

Use and Abuse of Tax Treaties

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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**
 - **Treaty anti-conduit rules (U.S.-U.K., U.S.-Australia, U.S.-Japan)**

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!