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Rethinking Treaty Shopping: Lessons for the European Union

Reuven S. Avi-Yonah and Christiana HJI Panayi

1. Introduction

Whilst treaty shopping is not a new phenomenon, it remains as controversial as ever. It would seem that the more countries try to deal with it, the wider the disagreements as to what is improper treaty shopping and what is legitimate tax planning.

In this paper, we reassess the traditional quasi-definitions of treaty shopping in an attempt to delineate the contours of such practices. We examine the various theoretical arguments advanced to justify the campaign against treaty shopping.

We also consider the current trends in treaty shopping and the anti-treaty-shopping policies under the OECD Model and the US Model. We focus on recent cases on beneficial ownership. Finally, we examine the possible implications of EU law on the treaty shopping debate.

2. Treaty shopping and improper use of tax treaties

2.1. Finding the contours of treaty shopping

The term "treaty shopping" is thought to have originated in the United States. The analogy was drawn with the term "forum shopping", which described the situation in US civil procedure whereby a litigant tried to "shop" between jurisdictions in which he expected a more favourable decision to be rendered.[1] David Rosenbloom, who served as International Tax Counsel in the US Treasury Department during 1977-1981, described the phenomenon as "the practice of some investors of '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

1. Becker, H. and F.J. Würm, *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (Deventer: Kluwer, 1988), p. 2.

the investment is to be made and the income in question is to be earned".[2] In other words, a person "shops" into an otherwise unavailable treaty through complicated structures; hence the term "treaty shopping".[3]

The term "treaty shopping" has never featured in any versions of the OECD Model. Nor has it been properly defined or explained in the OECD Commentary. Rather, the emphasis is always on eliminating treaty shopping and the measures that can be taken against it. Most of the references to treaty shopping are references by default; i.e. when discussing anti-treaty-shopping provisions. For example, references to the "problem commonly referred to as 'treaty-shopping'"[4] are made for the first time in the OECD Commentary on Art. 1, when discussing Limitation-of-Benefits (LOB) provisions and how these provisions are meant "to address the issue [of treaty-shopping] in a comprehensive way".[5] A description of treaty shopping is given indirectly and in very general terms. It is stated that LOB provisions are there to address treaty shopping. Then it is stated that LOB provisions are "aimed at preventing persons who are not residents of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of these States".[6]

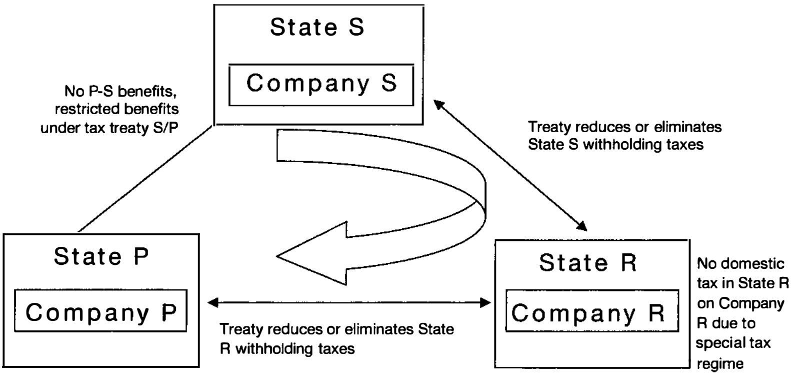
Treaty shopping features in a similarly elusive way in the new Technical Explanation to the 2006 US Model.[7] The term "treaty shopping" is used in the Technical Explanation when describing the function of anti-treaty-shopping provisions.[8] The new Technical Explanation to the Limitation on Benefits clause

2. Rosenbloom, D., "Derivative Benefits: Emerging US Treaty Policy", 22 *Intertax* 2 (1994), p. 83.
3. The concept was traced back to the early 1970s at the US Congressional Hearings on Offshore Tax Havens. See US Congress, Offshore Tax Havens, Hearings before the Subcommittee on Oversight of the House Comm. On Ways and Means, 96th Congr. 1st Session (1977) and Rosenbloom, D., "Tax Treaty Abuse: Policies and Issues", 15 *Law & Pol'y Int'l Bus.* (1983), p. 763.
4. 2008 OECD Commentary to Art. 1, Para. 20.
5. Id.
6. Id.
7. The phrase "improper use of tax treaties" is not used anywhere in the Technical Explanation to the 2006 US Model. Neither was it used in the Technical Explanation to the 1996 US Model.
8. 2006 Technical Explanation, p. 63. Contrast with the Technical Explanation to the 1996 US Model where it is stated that "[a] treaty that provides treaty benefits to any resident of a Contracting State permits 'treaty-shopping': the use, by residents of third states, of legal entities established in a Contracting State with a principal purpose to obtain the benefits of a tax treaty between the United States and the other Contracting State". The 1996 Technical Explanation emphasised that this definition "does not encompass every case in which a third state resident establishes an entity in a US treaty partner, and that entity enjoys treaty benefits to which the third state resident would not itself be entitled.

found in Art. 22 states that this article "contains anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries".

If one looks at the quasi-definitions of treaty shopping, what one notes is that the term "treaty shopping", as used, may encompass a broad spectrum of structures, ranging from the purely abusive and artificial ones to others with more substance. However, are all these instances of *improper* use of tax treaties? The OECD Commentary seems to perpetuate this confusion. The descriptions given in Paras. 9 and 20 of the OECD Commentary to Art. 1 would seem to catch general forms of treaty shopping; i.e. treaty shopping without tax haven or conduit connotations. However, the examples given in Para. 11 of the Commentary would seem to catch treaty shopping of a more specific and abusive nature; i.e. treaty shopping through conduits and/or base companies.

Therefore, there are the two obvious ends of the spectrum: treaty shopping through conduits and bona fide commercial structures. The typical scenario of treaty shopping through conduits, as also described in the OECD Conduit Companies Report, is the following.



A holding Company R would be organized in a State R that has beneficial tax provisions both with a State S where a subsidiary Company S is located and with a State P where its parent Company P is located. Company R would typically be controlled by Company P and Company S would itself be controlled by Company R.

If the third country resident had substantial reasons for establishing the structure that were unrelated to obtaining treaty benefits, the structure would not fall within the definition of treaty-shopping."

If the income from Company S is paid directly to Company P, it is subject to State S withholding tax with very few (if any) treaty benefits. The income to Company P is, however, tax exempt (or receives beneficial tax treatment) if channelled through Company R. This may be, if the income is in the form of dividends, by virtue of a parent-subsidiary regime under the domestic law of State R or a participation exemption or due to a convention between States S and R. This is the obvious case where there is minimal or zero other activity.

Therefore, treaty shopping of a clearly improper nature would entail the following:
- the beneficial owner (Company P) of the treaty shopping entity (Company S) does not reside in the country where the entity is created;
- the interposed company (Company R) has minimal economic activity in the jurisdiction in which it is located; and
- the income is subject to minimal (if any) tax in the country of residence of the interposed company.

There could be many variations of this structure. For example, it may be possible to use more than one tax treaty and move the funds through several countries, in the process of which, the funds may change their character (e.g. dividends transformed to interest).[9]

However, as already mentioned, this is only one end of the spectrum. A treaty shopping structure could be imbued by different degrees of artificiality. The intermediary company could be a complete sham or could have some *de minimis* economic substance or the arrangement could be a bona fide commercial nature.[10] Surely, not all instances of third-country residents benefitting from tax treaties to which their own countries are not privy are examples of improper use.

Whilst one may more readily distinguish a complete sham from a bona fide commercial arrangement – not always easy, as it depends on the jurisdictional perspectives on tax planning – the disputes (and litigation) usually

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9. For a description of various treaty-shopping arrangements, see OECD Conduit Companies Report in OECD, Committee on Fiscal Affairs of the OECD, *International Tax Avoidance and Evasion, Four Related Studies, Double Taxation Conventions and the Use of Conduit Companies*, Issues in International Taxation Series, No. 1 (Paris: OECD, 1987), (hereafter: OECD Conduit Companies Report).

10. For further analysis, see HJI Panayi, C., *Double Taxation, Tax Treaties, Treaty Shopping and the European Community*, EUCOTAX Series on European Taxation, Vol. 15 (Alphen aan den Rijn: Kluwer Law International, 2007), Chapters 2 and 5.

relate to the borderline cases. Successive Models and Commentaries have done little to clarify the confusion. In fact, they seem to perpetuate it. This may be deliberate. It is certainly to the advantage of the tax authorities to have discretion to determine on an ad hoc basis what is improper treaty shopping and what is legitimate tax planning.

It also seems that the traditional theoretical objections to treaty shopping do not make a more convincing case. Nor are they targeted against wholly artificial arrangements. This has important implications on how treaty shopping is tackled in various jurisdictions.

2.2. Theoretical objections to treaty shopping

Treaty shopping is, arguably, an instrument of international tax planning. What is it about this kind of tax planning that makes it objectionable? A number of arguments have been advanced in the international tax community.[11]

Firstly, it has been argued that treaty shopping is an instance of tax avoidance and as such improper and contrary to the purposes of tax treaties.

It has also been argued that treaty shopping breaches the reciprocity of a treaty and alters the balance of concessions attained therein between the two contracting states.[12] When a third-country resident "shops" into a

11. See, inter alios, Rosenbloom, D. and S. Langbein, "United States Tax Treaty Policy: An Overview", 19 *Colum. J. Transnational Law* (1981), p. 359; Rosenbloom, D., 15 *Law & Pol'y Int'l Bus.* (1983), p. 763; Becker and Würm, *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (1988); van Weeghel, S., *The Improper Use of Tax Treaties*, Series on International Taxation, No. 19 (London, Boston: Kluwer Law International, 1998); Reinhold, R.L., "What is Tax Treaty Abuse? (Is Treaty Shopping an Outdated Concept?)", 53 *Tax Lawyer* 3 (2000), p. 663; Grady, K.A., "Income Tax Treaty Shopping: An Overview of Prevention Techniques", 5 *Nw. J. Int'l L. & Bus.* (1983-4), p. 626; Roin, J.A., "Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems", 81 *Virginia Law Review* 7 (1995), p. 1753; Loengard, R.O. Jr., "Foreign Investors and Nimble Capital: Another Look at the U.S. Policy Towards Treaty Shopping", *Tax Forum* 439 (1988), pp. 25-26; Streng, W.P., "Treaty Shopping: Tax Treaty Limitation of Benefits Issues", 15 *Houston Journal of International Law* 1 (1992), pp. 1-66; Terr, L.O., "*Treaty Routing v. Treaty Shopping*: Planning for multi-country investment flows under modern limitation on benefits articles", 17 *Intertax* 12 (1989), p. 521.
12. This argument has been produced in both the OECD Report on Conduit Companies (Para. 7(a)) and the UN Report on the Prevention of Abuse of Tax Treaties. OECD Conduit Companies Report, Para. 7(a); UN Department of International Economic and

treaty, then the treaty concessions are extended to a resident, whose state has not participated in this arrangement and may not reciprocate with corresponding benefits (e.g. exchange of information). The usual quid pro quo of the treaty is therefore compromised and the process subverted.

Another argument is based on the principle of economic allegiance. Pursuant to economic allegiance, a taxable base is attributable to the jurisdiction in which it is thought to owe its economic existence. Tax treaties are premised on the allocation of taxing rights according to this principle. Treaty concessions are of a personal nature and are not to be extended to third-country residents. As a result of treaty shopping, the third country gains revenue power, absent of any (substantial) claim to economic allegiance.[13]

Furthermore, it is often claimed that treaty shopping creates a disincentive for countries to negotiate tax treaties. If third countries can get the benefits of reduced taxation for their residents without conferring reciprocal benefits to non-resident investors, then there is no need to enter into a tax treaty, especially if there are concerns that the tax treaty might be imbalanced.[14] This may put countries which comply with their duties of fiscal co-operation arising through tax treaties (e.g. exchange of information), at a competitive disadvantage internationally. Furthermore, lack of fiscal co-operation enhances opportunities for international tax evasion.[15]

Finally, it is argued that treaty shopping is often linked with (undesired) revenue loss.[16] Tax treaties are based on a perceived level of balance of actual and potential income and capital flows between one country and the other.[17] When the benefits of the given treaty are abused, the level and balance of these flows are distorted, with a resulting distortion in the share of the relevant chargeable income channelled to each state. Treaty shopping expands the normal bilateral relationship of the treaty. A generous treaty

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Social Affairs, Ad Hoc Group of Experts on International Co-operation in Tax Matters, *Contributions to international co-operation in tax matters: treaty shopping, thin capitalization, co-operation between tax authorities, resolving international tax disputes* (New York: United Nations, 1988) UN Doc. ST/EA/203, UN Sales No. E.88.XVI, p. 6 (hereafter: UN-Report (1988)).

13. Rosenbloom and Langbein, 19 *Colum. J. Transnational Law* (1981), pp. 359, 397-8.

14. Conduit Companies Report, Para. 7 (c); Becker and Würm, *Treaty Shopping* (1988), p. 6; Rosenbloom and Langbein, 19 *Colum. J. Transnational Law* (1981), p. 676.

15. Rosenbloom and Langbein, 19 *Colum. J. Transnational Law* (1981), pp. 396-397.

16. Also see Rosenbloom and Langbein, 19 *Colum. J. Transnational Law* (1981), p. 84.

17. UN Report (1988), p. 6.

with one trading partner becomes a treaty with the world.[18] This de facto multilateralization of the tax treaty is thought to entail a large and indeterminate cost to the source country.[19]

As for the first argument, it is never an easy task to distinguish between (international) tax avoidance and legitimate tax planning. What is it about treaty shopping that makes it an instance of the former rather than the latter? Why is it assumed that all forms of treaty shopping, irrespective of their degree of artificiality, constitute tax avoidance?

As already mentioned, not all treaty shopping structures can be characterized as artificial and devoid of economic substance. The term "treaty shopping", applied generically, may encompass a variety of structures. It could encompass structures in which the intermediary company imposed is a pure conduit with no economic substance whatsoever, completely owned and controlled by the parent company and based in a notorious conduit location or tax haven. However, this is only one end of the spectrum. There is also the other end, where the intermediary company is a company with some substance, conducting its own trading activities, not controlled by the parent company and liable to some tax in the country of residence. It should always be remembered that an arrangement may be imbued with some economic substance that is not immediately apparent to the tax authorities.

As for the reciprocity argument, although persuasive, it is premised on the assumption that there is always reciprocity and/or for every treaty benefit. This may not always be the case. Some treaty concessions may be unilateral if the other contracting state already provides for them in its domestic legislation. Also, whilst there might be reciprocity in the tax treaty, it is not guaranteed that the underlying balance of the treaty is a fair one. A tax treaty may be biased in favour of the economically more powerful country. Therefore, breaching reciprocity may not necessarily mean that a "fair" balance has become "unfair". It is the negotiated balance that is being subverted; whatever the fairness credentials of this balance.

As for the economic allegiance argument, this seems to be tautological. Opinions diverge as to the defining characteristics of economic allegiance; in other words, what kind of nexus is required for the duty of economic

18. See US Treasury Department's June 27 1979 New Release B-1694 relating to the US treaty with the Netherlands Antilles.
19. Rosenbloom, 22 *Intertax* 2 (1994), p. 84.

allegiance to be generated in favour of a jurisdiction. Even if the principle of economic allegiance was agreed upon, there are no guarantees that countries negotiating tax treaties would follow it. In any case, it should not be readily assumed that all instances of treaty shopping fall foul of the principle of economic allegiance. Some treaty shopping arrangements might be more abusive than others, for example, where the conduit country is a tax haven or where the conduit company has no other activity other than channelling payments to parent companies. In such instances, the principle is flagrantly breached as there is no economic activity whatsoever taking place in the conduit country that could justify the latter's claim of economic allegiance.

As for the disincentive-to-negotiate argument, in assessing the potency of this argument, the self-correcting forces of competition and the international economic pressure for fiscal convergence should not be ignored. Also, it should be pointed out that the competitiveness of foreign investors can still be preserved by their country of residence if double taxation is relieved through unilateral means. What is more, it is all too often assumed that treaty shopping disincentivizes the third country from entering into tax treaties and that the source country wants tax treaties. In some cases the source country might not want a tax treaty with the third country, for example, if the third country is a tax haven or a notorious conduit location.

This is, however, a valid argument. Even if double taxation can be alleviated by unilateral means, there are some reciprocal advantages which can only or more easily be achieved through tax treaties (e.g. provisions dealing with pensions, students, artists, dispute resolution). Tax treaty networks ensure that fiscal collaboration between the contracting states is strengthened and adapted to new forms of tax evasion and avoidance.

Therefore, the concern that treaty shopping creates a disincentive to negotiate tax treaties is a valid one, if treaties are entered into for the right reasons – that is to keep the momentum for international fiscal convergence and co-operation rather than enable one country to bully another into tax concessions.

As for the revenue-loss argument, again, there is no concrete evidence that treaty shopping actually causes revenue loss and economic distortions. Firstly, it is not easy to calculate the benefits and costs of a tax treaty to a contracting state. A contracting state might be both a country of residence and a country of source and enjoy benefits or bear costs under both capacities.[20] Therefore, finding the costs and benefits that a contracting state derives from a tax treaty entails quite complex calculations for which there might not be concurrence.[21] Some of the benefits, for example mutual assistance, cannot really be translated in monetary terms.

Secondly, why is there a presumption of a loss? It could be argued that when treaty shopping increases economic activity, the overall economic gain might exceed source-country losses.[22] This begs the question. When does treaty shopping increase economic activity and when does it not? Does it depend on whether the source country is a developing country? For example, in *Union of India v. Azadi Bachao Andolan*,[23] the Indian Supreme Court refused to imply an anti-treaty-shopping clause in the India-Mauritius tax treaty. In the judgment, the Supreme Court emphasized that in developing countries, treaty shopping was often regarded as a tax incentive to attract scarce foreign capital or technology. "Developing countries need foreign investments, and the treaty shopping opportunities can be an additional factor to attract them".[24] Countries had to take a holistic view. "The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy. Many of them do not appear to be too concerned unless the revenue losses are significant compared to the other tax and non-tax benefits from the treaty, or the treaty shopping leads to other tax abuses."[25] Treaty shopping may be a necessary evil, tolerated in a developing economy, in the interest of long-term development.[26]

Therefore, it ought not to be assumed that treaty shopping always leads to losses – in the medium or long term. The loss of tax revenues as a result of treaty shopping could be insignificant compared to the other non-tax

20. Van Weeghel, S., *The Improper Use of Tax Treaties* (1998), p. 122.
21. Even the same authors may reach inconsistent conclusions in subsequent reports. See, for example, Blonigen, B.A. and R.B. Davies, *The Effects of Bilateral Tax Treaties on US FDI Activity*, NBER Working Paper No. 7929, (Cambridge: NBER, 2000); Blonigen, B.A. and R.B. Davies, *Do Bilateral Treaties Promote Foreign Direct Investment*, NBER Working Paper No. 8834, (Cambridge: NBER, 2002).
22. Bracewell-Milnes, B., *Economics of International Tax Avoidance* (Deventer: Kluwer, 1980), p. 23.
23. *Union of India v. Azadi Bachao Andolan* [2003] 6 ITLR 233; (2003) SOL 619. For some commentary, see Baistrocchi, E., "The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications", *British Tax Review* 4 (2008), p. 352.
24. Id., p. 280.
25. Id., p. 281.
26. Id.

benefits generated in the economy as a result of the influx of capital and technology. An argument based on revenue loss and economic distortions should factor this in.

Thirdly, absent a truly neutral tax system, it is difficult to assess any distortions caused by treaty shopping. In fact, it could be argued that the inherent non-neutralities of tax systems create an incentive to treaty shop. In other words, treaties generate treaty shopping.[27] Treaty shopping is perhaps a self-help way of lessening or removing fiscal impediments to international business imposed by the inadequate relief of international double taxation and the incomplete nature of the treaty network.

Hence, so far, we see (deliberately) inadequate definitions and theoretical objections which are somewhat detached from reality. This would go some way in explaining the responses to treaty shopping.

3. Responses to treaty shopping: The OECD and the United States

In this section, we examine how the OECD and the United States have dealt with treaty shopping.

3 1. The OECD approach to treaty shopping

Some basic methods of curbing treaty shopping practices existed ever since the 1977 OECD Model: the beneficial ownership and the limitation on residence provisions. In the OECD Conduit Companies Report, the Fiscal Affairs Committee recognized the deficiencies of these basic methods[28] and conceded that the 1977 Model dealt with conduits in a rudimentary way, "expressing only a general concern that improper use of treaties should be avoided".[29] Other more specific measures were suggested.[30] The underlying theme of these measures was that treaty benefits should be available only to entities having a sufficient nexus with the country of residence,

27. Avery Jones, J.F., "The David R. Tillinghast Lecture: 'Are tax treaties necessary?'", 53 *Tax Law Review* 1 (1999), pp. 3-8; Spence, I., "Globalisation of Transnational Business: The Challenge for International Tax Policy", 25 *Intertax* 4 (1997), pp. 143-144.
28. OECD Conduit Companies Report, Paras. 13-1 5.
29. Id., Para. 15.
30. Id., Para. 10.

either because of direct or indirect ownership of the entity or because of the economic ties between the entity and the treaty country.

These suggestions were subsequently incorporated in the 1992 Commentary to Art. 1 and updated in the 2003 Commentary following the 2002 OECD Report on Restricting the Entitlement to Treaty Benefits. There have been no further amendments in the 2008 update to the OECD Commentary. The current OECD Commentary still does not offer a uniform solution for tackling improper use. However, it sets out the solutions, as suggested benchmarks that treaty negotiators might consider when searching for a solution to specific cases. These are the beneficial ownership approach,[31] the look-through approach,[32] the channel approach,[33] the limitation on

31. The beneficial ownership provision which is found in Arts. 10 to 12 of the OECD Model precludes the extension of specific treaty benefits to entities which are not *beneficial owners* of the particular income, even if they are formal recipients of it. Neither the OECD Model nor its Commentary gives a definition of the term "beneficial owner". However, a substance over form approach is preferred.

32. Look-through clauses focus on direct and indirect ownership of the entity. The typical wording of the clause reads as follows:
"A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State." (OECD Commentary, Para. 14);
It is up to the contracting states to agree on the criteria according to which a company would be considered to be owned or controlled by non-residents.

33. The channel approach, also called base erosion, seeks to catch intermediary entities whose tax base is eroded in favour of third-country residents (usually controlling shareholders or associated persons) through the payment of interest or royalties or by the discharge of obligations. The typical wording of a channel clause reads as follows:
"Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State:
(1) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and
(2) exercise directly or indirectly, alone or together, the management or control of such company, any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, depreciation of any kind of business assets including those on immaterial goods, processes etc)."

residence approach,[34] the exclusion approach[35] and the subject-to-tax approach[36].

The first three methods focus on the ownership of the intermediary entity and its relationship with the actual recipient of the payment. Their aim is to ensure that that tax treaty benefits are forfeited when the formal recipient of the income is not actually entitled to the income or the income will most certainly be passed on to a third-country resident. The last three methods focus on taxation in the country of residence. Their aim is to ensure that tax treaty benefits on source-country income are forfeited when the income is not taxed in the country of residence of the recipient entity but passes on to a third-country resident.[37]

It is recommended in the OECD Commentary that all of the above approaches be accompanied by "specific provisions to ensure that treaty benefits will be granted in bona fide cases".[38] Various bona fide provisions

34. The limitation on residence features in Art. 4 of the OECD Model. The article reads as follows:
"[...] the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. *This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.*" (Emphasis added).
35. The exclusion approach denies treaty benefits to companies that are tax-exempt or nearly tax-exempt. A typical clause would read as follows:
"No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under section [...] of [...] the Act, or under any similar provision enacted by [...] after signature of the Convention".
36. General subject-to-tax provisions provide that source-country treaty benefits are granted only if the respective income is subject to tax in the country of residence. The subject-to-tax approach, although similar to the exclusion approach, is not confined to tax exemptions or reductions in the country of residence. The OECD Model suggests a more restrictive clause incorporating a safeguarding provision such as the following.
"Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State:
(a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of participation or otherwise, or
(b) exercise directly or indirectly, alone or together, the management or control of such company, any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income which is subject to tax in the last-mentioned State under the ordinary rules of its tax law". (OECD Commentary, Para. 15).
37. Panayi, *Double Taxation, Tax Treaties, Treaty Shopping and the European Community* (2007), Chapter 2.
38. OECD Commentary to Art. 1, Para. 19.

were suggested in the OECD Conduit Companies Report[39] and subsequently added in the OECD Commentary to Art. 1 in July 1992.[40]

The 2003 OECD Commentary went further than its predecessors in suggesting a comprehensive clause to deal with treaty shopping: the LOB clause.[41] The Commentary replicates the standard LOB clause found in the US Model.

With the exception of the LOB, most of the OECD anti-treaty-shopping provisions tend to be broad and vague, likely to generate interpretational difficulties when applied in practice. This is hardly surprising, given the definitional inadequacies and the lack of solid theoretical underpinnings identified above.

Some recent cases on beneficial ownership illustrate these difficulties.[42] Beneficial ownership is perhaps the most widely used anti-treaty-shopping mechanism. However, the term is not defined in the OECD Model and most tax treaties do not contain a definition of beneficial ownership.[43] Moreover, the term may not even have a domestic tax meaning. This creates uncertainty when trying to delineate who is the true beneficial owner of income when treaty shopping concerns are raised.

Under the OECD Commentary, the term "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, including avoiding double taxation and the prevention of fiscal evasion and avoidance".[44] In his authoritative treatise on tax treaties, Professor Philip Baker QC claims that "the 'beneficial ownership' limitation is intended to exclude: (a) mere nominees or agents, who are not treated as owners of the income in their country of residence; (b) any other conduit who though the formal owner of the income, has very narrow powers over the income which render the conduit a mere fiduciary

39. OECD Conduit Companies Report, Para. 42.

40. See van Weeghel, S., *The Improper Use of Tax Treaties* (1998), p. 216.

41. OECD Commentary 2003, Para. 20.

42. See Sheppard, L., "Beneficial ownership too onerous?", Tax Analysts, *WTD* 176-4 (10 September 2008).

43. For exceptions, see Bernstein, J., "Beneficial Ownership: An international perspective", 45 *Tax Notes Int'l* (2007), p. 1211 (p. 1212).

44. OECD Commentary to Art. 10, Para. 12. In other words, the limitation of source country taxes by virtue of a tax treaty would not be available "when, economically, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income". See OECD Conduit Companies Report, Para. 14(b).

or administrator of the income on behalf of the beneficial owner. [T]he mere fact that the recipient may be viewed as a conduit does not mean that it is not the beneficial owner".[45]

Professor Baker argues that "the term [beneficial ownership] should be accorded an 'international fiscal meaning' not derived from the domestic laws of Contracting States".[46] The salience of the matter lies in determining whether a company controlled by another one, and therefore likely but not legally obliged to pay to its ultimate owner any sums received, is in fact the beneficial owner of such sums.[47]

The difficulty of explaining the concept of "beneficial ownership" was illustrated in the *Indofood* case.[48] In *Indofood*, an Indonesian trading group (Indofood) wanted to raise finance by issuing internationally marketed interest-bearing notes to the public. This was done through a Mauritian special purpose vehicle, in order to benefit from the reduced withholding tax rate of the Indonesia-Mauritius tax treaty.[49]

Two years after the issue of the notes, the Indonesian Government decided to terminate the Indonesia-Mauritius tax treaty. This meant that the Indonesian withholding tax of 20% would have applied rather than the one under the above tax treaty. Following this, Indofood tried to initiate the get-out clause of the notes and gave notice to the trustee of the bondholders (JP Morgan) of its intention to redeem early.[50] The trustee refused to accept early redemption on the basis that Indofood had not taken reasonable measures to prevent this. According to the trustee, one such measure would have been the setting

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45. Baker, P., *Double Taxation Conventions,* 3rd edn. (London: Sweet & Maxwell, 2001), Paras. 10B-10.4.
46. Id., Para. 10B-14.
47. "As a practical approach, one can ask whose income the dividends (interest/ royalties) are in reality. One way to test this is to ask: what would happen if the recipient went bankrupt before paying over the income to the intended, ultimate recipient? If the ultimate recipient could claim the funds as its own, then the funds are properly regarded as already belonging to the ultimate recipient. If, however, the ultimate recipient would simply be one of the creditors of the actual recipient (if even that), then the funds properly belong to the actual recipient." Id., Para. 10B-15.
48. *Indofood International Finance Ltd v. JP Morgan Chase Bank NA* (2006) EWCA Civ 158.
49. Had the notes been issued from Indonesia, a 20% withholding tax would have been levied on interest. By raising the finance through the Mauritian subsidiary, the withholding tax rate was reduced to 10%. There was no further withholding tax in Mauritius.
50. Under the terms and conditions of the notes, Indofood was entitled to redeem early on an adverse change of Indonesian law, if the effect of such adverse change could not have been avoided by Indofood taking reasonable measures.

up of a Dutch special purpose vehicle to perform the same function as the Mauritian one, but using the Indonesia-Netherlands tax treaty.[51]

The trustee initially succeeded at the High Court.[52] Indofood appealed. One of the issues considered by the Court of Appeal was whether a newly interposed Dutch company would have been the *beneficial owner* of the interest payable by Indofood for the purposes of the Indonesia-Netherlands tax treaty. The Court of Appeal decided the question of beneficial ownership in favour of Indofood; i.e. the Dutch company could not be a beneficial owner of the interest paid by Indofood.[53]

After examining the OECD Commentary, the Court of Appeal confirmed that the term "beneficial ownership" should be understood in its context and in light of the object and purposes of the OECD Model; namely, the avoidance of double taxation and the prevention of fiscal evasion and avoidance. The Court of Appeal cited Professor Baker's commentary approvingly. The term "beneficial ownership" was to be given an international fiscal meaning not derived from the domestic laws of contracting states.[54]

The Court of Appeal concluded that the concept of beneficial ownership was incompatible with that of a formal owner who does not have "the full privilege to directly benefit from the income".[55] On the facts of the case, looking at the legal, commercial and practical structure, neither the Mauritian nor the suggested Dutch company could be perceived as beneficial owners.[56] Rather, they were mere administrators of the income.[57]

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51. According to this scenario, on payment of interest by Indofood, the funds would have moved from Indofood, to the Dutch company, to the Mauritian company, to the noteholders. The debt owed by Indofood to the Mauritian company would have been novated to the Dutch company. In other words, when the Dutch company paid the interest to the Mauritian company, the Dutch company would be discharging a liability (the novated debt) to that company.
52. The reason why the case was litigated in English courts was because there was a "governing law" clause providing to that effect.
53. As a corollary, the setting up of a Dutch company was not a reasonable measure that Indofood could have undertaken to avoid the adverse consequences from the change of law.
54. *Indofood v. JP Morgan* (2006), Para. 42 (Lord Justice Chadwick).
55. Id., Para. 42.
56. In Para. 42, Lord Justice Chadwick pointed out that the fact that neither the Mauritian nor the suggested Dutch company were or could be a trustee, agent or nominee for the noteholders or anyone else in relation to the interest received from Indofood was "by no means conclusive". Nor was the absence of any entitlement of a noteholder to security over the interest received from Indofood. However, in his subsequent analysis, beneficial ownership was dismissed.
57. Id., Para. 44.

Following this decision, in a guidance note issued on 9 October 2006,[58] Her Majesty's Revenue & Customs (HMRC) confirmed that the Court of Appeal's decision was consistent with existing HMRC policy. HMRC found that the decision was binding insofar as it related to construing beneficial ownership in the context of the United Kingdom's tax treaties. Therefore, the international fiscal meaning of beneficial ownership and the test of full privilege to directly benefit from the income are considered to be applicable in the UK context. This test has been criticized in the United Kingdom as being too limited.[59]

Reading this case, it appears that the Court of Appeal focused more on what the intermediate entity *does or can do* with the income, i.e. its narrow powers, rather than anything. The Court seems to have applied a technical test. Rather than look at the overall substance of the scheme and effectively the end-result, the Court emphasized the specific payment and cash-flow arrangements[60] and how those affected the economic credibility of the intermediate entity.

In the *Bank of Scotland*[61] case, the French Supreme Administrative Court followed a similar approach. Here, a US parent concluded a usufruct agreement[62] with a UK bank. Under this usufruct agreement, the UK bank acquired for a three-year period fixed dividend coupons attached to the (non-voting preferred) shares of the French subsidiary of the US parent

58. Available at http://www.hmrc.gov.uk/manuals/intmanual/updates/intmupdate101007.htm.

59. See, for example, Fraser, R., and J.D.B. Oliver, "Treaty Shopping and Beneficial Ownership: *Indofood International Finance Ltd v. JP Morgan Chase Bank NA London Branch*", *BTR* 4 (2006), 422-426; Mehta, N.V. and K. Habershon, "U.K. Tax Authorities Issue Draft Guidance in Wake of Indofood Decision", Doc 2006-22678 or 2006 *WTD* 216-2; Kandev, M., "Beneficial Ownership: Indofood Run Wild", CCH *Tax Topics* No. 1812 (30 November 2006), p. 1; Baker, P., "Beneficial Owner: After Indofood", VI *Grays Inn Tax Chamber Review* 1, (2007), p. 15; Mehta, N.V. and K. Habershon, Doc 2006-22678 or 2006 *WTD* 216-2; Bundgaard, J. and N. Winther-Sørensen, "Beneficial Ownership in International Financing Structures", 50 *Tax Notes Int'l* 7 (2008), p. 587.

60. Two business days before the due date for the payment of interest to the noteholders, Indofood was to pay the Mauritian subsidiary. One business day before the due date, the Mauritian subsidiary was to pay the paying agent. On the due date, the paying agent was to pay the noteholders.

61. Conseil d'Etat, 29 December 2006, Ministre de l'Economie, des Finances et de l'Industrie c/Société Bank of Scotland, No. 283314; Revue de Droit Fiscal No. 4/2007, p. 34, Sec. 87. See Sheppard, L., "Indofood and Bank of Scotland: Who Is the Beneficial Owner?", 45 *Tax Notes Int'l* 5 (2007), p. 406; HJI Panayi, C., "Recent Developments to the OECD Model Tax Treaty and EC Law", 47 *European Taxation* 10 (2007), p. 452.

62. A usufruct is a civil law concept. It is the legal right to use and derive profit or benefit from property that belongs to another person, as long as the property is not damaged.

company. The usufruct contract was structured in such a way that the UK bank, in fact, undertook very little risk of default.[63]

The French company later on distributed dividends to the bank which were subject to a 25% withholding tax. Under Art. 9 of the applicable France–UK tax treaty, the maximum withholding tax was 15%. The tax treaty also provided for a transfer of the *avoir fiscal* tax credit. The UK bank requested a refund of the French withholding tax levied in excess of the maximum rate of 15% and the *avoir fiscal* tax credit as provided by the tax treaty.

The French tax administration rejected the claim on the basis that the beneficial owner of the dividend distribution was not the UK bank but the US parent. The case ended up in the Supreme Administrative Court, which agreed with the tax administration, in that the transaction implemented by the contracting parties in reality concealed a loan agreement between the UK bank and the US parent which was remunerated by the payment of the *avoir fiscal* tax credit to the UK bank. The Supreme Administrative Court concentrated on the fact that the price paid by the UK bank to the US parent to acquire the dividend coupons corresponded to the amount of the dividends, before the levying of withholding tax. The beneficial owner of the dividends was, in fact, the US parent. The US parent merely delegated to its French subsidiary the repayment of the loan contracted with the UK bank.

Again, although the Supreme Administrative Court looked at the overall scheme, in its analysis, it focused on specific elements, such as the payment arrangement and the question of risk. What was crucial to the French tax administration and to the Supreme Administrative Court was the fact that the return to the UK bank was pre-determined and guaranteed. A possible default of the French subsidiary would not have affected the UK bank. All these factors pointed to a loan rather than the usufruct agreement described by the parties.

A similarly factual approach was followed in the *Prévost* case.[64] Here, a Netherlands company (Prévost Holding) was owned 49% by a UK company

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63. The US parent had guaranteed the return and agreed to indemnify the UK bank against government failure to refund the *avoir fiscal*. The amount of the dividends was also predetermined. In addition, the usufruct contract contained an acceleration clause entitling the UK bank to sell the shares back to the US parent on a change in the applicable tax law.

64. Kandev, M. "Prévost Car: Canada's First Word on Beneficial Ownership", 50 *Tax Notes Int'l* 7 (2008), p. 526; Summerhill, L., J. Bernstein and B. Womdl, "Taxpayer Prevails in Canadian Beneficial Ownership Case", 50 *Tax Notes Int'l* 5 (2008), p. 363;

(Henlys) and 51% by a Swedish company (Volvo). Volvo had acquired all the shares of a Canadian company (Prévost) in 1995 and immediately thereafter transferred them to Prévost Holding. Volvo then sold 49% of its shares in Prévost Holding to Henlys. Prévost paid around CAD 80 million of dividends to Prévost Holding in the 1996 to 1999 and 2001 tax years. The Canadian tax authorities withheld tax at 5%. Prévost Holding was not subject to Netherlands tax on dividends from Prévost because of the Netherlands participation exemption.

Under the Canada–Netherlands tax treaty, the 5% rate applied if the dividend recipient was a company that owned at least 25% of the capital or at least 10% of the voting power in the company paying the dividends.[65] The Canadian tax authorities refused to allow the application of the Canada–Netherlands tax treaty by maintaining that Prévost Holding was not the beneficial owner of the dividends received from Prévost. This was because Prévost Holding did not have any office, assets, activities or employees in the Netherlands, its only asset consisted of the shares in Prévost and all its expenses were paid by its shareholders. The dividends paid by Prévost were treated as if they had been paid to Henlys and Volvo directly. As a result, 49% of the dividends were subject to tax at the 10% rate of the Canada–UK tax treaty and 51% of the dividends were subject to tax at the 15% rate of the Canada–Sweden tax treaty.[66]

The taxpayer objected to this treatment, arguing that Prévost Holding was entitled to the benefits of the Canada–Netherlands tax treaty. The taxpayer also argued that this company structure was a common form of business structure where two or more companies pooled their resources to carry on a joint business and that the structure did not have any unusual or tax-driven aspects.

Kandev, M.N. and B. Wiener, "Some thoughts on the Use of Later OECD Commentaries After Prévost Car", 54 *Tax Notes Int'l* 8 (2009), p. 667; Panayi, 47 *European Taxation* 10 (2007), p. 452; Bolderman, S., "Tour d'Horizon of the Term 'Beneficial Owner'", 54 *Tax Notes Int'l* 10 (2009), p. 881; Krishna, V., "Using Beneficial Ownership to Prevent Treaty Shopping", 56 *Tax Notes Int'l* 7 (2009), p. 537; Bernstein, J. and L. Summerhill, "Canadian Court Respects Dutch Holding Company", *WTD* 43-2 (9 March 2009), Doc 2009-4953.

65. Art. 10(2) Netherlands–Canada tax treaty.

66. The Canadian tax authorities initially applied the 5% rate under Art. 10(2)(a) of the Canada–Sweden tax treaty for certain years, but then revised the rate to 15% in a subsequent reassessment. Art. 10(2)(a) of the Canada–Sweden tax treaty provides for a 5% rate if the beneficial owner of the dividend is a company that directly controls at least 10% of the voting power of the dividend payer or directly holds at least 25% of its capital.

The Tax Court of Canada[67] and later on the Federal Court of Appeal[68] agreed with the taxpayer in that Prévost Holding was the beneficial owner of the dividends. The Federal Court of Appeal concurred with the judgment of Chief Justice Rip of the Tax Court in 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.[69]

"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."[70]

The relationship between Prévost Holding and its shareholders was not one of agency, or mandate. Prévost Holding was not a conduit for Volvo and Henlys and could not be said to have absolutely no discretion as to the use or application of funds put through it as a conduit. The Courts reasoned as follows.

There was no predetermined or automatic flow of funds to Volvo and Henlys. Prévost Holding's Deed of Incorporation did not obligate it to pay any dividends to its shareholders. In fact, Henlys and Volvo could not take action against Prévost Holding for failure to pay dividends. Prévost Holding was the registered owner of Prévost shares, paid for the shares and owned the shares for itself. When dividends were received by Prévost Holding in respect of shares it owned, the dividends were the property of Prévost Holding and were available to its creditors, if any, until such time as the management board declared a dividend and the dividend was approved by the shareholders.[71]

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67. *Prévost Car Inc. v. The Queen*, 2008 TCC 231 (22 April 2008). Judgment by the Associate Chief Justice Rip.
68. *Prévost Car Inc. v. The Queen*, 2009 FCA 57 (26 February 2009).
69. Id., Para. 13, citing Para. 100 in 2008 TCC 231.
70. Id.
71. Id., Para. 16, citing Paras. 100-105 in 2008 TCC 231.

Therefore, Prévost Holding, being the beneficial owner of the dividends, was entitled to the benefit of the reduced rate of tax on dividends under the Canada–Netherlands tax treaty.

Broadly, in this case, the real powers of the intermediary company and its relationship with the parent company were crucial. The courts focused on the governance model of the intermediary company, its actual management and the composition of its parent company's board. The ownership of the income received, the discretion to use, enjoy and dispose of it, as well as issues of risk and control, were addressed.

As in *Indofood,* the arrangement was not to be dismantled. Of course, the difference between the two cases is that in *Indofood,* a finding of *no* beneficial ownership of an intermediary (which ought to have been inserted, according to the trustee of the bondholder) protected the existing arrangement and enabled *Indofood* to redeem the notes early. By contrast, in *Prévost*, a finding of beneficial ownership of the intermediary protected the arrangement and the reduced withholding taxes of the underlying tax treaties applied.

However, in all of the above cases, the courts seem to have proceeded on an ad hoc and factual basis. The existence (or lack of) beneficial ownership was to be considered on the facts of each case, taking into account some of the factors mentioned above (ownership, risk, discretion, etc.) in a non-exhaustive manner. Whilst clear cases of abuse/sham may have been easily detected, there was no bright-line test for the less abusive but still to an extent contrived situations. Much depended on how national courts perceived and interpreted beneficial ownership in their own jurisdictions, independently of judicial precedents in other jurisdictions.

As a result of the lack of bright-line tests and the ad hoc application of beneficial ownership, taxpayers are faced with uncertainty when structuring arrangements that are akin to treaty shopping arrangements. Furthermore, the threshold test of business legitimacy with which the intermediary is to be imbued so as not to be part of a treaty shopping arrangement may differ from jurisdiction to jurisdiction. In other words, the benchmark of impropriety may shift with time and with location. This is hardly surprising, given the theoretical limitations of the treaty shopping polemic.

Neither does the United States seem to display a more uniform and coherent approach to treaty shopping. This is examined below.

3.2. The US approach to treaty shopping

The United States was the first country to advance objections to treaty shopping.[72] It remains the most vocal opponent to such practices. The Technical Explanation of the US Model, which describes treaty shopping, contains an unequivocal statement in that "tax treaties should include provisions that specifically prevent misuse of treaties by residents of third countries".[73]

Historically, however, the US attitude to treaty shopping had not always been so hostile. In fact, initially, the US fisc showed no particular concern over treaty shopping. After World War II, the US international tax policy focused on outbound rather than inbound investment. Its fiscal interests, mainly the minimization of foreign (source country) taxes imposed on US legal entities, were clearly influenced by its concerns as a country of residence. Therefore, treaty shopping was not a controversial issue in treaty negotiations as it worked to the advantage of the US fisc. If less tax was paid abroad by US persons, then less foreign tax credit depleting the US coffers was paid to such persons.

In the 1980s, the transition from being a major country of residence to a country of source had begun. The US administration concentrated its initiatives on attracting foreign capital, in order to help finance domestic investment. Inter alia, it exempted portfolio gains from taxation to encourage foreigners to invest in the US markets,[74] rendering the US "a sort of tax haven for foreign portfolio investment".[75] At the same time, it tried to discourage outbound investment.[76] Gradually, the country became the word's largest debtor with a huge trade deficit. Therefore, the US fisc became increasingly concerned with *reduction of source taxes* via treaty shopping. Treaty shopping was not only disliked because it caused an

72. In fact, most of the literature mentioned in 2.2. above originates in the United States. See, for example, Rosenbloom and Langbein, 19 *Colum. J. Transnational Law* (1981), pp. 396-7; Reinhold, 53 *Tax Lawyer* 3 (2000), p. 663; Oliva, R., "The Treasury's Twenty Year Battle with Treaty Shopping: Art. 16 of the 1977 United States Model Treaty", 14 *Ga. J. Int'l & Comp. L.* (1984), p. 293.
73. See Technical Explanation on Art. 22 of US Model.
74. See Foreign Investors Tax Act (1966).
75. Haug, S.M., "The United States Policy of Stringent Anti-Treaty Shopping Provisions: A Comparative Analysis", 29 *Vanderbilt Journal of Transnational Law* (1996), p. 191 (p. 239).
76. See Interest Equalisation Tax Act (1964) which restricted portfolio investment by US persons in long-term debt obligations of foreign issuers.

untoward erosion of source-based taxation. It was also objectionable as it often involved tax havens.

The United States had no limitation on treaty shopping until 1984, although certain cases limited the use of treaties in abusive situations. In *Aiken Industries*, the Tax Court held that the reduction of withholding tax under the US–Honduras treaty did not apply to back-to-back loans with identical interest payments between a US payer, a related Honduras corporation, and the Bahamas parent corporation. The court held that the treaty required that the recipient of the payment have "dominion and control" over the funds and that this requirement was not met when the Honduran corporation was a mere conduit.[77]

In 1984, the United States terminated the extension of its treaty with the Netherlands to the Netherlands Antilles, which was used by many US corporations as the location of finance subsidiaries that borrowed on the Eurobond market and onlent the funds to the US parent. At the same time, the IRS issued two Revenue Rulings applying the precedent of *Aiken Industries* even to situations where there is a "spread" between the two loans or when one payment is interest and the other a dividend.[78]

Subsequently, the United States began to incorporate LOB provisions first into the Internal Revenue Code and then into treaties. In 1986, the branch profit tax provision was adopted with a "qualified resident" definition that overrode treaties.[79] The US–Germany treaty from 1989 was the first to include an LOB provision, and all subsequent US treaties include LOB provisions, so that now there are almost no US treaties without such provisions.

In addition, in 1993 Congress authorized the IRS to adopt regulations involving "conduit arrangements" in multiple-party financing transactions.[80] The regulations adopted by the IRS follow the 1984 rulings and apply to a wide range of financing transactions, and they also constitute a treaty override.[81]

77. *Aiken Industries v. Inc Commissioner*, 56 TC 925 (1971).
78. Rev. Rul. 84-153, 1984-2 CB 383; Rev. Rul. 84-152, 1984-2 CB 381; see also Rev. Rul. 85-163, 1985-2 CB 349 and Rev Rul 89-110, 1989-2 CB 275.
79. IRC 884(e), 884(f)(3).
80. IRC 7701(1).
81. Treas. Reg. 1.881-3.

It is not clear to what extent these provisions are effective to prevent treaty shopping. For example, in the period between 1997 and 2001 many public US corporations engaged in "inversion" transactions in which they became subsidiaries of new public corporations in Bermuda. Bermuda does not have a treaty with the United States so for treaty purposes the new parent corporations qualified as residents of Barbados. Subsequently, the new parent would lend funds to the US subsidiary which would deduct the interest and pay no withholding tax under the Barbados treaty. The LOB provision in the treaty proved ineffective because it does not apply to public corporations (even though the corporation was traded in New York, not in Barbados).

The ambiguity as to what is treaty shopping and as such improper use of tax treaties and what is mere tax planning and as such legitimate is reflected in the case law. US case law since *Aiken Industries* has tended not to side with the IRS even in situations which clearly involved treaty shopping.

For example, in *Northern Indiana Public Utilities* the Court of Appeals rejected the IRS' attempt to apply a substance over form or economic substance analysis to a Netherlands Antilles finance subsidiary.[82] In *SDI Industries* the Tax Court rejected the IRS attempt to argue that when a Netherlands corporation licensed software from its Netherlands Antilles subsidiary and sublicensed it to a US affiliate, neither the royalty payments from the United States to the Netherlands nor from the Netherlands to the Antilles were subject to US withholding tax.[83]

Recent US treaties (e.g. with the Netherlands and Switzerland) include elaborate LOB provisions that are much more complex than the provision in the 2006 US Model. These provisions were generally negotiated by the other side to the treaty and indicate that despite the professed US hostility to all forms of treaty shopping and its insistence on including LOB provisions in all new US treaties, in practice these provisions can be negotiated to address the concerns of the treaty partner and create opportunities for tax planning.

Therefore, the US approach to treaty shopping is, to an extent, also beleaguered by lack of uniformity. Even the LOBs in its tax treaty network

82. *Northern Indiana Public Service Co. v. Commissioner, 115 F.3d 506* (7th Cir. 1997).
83. *SDI Netherlands v. Commissioner*, 107 TC 161 (1996). The case was decided for a tax year before there was an LOB provision in the Netherlands treaty.

show variable degrees of severity which may exonerate a range of arrangements. This approach seems to be perpetuated in recent US tax treaties.

Overall, as far as treaty shopping is concerned, we identify variable standards and shifting benchmarks of impropriety. What are the implications of this conclusion in the EU context? This is examined in the final part of this paper.

4. Treaty shopping and EU law

In this section, we consider the effect of EU law on treaty shopping and anti-treaty-shopping provisions. In the past few years, the compatibility of anti-treaty-shopping provisions with EU law has been a topic of intense debate. It has been argued that anti-treaty-shopping provisions and especially the LOB are in breach of the freedom of establishment and/or the free movement of capital.[84] May Member States include anti-treaty-shopping provisions in tax treaties between themselves or with non-EU Member States?

For this argument to succeed, it has to be shown that treaty shopping, i.e. the activity that these anti-abuse provisions seek to curb, is an activity protected under EU law. Of course, there has to be genuine (cross-border) activity; the more abusive the structure, the less likely that the fundamental freedoms will be triggered at all. For, if the intermediary entity is a complete sham, then, arguably, there is no genuine exercise of establishment in that jurisdiction nor is there any movement of capital. Therefore, the more economic substance there is in the intermediary company itself, the more likely that the setting up of the establishment itself will be recognized as an

84. See, for example, HJI Panayi, C., "Open Skies for EC Tax?", *BTR* 3 (2003), p. 189; Kofler, G. W., "European Taxation Under an 'Open Sky': LoB Clauses in Tax Treaties Between the U.S. and the EU Member States", 35 *Tax Notes International* 1(2004), p. 45; Hinnekens, L., "Compatibility of Bilateral Tax Treaties with European Community Law – The Rules", *EC Tax Review* 4 (1994), p. 146; Hinnekens, L., "Compatibility of Bilateral Tax Treaties with European Community Law- Application of the Rules", *EC Tax Review* 4 (1995), p. 202; Doyle, H., "Is Article 26 of the Netherlands–United States Tax Treaty Compatible With EC Law?", 35 *European Taxation* 1 (1996), p. 14; Martín-Jiménez, A.J., "EC Law and Clauses on 'Limitation of Benefits' in Treaties with the U.S. after Maastricht and the U.S.-Netherlands Tax Treaty", *EC Tax Review* 2 (1995), p. 78; Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law", 18 *Nw. J. Int'l L. & Bus.* (1997), p. 165; Essers/de Bont/Kemmeren (eds.) *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law* (The Hague: Kluwer international, 1998).

activity that could be prima facie covered by the freedom of establishment. Similarly, the more economic substance there is in the intermediary, the more likely that investment through it will be prima facie covered by the free movement of capital.

Assuming this first threshold issue is satisfied and the aforementioned fundamental freedoms are prima facie engaged, is there a restriction to them?

From a freedom of establishment perspective, it could be argued that treaty shopping, i.e. the use of the intermediary entity located in a favourable tax jurisdiction to effect the investment, is an exercise of freedom of establishment. The possibility that the intermediary entity has limited economic substance (but is short of a complete sham for threshold purposes) ought not prevent this from being characterized as an exercise of establishment. An analogy may be drawn with a line of non-tax related cases (*Centros*[85]/ *Überseering*[86]). These cases dealt with corporate forum shopping. Here, the European Court of Justice (ECJ) approved the formation of primary and secondary establishments, even if they lacked economic substance in one Member State and were thought to have been set up in order to circumvent the company law formation requirements applicable in another Member State.[87] Just because the undertaking was corporate forum shopping within the European Union with little economic substance in the establishment did not necessarily mean that the protection under the freedom of establishment was withdrawn. Can this strand of reasoning also apply with treaty shopping? Does the fact that treaty shopping entails tax-location shopping rather than corporate forum shopping change matters?

There is no reason why it should, at least prima facie. It could be argued that treaty shopping is an exercise of establishment, regardless of the motives behind it. What anti-treaty-shopping provisions tend to do is to disregard the intermediary entity and treat another company as the ultimate recipient of the income. Therefore, it could be argued that anti-treaty-shopping provisions restrict the freedom of establishment. Of course, this restriction could be justified, as explained below, but this is nonetheless a restriction.

85. ECJ 9 March 1999, C-212/97, *Centros* [1999] ECR I-1459.
86. ECJ 5 November 2002, C-208/00, *Überseering* [2002] ECR I-9919.
87. For recent analysis, see HJI Panayi, C., "Corporate Mobility under Private International Law and European Community Law: Debunking Some Myths", in Eeckhout/Tridimas (eds.) *Yearbook of European Law*, Vol. 28 (Oxford. Oxford University Press, 2009), p. 124.

From a free movement of capital perspective, it could be argued that a treaty shopper exercises its free movement of capital by investing in a company indirectly (i.e. through another Member State entity) and as a result receiving its return from such investment indirectly. The analysis here focuses on the existence (or lack of) indirect investment rather than the use of an intermediary entity. The issue is not so much the fact of establishing a related entity through which investment is made. What is important is the fact that the treaty shopper (whether EU national or not) takes advantage of the tax treaty network of another Member State in order to invest in a third Member State, by channelling income through an intermediary entity which it does not control.

In other words, this is an instance of *indirect rather than direct investment* (investment through a related entity) and as such, prima facie protected under the free movement of capital. Anti-treaty-shopping provisions tend to disregard the intermediary entity and/or re-characterize the payment as being directly made to another company. As a result, they may ultimately make the investment of capital through an intermediary in another Member State more expensive. Therefore, it could be argued that anti-treaty-shopping provisions restrict the free movement of capital.

Of course, as under freedom of establishment, this restriction could be justified by imperative requirements in the general interest. It also has to be suitable and proportional.[88] Not every kind of structure will ultimately be protected under EU law.

For example, the restriction could be justified on the basis of preventing tax avoidance/evasion.[89] In order for this ground to succeed, the anti-treaty-shopping provisions must have the specific purpose of preventing wholly artificial arrangements.[90] Broad anti-abuse clauses which do not distinguish between bona fide activities and abusive situations have been struck

88. ECJ 30 November 1995, C-55/94, *Gebhard* [1995] ECR I-4165, Para. 37.
89. See, for example, ECJ 16 July 1998, C-264/96, *ICI* [1998] ECR I-4695; ECJ 11 March 2004, C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de L'Economie des Finances et de l'Industrie* [2004] ECR I-02409. The ECJ tends to use the terms "avoidance" and "evasion" without distinction. In some cases, it refers to the justification as being based on tax avoidance (e.g. ECJ 16 July 1998, C-264/96, *ICI*, Para. 26), whereas in others (usually more recent ones), it referred to tax evasion (e.g. ECJ 12 December 2002, C-324/00 *Lankhorst-Hohorst*, Para. 37; ECJ 21 November 2002, C-436/00, *X and Y*, Para. 62).
90. ECJ 21 November 2002, C-264/96, *ICI*, Para. 26; ECJ 12 December 2002, C-324/00, *Lankhorst-Hohorst*, Para. 37.

down.[91] Prevention of tax avoidance/evasion could, therefore, exonerate a restrictive treaty provision if this is sufficiently targeted to that end. The provision must also be suitable and must not go beyond what is necessary to attain the objective pursued, whether this is prevention of tax evasion or tax avoidance.

Therefore, if less than wholly artificial arrangements are caught by an anti-treaty-shopping provision, then the restriction is unlikely to be justified. As a corollary, the more artificial the treaty-shopping arrangement, the more likely it is to have tax avoidance connotations – against which an anti-treaty-shopping provision can more readily be justified. It should be noted that obtaining a mere tax saving is not tax avoidance/evasion in the eyes of the ECJ.[92] Loss of revenue and erosion of tax base has not been accepted as a justification by the ECJ.[93] In any case, as explained above,[94] treaty shopping has not unequivocally proved to be fiscally harmful.

The restriction could also be justified on the basis of safeguarding the allocation of tax jurisdiction.[95] It could be argued that what anti-treaty-shopping provisions seek to do is restore the allocation choices of the tax treaty shopped. If State S wanted to grant the same tax concessions to State P and State R, it would have done so. As the original allocation choices of the relevant tax treaties are respected under EU law after the *D.* case,[96] so should measures to protect and restore those allocation choices.

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91. See 12 December 2002, C-324/00, *Lankhorst-Hohorst*, Paras. 34-38; ECJ 11 March 2004, C-9/02, *Lasteyrie du Saillant*, Para. 50.

92. See, for example, ECJ 26 October 1999, C-294/97, *Eurowings Luftverkehr* [1999] ECR I-7447, Para. 44 and other cases cited therein.

93. See, for example, ECJ 21 November 2002, C-264/96 *ICI*, Para. 28; ECJ 21 September 1999, C-307/97, *Saint-Gobain* [1999] ECR I-6161, Para. 50; ECJ 12 December 2002, C-385/00 *De Groot* [2002] ECR I-11819, Para. 103.

94. See 2.2. and the analysis on *Union of India v. Azadi Bachao Andolan* [2003]6 ITLR 233; (2003) SOL 619.

95. See Case ECJ 5 July 2005, C-376/03, *D* [2005] ECR I-5821; ECJ 13 December 2005, C-446/03 *Marks & Spencer* [2005] ECR I-10837; ECJ 18 July 2007, C-231/05, *OyAA* [2007] ECR I-6373; ECJ 7 September 2006, C-470/04, *N* [2006] ECR I-74091; ECJ 15 May 2008, C-414/06, *Lidl Belgium GmbH & Co KG/Finanzamt Heilbronn* [2008] ECR I-3601, Para. 51; ECJ 17 September 2009, C-182/08, *Glaxo Wellcome GmbH & Co. KG v. Finanzamt München II*, Para. 88.

96. In the *D* case, the ECJ accepted the allocation attained in the relevant tax treaties, even if this meant that some non-residents were treated more harshly than other non-residents. The ECJ found that the Netherlands was not obliged to extend to a German resident the treaty benefits given to Belgian residents. The Germany–Netherlands tax treaty did not provide for the same allowances as the Belgium–Netherlands tax treaty. This was a question of pre-agreed allocation of tax powers between these States. The relevant treaties were not to be interfered with by extending benefits given to Belgian

Certainly, the application of this justification has to be finely tuned and proportional. The allocation of tax jurisdiction is less threatened by intermediary entities imbued with economic substance. The more substance there is in the treaty shopping arrangement, the less likely that the allocation scheme under the underlying tax treaty would be frustrated. Anti-treaty-shopping provisions have to factor that in.

Also, the applicability of this ground as an imperative requirement could depend on the actual effect of the anti-treaty-shopping provisions on the structure. Do they restore the original withholding tax rate that would have applied absent the treaty shopping arrangement or do they impose a (penal) statutory withholding tax rate? If the former, then it could be argued that what the anti-treaty-shopping provision actually does is to restore the treaty balance. However, if the statutory withholding tax rate applies, then it is more difficult to see how the anti-treaty-shopping provision restores the treaty balance, since that balance is itself overridden.

A point to note is that under the free movement of capital, it does not matter whether the capital movement is to or from a non-Member State, so long as there is some capital movement to or from a Member State. However, this could be relevant at the justification stage.[97] A restriction may be more readily justified if it affects third-country nationals than if it affects EU nationals. Nevertheless, this has to be proven. Another point to note is that the freedom of establishment is only available to EU nationals. Therefore, if the intermediary entity is in a non-EU Member State, then an anti-treaty-

residents also to German residents. The current tendency of the ECJ seems to be respect for the allocation choices enshrined in tax treaties. See, for example, ECJ 15 May 2008, C-414/06, *Lidl Belgium* [2008] ECR I-3601, Para. 51; ECJ 17 September 2009, C-182/08, *Glaxo Wellcome GmbH & Co. KG v. Finanzamt München II*, Para. 88. The only case which explicitly dealt with anti-treaty-shopping provisions is the *ACT Group Litigation* case. Here, both the Advocate General and the ECJ refrained from using tax treaty allocation as a justification for a restriction. Instead, reliance was placed on non-comparability. However, the overtone of both the Opinion and the judgment is respect for tax treaties. The tax treaty package represented an equilibrium, into which no enquiries could have been sustained. ECJ 12 December 2006, C-374/04, *ACT Group Litigation*, Paras. 88-91. For further analysis, see Chapter 5 in HJI Panayi, C., *Double Taxation, Tax Treaties, Treaty Shopping and the European Community* (2007).

97. See, for example, ECJ 12 December 2006, C-446/04, *FII Group Litigation* case [2006] ECR I-11753, Paras. 169-172; ECJ 13 March 2007, C-524/04 *Thin Cap Group Litigation* [2007] ECR I-2107; ECJ 18 December 2007, C-101/05 *Case A* [2007] ECR I-11531; ECJ 23 April 2008, C-201/05 *The Test Claimants in the CFC and Dividend Group Litigation v. HMRC* [2008] STC 1513; ECJ 19 November 2009, C-540/07 *Commission v. Italy* [2009] ECR I-0000.

shopping provision frustrating the arrangement may not be incompatible with EU law.

In conclusion, it is possible that anti-treaty-shopping provisions restrict the freedom of establishment and/or the free movement of capital. However, they could be justified, depending on how these provisions are phrased, whether they are sufficiently targeted against wholly artificial arrangements and proportional. It also depends on whether these provisions try to curb treaty shopping through a non-EU Member State.

The recent trend, however, at the ECJ level appears to be respect for the allocation of taxing rights under a tax treaty and, generally, respect for tax treaties.

5. Conclusion

The first author has repeatedly stated his belief that an underlying principle of the international tax regime is the single tax principle, i.e. that cross-border flows of income should be subject to some tax and that double non-taxation should be addressed as much as double taxation.[98] The rationale is that double non-taxation weakens countries' ability to tax income by encouraging shifting income from domestic to cross-border activities. This view implies that reduction of tax by the source country should be premised on actual taxation by the residence country.

There is no question that this view was not always taken by any country; the first US tax treaty (1937) was with France at a time when the US system was purely territorial so that reduction of source taxation was not accompanied by residence taxation. However, the introduction of LOB provisions into US tax treaties and into the OECD Commentary indicate that this view is gaining ground and it may apply even in situations that are not purely abusive.

Nevertheless, this paper has shown that actual treaty practice and case law fall far short of implementing the single tax principle. In most cases anti-treaty shopping provisions are either absent or applied only to pure conduit situations. This may reflect the unclear theoretical basis to the attack

98. Avi-Yonah, R.S., *International Tax as International Law: An Analysis of the International Tax Regime,* Cambridge Tax Law Series (New York: Cambridge University Press, 2007), Chapter 10.

on treaty shopping in general, or (as in the India/Mauritius case) practical constraints stemming from tax competition. In any case, this debate is likely to continue.

As far as treaty shopping within the European Union is concerned, special considerations would seem to apply. If anti-treaty-shopping provisions are targeted against wholly artificial arrangements, then it is more likely that they will be compatible with EU law. However, as was shown in section 3., anti-treaty-shopping provisions may not be targeted against such arrangements only. In fact, provisions such as beneficial ownership can be so vague that they can be subject to different interpretations, catching a wider or narrower array of arrangements in each jurisdiction. Whilst a wholly artificial arrangement may be more easily found when double non-taxation is in place, anti-treaty-shopping provisions are not always applied to that effect. Therefore, EU Member States should re-examine their tax treaty policies, to ensure that EU law safeguards are reflected in the application and interpretation of their anti-treaty-shopping provisions.