Use and Abuse of Tax Treaties

International Taxation Conference

Mumbai
December 5, 2013

Patricia A. Brown
University of Miami School of Law
Uses of Tax Treaties

• Overarching goal is to facilitate international trade and commerce by:
  – Providing certainty to taxpayers regarding liability to tax by establishing common thresholds
  – Minimizing risk of double taxation
  – Minimizing risk of “excessive” taxation by putting limits on gross withholding taxes

• Allocating revenues between the parties
When Does Use Become Abuse?

• Presumably, when someone is receiving benefits in a manner inconsistent with the intentions of the parties.

• What if the two Contracting States have different views?
  – Some countries are very upfront about their desire to enter into tax treaties in order to spur development
  – Presumably, good if “real” business, bad if not
Transactions Identified as “Abuses”

- Treaty-shopping structures
- Conduit transactions
- Arbitrage transactions
- Over-leverage/base-erosion
- Profit-shifting transactions
Treaty Shopping

• What it is: the establishment of a vehicle in a treaty jurisdiction by a resident of a third state in order to receive reduced withholding rates or other benefits

• Approaches that have been used to combat it:
  – Limitation on benefits provisions
  – General anti-abuse rules
  – Targeted treaty rules (e.g., anti-Luxembourg holding company rules; Article XXX(3) Canada-Barbados)
Conduit Transactions

• What it is: back-to-back loans and similar transactions

• Approaches that have been used to combat it:
  – Economic substance
  – General anti-abuse rules
  – Treaty “main purpose” tests
Arbitrage Transactions

• What it is: can be any kind of mismatch of characterization between the source country and the residence country
  – Hybrid entities – goal is to claim treaty benefits without income being taxed in country of residence of the investor
  – Hybrid instruments – most often used to ensure deduction in source State and participation exemption in residence State
Arbitrage Transactions (2)

• Approaches that have been used to combat it:
  – General anti-abuse rules and substance-over-form
  – Interpretation of “beneficial owner” requirement (Bank of Scotland case)
  – Applying dividend rates to contingent interest (the Netherlands, United States)
  – Mutual agreement procedure (e.g., U.S.-Germany treaty provision on hybrid instruments)
  – Anti-arbitrage rules (e.g., 2005 U.K. anti-
Limits on Treaty Response to Arbitrage

• If benefit, such as a deduction, provided under domestic law, treaty anti-abuse rule may be ineffective

• “Non-aggravation” clause or principle
  – Klaus Vogel: “It is a widely recognized principle of treaty law that DTCs, rather than being capable of creating new tax liabilities, can do no more than restrict existing ones.”
  – Specific provision in U.S. treaties, subject to anti “cherry-picking” rule that prohibits combining domestic and treaty rules “in an inconsistent manner”
Over-leverage/Base Erosion

• What it is: reducing the tax base in high-tax jurisdictions by making deductible payments, usually to related parties in low-tax jurisdictions, and usually incurring low withholding taxes

• In developed countries, has been combined with “inversion” transactions, where companies change residence for tax purposes, but then claim treaty benefits
Over-leverage

• Approaches that have been used to combat it:
  – General anti-abuse rules
  – Economic substance
  – Thin capitalization rules
    • arm’s length requirement
    • maximum ratio
  – Limiting deduction for interest to a certain percentage of income
  – Retaining high withholding taxes on interest
Base Erosion

- Primary approach to combat it (with respect to expenses other than interest) is transfer pricing rules
- Arm’s length requirement is common-sense approach, but technical transfer pricing rules have led to results that defy common sense
- Political response is to blame arm’s length approach adopted in tax treaties, although Article 9 only requires arm’s length approach in Paragraph (2), not Paragraph (1)
Inversions

• United States has dealt with the problem in two ways:
  – Legislative change that continues to treat the inverted company as a U.S. resident
  – Changes to limitation on benefits provision of tax treaties to prevent claims for benefits

• First approach may not prevent base erosion from subsidiaries of the inverted company; second approach does
Profit-Shifting

• Catch-all phrase that can mean any and all of the preceding techniques, alone or in combination
  – Frequently requires favorable tax treaties
  – Within Europe, can be facilitated by EU Directives

• Base erosion may be seen as a host country problem, while profit shifting is the same problem from a residence country perspective
Major BEPS Action Items on Treaty Abuse

• “Neutralise the effect of” hybrid mismatch arrangements
• Strengthen CFC rules
• Limit base erosion via interest deductions and other financial payments
• Counter harmful tax practices more effectively
• Prevent treaty abuse
• Prevent the artificial avoidance of PE status
• Assure that transfer pricing outcomes are in line with value creation
• Taxpayer disclosure of aggressive tax planning
Questions for Governments

• Governments must decide:
  – what types of treaty abuses are of concern; and
  – which types of anti-abuse rules (general, specific) work with their legal and tax system

• It is much easier to make these decisions before entering into a tax treaty
  – Much harder to impose anti-abuse rules once a treaty is in force
Why Have the Treaty?

• But, the most important decision is whether it makes sense to have a tax treaty with a particular country in the first place

• That analysis brings us back to the beginning
  – Is there double taxation that cannot be avoided through unilateral measures
  – Is there sufficient real investment to justify costs of negotiation
  – Are there deal-breakers (such as lack of transparency)?
Message from Patricia Brown

Thank you!