I. Introduction

1. At its first meeting held on 5-9 December 2005,

(the United Nations Model Convention) was presented at the meeting. The proposal assumed that any update of the Commentary on article 1 of the United Nations Model Convention should take into account, as a point of departure, the update carried on by the OECD in 2003 to the Commentary on article 1 of the OECD Model Convention. Nevertheless, it was stressed that it was impossible to automatically assume and translate all the amendments made by OECD to its Model Convention, since there had been little discussion on certain issues at the United Nations meeting. The Group of Experts adopted the view that the discussion of changes to the Commentary should continue and should be taken up at the next meeting of the Group of Experts.

24. The general consensus was that the amendment of the Commentary on article 1 of the United Nations Model Convention deserved further attention and that a final decision should not be made until the next meeting of the Group of Experts. It was decided that the process of discussing the different approaches would continue so as to promote a consensus on the substantive amendments to the Commentary prior to the next meeting of the Group of Experts.

25. On the basis of the discussion, it was recommended by the Group of Experts that the question of whether the United Nations should recommend an article in the Model Convention on the limitation of benefits that would be responsive to the needs of developing countries sho(.8.2211( )-23.776(t)-15.3326(h)-18.2211(e)-15.5546( )-23.9(e)1( )-23.7)-18.22

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35. Many experts were of the view that the anti-abuse provisions should be included in the Commentary, which should also contain examples to illustrate situations in which treaty abuse might arise, as this could be of benefit to future negotiators."

7. Considering the decisions made at the first

and the response mechanisms that are legally acceptable from the standpoint of the international law of treaties.

11. The distinction is recognized in the OECD Model Convention in the commentary on article 1, paragraph 17, formerly paragraph 19, and has been strengthened in the 2003 update of the OECD Model Convention by new paragraphs 21 to 21.5 of the same section, particularly in the cases contemplated in paragraph 21.5."

B. Abuse by One of the Contracting States

10. An abuse of a tax treaty by a State refers to a situation where one of the Contracting States, through the subsequent exercise of its domestic power of taxation, modifies the obligations previously assumed by that State towards the other State and upsets the balance in the division of taxing powers expressed in the tax treaty concluded between these States. By doing so, it may abuse the treaty and cause significant damages to the legitimate financial interests of taxpayers or of the other Contracting State.

11. An example of "abuse by a State" would be the case where a State that exempts certain companies from tax introduces a 1% tax creditable against, and limited to, the annual registration fee of these companies for the sole purpose of allowing these companies to qualify as a resident for purposes of a tax treaty. However, there would also be rather an opposite type of the abuse. That is, a State would try to expand its taxing rights beyond the limit that both States agreed upon when they concluded the tax treaty. For example, if a State tries to define shares as a kind of the immovable properties by changing its domestic laws in order to tax dividends without any limit under an article of the relevant tax treaty, which follows the taxation principle of Article 6 of the UN or OECD Model Convention, such a case can be regarded as an "abuse by a State". This draft report, however, would confine the discussion of the "abuse by a State" to the former because it is more closely related with the topic of treaty abuse and treat shopping.

12. The following is a further elaboration of the "abuse by a State" by Prof. Garcia Prats[6]:

"14. State abuse of a tax treaty may occur in the following situations:

(a)It may result from the post-treaty amendment of a domestic tax law that must be taken in conjunction with a tax treaty in order to be interpreted and actually applied. The process may result in the concession of exceptional or excessive advantages to a certain number of persons or beneficiaries of the treaty that are not derived solely from the text of the treaty but from the treaty provisions in combination with the domestic tax legislation of the state in question. Such situations, however, are sometimes lumped together with other forms of 'treaty shopping'.

(b) Treaty abuse may be the consequence of an administrative practice of one of

(VCLT) of 1969, which requires the parties to a treaty to perform it in good faith, and Article 38 of the Statute of the International Court of Justice, which states that the Court shall apply the general principles of law recognized by civilized nations should be governing principles in dealing with issues of the abuse by a State.

14. Verification of the abuse by a State is actually not an easy task since, first, any tax treaty including UN or OECD Model Treaty does not set out a concept of minimum taxation of transnational income or of an obligation to tax such income. Secondly, lack of consensus among tax treaty partners on the harmfulness of double non-taxation makes it very difficult to infer the purpose of tax treaty at the time of its conclusion. Therefore, it is often dubious whether a situation of double exemption from tax should be seen as abusive. Thirdly, most tax treaties including UN or OECD Model Treaty do not provide a well-defined verification procedure by which the abuse of treaty either by a State or a taxpayer can be identified or confirmed. As a consequence, the offended States that wish to correct the situation soon are often tempted to directly rely on unilateral countermeasures.

15. However, the determination on sanctions against the abuse by a State is required to be in line with principles of international law as mentioned above. If the offended State takes the following steps before taking sanctions, it would be regarded as faithful to the principles of international law.

16. The first step: The offended State may make a first call to the abusing State in order to ask for explanations of the supposed abuse of the treaty as a result of a posterior action of the abusing State (legislative, applicative or interpretative action).

The second step: The offended State may start a dispute settlement procedure, if necessary, through the mutual agreement procedure or mechanism provided in the tax treaty.

The third step: If the cooperative mechanism of the tax treaty does not lead to a settlement of the dispute and the offended State still considers the treaty to have been abused, then unilateral measures may be taken against the improper application of the treaty by the other State after notification to the other contracting State. In that case, international law, case law and standards established in the Draft Articles on Responsibility of States for Internationally Wrongful Acts (Articles 49-54) should be respected. Unilateral reaction may consist of retorsion or countermeasures proportionate with the injury suffered, allowing the other State to fulfil the affected obligations again.

17. It is recommended that a sub-committee under the Committee of Experts of the UN be set up with a view to developing mechanisms for the verification of the abuse by a State and the determination of proper measures to counter such an abuse. This job may be conducted as a part of the work of the development of the *dispute settlement mechanism* in general.

①[Members of the Committee are invited to make their comments on the subsection II-B (Abuse by One of the Contracting State).]

III. Abuse of Tax Treaties by Individuals and Entities

A. Analysis on Some Important Concepts

1. Treaty Abuse

18. The Group of Experts roughly defined terms the abuse of tax treaties as “the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits the treaties were not designed to give them”.

19. More sophisticated definition on the term of ‘abuse of tax treaties’ can be found in van Weeghel’s study[7] as follows:

“ [T]he use of that term is arguably narrowed down to those situations where the particular use of a tax treaty *i)* has the sole intention to avoid the tax either or both of the contracting states, and *ii)* defeats fundamental and enduring expectations and policy objectives shared by both states and therefore the purpose of the treaty in a broad sense.” Thus, under this definition, even though a taxpayer acted to avoid tax by using the treaty, the purpose, expectations and policy objectives of the tax treaty should be considered before the determination is made with regard to whether his use of the treaty is regarded as abusive.

20. According to van Weeghel’s analysis, the purpose of a tax treaty is a function of ***i)*** the primary goals to avoid double taxation and to prevent tax evasion; and ***ii)*** the expectations and policy objectives of the treaty partners. He views that the position taken by the OECD as to improper use of tax treaties should be given considerable weight since the purposes of avoidance of double taxation and prevention of tax evasion have their roots in the earliest tax treaties and were further developed by the different committees earlierl6657(o)-18.277265546(r)-186(

a) Treaty benefits negotiated between two States are economically extended to persons resident in a third State in a way unintended by the contracting States; thus the principle of reciprocity is breached and the balance of sacrifices incurred in tax treaties by the contracting parties altered;

b) Income flowing internationally may be exempted from taxation altogether or be subject to inadequate taxation in a way unintended by the contracting States. This situation is unacceptable because the granting by a country of treaty benefits is based, except in specific circumstances, on the fact that the respective income is taxed in the other State or at least falls under the normal taxing regime of that State;

c) The State or residence of the ultimate income beneficiary has little incentive to enter into a treaty with the State of source, because the residents of the State of residence can indirectly receive treaty benefits from the State of source without the need for the State of residence to provide reciprocal benefits.

23. It seems safe to assume that the views held by the OECD are widely shared by those countries that are opposed to treaty shopping.

24. Prof. Garcia Prats distinguishes the concept of “treaty abuse” from that of “treaty shopping” by stating that the term “treaty shopping” — in other words, searching for a more favorable treaty — should not be equated with treaty abuse. According to his view, the conclusion that a situation is abusive — or that an individual is benefiting from the application of a double taxation treaty in an abusive fashion — requires and implies verification of the occurrence of an indirect, rather than a direct, breach of a provision through a violation of its object, spirit or purpose, something that is difficult to determine a priori[13].

3. Qualification

25. The term ‘qualification’ is often used to denote the process of identifying the treaty object under domestic law and under the treaty[14]. The character of income must be identified so that a tax treaty provision can be applied properly. For example, if a company resident in one Contracting State paid a certain amount of money to its shareholder resident in the other Contracting State, it should be determined whether the money paid constitutes a dividend, interest, or any other kind of income of the shareholder. Depending on the character of income, the State having taxing right on the income and the way of taxation may differ.

26. The process of qualification, in the application of a tax treaty, normally occurs twice in each instance, i.e., the source state will determine which treaty provision can be applied to the item of income in question, and the residence state will do the same. In most instances, the qualification will be the same in the source state and in the residence state, but in a quite a few instances the qualification in the source state and in the residence state may be different from each other. van Weeghel introduces in his book[15] the concept of ‘positive qualification conflict’ as the situation where both States tax the same ite

27. A taxpayer may try to create a negative qualification conflict in order to avoid every taxation on cross-border income. The question is whether a successful effort to create a negative qualification can be treated as abusive. On the one hand, one could argue that the creation of a negative qualification conflict can never be labeled as abusive because each State applies the treaty to every cross-border income, and the result of its application in principle squares with fundamental and enduring expectations and policy objectives of the tax treaty concluded by both States.

28. On the other hand, one could argue that while the treaty has been applied properly in both States, the result – no or less than single taxation in either State – is not consistent with the above expectations, policy objectives and principles since both States would expect at least single taxation (i.e., being taxed at least once). In this light, the creation of a negative qualification conflict with the sole intention of avoiding every taxation would be regarded as abusive or improper. This would be true if one would give more weight to the overall expectation of the States that any item of income will be taxed at least once than to the fact that each State may be satisfied with the result of its own treaty application without paying attention to the consequence as a whole.

this job, which is more than citation of certain doctrines or formulas (such as the “substance-

commissions, service fees and similar expenses to a second related ‘conduit company’ set up in State D. These payments are deductible in State A and tax-exempt in State D where the company enjoys a special tax regime[17].

36. A conduit company may be a financial intermediary such as an investment company or a holding company (for example, in a back-to-back loan context). The fact that a company carries on the business of financial intermediary may make it difficult for State B to treat that company as a conduit and deny the application of a tax treaty. That is because the main business decisions of the corporation are made (or

41. If the levy of withholding tax is authorized by the tax treaty concluded by the contracting states (even if the company making payments is genuinely engaged in business – and not merely a treaty shopping device in the state of its residence), one could conclude that the avoidance of withholding taxes by relocating the place of effective management of the company without legitimate non-tax reasons followed by the subsequent payments can be treated as abusive, because it defeats fundamental and enduring expectations and policy objectives shared by both states.

1.3 Triangular Cases

42. The term 'triangular cases' has been used to denote the application of tax treaties where three states are involved. The OECD has described the typical triangular case as one in which:

— income from dividends, interest or royalties is derived from a source in State S;
— such income is received by a permanent establishment in State P;
— the permanent establishment depends on an enterprise resident of State R[20].

43. Tax treaties are generally concluded on a bilateral basis and do not explicitly address triangular situations. This lack of coverage may lead to situations of double taxation despite the existence of bilateral tax treaties between all three states. On the other hand, there may be situations in which income is entirely or almost entirely untaxed. According to views of the OECD, 'the most difficult problem appears to arise in the situation where income arising in State S and paid to a permanent establishment in a tax haven would be taxed very little or not at all'[21]. This problem arises because the State of residence of the permanent establishment, albeit being situated in State P, is regarded as State R.

44. In order to solve the above problem, the Commentary on Article 24(3) of the OECD Model Convention states in paragraph 53 as follows:

> "If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment."[22]

45. However, even though State R and State S agree to include the provisions recommended in the Commentary, the problem may remain unresolved if the enterprise changes its residence from State R to another State (e.g., State Q) which does not have the same type of provisions with State S and thereby the permanent establishment continues to be taxed very little or not at all.

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[20] OECD Committee on Fiscal Affairs, 'Triangular Cases', in *Model Tax Convention*, OECD April 2000, R(11)-3, paragraph 2.
[21] *Id.*, R(11)-15, paragraphs 53.
[22] This provision is regarded as relevant for the Commentary on Article 24(3) of the UN Model Convention. See paragraph 4 of the Commentary on Article 24 of the UN Model Convention.

1.4 Transfer of Residency

46. The Commentary on Article 1 of the OECD Model Convention 2005 mentions in paragraphs 8 and 9 an example of case where improper use of tax treaty takes place by transferring residence[23].

> "8. It is also important to note that the extension of double taxation conventions increases the risk of abuse by facilitating the use of artificial legal constructions aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in double taxation convention.
>
> 9. This would be the case, for example, if a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly. Another case would be an individual who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, and who, essentially in order to sell the shares and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 4 of Article 13), **transfers his permanent home** to the other Contracting State, where such gains are subject to little or no tax."

2. Attributing Profits or Income to a Specific Per

49. Tax treaties are frequently used by individuals in respect of their income from personal services. Improper use or abuse of tax treaties may be perceived where the individual purportedly creates a qualification conflict with respect to the income from the services rendered as shown in the following examples[24].

2.1 Directors' Fees

50. Article 14 (Independent Services) and Article 15 (Dependent Services) of both the UN Model Convention and '92 OECD Model Convention assign the right to tax the income from independent and dependent services to the state where these services are performed subject to certain conditions. Article 16 (Directors' fees) of the Model Convention, however, takes a different approach by providing that:

> [d]irectors' fees and other similar payments derived by a resident of a Contracting state in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

51. The Commentaries of both the UN and OECD Model Conventions explain this deviation from the rules provided in Articles 14 and 15 by stating that 'it might sometimes be difficult to ascertain where the services are performed'[25].

52. The rule contained in Article 16 has been used in so-called 'salary split' arrangements. For example, multinational A has subsidiaries B and C, which are residents of countries X and Y respectively. Mr. D is employed in a high level managerial capacity by subsidiary B and has his residence in country X. Country X levies an income tax on its residents and non-residents having domestic income, at progressive rates of up to 50%. Country Y has a similar income tax system but with a very low tax rate. Countries X and Y have a tax treaty which employs the exemption system in the residence state for income that may be taxed in the source state under Article 16 of the OECD Model or the UN Model Convention. If Mr. D receives his salary only in respect of services performed in country X for company B, a large part of his salary will be subject to the highest tax rate in that country. Therefore, for the purpose of mitigating tax burdens, it has been decided to appoint Mr.D as a member of the board of directors of company C. This part of his compensation is subject to country Y's income tax at a very low rate, because it falls in the lower income tax brackets. Mr. D invokes the provisions of Article 16 of the treaty to benefit from the exemption from tax in country X in respect of his compensation from company C.

53. If a salary split arrangement is used in a situation where the position of director exists merely in form but not in substance, the application of Article 16 would be improper. Article 16 explicitly states that the fees should be derived 'in [the taxpayer's] capacity as a member of the board of directors' in order for that Article to be applied. It also requires that, if the directorship merely exists in form but not in substance, remuneration should not be made in that capacity. On the other hand, in the situation where the taxpayer really derives the remuneration in his capacity as a member of the board of directors and not as part of an arrangement the sole purpose of which is to avoid tax in the State of residence, this would not constitute an improper

2.2 Artistes and Sportsmen

54. In the 1963 Draft OECD Model Convention, Article 17 reads as follows:

"Notwithstanding the provisions of Articles 14 and 15, income derived by public entertainers, such as theatre, motion picture, radio or television artistes, and musicians, and by

replicating the economic effect of any type of financial transactions regardless of their legal form. The following example shows that a shareholder who does not retain any legal ownership of shares can enjoy substantially the same economic position as if he actually owned the shares.

67. When an investor buys a bond and at the same time buys a cash-settled forward contract which

75. This threshold, however, can be easily abused through the prospective dilution of the value of such property before the actual transfer of a share of the company concerned. Therefore, some tax authorities feel that it would be advisable to add some guidance in the relevant parts of the Commentaries to deter taxpayers from attempting to dilute the value of particular assets[38].

76. Another threshold issue can be raised with regard to Article 13(5) of the UN Model Convention which provides as follows:

> "5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of at least ____ per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State."

77. In fact, a number of actual tax treaties include the similar provision to the above paragraph with a fixed percentage (in most cases 25%), which is usually set in negotiations. The fixed participation ratio, however, can be abused by taxpayers through multiple or time-splitting transfer of shares if further detailed provisions are not provided in the above paragraph[39].

78. In order to reduce room for potential treaty abuse, it seems necessary either to redraft the provision or to add something in the Commentary to clarify the provision. The following is an example of redraft of Article 13(5), which may serve the above purpose.

> "Gains derived by a resident of a Contracting State from the alienation of stock, participation, or other rights in the capital of a company or other legal person which is a resident of the other Contracting State may be taxed in that other Contracting State if the recipient of the gain, during the 12 month period preceding such alienation, had a participation, directly or indirectly, of at least _____ percent in the capital of that company or other legal person."

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[38] For example, the following guidance would be useful:

> "Temporary injection of cash or other assets in the company shortly before the transfer of shares would be disregarded when interpreting paragraph 4."

[39] The following case shows an example of tax avoidance using "dilution or splitting". This case is excerpted from [case 2] of the comments on Abusive Transaction, which Mexican Expert (Mr. Armando Lara Yaffar) of the Committee has submitted:

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IV. Reaction to Tax Treaty Abuse: Measures to Coun

83. Where a taxpayer incurs expenditure that is not viewed as being exclusively for the business, that expenditure should not be eligible for tax deduction.

1.4 Re-characterization of Income in case of Conduit Arrangement

84. If

secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and the purpose of the relevant provisions.

22. Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including "substance-over-form", "economic substance" and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties, which is the second question mentioned in paragraph 9.1 above.

developed. The following provision is an example of a GAAR of the treaty by means of the above-mentioned ‘guiding principle’:

the relationship between tax treaty and domestic anti-abuse measures. Such conclusion is drawn because the OECD Commentary justifies the application of the domestic anti-abuse measures to the cases of treaty abuse **to the extent that** such domestic measures meet the criteria set out in the guiding principle of paragraph 9.5[54] of the 2003 Commentary on Article 1 of the OECD Model Convention as shown below:

> "9.2 […] As indicated in **paragraph 22.1 below**, the answer to that second question is that to the extent these anti-abuse rul

106. The current UN Model Convention deals with specific treaty anti-abuse rules in Articles 10 (2), 11(2), 11(6), 12(2) and 12(6) for the concept of “beneficial ownership” and Article 17 (2) for the prevention of tax abuse using so-called ‘artiste company’. Besides, paragraphs 8 to 11 of the Commentary on Article 1 of the UN Model Convention introduce specific provisions on the criteria for identifying bona fide cases from conduit cases. Further, paragraph 4 of the Commentary on Article 24(3) of the UN Model Convention includes a provision for preventing a treaty abuse technique using the triangular cases discussed in Section 3.3.1.3. of this draft report.

107. All wordings and paragraphs mentioned above reproduce the relevant parts of the 1992 OECD Model Convention and its Commentary. However, as the report of Prof. Garcia Prats shows below, there may be some invalid omission in assimilating appropriate parts of the 1992 OECD Commentary and therefore a further consideration may be needed in updating the UN Model Convention and its Commentary:

> “39. According to paragraphs 28 and 29 of the “Draft report of the Focus Group of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on its second meeting”,[6] paragraphs 7 to 10 of the commentary on article 1 of the OECD Model Convention should be inserted into the United Nations Model Convention, and the discussion in the OECD commentary on treaty abuse issues (paragraphs 22 to 26 in the version of the OECD Model Convention current at that time) could usefully be incorporated in the United Nations Model Convention.
>
> 40. However, the material finally inserted differed considerably from this suggestion, although no reason for the omissions emerged in the debate in the Group of Experts. Former paragraph 12 of the OECD commentary on article 1, which contains general considerations to be borne in mind in adopting one approach or another was not inserted. Moreover, the paragraphs enumerating the advantages and disadvantages of adopting each particular approach were omitted (paragraphs 14, 16,

109. The question naturally to be raised at this stage is whether or not (and to what extent if incorporation is made) the UN Model Commentary incorporates in its updated version each changed part of the OECD Commentary. Additionally, the question of whether the ‘limitation

problem in the case of abuses of domestic laws but since tax treaties take so long to amend or replace, this is a very serious deficiency as regards the inclusion of specific anti-abuse rules in tax treaties.

20. Second, the inclusion of a specific anti-abuse provision in a treaty can seriously weaken the case as regards the application of general anti-abuse rules or doctrines to other forms of treaty abuses. Adding specific anti-abuse rules to a tax treaty may well create an expectation that all unacceptable avoidance strategies that rely on treaty provisions will be similarly dealt with and cannot, therefore, be challenged under general anti-abuse rules.

21. Third, in order to specifically address complex avoidance strategies, complex rules may be required. This is especially the case where these rules seek to address the issue through the application of criteria that leave little room for interpretation rather than through more uncertain criteria such as the purposes of a transaction or arrangement. The comprehensive limitation-of-benefits provision put forward in new paragraph 20 of the Commentary on Article 1 provides a good example: that provision attempts to deal with the issue of treaty shopping through precise criteria but is also the longest put forward in the OECD Model Convention. Complex treaty rules are often difficult to negotiate, are more likely to be literally interpreted and carry more risk of affecting non-abusive transactions than short rules that focus on principles.

22. For these reasons, the inclusion of specific anti-abuses rules in tax treaties cannot