Philip Baker*
and Tizhong Liao**

Improper Use of Tax Treaties: The New Commentary on Article 1 and the Amended Article 13(5)

The UN Model (2011) contains a new section in the Commentary on Article 1 regarding the improper use of tax treaties. An example of potential abuse of a treaty provision is dealt with by amendments to article 13(5). This article, therefore, discusses both the new Commentary and article 13(5).

1. Attitudes towards the Improper Use of Tax Treaties

It is instructive to chronicle changing attitudes towards the improper use of tax treaties by looking at changes to the two main Models.

The OECD Draft (1963)[1] said nothing about improper use of tax treaties. This topic only appeared in the Commentary on Article 1 of the OECD Model (1977), with four paragraphs[2] dealing with the issue. By the Commentary on Article 1 of the OECD Model (1992), this had expanded to 20 paragraphs.[3] There were major amendments to the Commentary on Article 1 of the OECD Model (2003),[4] thereby producing the current position where the Commentary on Article 1 of the OECD Model (2010) contains 34 paragraphs[5] dealing with the issue.

A similar development can be chronicled with regard to the UN Model. The UN Model (1980)[6] contained nothing on the improper use of tax treaties. The Commentary on Article 1 of the UN Model (2001) contained four paragraphs,[7] which only introduced some, but not all, of the OECD Commentary on Article 1. The new Commentary on Article 1 of the UN Model (2011) goes further than any previous version of either of the UN Models, with 96 paragraphs[8] on the topic. Within these paragraphs, much of the OECD Commentary is quoted, but with a great deal more that is unique to the UN Model (2011).[9]

The impression might be derived from this historical progression that few states were concerned with the improper use of tax treaties 50 years ago, but that many states are concerned about this issue now. Of course, that impression might be entirely false. The new Commentary on the UN Model (2011) largely consists of a number of approaches to tackling treaty abuse, which states might or might not wish to adopt. A realistic assessment of how far states are really concerned about this issue can only be established by looking at what states do in practice, not what the UN Commentary says.

2. The History of the New Commentary on the UN Model (2011)

The history of the new Commentary on Article 1 of the UN Model (2011) stretches back to the Ad Hoc Group of Experts and a discussion at their eleventh meeting in December 2003.[10] The Committee of Experts on International Cooperation in Tax Matters (the "Committee") took up this issue at its First Session in 2005, and decided to set up a Subcommittee,[11] which reported back at the Second Session in 2006.[12] At that Session, the Committee asked the Subcommittee to draft a new UN Commentary on Article 1, which was to include practical examples of treaty abuse and possible wording for anti-abuse clauses.

The first draft of the new UN Commentary was presented by the Subcommittee at the Third Session of the Com-

* **QC, Gray's Inn Tax Chambers and Institute for Advanced Legal Studies, London University. The author can be contacted at pb@taxbar.com.**

** **Deputy Director General of International Taxation, the State Administration of Taxation of the People's Republic of China. The author can be contacted at liaotizhong_t@hotmail.com.**

Tizhong Liao is a Member of the UN Committee of Experts on International Cooperation in Tax Matters and was a Member of the Subcommittee on Tax Treaty Abuse that drafted the new Commentary. Any views critical of the new Commentary on the UN Model (2011) are exclusively those of Philip Baker. All of the views expressed in this article are personal and do not reflect the views of any organization or government with which either author is associated.

1. *OECD Draft Tax Convention on Income and on Capital* (30 July 1963), Models IBFD.
2. *OECD Model Tax Convention on Income and on Capital: Commentary to Article 1* paras. 7-10 (11 Apr. 1977), Models IBFD.
3. *OECD Model Tax Convention on Income and on Capital: Commentary to Article 1* paras. 7-26 (1 Sept. 1992), Models IBFD.
4. *OECD Model Tax Convention on Income and on Capital: Commentary to Article 1* paras. 7-26 (28 Jan. 2003), Models IBFD.
5. *OECD Model Tax Convention on Income and on Capital: Commentary to Article 1* paras. 7-26 (1 Sept. 1992), Models IBFD, but several paragraphs have subsidiary numbering.
6. *UN Model Tax Convention on Income and on Capital* (1 Jan. 1980), Models IBFD.
7. *UN Model Tax Convention on Income and on Capital: Commentary to Article 1* paras. 8-11 (1 Jan. 2001), Models IBFD.
8. *UN Model Tax Convention on Income and on Capital: Commentary to Article 1* paras. 8-103 (1 Jan. 2011), Models IBFD.
9. *UN Model Tax Convention on Income and on Capital* (1 Jan. 2011), Models IBFD.
10. The issues of abuse of tax treaties and treaty shopping were discussed at the eleventh meeting on the basis of a note prepared by Prof. Alfredo Garcia Prats, *Abuse of Tax Treaties and Treaty Shopping*, reference ST/SG/AC.8/2003/L.3. The issue of abuse of tax treaties had been examined by the Group on two previous occasions, in 1983 and 1987.
11. Coordinated by Mr Lee and comprising Mr Silitonga, Mr Lara Yaffar, Mr Zhiyong Zhang, Prof. Garcia Prats and Mr Sasseville. Subsequently, Mr Arrindell joined the Subcommittee and Mr Tizhong Liao replaced Mr Zhiyong Zhang.
12. The report of the Subcommittee is contained in the document entitled *Treaty Abuse and Treaty Shopping* (*see* E/C.18/2006/2).

mittee in 2007.[13] This draft was discussed, some drafting changes were agreed to and a revised version was presented to the Fourth Session in 2008.[14] Finally, the text of the new UN Commentary was agreed by written procedure in June 2009.[15]

It can, therefore, be said that the new UN Commentary (2011) is the result of a long process of discussion by the Committee over more than four years.

3. The Contents of the New Commentary on Article 1 of the UN Model (2011)

3.1. Introductory remarks

The long, new Commentary on Article 1 of the UN Model (2011) begins with two short paragraphs on "Improper Use of Tax Treaties". The first of these provides a limited definition by stating that taxpayers may be tempted to apply provisions in tax treaties to obtain benefits in circumstances where the contracting states did not intend that those benefits be provided.[16] This raises an issue as to what the intention of states really is when concluding a tax treaty, an issue which is returned to in section 3.2. The introductory paragraphs also emphasize that "it is important to maintain a balance between the need for tax administrations to protect their tax revenues from the misuse of treaty provisions and the need to provide legal certainty and to protect the legitimate expectations of taxpayers".[17] The real difficulty with anti-abuse provisions is, of course, how to maintain this difficult balance and, in particular, how to provide legal certainty.

The new UN Commentary (2011) covers three topics. The first concerns "approaches to prevent the improper use of tax treaties"[18] (*see* section 3.2.), the second (and longest) part contains "examples of improper uses of tax treaties"[19] (*see* section 3.3.), and the third part deals with "the importance of proper mechanisms for the application and interpretation of tax treaties"[20] (*see* section 3.5.).

3.2. Approaches to prevent the improper use of tax treaties

The first section of the new Commentary on Article 1 of the UN Model (2011) discusses six approaches to prevent the improper use of tax treaties. There is nothing terribly novel about the six approaches: three involve domestic law and the other three involve treaty provisions. The six are:
(1) specific legislative anti-abuse rules found in domestic law;
(2) general legislative anti-abuse rules found in domestic law;
(3) judicial doctrines that are part of domestic law;
(4) specific anti-abuse rules found in tax treaties;
(5) general anti-abuse rules in tax treaties; and
(6) the interpretation of treaty provisions.

Under the first of these approaches, specific anti-abuse rules found in domestic law, the UN Commentary discusses controlled foreign company rules, foreign investment fund rules, thin capitalization and transfer pricing rules, as well as exit taxes and dividend stripping rules. The main issue considered here is the possible conflict with the provisions of tax treaties. The UN Commentary first notes that, where states take different views as to possible conflicts, this may be resolved through the mutual agreement procedure, but there are certain principles that can be followed. Generally, where there is a conflict the provisions of the tax treaty are intended to prevail. However, such conflicts can often be avoided, either because the tax treaty specifically allows the application of certain domestic anti-abuse rules, because the operation of the treaty provisions depends on the application of domestic law or because the abusive application of the treaty is denied on a proper interpretation, so that there is no conflict with domestic law.

It is interesting to contrast this approach in the UN Commentary with that taken in the amendment to the Commentary on Article 1 of the OECD Model (2003). The issue of conflict with domestic law rules is dealt with primarily in paragraphs 22.1 and 22.2 of the OECD Commentary, which appear to be rather more definite in their statement that, as a general rule, there is no conflict between domestic tax law rules and provisions in tax treaties. In contrast, the United Nations appears to be more willing to accept that specific anti-abuse rules in domestic law may be in conflict with the provisions of tax treaties and that tax treaties should prevail, but that such conflicts can often be avoided for the three reasons explained previously.

The second approach in the UN Commentary concerns general anti-abuse rules in domestic law. Again, the question of possible conflict with the provisions of tax treaties is discussed[21] and, here, the general conclusion of the Commentaries on Article 1 of the OECD Model (2010) at paragraph 22.1 is quoted, i.e. in the case of general anti-abuse rules, conflicts with the provisions of tax treaties should not usually arise. The new UN Commentary (2011) then quotes from the OECD that "[s]tates do not have to grant the benefits of the double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into".[22]

This leads to a discussion of the meaning of the abuse of a tax treaty, and here the United Nations quotes the OECD's "guiding principle":[23]

> A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable

13. *See Improper Use of Treaties*, E/C.18/2007/CRP.2.
14. *See Note by the Co-ordinator of the Sub-Committee on Improper Use of Treaties: Proposed Amendments*, E/C.18/2008/CRP.2.
15. *See Improper Use of Tax Treaties*. This does not have a formal UN number, but is available at http://www.un.org/esa/ffd/tax/RevisionToArt13.pdf.
16. Para. 8 *UN Model: Commentary on Article 1* (2011).
17. Para. 9 *UN Model: Commentary on Article 1* (2011).
18. Paras. 10 to 39 *UN Model: Commentary on Article 1* (2011).
19. Paras. 40 to 99 *UN Model: Commentary on Article 1* (2011).
20. Paras. 100 to 103 *UN Model: Commentary on Article 1* (2011).
21. *See* para. 21 of the *UN Model: Commentary on Article 1* (2011).
22. *See* para. 22 of the *UN Model: Commentary on Article 1* (2011).
23. Para. 23 *UN Model: Commentary on Article 1* (2011).

> treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

The UN Model (2011) endorses that principle, but adds[24] that countries should not escape their treaty obligations simply by arguing that legitimate transactions are abusive. The new UN Commentary (2011) breaks the principle down into two elements: (1) a main purpose for entering into the transactions or arrangements being to secure a more favourable tax position; and (2) the obtaining of that more favourable treatment being contrary to the object and purpose of the relevant provisions. The UN Commentary (2011) adds that this guiding principle should only be applied on the basis of objective findings of fact and an objective determination of whether a reasonable taxpayer would have entered into the same transactions or arrangements.[25]

This all appears to be highly rational but, if this is considered, it is not that easy to apply in practice. Tax treaties operate by relieving from tax that would otherwise be due. Any well informed taxpayer is likely to be aware that entering into transactions or arrangements to which a tax treaty applies secures a more favourable tax position. Accordingly, in most cases, the only issue is whether or not the more favourable treatment is contrary to the object and purpose of the tax treaty. This depends on the purpose of the two contracting states, who may not share the same concept of what the purpose is. A developing country anxious to attract foreign direct investment (FDI) may well have a different purpose for a relief from taxation at source as opposed to the purpose of the state from where the investment is likely to come. Reference to "a reasonable taxpayer" does little to help the operation of these provisions. If a reasonable taxpayer is pursuing economic efficiency, he, she or it should be seeking opportunities to minimize taxation and maximize post-tax results.

There are egregious cases where it is absolutely clear that neither contracting state could have intended the result that the taxpayer seeks to achieve. However, the guiding principle proposed by the OECD and now endorsed by the United Nations does little to help determining whether or not a matter is abusive outside this egregious category, especially where the position of the two states may not be the same.

Finally, under the approaches in domestic law, the new UN Commentary (2011) discusses judicial doctrines. In this context, it refers to the business purpose approach, substance over form, economic substance, step transaction, abuse of law and *fraus legis*.[26] The new UN Commentary (2011) then notes that the interpretation of tax treaties is governed by rules codified in articles 31 to 33 of the Vienna Convention on the Law of Treaties (the "Vienna Convention") (1969)[27] but that "nothing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties".[28]

With respect, it can be wondered whether or not this is right. Tax treaties are international conventions, subject to the rules of interpretation set out in the Vienna Convention (1969). They are not drafted by national draftsmen and they do not take the same form as national legislation. Courts in different countries have taken different views on the issue as to whether or not general abuse of law doctrines should apply to tax treaties.[29] Perhaps the better view of the statements in the UN Commentary is that nothing in principle prevents national courts from deciding to apply domestic judicial doctrines to issues of treaty interpretation. However, any such applications must be consistent with the principles set out in the Vienna Convention (1969).

Turning from domestic law provisions to provisions found in tax treaties, the new UN Commentary (2011) identifies specific anti-abuse rules found in the UN Model (2011), such as the "beneficial owner" limitation in articles 10, 11 and 12, the "special relationship" rules in articles 11 and 12, and the "star-companies" provision in article 17(2).[30]

A new paragraph emphasizes, however, the risks of relying on specific treaty anti-abuse rules.[31] These risks are that the rules are drafted once a particular strategy has been identified, that they can weaken the case for general anti-abuse rules and that complex rules may be required to address complex strategies. The new UN Commentary (2011) concludes that "whilst the inclusion of specific anti-abuse rules in tax treaties is the most appropriate approach to deal with certain situations, it cannot, by itself, provide a comprehensive solution to treaty abuses".[32]

Again, it can be wondered if this conclusion is really correct. Specific anti-abuse provisions identify particular types of abuse that the states have agreed to cover. If new abuse scenarios arise, and the states are agreed, amendments can be made by protocol to add further specific provisions. What the new UN Commentary (2011) is effectively saying is that an approach that relies on specific provisions cannot deal with new forms of abuse, unless and until the contracting states agree to take a common approach to add further specific provisions. There is both a time lapse and a possibility that the two states cannot agree. That is not the strongest position to justify the conclusion that specific rules do not provide a comprehensive solution.

Having concluded that specific anti-abuse rules do not provide a comprehensive solution to treaty abuse, the new UN Commentary (2011) turns to discuss general anti-abuse rules found in tax treaties. Two examples are given.[33] This is then followed by suggested wording for a general

24. *See* para. 24 of the *UN Model: Commentary on Article 1* (2011).
25. Para. 27 *UN Model: Commentary on Article 1* (2011).
26. *See* para. 28 of the *UN Model: Commentary on Article 1* (2011).
27. *Vienna Convention on the Law of Treaties* (23 May 1969), Treaties IBFD.
28. *See* para. 30 of the *UN Model: Commentary on Article 1* (2011).
29. *See*, for example, S. van Weeghel, *General Report*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, *Cahiers de Droit Fiscal International* vol. 95A (Sdu Uitgevers 2010), Online Books IBFD.
30. *See* para. 31 of the *UN Model: Commentary on Article 1* (2011).
31. *See* para. 33 of the *UN Model: Commentary on Article 1* (2011).
32. At the end of para. 33 of the *UN Model: Commentary on Article 1* (2011).
33. *See* paras. 34 and 35 of the *UN Model: Commentary on Article 1* (2011).

anti-avoidance provision based on the "guiding principle" discussed previously. The proposed wording is:[34]

> Benefits provided for by this Convention shall not be available where it may reasonably be considered that a main purpose for entering into transactions or arrangements has been to obtain these benefits and obtaining the benefits in these circumstances would be contrary to the object and purpose of the relevant provisions of this Convention.

As discussed previously in this section, the application of such a provision would ultimately rely heavily on the perception of what the object and purpose of the relevant provision in question are.

The final approach identified in the UN Commentary involves the interpretation of treaty provisions to disregard abusive transactions, having regard to the tax treaty's object and purpose, as well as the obligation to interpret the provisions of the tax treaty in good faith. Reference is made here to paragraph 9.3 of the Commentary to Article 1 of the OECD Model (2010).

In the absence of specific or general anti-abuse provisions in a tax treaty, this approach of interpretation is likely to play a key role in dealing with perceived abuses. However, as with the guiding principle discussed previously, much turns on the perception of the object and purpose of the provision. Where, for example, a contracting state is primarily interested in attracting FDI, it may be far from clear that a particular arrangement is contrary to the object and purpose and, therefore, is found to be abusive.

3.3. Examples of the improper use of tax treaties

The bulk of the new Commentary on Article 1 of the UN Model (2011) gives examples of improper use of tax treaties, together with suggestions as to how these might be countered by use of one of the six approaches discussed in section 3.2. There are some eight different categories of examples, covering: (1) transfers of residence; (2) treaty shopping; (3) triangular cases; (4) attribution of profits or income to a specific person or entity; (5) hiring out of labour; (6) artistes and sportsmen; (7) transactions that modify the treaty clarification of income; and (8) transactions that seek to circumvent thresholds in treaty provisions. Along the way, a large part of the Commentary on Article 1 of the OECD Model (2010) is quoted verbatim.[35]

Rather than summarizing these examples, some general comments are made here.

First, it is far from clear that everyone would agree that some of the examples constitute improper use of tax treaties. For instance, a genuine transfer of residence by an individual, even if motivated by tax reasons and advantages to be obtained by a tax treaty, would not be regarded by everyone as an abuse. Similarly, the discussion of treaty shopping fails to recognize that some states are more than willing to allow entities formed there to take the benefit of its tax treaties, and some developing and middle income countries are more than happy to accept the FDI that flows from such treaty shopping.

The second comment is that this part does no more than making recommendations and suggesting solutions. There are, for example, suggestions as to how states may provide in their tax treaties for countering conduit companies. The absence of such provisions in the UN Model itself implies the lack of a consensus amongst the states represented to regard the particular examples as warranting a common approach. Equally, the absence of any of the specific provisions in a specific tax treaty must give a strong indication that the two contracting states either failed to consider this particular abuse, or lacked a common intention to combat it. Accordingly, for example, the absence of any form of anti-conduit provision in a convention suggests that one or both of the states was not troubled by the prospect of treaty shopping.

Looking at the examples discussed in the new UN Commentary, it is hard not to come to the conclusion that the Committee was well behind the learning curve when they drafted this material. There is one short paragraph discussing derivative transactions with only a rather limited example of how these might be used for abuse.[36] A more complete list of examples would explain the use of hybrid entities and hybrid instruments, and give some explanation of cross-border arbitrage. This is an area where tax authorities could clearly provide helpful assistance to one another. The structured arrangements that have been seen by tax authorities in the most developed countries are likely to percolate through to middle income and developing countries. Tax authorities can hardly wait for regular updates to this part of the UN Commentary to know what to watch out for and how to respond to these arrangements. The OECD has a vault containing details of tax avoidance schemes, accessible only to an inner circle of adherents. Perhaps the Committee or its secretariat should consider doing the same.

3.4. An example of circumventing thresholds: article 13(5) of the UN Model (2011)

While discussing examples, it might be appropriate to consider one change that was made to the UN Model (2011) in article 13(5).

In the UN Model (2001), article 13(5) reads:

> Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of __ 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.

In the UN Model (2011), article 13(5) has been amended to read:

> Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 12 month period preceding such alienation, held directly or

34. Para. 36 *UN Model: Commentary on Article 1* (2011).
35. *See* para. 56 of the *UN Model: Commentary on Article 1* (2011).
36. Para. 93 *UN Model: Commentary on Article 1* (2011).

> indirectly at least __ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.

The change in wording was intended to deal with arrangements whereby shares might be disposed of in parcels to bring the taxpayer below the percentage fixed in the provision and also to deal with a situation where those shares were held indirectly. The amendments to article 13(5) are intended to counter the manipulation of the shareholding.

3.5. The importance of proper mechanisms for the application and interpretation of tax treaties

The final part of the new Commentary on Article 1 of the UN Model (2011) consists of only four paragraphs and appears to be something of a concession to taxpayer concerns.

This section first states that the Committee recognizes the role that proper administrative procedures can play in minimizing the risks of improper use of tax treaties.[37] It also recognizes the importance of proper mechanisms for treaty interpretation, particularly in countries which have a weaker judicial system or where there is little judicial expertise in treaty interpretation. Such countries may consider "alternative mechanisms". It would have been interesting if the UN Commentary had included some examples of what the "alternative mechanisms" might be. In this respect, the possibility of arbitration might have been noted.

The UN Commentary recognizes the blindingly obvious, i.e. that the application of certain anti-abuse rules may be "challenging" for tax administrations, especially in developing countries. No solution is suggested here.

Finally, "[d]eveloping countries may also be hesitant to adopt or apply general anti-abuse rules if they believe that these rules would introduce an unacceptable level of uncertainty that could hinder foreign investment in their territory".[38] The paragraph suggests the possibilities of a ruling system, a strong independent judicial system and effective application of the mutual agreement procedure to reduce the level of uncertainty. Here the Committee has, perhaps, hit the nub of the problem. A major function of tax treaties is to remove potential barriers to cross-border investment that would be created by unrelieved double taxation or even by excessive single taxation in the host state. Tax treaties can very effectively remove those barriers, but in doing so they inevitably result in less tax collected, at least in the source state. Anti-abuse rules either stop such benefits in the first place or create a fog of uncertainty as to whether or not the particular investment would enjoy the benefit. Uncertainty may prevent the cross-border investment or increase its cost, particularly if the foreign investor transfers the uncertainty to the recipient of the investment. All too often developing countries are willing to accept treaty shopping and conduit arrangements to attract FDI, but then the tax authorities subsequently (i.e. once the investment has been made or once the country perceives itself as no longer requiring so much foreign investment) seek to prevent the revenue loss by trying to find an anti-abuse concept to deny the treaty benefits. This type of uncertainty is fundamentally dangerous to developing countries and could either choke off FDI or make it more expensive for the recipient country.

4. Conclusions

It is really with the last comments that the conclusions should begin. This new, detailed Commentary on Article 1 of the UN Model (2011) suggests a consensus on the need to counter treaty abuse. However, scratch the surface and it is doubtful if the consensus is really present. The UN Model (2011) was not amended to include a general anti-abuse provision or a battery of new, specific anti-abuse provisions. Rather, the UN Commentary suggests that contracting states may, if they are concerned by the examples of abuse, adopt one of the approaches identified. Whether or not a consensus really exists will only be seen by examining the actual treaty practice of states. The one amendment discussed here, i.e. the new wording of article 13(5) of the UN Model (2011), is narrow in its scope.

It would be quite wrong, therefore, to deduce from this new UN Commentary (2011) the dawn of a new era in countering treaty abuse. That is something that can only be assessed by looking at specific tax treaties, the actions of tax authorities and the reaction of the judiciary in the countries concerned. The new UN Commentary (2011) does no more than identify possible examples and suggested solutions. It is now a matter for the states as to how they want to react to this.

37. Para. 100 *UN Model: Commentary on Article 1* (2011).
38. Para. 103 *UN Model: Commentary on Article 1* (2011).