anti-conduit rules in 2014 addressing back-to-back loan arrangements, which were expanded in 2016 to include back-to-back royalty payments and shareholder loans, to include "character substitution rules" to prevent the avoidance of these rules through economically similar arrangements between an intermediary and another non-resident person, and to clarify that these rules apply to multiple-intermediary arrangements.²⁹

In addition to these domestic specific anti-avoidance rules, tax authorities have challenged treaty-shopping transactions or arrangements under domestic anti-avoidance doctrines and statutory general anti-avoidance rules, on the basis that tax treaties are subject to an implicit general anti-abuse principle under international law, and on the ground that the recipient of income who would otherwise be eligible for treaty benefits is not its beneficial owner. As well, several jurisdictions have adopted specific anti-avoidance provisions in tax treaties, including limitation-on-benefit (LOB) provisions that restrict treaty benefits to specific categories of

27 For brief discussions of this provision, see De Broe, *supra* note 18, at 419-23; and Andreas Kempf and Emma Moesle, "The Revised German Anti-Treaty Shopping Provisions—A Critical Review" (2012) 66:8 *Bulletin for International Taxation* 395-400. In two cases decided in 2017, the European Court of Justice held that the original version of this anti-treaty-shopping regulation was incompatible with European Community law and the EC parent-subsidiary directive: C-504/16 (*Deister Holding AG*) and C-613/16 (*Jubler Holding A/S*). The German Ministry of Finance has issued new guidance on the application of the revised provision in order to comply with these decisions.

28 *Bundesratsbeschluss betreffend Massnahmen gegen die ungerechtfertigte Inanspruchnahme von Doppelbesteuerungsabkommen des Bundes*, December 14, 1962 (SR 672.202). For a brief description of this anti-abuse provision, see De Broe, *supra* note 18, at 440-41, explaining that the provision was adopted "in response to the risk of Switzerland being categorized as a tax haven by important industrialized countries (the United States in the first place), which would have had an adverse effect on the country's ability to conclude tax treaties." It is perhaps not coincidental that the decree was adopted around the time of the *Johansson* case, discussed below at notes 32-39 and the accompanying text, which involved a Swiss company claiming benefits under the Switzerland-US tax treaty.

29 Subsections 212(3.1) through (3.94) and 15(2.16) through (2.192) of the Income Tax Act. For a useful overview of these rules, see Michael N. Kandev, "Canadian Interest Anti-Conduit Rule Soon To Be Law" (2014) 76:11 *Tax Notes International* 1027-30; and Michael N. Kandev, "Canada Expands Back-to-Back Regime: Examining the Character Substitution Rules" (2017) 86:12 *Tax Notes International* 1087-92.

residents or income and purpose tests that deny access to some or all treaty benefits where the main purpose or one of the main purposes of the transaction or arrangement was to obtain the treaty benefit. The following sections review each of these pre-BEPS responses to tax treaty shopping.

Domestic Anti-Avoidance Doctrines and General Anti-Avoidance Rules

Since the characterization of transactions or arrangements to which a tax treaty may apply generally depends on the domestic law of the contracting state from which a treaty benefit is sought, it is not surprising that tax treaty shopping might be challenged first under domestic anti-avoidance doctrines and general anti-avoidance rules that determine the characterization of these transactions or arrangements.³⁰ In the United States, for example, where courts have developed broad anti-avoidance doctrines in the form of business purpose and economic substance tests,³¹ at least three notable judicial decisions have applied these doctrines in order to deny treaty benefits that would otherwise have resulted from tax treaty shopping.

In *Johansson v. United States*,³² the taxpayer was a Swedish boxer who fought three world heavyweight championship fights in the United States against US boxer Floyd Patterson.³³ After winning the first fight, Johansson obtained tax residence in Switzerland, where he incorporated a company with which he entered into an employment contract and from which he received substantial compensation for the second and third fights. He then argued that the compensation was exempt from US tax under article X(1) of the 1951 Switzerland-US tax treaty,³⁴ according to which individuals resident in Switzerland were exempt from US tax on “compensation for labor or personal services performed in the United States” where the individual was “temporarily present in the United States for a period or periods not exceeding 183

30 Although it might be argued that these domestic anti-avoidance doctrines or general anti-avoidance rules conflict with tax treaties, it is also arguable that these doctrines and rules are compatible with tax treaties that apply to transactions or arrangements as determined under domestic tax law. The OECD commentaries have reflected the latter view since the adoption of revisions in 2003: paragraphs 73 and 76-80 of the commentary on article 1 of the OECD model convention. In Canada, section 245 of the Income Tax Act (GAAR) was amended in 2005 to explicitly apply to the misuse or abuse of provisions of a tax treaty, and section 4.1 of the Income Tax Conventions Interpretation Act, RSC 1985, c. I-4, as amended, declares that Canada’s GAAR applies to “any benefit” provided under a tax treaty, notwithstanding the provisions of the treaty or legislation giving the treaty the force of law in Canada.

31 See, for example, *Gregory v. Helvering, Commissioner of Internal Revenue*, 293 US 465 (1935); *Comm’r. v. Court Holding Co.*, 324 US 331 (1945); and *Bazley v. Commissioner*, 331 US 737 (1947).

32 336 F.2d 809 (5th Cir. 1964).

33 Johansson won the first match on June 26, 1959, becoming the heavyweight champion of the world, but lost the second and third bouts on June 20, 1960 and March 13, 1961.

34 Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, signed at Washington, DC on May 24, 1951 (herein referred to as “the Switzerland-US tax treaty”).

days” and the compensation was received for “labor or personal services performed as an employee of, or under contract with, a resident or corporation or other entity of Switzerland.”³⁵

Observing that Johansson was the Swiss company’s “sole employee and sole source of revenue” and “conducted his affairs largely independent of” its sole director and stockholders,³⁶ the Fifth Circuit court upheld the judgment of the District Court, which had held against the taxpayer on the basis that the company

had no legitimate business purpose, but was a device which was used by Ingemar Johansson as a controlled depository and conduit by which he attempted to divert temporarily, his personal income, earned in the United States, so as to escape taxation thereon in the United States.³⁷

In addition, the Fifth Circuit court continued, exemption would contradict “the genuine shared expectations of the contracting parties” and the “primary objective” of the treaty with Switzerland and other tax treaties to eliminate “impediments to international commerce resulting from the double taxation of international transactions” by allocating tax jurisdiction to the “most appropriate locus for the taxation of any given transaction.”³⁸ As a result, the court concluded:

[W]hile Johansson may have brought himself within the words of the Swiss treaty by his “residence” in Switzerland and his “employment” by a “Swiss corporation,” he has failed to establish any substantial reasons for deviating from the treaty’s basic rule that income from services is taxable where the services were rendered. International trade will not be seriously encumbered by our refusal to grant special tax treatment to one only marginally, if at all, a Swiss resident and only technically, if at all, employed by a paper Swiss corporation.³⁹

35 This provision is similar to article 15(2) of the OECD model convention, which exempts remuneration derived by a resident of a contracting state in respect of employment exercised in the other contracting state if the recipient is present in the other state for a period or periods not exceeding 183 days in any 12-month period commencing or ending in the fiscal year, and the remuneration is paid by or on behalf of an employer who is not a resident of the other state, and is not borne by a permanent establishment that the employer has in the other state. Although this provision is subject to article 17, which provides broader source jurisdiction for income derived as an entertainer or sportsperson and includes a specific anti-avoidance rule in article 17(2) for income that “accrues not to the entertainer or sportsperson but to another person,” the 1951 Switzerland-US tax treaty did not include comparable provisions.

36 *Johansson*, supra note 32, at 813.

37 Cited in *Johansson*, *ibid.* The court also concluded that Johansson was not a resident of Switzerland during the period in question, rejecting his argument that the United States was bound by a determination to the contrary by the Swiss tax authorities.

38 *Johansson*, supra note 32, at 813.

39 *Ibid.*, at 814.

Similarly, in *Aiken Industries, Inc. v. Commissioner*,⁴⁰ the US Tax Court relied on domestic anti-avoidance doctrines to deny treaty benefits that might otherwise have been available. In this case, the taxpayer borrowed funds from a company that was resident in the Bahamas (with which the United States did not have a tax treaty), which assigned the debt to a wholly owned subsidiary that it had incorporated in Honduras (with which the United States had entered into a tax treaty) in exchange for notes on which interest was payable at the same rate as the rate of interest payable on the loan to the taxpayer. Concluding that the “only purpose” of the assignment was “to obtain the benefits of the exemption established by the treaty” and that the taxpayer had “failed to establish that a substantive indebtedness existed” between the taxpayer and the Honduran subsidiary,⁴¹ the court rejected the taxpayer’s argument that the interest payments were exempt from US withholding tax under article IX of the Honduras-US tax treaty,⁴² on the ground that the interest was not “received by” the Honduran subsidiary as required by the treaty.⁴³ On the contrary, the court concluded, since the words “received by” contemplate “complete dominion and control” over an amount without an “obligation to transmit” the amount to another person,⁴⁴ the Honduran subsidiary was in effect “a collection agent with respect to the interest it received” from the taxpayer and a “conduit for the passage of interest payments” that “had no actual beneficial interest” in the funds and therefore “cannot be said to have received the interest as its own.”⁴⁵

The outcome was again similar in *Del Commercial Properties, Inc. v. Commissioner of Internal Revenue*.⁴⁶ In this case, the taxpayer, an indirect US subsidiary of a Canadian company, borrowed funds from an indirect Dutch subsidiary of the Canadian company, which had obtained the funds through a series of “related and essentially simultaneous” loans and equity investments by upper-tier subsidiaries of the Canadian company.⁴⁷ The US Tax Court held that interest payments on the borrowed

40 56 TC 925 (1971). For a useful discussion of this case, see Yariv Brauner, “Beneficial Ownership in and Outside US Tax Treaties,” in Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer, and Alfred Storck, eds., *Beneficial Ownership: Recent Trends* (Amsterdam: International Bureau of Fiscal Documentation, 2013), 143-60, at 146-49.

41 *Aiken Industries*, supra note 40, at 934.

42 Convention Between the United States of America and the Republic of Honduras for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Washington, DC on June 25, 1956.

43 *Aiken Industries*, supra note 40, at 934.

44 *Ibid.*, at 933.

45 *Ibid.*

46 TC Memo 1999-411. For a useful discussion of this case, see Brauner, supra note 40, at 155-58.

47 *Del Commercial Properties*, supra note 46, at 2. The funds were originally borrowed by a Canadian company called Delcom Financial Ltd., a second-tier subsidiary of the affiliated group. Delcom Financial Ltd. loaned the funds to a wholly owned Canadian subsidiary called Delcom Holdings, which contributed the funds to a wholly owned company organized in the Cayman Islands, in exchange for common shares. The Cayman Islands company then contributed the

funds were subject to withholding tax under the Canada-US tax treaty⁴⁸ and not exempt under the Netherlands-US tax treaty⁴⁹ on the ground that the Dutch subsidiary “had no purpose other than avoidance of withholding tax.”⁵⁰ Emphasizing that the Dutch subsidiary “had minimal assets, . . . engaged in minimal business activity,” and “had only transitory possession of and no control over the . . . loan proceeds” that were conveyed to the taxpayer,⁵¹ and that loan payments that were received by the Dutch company were transferred directly to upper-tier Canadian subsidiaries in order to make payments on an original loan from the Royal Bank of Canada,⁵² the court held that the Dutch company “acted as a mere shell or conduit with respect to the interest payments” made by the taxpayer, which had “in substance” received the borrowed funds from and made the loan payments to the upper-tier Canadian subsidiary with which the series of transactions had commenced when it borrowed funds from the Royal Bank of Canada.⁵³ On appeal, the DC Circuit court held that “the Tax Court did not clearly err in concluding that the payments from [the] appellant to [the Dutch company] were in substance payments made to [the upper-tier Canadian subsidiary] and that those payments only served to avoid U.S. taxes.”⁵⁴

In other countries, where courts have not adopted broad business purpose or economic substance doctrines, tax-treaty-shopping transactions or arrangements may still be rejected under other judicially developed anti-avoidance doctrines or statutory general anti-avoidance rules. In *Antle v. The Queen*,⁵⁵ for example, a resident of Canada purported to transfer shares of a Canadian company to a

funds to a wholly owned company organized in the Netherlands Antilles, in exchange for common shares, and the Netherlands Antilles company contributed the funds to a wholly owned company organized in the Netherlands, also in exchange for common shares.

48 Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (subsequently amended by a protocol signed on September 21, 2007) (herein referred to as “the Canada-US tax treaty”).

49 Convention Between the United States of America and the Kingdom of the Netherlands with Respect to Taxes on Income and Certain Other Taxes, signed at Washington, DC on April 29, 1948, as modified and supplemented by the Supplementary Convention signed at Washington, DC on December 30, 1965.

50 *Del Commercial Properties*, supra note 46, at 12.

51 *Ibid.*

52 *Ibid.*, at 7, adding that the taxpayer subsequently made payments directly to an upper-tier Canadian subsidiary, bypassing the Dutch company entirely.

53 *Ibid.*, at 12.

54 *Del Commercial Properties, Inc. v. CIR*, 251 F.3d 210, at 214 (DC Cir. 2001). For a critical comment on the appellate court’s reasons, see Peter A. Glicklich and Michael J. Miller, “Appeals Court Invalidates US-Netherlands ‘Double-Dip’ Financing Structure,” Selected US Tax Developments feature (2001) 49:4 *Canadian Tax Journal* 1076-84.

55 2009 TCC 465.

non-resident trust on a tax-deferred basis, and the trust claimed a treaty exemption on a capital gain resulting from a subsequent sale of the shares; however, the Tax Court of Canada held that the gain was properly attributable to the taxpayer on the grounds that the alleged trustee acted as an agent for the taxpayer and the transactions had not established the legal relationship of a trust.⁵⁶ In addition, the court continued, even if the transactions had established a trust, they would have abused domestic tax law and the tax treaty, and the Canadian GAAR would have applied to attribute the gain to the taxpayer.⁵⁷ On appeal, the Federal Court of Appeal upheld the decision on the basis that the purported trust was a sham that did not reflect the real rights and obligations created by the taxpayer and the supposed trustee.⁵⁸

Likewise, in *Ministre de l'Économie v. Bank of Scotland*,⁵⁹ the French Conseil d'État relied on domestic anti-avoidance principles to deny a refundable tax credit (“l’avoir fiscal”) available under the France-UK tax treaty⁶⁰ for dividends paid by a French company to a resident of the United Kingdom. In this case, the taxpayer, which was a resident of the United Kingdom, acquired preferred shares of a French company from its US parent under a usufruct agreement lasting for three years, for an amount that was slightly less than the cumulative amount of the dividends expected during the three years. Characterizing the usufruct agreement as an artificially concealed loan arrangement in which the US parent remained the true owner of the shares (which were pledged to the taxpayer as a guarantee for the loan), the court held that the US parent was the beneficial owner of the dividends and the provisions of the France-UK treaty did not apply. In addition, the court continued, because the arrangement was entered into for the sole purpose of obtaining abusively the benefit of the tax credit, the tax administration could recharacterize the disputed assignment contract as a loan.⁶¹

In contrast to these decisions, the courts in each of these countries have declined to apply domestic anti-avoidance doctrines and statutory general anti-avoidance rules to other treaty-shopping transactions or arrangements. In *Northern Indiana Public Service Corp. v. Commissioner*,⁶² for example, a US company incorporated a

56 Ibid., at paragraphs 48 and 58, concluding that the trust “never came into existence.”

57 Ibid., at paragraph 120, concluding that the transactions resulted in “an abuse of the *Act*, of the Treaty and of the joint operation of both.”

58 2010 FCA 280. For this reason, the court did not consider it necessary to consider the possible application of GAAR.

59 (2006), 9 ITLR 683 (Conseil d'État).

60 Convention Between the Republic of France and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on May 22, 1968 (herein referred to as “the France-UK tax treaty”).

61 See the discussion of the case in De Broe, *supra* note 18, at 699-701.

62 115 F.3d 506 (7th Cir. 1997). For a useful discussion of this case, see Brauner, *supra* note 40, at 149-51.

subsidiary (“Finance”) in the Netherlands Antilles, which issued notes in the euro-bond market at a rate of 17.25 percent and loaned these funds to the taxpayer at a rate of 18.25 percent. The Seventh Circuit court rejected the commissioner’s argument that Finance should be disregarded for tax purposes because the transactions were undertaken to avoid US withholding tax that would have been payable had the taxpayer itself issued notes in the eurobond market.⁶³ Notwithstanding that the taxpayer guaranteed all payments on the euronotes issued by Finance and that Finance was wound up less than a year after the back-to-back loans were repaid, the court held that the transactions were “recognizable for tax purposes, despite any tax-avoidance motive” because Finance conducted “recognizable” though “concededly minimal” business activity, and the transactions resulted in “actual, non-tax-related changes” in its “economic position” since it earned a profit from the spread in interest rates and reinvested profits.⁶⁴ As a result, the court concluded, the arrangement “had economic substance” to both Finance and the taxpayer.⁶⁵

Similarly, in *SARL Foundation Industries France*,⁶⁶ where a French company paid royalties to a Dutch company, which distributed 93 percent to 98 percent of those royalties to another company resident in the Netherlands Antilles, the Administrative Tribunal of Lille rejected the argument of the French tax authorities that the Dutch company should be disregarded for the purposes of the withholding tax exemption under the France-Netherlands tax treaty.⁶⁷ Although the terms of the licence agreements required the Dutch company to verify the accounts of the French sublicensee and convey this information to the Antillean company if requested, the court held that this evidence was not sufficient to conclude that the Dutch company was a mere financial agent for the Antillean company. As in *Northern Indiana Public Service Corp.*, therefore, minimal business activity and an economic profit were sufficient for the Dutch company to be recognized for tax purposes.

Similar considerations entered into the Tax Court of Canada decision in *MIL Investments (SA) v. The Queen*.⁶⁸ In this case, the taxpayer, which was a resident of the Cayman Islands and was wholly owned by an individual who was a resident of

63 *Northern Indiana*, supra note 62, at 511.

64 *Ibid.*, at 512-14.

65 *Ibid.*, at 514.

66 (March 19, 1999), case nos. 95-5403 and 96-738, RJF 8-9/99 no. 961 (Admin. Trib. Lille). For brief discussions of this case, see De Broe, supra note 18, at 697; and Daniel Gutmann, “Beneficial Ownership Without Specific Beneficial Ownership Provision,” in *Beneficial Ownership: Recent Trends*, supra note 40, 161-66, at 165.

67 Convention Between the Government of the French Republic and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, signed on March 16, 1973 (herein referred to as “the France-Netherlands tax treaty”).

68 *MIL Investments*, supra note 17.

Monaco, owned shares of a Canadian mining company called Diamond Field Resources (“DFR”), the value of which had increased substantially and was primarily attributable to immovable property situated in Canada. Before selling most of those shares, the taxpayer reduced its percentage interest in DFR to slightly less than 10 percent and continued into Luxembourg, where the gain was exempt from domestic tax owing to a step-up in the cost of the shares. Although the gain was taxable in Canada under domestic law, the taxpayer claimed an exemption under article 13 of the Canada-Luxembourg tax treaty; paragraph (4) of that article extends source taxation to gains from the alienation of shares deriving their value principally from immovable property situated in a state only where the shares form part of a “substantial interest” in the company, which the provision specifically defines as “10 per cent or more of the shares of any class.”⁶⁹

Accepting the testimony of the taxpayer’s sole shareholder that he wanted “to get back to exploring and building mines in Africa”⁷⁰ and the argument of the taxpayer’s counsel that “Luxembourg was a better jurisdiction than the Cayman Islands in which to carry on a mining business in Africa,”⁷¹ the Tax Court held that the Canadian GAAR did not apply because none of the transactions, including the continuation into Luxembourg, were avoidance transactions that were undertaken primarily to obtain a tax benefit.⁷² In addition, the court continued, even if one or more of the transactions had been primarily tax-motivated, GAAR would not apply because none of the transactions abused either the treaty as a whole or the specific provision on which the taxpayer relied. On the contrary, the court concluded, “the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive”⁷³ and the taxpayer’s “reliance upon a Treaty provision as agreed upon by both Canada and Luxembourg cannot be viewed as being a misuse or abuse.”⁷⁴

69 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, signed at Luxembourg on September 10, 1999 (herein referred to as “the Canada-Luxembourg tax treaty”).

70 *MIL Investments*, supra note 17, at paragraph 46.

71 *Ibid.*, at paragraph 49.

72 *Ibid.*, at paragraph 67.

73 *Ibid.*, at paragraph 72.

74 *Ibid.*, at paragraph 74, noting that the exemption in article 13(4) of the treaty was “not found in the OECD model convention upon which the Treaty is based” and concluding on this basis that “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 court also suggested that the circumstances would have been different had the taxpayer originally been a resident of Canada rather than the Cayman Islands, since emigration to Luxembourg would have triggered the exit tax under section 128.1 of the Income Tax Act, and article 13(6) of the treaty would have given Canada the right to tax any gains realized by former residents of Canada for six years. *Ibid.*, at paragraph 75.

On appeal, the taxpayer conceded that the continuation into Luxembourg was an avoidance transaction,⁷⁵ but the Federal Court of Appeal nonetheless upheld the decision on the ground that the Crown had failed to establish that the transactions were abusive. According to the court, it was “unable to find . . . an object or purpose” behind the treaty provision that would justify the court’s “departure from the plain words” of the text.⁷⁶ Nor was the court persuaded that “the Tax Treaty should not be interpreted so as to permit double non-taxation,” since “the issue raised by GAAR is the incidence of Canadian taxation, not the foregoing of revenues by the Luxembourg fiscal authorities.”⁷⁷ Unlike the decision in *Northern Indiana Public Service Corp.*, therefore, the appellate court decision in *MIL Investments* turned not on the existence of any bona fide business activity or economic substance in Luxembourg, but on the Crown’s failure to demonstrate that admitted tax-motivated treaty shopping was contrary to the object and purpose of the Canada-Luxembourg tax treaty or the provision on which the taxpayer relied. As will be explained in the second part of this article, the object and purpose of a tax treaty or treaty provision are a key aspect of the PPT, the interpretation of which is apt to pose the greatest difficulty in the application of the test—though this interpretive exercise will now be guided by the amended preamble text and other provisions of the MLI as well as the OECD commentaries.

Implicit General Anti-Abuse Principle

Regardless of whether tax treaty shopping is disallowed under domestic anti-avoidance doctrines and statutory general anti-avoidance rules, some commentators and tax authorities have taken the position that such transactions or arrangements may be challenged on the basis of an implicit or inherent general anti-abuse principle under international law. According to Klaus Vogel, such a principle may be derived from the *pacta sunt servanda* principle in article 26 of the Vienna Convention on the Law of Treaties, according to which treaties are to be performed “in good faith.”⁷⁸ Since this principle dictates that a contracting state “need not tolerate a circumvention of a treaty by the other contracting State,” Vogel maintains, “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.”⁷⁹ As a result, he concludes, tax treaties are “subject to a general

75 *Canada v. MIL Investments (SA)*, 2007 FCA 236, at paragraph 3.

76 *Ibid.*, at paragraph 6. The court added, *ibid.*, at paragraph 7, that “[i]f the object of the exempting provision was to be limited to portfolio investments, or to non-controlling interests in immoveable property . . . , it would have been easy enough to say so.”

77 *Ibid.*, at paragraph 8.

78 Vienna Convention on the Law of Treaties, signed at Vienna on May 23, 1969, UN doc. A/Conf. 39/27, fourth annex, UNTS 1155/331.

79 Klaus Vogel et al., *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD-, UN- and US Model Conventions for the Avoidance of Double Taxation of Income and Capital* (Deventer, the Netherlands: Kluwer Law and Taxation, 1991), Introduction, at paragraph 121.

‘substance v. form proviso’ based on international law,” which “restricts the treaty’s binding effect under international law and thus also its binding effect under domestic law, since only so much of a treaty’s contents can become domestic law as is applicable by virtue of international law.”⁸⁰

Another argument for a general anti-abuse principle under international law looks to an alternative source of international law, namely, customary international law. According to David Ward,

[i]n light of the fact that the International Court of Justice has already given recognition to the principle of abuse of rights in interpreting treaties generally, that Article 26 of the *Vienna Convention* requires parties to a treaty to perform the treaties in good faith, that the principle of abuse of rights has been incorporated in the *Convention of the Law of the Sea* and, more specifically in a tax context, that anti-abuse principles have developed judicially or have been enacted by statute in the internal law of a great number of countries (albeit with some differences in the frequency of application and in the formulation of the rules and in the labels applied to them), one can say that an anti-abuse rule in taxation matters is one of the “general principles recognized by civilized nations.” (According to Article 38(1) of the *Statute of the International Court of Justice*, general principles recognized by civilized nations constitute one of the sources of international law.)⁸¹

On this basis, Ward concurs with Vogel’s conclusion that “a general anti-abuse doctrine should be recognized by tax administrations and courts generally in interpreting and applying tax treaties.”⁸²

A third rationale for an implicit anti-abuse principle turns not on the *pacta sunt servanda* principle nor on customary international law, but on general principles of treaty interpretation according to which a treaty is to be interpreted in good faith and in light of its object and purpose.⁸³ On this basis, Frank Engelen concludes that there is “a sound legal basis” for the existence of a general anti-abuse principle in the interpretation of a tax treaty irrespective of any such provision in the text of the treaty.⁸⁴ Luc De Broe arrives at a similar conclusion, suggesting that treaty benefits that might otherwise be claimed by a taxpayer under a tax treaty may be denied in circumstances where “the granting of such benefits would frustrate the treaty’s object and purpose.”⁸⁵

80 Ibid.

81 Davies, Ward & Beck, *Ward’s Tax Treaties 1996-1997* (Toronto: Carswell, 1996), at 61.

82 Ibid.

83 Vienna Convention on the Law of Treaties, *supra* note 78, at article 31(1).

84 Frank A. Engelen, *On Values and Norms: The Principle of Good Faith in the Law of Treaties and the Law of Tax Treaties in Particular* (Deventer, the Netherlands: Kluwer Law International, 2006), at 36.

85 De Broe, *supra* note 18, at 316.

Although the first of these arguments for an implicit anti-abuse principle under international law has been challenged on the basis that the *pacta sunt servanda* principle applies only to contracting states, and not to taxpayers who are not themselves parties to tax treaties,⁸⁶ and the second argument has been questioned on the ground that there is little international consensus on the existence of a general anti-abuse principle absent specific treaty provisions to this effect,⁸⁷ the third rationale for an implicit anti-abuse principle appears to have been more widely accepted.⁸⁸ At the same time, since general principles of treaty interpretation also require treaties to be interpreted according to their ordinary meaning,⁸⁹ it is not obvious that these interpretive principles allow treaty benefits to be denied on the basis of an object or purpose that is not consistent with the text of the treaty and supported by other authoritative indications of the intentions of the contracting states.⁹⁰ Indeed, since tax treaties have several purposes, some of which may be differently construed,⁹¹

86 See, for example, Stef van Weeghel, *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and the United States* (London: Kluwer Law International, 1998), at 116; Nathalie Goyette, *Countering Tax Treaty Abuses: A Canadian Perspective on an International Issue* (Toronto: Canadian Tax Foundation, 1999), at 10-12; and De Broe, *supra* note 18, at 302-8.

87 See, for example, De Broe, *supra* note 18, at 308-16. As will be explained in the second part of this article, the PPT is clearly intended to establish and codify an international consensus on a general anti-abuse principle.

88 See, for example, Stef van Weeghel and Anna Gunn, "A General Anti-Abuse Principle of International Law: Can It Be Applied in Tax Cases?" in Guglielmo Maisto, Angelo Nikolakakis, and John M. Ulmer, eds., *Essays on Tax Treaties: A Tribute to David A. Ward* (Toronto: Canadian Tax Foundation and International Bureau of Fiscal Documentation, 2013), 305-23, at 322, concurring with Engelen that "the requirement to grant treaty benefits in cases which are clearly abusive would be unreasonable."

89 Vienna Convention on the Law of Treaties, *supra* note 78, at article 31(1).

90 See, for example, De Broe, *supra* note 18, at 308, emphasizing that a denial of treaty benefits based on principles of treaty interpretation must be "supported by the terms of the treaty." According to the Vienna Convention on the Law of Treaties, *supra* note 78, the ordinary meaning of a treaty is to be determined "in context" (article 31(1)), and this context

shall comprise, in addition to the text, including its preamble and annexes:

(a) Any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty; and

(b) Any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty [article 31(2)].

It therefore follows that treaty interpretation may also take into account extrinsic materials such as explanatory memorandums jointly prepared by both contracting states or drafted by one state and approved by the other (for example, the technical explanation to the Canada-US tax treaty) as well as OECD commentaries existing at the time the treaty was concluded.

De Broe, *supra* note 18, at 345. On the relevance of the OECD model convention and OECD commentaries to the interpretation of tax treaties, see *Crown Forest Industries Ltd. v. Canada*, [1995] 2 SCR 802.

91 Although the primary purpose of a tax treaty is generally said to be the elimination of double taxation (accomplished through distributive provisions and the elimination-of-double-taxation

and since the object or purpose of many tax treaty provisions is not clearly stated in the text of the treaty or in explanatory memorandums and commentaries,⁹² the application of an implicit anti-abuse principle based on unstated objects and purposes can be difficult and highly uncertain.⁹³ For this reason, most commentators who have affirmed the existence of an implicit anti-abuse principle have insisted on a high threshold for its application,⁹⁴ limiting its reach to “wholly artificial” transactions or arrangements that are entered into solely for the purpose of avoiding tax.⁹⁵

provision), this purpose is arguably subordinate to a more general purpose of allocating taxing rights between the contracting states, which is itself subsidiary to an overriding purpose of reducing or eliminating tax barriers to cross-border economic activity. See, for example, De Broe, *supra* note 18, at 325-29. Other purposes of tax treaties include the prevention of fiscal evasion (accomplished through information exchange and assistance in the collection of taxes), non-discrimination, and the resolution of tax disputes through the mutual agreement procedure. Where the primary purpose of a tax treaty is construed as the elimination of double taxation, it is of course much easier to derive a corresponding purpose to prevent tax avoidance resulting in double non-taxation. As will be explained in the second part of this article, the revised preamble language in article 6(1) of the MLI is clearly intended to influence the interpretation of the PPT.

- 92 See, for example, Richard Vann, “Beneficial Ownership: What Does History (and Maybe Policy) Tell Us,” in *Beneficial Ownership: Recent Trends*, *supra* note 40, 267-331, at 296, explaining that the OECD’s work on treaty abuse has been “bedeviled” by “the lack of a clear . . . elucidation of the policy (or rather policies . . .) underlying particular provisions in tax treaties”; and De Broe, *supra* note 18, at 344, stating that the distributive provisions of the OECD model convention are “drafted in general wording, in a sober and technical fashion”—making the determination of their object and purpose “not an easy task.” In this respect, see the Federal Court of Appeal decision in *MIL Investments*, *supra* note 75, at paragraph 6, stating that the court was “unable to find . . . an object or purpose” behind article 13(4) of the Canada-Luxembourg tax treaty that would justify the court’s “departure from the plain words” of the text.
- 93 See, for example, van Weeghel and Gunn, *supra* note 88, at 323, describing the application of an implicit anti-abuse principle as “rather arbitrary.” As will be explained in the second part of this article, a similar challenge exists with the “object and purpose” criterion of the PPT.
- 94 See, for example, Klaus Vogel et al., *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD-, UN- and US Model Conventions for the Avoidance of Double Taxation on Income and Capital*, 3d ed. (London: Kluwer Law International, 1997), article 1, at paragraph 95, stating 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.” As will be discussed in the second part of this article, the threshold for the PPT is much lower, such that the test applies where “one of the principal purposes” of a transaction or arrangement was to obtain a treaty benefit.
- 95 Engelen, *supra* note 84, at 36. See also van Weeghel, *supra* note 86, at 258, stating that the improper use of a tax treaty must have “the sole intention to avoid the tax of one or both contracting states and must defeat fundamental and enduring expectations and policy objectives shared by both states and therewith the purpose of a treaty in the broad sense”; and De Broe, *supra* note 18, at 320, arguing that because tax treaties provide specific tax benefits in order to encourage cross-border economic activities, “[i]t would be contrary to the object and purpose of a tax treaty if a transaction that has a reasonable business justification would be denied treaty

At the OECD, the Committee on Fiscal Affairs originally rejected the idea of an implicit general anti-abuse principle, concluding in the 1987 conduit companies report that the *pacta sunt servanda* principle requires the contracting states to a tax treaty to grant treaty benefits “even if considered to be improper,” absent explicit anti-abuse provisions within the treaty itself.⁹⁶ For this reason, some treaties include specific provisions declaring that treaty benefits may be denied where doing otherwise would result in an abuse of the treaty’s provisions.⁹⁷ Until the MLI, however, the inclusion of explicit general anti-abuse provisions in tax treaties was “the exception rather than the rule.”⁹⁸

Despite the OECD’s initial unwillingness to recognize an implicit anti-abuse principle, that position changed by 2003, as the OECD grew increasingly concerned that the expanding tax treaty network posed greater risks of abuse,⁹⁹ and that the increased use of conduit arrangements could result in the granting of tax treaty benefits that were not intended by the contracting states.¹⁰⁰ Explaining that some states consider the abuse of a tax treaty to be an abuse of domestic-law provisions

protection because that transaction also permits the taxpayer to alleviate his tax burden,” and concluding on this basis that transactions or arrangements defeat the object and purpose of a tax treaty only where they serve “no purpose other than obtaining the tax advantages.”

96 OECD conduit companies report, *supra* note 18, at paragraph 43.

97 See, for example, article XXIX A(7) of the Canada-US tax treaty, *supra* note 48, which was added by the third protocol in 1995, and article 29(6) of the Canada-Germany tax treaty, which was added in 2001 (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, signed at Berlin on April 19, 2001). In the absence of these provisions, an inference might be drawn that the parties intended that the treaty would not be subject to a general anti-abuse principle. See, for example, Nathalie Goyette and Phil D. Halvorson, “Canada,” in International Fiscal Association, *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, Cahiers de droit fiscal international vol. 95a (The Hague: Sdu Uitgevers, 2010), 171-91, at 185. Indeed, this was the basis for the Tax Court of Canada’s conclusion in *MIL Investments*, *supra* note 17, at paragraph 87, that the Canada-Luxembourg tax treaty could not be “construed as containing an inherent anti-abuse rule.”

98 Stef van Weeghel, “General Report,” in *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, *supra* note 97, 17-55, at 46.

99 Paragraph 8 of the commentary on article 1 of the 2003 OECD model convention (Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, January 2003)), noting 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 law and the reliefs from tax provided for in double taxation conventions.” This observation appears in paragraph 55 of the commentary on article 1 of the current OECD model convention, which, significantly, substitutes the word “arrangements” for the original words “artificial legal constructions.”

100 Paragraph 11 of the commentary on article 1 of the 2003 OECD model convention, *supra* note 99, stating that “there has been a growing tendency toward the use of conduit companies to obtain treaty benefits not intended by the Contracting States in their bilateral negotiations.”

under which taxes are levied,¹⁰¹ while others “consider 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,”¹⁰² the revised OECD commentary concluded that both approaches allow states to deny the benefits of a tax convention “where arrangements that constitute an abuse of the provisions of the convention have been entered into.”¹⁰³ More generally, the commentary stated, although “it should not be lightly assumed” that a taxpayer has entered into an abusive transaction or arrangement,

[a] guiding principle is that the benefits of a double taxation 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.¹⁰⁴

With this “guiding principle,” therefore, the OECD accepted the idea of an implicit general anti-abuse principle that it had rejected several years earlier.

In addition to these statements, the revised OECD commentary contained two other comments of relevance to the possible application of the guiding principle. First, the commentary declared that although the principal purpose of double taxation conventions is “to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons,” it is also a purpose of tax conventions “to prevent tax avoidance and evasion.”¹⁰⁵ Second, the commentary provided two examples of tax-treaty-shopping transactions or arrangements to which a specific or general anti-abuse provision might be expected to apply: the first involving “a person (whether or not a resident of a Contracting State)” who “acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly”; the second involving “an individual

101 Paragraph 9.2 of the commentary on article 1 of the 2003 OECD model convention, *supra* note 99. This language appears in paragraph 58 of the commentary on article 1 of the current OECD model convention.

102 Paragraph 9.3 of the commentary on article 1 of the 2003 OECD model convention, *supra* note 99. This language appears in paragraph 59 of the commentary on article 1 of the current OECD model convention.

103 Paragraph 9.4 of the commentary on article 1 of the 2003 OECD model convention, *supra* note 99. This language appears in paragraph 60 of the commentary on article 1 of the current OECD model convention.

104 Paragraph 9.5 of the commentary on article 1 of the 2003 OECD model convention, *supra* note 99. This language appears in paragraph 61 of the commentary on article 1 of the current OECD model convention.

105 Paragraph 7 of the commentary on article 1 of the 2003 OECD model convention, *supra* note 99. Similar language appears in paragraph 54 of the commentary on article 1 of the current OECD model convention, which also states that these purposes are “confirmed” by the revised preamble to the convention.

who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, . . . who, essentially in order to sell the shares and escape taxation in that State on the capital gains from the alienation . . . transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax.”¹⁰⁶

Although these revisions to the OECD commentary have been criticized on the grounds that there is little basis for the claim that a purpose of tax treaties is to prevent avoidance,¹⁰⁷ and that the guiding principle established a low and indeterminate threshold for determining whether a transaction or arrangement was abusive,¹⁰⁸ the changes appear to have had a significant influence on some judicial

106 Paragraph 9 of the commentary on article 1 of the 2003 OECD model convention, *supra* note 99. Identical language appears in paragraph 56 of the commentary on article 1 of the current OECD model convention.

107 See, for example, De Broe, *supra* note 18, at 330-37, arguing that this claim has little support in the provisions of most tax treaties and is inconsistent with the function of tax treaties to restrict the application of domestic law. See also Brian J. Arnold, “Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model” (2004) 58:6 *Bulletin for International Fiscal Documentation* 244-60. Arnold states, *ibid.*, at 249, that “it can be argued that the purpose of preventing tax avoidance was created out of thin air by the OECD in 2003,” but he notes as well (*ibid.*, at 247) that the exchange-of-information provision of tax treaties can be useful in combatting tax avoidance as well as tax evasion. Although the OECD commentary continues to state that a purpose of tax treaties is to prevent avoidance, the amended preamble language in article 6(1) of the MLI is somewhat different, stating instead that a CTA is not intended to create opportunities for non-taxation or to reduce taxation through tax avoidance. In this respect, see De Broe, *supra* note 18, at 337, arguing that “the correct view” is that “treaties are not meant to facilitate avoidance.”

108 See, for example, De Broe, *supra* note 18, at 319-25, arguing that the first component of the guiding principle requiring a tax motivation to be “a main purpose for entering into certain transactions or arrangements” is contrary to the principal purpose of tax treaties, which is to encourage cross-border economic activities through treaty reliefs and benefits. See also Adolfo Martín Jiménez, “The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries?” (2004) 58:1 *Bulletin for International Fiscal Documentation* 17-30, at 18-19, arguing that the examples of “abusive” tax treaty shopping in paragraph 9 of the revised OECD commentaries may involve legitimate tax planning with real substance; and Juan José Zomoza Pérez and Andrés Báez, “The 2003 Revisions to the Commentary to the OECD Model on Tax Treaties and GAARs: A Mistaken Starting Point,” in Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer, Alfred Storck, and Martin Zagler, eds., *Tax Treaties: Building Bridges Between Law and Economics* (Amsterdam: International Bureau of Fiscal Documentation, 2010), 129-59, at 155-58, arguing that the object and purpose component of the guiding principle is “circular” if a purpose of tax treaties includes the prevention of avoidance, and that the OECD ought to have designed “a standard that does not rely on the object and purpose of the treaty provisions, but on the special characteristics of the arrangements,” specifically artificiality. Arnold acknowledges the “circularity” critique, but he rightly points out that the object and purpose requirement presumably turns not on a finding of tax motivation, but on the existence of “a more specific treaty scheme or purpose that is frustrated or abused by the transaction.” Arnold, *supra* note 107, at 247. Since many of these criticisms of the OECD’s guiding principle may also be applied to the PPT, they will be addressed in more detail in the second part of this article.

decisions involving tax treaty shopping.¹⁰⁹ In *A Holdings ApS v. Federal Tax Administration*,¹¹⁰ where a company resident in Guernsey established a Danish holding company whose only activity was to own shares of a company resident in Switzerland, the Federal Court of Switzerland relied on an implicit anti-abuse principle to deny the Danish company the benefit of a withholding tax exemption on dividends that would otherwise have been available to a resident of Denmark under the Switzerland-Denmark tax treaty.¹¹¹ Although the court noted that Denmark recognized an abuse-of-rights concept and that the treaty did not include any reservation regarding the Swiss anti-abuse decree, suggesting that the treaty benefit might be denied under domestic law, the decision turns on the recognition of an implicit anti-abuse principle in all tax treaties. According to the court, “[b]ecause the prohibition of abuses is part of the principle of good faith” in international law, “the prohibition of an abuse of rights as regards conventions is . . . recognised . . . without [it] being necessary to adopt an explicit provision in the respective convention.”¹¹²

Likewise, in *Yanko-Weiss v. Holon Assessing Office*,¹¹³ where a company that was incorporated in Israel moved its place of management to Belgium and became a resident of Belgium under Belgian tax law, the District Court of Tel Aviv relied on an implicit anti-abuse principle to dismiss the taxpayer’s argument that the Israel-Belgium tax treaty¹¹⁴ required the Israeli tax authority to extend treaty benefits to dividends paid to the taxpayer by an Israeli subsidiary even though the company’s emigration to Belgium was solely tax-motivated.¹¹⁵ According to the court,

[t]ax 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 use can be made of them which constitutes improper use of provisions set forth and the benefits which they grant.¹¹⁶

109 See van Weeghel, supra note 98, at 41.

110 (2005), 8 ITLR 536 (Swiss FC).

111 Convention Between the Swiss Confederation and the Kingdom of Denmark for the Avoidance of Double Taxation with Respect to Taxes on Income and Net Worth, signed November 23, 1973. For useful discussions of the case, see De Broe, supra note 18, at 445-48; van Weeghel, supra note 98, at 38; and René Matteotti and Fabian M. Sutter, “Switzerland: Broad vs Narrow Interpretation of the Beneficial Owner Concept,” in *Beneficial Ownership: Recent Trends*, supra note 40, 51-58, at 51-54.

112 *A Holdings ApS*, supra note 110, at paragraph 3.4.3.

113 (2007), 10 ITLR 524 (Tel Aviv-Yafo DC).

114 Convention Between the State of Israel and the Kingdom of Belgium for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, signed at Brussels on July 13, 1972.

115 For useful discussions of the case, see Guy Katz, “Israel,” in *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, supra note 97, 407-26, at 417-18; and van Weeghel, supra note 98, at 37.

116 *Yanko-Weiss Holdings*, supra note 113, at 544 (also cited in David A. Ward, *Access to Tax Treaty Benefits*, Research Report Prepared for the Advisory Panel on Canada’s System of International Taxation (Ottawa: Department of Finance, September 2008), at 22).

On the contrary, it concluded:

[T]reaties 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 the domestic law and international law.¹¹⁷

In contrast to these judgments, however, other notable tax cases have rejected the argument that treaty-shopping transactions or arrangements are inherently abusive. In *Union of India v. Azadi Bachao Andolan*,¹¹⁸ a public interest organization challenged a tax department circular confirming that capital gains realized by Mauritian residents from the alienation of shares of Indian companies were exempt from Indian tax under article 13 of the India-Mauritius tax treaty.¹¹⁹ The Supreme Court of India refused to regard tax treaty shopping as an illegal “fraud on the treaty” on the grounds that developing countries allow treaty shopping to encourage capital and technology inflows, that treaty shopping may have been intended when the treaty was entered into, and that the Indian minister of finance had himself encouraged the use of conduit companies in Mauritius as a way to promote capital investment into India.¹²⁰ Two other cases involved residents of the Netherlands who were sole shareholders of Dutch companies, both of whom emigrated to Belgium and transferred the effective management of their companies to Belgium shortly before realizing proceeds from the liquidation or alienation of these companies.¹²¹ The Hoge Raad (Dutch Supreme Court) rejected the argument advanced by the Dutch tax authorities that the proceeds should be taxable in the Netherlands on a reasonable application of the Netherlands-Belgium tax treaty,¹²² on the ground that neither the text of the treaty nor extrinsic materials evidencing the intentions of the contracting states demonstrated that the object and purpose of the treaty would be

117 *Yanko-Weiss Holdings*, supra note 113, at 545. According to the court, *ibid.*, at 546, “[t]his approach is in line 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.”

118 (2003), 6 ITLR 233 (India SC).

119 Convention Between the Government of the Republic of India and the Government of Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at Port Louis on August 24, 1982.

120 This case is briefly discussed in Alope J. Majumdar and P.V. Satya Prasad, “India,” in *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, supra note 97, 369-88, at 372-73; and van Weeghel, supra note 98, at 38-39.

121 (May 12, 2006), BNB 2007/36c and BNB 2007/42 (Netherlands SC). These cases are briefly discussed in De Broe, supra note 18, at 412-13.

122 Convention Between the Kingdom of the Netherlands and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and the Regulation of Certain Other Fiscal Matters, signed at Brussels on October 19, 1970.

frustrated if the proceeds were not taxed in the Netherlands. Like Canada's Federal Court of Appeal in *MIL Investments*,¹²³ the courts in these cases could not identify any underlying object or purpose in the applicable treaty provision or the treaty as a whole that would render the transactions or arrangements abusive.

Beneficial Ownership

In addition to domestic anti-avoidance doctrines and statutory general anti-avoidance rules, and the notion of an implicit anti-abuse principle under international law, the concept of beneficial ownership has provided another approach for tax authorities to challenge treaty-shopping transactions or arrangements. Introduced into the OECD model convention in 1977, the requirement that the recipient of a payment be its "beneficial owner" determines the eligibility of residents of a contracting state for the reduction or elimination of source-country withholding taxes on dividends, interest, and royalties under articles 10, 11, and 12 of the OECD model convention and corresponding provisions of bilateral tax treaties.¹²⁴

Origins and Pre-2014 OECD Commentaries

First included in the 1942 tax treaty between Canada and the United States,¹²⁵ and added by the 1966 protocol to the 1945 UK-US tax treaty,¹²⁶ the original purpose of the "beneficial owner" language appears to have been primarily to ensure that treaty benefits available for payments to nominees and agents were extended to the persons on whose behalf these payments were received.¹²⁷ At the same time, recognition that a resident of one contracting state might deliberately transfer income

123 See *supra* note 75 and the accompanying text.

124 OECD model convention, article 10(2) (reducing the withholding tax rate on dividends paid to a beneficial owner who is resident in the other contracting state); article 11(2) (reducing the withholding tax rate on interest paid to a beneficial owner who is resident in the other contracting state); and article 12(1) (prohibiting source-country taxation of royalties that are beneficially owned by a resident of the other contracting state) (introduced in the 1977 OECD model convention, *infra* note 129).

125 Convention Between Canada and the United States of America for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance in the Case of Income Taxes, signed at Washington, DC on March 4, 1942 (herein referred to as "the 1942 Canada-US tax treaty").

126 Protocol signed in 1966 amending the Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Washington, DC on April 16, 1945 (herein referred to as "the UK-US tax treaty"). See Vann, *supra* note 92, at 271; and John F. Avery-Jones et al., "The Origins of Concepts and Expressions Used in the OECD Model and Their Adoption by States" [2006] no. 6 *British Tax Review* 695-765, at 753-54.

127 Vann, *supra* note 92, at 273-79. In addition, Vann explains, the concept was used "to ensure that the reduced rate of tax on subsidiary parent dividends only applied if the subsidiary was a real subsidiary" that "was genuinely owned long term by the parent." *Ibid.*, at 271-72.

rights to a nominee in a third state in order to obtain otherwise unavailable treaty benefits suggested that the concept could also serve an anti-abuse function to prevent tax treaty shopping.¹²⁸ On this basis, the commentary to the 1977 OECD model convention explained that “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.”¹²⁹

Since opportunities for tax treaty shopping are not limited to nominees and agents, however, it was not long before the OECD identified the use of other conduit arrangements as targets to which the beneficial ownership concept might also apply to deny treaty benefits. According to the OECD conduit companies report, although the commentary to the model convention mentioned only “the case of a nominee or agent” when discussing the beneficial owner limitation on treaty benefits for dividends, interest, and royalties, the concept would also apply to “other cases where a person enters into contracts or takes over obligations under which he has a similar function to a nominee or an agent.”¹³⁰ As a result, the report concluded:

[A] conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company).¹³¹

Explaining, however, that “it will usually be difficult for the country of source to show that the conduit company is not the beneficial owner” and that “not even the country of residence of the conduit company may have the necessary information regarding the shareholders of the conduit company,” the report added that the commentary, “apparently in view of these difficulties,” had observed that the treatment of these companies could be determined through bilateral negotiations.¹³² With this statement in mind, much of the report discussed various tax treaty provisions that might be adopted to prevent the use of conduit companies for tax treaty shopping.¹³³

128 Ibid., at 281, noting that the “agent/nominee situation could be deliberately contrived,” and *ibid.*, at 281-96, reviewing discussions at the OECD leading up to the 1977 amendments to the OECD model convention, *infra* note 129.

129 Paragraph 12 of the commentary on article 10 of the 1977 OECD model convention: Organisation for Economic Co-operation and Development, *Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 1977).

130 OECD conduit companies report, *supra* note 18, at paragraph 14(b).

131 Ibid., adding that the fact that a company’s “main function is to hold assets or rights” is “not itself sufficient” to categorize a company as “a mere intermediary.”

132 Ibid.

133 Ibid., at paragraphs 21-42. These provisions are discussed below under the heading “Treaty-Based Specific Anti-Avoidance Rules.” According to Vann, *supra* note 92, at 298, these provisions were the “real value” of the report.

Although the comments in the OECD conduit companies report extending the scope of the beneficial owner limitation to conduit companies were not included in the commentary to the OECD model convention when it was revised in 1992,¹³⁴ they were adopted as part of the 2003 revisions to the commentary. According to paragraph 12.1 of the 2003 commentary on article 10 addressing the taxation of dividends,

[w]here an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally 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. For these reasons, the report from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Conduit Companies” concluded that 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.¹³⁵

Identical language was also added to the commentaries on articles 11 and 12 dealing with interest and royalties.¹³⁶

In addition to these paragraphs, the 2003 revisions also included more general language stating that

[t]he term “beneficial owner” is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention,

134 Vann, *supra* note 92, at 298.

135 Paragraph 12.1 of the commentary on article 10 of the 2003 OECD model convention, *supra* note 99. This language appears in paragraphs 12.2 and 12.3 of the commentary on article 10 of the current OECD model convention.

136 Paragraph 8.1 of the commentary on article 11 and paragraph 4.1 of the commentary on article 12 of the 2003 OECD model convention, *supra* note 99. This language appears in paragraphs 10 and 10.1 of the commentary on article 11, and paragraphs 4.1 and 4.2 of the commentary on article 12 of the current OECD model convention. The text of these commentaries commences with an introductory sentence stating that “[r]elief or exemption in respect of an item of income is granted by the State of source to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence.” Curiously, this sentence is omitted from the commentary on article 10.

including avoiding double taxation and the prevention of fiscal evasion and avoidance.¹³⁷

As a result, the revised commentary suggested that the concept of beneficial owner should not only apply to exclude nominees and agents, but also be broadly interpreted to prevent tax avoidance associated with the use of conduit arrangements more generally.

Interpretive Options

Since neither the commentary nor the OECD model convention actually defined the meaning of beneficial owner, the addition of this language to the 1977 OECD model convention and the 2003 revisions to the commentary created a difficult interpretive challenge.¹³⁸ On the one hand, it might be argued that the term should be interpreted according to the domestic-law meaning applied by the relevant state.¹³⁹ On the other hand, it could be argued that the OECD model convention adopted a common-law concept of beneficial ownership as the meaning for treaty purposes irrespective of the domestic law of the relevant state.¹⁴⁰ Alternatively, the tax treaty meaning of beneficial owner could have a separate “international fiscal meaning” independent of either the domestic law of the relevant state or common-law concepts.¹⁴¹

Although the first approach is arguably consistent with article 3(2) of the OECD model convention and corresponding provisions of bilateral tax treaties, according to which a term that is not defined in a tax convention “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,” this rule cannot apply where the domestic law of the state in question has no concept of beneficial ownership, as is the case in most civil-law jurisdictions,¹⁴² and it is difficult to apply where domestic law interprets beneficial ownership in different ways for different

137 Paragraph 12 of the commentary on article 10, paragraph 9 of the commentary on article 11, and paragraph 4 of the commentary on article 12 of the 2003 OECD model convention, *supra* note 99. This language appears in paragraph 12.1 of the commentary on article 10, paragraph 9.1 of the commentary on article 11, and paragraph 4 of the commentary on article 12 of the current OECD model convention.

138 For a useful overview of the various interpretive options, see De Broe, *supra* note 18, at 662-94.

139 See, for example, H. Pijl, “Beneficial Ownership and Second Tier Beneficial Owners in Tax Treaties of the Netherlands” (2003) 31:10 *Intertax* 353-61.

140 See, for example, Charl P. du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* (Amsterdam: International Bureau of Fiscal Documentation, 1999).

141 Philip Baker, *Double Taxation Conventions*, 3d ed. (London: Sweet & Maxwell) (looseleaf), at section 10B-14.

142 De Broe, *supra* note 18, at 668.

purposes, as is the case in at least some common-law jurisdictions.¹⁴³ Nor is it desirable to apply a domestic-law meaning only for the purposes of taxes imposed by states with a clear domestic-law meaning of beneficial ownership, since this would result in different meanings of the term “beneficial owner” in different treaties and asymmetrical meanings in treaties where one of the contracting states does not recognize the concept in its domestic law.¹⁴⁴ In addition, the OECD commentary makes no reference to domestic-law meanings of beneficial ownership, and the 2003 revisions to the commentary explicitly state that “the term . . . is not used in a narrow and technical sense” but “rather . . . 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 and avoidance.”¹⁴⁵ For these reasons, even where a meaning of the term “beneficial owner” can be determined under the domestic law of the relevant state, it seems reasonable to conclude that the context in which the term is used in the OECD model convention and in bilateral tax treaties based on the model convention requires a meaning other than that under domestic law.¹⁴⁶

The second interpretation, that the OECD model convention adopted a common-law concept of beneficial ownership as an independent treaty concept, is also unconvincing. Although the term “beneficial owner” is itself obviously derived from common-law legal systems and was originally used in tax treaties between common-law jurisdictions, the common-law concept relates to the ownership of assets while the tax treaty concept concerns entitlement to income, suggesting that these are different concepts with different meanings.¹⁴⁷ This conclusion is also supported by translations of “beneficial owner” in other tax treaties, including in particular the official French version of the OECD model convention. Those translations refer not to ownership at all, but to the “real beneficiary” (“bénéficiaire effectif” in French

143 See, for example, Catherine Brown, “Symposium: Beneficial Ownership and the Income Tax Act” (2003) 51:1 *Canadian Tax Journal* 401-53, at 452, concluding that the term “beneficial ownership” may have “multiple meanings” for tax purposes, which “may change depending on the provision in issue.” In New Zealand, on the other hand, the concept of beneficial ownership apparently has a clear meaning under domestic law. Craig Elliffe, “The Interpretation and Meaning of ‘Beneficial Owner’ in New Zealand” [2009] no. 3 *British Tax Review* 276-305.

144 De Broe, supra note 18, at 669-71.

145 See supra note 137 and the accompanying text.

146 See, for example, De Broe, supra note 18, at 672; and Michael N. Kandev, “Tax Treaty Interpretation: Determining Domestic Meaning Under Article 3(2) of the OECD Model” (2007) 55:1 *Canadian Tax Journal* 31-71, at 59-60 and 69.

147 De Broe, supra note 18, at 679. The distinction is most apparent with respect to beneficiaries of common-law trusts, who are generally understood to be the beneficial owners of the trust property for common-law purposes but not necessarily the beneficial owners of trust income for tax treaty purposes. See John Prebble, “Accumulation Trusts and Double Tax Conventions” [2001] no. 1 *British Tax Review* 69-82, at 75-80.

and “*beneficario efectivo*” in Spanish) or the person who is “entitled to use” (“*Nutzungsberechtigter*” in German) or “ultimately entitled to” (“*Uiteindelijk gerechtigde*” in Dutch) the income.¹⁴⁸ Finally, there is nothing in the OECD commentary to suggest that the use of this term in the OECD model convention was intended to be limited to a common-law meaning, and the 2003 revisions to the commentary emphasize the very opposite—that “the term . . . is not used in a narrow and technical sense” but “rather . . . 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 and avoidance.”¹⁴⁹ Indeed, it is difficult to imagine that two civil-law jurisdictions would deliberately agree to incorporate a common-law concept into a bilateral tax treaty between them.¹⁵⁰ As a result, it seems reasonable to conclude that the tax treaty concept of beneficial ownership has an “international fiscal meaning” that is independent not only of the domestic law of the contracting states but also of any common-law meaning.¹⁵¹

Accepting that the term “beneficial owner” has an autonomous international fiscal meaning for tax treaty purposes, however, does not determine whether that meaning should be broadly construed according to the economic substance of transactions or arrangements, or be more narrowly understood in terms of their legal character. A broad economic approach is supported by a presumed purpose of the concept to discourage tax treaty shopping,¹⁵² and by statements in the 2003 revised OECD commentary that the term “beneficial owner” is not used “in a narrow technical sense,”¹⁵³ does not contemplate a person who “acts as a conduit for another person who *in fact* receives the benefit of the income concerned,”¹⁵⁴ and would not normally include a conduit company “if . . . it has, *as a practical matter*, very narrow powers . . . in relation to the income concerned.”¹⁵⁵ A narrower legal approach is premised on the original focus in the OECD commentary on agents or nominees,¹⁵⁶ on the statement in the 2003 commentary that a conduit company cannot be regarded as the beneficial owner of income where it has “very narrow powers which render it, in relation to the income concerned, a *mere fiduciary or administrator* acting on account of the interested parties,”¹⁵⁷ and on the fact that the 2003 revisions to the OECD commentary also included several paragraphs identifying treaty-based

148 See du Toit, *supra* note 140, at 165.

149 See *supra* note 137 and the accompanying text.

150 De Broe, *supra* note 18, at 679.

151 *Ibid.*

152 See, for example, Pijl, *supra* note 139, at 354-56.

153 See *supra* note 137 and the accompanying text.

154 See *supra* note 135 and the accompanying text (emphasis added).

155 *Ibid.* (emphasis added).

156 See *supra* note 129 and the accompanying text.

157 See *supra* note 135 and the accompanying text (emphasis added). See, for example, De Broe, *supra* note 18, at 686.

specific anti-avoidance rules to address conduit arrangements¹⁵⁸—which arguably would be unnecessary if the term “beneficial owner” were broadly construed as an anti-avoidance concept that can be used to challenge any conduit arrangement.¹⁵⁹ Moreover, to the extent that the 2003 revisions to the OECD commentary expanded the meaning of beneficial owner, it might also be argued that a broad economic understanding of this term should not apply to tax treaties that were concluded before these revisions.¹⁶⁰ In the absence of any further guidance, however, the meaning of the tax treaty concept of beneficial ownership was left to the courts.

Judicial Decisions

Perhaps not surprisingly, given varied statements in the OECD commentaries, judicial decisions following the 2003 revisions have taken different positions on the meaning of beneficial ownership, with some courts adopting a broad economic approach and others emphasizing the legal character of the transactions or arrangements at issue.¹⁶¹ In *Indofood International Finance Ltd. v. JP Morgan Chase Bank, NA, London Branch*,¹⁶² for example, where the UK courts were called upon to rule on the viability of a proposed financing arrangement in order to resolve a commercial dispute, the High Court construed the meaning of the term “beneficial owner” by reference to

158 Paragraphs 13-20 of the commentary on article 1 of the 2003 OECD model convention, *supra* note 99. See the discussion below under the heading “Treaty-Based Specific Anti-Avoidance Rules.”

159 Adolfo Martín Jiménez, “Beneficial Ownership: Current Trends” (2010) 2:1 *World Tax Journal* 35-63, at 54.

160 Although opinions differ on the relevance of subsequent OECD commentaries to the interpretation of treaties concluded before the commentaries were adopted, most commentators conclude that revisions that exceed mere clarification should not be taken into account. See, for example, John F. Avery Jones, “The Effect of Changes in the OECD Commentaries After a Treaty Is Concluded” (2002) 56:3 *Bulletin for International Fiscal Documentation* 102-9; Michael Lang and Florian Brugger, “The Role of the OECD Commentary in Tax Treaty Interpretation” (2008) 23:2 *Australian Tax Forum* 95-108; and Michael N. Kandeve and Matthew Peters, “Treaty Interpretation: The Concept of ‘Beneficial Owner’ in Canadian Tax Treaty Theory and Practice,” in *Report of Proceedings of the Sixty-Third Tax Conference, 2011 Conference Report* (Toronto: Canadian Tax Foundation, 2012), 26:1-60. In several cases, however, courts have been willing to consider the 2003 OECD commentary in interpreting the meaning of the term “beneficial owner” for the purposes of treaties concluded before 2003. See, for example, *Prévost Car Inc. v. The Queen*, 2009 FCA 57; *aff’g.* 2008 TCC 231, in which the Federal Court of Appeal stated (at paragraph 11) that “later Commentaries” could be relied upon to interpret a tax treaty concluded prior to these commentaries “when they 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 and when, of course, neither treaty partner has registered an objection to the new Commentaries.” This case is discussed in more detail below—see *infra* notes 201-211 and the accompanying text.

161 For a comprehensive review of cases in multiple jurisdictions, see Angelika Meindl-Ringer, *Beneficial Ownership in International Tax Law* (Alphen aan den Rijn, the Netherlands: Wolters Kluwer, 2016), at chapter 5.

162 [2005] EWHC 2103; *rev’d.* [2006] EWCA Civ. 158.

legal relationships while the Court of Appeal looked to economic or commercial substance.¹⁶³ The facts of the case involved an Indonesian company (“the parent guarantor”), which borrowed funds in 2002 through a Mauritian finance subsidiary (“the issuer”) in order to obtain the benefit of the 10 percent withholding tax rate under the 1996 Indonesia-Mauritius tax treaty.¹⁶⁴ When the Indonesian government terminated the treaty effective January 1, 2005, the issuer invoked an early redemption clause that was available if the treaty was terminated in order to refinance at lower interest rates prevailing at the time. Since the early redemption option was available only if there was no reasonable alternative arrangement through which a 10 percent withholding tax rate could be maintained, the lenders argued that early redemption was prohibited because the debt could be assigned to a new company resident in the Netherlands (“Newco”), which would be eligible for the same withholding tax rate as the Mauritian subsidiary. The issuer argued that the Indonesian tax authorities would not recognize Newco as the beneficial owner of the interest for the purpose of the reduced withholding tax rate under the Indonesia-Netherlands tax treaty.¹⁶⁵ As a result, the UK courts were put in the odd position of having to rule on how Indonesian law would view the proposed restructuring.

At the High Court, the issuer relied on correspondence in which the Indonesian tax authorities adopted a broad economic understanding of beneficial ownership, concluding that they would not regard Newco as the beneficial owner of interest received from the parent guarantor because “the term ‘beneficial owner’ means the actual owner of the interest income who truly has the full right to enjoy directly the benefits of that interest income,” not a “conduit company” such as Newco.¹⁶⁶ Rejecting this interpretation, the court adopted a legal conception of beneficial ownership, concluding that Newco would “not be a nominee or agent for any other party” or “any sort of trustee or fiduciary.”¹⁶⁷ Instead, the court reasoned, since

163 For useful discussions of the case, see De Broe, *supra* note 18, at 706-13; and Philip Baker, “United Kingdom: Indofood International Finance Ltd v. JP Morgan Chase Bank NA,” in *Beneficial Ownership: Recent Trends*, *supra* note 40, 27-38.

164 The Agreement Between the Government of the Republic of Mauritius and the Government of the Republic of Indonesia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Jakarta on December 10, 1996.

165 Convention Between the Government of the Republic of Indonesia and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Jakarta on January 29, 2002 (herein referred to as “the Indonesia-Netherlands tax treaty”).

166 *Indofood*, *supra* note 162 (HC), at paragraph 26.

167 *Ibid.*, at paragraph 46. Although this conclusion might suggest that the court adopted a domestic-law meaning of beneficial ownership based on the common law of England (which would have been inappropriate for the task before it—namely, determining how beneficial ownership would be understood in Indonesia), the court’s references to the OECD conduit companies report and the OECD commentaries as interpreted by Philip Baker suggest more strongly that it considered the international fiscal meaning of beneficial ownership to be indistinguishable from its common-law meaning.

Newco would “have the power to dispose of the interest when received as it wishes, although . . . constrained by its contractual obligation . . . to apply the proceeds of the interest” to the ultimate lenders,¹⁶⁸ and any undistributed interest that it received would be generally available to all its creditors in the event of its insolvency,¹⁶⁹ it followed that Newco would be the beneficial owner of the interest and the reduced withholding tax rate in the Indonesia-Netherlands tax treaty would apply.¹⁷⁰ On this basis, the High Court found for the lenders.

The Court of Appeal, on the other hand, adopted a broad meaning of beneficial ownership and allowed the issuer’s appeal on the basis that Newco would not be the beneficial owner of the interest. Since “the term ‘beneficial owner’ is to be given an international fiscal meaning not derived from domestic laws of contracting states,” the court explained, it was “by no means conclusive” that “neither the Issuer nor Newco was or would be a trustee, agent or nominee . . . in relation to the interest receivable from the Parent Guarantor.”¹⁷¹ On the contrary, the court continued, the 2003 OECD commentary and observations on that commentary demonstrate that “the concept of beneficial ownership is incompatible with that of the formal owner who does not have ‘the full privilege to directly benefit from the income.’”¹⁷² In addition, the court explained, since this concept is not limited to a “technical and legal . . . approach,” it follows that courts should have regard not only to the “legal, commercial and practical structure” of the arrangement, but also to “the substance of the matter.”¹⁷³ On both grounds, therefore, the court concluded that neither the issuer nor Newco could be regarded as the beneficial owner of the interest, since the former was and the latter would be “bound to pay” all interest received from the parent guarantor to the paying agent for the lenders once the interest was received,¹⁷⁴ making it “impossible to conceive of any ‘direct benefit’ from the interest payable by the Parent Guarantor except by funding its liability” to the lenders.¹⁷⁵ As a result, it followed that the assignment of the debt to Newco was not a reasonable alternative

168 *Indofood*, supra note 162 (HC), at paragraph 46.

169 *Ibid.*, at paragraph 49.

170 The High Court also concluded, *ibid.*, at paragraph 47, that Newco would have earned a profit on an interest-rate spread that the Netherlands tax authorities would have insisted upon under domestic “substance and risk” requirements. The Court of Appeal concluded that the High Court was mistaken on this point, since the “substance and risk” requirement “would be satisfied by providing Newco with a combination of ‘handling charges’ and paid up equity capital.” *Indofood*, supra note 162 (CA), at paragraph 22.

171 *Ibid.*, at paragraph 42.

172 *Ibid.*, citing a circular letter issued by the Indonesian director of general taxes (DTG).

173 *Ibid.*, at paragraphs 43-44.

174 *Ibid.* Indeed, it was agreed at the appeal hearing that the parent guarantor actually bypassed the issuer, making payments directly to the paying agent. *Ibid.*, at paragraph 13.

175 *Ibid.*, at paragraph 44, adding that neither the issuer nor Newco had “the ‘full privilege’ needed to qualify as the beneficial owner of the income, rather the position of Issuer and Newco equates to that of an ‘administrator of the income.’”

arrangement through which a 10 percent withholding tax rate could be maintained.¹⁷⁶

Although *Indofood* was a commercial case addressing the meaning of beneficial ownership in the context of the Indonesia-Netherlands tax treaty, the Court of Appeal's conclusion that the term "beneficial owner" has an international fiscal meaning implies that this meaning would apply to all states, and not only to Indonesia.¹⁷⁷ This point was not lost on Her Majesty's Revenue & Customs (HMRC), which released draft guidance on the decision that was subsequently incorporated into the HMRC *International Manual*.¹⁷⁸ The guidance explained that the Court of Appeal decision was consistent with UK policy and had "simply confirmed" the position taken in the OECD commentary that

beneficial ownership "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 and avoidance" and that tests of the legal structure, and of the commercial and practical substance of the scheme, should be adopted to determine beneficial ownership.¹⁷⁹

The guidance also stated that HMRC would apply this broad international fiscal meaning in the context of double tax conventions (DTCs) when "the substance of an arrangement amounts to an improper use of the relevant DTC in the light of the DTC's object of prevention of fiscal evasion and avoidance, for example, 'treaty shopping.'"¹⁸⁰ As a result, HMRC affirmed the use of beneficial ownership as an anti-avoidance concept to address tax treaty shopping.

Tax authorities and courts in other countries have also adopted a broad understanding of beneficial ownership in order to challenge treaty-shopping transactions or arrangements. In a number of Spanish cases involving payments by the Real Madrid football team to Hungarian companies for the image rights of various team members,¹⁸¹ the Audiencia Nacional held that the Hungarian companies were not the beneficial owners of the royalties on the ground that the concept of beneficial

176 *Ibid.*, at paragraph 59.

177 Baker, *supra* note 163, at 32.

178 United Kingdom, HM Revenue & Customs, *International Manual* (London: HMRC), INTM332050, "Double Taxation Applications and Claims: HMRC Reaction to *Indofood* Case" (www.gov.uk/hmrc-internal-manuals/international-manual/intm332050).

179 *Ibid.*, at paragraph 2.

180 *Ibid.*, at paragraph 4.

181 (July 18, 2006), JUR\2006\204307, JUR\2007\8915, and JUR\2007\6549; (November 10, 2006), JUR\2006\284679; (July 20, 2006), JUR\2007\6526; (November 13, 2006), JUR\2006\284618; and (March 26, 2007), JUR\2007\101877. This summary is based on the discussion in Adolfo Martín Jiménez, "Beneficial Ownership as a Broad Anti-Avoidance Provision: Decisions by Spanish Courts and the OECD's Discussion Draft," in *Beneficial Ownership: Recent Trends*, *supra* note 40, 127-42, at 128-33.

ownership is intended to prevent tax treaty shopping and must therefore be given a broad “economic interpretation” suggested by the 2003 revisions to the OECD commentary.¹⁸² Of particular relevance to the decisions were the fact that all but a small percentage of the royalties (0.5 percent to 2 percent) were paid to companies resident in Cyprus or the Netherlands when received, and the inference that the only purpose for interposing the Hungarian companies was to take advantage of the fact that the tax treaty between Spain and Hungary imposed no withholding tax on royalties—unlike almost all other Spanish tax treaties at the time.¹⁸³

Similarly in Denmark, where the tax authorities have denied withholding tax relief in a large number of cases involving payments to alleged conduit companies, at least two judgments of the Danish Tax Tribunal have relied on a broad economic interpretation of beneficial ownership to uphold these assessments.¹⁸⁴ In the *HHU* case,¹⁸⁵ a Jersey company that had acquired the shares of a Danish company transferred the shares to a Swedish holding company structure. The Jersey company then loaned funds to the Swedish companies, which loaned the funds to the Danish company. The tribunal held that the Swedish companies were not the beneficial owners of interest received from the Danish company on the grounds that all moneys received were automatically paid on to the Jersey company without any tax in Sweden; that the Swedish companies had no employees, no office or administration, and no business activities in Sweden; and that the purpose of the arrangement was to avoid Danish withholding tax.¹⁸⁶ The *Cook* case¹⁸⁷ involved a similar structure in which a Cayman Islands company transferred shares of a Danish company to a Swedish holding company structure, to which it loaned funds that were re-loaned to the Danish company. In this case also, the tribunal held that the Swedish companies were not the beneficial owners of interest received from the Danish company on the grounds that the interest payments were distributed to the Cayman Islands company without any Swedish tax, and that the holding companies engaged in no activities other than holding shares of the Danish company.¹⁸⁸

Likewise in Switzerland, where the Federal Court relied on an implicit anti-abuse principle to challenge tax treaty shopping in *A Holdings ApS*,¹⁸⁹ the courts have endorsed a broad economic concept of beneficial ownership in order to deny tax

182 Jiménez, *supra* note 181, at 130.

183 *Ibid.*, at 129.

184 See Jakob Bundgaard, “Danish Case Law Developments on Beneficial Ownership” (2012) 68:1 *Tax Notes International* 63-74.

185 SKM 2011.57 LSR (Danish Tax Tribunal). The summary of the case presented here is based on the discussion in Bundgaard, *supra* note 184, at 67-69.

186 Bundgaard, *supra* note 184, at 68.

187 SKM 2011.485 LSR (Danish Tax Tribunal). The summary of the case presented here is based on the discussion in Bundgaard, *supra* note 184, at 69-70.

188 Bundgaard, *supra* note 184, at 70.

189 See the discussion of this case in the text above at note 110 and following.

treaty benefits. In the *VSA* case,¹⁹⁰ two UK companies, one of which was resident in the Isle of Man, loaned funds to a Luxembourg holding company, which that company used to acquire shares of a Swiss company. The Swiss Tax Appeals Commission held that dividends paid to the Luxembourg company were not eligible for treaty benefits under the Switzerland-Luxembourg tax treaty on the grounds that the Luxembourg company was neither the *bénéficiaire* nor the *bénéficiaire effectif* of the dividend as required by the treaty.¹⁹¹ Concluding that these terms contemplate “the person who economically enjoys the income and not a conduit company interposed between the debtor of the income and the ultimate recipient,”¹⁹² the commission held that the Luxembourg company did not qualify because the full amount of the dividends that it received was used to pay interest on the shareholder loans and some other charges, so that the economic benefit of the income was enjoyed exclusively by the UK and Manx companies.¹⁹³

A more recent Swiss case involved a Danish bank that entered into swap agreements with counterparties in France, Germany, the United Kingdom, and the United States, and hedged against these swap agreements by purchasing shares of Swiss companies, the total return on which determined the amount of the swap payments that the Danish bank was obliged to pay to the counterparties.¹⁹⁴ Although the Federal Administrative Court had held that the Danish bank was the beneficial owner of dividends that it received from the Swiss companies, the Swiss Federal Supreme Court reversed that decision on the basis that the factual interdependence of the payments deprived the Danish bank of beneficial ownership. Concluding that

190 (February 28, 2001), 4 ILTS 2002, 191 (Swiss Commission of Appeals in Tax Matters). The summary of the case presented here is based on the discussion in De Broe, *supra* note 18, at 702-6.

191 Convention Between the Swiss Confederation and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, signed at Bern on January 21, 1993. Under article 10(2) of the treaty, dividends were subject to a 5 percent withholding tax rate if the *bénéficiaire effectif* of the dividend was a company holding directly at least 25 percent of the capital of a Swiss company, and were exempt from Swiss withholding tax altogether if the *bénéficiaire* held directly for an uninterrupted period of two years preceding payment of the dividends at least 25 percent of the capital of the Swiss company. Since the case involved dividend payments in two years and it was not clear that the Luxembourg subsidiary had held the shares for more than two years in the first of these years, the decisions addressed the meaning of both terms.

192 Cited in De Broe, *supra* note 18, at 703.

193 *Ibid.*, at 702.

194 (May 5, 2015), BGE 141 II 447, no. 2C_364/2012 (Swiss Federal Supreme Court). The summary of the case presented here is based on the discussions in Matteotti and Sutter, *supra* note 111, at 55-58; and Stefano Bernasconi and Michael Beusch, “Switzerland: ‘Swap Case’ and Beneficial Ownership,” in Peter Essers, Eric Kemmeren, Daniël Smit, Michael Lang, Jeffrey Owens, Pasquale Pistone, Alexander Rust, Josef Schuch, Claus Staringer, and Alfred Storck, eds., *Tax Treaty Case Law Around the Globe 2016* (Amsterdam: International Bureau of Fiscal Documentation, 2017), 295-303.

the key element of beneficial ownership involves “the power of disposal” (*Verfügungsberechtigung*), which needs to be assessed in accordance with the economic substance of the transaction or arrangement, taking into account “any legal, contractual or factual limitation” on the use of and benefit from the income as well as any risks borne by the recipient,¹⁹⁵ the court held that the Danish bank was not the beneficial owner of the dividends because the full amount of the dividends was committed to the counterparties in the form of the swap payments and the Danish bank did not bear any risk in respect of this income or its share ownership in the Swiss companies.¹⁹⁶

In contrast to these decisions, other cases have adopted a narrower meaning of the term “beneficial owner,” emphasizing legal rights and relationships rather than the economic substance of transactions or arrangements. In a decision involving a UK-resident company that had purchased detached dividend coupons from shares of the Royal Dutch Oil Company after dividends had been declared but before they were payable,¹⁹⁷ the Hoge Raad held that the UK company was the beneficial owner of the dividend and was entitled to the reduced withholding tax rate under the Netherlands-UK tax treaty¹⁹⁸ on the grounds that it had free disposal of the coupons and the dividend income when paid, and that it did not act as an agent (*zaakwaarnemer*) or for the account of a principal (*lasthebber*). Although the case did not involve a conduit arrangement in which a dividend recipient distributed such income to a third party resident in another state,¹⁹⁹ the decision has been interpreted to stand for the proposition that an entity that is not legally or contractually obliged to pay specific amounts that it has received to one or more third parties is the beneficial owner of that income.²⁰⁰

195 Bernasconi and Beusch, *supra* note 194, at 299-300.

196 *Ibid.*, at 300. Interestingly, the court came to this conclusion notwithstanding the absence of an explicit beneficial owner requirement in the Switzerland-Denmark tax treaty, *supra* note 111; the court considered this requirement to be implicit in all Swiss tax treaties.

197 (June 6, 1994), BNB 1994/217 (Netherlands Supreme Court) (hereinafter referred to as “the Royal Dutch Oil Company case”). The summary presented here is based on discussions of the case in De Broe, *supra* note 18, at 694-97, and Daniël S. Smit, “The Concept of Beneficial Ownership and Possible Alternative Remedies in Netherlands Case Law,” in *Beneficial Ownership: Recent Trends*, *supra* note 40, 59-89, at 62-65.

198 Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at The Hague on November 7, 1980.

199 On this basis, du Toit argues that the case does not provide “unqualified sanctioning for the use of conduit entities in situations where there is a legal obligation on the conduit entity to pay on the distributions received.” See du Toit, *supra* note 140, at 154.

200 See, for example, van Weeghel, *supra* note 86, at 77.

In *Prévost Car Inc. v. The Queen*,²⁰¹ companies resident in Sweden and the United Kingdom acquired shares of a Canadian company through a holding company that they had established in the Netherlands in order to obtain the benefit of a lower withholding tax rate on dividends from the Canadian company. The Tax Court of Canada adopted a similar legal understanding of beneficial ownership to that outlined above, to conclude that the Dutch holding company (“PHBV”) was the beneficial owner of dividends that it received from the Canadian company—even though the Dutch company had no physical office or employees in the Netherlands or elsewhere, and it distributed most of the dividend income to its parent companies in accordance with a shareholders’ agreement entered into between the two parent companies.²⁰² Rejecting the Crown’s argument that the term “beneficial owner” should be given a broad international fiscal meaning, looking “behind the legal relationships in order to identify the person who, as a matter of fact, can ultimately benefit from the dividends,”²⁰³ the court relied on domestic law and the OECD commentaries to conclude that “the ‘beneficial owner’ of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received.”²⁰⁴ According to the court,

201 *Prévost Car*, supra note 160 (TCC).

202 For a useful discussion of the case, see Brian J. Arnold, “The Concept of Beneficial Ownership Under Canada’s Tax Treaties,” in *Beneficial Ownership: Recent Trends*, supra note 40, 39-49, at 40-43. Arnold concludes, *ibid.*, at 43, that the decision “makes sense in policy and practical terms” since Canada’s treaty negotiators “knew or should have known” when they agreed, in a 1993 protocol to the Canada-Netherlands tax treaty, to a reduced withholding tax rate on dividends that the lower rate “would make Netherlands holding companies attractive as vehicles for holding investments in Canadian companies” and yet “did not insist on the inclusion of a limitation-on-benefit provision or other protection against treaty shopping through the use of Netherlands holding companies.” (See the Convention Between Canada and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at The Hague on May 27, 1986, as amended by the protocols signed on March 14, 1993 and August 25, 1997 [herein referred to as “the Canada-Netherlands tax treaty”].) Although Arnold’s conclusion suggests that the arrangement, though clearly tax treaty shopping, was not abusive, it does not address the meaning of the term “beneficial owner.”

203 *Prévost Car*, supra note 160 (TCC), at paragraph 84. The Crown’s argument turned mainly on the official translations of the term “beneficial owner” in French and Dutch, which, it argued, strongly suggested a factual determination. *Ibid.*, at paragraphs 78 and 82.

204 *Ibid.*, at paragraph 100. Although the court (mistakenly in my view) stated that article 3(2) of the Canada-Netherlands tax treaty (supra note 202) required it “to look to a domestic solution in interpreting ‘beneficial owner,’” it added that the OECD commentaries were “also relevant” and considered both common-law and civil-law conceptions of beneficial ownership under domestic law. *Ibid.*, at paragraphs 95 and 97-98. As a result, as the Federal Court of Appeal concluded, the decision was based not solely on the domestic-law meaning of “beneficial owner” nor on a common-law understanding of this term, but on “general, technical and legal meanings,” including those expressed in the OECD commentaries and the OECD conduit companies report. See *infra* note 210 and the accompanying text.

[t]he person who is [the] beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership. In short the dividend is for the owner's own benefit and this person is not accountable to anyone for how he or she deals with the dividend income. . . . 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 who is the registered owner of the shares it holds for clients.²⁰⁵

Since the shareholders' agreement bound only the parent companies and not PHBV,²⁰⁶ which had to declare and pay dividends in accordance with Dutch law,²⁰⁷ the court concluded that there was "no predetermined and automatic flow of funds" to the parent companies,²⁰⁸ and that the dividends became property of PHBV that was generally available to the holding company's creditors and available for its use as it wished.²⁰⁹

On appeal, the Federal Court of Appeal dismissed the argument that the Tax Court had erroneously adopted a purely common-law conception of beneficial ownership, concluding that the judge's interpretation "captures the essence of the concepts of 'beneficial owner,' '*bénéficiaire effectif*' as it emerges from the review of the general, technical and legal meanings of the terms" and "accords with what is stated in the OECD Commentaries and in the Conduit Companies Report."²¹⁰ It also rejected the Crown's argument that "beneficial owner" means "the person who can, in fact, ultimately benefit from the dividend," on the grounds that this definition

does not appear anywhere in the OECD documents and the very use of the word "can" opens up a myriad of possibilities which would jeopardize the relative degree of certainty and stability that a tax treaty seeks to achieve.²¹¹

205 *Prévost Car*, supra note 160 (TCC), at paragraph 100.

206 *Ibid.*, at paragraph 103.

207 *Ibid.*, at paragraph 104.

208 *Ibid.*, at paragraph 102.

209 *Ibid.*, at paragraph 105.

210 *Prévost Car*, supra note 160 (FCA), at paragraph 14.

211 *Ibid.*, at paragraph 15, adding that "[t]he Crown . . . is asking the Court to adopt a pejorative view of holding companies which neither Canadian domestic law, the international community nor the Canadian government through the process of objection, have adopted."

In *Velcro Canada Inc. v. The Queen*,²¹² the Tax Court of Canada held that a holding company resident in the Netherlands was the beneficial owner of royalties received under a licence agreement that its parent company assigned to it immediately after moving its residence from the Netherlands to the Netherlands Antilles, even though the holding company was contractually obliged to pay 90 percent of all amounts received to the parent.²¹³ Rejecting the Crown's argument that this contractual obligation deprived the holding company of the "use and enjoyment" of the royalties,²¹⁴ the court held that there was no "automatic" or "predetermined flow of funds"²¹⁵ because royalties were received in Canadian dollars and converted into Dutch or US funds;²¹⁶ the royalties were not segregated from the holding company's other funds;²¹⁷ the holding company had 30 days before it had to make payments to its parent;²¹⁸ and the agreement allowed the holding company to retain 10 percent of the royalties that it received.²¹⁹ For these reasons, the court concluded, the holding company was not "a mere agent, nominee or conduit" with no discretion as to the use or application of the royalties²²⁰ but had possession, use, and control of this income,²²¹ and assumed risks in relation to the royalties, which were available to creditors and were subject to currency fluctuations.²²²

2014 Revisions to the OECD Commentary

Given the differing judicial opinions on the meaning of beneficial owner, and the uncertainty created by these differences, it is not surprising that several commentators began to call upon the OECD to clarify the meaning of the term,²²³ or that the OECD took up this task in the spring of 2011 when it released a discussion draft containing

212 2012 TCC 57.

213 For a useful discussion of the case, see Arnold, *supra* note 202, at 44-48.

214 *Velcro*, *supra* note 212, at paragraph 28.

215 *Ibid.*, at paragraphs 28 and 45.

216 *Ibid.*, at paragraph 40.

217 *Ibid.*, at paragraph 33.

218 *Ibid.*, at paragraph 28.

219 *Ibid.*, at paragraph 43. Since the withholding tax rate on royalties was 10 percent under the Canada-Netherlands tax treaty for some of the years at issue, Arnold concludes that the legal obligation to pay 90 percent of royalties received effectively meant that the holding company was required to pay all after-tax income to the parent. Arnold, *supra* note 202, at 47. This conclusion, however, is not clear from the facts, and would not apply to some of the years at issue during which royalties were exempt from withholding tax in Canada.

220 *Velcro*, *supra* note 212, at paragraph 51.

221 *Ibid.*, at paragraphs 35, 37-38, and 42.

222 *Ibid.*, at paragraph 40.

223 See, for example, Jinyan Li, "Beneficial Ownership in Tax Treaties: Judicial Interpretation and the Case for Clarity," in Philip Baker and Catherine Bobbett, eds., *Tax Polymath: A Life in International Taxation* (Amsterdam: International Bureau of Fiscal Documentation, 2010), 187-209, at 206-9.

proposed revisions to the OECD commentary.²²⁴ Adopted with some modifications in 2014, these revisions include five important statements on the meaning of the term “beneficial owner.”

First, the 2014 revisions explain, since the term “beneficial owner” was added to the OECD model convention to address potential uncertainties in the application of articles 10, 11, and 12 to the payment of dividends, interest, and royalties to intermediaries, it was not intended to refer to “any technical meaning that it could have under the domestic law of a specific country,” nor was it “used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries),” but it was “intended to be interpreted in this context . . . and in light of the object and purposes of the Convention.”²²⁵ In other words, as argued earlier,²²⁶ the term was always intended to have an international fiscal meaning independent of the domestic law of a specific state and any common-law meaning.

Second, the revised commentary notes, in each of the examples in which the direct recipient of a payment is not regarded as its beneficial owner (that is, an agent, a nominee, and a conduit company acting as a fiduciary or administrator), the recipient’s “right to use and enjoy the dividend” is “constrained by a contractual or legal obligation to pass on the payment received to another person.”²²⁷ In this respect, the revised commentary rejects the broad economic meaning of beneficial owner adopted in several judicial decisions,²²⁸ affirming instead the narrower legal understanding of the term applied in *Prévost Car*²²⁹ and in the Royal Dutch Oil Company case.²³⁰

Third, the revised commentary continues, the existence of a contractual or legal obligation to pass on a payment received to another person

will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly

224 Organisation for Economic Co-operation and Development, *Clarification of the Meaning of “Beneficial Owner” in the OECD Model Tax Convention: Discussion Draft* (Paris: OECD, April 29, 2011).

225 Paragraphs 12 and 12.1 of the commentary on article 10, paragraphs 9 and 9.1 of the commentary on article 11, and paragraph 4 of the commentary on article 12 of the OECD model convention (introduced in Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version 2014* (Paris: OECD, July 2014)).

226 *Supra* notes 138-151 and the accompanying text.

227 Paragraph 12.4 of the commentary on article 10, paragraph 10.2 of the commentary on article 11, and paragraph 4.3 of the commentary on article 12 of the OECD model convention.

228 See the cases discussed at *supra* notes 162-196 and the accompanying text.

229 See *supra* notes 201-211 and the accompanying text.

230 *Supra* notes 197-211 and the accompanying text. For a similar conclusion, see Robert J. Danon, “Treaty Abuse in the Post-BEPS World: An Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups” (2018) 72:1 *Bulletin for International Taxation* 31-55, at 34-35.

does not have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person.²³¹

Although the test for determining beneficial ownership remains whether or not the recipient has a contractual or legal obligation to pass on the payment to another person, therefore, evidence of this obligation may be derived not only from “relevant legal documents” but also from the “facts and circumstances” of the transactions or arrangements.²³²

Fourth, the revised commentary adds, a contractual or legal obligation to pass on a payment received to another person “would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient”—for example,

an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions, or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits.²³³

As a result, the kind of legal or contractual obligation to pass on a payment that would deprive the direct recipient of a payment of recognition as its beneficial owner is not any contractual or legal obligation that happens to be financed by the payment as a factual matter (a relationship of factual dependence), but a contractual or legal obligation that is contractually or legally dependent on the receipt of the payment by the direct recipient (a relationship of contractual or legal dependence). Although this dependence clearly existed in *Velcro*²³⁴ and may have existed in many of the cases decided under a broader economic interpretation of the term beneficial owner,²³⁵ it was not the case in *Prévost Car*,²³⁶ where the shareholders’

231 Paragraph 12.4 of the commentary on article 10, paragraph 10.2 of the commentary on article 11, and paragraph 4.3 of the commentary on article 12 of the OECD model convention.

232 For this reason, the reference to the “substance” of the recipient’s right should not be read to invite the kind of broad economic analysis that an emphasis on contractual or legal obligations denies. For a similar conclusion, see Danon, *supra* note 230, at 35.

233 Paragraph 12.4 of the commentary on article 10, paragraph 10.2 of the commentary on article 11, and paragraph 4.3 of the commentary on article 12 of the OECD model convention.

234 *Velcro*, *supra* note 212.

235 See the cases discussed in the text above at notes 162-198. In particular, see *Indofood*, *supra* note 162, where the Court of Appeal held that Newco would be “bound to pay” all interest received from the parent guarantor to the paying agent for the lenders once the interest was received, and the Spanish cases involving payments by the Real Madrid soccer team to Hungarian companies, *supra* note 180, where all but a very small percentage of the royalties were paid on to companies in other states. According to Jiménez, for example, the Audiencia Nacional “could have reached the same conclusion by simply analysing the legal position of the Hungarian companies and without assimilating the concept of beneficial ownership to a broad anti-abuse provision.” Jiménez, *supra* note 180, at 132. Similarly, Baker notes that the facts in
(Notes 235 and 236 are continued on page 661.)

agreement between the parent companies was not contractually or legally binding on the holding company. Nor is it likely that this test would be satisfied for payments under the swap agreements in the Swiss swap case,²³⁷ which were factually dependent on dividends that the Danish bank received from Swiss companies once it had hedged its position by purchasing shares, but presumably were not contractually or legally dependent on those payments. For this reason, as several commentators have observed, the revised commentary narrows the scope of the beneficial ownership requirement as a mechanism to challenge tax treaty shopping.²³⁸

Indeed, the limited scope of beneficial ownership as an anti-abuse concept is suggested by the fifth revision to the commentary, which emphasizes that treaty benefits under article 10, 11, or 12 need not “automatically be granted” under these provisions even if the recipient of a dividend, interest, or royalty payment is a beneficial owner of the payment.²³⁹ On the contrary, the revised text of the commentary states:

Whilst the concept of “beneficial owner” deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of abuses, such as certain forms of treaty shopping . . . and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.²⁴⁰

As the current version of the OECD commentary confirms, these “other approaches” to address tax-treaty-shopping transactions or arrangements include LOB provisions and the PPT.²⁴¹ The use of such measures in tax treaties is discussed in the text that follows.

Treaty-Based Specific Anti-Avoidance Rules

A more targeted approach to tax treaty shopping involves the negotiation of specific anti-avoidance rules to be included in tax treaties. In order to discourage tax-motivated emigration, for example, tax treaties may include provisions permitting source taxation of capital gains from the alienation of property by former residents,

Indofood were “very extreme” since Newco “would have had no function other than to receive and pay on interest.” Baker, *supra* note 163, at 32.

236 *Prévost Car*, *supra* note 160.

237 *Supra* note 194.

238 See, for example, Danon, *supra* note 230, at 35, concluding that “beneficial ownership is of very limited use in conduit situations.”

239 Paragraph 12.5 of the commentary on article 10, paragraph 10.3 of the commentary on article 11, and paragraph 4.4 of the commentary on article 12 of the OECD model convention.

240 *Ibid.*

241 *Ibid.*, referring to article 29 of the OECD model convention, which includes the framework for a LOB provision and the PPT.

which often supplement domestic exit tax provisions.²⁴² In order to discourage the use of conduit arrangements, tax treaties may include one or more of the following measures:

- “lookthrough” provisions that deny treaty benefits to a company resident in a contracting state to the extent that the company is not owned directly or indirectly by residents of that state;²⁴³
- “exclusion” provisions denying treaty benefits to companies enjoying special tax privileges;²⁴⁴

242 See, for example, article 13(9) of the Canada-UK tax treaty, which preserves “the right of a Contracting State to levy according to its law a tax on or in respect of gains from the alienation of any property on a person who is a resident of that State at any time during the fiscal year in which the property is alienated, or has been so resident at any time during the six years immediately preceding the alienation of the property.” Convention Between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at London on September 8, 1978, as amended by the protocols signed on April 15, 1980, October 16, 1985, May 7, 2003, and July 21, 2014.

243 See, for example, article 2 of the protocol to the Belgium-Spain tax treaty (Convention Between the Kingdom of Belgium and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion and Tax Frauds with Respect to Taxes on Income and on Capital, signed at Brussels on June 14, 1995, with protocol), which provides, “notwithstanding the provisions of Arts. 10-13, that the source State shall not provide relief if dividends, interest, royalties or capital gains are derived by a company which is a resident of the other Contracting State, where persons who are not residents of that other State hold, directly or indirectly, more than 50% of the capital of that company.” De Broe, *supra* note 18, at 736. These provisions (which appear to be based, in part, on the German anti-treaty-shopping provision discussed above in the text accompanying note 28) are discussed in the OECD conduit companies report, *supra* note 18, at paragraphs 23-24, and were incorporated into paragraph 14 of the commentary on article 1 in the 1992 update to the OECD model convention (Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, July 23, 1992)). That paragraph was deleted from the OECD commentary in 2017.

244 See, for example, article 26(3) of Canada-Finland tax treaty, which excludes from the application of the treaty “any company, trust or other entity that is a resident of a Contracting State and is beneficially owned or controlled, directly or indirectly, by one or more persons who are not residents of that State, if the amount of the tax imposed on the income or capital of the company, trust or other entity by that State (after taking into account any reduction or offset of the amount of tax in any manner, including a refund, reimbursement, contribution, credit or allowance to the company, trust, or other entity or to any other person) is substantially lower than the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or other entity, as the case may be, were beneficially owned by one or more individuals who were residents of that State.” 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 July 20, 2006. This “exclusion approach” is discussed in the OECD conduit companies report, *supra* note 18, at paragraphs 26-28, and was incorporated into paragraphs 21-21.2 of the commentary on

- “subject-to-tax” provisions that grant source-state treaty benefits only for income that is subject to tax in the residence state;²⁴⁵
- “channel” provisions that deny treaty benefits for income received by a company resident in the other contracting state that is used primarily to satisfy claims of one or more persons not resident in that state who have a substantial interest in the company and exercise control of the company;²⁴⁶
- detailed LOB provisions that limit treaty benefits to specific persons or categories of income;²⁴⁷ and
- purpose tests that deny some or all treaty benefits where the main purpose or one of the main purposes of the transaction or arrangement that would otherwise result in a treaty benefit was to obtain the benefit.²⁴⁸

article 1 in the 1992 update to the OECD model convention, *supra* note 243. A greatly expanded discussion of tax treaty provisions to address “special tax regimes” now appears in paragraphs 85-100 of the 2017 OECD commentary.

- 245 See, for example, article 27(2) of the Canada-UK tax treaty, *supra* note 242, which limits treaty relief for persons subject to tax on a remittance basis “only to so much of the income as is taxed in the other Contracting State.” Another example of this subject-to-tax approach is found in anti-abuse rules for income attributed to a permanent establishment in a low-tax jurisdiction that is exempt from tax in the residence state. See, for example, article 29(8) of the Convention Between Canada and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Paris on May 2, 1975, as amended by the protocols signed on January 16, 1987, November 30, 1995, and February 2, 2010; and article 10 of the MLI, which will be discussed in the second part of this article. This “subject-to-tax” approach was discussed in the OECD conduit companies report, *supra* note 18, at paragraphs 29-36, and incorporated into paragraphs 15-16 of the commentary on article 1 in the 1992 update to the OECD model convention, *supra* note 243. These paragraphs were deleted from the OECD commentary in 2017.
- 246 See, for example, article 22 of the Belgium-Switzerland tax treaty, which incorporates the Swiss anti-abuse decree discussed above in the text accompanying note 28 (Convention Between the Swiss Confederation and the Kingdom of Belgium for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, signed at Bern on August 28, 1978). See De Broe, *supra* note 18, at 732-34. This “channel” approach was discussed in the OECD conduit companies report, *supra* note 18, at paragraphs 37-41, and was incorporated into paragraphs 17-18 of the commentary on article 1 in the 1992 update to the OECD model convention, *supra* note 243. These paragraphs were deleted from the OECD commentary in 2017.
- 247 See, for example, article XXIX A of the Canada-US tax treaty, *supra* note 48. A discussion of this approach to tax treaty shopping was first added in paragraph 20 of the commentary on article 1 of the 2003 OECD model convention, *supra* note 99. With the addition of a detailed LOB provision to the OECD model convention in 2017, that discussion was deleted from the commentary on article 1 and replaced with commentary on new article 29.
- 248 See, for example, articles 10(8), 11(9), and 12(8) of the Canada-UK tax treaty, *supra* note 242. A discussion of this approach to tax treaty shopping was first added in paragraph 21.4 of the commentary on article 1 of the 2003 OECD model convention, *supra* note 99. With the addition of the PPT to the OECD model convention in 2017, that discussion was deleted from the commentary on article 1 and replaced with commentary on new article 29(9).

Although these specific anti-avoidance rules appear in many tax treaties,²⁴⁹ the most important of these provisions in the context of the MLI and the PPT are detailed LOB provisions and purpose tests. The former form the basis for the “simplified limitation-on-benefit” (SLOB) provisions in articles 7(8) through (13) of the MLI and the framework for detailed LOB provisions in articles 29(1) through (7) of the 2017 OECD model convention; the latter are incorporated into the PPT in article 7(1) of the MLI and article 29(9) of the 2017 OECD model convention, which applies in place of or in the absence of these purpose tests in CTAs.

Detailed LOB Provisions

First included in the OECD commentary in 2003²⁵⁰ and added to the OECD model convention in 2017,²⁵¹ detailed LOB provisions were originally developed in the United States, which has had policy concerns about tax treaty shopping dating back to at least the 1980s.²⁵² Although early versions of these LOB provisions contained relatively simple lookthrough elements as well as purpose tests,²⁵³ the provisions became more detailed over time as US treaty negotiators devised a growing number of objective criteria to preclude treaty-shopping transactions or arrangements.²⁵⁴ The 1989 US-Germany tax treaty was the first US treaty to contain a detailed LOB provision.²⁵⁵ Since then, the United States has generally insisted on including a detailed LOB provision in all its tax treaties.²⁵⁶ These LOB provisions usually operate on a reciprocal basis; however, the provision that was added to the Canada-US tax treaty by the third protocol in 1995 initially applied only to US treaty benefits, and was extended to Canadian treaty benefits only after the signing of the fifth protocol in 2007.

249 For a brief summary of International Fiscal Association branch reports on specific anti-avoidance provisions in tax treaties, see van Weeghel, *supra* note 98, at 47-53.

250 Paragraph 20 of the commentary on article 1 of the OECD model convention.

251 Articles 29(1) through (7) of the OECD model convention.

252 Anna A. Kornikova, “Solving the Problem of Tax-Treaty Shopping Through the Use of Limitation on Benefit Provisions” (2008) 8:2 *Richmond Journal of Global Law and Business* 249-86, at 279.

253 *Ibid.*, at 279-80. See also the discussion of early US approaches in Rosenbloom, *supra* note 15, at 779-810.

254 Patricia A. Brown, “Policy Forum: What Makes a Dutch Company Dutch? The Evolution of US Limitation-on-Benefit Provisions” (2014) 62:3 *Canadian Tax Journal* 741-52.

255 Convention Between the United States of America 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 Capital and to Certain Other Taxes, signed at Bonn on August 29, 1989 (herein referred to as “the US-Germany tax treaty”), article 28. Reuven S. Avi-Yonah and Christiana Hji Panayi, “Rethinking Treaty Shopping: Lessons for the European Union,” in *Tax Treaties: Building Bridges Between Law and Economics*, *supra* note 108, 21-50, at 42.

256 J. Clifton Fleming Jr., “Searching for the Uncertain Rationale Underlying the US Treasury’s Anti-Treaty Shopping Policy” (2012) 40:4 *Intertax* 245-53.

Even though most US tax treaties concluded since the early 1990s contain detailed LOB provisions, it was only in 2006 that these provisions were added to the US model income tax convention.²⁵⁷ The more recent 2016 US model income tax convention contains even more detailed LOB provisions that expand upon the provisions in the 2006 model convention.²⁵⁸ Although the final report on BEPS action 6 was completed before the final 2016 model convention was released, the LOB provisions in the 2016 model form the basis for the SLOB provisions in the MLI and the framework for detailed LOB provisions in articles 29(1) through (7) of the 2017 OECD model convention. In general terms, these provisions limit treaty benefits to specific types of persons resident in a contracting state and specific kinds of income received by residents of a contracting state.

Beginning with article 22(1) of the 2016 US model convention, the first limitation on treaty benefits provides that these benefits are, except as otherwise provided in article 22 and a few other treaty provisions, granted only to residents of a contracting state who are “qualified person[s].”²⁵⁹ For this purpose, article 22(2) generally defines a qualified person as

1. an individual;²⁶⁰
2. a contracting state or political subdivision or local authority;²⁶¹
3. a company if the principal class of its shares (and any disproportionate class) is regularly traded on one or more recognized stock exchanges, and either its principal class of shares is primarily traded on more or more recognized stock exchanges of the contracting state of which it is a resident, or its primary place of management and control is in the contracting state of which it is a resident;²⁶²

257 United States, Department of the Treasury, United States Model Income Tax Convention of November 15, 2006, at article 22 (herein referred to as “the 2006 US model convention”) (www.treasury.gov/press-center/press-releases/Documents/hp16801.pdf).

258 United States, Department of the Treasury, United States Model Income Tax Convention, February 17, 2016, at article 22 (herein referred to as “the 2016 US model convention”) (www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-us%20Model-2016.pdf).

259 *Ibid.*, at article 22(1).

260 *Ibid.*, at article 22(2)(a).

261 *Ibid.*, at article 22(2)(b).

262 *Ibid.*, at article 22(2)(c). The term “principal class of shares” is generally defined as “the ordinary or common shares of the company” provided that the class represents a majority of the company’s aggregate votes and value. *Ibid.*, at article 22(7)(b). The term “disproportionate class of shares” is generally defined as “any class of shares of a company, or in the case of a trust, any class of beneficial interests in such trust, resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other Contracting State.” *Ibid.*, at article 22(7)(c).

4. a company that satisfies a two-part ownership and base erosion test, generally requiring that
 - a. at least 50 percent of the aggregate vote and value of its shares (and any disproportionate class) is owned directly or indirectly by five or fewer companies entitled to benefits under category (3),²⁶³ and
 - b. less than 50 percent of the company's gross income is paid, directly or indirectly, in the form of deductible payments to persons other than qualified persons under category (1), (2), (3), or (5), or connected persons benefiting from a special tax regime or notional deductions;²⁶⁴
5. a pension fund or charitable organization, provided that in the case of a pension fund operated to administer pension or retirement benefits, more than 50 percent of its beneficiaries, members, or participants are resident in either contracting state, and in the case of a pension fund operated to earn income for an exempt entity that administers pension or retirement benefits, the earnings benefit exclusively or almost exclusively pension funds more than 50 percent of the beneficiaries, members, or participants of which are resident in either contracting state;²⁶⁵ or
6. a person other than an individual that satisfies a two-part ownership and base erosion test generally requiring that
 - a. shares or other beneficial interests (including any disproportionate class) representing at least 50 percent of the aggregate votes and value of the shares or beneficial interests are owned, directly or indirectly, by qualified persons of the contracting state under category (1), (2), (3), or (5),²⁶⁶ and
 - b. less than 50 percent of the person's gross income for the taxable year is paid, directly or indirectly, in the form of deductible payments to persons other than qualified persons under category (1), (2), (3), or (5), or connected persons benefiting from a special tax regime or notional deductions.²⁶⁷

Incorporating lookthrough elements in categories 4, 5, and 6, and a channel approach in the form of the base erosion tests in categories 4 and 6, this provision is designed to limit treaty benefits to residents of a contracting state with a substantive economic connection to that state.²⁶⁸

263 Ibid., at article 22(2)(d)(i). Where ownership is indirect, the provision also requires each intermediate owner to be a resident of the contracting state from which the benefit is being sought, or a "qualifying intermediate owner" as defined in article 22(7)(f), *ibid.*

264 Ibid., at article 22(2)(d)(i).

265 Ibid., at article 22(2)(e). Where ownership is indirect, the provision also requires each intermediate owner to be a "qualified intermediate owner" as defined in article 7(f).

266 Ibid., at article 22(2)(f)(i).

267 Ibid., at article 22(2)(f)(ii).

268 Kornikova, *supra* note 252, at 281, referring to comparable provisions in the 2006 US model convention.

In addition to these provisions, article 22(3) grants treaty benefits for items of income that are derived by a resident of a contracting state from the other state if the resident is engaged in the active conduct of a trade or business in the first state and the income derived from the other state emanates from or is incidental to that trade or business.²⁶⁹ Article 22(5) further extends treaty benefits to dividends and interest paid by members of a multinational corporate group to a company resident in a contracting state “that functions as a headquarters company for a multinational corporate group.”²⁷⁰ Thus, through these provisions as well, the US LOB provisions extend specific treaty benefits to residents with a significant economic connection with a contracting state, even if they are not qualified persons.

Finally, the 2016 US model convention includes two other provisions that also grant treaty benefits to residents other than qualified persons. The first is a derivative benefits provision, which grants treaty benefits to a company at least 95 percent of the aggregate votes and value of which is owned by seven or fewer persons who are “equivalent beneficiaries” entitled to the same or more advantageous treaty benefits under a tax treaty between their state and the source state, provided that less than 50 percent of the company’s gross income is paid in the form of deductible payments to persons who are not equivalent beneficiaries or persons who are equivalent beneficiaries under specific circumstances.²⁷¹ The second provision allows the competent authority of a contracting state to grant treaty benefits to a resident of the other state either generally or with respect to a specific item of income, “taking into account the object and purpose of this Convention,” if the resident “demonstrates to the satisfaction of such competent authority a substantial nontax nexus to its Contracting State of residence and that neither its establishment, acquisition or maintenance, nor the conduct of its operations had as one of its principal purposes the obtaining of benefits under this Convention.”²⁷² Since the first of these provisions grants treaty benefits to an entity if the same or more advantageous treaty benefits would be available to its owners or most recipients of deductible payments under another tax treaty, and the second provision grants treaty benefits where the resident demonstrates a “substantial nontax nexus” to the residence state and also demonstrates that one of the principal purposes of its establishment, acquisition, or maintenance was not to obtain benefits under the

269 2016 US model convention, *supra* note 258, at article 22(3)(a). Where the resident of one contracting state derives an item of income from a trade or business activity conducted by the resident in the other state, or derives an item of income arising in the other state from a related person, article 22(3)(b) further provides that the test in article 22(3)(a) is considered to be satisfied with respect to the item of income “only if the trade or business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the trade or business activity carried on by the resident or such person in the other Contracting State.”

270 *Ibid.*, at article 22(5).

271 *Ibid.*, at article 22(4).

272 *Ibid.*, at article 22(6).

convention, these provisions extend treaty benefits to circumstances in which entitlement to these benefits does not result from abusive tax treaty shopping.

Purpose Tests

In addition to, or instead of, detailed LOB provisions, many tax treaties include purpose tests that deny some or all treaty benefits where “the main purpose or one of the main purposes” of the transaction or arrangement that would otherwise result in a treaty benefit was to obtain that benefit. Although subjective intention-based anti-abuse provisions were included in the 1942 Canada-US tax treaty and the 1945 UK-US tax treaty as a way to limit entitlement to the lower withholding tax rate on dividends paid to a parent corporation,²⁷³ the words “the main purpose or one of the main purposes” appear to have originated in the United Kingdom, where the same language is used in many domestic anti-avoidance provisions.²⁷⁴

Beginning in the late 1960s, several UK tax treaties began to include provisions denying reduced withholding tax rates under interest and royalty articles if the debt claim or right in respect of which the interest or royalty was paid “was created or assigned mainly for the purposes of taking advantage of this article and not for *bona fide* commercial purposes.”²⁷⁵ In the 1992 UK-Guyana tax treaty, this language was modified to deny treaty benefits under these articles if “the main purpose or one of the main purposes of any person concerned with the creation or assignment” of the debt-claim or right in respect of which the interest or royalty was paid was “to take advantage of this Article by means of that creation or assignment.”²⁷⁶ As a result, these provisions dropped the “*bona fide* commercial purposes” test, lowered the purpose threshold to include transactions or arrangements where “one of the main purposes” was to obtain the reduced withholding tax rate, and expanded the scope of the purpose inquiry to encompass “any person concerned with the creation or assignment” of the debt-claim or right.²⁷⁷

Subsequent UK tax treaties have generally included these limitations in interest and royalty articles and occasionally in the “other income” article,²⁷⁸ and the OECD

273 According to article XI(2) of the 1942 Canada-US tax treaty, *supra* note 125, the lower 5 percent withholding tax rate (as opposed to 15 percent) was not available if “the competent authority” of the source state was “satisfied that the corporate relationship between the two corporations has been arranged or is maintained primarily with the intention of taking advantage of this paragraph.” Similar language appears in article VI of the 1945 UK-US tax treaty, *supra* note 126. See Vann, *supra* note 92, at 271, and Rosenbloom, *supra* note 15, at 779.

274 Jonathan Schwarz, *Schwarz on Tax Treaties*, 3d ed. (London: Wolters Kluwer, 2013), at 421.

275 *Ibid.*, at 415.

276 Articles 12(9) and 13(7) of the Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Co-operative Republic of Guyana for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at Georgetown on August 31, 1992.

277 Schwarz, *supra* note 274, at 421.

278 *Ibid.*, speculating that inclusion in the “other income” article was designed to address derivative financial instruments, which can replicate other types of income.

adopted identical language in its 2003 revisions to the OECD commentary.²⁷⁹ Since the mid-1990s, similar provisions have also been included in the tax treaties of many other countries, mostly in interest and royalty articles,²⁸⁰ but also in articles dealing with dividends²⁸¹ and capital gains,²⁸² and sometimes in separate provisions limiting treaty benefits to different categories of income.²⁸³ In addition to these provisions, which apply only to specific categories of income, a comprehensive purpose provision was included in the 2012 protocol to the India-UK tax treaty, stipulating that

279 Paragraph 21.4 of the commentary on article 1 of the 2003 OECD model convention, *supra* note 99, suggesting that this anti-abuse provision could be used to deal with source taxation of dividends, interest, royalties, and other income.

280 See, for example, Canada's tax treaties with Chile (Convention Between Canada and the Republic of Chile for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Santiago on January 21, 1998) and Ukraine (Convention Between the Government of Canada and the Government of Ukraine for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Kiev on March 4, 1996).

281 See, for example, Canada's tax treaties with Hong Kong (Agreement Between the Government of Canada and the Government of the Hong Kong Special Administrative Region of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Hong Kong on November 11, 2012); Israel (Convention Between the Government of Canada and the Government of the State of Israel for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at New York on September 21, 2016); Mexico (Convention Between the Government of Canada and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Mexico City on September 12, 2006); New Zealand (Convention Between Canada and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Wellington on May 3, 2012); and Poland (Convention Between Canada and the Republic of Poland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Ottawa on May 14, 2012).

282 See, for example, article 13(7) of the Canada-Israel tax treaty, *supra* note 281.

283 See, for example, article 26(1) of the Canada-Colombia tax treaty (Convention Between Canada and the Republic of Colombia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Lima on November 21, 2008), which denies treaty benefits under the dividend, interest, and royalty articles if "the purpose or one of the main purposes of any person in relation to the creation or assignment of a share, a debt-claim, or a right with respect to which dividends, interest or royalties are paid, was to derive benefits from one or more of those Articles through such creation or assignment"; and article 23(2) of the Spain-UK tax treaty (Convention Between the Kingdom of Spain and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at London on March 14, 2013), which denies "relief . . . under this Convention" if "the main purpose or one of the main purposes of any person concerned with the creation, assignment or alienation of any shares, debt-claims, assets or other rights in respect of which income or gains arise was to take advantage of this Convention by means of that creation, assignment or alienation."

[b]enefits of this Convention shall not be available to a resident of a Contracting State, or with respect to any transaction undertaken by such a resident, if the main purpose or one of the main purposes of the creation or existence of such a resident or of the transaction undertaken by him, was to obtain benefits under this Convention.²⁸⁴

Together with the OECD's guiding principle discussed earlier,²⁸⁵ this generalized purpose test is an obvious antecedent to the PPT in article 7(1) of the MLI and article 29(9) of the 2017 OECD model convention.

OTHER TREATY ABUSES

In addition to tax treaty shopping, other transactions or arrangements may result in tax treaty abuse where they enable persons either to obtain benefits under particular treaty provisions in a manner that contradicts the object and purpose of these provisions or the treaty as a whole, or to circumvent the application of other treaty provisions in a manner that contradicts their object and purpose. Examples of these transactions or arrangements include the following:

- “surplus-stripping” transactions that convert dividends that would otherwise be subject to withholding tax under provisions comparable to article 10 of the OECD model convention into gains from the alienation of shares that are exempt from taxation in the state in which the company is resident under provisions comparable to article 13 of the OECD model convention;²⁸⁶
- “hiring-out of labour” arrangements that divert employment income that would otherwise be paid by an employer resident in the state in which the employment is exercised into service fees paid to an employer resident in another state, in order to convert employment income that would otherwise be subject to tax in the state in which the employment is exercised under provisions comparable to article 15(1) of the OECD model convention into

284 Article 28C(1) of the Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at New Delhi on January 25, 1993, added by article IX of the amending protocol of October 30, 2012. In Canada, the federal government proposed a similarly comprehensive purpose-based anti-abuse provision in 2013, which would have applied as a domestic override of all Canadian tax treaties. Canada, Department of Finance, *Consultation Paper on Treaty Shopping—The Problem and Possible Solutions* (Ottawa: Department of Finance, August 2013) (www.fin.gc.ca/activty/consult/ts-cf-eng.asp#a1). The government withdrew the proposal in August 2014, choosing to await the outcome of BEPS action 6 before proceeding further. For a critical assessment of the proposal, arguing among other things that it was inconsistent with Canada's tax treaty obligations, see Ken Snider, “Policy Forum: Canada's Anti-Treaty-Shopping Proposals and International Treaty Obligations” (2014) 62:3 *Canadian Tax Journal* 705-28.

285 See *supra* notes 101-106 and the accompanying text.

286 See, for example, the UN report *Treaty Abuse and Treaty Shopping*, *supra* note 22, at paragraphs 61-64.

employment income that is exempt from tax in the state in which the employment is exercised under provisions comparable to article 15(2) of the OECD model convention;²⁸⁷

- transactions or arrangements that divert income that would otherwise be paid to an entertainer or sports person in respect of personal activities exercised in one state to a “star company” resident in a contracting state that does not have a permanent establishment in the state in which these activities are exercised, in order to convert income that would otherwise be subject to tax in the state in which the activities are exercised under provisions comparable to article 17(1) of the OECD model convention into income that would be exempt from tax in that state under provisions comparable to article 7 of the OECD model convention if the treaty did not include a star company provision like article 17(2) of the OECD model convention;²⁸⁸
- indirect ownership of immovable property situated in a state in order to convert gains from the alienation of this property that would otherwise be taxable in that state under provisions comparable to article 13(1) of the OECD model convention into gains from the alienation of shares or other interests that would be exempt from tax in that state under provisions comparable to article 13(5) if the article did not include a substituted property rule like article 13(4) of the OECD model convention;²⁸⁹
- transactions or arrangements that convert dividends that would otherwise be subject to withholding tax at the high rate under provisions comparable to article 10(2)(b) of the OECD model convention into dividends that qualify for the low treaty rate under provisions comparable to article 10(2)(a) of the OECD model convention on dividends paid by a subsidiary to its parent company;²⁹⁰ and
- transactions that dilute the proportion of an entity’s value attributable to immovable property situated in a state in order to convert gains that would otherwise be subject to tax in that state under a substituted property rule into gains that are exempt from tax in the state in which the immovable property is situated under provisions comparable to article 13(5) of the OECD model convention.²⁹¹

Since these kinds of transactions or arrangements may be undertaken by persons who are already residents of a contracting state in order to access benefits under a

287 Paragraphs 8.2-8.28 of the commentary on article 15 of the OECD model convention.

288 See, for example, the UN report *Treaty Abuse and Treaty Shopping*, supra note 22, at paragraphs 54-57.

289 Ibid., at paragraphs 59-60.

290 Ibid., at paragraphs 68-69.

291 Ibid., at paragraphs 74-75.

specific provision of a tax treaty entered into by that state, they are often labelled “rule shopping” as opposed to “treaty shopping.”²⁹²

Unlike objections to tax treaty shopping, which address the objects and purposes of tax treaties as a whole,²⁹³ objections to treaty rule shopping emphasize the objects and purposes of specific treaty provisions themselves, which may be undermined by transactions and arrangements that qualify for benefits under a specific provision or circumvent the application of a less advantageous provision in a manner contrary to the object and purpose of these provisions.²⁹⁴ Where an entertainer or sportsperson diverts income from personal activities exercised in one state to a star company resident in another state in order to avoid a treaty provision that would otherwise allow this income to be taxed in the state in which the activities are exercised, for example, this diversion circumvents the application of the treaty provision in a way that may defeat its underlying object or purpose of allowing the state in which these activities are exercised to tax the income from these activities. Likewise, where the incorporation of immovable property situated in one state allows a person resident in another state to avoid a treaty provision that would otherwise allow the first state to tax gains from the alienation of the property, the incorporation and alienation of shares circumvents the application of the treaty provision in a way that may defeat its underlying object or purpose of allowing the state in which immovable property is situated to tax gains from the alienation of such property. Moreover, to the extent that these and other rule-shopping transactions or arrangements facilitate unintended non-taxation or reduced taxation, treaty rule shopping raises the same concerns as tax treaty shopping.²⁹⁵

As with tax treaty shopping, states have relied on domestic anti-avoidance doctrines and rules as well as treaty-based anti-avoidance rules to counteract many of these rule-shopping transactions or arrangements. In order to deny treaty benefits that could otherwise be available through surplus-stripping transactions that convert dividends into gains from the alienation of shares, for example, some states have relied on domestic anti-avoidance doctrines while others have introduced specific statutory anti-avoidance rules that recharacterize proceeds from certain share transactions as dividends.²⁹⁶ Although it might be argued that these domestic

292 See, for example, Adolfo J. Martín Jiménez, “Domestic Anti-Abuse Rules and Double Taxation Treaties: A Spanish Perspective—Part I” (2002) 56:11 *Bulletin for International Fiscal Documentation* 542-53, at 543; De Broe, *supra* note 18, at 10; and Danon and Salomé, *supra* note 2, at 214.

293 See *supra* notes 19-23 and the accompanying text.

294 Final report on BEPS action 6, *supra* note 9, at 69.

295 See, for example, the UN report *Treaty Abuse and Treaty Shopping*, *supra* note 22, at paragraph 32.

296 In the Netherlands, for example, the tax authorities have sought to rely on the *fraus legis* (abuse-of-law) doctrine, apparently without success. De Broe, *supra* note 18, at 407-9. In Canada, on the other hand, cross-border surplus-stripping transactions are subject to a specific statutory anti-avoidance rule in section 212.1 of the Income Tax Act.

anti-avoidance doctrines and statutory anti-avoidance rules contradict tax treaty obligations,²⁹⁷ the OECD takes the position that these doctrines and rules do not conflict with tax treaty obligations to the extent that they determine the characterization of transactions and arrangements to which tax treaties apply.²⁹⁸ The Tax Court of Canada took a similar view in a case involving a cross-border surplus-stripping transaction, concluding that it would be

a surprising conclusion that Canada, or indeed any of the other countries with which it has tax treaties . . . had intentionally or inadvertently bargained away its right to deal with tax avoidance or tax evasion by residents of treaty countries in its own domestic tax laws . . . [and] equally 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 perpetuated with impunity by non-residents under the protection of a treaty.²⁹⁹

Likewise for hiring-out of labour arrangements, the OECD commentary notes that “many States” have developed “various legislative or jurisprudential rules and criteria” in order to distinguish “cases where services rendered by an individual to an enterprise should be considered to be rendered in an employment relationship (contract of service) from cases where such services should be considered to be rendered under a contract for the provision of services between two separate enterprises (contract for services).”³⁰⁰ In addition, the commentary explains:

297 This appears to have been the basis for decisions in the Netherlands in which the courts rejected the argument that capital gains should be recharacterized as dividends.

298 Paragraphs 73 and 76-80 of the commentary on article 1 of the OECD model convention. For an exhaustive analysis of the relationship between domestic anti-avoidance rules and tax treaties, see Jinyan Li and Daniel Sandler, “The Relationship Between Domestic Anti-Avoidance Legislation and Tax Treaties” (1997) 45:5 *Canadian Tax Journal* 891-958.

299 *RMM Canadian Enterprises Inc. et al. v. The Queen*, 97 DTC 302, at paragraph 56 (TCC). The court’s conclusion that section 212.1 of the Income Tax Act did not conflict with provisions of the Canada-US tax treaty also turned on the text of article X(3) of that treaty, which defines a dividend 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.” For a useful discussion of the case in the context of OECD commentaries on the relationship between tax treaties and domestic anti-avoidance rules, see Arnold, *supra* note 107, at 249-52.

300 Paragraph 8.4 of the commentary on article 15 of the OECD model convention. In the event that states have not adopted such legislative or jurisprudential rules, the commentary explains that states are free to adopt bilaterally a provision along the following lines:

Paragraph 2 of this Article shall not apply to remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State and paid by, or on behalf of, an employer who is not a resident of that other State if:

a) the recipient renders services in the course of that employment to a person other than the employer and that person, directly or indirectly, supervises, directs or controls the manner in which those services are performed; and

[E]ven where the domestic law of the State that applies the Convention does not offer the possibility of questioning a formal contractual relationship and therefore does not allow the State to consider that services rendered to a local enterprise by an individual who is formally employed by a non-resident are rendered in an employment relationship (contract of service) with that local enterprise, that State may deny the application of the exception [in article 15(2)] in abusive cases.³⁰¹

As a result, the commentary concludes, these transactions or arrangements may be challenged either under domestic anti-avoidance doctrines or statutory general anti-avoidance rules, or as an abuse of the convention itself.³⁰²

In order to address the diversion of income to star companies, on the other hand, the OECD model convention was amended in 1977 to allow states in which personal activities are exercised by an entertainer or sportsman to tax income in respect of those activities that accrues to a person other than the entertainer or sportsman.³⁰³ As the OECD commentary explains, this provision allows states whose domestic law does not allow them to look through these arrangements “to impose a tax on the profits diverted from the income of the entertainer or sportsman to the enterprise.”³⁰⁴ In the years since 1977, a corresponding star company provision has been added to many bilateral tax treaties.³⁰⁵

The OECD model convention was also amended to eliminate treaty benefits that could otherwise be obtained through indirect ownership of immovable property, by adding a provision that extends source-state jurisdiction to gains derived by a resident of a contracting state from the alienation of shares “deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State.”³⁰⁶ Based on an earlier provision in the 1980 UN model

b) those services constitute an integral part of the business activities carried on by that person.

Paragraph 8.3 of the commentary on article 15 of the OECD model convention.

301 Paragraph 8.8 of the commentary on article 15 of the OECD model convention.

302 This conclusion was clear from paragraph 8.9 of the commentary on article 15, which specifically referred to paragraph 9.4 of the commentary on article 1. These paragraphs were deleted with the 2017 revisions to the commentary. For a useful discussion of the commentaries on article 15, see Luc De Broe and Katrina Petrosovitch, “The Concepts of ‘Employment’ and ‘Employer’ Under Article 15 of the OECD Model Convention,” in *Essays on Tax Treaties: A Tribute to David A. Ward*, supra note 88, 207-38.

303 Article 17(2) of the OECD model convention.

304 Paragraph 11(c) of the commentary on article 17 of the OECD model convention. For a useful review of this provision, see Dick Molenaar and Harald Grams, “Rent-a-Star—The Purpose of Article 17(2) of the OECD Model” (2002) 56:10 *Bulletin for International Fiscal Documentation* 500-9.

305 See, for example, article XVI(2) of the Canada-US tax treaty, supra note 48.

306 Article 13(4) of the 2003 OECD model convention, supra note 99. As will be explained in the second part of this article, this provision was amended following BEPS action 6 to also include

convention³⁰⁷ and consistent with prior treaty practice of many states, including Canada,³⁰⁸ the obvious purpose of this provision is “to prevent the avoidance of taxes on the gains from the sale of immovable property,” which would otherwise be “relatively easy to avoid . . . through the incorporation of a company to hold such property.”³⁰⁹ As with the star company rule, this “substituted property rule” has also been added to many bilateral tax treaties.³¹⁰

Treaty-based specific anti-avoidance provisions have also been relied on to ensure that the reduced withholding tax rate on dividends paid by a subsidiary to a parent company is available only if the subsidiary is a “real subsidiary” that “was genuinely owned long term by the parent.”³¹¹ As explained earlier,³¹² the dividend article in the 1942 Canada-US tax treaty included anti-abuse language denying the lower withholding tax rate where the relationship between the two corporations “has been arranged and is maintained primarily with the intention of taking advantage of this paragraph.”³¹³ This provision is a clear antecedent to contemporary purpose tests that deny all benefits under the dividend articles of tax treaties if

it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.³¹⁴

gains from the alienation of other interests deriving their value primarily from immovable property, and to apply where this proportionate value threshold is met at “any time during the 365 days preceding the alienation” of the shares or comparable interests. These amendments are also included in article 9(1) of the MLI.

- 307 United Nations, *Model Double Taxation Convention Between Developed and Developing Countries* (New York: United Nations, 1980), article 13(4). For a detailed discussion of the capital gains article in model tax conventions, see David W. Smith, “Model Conventions and the Capital Gains Article,” in *Essays on Tax Treaties: A Tribute to David A. Ward*, supra note 88, 147-205, at 181.
- 308 Luca Tagliatalata, “Treaty Abuse and Passive Income: Holding Period for Intercompany Dividends and Modifications to Article 13 Para. 4 OECD MC,” in Daniel W. Blum and Markus Seiler, eds., *Preventing Treaty Abuse* (Vienna: Linde, 2016), 463-98, at 489-90.
- 309 United Nations, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York: United Nations, 2011), paragraph 8 of the commentary on article 13.
- 310 For a list of Canada’s tax treaties with and without this rule, see David N. Finkelstein and Ronald K. Durand, “The Substituted Property Rule in Article 13 of the OECD and UN Model Tax Conventions,” in *Essays on Tax Treaties: A Tribute to David A. Ward*, supra note 88, 103-45, at 132-42.
- 311 Vann, supra note 92, at 271-72.
- 312 See supra note 273 and the accompanying text.
- 313 Article XI(2) of the 1942 Canada-US tax treaty, supra note 125. Similar language appeared in article VI of the 1945 UK-US tax treaty, supra note 273.
- 314 See, for example, article 10(8) of the Canada-UK tax treaty, supra note 242.

Although these provisions may be used to challenge tax-treaty-shopping transactions or arrangements, they may also be used to challenge rule-shopping transactions or arrangements undertaken to obtain a reduced withholding tax rate on dividends paid by a subsidiary to a parent company.³¹⁵ Even without these specific anti-avoidance provisions, however, the OECD commentary has taken the position that the reduced withholding tax rate under the dividend article “should not be granted in cases of the abuse of the provision”—for example, where a company increases its shareholding “shortly before . . . dividends become payable . . . primarily for the purpose of securing” the low withholding tax rate, or “where the qualifying holding was arranged primarily in order to obtain the reduction.”³¹⁶

In contrast to these measures to counteract treaty rule shopping, there appears to have been less concern, until recently, about transactions designed to circumvent the substituted property rules by diluting the proportion of an entity’s value attributable to immovable property prior to the alienation of shares or other interests. After these transactions were identified as a type of treaty abuse in the 2006 United Nations report *Treaty Abuse and Treaty Shopping*,³¹⁷ however, the UN model tax convention was amended to include a provision extending source-state taxation to

[g]ains . . . derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State . . . if the alienator, at any time during the 12-month period preceding such alienation, held directly or indirectly at least ___ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.³¹⁸

As will be explained in more detail in the second part of this article, a similar anti-abuse provision appears in article 9(1)(a) of the MLI, which has been incorporated into article 13(4) of the OECD model convention.

According to the final report on BEPS action 6, “targeted specific treaty anti-abuse rules” such as these “generally provide greater certainty for both taxpayers and tax administrations” than general anti-abuse provisions like the PPT.³¹⁹ What is less clear is the relationship between these specific anti-avoidance rules and a

315 In this circumstance, however, it appears that the effect of the rule is to deny all benefits under the dividend article, even including the higher withholding tax rate on dividends! As the second part of this article will explain, a similar result may occur under the PPT if it is not accompanied by a remedial provision like article 7(4) of the MLI.

316 Paragraph 17 of the commentary on article 10 of the 2003 OECD model convention, supra note 99. As will be explained in the second part of this article, concerns about this type of rule shopping underlie the anti-abuse provision in article 8(1) of the MLI, which was incorporated into article 10(2)(a) of the OECD model convention.

317 Supra note 22.

318 Article 13(5) of the UN model tax convention, supra note 309.

319 Final report on BEPS action 6, supra note 9, at paragraph 27.

general anti-abuse provision, and the extent to which a general anti-abuse provision like the PPT can be applied to rule-shopping transactions or arrangements that are not subject to a specific anti-abuse rule in a CTA. This and other issues concerning the MLI and the PPT will be taken up in the second part of this article, which will appear in a subsequent issue of this journal.

