OECD Project taking measures against tax treaty abuse

Bilateral tax treaties have long served to prevent harmful double taxation and remove obstacles to cross-border trade and investment. The extensive network of more than 3000 treaties worldwide has, however, also given rise to treaty abuse and so-called "treaty-shopping" arrangements. Treaty shopping typically involves the attempt to indirectly access the benefits of a tax treaty between two jurisdictions by a person who is not a resident of one of those jurisdictions, often through complex structures and arrangements. Taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations where these benefits were not intended to be granted, thereby depriving jurisdictions of tax revenues.

Treaty Abuse under the Multilateral Instrument (MLI) and the Principal Purpose Test

The Multilateral Instrument (MLI), developed as part of the broader OECD BEPS (Base Erosion and Profit Shifting) project, has had profound implications for international tax practice. One of the key aspects of the MLI is the introduction of measures aimed at combating treaty abuse, including the Principal Purpose Test (PPT).

Treaty abuse refers to situations where taxpayers misuse international tax treaties to obtain tax benefits that are not in line with the intentions of the treaty parties. The MLI aims to combat this abuse through specific anti-abuse provisions, including the PPT.

The PPT is included in Article 7 of the MLI and states that a treaty benefit shall not be granted if obtaining that benefit was one of the principal purposes of any arrangement or transaction. The purpose is to prevent situations where tax treaties are used solely for tax optimization purposes.

Example.
1. Holding structure for dividend distributions: A company establishes a subsidiary in a country with a favorable tax treaty to receive dividend payments at a lower withholding tax rate. If the PPT applies, the treaty benefit may be denied if tax savings was one of the main purposes of the structure.
2. Intercompany loans: A company lends money to an affiliated entity in another country to benefit from a lower interest rate based on a tax treaty. If the PPT applies, the treaty benefit may be denied if obtaining this benefit was one of the principal purposes of the loan transaction.

Multilateral Nature:
The MLI is a multilateral instrument that can be ratified by multiple countries simultaneously, resulting in a standardized approach to combating treaty abuse across different jurisdictions.

Implementing the PPT and other anti-abuse provisions requires a thorough analysis of national legislation and the specific provisions of tax treaties being modified by the MLI. Lawyers need to be aware of the interaction between national rules and the international obligations arising from the MLI.

SAAR and GAAR as the basis of the PPT.

In the context of tax law, anti-avoidance rules are crucial for ensuring a fair and effective tax system. Two important categories of these rules are Specific Anti-Avoidance Rules (SAARs) and General Anti-Avoidance Rules (GAARs). Although both types of rules aim to prevent tax avoidance, they differ significantly in their approach and application.

Specific Anti-Avoidance Rules (SAARs)

SAARs are rules designed to counteract tax avoidance in specific, well-defined situations. These rules are often included in tax legislation or tax treaties and are intended to prevent specific abuse structures or transactions.

SAARs are applied when the conditions described in the legislation are met. They offer little room for interpretation, as they target clearly delineated situations.

Examples:

1. Dividend Stripping: SAAR might be aimed at preventing dividend stripping, where a taxpayer tries to avoid dividend withholding tax by purchasing shares shortly before a dividend payment and selling them immediately after.

2. Interest Deduction Limitation: Article 10a of the Dutch Corporate Income Tax Act 1969 limits the deductibility of interest if the debt is primarily incurred for tax advantages.

Advantages: Clarity and predictability; taxpayers and tax authorities know exactly when a SAAR applies.

Disadvantages: Limited scope; taxpayers may still find avoidance opportunities outside the specific situations covered by SAARs.

General Anti-Avoidance Rules (GAARs)

GAARs are broader, more flexible rules designed to combat tax avoidance by disregarding transactions that are primarily set up to obtain tax benefits without substantial commercial purpose. These rules are less specific and offer more room for interpretation.

GAARs are applied based on a general principle that transactions primarily aimed at tax avoidance should be ignored for tax purposes. This often requires a detailed analysis of the taxpayer's intentions and the economic reality of the transactions.

Examples:

1. Fraus Legis: In the Netherlands, 'fraus legis' is a doctrine where tax authorities can intervene if a transaction is solely set up to avoid taxes without a legitimate business reason.

2. Section 245 of the Canadian Income Tax Act: This GAAR states that a tax benefit obtained through a tax avoidance arrangement can be denied if it is reasonable to conclude that one of the main purposes of the transaction was to avoid tax.

Advantages: Broad applicability; GAARs can address a wide range of avoidance behaviors.

Disadvantages: Legal certainty; the vague and general nature of GAARs can lead to uncertainty for taxpayers and complex legal disputes.

Conflicts and Interaction between SAARs and GAARs

In some cases, SAARs and GAARs may conflict or overlap. For example, a SAAR might target a specific avoidance structure, while a GAAR could apply to a broader set of transactions that similarly abuse tax benefits.

Courts often have the task of determining whether a SAAR excludes a GAAR or whether both rules can be applied simultaneously. This usually depends on the specific wording of the legislation and the context of the transaction.

When advising clients, lawyers must consider both the specific provisions of SAARs and the broader principles of GAARs. It is essential to look not only at the letter of the law but also at its spirit, to prevent clients from getting entangled in complex disputes with tax authorities.

Conclusion

The OECD BEPS project and the Multilateral Instrument (MLI) signify a significant shift in addressing tax avoidance on an international scale. The introduction of the Principal Purpose Test (PPT) as part of the MLI strengthens efforts to safeguard tax treaties against abuse and provides a framework for more consistent application of anti-abuse measures globally.

SAARs and GAARs are both indispensable tools in the arsenal of tax authorities to combat tax avoidance. While SAARs are clear and predictable, GAARs provide the flexibility to tackle new and innovative avoidance strategies. Lawyers must have a thorough understanding of both types of rules to ensure effective advising and compliance in the dynamic field of tax law.

For lawyers and tax advisors, staying well-informed about these developments and their impact on the practice of international tax advisory is essential.

A.J.W. (Andre) Derksen RBc
International tax lawyer

Member of
Dutch Order of Administration and Tax Professionals
Register of Tax Advisors
International Fiscal Association

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