Domestic Anti-Avoidance Legislation in Relation to Tax Treaty Law

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Abstract

In today's international taxation most of the developing countries enter into tax treaties which are drafted in line with the OECD MC to eliminate double taxation. Yet, is well-known fact that tax treaties in practice are abused by tax payers, therefore, majority of states have introduce legislation specifically designed to prevent tax avoidance and protect their domestic interests. In legal practice and literature the act of overriding international tax treaties and denying treaty benefits in favour of domestic law provisions threatens main principle of international law and therefore is questionable to what extend the relationship between domestic law and international tax treaty agreements bridges the international norms.

Keywords: *domestic law, tax treaty, tax avoidance, OECD MC*

Introduction

The free movement of people and capital has enabled individuals and businesses to engage in cross-border transactions, this fact has raised concerns in many states about the potential erosion of the domestic tax base. In the other hand, there are several jurisdictions that have made their tax environment available for tax avoidance known as 'tax haven'. Apparently, this problem has become pressing issue for different countries, as well as, intensively have been discussed in an international context. Most of the countries have introduced legislation specifically designed to prevent tax avoidance and protect their domestic interests[1].

Accordingly, the act of overriding international tax treaties in favour of domestic law provision threatens the internationality of bilateral and multilateral agreements as founding principles of international law strongly advised by Vienna Convention and adopted in international law practice. Nevertheless, it is a notable fact that international tax treaties might be abused by tax payers to benefit tax advantages that are not meant by the context and purpose of the treaty, hence, while tax treaties provide a great structure that encourages cross-border trade and investments they also provide opportunities for taxpayers to avoid domestic tax obligations. Therefore, nowadays this is a pressing legal issue and signified by 'disagreements' among scholars' weather domestic anti-avoidance legislation can be applied to deny the treaty benefits[2].

In this regard, states have introduced domestic anti-avoidance rules to prevent the possible tax evasion, however, it is questionable to what extend the relationship is between domestic law and international tax treaty agreements.

In addition, OECD in its Commentary has incorporated a note on this issue by setting an analytical framework from which the relationship between domestic general anti-avoidance rules and international tax treaty agreements is to be evaluated as this is the main purpose of this paper to analyse the changes made in the commentary in 2003 and the weight of this work with the reference to guiding principles set in the Commentary.

Conceptualizing the issue of domestic anti-avoidance rules and international tax treaty agreements

With the free movement of capital and the fact that businesses are becoming more and more international tax avoidance as mentioned it is a pressing issue for countries worldwide. However, in order to facilitate the 'process' of cross-border transactions and protect domestic economise from tax avoidance there is a great need for coherent structures; in this regard, such structures are considered international tax treaties[3]. International tax treaties encourage economic

[1] Michael Lang (ed.) '*History of Tax Treaties'* (Linde, 2011), p.19
[2] Michael Lang '*Introduction to the Law of Double Taxation Convention'* (IBFD, 2010) p.59
[3] Lang (ed.) (2011) p. 45-56

investments by promoting the movement of capital and exchange of goods and services by preventing international double taxation which is generally defined as *"a form of double taxation on the same income by both country of residence and the source country in respect of the same subject matter and for the same period*[1]*".*

However, it is evident that international tax treaties provide taxpayers with the possibility to avoid domestic tax obligations by receiving benefits under the treaties. In this regard, countries have passed anti-avoidance rules to protect their domestic interests by provoking a 'direct tension' between the international treaty and the domestic law. However, it is worth mentioning that the Commentary on the OECD MC considers the notion of the abuse of a treaty as a doctrine of international law which according to the commentary might denied the benefits from the treaty by considering it as purposive interpretation of tax convention[2].

In order to evaluate the approaches of the relationship between tax treaties and domestic anti-avoidance rules there are two fundamental principles which should be taken into account. First; the application of the domestic anti-avoidance rules, application of which may 'weaken' the certainty of tax treaties and second: the inviolability of the agreements signed between states[3]. The relationship between tax treaties and domestic anti-avoidance rules it is a dynamic process which differs from country to country, however, most of the practitioners and scholars often refer to the OECD MC Commentary for further explanation.

The Commentary on OECD MC Article 1 sets an interpretative framework in order to analyse the connection between domestic anti-avoidance rules and international tax treaties, however, is important to mention that according to different legal ieenterpretations the Commentary on Art.1 before the revisions on 2003 was unclear about this matter by indicating in one hand the right of countries that had domestic anti-avoidance rules to include this legal provisions in their treaties with the aim on preventing the application of these rules, on the other hand, the commentary had provisions suggesting that domestic anti-avoidance rules which are not in line with the treaties do not have to be expressly included in treaties[4]. Consequently, before the revision on 2003 two main questions that domestic anti-avoidance rules had to consider where if; benefits derived by the treaty must be granted even if they abuse the treaty provision and second if domestic anti-avoidance rules conflict with treaties[5].

Changes made on Article 1 of the OECD Commentary in 2003

Changes made in the Commentary on Article 1 in 2003 were described as considerable changes which intend to clarify the relationship between tax treaties and domestic anti-avoidance rules. However, it is pointed out that the Article 1 of the Commentary has gone beyond its provisions by commenting the relationship between domestic anti-avoidance rules and tax treaties[6].

It is worth mentioning that changes in commentary have been preceded by the Rome Congress of the International Fiscal Association in 2010 which served as a forum to analyse this relationship of domestic law and tax treaty worldwide. Stef van Weeghel in his report about the forum has concluded that most of the countries has reported that their anti-avoidance rules are in light with their treaty obligations[7].

The changes made on Article 1 of the OECD Commentary in 2003 might be consider in three areas. Changes on paragraph 7, an additional paragraph in 9.1 to 9.6 and 22, as well as, changes on paragraphs 10.1 and 21.5 regarding avoidance issues defined as conduit companies and beneficial ownership as well as under paragraph 23 and 26 regarding controlled foreign companies.

Paragraph 7 indicates two major differences after the changes has been made in 2003; the word 'principal' is inserted referring to the objective and purpose of tax treaties to promote cross-border trade by eliminating double taxation and encouraging the movement of persons and capital. Hence, this is explained that the purpose of tax treaties is to prevent tax avoidance/evasion, the previous commentary hasn't been so expressive on this issue[8]. Further, par.7.1 considers the

[1] Same definition can be found also in different business dictionaries (example: http://www.businessdictionary.com/definition/juridical-double-taxation.html)
[2] OECD Commentary to Article 1 par.9.2
[3] Lang, (2010) p.62-63
[4] Guglielmo Maisto '*Tax Treaties and Domestic Law*', p. 99, Same interpretation can be found also at Lang '(2010), p. 62
[5] Commentary on Article 1 par.9
[6] Craig Elliffe '*Cross Border Tax Avoidance: Applying the 2003 OECD Commentary to Pre-2003 Treaties*'
[7] International Fiscal Association '*Key Issues Report*' 2010, The report indicates the reservation made by Netherland and Portugal.
[8] Commentary on Article 1 of the OECD MC, 2010, and Commentary on Article 1 of the OECD MC 2013

possibility of abusing the tax laws of states by exploiting the differences that countries might have in their domestic laws, however, the commentary acknowledge that this attempts most probably will be 'rejected' by domestic law, but also suggests that states would not agree to tax treaty provision that might allow transactions which may allow tax benefits[1].

Nonetheless, there are views that the changes on 2003 where more in the nature of clarification rather than substantial changes, in this direction according to David Ward most of these changes has been proposed in the 1986 Base Companies Report in particular discussion weather the general anti-avoidance rules can be applied in all the circumstances or only in particular cases where are expressly mention[2]. Paragraph 40 of the Base Companies Report stated: *"It is the view of the majority that such rules and the underlying principle do not have to be confirmed in the text of the convention to be applicable"*[3]. Further, the paragraph 39 of the Base Companies Report was discussed in the Commentary of 1992 in its paragraph 23 by emphasising the fact that majority of OECD countries would consider domestic anti-abuse rules or as known 'substance over form' as basic rule for determining the facts which give rise to tax liability in domestic context, in this regard changes proposed under Commentary 2013 paragraph 22.1 are reflection of this suggestion made back in time in 1992[4].

In this regard, changes under par. 10.1 and 21.5 as well as under par. 23 and 26 are mostly reflections to clarify the confusion of the 1992 Commentary made which was supported only by few OECD countries at that time, which where protective to apply domestic anti-abuse rules.[5]

Nevertheless, the 2003 OECD Commentary has brought new reflections in relation to its article 1 on the improper use of tax treaties by deleting the point 7 of the Commentary on Art.1 which was defending states to preserve the application of their domestic anti-avoidance rules by obliging sates to add specific provision to that effect in their treaties. However, this changes have been justified by the commentary by making a distinguish between states for which an abuse of treaty is also an abuse of the domestic law and those states that consider these abuse as treaty abuse. Furthermore, the changes of 2003 OECD Commentary emphasis the fact that states by applying anti-abuse provision in a treaty context will not find legal problems as far as these rules are part of basic rules for addressing tax abuses. In addition, states will be able to attack treaty abuses which will result the purpose of the treaty and the obligation on interpreting it in good faith, nevertheless, in both cases when application of domestic anti-abuse rules in a tax treaty context seems to be acceptable by the commentary[6].

Interaction between domestic anti avoidance rules and tax treaty

When it comes to the interaction between domestic anti-avoidance rules and tax treaty in respect of the 2003 revision of the OECD commentary two main views have been identified by scholars, Brian Arnold has described them as the 'factual approach' and the 'interpretative approach'[7]. According to the Commentary states fall into one of two categories depending on how the general anti-avoidance rules operates. As for Craig Elliffe depends on the legal effect they give; countries will fall under one of these two approaches, for example if the general anti-avoidance rules provide the ability for reconstruction of the abusive transaction that country will fall under the factual approach, as for the interpretative approach the anti-abusive rule is viewed as an abuse of the treaty itself and not as an abuse of the domestic law.[8]

Factual approach

The factual approach has been a result of 2003 Commentary adoption and was very much debated. The factual approach has been used in different states for domestic purposes. The OECD Commentaries have been stressing out that anti-avoidance rules are part of the domestic rules, hence are not affected by the treaty rules[9]. However, OECD approach

[1]Commentary on Article 1 par.7.1
[2] David Ward '*The Role of the Commentaries on the OECD MC in Tax Treaty Interpretation Process*' (2006)
[3] Double Taxation Conventions and the Use of Base Companies" Committee of Fiscal Affairs which was adopted by the OECD Council, as well par.2 of the Commentary 1992, November 1986
[4] Report "*The Revision of the Model Convention*" based on par. 39 of the Base Company Report adopted by the Council of the OECD, November 1986
[5] Craig Elliffe '*Cross Border Tax Avoidance: Applying the 2003 OECD Commentary to Pre-2003 Treaties*'
[6] Juan Jose Zornoza and Andres Baez *'Tax Treaties: Building Bridges between Law and Economics: The 2003 revision to the Commentary to the OECD MC on Tax treaties and GAARS: a mistaken starting point*', p.290
[7] Brian Arnold '*Tax Treaties and Tax Avoidance; The 2003 Revision to the Commentary to the OECD Model*' p.251.
[8] Craig Elliffe, '*International Tax Avoidance – The tension between protecting the tax base and certainty of law*'
[9] Commentary on article 1 par.9.2

according to literature might sent to wrong solutions in domestic jurisdictions as well as on the basis that this approach is too simple.[1]

Different scholars have been considering that the factual approach avoids the possible conflict between tax treaty and domestic anti-avoidance rules by giving a priority to anti-avoidance rules and considering the factual approach as more goal-oriented reasoning comparing to the interpretative approach[2].

Interpretative approach

The interpretative approach by the commentary is seen as abuse of the convention itself and not as the abuse of the domestic rules. Accordingly, the tax legislation either in domestic or treaty level will not be applied if these transactions are not in line with the treaty and aim to obtain unintended benefits by the treaty itself[3].

Guiding principles

Guiding principles are set in paragraph 9.5 of the OECD Commentary and they highlight that the benefits of any kind which are not meant by the purpose of the double tax convention will not be available[4]. In this regard, par.9.4 stress that states are not obliged to grant such benefits when these *'arrangements'* do not reflect the provisions of the treaty or constitutes a possible abuse[5]. However, the commentary it is vague and does not give further explanations what is an abusive *'arrangement'*. In addition, guiding principles sets the so called 'main purpose test', the purpose test might be different depends on the conditions imposed to apply the domestic anti-avoidance rules. In this regard, if both; tax treaty and domestic anti-avoidance test is the same there will not be a conflict, moreover, every time where the domestic test is fulfilled or satisfied the treaty test itself will be met[6].

However, in the literature is arguable if the guiding principle in fact establishes a treaty anti-avoidance rule or it establishes a test which should be met before applying domestic anti-avoidance rule. In the first 'scenario' the principle requires courts and tax administrators to analyse if transaction aims to abuse the treaty while the test should take place only to secure that transactions in the context of tax treaties when they might result on defeating the object and the purpose of the treaty.

In addition, the guiding principle set on par.9.5 sets a limitation on the use of domestic anti-avoidance rule and doesn't necessary mean that the states can avoid their treaty obligations by taking any position without proper justification and claiming that actions by individuals or companies are abusive. Though, there are areas of concern when it comes to the reliance of guiding principle, domestic law test has a lower threshold, thus, it is possible to have situation where domestic test it is fulfil but not under the treaty as set in the commentary. Furthermore, in tax treaties we might have situations where one country has no provision about domestic anti-avoidance rules, in this situation according to Brian Arnold countries without anti-avoidance provision have a 'better' position since they can introduce provision in the treaty which abolish the application of the domestic anti-avoidance rules that other country has[7], however, in the light of the commentary this can be interpreted that the guiding principles could create a standard which each transaction should meet before domestic anti-avoidance rules are applied. Different scholars preserve the opinion that guiding principles have their limitations and are open to very subjective interpretations by tax authorities and taxpayers which might lead to tax disputes[8]. Furthermore, the guiding principles with respect to changes in 2003 has not in detail explained the burden of proof, however, there are indications that tax authorities have to prove that transactions of different legal persons or individuals are in line with the treaties or not[9].

Conclusion

The author of this work keeps the opinion that changes made in the 2003 commentary cannot be consider as fundamental changes but more as clarification of changes made in the commentary on 1992. Even though the OECD Commentary with the updates in 2003 for the first time in its par.7 explicitly stresses that "*it is also a purpose of tax conventions to prevent*

[1] Michael Lang (editor) '*Series on International Tax Law'* Volume 101, Preventing Treaty Abuse, Sriram Govind, p.242.
[2] Juan Jose Zornoza and Andres Baez '*Tax Treaties: Building Bridges between Law and Economics; The 2003 revision to the Commentary to the OECD MC on Tax treaties and GAARS: a mistaken starting point*', p. 134 – 135
[3] Commentary on Article 1 par.9.3
[4] Commentary on Article 1, par.9.5
[5] Commentary on Article 1 par.9.4
[6] Luca De Broe, '*International Tax Planning and Prevention of Abuse*' p. 394
[7] Brian Arnold '*Tax Treaties and Tax Avoidance; The 2003 Revision to the Commentary to the OECD Model*' (IBFD, 2004) p. 295
[8] Vikram Chand '*The Guiding principle and the principal purpose test'* p. 486
[9] Ibidi, page 487

tax avoidance and evasion"[1]. Domestic anti-avoidance rules can be applied in tax treaty situations and there is no infringement of international law. Guiding principles are an additional 'statement' of the right that countries have to override treaty benefits which are not on the light of the treaty. Moreover, the author believes that guiding principles set in the commentary can be used in accordance with the international law. OECD member countries use the commentary as the main legal source when it comes to tax treaties, however, when it comes to the relationship between domestic anti-avoidance rules and tax treaties, guiding principles should be the only principles given weight on evaluating this relationship which is not the case since some countries has put limitation, however, OECD through guiding principles aims to prohibit any kind of benefits arising from treaties, hence, guiding principles are the core work of OECD which should be taken into account in this situations.

Furthermore, the author of this work considers that BEPS reports on Action 6 and Action 14[2] will be very important on further addressing this issues in the future.

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[2] BEPS Action 14 Making Dispute Resolution Mechanisms More Effective, Due to possible subjective interpretation of guiding principles by tax authorities or taxpayers tax disputes may increase in upcoming years, hence, action 14 might be important on resolving possible disputes. Therefore, the author of this work considers both this actions important to be mention.