A critical analysis of how double tax agreements can facilitate fiscal avoidance and evasion.

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Abstract

Benefits offered by double tax agreements as well as the differences in tax rates of varying tax regimes create opportunities for fiscal avoidance and evasion. Through the use of artificial legal structures, definitions and provisions contained within double tax agreements international taxpayers are able to use these for the purpose of tax avoidance and evasion. Different approaches have been identified to prevent improper use of double tax agreements such as general and specific anti-abuse rules contained with the agreements and specific, general and juridical doctrines contained in domestic taxation laws. The preventative measures available are effective in their own right however, without renegotiating the agreements they will not prevent tax avoidance and evasion.

Introduction

Each country has their own distinct tax laws, which vary depending on the goals of the government. Differences in tax laws and rates can tempt taxpayers to exploit these differences resulting in a type of tax arbitrage. In addition the extension of double tax agreements can facilitate improper usage of the agreements in the form of abusive transactions or the creation of artificial legal structures to obtain treaty benefits.

The aim of this paper is to critically analyze the statement that 'far from aiding in the prevention of fiscal avoidance and evasion, double tax agreements more often facilitate such activities.' The first section of this paper will analyse various avoidance opportunities available to international taxpayers that exist within the model double tax agreements developed by the OECD, UN and the USA. The key focus will be given to treaty shopping, manipulating specific articles and definitions for the benefit of obtaining treaty benefits. The second part of this paper will explain specific double tax agreement measures for combating international tax avoidance. This section will analyse the limitation of benefits, beneficial ownership and specific anti-abuse provisions that have been adopted by the model double tax agreements. Finally, an analysis of the preventative measures versus the exploitation of double tax agreements will be conducted.

Avoidance opportunities

In addition to eliminating double taxation, double tax agreements offer benefits to taxpayers who are resident in the states contracting to the agreements, such as reduced withholding taxes on passive income. The following subsections identify and explain the various opportunities for avoiding taxes that stem from the current published model of double tax agreements.

Treaty shopping

Treaty shopping refers to 'arrangements through which persons who are not entitled to the benefits of a tax treaty use other persons who are entitled to such benefits in order to indirectly access these benefits.'[1]

Most treaty shopping involves the attempt to gain access to reduced withholding tax rates on passive income, such as dividends, interest and royalties. These arrangements make use of conduit companies, which are incorporated in one of the tax jurisdictions contracting in the double tax agreement. There are two types of conduits, a direct and a stepping stone conduit. An example of a direct conduit is when a resident of Hong Kong derives dividends from Australia for which there is no agreement in place between Hong Kong and Australia. The withholding tax rates on dividends paid from Australia to non-residents is 30%. The Hong Kong resident establishes a company in Singapore, which has an extensive treaty network including Australia. The newly established company is resident of Singapore for the purposes of the Australia Singapore double tax agreement and as such entitled to all benefits provided by the treaty. The withholding tax rate under this agreement limits Australia's taxing right to charge tax not exceeding 15%.[2]

A stepping stone conduit is a variant of the direct conduit. As an example, a company resident in State R is to receive dividends, interest or royalties from a company resident in State S, for which no double tax agreement is in place. The resident of State R establishes a company in State C that is subject to full tax on income derived in State S. The State C company charges high interest, royalties, service fees, commission etc to a related company set up in State B, which is controlled by the conduit in State C. These payments are deductible in State C leaving minimal income in State C subject to taxation. In addition State B has a preferential tax regime in which limits the taxed imposed on these types of income. The company resident in State B, which has a double tax agreement in place with State R, pays dividends, interest and royalties onto the company resident in State R, which has a favourable withholding tax rate on such passive income.

The conduit structure is regarded as an improper use of treaties by the OECD Committee on Fiscal Affairs since the treaty benefits are extended to third state residents, which was unintended by the convention and as such, the cross-border income may be exempted from or subject to a low rate of taxation.

Change of residence

Article 4 of the OECD model tax convention on income and capital establishes that a 'resident of a Contracting State' is to be determined under the domestic laws of each country, and use methods such as, the place of management and place of incorporation for a company to determine residence. In the case of an

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[1] Economic and Social Council Committee of Experts on International Cooperation in Tax Matters, The Improper Use of Treaties, 22 October 2007

[2] Ignoring the fact that a beneficial owner clause is in place in paragraph 1 of article 8 of the Singapore Australia double tax agreement.

individual the personal attachment to the state such as permanent home, place of vital interests and habitual abode are considered.

This term and its definition is the key for a person being entitled to the benefits of a double tax agreement.[3] By changing tax residence from one country to another it is possible that a person is able to obtain benefits from the double tax agreements and domestic tax laws of the new country of residence.
Three examples in which persons changed their tax residence have been provided by the United Nations in their analysis of improper use of treaties. These can be summarized as follows:

First, is a scenario under which a person has accumulated pension rights in their country of residence. Assume a resident of State A becomes a resident in State B under the terms of paragraph 2 of Article 4 of the OECD model tax convention[4]. State B does not tax pension payments while State A does. During the period of residency in State B, the individual receives a lump sum payment form the pension from the originating state. Article 18 of the OECD model tax convention provides that 'pensions and other similar remuneration paid to a resident of a contracting state in consideration of past employment shall be taxable only in that State.' [5] Thus by changing residency from State A to State B the individual has avoided taxation on the pension payment made from State A.

The second example provided explains that a company resident of State A is considering the sale of shares of companies that are also resident in State A. The sale would trigger a capital gain subject to taxation in State A. Assuming State B does not tax capital gains, if the company changes its place of effective management to State B, thus becoming a resident of State B then the capital gains would not be subject to taxation since 'gains from the alienation of any property, other than that referred to in paragraphs 1,2,3 and 4, shall be taxable only in the contracting state of which the alienator is a resident'[6]. Paragraph 30 of the commentary on Article 13 explains that there are no special rules for gains on the sale of shares and as such are taxable only in the state of residence.

The third example assumes an individual resident in State A owns all shares in a company resident in State A. State A and B both tax capital gains, however, State B provides that residents who are not domiciled in that state are only taxed on income derived from sources outside that state to the extent that the gains are repatriated.

In summary, taxpayers have an opportunity to change their residence by meeting the requirements of the definitions and rules of resident provided in the double tax agreements.

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[3] OECD Committee on Fiscal Affairs, Model tax convention on income and capital, Condensed version 17 July 2008, Article 1 Persons covered.

[4] This paragraph acts as a tie-breaker rule in the situation a person is deemed resident of both contracting states.

[5] OECD Committee on Fiscal Affairs, Model tax convention on income and capital, Condensed version 17 July 2008, Article 18.

[6] OECD Committee on Fiscal Affairs, Model tax convention on income and capital, Condensed version 17 July 2008, Article 13 paragraph 5.

Attributing profit to specific persons

It is possible to enter into transactions or arrangements in order to divert income from one taxpayer across to a related person in order to obtain treaty benefits, which would not otherwise apply.

Base companies

A base company is generally established in a low tax jurisdiction and used for the purpose of diverting income, which would otherwise be subject to high levels of taxation in the shareholder's state of residence. The income earned by a resident would be collected by the base company and, until remitted, would not be taxed by the beneficial owner. Upon remitting the income to the resident's state, strategies would be undertaken to ensure a further tax advantage is available. Such strategies include:

- Distributing income that is tax exempt for example dividends which have an affiliation exemption
- Distributing income as a loan back to the shareholder company creating a deduction for interest

Interest paid to tax exempt entities

Many countries exempt investment income from tax on pension funds and similar entities. In addition, the double tax agreements also exempt these entities from source taxation on their investment income. The exempt entities have the opportunity to enter into back-to-back arrangements with persons not entitled to the exemption. Such arrangements will effectively pass onto the third party the tax savings the exempt entity received under the agreement.

Employment Income

Article 15 of the OECD model convention, which is concerned with the taxation of income from employment[7] can be used as a method of avoiding taxation. The article allows the state in which the employment is exercised to tax that employment income. Paragraph 2 provides the following three conditions, that if met, will allow the resident state to tax the employment income:

- The recipient of the income is in the source state for less than 183 days
- Remuneration is paid by an employer not resident of the state where the employment is exercised
- Remuneration is not borne by a permanent establishment, which the employer has in the other state

By fulfilling the three criteria an employee qualifies for the tax exemption in the source state. The practice of 'international hiring-out of labour' would have an intermediary established who purports to be the employer, meets the three criteria and hires out the labour to the local enterprise.

Artistes and Sportsmen

Paragraph 1 of article 17 of the OECD model tax convention creates an opportunity for artistes and athletes to set up an "artiste company" for which any remuneration earned by the artiste or athlete is paid to that company. The income earned by the artiste company will not be treated as income from

[7] Previously referred to "Dependent Personal Services" prior to 2000.

employment under article 15 because it does not meet the definition of income derived from employment. In addition, with the absence of a permanent establishment in the source state it will not be treated as business profits[8].

Income classification

The taxing rights on the various income defined in Articles 6 to 21 differ. For example, dividends may be taxed at 5% while interest is exempt from tax for the purpose of the agreements. Taxpayers can enter into arrangements to change the classification of income in order to receive a greater benefit. A number of examples were identified in the United Nations paper on the improper use of tax treaties. Two examples are the conversion of dividends to interest and the use of derivative transactions.

Conversion of dividends into interest

If a double tax agreement allows for the source taxation of dividends but not interest, the conversion of dividends into interest will provide a significant tax benefit for the recipient. A method of undertaking this arrangement would be to set up a holding company in the same state as the company paying the dividends. The owner of the shares in the company declaring the dividend will exchange those shares for interest bearing notes with the newly incorporated company. The original owner will receive interest instead of dividends and, as such, not be subject to tax on the receipt of interest.

Use of derivative transactions

Derivative transactions can create a position for taxpayers to minimize or eliminate the payment withholding taxes on passive income streams. This can be achieved by entering into a swap agreement between two parties. Assume a company resident in State A wanted to purchase shares in a company in State B while a company in State B wanted to purchase government bonds from State A. Under the double tax agreements between States A and B, dividends and interest are taxed at source. The company in State A would purchase the bonds in State A while the other party would purchase the shares. A swap arrangement could be created under which the parties agree to swap the payments between each other based on the difference in dividends and interest received. The difference would remain taxable under article 21 other income but the withholding taxes on the interest and dividends would not apply.

Circumventing thresholds

Subparagraph 2(a) of article 10 of the OECD model tax convention specifies a minimum of 25% ownership of capital of a company paying dividends in order to benefit from the reduced withholding tax rate of 5%. Prior to the payment of dividends the shareholders could enter into an arrangement to have shares transferred to the shareholder in order to increase the holding ratio above the threshold and would thus be entitled to the reduce withholding tax rates.

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[8] Business profits are taxed in the source state only in the case that an enterprise carries on business through a permanent establishment in the source state.

Combating international avoidance

In order to safeguard against the improper use of double tax agreements it is important for the agreements to contain clauses that prevent such behaviour. 'Where no such provision exists, treaty benefits will have to be granted under the principle of "pacta sunt servanda" even if considered improper'.[9] This principle stems from the Vienna convention on the Law of Treaties.

Anti-abuse rules

The use of specific provisions contained within the double tax agreements provides greater certainty to the taxpayers, because these specifically focus on anti-avoidance schemes.

Limitations of benefits

In order to prevent persons not entitled under the agreement from obtaining benefits provided by double tax agreements in a manner than was otherwise intended, new provisions for the limiting of benefits have been inserted into the model double tax agreements. Article 22 of the US model income tax convention and paragraph 20 of the commentary on article 1 of the OECD model tax convention both explain the limitation of benefits. These models provide that only qualified persons are entitled to the benefits provided for in articles 6 to 21, 23 and 24 in the case of the US model. A qualified person is defined in paragraph 2 as:

- An individual
- A government entity
- A publicly traded corporation. This entity must be listed on a recognized stock exchange and the principle class of shares is must be traded regularly
- A subsidiary of a public traded corporation
- Tax exempt organizations. Pension funds are qualified persons if greater than 50% of the beneficiaries are resident of the contracting states tax exempt organizations other than pension funds automatically meet the requirements of a qualified person
- Ownership and base erosion

The limitations of benefits provisions may cover normal business transactions, thus during the negotiating process, the contracting states will need to include a provision for "bona fide" business transactions. This provision will ensure that treaty benefits are granted for transactions that have sound business motivations.

The limitation of benefits article is a comprehensive approach to dealing with conduit companies and treaty shopping in general. Other approaches which require specific anti-abuse provisions to be inserted into the double tax agreements have been proposed for agreements between developing and developed countries.

When it is clear that the transactions are intended to circumvent the purpose of the double tax agreement the best approach to addressing is through legislative anti-abuse measures.

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[9] OECD international avoidance and evasion, double tax conventions and the use of conduit companies, issues in international taxation no1 OECD Paris 1987.

Beneficial ownership

The beneficial ownership concept assists in preventing treaty shopping for specific classes of income, primarily dividends, interest and royalties through the use of conduit companies. Paragraph 2 of Articles 10 and 11 of the OECD model tax convention place a limit on the tax imposed by the source state of the dividends and interest to the extent that the recipient is the beneficial owner. This is within the primary purpose of the double tax agreement that is intended to prevent the double taxation of income.

When the recipient of the income is acting in the capacity of an agent or nominee, the beneficial ownership provision does not place a limit on the tax imposed by the source state. The nominee or agent in this example would not be the recipient of the income in the resident state and as such not be treated as the owner or subject to taxation.[10]

It allows the source state to tax the income in its full capacity, as the beneficial owner is not a resident of the contracting states. However, it is difficult for the source country's tax administration to establish that the relationship between the intermediary and the parent is in the form of a nominee or agent. The OECD Committee on Fiscal Affairs stated that in order to establish the relationship 'further examination is necessary. This examination in any case will be highly burdensome for the country of source and not even the country of residence of the conduit company may have the necessary information regarding the shareholders of the conduit company.' [11] Ultimately the articles relating to the exchange of information may not assist in identifying the true beneficial owner.

In the US case Aiken Industries Inc v. Commissioner of Internal Revenue (1971) 56 TC 925 (US), the United States court held that the conduit company had no beneficial ownership in the interest payments which it received from the United States company as it was committed under a promissory note assigned by the parent company to pay the interest to its parent company. The case is a prime example of the beneficial ownership being put into practice.

Specific anti-abuse provisions

Throughout the model agreements various provisions have been inserted to prevent specific cases of tax avoidance.

In section one it was identified that tax-exempt companies can facilitate fiscal avoidance and evasion by entering into back-to-back arrangements to pass on the tax benefits to third parties. Excluding tax-exempt companies from the benefits in the agreements can prevent this. However, it would also preclude them from protection offered under Article 24 non-discrimination and Article 25 mutual agreement procedure. The UN has proposed a safeguarding clause, which would restrict the benefits of exempt organizations to specific income types yet, allow the entities protection under articles 24 and 25.

Paragraph 2 of article 17 Artistes and Sportsmen has been inserted into the more recent OECD models. The paragraph extends to the source state the ability to

[10] OECD paragraph 12.1 commentary on article 10.

[11] OECD Committee on Fiscal Avoidance, Issues in International Taxation No. 1: International Tax Avoidance and Evasion – Four related Studies, (Paris: OECD, 1987), 93.

tax the income of the artiste where the income has been attributed to a person other than the artiste or athlete in question. The “look-through” approach can enable the source state to tax under paragraph 1. Paragraph 2 enables the source state to tax the diverted income under this scenario.

Article 15 does not contain any specific provision to deal with the hiring out of labour however the OECD recommends that the contracting states agree on a set of conditions that are required for an employer to be an employer within the meaning of paragraph 2 of article 15. The agreed criteria can be inserted within the provisions of the double tax agreement.

The US model income tax convention paragraph 4 of article 1 allows the US to continue to tax their former residents and citizens for a period of ten years following the change in status of residence. This provision will assist in the prevention of avoidance through the change of residence however, it comes at a cost for those individuals who legitimately wish to change their status.

Whilst new provisions as described above have been inserted into the later model tax agreements to prevent avoidance, many of the older versions do not contain these, thus the opportunities to avoid taxation still exist.

Domestic legislation remedies

An effective preventative technique for those persons changing residence for the purposes of tax avoidance is the implementation of a departure tax or exit tax. For example, in Australia the departure of a resident will trigger an automatic deemed disposal of asset and the gains would be immediately subject to taxation. In order to avoid the conflict between double tax agreements and domestic legislation these events take place immediately prior to the change of residence.

In addition a country’s own anti-avoidance legislation can be used to prevent international tax avoidance. Key legislation would include controlled foreign corporations, foreign investment funds, transfer pricing, thin capitalization and foreign investment trusts. It is critical at this point to ensure that such domestic legislation is compatible with the double tax agreements in place. Article 26 of the Vienna Convention on the Law of Treaties 1969 provides that the double tax agreements prevail over the domestic legislation in the case of such conflict. A detailed analysis of the country’s domestic tax law and double tax agreement network should be conducted to ensure conflicts do not exist.

Summary

The above analysis has identified various examples of provisions and definitions contained within double tax agreements that facilitate fiscal avoidance and evasion. In addition ultra-national governing bodies have undertaken significant research in the area of improper use of double tax agreements. As such, new provisions and interpretations have been designed and implemented within model agreements to curtail such avoidance, however each country will need to renegotiate their current treaties. This will require a significant use of resources, which may impede a thorough implementation to truly prevent fiscal avoidance and evasion.

While reduced tax rates on passive income are available within double tax agreements, taxpayers will always seek a way to obtain those benefits. The limitation of benefits provision is a comprehensive method to prevent treaty shopping especially on direct and stepping stone conduits however, it has not been widely implemented. Many countries have adopted general approaches to deal with conduits such as the "look-through" provision under which benefits are denied if non-residents own the conduit. Another is the subject-to-tax approach, which grants treaty benefits only if that income is taxed in the source state. 'Such an approach does not offer adequate protection against advanced tax avoidance schemes such as "stepping stone strategies".'[12] Furthermore, implementation of the above requires significant changes to the complex tax laws of the contracting states.

Arrangements that modify the nature of income may be addressed through specific anti-abuse provisions however, it may be difficult to establish a connection between the transactions and the purpose for the alteration of the classification of income. Therefore, the treaty provisions will not prevent this type of improper use.

The provisions that have been proposed to assist in the prevention of avoidance and evasion are based on the premise that taxpayers are seeking to avoid taxation. In addition, a "bona fide" provision needs to be inserted to cover business transactions that can result in the same tax advantage but are not for the purpose of avoidance.

In order for double tax agreements to be effective in preventing fiscal avoidance and evasion it is essential that comprehensive rather than adhoc provisions are implemented.

Conclusion

This paper reviewed an array of examples for which international taxpayers may use the double tax agreements in order to obtain benefits that they are not entitled to. These examples covered treaty shopping and specific provisions that may facilitate fiscal avoidance such as the passive income articles, employment income article and artistes and sportsmen article. In addition, opportunities were proposed which circumvent thresholds and modify the classification of income within double tax agreements to obtain tax benefits.

Specific double tax agreement measures for combating international tax avoidance were analysed, for example, the limitation of benefits, beneficial ownership and specific anti-abuse provisions, which have been adopted by the model double tax agreements. These play a pivotal role in preventing fiscal avoidance and evasion however, due to previously discussed limitations in implementing such provisions, unintended tax advantages continue to exist.

Further analysis of existing double tax agreements, domestic anti-avoidance legislation and their compatibility with the Vienna Convention on the Law of Treaties 1969 should be undertaken. The research and guidance on the improper use of treaties provided by the OECD, United Nations and United States model double tax agreements could further assist in such analysis. This would provide a significant step towards the tightening of international tax avoidance nets. This needs to be an ever-evolving iterative process, which builds on international cooperation.

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[12] Economic and Social Council Committee of experts on International Cooperation in Tax Matters, Improper use of treaties, Geneva, 2007

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