EUCOTAX Series on European Taxation

Limitation on Benefits Clauses in Double Taxation Conventions

Félix Alberto Vega Borrego

Instituto de Estudios Fiscales

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Félix Alberto Vega Borrego

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To my Family

Foreword

As the network of double taxation conventions has increasingly become a regulatory superstructure that protects and provides tax security to income obtained from transnational investments and transactions, the objectives assigned to these tax treaties have become broader. Noteworthy in this respect is the change in the name of these conventions from simple tax treaties on income and on capital even in the 1992 OECD Model Convention.

The establishment of this superstructure and the appearance of the *treaty shopping* phenomenon have caused many States to redefine their viewpoint with respect to the function and subjective and objective criteria for the application of the double taxation conventions by establishing mechanisms which condition or fully or partially limit the application and interpretation of treaties.

Double taxation treaties have traditionally been considered to be instruments which are appropriate for the establishment of mechanisms by which to eliminate or mitigate the effects of the simultaneous exercise of tax powers on the same income by two Contracting States. The OECD Model Tax Convention's competence distribution system establishes certain security in regard to the tax burden in the State of Source, whose tax powers are limited or conditioned pursuant to the terms of a specific treaty, whereas the State of Residence is obligated to apply a method to eliminate the remaining double taxation. In this manner, the transnational exchange of goods and persons is fostered. The Recommendation of the OECD Council concerning the Model Tax Convention on Income and on Capital adopted by the Council on 23 October 1997, recognizes 'the need to remove the obstacles that international juridical double taxation presents to the free movement of goods, services, capital, and persons between such conventions to all Member countries and where appropriate to non-Member States'.

On the other hand, the initial approach has given way to a renewed approach in which the effects and possibilities of applying the tax treaties have been more clearly defined, and in which some States have even reconsidered the merits and benefits of signing double taxation conventions with certain other States. The use of *treaty shopping* as one of the most significant, although not the only international tax planning instrument, demonstrates that in international taxation, the shortest

distance between two points is not always a straight line, since the triangulation phenomena can be turned into a significant tax savings mechanism for international companies and economic operators. This situation has led the tax authorities to strengthen tax treaties in order to counter the possible abuse or undesired use thereof through the inclusion of clauses and safeguards of varying scope and reach. Consequently, for example, new rules such as the beneficial ownership clause, exclusion clauses, artistes and sportsmen clause, subject to tax clauses, minimum or substantial shareholding clauses, or the most complete and complex limitation on benefits clauses dealt with in depth in this monograph have been included. Additionally, and more generically, inter-administrative cooperation mechanisms have been strengthened through the inclusion of empowering clauses which permit mutual assistance for the collection of tax debts or reformulate and broaden the scope and effectiveness of the exchange of information which is significant for tax purposes. In this respect, new clauses have been included in the OECD Model Convention, such as the new Article 13.4, and fundamentally, the new revised wording of the Commentaries on Article 1 in relation to the precedence of the application of domestic anti-abuse legislation over tax treaties. The consideration of all these clauses and rules reformulates the analysis of the effects of tax treaties on transnational economic relations as well as the criteria which should be followed with respect to their application and interpretation.

To date most of these clauses have been drafted to the *detriment* of certain taxpayers, meaning that taxpayers are required to have the status of qualified residents in order to obtain the benefits of the treaty and that it is necessary for administrative procedures to be followed in the Contracting States to insure the correct application of those 'limitation clauses'. The above might greatly condition the effectiveness or immediate application of the treaties and might also cause the application of the clauses to be dependent on the position taken by the other Contracting State and its mechanisms to verify that all qualification requirements are met.

However, singling out taxpayers or certain taxpayers as the only agents that seek means by which to use a certain country's network of treaties in an abusive manner does not seem to be completely in line with reality. In a certain percentage of cases the State itself fosters the use of its network of treaties through the establishment of base companies or companies interposed within its territory to take sides and financially benefit from the development of economic internationalization. Countries faced with economic internationalization position themselves by establishing the tax environment which they consider to be most favourable with respect to the internationalization of production factors. This positioning is not only carried out by means of an increase in the number of tax treaties available with third states, or through the inclusion of clauses which are especially favourable to certain transactions in the tax treaties, but also by means of the inclusion of clauses, rules and specific or general regimes in its domestic tax system whose integration with the network of applicable tax treaties leads to overall or partial taxation which is of interest to the companies or groups that operate on a transnational level.

In these circumstances, defining a treaty's abusive use of the network of conventions and the domestic laws of the other Contracting State to abuse the tax law of a certain state does not seem to be an easy task, especially with respect to determining the legal consequences of this use of the integration of the treaties with domestic tax legislation in order to give rise to an undesired effect or consequence of the tax treaties. Without the incorporation, which on occasion is of interest, of tax mechanisms and techniques, special regimes or more or less explicit tax benefits or advantages in the domestic legislation of some states, the interest in using or applying certain treaties might disappear, meaning that the *agent or taxpayer considered to be abusing a treaty* on an international level should be better defined.

However, the international legal order has few mechanisms which correctly penalize the use of some or all tax treaties for abusive purposes by the Contracting States. The Vienna Convention on the Law of Treaties only regulates the possibility of taking countering measures in the case of a material breach of the obligations resulting from a treaty (Article 60). However, in view of the harmful effect which arises not only in respect to the abusive use, but rather the correct use of the treaty by the other taxpayers, the penalty provided (termination of the treaty) seems to be excessive and only applicable as a last resort.

Therefore, in the update of the Commentaries on Article 1 of the Model Convention in 2003, for good reason, the OECD chose to include a specific clause in the treaty in which the conditions under which abuse is considered to exist is determined, as well as the manner in which to counter it. Abuse is normally countered through the exclusion of the benefits of those rules that are considered to be infringed. Abuse by Contracting States is normally countered in a different manner than abuse by taxpayers. Accordingly, the OECD Model Convention provides for cases in which there is abuse of the treaty by a state since there are no international or independent bodies to verify such abuse. It also expressly establishes the consequences of abuse by a State in such a manner that a unilateral measure by the other Contracting State against either the State responsible for such abuse or the entities or individuals that indirectly benefit therefrom is not admissible.

In any case, the practice of *treaty shopping* and the generalized use of tax treaties by economic operators, as well as the increased integration in the determination of the tax regime of a higher number of taxpayers demonstrate the need to formulate alternatives which overcome the stringency and the difficulties in adapting conventional legal status to that which should be applicable in reality, without harming the legal security provided by the prevalence of tax treaties over domestic tax legislation. From this standpoint, the formulation of *a priori* criteria which limit the exclusion and application of the treaty to a certain taxpayer can easily be overcome by correct planning, whereas convention criteria which require a case by case analysis may give rise to an excessive delay in the valuation thereof in detriment to the effectiveness of the treaty.

To resolve the conflict between these two positions, the Commentaries on Article 1 of the OECD Model Convention have been changed so that the application of domestic anti-abuse legislation is favoured even over the prevalence of conventions.

In my opinion, neither the technique nor the content used are the most appropriate since firstly, a simple change in the Commentaries on the OECD Model Convention is relied on to provide validity to the application of domestic legislation over the international prevalence of double taxation conventions, without taking into account the specific rules of integration and of the application and interpretation of the double taxation conventions of each of the Contracting States, which are inferred from the specific treaty rules. Secondly, a simple change in the Commentaries does not seem to be sufficient to safeguard the necessary update of the double taxation conventions in order to overcome the strict procedures and difficulties which must be resolved for an amendment or renegotiation thereof. Thirdly, this means implies and aims to render useless the particular rules of integration between conventions and domestic tax legislation which are inferred from the constitutional order in the member states, and even call for a retroactive effect with respect to the changes made in the Commentaries.

It is clear that the reaction in the Commentaries evidences the need to find a balance point between the legal security of the investments from the other Contracting State and the income generated thereby and the need to assure a certain level of *fair-play* between the economic operators giving rise to a separation of the Contracting States financial interests. However, the solution is not likely to be very respectful of the requirements inferred from the other rules relating to the treaties' application and interpretation.

Furthermore, the bilateral nature of the double taxation conventions and the legal effects thereof should be reconsidered, fundamentally bearing in mind the contents of the treaty entered into between the Contracting States. The subjective delimitations inferred from Articles 1-4 allow the Contracting States to specify which taxpayers *may claim the benefits of* the treaty by reference to their domestic tax laws, and in this manner, convert practically any tax treaty into a treaty with the world, giving rise to possibilities of treaty shopping to the extent that the decision as to the persons considered to be beneficiaries of the treaty is made by the other state in accordance with its domestic tax laws. Accordingly, the notion of residence for the purposes of the treaty should be reinforced positively through the progressive inclusion of a *conventional concept of residence*, mainly in respect of legal entities, in the form of the definition established for permanent establishments for the purposes of the conventions.

Last but not least, as the author points out, in Europe the subjective delimitation of the *beneficiaries* of the double taxation conventions is subject to the prevalence of EC law over the treaties and particularly, to the requirements that the Court of Luxembourg sets forth with respect to the fundamental Community freedoms and the exercise of the rights derived therefrom for economic agents. The devastating action of ECJ case law requires the function, scope and application mechanisms used to limit the beneficiaries of the double taxation conventions entered into by the Member States to be reconsidered, or in positive terms, delimitation as to the taxpayers and entities that should benefit from the treaties. On a significant number of occasions, the limited acceptance of the criteria which are grounds for the limitation of these EC rights having taken into account the tax interests of the states allows for the conclusion

that the limitation on benefits clauses and many anti-abuse laws of the EC order are inadequate and that those which are in accordance with EC law are effectively rendered to be ineffective, bearing in mind the strict considerations made under the prism of respect for the principle of proportionality. This is currently an ongoing discussion, with various legal possibilities and practices to be considered, which are still difficult to resolve and even more difficult to make provisions for, given that this is a sensitive issue for the Member States, and will require a significant consensus in defence of the interests of the Member States, as well as an observation of the significant financial and political interests at stake by the Court of Luxembourg.

The book that the reader has at hand rigorously and correctly tackles these issues in depth. This study is a revised and updated version of the author's doctoral thesis 'Limitation on Benefits Clauses in Double Taxation Conventions' which was defended in June 2002 at the Universidad Autónoma de Madrid and received the grade of summa cum laude by unanimous decision in addition to the Extraordinary Doctorate Prize from this university's school of law for the 2002 academic year. The author received wide national recognition for his publication, as well as the 2002 prize for the best doctoral thesis on financial and tax law by the Spanish Instituto de Estudios Fiscales and was awarded an Honourable Mention from jury of 'Premio Europa 2002', which was sponsored by the Consejería de Presidencia and the Consejería de Educación of the Comunidad de Madrid.

The author's young age was not a hindrance for his research, but rather a stimulus and incentive for the achievement of his objectives, which were to tackle issues as complex as those relating to the delimitation of the subjective scope of conventions, the effects of the limitation clauses included in the double taxation conventions entered into be the EC States and the effects of EC Law on the double taxation conventions containing such limitations. In this respect he benefited from his stays in the IBFD as well as the University of Cologne in which he was able to carry out the comparative studies required for a proper understanding of these matters. The results achieved foretell the author's brilliant scientific career as well as his significant scientific achievements.

Finally, it is important to publicly acknowledge the efforts and resolute financial support of the Spanish Instituto de Estudios Fiscales and the Ministerio de Educación in their interest in the due dissemination of this study. Gratitude should also be expressed to the publisher Kluwer and the Eucotax group for their interest in and decision to publish the English version of this study as part of their Series on European Taxation, which will continue the interesting debate opened in the study with which the series commenced: *The Compatibility of Anti-Abuse Provisions in tax Treaties with EC Law*.

Dr. Francisco Alfredo García Prats
Professor of Financial and Tax Law,
Universitat de València, Spain

Valencia, June 2005

Author's Note

This study is based on the doctoral thesis that I wrote under the supervision of Professor Juan Ramallo Massanet (Universidad Autónoma de Madrid, Spain), which was submitted to the School of Law of the Universidad Autónoma de Madrid in June 2002, and was defended before the doctoral committee formed by the Professors Carlos Palao Taboada (Universidad Autónoma de Madrid, Spain), María Teresa Soler Roch (Universidad de Alicante, Spain), Juan Zornoza Pérez (Universidad Carlos III de Madrid, Spain), Alfredo García Prats (Universidad de Valencia, Spain) and José Manuel Calderón Carrero (Universidad de la Coruña, Spain). I would like to express my sincere appreciation to them for their observations, which without a doubt, have significantly enriched the contents of this study. This thesis was awarded with the prize for the best doctoral thesis on financial and tax law by the Spanish Instituto de Estudios Fiscales (Ministerio de Economía y Hacienda) in 2002 and was published in Spanish by this Institute under the title '*Las medidas contra el* treaty shopping' in 2003.

I would also like to thank Professor Juan Ramallo Massanet, my thesis director, for his valuable suggestions, as well as his guidance and constant stimulation during the preparation of this thesis, which were fundamental.

In this same respect, I would like to express my gratitude to Juan Arrieta Martínez de Pisón (Universidad de Castilla-La Mancha, Spain), Juan Manuel Barquero Estevan (Universidad Autónoma de Madrid, Spain), Andrés García Martínez (Universidad Autónoma de Madrid, Spain) and my colleagues in the Financial and Tax Law Department of the Universidad Autónoma de Madrid. Their suggestions have notably improved this study.

The English version of this study now being published differs somewhat from my original doctoral thesis in that it contains important updates and revisions. In this respect, for example, this updated version includes the limitation on benefits clauses provided in the double taxations conventions concluded between the US and the ten new states which were currently brought into the European Union.

I also extend my gratitude to Kluwer Law International, for agreeing to publish this book, and, particularly to Professors Alfredo García Prats and Eric Kemmeren (Tilburg University, The Netherlands), whose efforts made this possible. Additionally,

I am deeply indebted to the Spanish Instituto de Estudios Fiscales, and especially to Professors Manuel Gutiérrez Lousa and Pedro Manuel Herrera Molina, who assisted in obtaining financing from this institution for part of the translation of this study. In this respect, I am also grateful to those who collaborated in translating this book.

This study was carried out in the context and with the financing of the SEC2003-00696 research project entitled 'La incidencia de los convenios de doble imposición en el comercio internacional' (The effect of double taxation conventions on international trade), by the Spanish Ministerio de Educación y Ciencia. Any comments that will contribute to the improvement of this study are greatly appreciated and can be sent to the following e-mail address: felix.vega@uam.es.

List of Abbreviations

ALI	American Law Institute
BIFD	*Bulletin of International Fiscal Documentation*
BTR	*British Tax Review*
CDFI	*Cahiers de droit fiscal international*
CFC	Controlled foreign company
CT	*Crónica Tributaria*
DTC(s)	Double Taxation Convention(s)
ECJ	Court of Justice of the European Communities
ECT	European Community Treaty
EEA	European Economic Area
ET	*European Taxation*
EU	European Union
GF	*Gaceta Fiscal*
HPE	*Hacienda Pública Española*
IBFD	International Bureau of Fiscal Documentation
IEF	Instituto de Estudios Fiscales
IFA	International Fiscal Association
IRC	Internal Revenue Code
IRS	Internal Revenue Service
IStR	*Internationales Steuerrecht*
ITR	*International Tax Review*

LOBs	Limitation on Benefits Clauses
NAFTA	North American Free Trade Agreement
NUE	*Noticias de la Unión Europea*
OECD	Organization for the Economic Cooperation and Development
OECD Model	OECD Model Double Taxation Convention on Income and on Capital
OJ	*Official Journal of the European Communities*
PE	Permanent establishment
PSF	*Perspectivas del Sistema Financiero*
QF	*Quincena Fiscal*
RDADF	*Revue de Droit Administratif et de Droit Fiscal*
RDFHP	*Revista de Derecho Financiero y Hacienda Pública*
RCT	*Revista de Contabilidad y Tributaciń (Comentarios y Casos Prácticos) Ed. Estudios Financieros*
REDF	*Revista española de Derecho Financiero*
RESE	*Revista de Economía Social y de la Empresa*
SE	Societas Europea (European Company)
TJIT	*The Journal of International Taxation*
TMIF	*Tax Management International Forum*
TMIJ	*Tax Management International Journal*
TNI	*Tax Notes International*
TPIR	*Tax Planning International Review*
UN	United Nations
VAT	Value added tax
VCLT	1969 Vienna Convention on the Law of Treaties

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