Treaty Shopping and International Tax Planning

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1. Introduction

Countries consider taxes an essential manifestation of their sovereignty. Economic power is often superior to political power and nowadays in a "globalized world" over 3,000 bilateral treaties are in force, limiting the national right to levy taxes.[1]

The League of Nations[2] and the Organization for Economic Cooperation and Development (OECD) try to promote treaties to avoid double direct taxation by issuing models, commentaries as well as reports[3] on specific international tax issues. However, many countries started to implement domestic provisions to reduce double taxation at the beginning of the 1900s.[4]

The declared intention of the Model Tax Convention on Income and Capital issued by the OECD is to *"[...] clarify, standardise, and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation [...]"*.[5]

A tax treaty applies to resident persons and allocates taxing rights between the contracting states without saying anything about the application and the kind of tax.[6] Double taxation can be eliminated through unilateral domestic measures or by the treaty provision on the credit method or the exemption method.[7] When the

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1 Uckmar et al., *Diritto tributario internazionale – Manuale* – (Milanofiori Assago (MI): Cedam, 2012), p. XXII and *Addressing Base Erosion and Profit Shifting* (OECD: Paris, 2013), p. 34.

2 HJI Panayi, *Double Taxation*, *Tax Treaties*, *Treaty Shopping and the European Community* (Eucotax, 2007), p. 15 *"[...] As early as the 1923 League of Nations report it was noted that [this] 'double' tax was, in effect, a protective tariff on the importation of capital into the source state [...]"*.

3 *Issues in International Taxation Series*, *n. 1*, *International Tax Avoidance and Evasion*, *Four Related Studies*, (OECD: Paris, 1987); *Taxing Profits in a Global Economy: Domestic and International Issues* (OECD: Paris, 1991); *Harmful Tax Competition: An Emerging Global Issue* (OECD: Paris, 1998); *Consolidated Application Note – Guidance in applying the 1998 Report to preferential tax regimes* (OECD: Paris, 2004); *Hybrid Mismatch arrangements; Tax policy and compliance issues* (OECD: Paris, 2012).

4 Ward, *Access to tax treaty benefits* (Toronto: Advisory Panel on Canada's System of International Taxation, 2008), p. 2.

5 *Organization for Economic Cooperation and Development. Model Tax Convention on Income and on Capital* (Paris: OECD, 2010), p. 7.

5 The mainstream opinion reports that a general international avoidance of double taxation would bring to a general lack of taxation, treaties can allocate income and capital between states (Fantozzi and Vogel, *Doppia imposizione internazionale*, *Digestio delle Discipline Privatistiche*, *Sezione Commerciale* (Torino: UTET, 1990), p. 183.

6 Vanistendael, "Taxation and Non-Discrimination, A Reconsideration of Withholding Taxes in the OECD" *World Tax Journal* June 2010, p. 176.

7 The credit method enables the granting of credit for the taxes levied by the source state; in contrast, the exemption method provides for the exemption of certain items of income; the first method is adopted by Anglo-American countries; the exemption method is generally the most common among the other countries.

last method is adopted, the application of a tax treaty may result in "double non-taxation".[8]

Starting from 2003 the OECD Commentary[9] to Model Tax Convention suggests that the aim of tax treaties is not only the avoidance of double taxation but also the prevention of tax avoidance and evasion[10]. However, in international taxation there is no clear distinction between legitimate tax planning and tax avoidance or evasion. *Rosenbloom observes that "treaty abuse" is not a point of common understanding and agreement.*[11]

In recent years the global financial and economical crisis supports the general idea of raising taxes between governments. In 2006 the Tax Administrations from more than 30 countries in a meeting in Seoul expressed the necessity to achieve a better compliance with the law, working within the existing framework of bilateral agreements. This important meeting agreed on four areas of improvement and study: implementing a directory of aggressive tax planning schemes, identifying trends and possible countermeasures; evaluating the role of tax intermediaries; realizing Corporate Governance Guidelines and improving the training of tax officials in international tax issues.[12]

The European Commission has published Recommendations and Communications in relation to this problem.[13]

Lately the OECD has issued relevant reports about aggressive international tax planning.[14] The OECD recently prepared a directory of Aggressive Tax Planning at the disposal of government officials.[15]

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8 Lang, *Introduction to the Law of Double Taxation Conventions* (Vienna: Linde, 2010), p. 31.

9 *OECD Model Tax Convention on Income and on Capital* p. 59 "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".

10 In the version of 1997 OECD Commentary on Art. 1 (7) reported *"they should not, however, help tax avoidance or evasion [...]"*.

11 Rosenbloom, "Tax Treaty abuse: Policy and Issues", *Law and Policy in International Business*, (1983), p. 766.

12 *Final Seoul Declaration* http://www.oecd.org/tax/taxadministration/35415572.pdf (accessed on 7 January 2013).

13 *Commission Recommendation of 6.12.2012 on aggressive tax planning* (Brussels, 6.12.2012 C (2012) 8806 final, *Communication from the Commission to the European Parliament and Council an Action Plan to strengthen the fight against tax fraud and tax evasion* (Brussels, 6.12.2012 COM (2012) 722 final, *Commission Recommendation of 6.12.2012 regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters*, (Brussels, 6.12.2012 C (2012) 8805.

14 *Addressing Base Erosion and Profit Shifting* (OECD: Paris, 2013); *Hybrid Mismatch arrangements: Tax policy and compliance issues* (OECD: Paris, 2012); *Corporate Loss Utilisation through Aggressive Tax Planning* (OECD: Paris, 2011); *Tackling Aggressive Tax Planning through Improved Transparency and Disclosure* (OECD: Paris, 2011); *Engaging with high net worth individuals on tax compliance* (OECD: Paris, 2011).

15 *Forum on Tax Administration, List of publications Tax Administration Guidance & Information Series* www.oecd.org/ctp/taxadministration/48155143.pdf (accessed on 7 January 2013); also some national government such as Australia have implemented a website with aggressive tax planning schemes.

Currently there is a general interest in corporate tax planning strategies that ensure: (i) minimisation of taxation at source country, (ii) low or no withholding tax at source, (iii) low or no taxation at the level of the recipient and no taxation at the level of the ultimate parent company. These strategies may be technically legal but the overall effect is to erode the overall level of taxation.[16] The US President *Obama* in his report for Business Tax Reform stated that "*[...] there is also strong evidence that corporations use accounting mechanisms to shift profits from where they are actually earned to tax havens and other low-tax jurisdictions [...]"*.[17]

Hence, it seems that aggressive tax planning is an important topic on the agenda of governments.

1.1. The definition of "treaty shopping"

Treaty shopping is a well-known phenomenon among Tax Administrations, practitioners and academics. There is still debate if it is or is not legitimate tax planning.[18] Even at the OECD level there is no clear guidance on what should be considered tax avoidance and legitimate tax planning.[19]

One of the aims of this paper is to try to analyse the treaty shopping concepts among international institutions and some countries thereby underlining similarities and differences.

For a correct interpretation of tax treaties Article 31 of the Vienna Convention concluded 23 May 1968 provides that "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose […]".[20]

A different interpretation of the above-mentioned principle could lead to an improper use of treaties and illegitimate tax planning.

The etymology of treaty shopping comes from the US civil procedure known as "forum shopping" where litigants try to "shop" for the most suitable jurisdiction.[21] *Rosenbloom* defines this expression as *"the practice of some investors of*

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16 *Addressing Base Erosion and Profit Shifting* (OECD: Paris, 2013), p. 45..

17 The President's Framework for Business Tax Reform (see http://www.treasury.gov/resource-center/tax-policy accessed on 28 November 2012). Big hi-tech multinationals in recent years have been able to cut their taxes using a technique that moves profit to tax havens, and this behaviour seems, so far, not to break any laws in any country. One of those techniques is a complex tax planning scheme that also includes treaty shopping called the "Double Irish Dutch Sandwich" Russo, "*Principles of International Tax Planning"*, (materials of the LL.M. lecture in International Tax Law, Vienna, November 2012) and *Addressing Base Erosion and Profit Shifting* (OECD: Paris, 2013), p. 74.

18 Avi-Yonah and HJI Panyi, "Rethinking Treaty-Shopping Lessons for the European Union", University of Michigan Law School, Working Paper 182 (2010).

19 Finnerty et al., *Fundamentals of International Tax Planning* (Amsterdam: IBFD, 2007), p. 54.

20 *Vienna Convention on the Law of Treaties 1969* (Vienna: United Nations, 1969), p. 12.

21 Avi-Yonah and HJI Panyi, "Rethinking Treaty-Shopping Lessons for the European Union", *University of Michigan Law School*, *Working Paper* 182 (2010), p. 2.

"borrowing" a tax treaty by forming an entity (usually a corporation) in a country having a favourable tax treaty with the country of source – that is, the country where the investment is to be made and the income in question is to be earned".[22] *Vogel* observes that those transactions are entered or established in other States *"[...] solely for the purpose of enjoying the benefit of particular treaty rules existing between the State involved and a third State which otherwise would not be applicable, e.g. because the person claiming the benefit is not a resident of one of the contracting States [...]"*.[23]

In this particular structure there is an interposition of an entity resident in a third State between the income flow of the source State and the beneficiary State. This interposition reduces the taxation due to the use of existing treaties. Those benefits would not be available if the income flow was naturally direct from the source State to the recipient State.[24]

A simple example of treaty shopping could be the following: A Romanian company needs US technology for its production plant. The US-Romania tax treaty provides for a source taxation of 15% on industrial royalties.[25] In contrast, according to the Austria-Romania tax treaty, withholding tax for the source state is 3%[26] (if the Interest-Royalties Directive is not applicable)[27]; besides the US-Austria tax treaty provides for the exemption of royalties for the source state.[28] Instead of a direct licence agreement between the US and Romanian company a licence agreement between the US and Austria with a sub-licence from the Austrian company to the Romanian one would have a global lower withholding taxation

22 Rosenbloom, "Derivative Benefits: Emerging US Treaty Policy", *Intertax*, (1994), p. 83.

23 Vogel, *On Double Tax Conventions*, (Deventer/Boston: Kluwer, 1991), p. 50.

24 Van Weeghel, *The improper use of tax treaties. With particular reference to the Netherlands and the United States* (London: Kluwer, 1998), p. 119.

25 See Art. 12 of the Convention between the Government of the United States of America and the Government of the Socialist Republic of Romania with respect to taxes on income, signed at Washington on December 4, 1973, in www.irs.gov/pub/irs-trty/romania.pdf, accessed on 20 February 2013).

26 See Art. 12 of the Convention between the Republic of Austria and Romania for the Avoidance of Double Taxation and the prevention of fiscal evasion with respect to taxes on income and on capital, signed in Bucharest on 30 March 2005, in www.ris.bka.gv.at, (accessed on 20 February 2013).

27 Art. 1 (4) of the Interest-Royalties Directive 2003/49/EC of 3 June 2003, provides that *"A company of a Member State shall be treated as the beneficial owner of interest or royalties only if receives payments for its own benefit and not as an intermediary, also as an agent, trustee or authorised signatory, for some other person"*.

28 See Art. 12 of the Convention between the United States of America and the Republic of Austria Republic of Austria and Romania for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed at Vienna on May 31, 1996, in http://www.irs.gov/pub/irs-trty/austria.pdf, (accessed on 20 February 2013).

(3% instead of 15%). This is a simple structure of treaty shopping, defined by the OECD as a "direct conduit".[29]

To sum up, the aim of treaty shopping is to optimise the tax burden of a financial transaction especially where there is the need to distribute passive income (dividend, interest and royalties). Generally, some countries with zero/really low withholding tax or with peculiar holding domestic regimes are taken into consideration for treaty shopping structures (generally the Netherlands, Luxembourg, Switzerland, etc.).[30]

Some authors make a distinction between "treaty shopping" and "rule shopping"[31]. The latter is *"[...] usually directed towards making a certain distributive role of a tax treaty and who employs that treaty in the most favourable manner [...]"*.[32] For example, in order to avoid the withholding tax on a dividend, a taxpayer restructures the operation in an alienation of shares to a company; in a second moment the dividend is paid to another company according to the Parent-Subsidiary Directive.[33] This structure is a tax-saving one where a tax treaty does not provide for withholding on capital gains.[34]

Directive shopping[35] can be considered another form of treaty shopping. European directives on parent-subsidiaries, mergers, interest and royalties and savings aim to eliminate the tax disadvantages within Europe with provisions generally

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29 See *Issues in International Taxation Series*, *n. 1*, *International Tax Avoidance and Evasion*, *Four Related Studies*, (OECD: Paris, 1987). This report analysed in Section II has contributed to the revision of the OECD Commentary of Art. 1 in 2003. See Arnold, "Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model", *Bulletin – Tax Treaty Monitor*, (2004), 244, and Lukota, "*Abuse of Tax Treaties*," (materials of the LL.M. lecture in International Tax Law, Vienna, March 2012). In this simple example it has been assumed that all the anti-avoidance domestic provisions and the beneficial owner concept of the tax treaty are fulfilled.

30 According to *Eynatten* ,*"[...] the Netherlands remain the first choice of holding company location within Europe for many multinational groups and Luxemburg the natural alternative [...]*, see Eynatten "European Holding Company Tax Regimes: A Comparative Study", *European Taxation*, (2007), p. 563.

30 Switzerland, in contrast to the above quoted states, generally has a higher withholding tax on passive income (only if the debtor is a person resident in Switzerland) but has very favourable tax regime for holding companies, administrative companies and mixed companies and an agreement with the EU on interest androyalties; see Waldburger, "*Swiss Tax Law"*, (materials of the lecture of LL.M. in International Tax Law, Vienna, March 2013).

31 For a deeper analysis of directive shopping see Bonschak's contribution to this volume "Rule shopping and international tax planning".

32 De Broe, *International tax Planning and prevention of Abuse* (Amsterdam: IBFD, 2009), p. 10.

33 The Parent-Subsidiary Directive 2011/96/EU of 30 November 2011 at Art. 4 provides relief for dividends between a parent company and its subsidiary; see Section III.3.

34 Such as the majority of Belgian tax treaties; see De Broe, *International Tax Planning and Prevention of Abuse* (Amsterdam: IBFD, 2009), pp. 10-11.

35 For a deeper analysis of directive shopping, see Csővári's contribution to this volume "Directive shopping and international tax planning".

more favourable than the tax treaties between European countries; a non-European resident could still exploit those advantages and avoid a withholding tax on a dividend by channelling the passive income via a conduit European company. This directive shopping could also take place among European corporations as well; in fact, the implementation of the directive is provided for by the national legislator. For this reason, still might be some differences between European countries, such as the minimum holding period,[36]that could lead to directive shopping within the European Union.[37]

1.2. The role of OECD Commentaries with respect to treaty shopping

Art. 3 of the OECD Model Convention provides for a general interpretation rule of terms provided for in a treaty[38]. The Commentary suggests a dynamic interpretation for the undefined expressions; according to this concept the meaning has to be clarified according to the domestic tax law *"[...] in force when the Convention is being applied, i.e. when the tax is imposed [...]"*.[39] Some authors argue, however, that the dynamic interpretation could be used by a contracting state for a non *bona fide* reinterpretation.[40]

Another important issue is the ongoing evolution of models and Commentaries. The OECD Committee on Fiscal Affairs (CFA) argues that changes to the Commentary are applicable to previous tax treaties, concluded before the change of the Commentary, as well.[41]

36 For example, the minimum holding period; the Parent-Subsidiary Directive 2011/96/EU of 30 November 2011, provides at Art. 3 (2) for a maximum holding period of two years as a condition for the application of the directive; Member States decided in their domestic law to adopt different holding periods; France has adopted a two-year holding period; generally other Member States have a holding period requirement of one year; The Netherlands has no minimum holding period. See Eynatten, "European Holding Company Tax Regimes: A Comparative Study", *European Taxation*, (2007), p. 562. On the other hand, differences never exist with respect to the tax rate among European Member States.

37 De Broe, *International Tax Planning and Prevention of Abuse*, pp. 21-23.

38 "*As regards the application of the Convention at any time by a Contracting State*, *any term not defined therein shall*, *unless the context otherwise requires*, *have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies*, *any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State"*.

39 OECD Commentary Art. 3 paragraph 2.

40 Kuiper, "l'interpretazione dei trattati" in: Dragonetti Piacentini Sfondrini, *Manuale di fiscalità internazionale* (Milanofiori Assago (MI): Ipsoa, 2010), pp. 117–121.

41 In September 2006 the majority of a group of experts participating in a conference about the legal status of OECD Commentaries expressed the view that there is no binding obligation to follow commentaries, see Duoma and Engelen, *The Legal Status of the OECD Commentaries* (Amsterdam: IBDF, 2010), pp. 251-272; on the same issue Maisto observes that the Commentary can be used for interpretation of treaties in force from 2003; see Maisto, "Elusione ed abuso del diritto tributario", *Quaderni della rivista di diritto tributario* (2009), p. 277.