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The Improper Use of Tax Treaties by Contracting States

Tax Treaty Dodging

ACADEMISCH PROEFSCHRIFT

ter verkrijging van de graad van doctor
aan de Universiteit van Amsterdam
op gezag van de Rector Magnificus
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ten overstaan van een door het College voor Promoties ingestelde
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Promotiecommissie:

Promotor: prof. dr. S. van Weeghel (Universiteit van Amsterdam)

Copromotor: prof. mr. P.A. Nollkaemper (Universiteit van Amsterdam)

Overige leden: prof. dr. J.M.F. Wouters (KU Leuven)

prof. dr. O.C.R. Marres (Universiteit van Amsterdam)

prof. mr. P.J. Wattel (Universiteit van Amsterdam)

mr. dr. C.M. Brölmann (Universiteit van Amsterdam)

dr. J.F. Avery Jones

prof. dr. R.J. Danon (University of Lausanne)

Faculteit: Faculteit der Rechtsgeleerdheid

Dedicated to my parents

Abstract

In the same way taxpayers may make use of business arrangements that work through the loopholes of legal and treaty provisions for the purpose of reducing tax liability, contracting states too may exercise sovereign rights within tax treaty gap areas in such a manner as to modify the outcome of these agreements to their own benefit. Through legislative and executive actions or omissions, contracting states may circumvent obstacles or artificially stretch advantages in a way that complies with the wording of tax treaties but that ultimately impacts the allocation of taxing rights and the tax burden borne by taxpayers. These actions and omissions unilaterally broaden the scope of circumstances in which contracting states are allowed to tax by creating new scenarios that either fall outside the scope of tax treaties or require the application of treaty articles that are more favourable to these states. Conversely, contracting states may also attract foreign investment and consequently obtain economic advantages by allowing the application of tax treaty benefits to taxpayers in scenarios when these benefits would normally be denied. Despite its conformity with the literal wording of tax treaties, this practice may be considered illegitimate on the basis of international law rules that spell out the correct standards and guide the interpretation and application of treaties. In such case, these illegitimate actions and omissions amount to an improper use of tax treaties by contracting states or "tax treaty dodging" as defined by the author. The elements derived from the legal bases limiting tax treaty dodging offer guidance for interpreters in the assessment of how far contracting states may exercise their sovereign rights under international law, so that legitimate exercise of rights can be more clearly demarcated from the improper use of the treaty by contracting states. Affected contracting states and taxpayers should make better use of the tools currently available under international law, varying from preventive measures against this practice to reparation in the form of compensation for damages caused. To assist them, the current study submits a clearer definition of the improper use of tax treaties by contracting states (tax treaty dodging) and recommends ways to better address the phenomenon.

Samenvatting

Net zoals belastingplichtigen gebruik kunnen maken van zakelijke overeenkomsten die de mazen van wettelijke en verdragsbepalingen opzoeken om hun belastingschuld te verminderen, kunnen verdragsluitende landen hun soevereine rechten binnen de lacunes van een belastingverdrag op een manier uitoefenen die de toepassing van dat verdrag in hun voordeel wijzigt. Door middel van wetgevende en uitvoerende maatregelen of omissies, kunnen verdragsluitende staten obstakels omzeilen, of voordelen kunstmatig oprekken, op een wijze die weliswaar voldoet aan de letterlijke bewoordingen van een belastingverdrag, maar uiteindelijk de toewijzing van heffingsrechten en de belastingdruk op belastingplichtigen beïnvloedt. Deze maatregelen en omissies verruimen unilateraal de reikwijdte van omstandigheden waarin verdragsluitende staten belasting mogen heffen door het creëren van nieuwe situaties die buiten de reikwijdte van belastingverdragen vallen, dan wel een toepassing van verdragsartikelen vereisen die gunstiger uitpakt voor deze staten. Omgekeerd kunnen verdragsluitende staten ook buitenlandse investeringen aantrekken – en bijgevolg economische voordelen behalen – door verdragsvoordelen te verlenen aan belastingplichtigen in situaties waarin toekenning van zulke voordelen normaliter geweigerd zou worden. Ondanks het feit dat zij conform de letterlijke bewoording van belastingverdragen is, kan deze praktijk als onwettig worden beschouwd op basis van regels van internationaal recht die de juiste normen uiteenzetten en de interpretatie en toepassing van verdragen bepalen. In dergelijke gevallen komen deze onwettige handelingen en omissies neer op een oneigenlijk gebruik van belastingverdragen door verdragsluitende staten, ofwel "ontwijking van belastingverdragen" (tax treaty dodging) zoals gedefinieerd door de auteur. De elementen die zijn afgeleid van de rechtsgrondslagen die dit oneigenlijk gebruik beperken, bieden richtsnoeren voor de beoordeling van de mate waarin verdragsluitende staten hun soevereine rechten volgens het internationale recht kunnen uitoefenen, zodat de legitieme uitoefening van deze rechten duidelijker onderscheiden kan worden van het oneigenlijke gebruik van het verdrag door de verdragsluitende landen. Getroffen verdragsluitende landen en belastingplichtigen zouden de instrumenten die momenteel beschikbaar zijn onder internationaal recht, variërend van preventieve maatregelen tot herstel in de vorm van een schadevergoeding, beter moeten inzetten tegen deze praktijk. Om hen bij te staan, stelt deze studie een helderdere definitie voor van het oneigenlijke gebruik van belastingverdragen door verdragsluitende staten (tax treaty dodging), en beveelt manieren aan om dit fenomeen beter aan te pakken.

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List of Abbreviations

ATO	Australian Taxation Office
BEPS	Base Erosion and Profit Shifting
BFH	*Bundesfinanzhof* (federal tax court)
BIT	Bilateral investment treaty
CCTV	China Central Television
CFC	Controlled Foreign Corporation
CGT	Capital gain tax
CIDE	*Contribuição de Intervenção no Domínio Econômico* (contribution for the intervention in the economic domain)
CIT	Corporate income tax
COSIT	*Coordenação-Geral de Tributação* (general coordination for taxation)
DBA	*Doppelbesteuerungsabkommen* (tax treaty)
DPT	Diverted profit tax
DST	Digital service tax
DTAC	Double tax avoidance convention
DTC	Double taxation convention
EAW	European Arrest Warrant
FDI	Foreign direct investment
FET	Fair and equitable treatment
FGTC	French general tax code
FEZ	Free economic zone
G20	Group of Twenty
GAAR	General anti-avoidance rule
IBFD	International Bureau of Fiscal Documentation
ICJ	International Court of Justice
ICSID	International Centre for Settlement of Investment Disputes

IFA	International Fiscal Association
ILC	International Law Commission
ISDS	Investor-state dispute settlement
ITLS	International Tribunal for the Law of the Sea
MC	Model convention
MITL	Mexican income tax law
MOBAA	Mauritius Offshore Business Activities Act
OAS	Organization of American States
OECD	Organization for Economic Cooperation and Development
OEEC	Organisation for European Economic Cooperation
PGFN	*Procuradoria-Geral da Fazenda Nacional* (General Office of the National Treasury's Attorney)
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNCLOS	United Nations Convention for the Law of the Sea
VC	Vienna Convention
VCLT	Vienna Convention on the Law of Treaties
WTO	World Trade Organization

Chapter 1 - Introduction

1.1. Aim and scope of the study

Discussions on different types of legal arrangements designed by taxpayers for the avoidance of taxes have occupied an increasingly large space in literature during the past years and have dominated the debate among academics and practitioners more recently in view of the Organization for Economic Co-operation and Development (hereinafter OECD)/G20 Base Erosion and Profit Shifting Project (hereinafter BEPS Project). Most countries have developed extensive legislation and case law with the purpose of combating such behaviour. In contrast, not much has been said on how contracting states can operate in a similar way. If on the one hand the wish to decrease the global tax liability may lead taxpayers to make use of abusive practices, contracting states may also wish to increase their tax revenue by unilaterally broadening the scope of circumstances in which they are allowed to tax under tax treaties. It is possible that as much as taxpayers may be able to design different types of legal arrangements in conformity with the requirements of law but with the view of avoiding taxes, contracting states may also be able to impact the application of treaties and extend the advantages for their own benefit without breaching the wording of such agreements. The analysis of this possibility, which will be referred to throughout this work as (Klaus Vogel's terminology) *tax treaty dodging*, is the core of the present study.

This thesis proposes new insights on the way contracting states interfere in the interpretation and application of tax treaties. It intends to demonstrate how the exercise of rights by contracting states may, under certain circumstances, interfere in the performance of signed tax treaties. It tries to assess whether this behaviour could be regarded as an illegitimate[1] practice as understood by the tax community, that is, in conformity with the wording of written legal rules but not in accordance with accepted principles governing the good usage of such written legal rules.[2] If the answer to this is yes,

[1] "Illegitimate" as synonym of "not in accordance with accepted standards of what is right" (*Collins Dictionary*, available at https://www.collinsdictionary.com/dictionary/english/illegitimate (accessed 25 Nov. 2018)) or "not authorized by good usage" (*Merriam-Webster Dictionary*, available at https://www.merriam-webster.com/dictionary/illegitimate (accessed 25 Nov. 2018)); therefore, in the sense of being in conformity with the legal text it relates to but not in accordance with other accepted principles that speak out the correct standards and guide the good usage of that legal text. See also footnote 2.

[2] Although this specific understanding of legitimate/illegitimate (as opposed to legal/illegal) is not commonly used in the public international law field, the international tax community commonly adopt this understanding of the terms when referring to actions being in conformity with the text of written legal rules, such as laws and treaties (i.e. those being "legal"), but not in line with more general principles or even morality (i.e. those being "illegitimate"; and therefore legal but illegitimate). This understanding of illegitimacy is commonly used by tax practitioners for tax avoidance actions or abusive tax planning carried out by taxpayers (either for supporting taxpayers' action on the basis of its legality or for

the study will try to assess the extent to which the methods used by contracting states may be regarded as illegitimate actions and, as a result, will try to identify elements on the basis of which a clearer dividing line can be draw between what is considered a legitimate exercise of rights and what is regarded as an illegitimate practice, i.e. a tax treaty dodging.

This aim is achieved on the basis of a three-phase analysis: (i) *the identification of the phenomenon* (i.e. observation of the phenomenon, its origins, how it operates and its effects); (ii) *legal assessment of the phenomenon* (i.e. if the phenomenon could be considered condemnable from the perspective of international law – that is, illegitimate – and, if yes, to what extent it would be considered condemnable); and finally (iii) *the way forward* (i.e. identification of the measures available to damaged parties and suggestions to better address the phenomenon).

The initial analysis of this work starts from the identification of the phenomenon and the assessment of the different ways in which contracting states are able to impact the effects of signed tax treaties without directly breaching their wording. It detects the two conditions for the phenomenon to exist and derives from this the scenario in which tax treaties become vulnerable to such practice. From the competent authorities that exercise the jurisdictional competences of a state (legislative, administrative and judicial competences) and the way these competences are exercised in practice, the study deducts the possible types of tax treaty dodging and identifies potential cases where contracting states exercising jurisdictional competences in scenarios vulnerable to tax treaty dodging seem to make use of these opportunities. On the basis of an inductive methodology, the study further derives, from the potential cases observed, the methods in which contracting states may exercise tax treaty dodging. This phase is concluded with the acknowledgement of the consequences of the phenomenon and identification of the affected parties.

The second part of the study moves from a factual-analysis to a legal-analysis stage by placing the phenomenon of tax treaty dodging into the legal scenario with the aim to answer the research question of this thesis (Section 1.3.). It assesses the phenomenon from the perspective of international law to verify whether this practice could be qualified as an illegitimate behaviour. This assessment is made on the basis of legal sources of international law governing the relation between sovereign states. The identification of possible legal limitations to their exercise of rights also allows the detection of the elements indicating the extent to which these states may act without overstepping such limitations.

In the last phase, the study tries to identify, under international and tax treaty law, the measures currently available for the two parties affected by tax treaty dodging and finalizes by proposing a definition for tax treaty dodging and recommending ways to better address this phenomenon.

Finally, the author indicates that this study focuses on the ways in which contracting states may exercise their rights in a way to impact the outcome of treaties and, therefore, only covers actions (or

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condemning such actions as illegitimate on the basis of principles of law). The term "illegitimate" will be used in this thesis with this special connotation.

omission) that are allowed or not forbidden by the wording of these agreements. Consequently, situations where contracting states act in contradiction with the text of tax treaties are not covered in this thesis.

1.2. Relevance and originality of the study

There is no comprehensive academic study on tax treaty dodging as yet. Its rationale has been mentioned in relatively few discussions and mainly as a side subject. The topic was presented in a short but more comprehensive way by Klaus Vogel. However, his discussions do not cover all the aspects necessary for a proper understanding of the subject. This thesis is the first attempt to study this phenomenon in a comprehensive manner by describing the main elements of the mechanism, identifying the different types of tax treaty dodging and methods used, and analysing possible legal limitations and measures available to affected parties.

The author also presents a number of relevant selected examples and case law around the globe involving possible dodging practices by contracting states in connection with tax treaties. These cases are categorized according to common elements identified by the author in order to illustrate the different tax treaty dodging methods applied by contracting states. The presentation of such a collection is hopefully a significant contribution to the academic literature not only because of the disclosure of few relatively unknown cases – which necessarily happens in many research projects - but also because the analysis of such cases and of those already widely discussed in the literature is herein made from a different perspective: the one of tax treaty dodging.

This different perspective is also used when analysing the interaction between domestic rules and tax treaties. For instance, the relation between domestic anti-avoidance rules and tax treaties commonly leads to the core question of whether there may or may not be a treaty override. This thesis offers a new way of approaching and understanding this interaction and proposes a possible alternative answer to this question. This study also innovates in the tax treaty law field by suggesting the use of preventive and compensatory measures available under public international law and by proposing ideas to address the phenomenon in a more efficient manner.

The author believes this work could contribute to a better understanding of the different ways in which contracting states may interfere in the performance of tax treaties. It draws attention to subtle methods used by treaty partners and possibly ignored by the tax community.

1.3. Research question

This study addresses the following research question (which entails one sub-question):

a) O*n what legal basis the exercise of rights by contracting states in conformity with the wording of tax treaties but having an impact on the outcome of such agreements to their own benefit could be qualified as an illegitimate*[3] *act? If such legal basis exists, where is the dividing line between a legitimate exercise of rights by contracting states and such illegitimate acts under international law?*

1.4. Methodology

For purposes of this study, it was sufficient to appreciate the problem in principle and to demonstrate and catalogue the most common methods of tax treaty dodging. Because of that, the author made use of the *deductive* and *inductive methodologies* as follows.

The *deductive methodology* was used in all phases of this research. On the basis of the analysis of fundamental principles of international law, the author considered the possible ways in which contracting states may exercise their rights under tax treaties and from this analysis derived the scenarios vulnerable to tax treaty dodging. The types of tax treaty dodging were also concluded on the basis of the competent authorities that exercise the legislative, administrative and judicial competences under state jurisdiction and how they exercise this competence in respect of tax treaties. This methodology was also widely used in the second phase of the research, where the author identified possible limits to the exercise of rights by contracting states through the analysis of available international legal sources and fundamental theories. This analysis allowed the development of a conclusion on whether (and to what extent) these sources and theories may also serve as legal basis to limit tax treaty dodging practices.

The *inductive methodology* was broadly used in the first phase of the study. The identification and analysis of selected cases and case law worldwide allowed the detection and categorization of common elements in selected cases on the basis of which the different methods of tax treaty dodging were identified by the author. A complete overview of all cases worldwide is beyond the scope and means of this study. For this reason, the inductive methodology used in this thesis for the purpose of identifying the methods of tax treaty unfortunately has the downside of preventing the detection of other possible existing methods of tax treaty dodging.

1.5. Structure of the thesis

This study consists of six chapters (including this introduction as Chapter 1), as follows:

[3] See *supra* n. 1 and 2.

Chapter 1 (Introduction) presents the aim and scope of the study and explains the relevance and originality of the topic chosen. It introduces the research question of this thesis, the methodology followed by the author as well as the structure of this study.

Part I – The Phenomenon of Tax Treaty Dodging

Chapter 2 (The Genesis of the Phenomenon) presents the phenomenon of tax treaty dodging where the exercise of rights by contracting states in conformity with the wording of tax treaties interferes in the performance of these agreements to the benefit of these states. The chapter explains its origins, how the phenomenon was observed and debated in literature throughout the decades and the reasons for labelling the phenomenon "tax treaty dodging".

Chapter 3 (A Phenomenology: the Functioning of Tax Treaty Dodging) delimitates the scenarios where treaty dodging is possible by identifying the conditions of the phenomenon. The chapter describes how the tax treaty gaps together with the ambulatory interpretation open doors to dodging practices. The categorization of the phenomenon into types of tax treaty dodging and the different methods through which it can be implemented is proposed by the author as a result of the analysis of cases of potential tax treaty dodging, carried out under the inductive methodology. The chapter concludes the factual-analysis stage necessary for the overview of the phenomenon by detecting the consequences of tax treaty dodging practices for treaty partners and taxpayers.

Part II – The Legal Assessment of Tax Treaty Dodging

Chapter 4 (Tax Treaty Dodging from the Perspective of International Law) initiates the legal-analysis phase of this study by addressing the research question of whether (and on which legal basis) tax treaty dodging practices could be regarded as an illegitimate behaviour. The answer to the first research question gives the elements necessary for answering the sub-question of how to identify the dividing line between the legitimate exercise of rights by contracting states under tax treaties and tax treaty dodging. The chapter finalizes by indicating the reasons for differentiating tax treaty dodging from actions violating the wording of tax treaties.

Part III – The Way Forward: Addressing Tax Treaty Dodging

Chapter 5 (Available Measures) investigates measures currently available under international and tax treaty law to affected treaty partners and taxpayers.

Chapter 6 (Conclusion and Recommendations) summarizes the main conclusions of this thesis, proposes a definition for tax treaty dodging and recommends ways to better address this phenomenon.

Part I

The Phenomenon of Tax Treaty Dodging

Chapter 2 - The Genesis of the Phenomenon

2.1. Introduction

The violation of treaties is not a recent subject. It has been discussed and analysed by public international law scholars and practitioners for several decades. One type of infringement that is of particular interest to the international tax community is the enactment of domestic tax legislation in violation of provisions in existing tax treaties. However, there are more subtle ways for contracting states to interfere in the application of tax treaties; so subtle to the point that any possible violation of the treaty would not be obvious or easy to assess. These attempts are not in a conflict with the text of treaty provisions, but lead to effects similar to those contradicting the wording of the treaty.[4] As a consequence, it is not clear whether they could legally constitute an actual infringement of the treaty. For example, this may be the case when a contracting state redefines the nature of a charge from income tax to a type of contribution so that this levy is no longer covered by a tax treaty (and consequently no longer limited by this agreement) or when a contracting state makes use of its right to define a certain treaty term in order to broaden its treaty taxing rights by artificially including unusual items, such as in the case of defining immovable property to include gambling machines and consequently triggering taxing rights over the related income according to treaty rules. These contracting states' actions (or omissions, as the reader will later see in Chapter 3)[5] follow a certain pattern, which is the one of complying with the wording of tax treaties by making use of tax treaty gaps, but having an unexpected impact on the outcome of these agreements to the benefit of such states. This occurrence is observed by the author and introduced to the reader in Part I of this thesis as the phenomenon[6] of tax treaty dodging.[7]

The legal aspects of the phenomenon are not analysed in Part I of this thesis. The analysis and assessment of tax treaty dodging from the perspective of international law are only presented in Part II. This Part I aims at detecting the existence of a particular event that affects the application of tax treaties, irrespective of its legal nature and regardless of the legal aspects involved. It simply apprehends a fact before judgment is applied. For this purpose, this chapter initiates the first of the three-step analytical process indicated in Chapter 1 by identifying the phenomenon of tax treaty

[4] Contracting states' actions qualified in this thesis as tax treaty dodging should be distinguished from those acts violating the wording of the treaty. Whether both or only the latter method are qualified as tax treaty override is a matter of the scope of the concept of tax treaty override that is used by the interpreter – see details in Chapter 4, Section 4.4.

[5] Chapter 3, Section 3.3.1.1.

[6] "Phenomenon" is generally defined as an observable fact or event. Modern philosophers have used "phenomenon" to designate what is apprehended before judgment is applied (*Concise Oxford English Dictionary*, 11th edition (Oxford University Press 2006); *Columbia Electronic Encyclopedia* (Columbia University Press 2013).

[7] The reasons for labelling the phenomenon (and labelling it "tax treaty dodging") are explained in section 2.4.

dodging and its origins. The author considers that the observation of the background and the way the phenomenon has been spotted by scholars is an important and necessary step for the appropriate analysis developed in the following chapters of this thesis.

This chapter starts by presenting, in Section 2.2., the roots of the phenomenon of tax treaty dodging. It shows how the dodging mechanism emerged as an alternative solution for countries on the one hand facing inconvenient effects of signed tax treaties and, on the other, being reluctant to directly override treaty provisions. The basic aspects of the dodging mechanism will become evident in this section and the reader will be introduced to how the *non-self-sufficiency*[8] of tax treaties plays a decisive role in this respect. Section 2.3. travels back in time to show how the phenomenon of tax treaty dodging has been discussed in literature throughout the decades and how opposing views and different understandings in the debate prevented the development of a coherent and systematic theory on tax treaty dodging today. Also, no expression has been used in literature in a consistent manner to the point of becoming the common designation of the phenomenon. But labelling the phenomenon and labelling it "*tax treaty dodging*" (as originally did Klaus Vogel) has its advantages, as explained in the last section of this chapter.

2.2. The origins of the phenomenon

2.2.1. The need for a subtle backdoor alternative for mischievous countries

The first step for a systematic understanding of a phenomenon is the investigation of the reasons behind its existence. In this sense, the phenomenon of tax treaty dodging seems to emerge as an alternative solution for contracting states facing the impasse of having to either (i) bear inconvenient effects, whenever they exist, of signed tax treaties, (ii) tolerate the time consuming process of renegotiation or (iii) directly override these signed agreements and consequently face international repercussion and sanctions for this practice. This frustrating impasse may encourage contracting states to explore other more convenient alternatives for solving the problem, such as the one through which they could mitigate the undesired effects of signed tax treaties without being noticed or blamed for having breached treaty provisions.

The violation of a treaty provision may take different forms. One form is through legislature or judicial actions, such as in the case of the enactment of domestic legislation or the issue of a court decision in clear contradiction with treaty provisions. It may also consist of actions of a more executive nature,

[8] Non-self-sufficiency in the sense that tax treaties are generally not able to provide all elements necessary for their own application and, therefore, they need to be complemented by other rules normally existing in domestic laws – see details in Section 2.2.2. and in Chapter 3, Section 3.2.1.

as in the case of a state declining to surrender an alleged criminal to another state in pursuance of an extradition treaty between them that covers the crime alleged.[9]

From a more traditional and theoretical public international law perspective, the possibility of a violation of a treaty provision through legislation or, to a certain extent,[10] judicial and executive actions is intrinsically connected with the fundamental theories on the relationship between international law and national law: the dualist theory, first systematically developed in the absolutist thoughts of Carl Heinrich Triepel and Dionisio Anzilotti,[11] and the monist theory, defended by a number of scholars with theories that diverge significantly, but having its most representative support in the ideas of Hans Kelsen, Georges Scelle and Hersch Lauterpacht.[12]

The dualist (or pluralist)[13] theory, inspired by the 19th century Hegelian conjectures on the glorification of State and its sovereignty,[14] provides that, since international and national law have different sources, address different subjects of international law and rule different relations,[15] they are complete distinct self-contained legal orders that coexist but never intersect.[16] In this sense, conflicting international and

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[9] Example in A.D. McNair, *The Law of Treaties* (Oxford University Press 1961), p. 540.

[10] To the extent that they are related to the application of domestic legislation.

[11] Carl Heinrich Triepel was the first to present a systematic study on dualism in his work *Völkerrecht und Landesrecht* (CL Hirschfeld, 1899) – french version used for this thesis: H. Triepel, *Droit International et Droit Interne* (Panthéon-Assas 2010). His theory was later adapted and completed by Dionisio Anzilotti in *Il Diritto Internazionale nei Giudizi Interni* (Ditta Nicola Zanichelli 1905).

[12] Hans Kelsen defends monism on formalistic logical grounds (H. Kelsen, *General Theory of law & State* (Transaction Publishers 2006 – original edition of 1949), pp. 363-383; H. Kelsen, *Principles of International Law* (Rinehart & Company 1952), pp. 401-447; H. Kelsen, *Pure Theory of Law* (University of California Press 1970 – second extended edition of 1960), pp. 328-347), while Hersch Lauterpacht upholds a strong ethical position with deep concern for human rights.

[13] The systems under consideration in the dualist theory are actually the international system and the several national legal systems, leading to the conclusion that a "pluralist" conception would be more appropriate than a "dualist" conception. However, most international law scholars refer to dualism as a simplified version of pluralism (G. Arangio-Ruiz, *International Law and Interindividual Law*, in New Perspectives on the Divide Between National & International Law (J. Nijman & A. Nollkaemper eds., Oxford University Press 2007), p. 17; see also Kelsen, *ibid.* (1952), p. 404; Kelsen, *ibid.* (2006), p. 363; G. Gaja, *Dualism – a Review*, New Perspectives on the Divide Between National & International Law (J. Nijman & A. Nollkaemper eds., Oxford University Press 2007), p. 53).

[14] Georg Friedrich Wilhelm Hegel was a German post-Kantian philosopher who defended a state-centered perception of international law, where sovereignty is understood as absolute independence and freedom and where states are "perfectly independent totalities" and the "realization of freedom" (M. Isenbaert, *EC Law and the Sovereignty of the Member States in Direct Taxation* (IBFD 2008), IBFD Doctoral Series, p. 51). On the importance of Hegel's doctrine for international law, see Anzilotti, *supra* n. 11, pp. 12-20 and 27, footnotes.

[15] According to dualists, international law regulates the conduct of States as subjects of international law and, therefore, inter-state relations, while national law applies to the relation between state organs and individuals and between individuals. In addition, international law is sourced on the collective will of states (customs and treaties) while national law on the unilateral will of a state (law) - H. Triepel, *supra* n. 11, pp. 11-13. There are several criticisms on these assumptions, such as the one defending that current international law does not appear to make a distinction on the basis of the legal subjects, since international law may also govern the relations between state and individuals and create rights and obligations for individuals (Gaja, *supra* n. 13, p. 56; for other criticisms, see also Kelsen, *supra* n. 12 (1952), pp. 404-419 and Kelsen, *supra* n. 12 (2006), pp. 364-368).

[16] Triepel, *supra* n. 11, pp. 11-12 and p. 252; Kelsen, *supra* n. 12 (1952), pp. 403-404; Kelsen, *supra* n. 12 (2005), pp. 363-364; G. Fitzmaurice, *The General Principles of International Law Considered from the Standpoint of the Rule of Law,* 92 Recueil des Cours (The Hague Academy of International Law 1957), p. 70; I. Brownlie, *Principles of Public International Law* (Oxford

national provisions do not affect the validity of each other[17] and neither legal order has the power to create or alter rules of the other.[18] As a consequence of this divide, international law needs to be transformed into national law to be applicable in the national legal order. Once international law, such as a tax treaty, is transformed, it receives the status of a national law, which can be amended or repealed by subsequent national legislation in the same hierarchy level (*lex posterior derogat priori*).[19] The fact that the international law transformed and inserted into the national legal order does not, in general,[20] prevail over national legislation and may be overruled by it under the *lex posterior derogat priori* rule, makes treaty override a possible and legitimate occurrence within the dualist system. This means that if an amendment or repeal results internationally in a breach of treaty, there would be no remedy in domestic law since there would have been no violation of it.[21]

University Press 2008), pp. 31-32; D. Nguyen Quoc, P. Daillier & A. Pellet, *Droit International Public* (Librairie Générale de Droit et de Jurisprudence 1987), pp. 86-87; M. N. Shaw, *International Law* (Cambridge University Press 2008), p. 131; A. Aust, *Modern Treaty Law and Practice* (Cambridge University Press 2000), pp. 151-152; M. Dixon, *Text Book on International Law* (Oxford university Press 2007), p. 89; E. Denza, *The Relationship Between International and National Law*, International Law (M. Evans ed., Oxford University Press 2006), pp. 428-429; Gaja, *supra* n. 13, pp. 52-54; M. P. Brichambaut, J-F. Dobelle & M-R. D'Haussy, *Leçons de Droit International Public* (Presses de Sciences PO et Dalloz 2002), p. 180; H. Accioly, G. E. N. Silva & P. B. Casella, *Manual de Direito Internacional Público* (Saraiva 2009), p. 211.

[17] According to Triepel, "il est donc impossible qu'un principe de l'un de ces systèmes juridiques entre en conflit avec un principe de l'autre" (Triepel, *supra* n. 11, p. 252).

[18] Brownlie, *supra* n. 16, p. 32.

[19] It is interesting to observe that this rule has some reservations when it comes to tax treaties. A relevant number of scholars argues that these agreements are special legislation (*leges speciales*), as restricted to cross-border taxation of resident of the contracting states, and thus cannot be affected by subsequent changes of general domestic law (*lex generalis*) as a result of the rule *lex posterior generalis non derogat legi priori speciali*. Only if legislature states its intention to override a tax treaty could general domestic legislation derogate tax treaty provisions. According to Klaus Vogel "under a supplementary rule of "Lex posterior generalis non derogat legi priori speciali" ("later general legislation does not overrule earlier special legislation"), changes of domestic tax law normally will not affect existing treaties" (K. Vogel, *The Domestic Law Perspective*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, p. 3). In the same line, Jacques Sasseville says "the principle that a more specialized enactment prevails over a more general on ("*lex specialis derogat legi generali*") is more likely to ensure the priority of tax treaty provisions than the principle that a later provision prevails over an old one" (J. Sasseville, *A Tax Treaty Perspective: Special Issues*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, p. 42). See also K. Vogel & R. G. Prokisch, *Interpretation of double taxation conventions - General Report,* 78a IFA Cahiers de Droit Fiscal International (Deventer Kluwer 1993), Online Books IBFD, p. 59; A. Rust, *Germany*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, pp. 235 and 238; D. Hohenwarter, *Austria*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, pp. 169-171; P. Bracco, *Italy*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, p. 254; H. Tôrres, *Pluritributação Internacional sobre as Rendas de Empresas* (Revista dos Tribunais 2001), pp. 593-594. See also Brazilian case law in the sense that tax treaties are special law and thus prevail over a general posterior domestic law: BR: STJ, 17 May 2012, RE 1.161.467 – RS *Copesul – CIA / Petroquímica do Sul*, Tax Treaty Case Law IBFD.

[20] The non-application of national law in view of the supremacy of international law within a dualist system may only derive from a rule pertaining to the national legal order, such as the one of many constitutional provisions that require compliance with international law. This supremacy could only be achieved as far as the constitutional provision goes, since this result could be reversed by a future change in the national constitutional law (Gaja, *supra* n. 13, p. 61).

[21] Aust, *supra* n. 16, p. 151.

In contrast, the monist theory is rooted in the reactive ideas of liberation of the individual in the early 20th century, and generally defends the view that international and national law are part of one single legal order.[22] Under this theory, international law is automatically applicable at a national level, without the need for transformation into a national law. Since they both belong to the same legal order, a conflict of norms may arise resulting in the necessary primacy of one over the other. For one segment of the monist theory that sees international law as a mere external public law of the state (state monism) - today abandoned by most part of the monist scholars - internal law prevails over international law.[23] In contrast, the other more representative segment of monism (internationalist monism), supported by sociological objectivist scholars like Georges Scelle and by the founders of the Viennese School of Jurisprudence,[24] advocates the superiority of international law.[25] For this major segment, treaty override by domestic law would not be possible or legitimate.[26]

Under the dualist theory and the state monist theory, contracting states facing inconveniences of an international agreement would have the possibility to have this problem solved through a direct override and thus, in theory, no alternative solution would necessarily need to be explored. But internationalist monist countries, on the other hand, would not be able to legitimately override treaty

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[22] Kelsen, *supra* n. 12 (1952), pp. 424-428; Kelsen, *supra* n. 12 (2006), p. 373; Fitzmaurice, *supra* n. 16, p. 70; Brownlie *supra* n. 16, p. 32; Nguyen Quoc, Daillier & Pellet, *supra* n. 16, pp. 86-87; Shaw, *supra* n. 16, pp. 131-132; Aust, *supra* n. 16, p. 146; Dixon, *supra* n. 16, p. 88; Denza, *supra* n. 16, p. 428; Brichambaut, Dobelle & D'Haussy, *supra* n. 16, p. 181; Accioly, Silva & Casella, *supra* n. 16, p. 211.

[23] Nguyen Quoc, Daillier & Pellet, *supra* n. 16, p. 88.

[24] Alfred Vendross and Joseph L. Kunz held a stronger position than Hans Kelsen on the superiority of international law. For Vendross and Kunz, the departing point is inevitably the principle of the superiority of international law, since the various states do not dispose of sovereignty in its full sense, while Kelsen, after revisiting his initial position for the supremacy of international law exposed on the first edition of *Reine Rechtslehre* (first edition of *Pure Theory of Law* or simply *Introduction to the Problems of Legal Theory*), understood that the problem did not have an imperative solution and exposed a more moderate view by arguing that one could support the supremacy of either international law or national law: "the Pure Theory of Law opens the road to either the one or the other political development, without postulating or justifying either, because as a theory, the Pure Theory of Law is indifferent to both" (Kelsen, *supra* n. 12 (1970), p. 347) – see also footnote n. 28; Nguyen Quoc, Daillier & Pellet, *supra* n. 16, p. 72 and pp. 88-89; Accioly, Silva & Casella, *supra* n. 16, p. 211.

[25] For Georges Scelle, "toute norme intersociale prime toute norme interne en contradiction avec elle, la modifie ou l'abroge ipso facto" (Nguyen Quoc, Daillier & Pellet, *supra* n. 16, p. 89). Kelsen exposes that the legality of one norm is derived from an anterior, more general and superior rule, and that the referral to previous rule leads to the ultimate or basic norm (*Grundnorm*) – Kelsen, *supra* n. 12 (1952), pp. 408-415. For him, "it is the basic norm of international legal order which is the ultimate reason of validity of the national legal orders, too" (Kelsen, *supra* n. 12 (1952), p. 415). However, he later admits his basic norm as a hypothesis based on assumptions, since the mandatory nature of international custom could not be proven, and that the primacy of international law can only be decided on the basis of non-strictly legal considerations: "Both systems are equally correct and equally justified. It is impossible to decide between them on the basis of the science of law. (...) It can be made only on the basis of nonscientific, political considerations" (Kelsen, *supra* n. 12, 1970, p. 346) – see also *supra* n. 24; Nguyen Quoc, Daillier & Pellet, *supra* n. 16, p. 94; Brownlie, *supra* n. 16, p. 33. Lauterpacht also recognizes that the supremacy of international law is the best way for attaining the primary function of law, which is the well-being of individuals (Shaw, *supra* n. 16, p. 131-132; Dixon, *supra* n. 16, p. 88).

[26] The fact that courts and legislatures of certain monist countries may not, in practice, behave in accordance with these rules does not invalidate the theory, but only indicates the weakness of international law (Denza, *supra* n. 16, p. 428).

provisions through the enactment and application of conflicting domestic legislation. At the same time, the process of renegotiation of a treaty may be perceived as being too time consuming to offer a viable method of resolving this problem.[27] How would they then counter the undesired effects of a signed treaty? This was one of the points raised by Maarten J. Ellis when detecting this deadlock situation for a monist country like the Netherlands: "how does a monist country override tax treaties? That is the puzzle that faces our legislature, i.e. when our legislators and government are faced with treaty provisions that, in their view, have undesired effects and should be changed".[28]

Maarten J. Ellis concludes that in these situations a monist country cannot override tax treaties from the front door.[29] In fact, as explained here, a front door override is in theory incompatible with the internationalist monist system. The undesired effects of signed treaties would have to be accepted by those countries, unless a compatible alternative solution could be found; a compatible alternative solution mitigating the undesired effects of tax treaties, but implemented in a way to arguably avoid a clash within the monist structure; a compatible alternative solution so subtle to the point that its possible illegitimacy or incompatibility with the internationalist monist theory, if any at all, would be difficult to detect or assess.

That seems to be the point Maarten J. Ellis makes when he lists attempts that he calls "*backdoor overrides*". These attempts, implemented though the "backdoor", would be alternative solutions that would nullify the inconveniences of signed tax treaties without a direct violation of their provisions; quite the opposite, they would be formally in line with the wording of these agreements to the point that they would simply "work through into the treaties"[30].

The analysis of the need for a subtle backdoor alternative presented here is made from a more traditional and theoretical public international law perspective on the relationship between international and national law, because based on the dichotomy between monism and dualism. However, a considerable number of international law scholars has been adhering to a more pragmatic view on the subject in recent years. This more pragmatic view, which is dominant today, is that reality is not in conformity with either monism or dualism, and that a concrete look into practice is a more

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[27] M. Rigby, *A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism*, 8 Australian Tax Forum 3 (1991), pp. 321-427, at p. 385. Michael Rigby also reminds that the OECD recognizes that treaty negotiations may be time consuming but that this cannot justify treaty override (p. 406). The same remark is made by D. Lüthi, *Consequences of Conflicts between International Treaty Law and International Law*, Tax Treaties and Domestic Legislation – 14b Proceedings of a Seminar held in Rio de Janeiro in 1989 during the 43rd Congress of the International Fiscal Association (IFA) (Kluwer 1991), p. 9. This puts an even greater pressure on states to find an alternative solution.

[28] Comments by M. J. Ellis in B. J. Arnold et al., *Round Table: Improving the Relationships Between Tax Treaties and Domestic Law (Chapter 14)*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, p. 393.

[29] *Ibid.*, p. 394.

[30] *Supra* n. 28, p. 394.

appropriate way to understand the relationship between international and national law.[31] Modern scholarship has become pragmatic, inductive, and largely anti-theoretical.[32] In this sense, one needs to observe what countries actually do in reality to better understand this relationship.

The observation of practice reveals that some countries do require transformation of international law into national law while other countries directly apply international law, and that some admit the possibility of treaty override under *lex posterior derogat priori* while others opt for the superiority of international law over national law. However, the coordination of these features are not necessarily linked together in the synchronized way presented by the monist and dualist theories, so that one may actually find in practice countries with some elements of monism (e.g. direct application of international law) and, at the same time, of dualism (e.g. possibility of treaty override).[33]

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[31] Brownlie, *supra* n. 16, pp. 33-34; Denza, *supra* n. 16, p. 429; Shaw, *supra* n. 16, pp. 132-133; Dixon, *supra* n. 16, pp. 90-91; B. Conforti, *Diritto Internazionale* (Editoriale Scientifica 2010), p. 308; V. S. Vereshchetin, *Some Reflections on the Relationship Between International Law and National Law in the Light of the New Constitutions*, Constitutional Reform and international Law in Central and Eastern Europe (R. Müllerson, M. Fitzmaurice & M. Andenas eds., Kluwer International Law 1998), pp. 5-13, at pp. 6-7; J. Nijman & A. Nollkaemper, *Introduction*, New Perspectives on the Divide Between National & International Law (J. Nijman & A. Nollkaemper eds., Oxford University Press 2007), pp. 2-3. The opinions on the relevance of the traditional theories for understanding the relationship between international and national law vary among scholars from a more radical view, like Fitzmaurice with his theory of the absence of a common field ("... a radical view of the whole subject may be propounded to the effect that the entire monist-dualist controversy is unreal, artificial and strictly beside the point, because it assumes something that has to exist for there to be any controversy at all – and which in fact does not exist – namely a common field in which the two legal orders under discussion both simultaneously have their spheres of activity" - Fitzmaurice, *supra* n. 16, p. 71) and Eileen Denza's ("the theories are not useful..." - Denza, *supra* n. 16, p. 429) to more cautious opinions. As an example, Nijman and Nollkaemper detect this trend, but propose the development of a new perspective grounded in practice, but recognizing the importance of a more conceptual and normative perception of this evolution, and adapted modern developments, such as globalization, emergence of common values and the dispersion of authority over different public and private actors (J. Nijman & A. Nollkaemper, *ibid.*, pp. 2-3 and 10-12).

[32] Nijman & Nollkaemper*, ibid.*, p. 2.

[33] According to Brichambaut, Dobelle & d'Haussy, "en pratique, les énoncés constitutionnels sont souvent ambigus et il est rare qu'un État relève entièrement de l'un ou l'autre système" (Brichambaut, Dobelle & d'Haussy, *supra* n. 16, p. 181). For example, although the United States does not require transformation of international law into national law (except in cases of non-self-executing agreements) - since article VI s 2 of the US Constitution considers that all treaties signed are automatically "Supreme Law of the Land", international law and national law have the same hierarchy and treaty override is possible under the *lex posterior derogat priori* rule. Therefore, as stated by Anthony Aust, "the United States reflects both dualist and monist approaches" (Aust, *supra* n. 16, p. 157). In Italy, where treaty provisions need to be transformed into national law, the supremacy of treaties was introduced in 2001 by an amendment to article 117(1) of the Italian Constitution (B. Conforti, *supra* n. 31, pp. 325-327). In the Netherlands, treaty provisions prevail over domestic law and international law does not require transformation into national law, but according to Hans Pijl, a number of factors may limit the full effect of international law in the national legal order and "the automatic validity does not mean that the Dutch system is completely monistic from an operational point of view" (H. Pijl, *Netherlands*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, pp. 281-312, at p. 281). On the cases of United States, Italy and the Netherlands, see also Aust, *supra* n. 16, pp. 157-161; Denza, *supra* n. 16, pp. 429-430 and pp. 432-433; C. de Pietro, *Tax Treaty Override* (Wolters Kluwer 2014), pp. 19-25 and pp. 28-30; A. C. Infanti, *United States*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, pp. 355-360; H. Pijl, *ibid.*, pp. 281-293; Bracco, *supra* n. 19,

The thesis of a need for a subtle backdoor solution remains valid even under this more pragmatic approach, for the reason that a relevant (but not determining) factor for such a need is whether a country is able or not to override a treaty, regardless of how the applicable theory sees the relationship between international and national law or of the logic of a country's own system on this subject. But this need is not only determined by whether treaty override is considered a legitimate act or not. The search for less obvious ways to render the state of affairs more convenient goes beyond the legitimacy of an override, since a contracting state may also be tempted to explore other backdoor alternatives for nullifying the inconvenient effects of signed treaties not because they cannot override, but simply because they prefer not to. The United States, where treaty override is acceptable, for instance, rarely resorts to it.[34] This happens because despite the possibility of making use of treaty override as a legitimate tool within the national system, a contracting state may not wish to face international consequences[35] or even difficulties in future treaty negotiations.[36] Michael Rigby has also

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pp. 257-258; P. Arginelli & C. Innamorato, *The Interaction Between Tax Treaties and Domestic Law: An Issue of Constitutional Legitimacy*, 48 Eur. Taxn. 6 (2008), Journals IBFD, pp. 250-252).

[34] According to Reuven S. Avi-Yonah, the fact that treaty override is accepted under the US system could have led to hundreds of tax treaty overrides each year, given the frequency of US tax legislation. However, in practice the United States rarely resort to it. Avi-Yonah states that "it is thus plausible to assume that the Office Tax Policy, which is in charge of negotiating tax treaties, would usually prefer that there be no treaty overrides, given that these make the task of negotiating future treaties harder. Thus, Treasury and the IRS, as well as the courts, may be inclined to minimize treaty overrides by interpreting away potential conflict, and by stressing the need for Congress to be explicit" (R. S. Avi-Yonah, *Tax Treaty Overrides: A Qualified Defence of U.S. Practice*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, p. 69 and pp. 74-75).

[35] On treaty override being theoretically possible in certain states, but avoided due to international legal obligations, see Vogel & Prokisch, *supra* n. 19, p. 59. In this sense, the questions raised by Nijman and Nollkaemper touch directly the point: "But is it necessarily the case that what states do (...) in itself generates a norm (or rather, a liberty) of public international law? Does the fact that states retain the competence under their national law to enact laws inconsistent with their international obligations mean that we have to accept an international legal liberty to do so?" (Nijman & Nollkaemper, *supra* n. 31, p. 3). As Fitzmaurice explains, although a state's position may be perfectly valid on the domestic plane, it may be, at an international level, guilty of a breach of international law (Fitzmaurice, *supra* n. 16, p. 69 and pp. 79-80). Indeed, since under the international legal order a state "may not invoke the provisions of its internal law as a justification for its failure to perform a treaty" (Article 27 of the Vienna Convention (1969)), treaty override is considered a violation of international law from an international law perspective, even if based on its legitimacy under a national legal order. A rule similar to article 27 exists in article 13 of the Draft Declaration on Rights and Duties of States prepared by the International Law Commission and endorsed by the United Nations General Assembly in 1949. This has also been applied by the Permanent Court of International Justice, the International Court of Justice and the Inter-American Court of Human Rights – for the cases, see Denza, *supra* n. 16, pp. 425-427; see also Accioly, Silva & Casella, *supra* n. 16, pp. 211-212. Also generally on the topic, Accioly, Silva & Casella, *supra* n. 16, p. 211; Dixon, *supra* n. 16, p. 89; S. E. Shay, *The Relationship of Tax Treaties to Domestic Law in the United States*, Tax Treaties and Domestic Legislation – 14b Proceedings of a Seminar held in Rio de Janeiro in 1989 during the 43rd Congress of the International Fiscal Association (IFA) (Kluwer 1991), p. 21.

[36] "The deliberate and continuous breach of a treaty will give rise to severe doubts as to the reliability and integrity of the offender. (...) The breaching party could lose the standing it has developed in the international community if it officially adopts the policy that it considers itself entitled to override treaties unilaterally by way of new national legislation. (...) Any country that continuously overrides tax-treaty obligations can be suspected of a willingness to ignore obligations it has assumed in other treaties (...). An intentional or systematic breach of a double-taxation convention will have serious

acknowledged this cause-effect relation when he indicates that a "*more subtle approach*"[37] could be an alternative to treaty override, since "countries are generally reluctant to override treaty obligations because of unfavorable reaction that it is likely to provoke from treaty partners. Thus, legislation that effectively overrides treaty obligations might be designed so that it can be argued that there is no technical breach of those obligations".[38]

Therefore, the relevant point of departure for understanding why some countries may be encouraged to explore different ways of dealing with treaties to mitigate undesired effects is the fact that they cannot do it (because of either the dichotomy between monism and dualism or the logic of the country's own system), or may not want to do so (not to face international consequences), through a direct violation of the treaty (i.e. violation of the text of the treaty; or, for some, treaty override depending on the scope of its definition[39]). The author agrees with Michael Rigby and Maarten J. Ellis to the extent that one different way of doing it is by making it work through treaties via a subtle backdoor implementation that is designed in such a way that its legitimacy could be reasonably defended. This subtle backdoor alternative, which has been effectively used by some contracting states in practice, is presented in the following section as tax treaty dodging.

2.2.2. Tax treaty dodging as a subtle backdoor solution

One subtle backdoor alternative for contracting states to mitigate the undesired effects of tax treaties without resorting to a direct conflict with treaty provisions is through the performance of actions (or omissions)[40] that modify the outcome of signed tax treaties but at the same time do not violate the wording of these agreements. Although these actions (or omissions) are in conformity with the text of treaty provisions, they affect their application in such a way that the new treaty outcome is more favourable for the contracting state performing such actions than the one that would have resulted if no actions were undertaken. This means that a contracting state is able to avoid treaty consequences that they may consider undesirable and consequently create new treaty situations that are more favourable for their national tax revenue without a direct violation of treaty provisions (i.e. violation of the text of the treaty).[41] As a result, the balance of taxing rights agreed at the signature of these agreements is changed for the benefit of the contracting state making use of such mechanism. This

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repercussions on any future treaty negotiations that the breaching party may undertake. The prospective treaty partners will wonder whether they will be able to reach an effective lasting agreement with the party that has intentionally breached another treaty" (H. Becker & F. Würm, *Double-taxation Conventions and the Conflict between International Agreements and Subsequent Domestic Laws*, Intertax 8-9 (1988), pp. 257-263, at pp. 262-263). "Corresponding retaliatory measures are also an acceptable response to treaty violation. The United Kingdom and other countries have threatened the USA with such measures in response to unitary taxation (...)" (K. Vogel et al., *Klaus Vogel on Double Taxation Conventions* (Kluwer Law International 1997), p. 70, marginal n. 133).

[37] Rigby, *supra* n. 27, p. 385.

[38] Rigby, *supra* n. 27, p. 400.

[39] See Chapter 4, Section 4.4.

[40] For omission as a method of tax treaty dodging, see Chapter 3, Section 3.3.1.3.

[41] K. Vogel et al., *supra* n. 36, p. 65, marginal n. 125.

circumvention of treaty obligations through contracting states' actions (or omissions) that are in line with the wording of signed tax treaties is referred to throughout this study as *tax treaty dodging*.[42]

The fact that tax treaty dodging does not entail a violation of the text of tax treaties makes it an alternative that may be convenient enough to satisfactorily solve the impasse described under section 2.2.1. without drawing treaty partners' attention as it would have in case of a direct infringement of the text of the treaty provision. In fact, further in this study the reader will see that the fact that those actions are performed in accordance with the wording of signed tax treaties may raise the question of whether tax treaty dodging could be considered a legal practice.[43] It goes without saying that this would make tax treaty dodging not only a convenient backdoor alternative for mischievous countries but also a possible attractive "legal" solution for any contracting state.

The phenomenon of treaty dodging emerges from the fact that tax treaties are not self-sufficient agreements, as they are understandably not able to cover all tax aspects of all international situations. They look, in fact, very simple and have fewer provisions by far than most domestic laws.[44] This lack of self-sufficiency is a consequence of different factors. First, it would not be practical for these agreements to cover all aspects of all different international tax relations[45]; second, they are generally made to relieve from tax - from international double taxation - and not to charge a tax[46]; and last, tax treaties need a certain degree of flexibility in order to accommodate the differences between states and the development of society in general.[47] As a consequence, several spaces are left open, and they

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[42] For the origins of the expression and the reasons why the author decided to use Kalus Vogel's term when referring to the phenomenon object of this thesis, see Sections 2.3. and 2.4.

[43] See this analysis in Chapter 4.

[44] J. Wheeler, *The Missing Keystone of Income Tax Treaties* (IBFD 2012), IBFD Doctoral Series, p. 1.

[45] If all tax aspects were covered, tax treaties would become extremely extensive conventions. In this regard, Vogel and Prokisch state that the overloading of double taxation conventions with definitions would render the application of conventions difficult (Vogel & Prokisch, *supra* n. 19, p. 77). The national reporters and the general reporter of the 14th IFA Congress in Basel in 1960 have realized this already back at that time (R. Lenz, *The Interpretation of double taxation conventions - General Report*, XLII IFA Cahiers de Droit Fiscal International (IFA 1960), pp. 295 and 298). See also B. Aniceto da Silva, *The Tie-breaker Rule (Art. 4 of the OECD MC): Relevance of Domestic Law or Autonomous Interpretation?*, Fundamental Issues and Practical Problems in Tax Treaty Interpretation (M. Schilcher & P. Weninger eds., Linde 2008), 54 Series on International Tax Law, pp. 329-350, at p. 337.

[46] J. F. Avery Jones et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model – I*, British Tax Review 1 (1984), pp. 14-54, at p. 17. Different from tax treaties, legislation that is made to charge a tax is expected to bring all elements of the tax liability, such as the taxable base, the taxpayer, tax rates, etc. According to Kees van Raad, the first fundamental rule in applying tax treaties is that tax treaties restrict the application of internal law, which means that the imposition of tax is based on internal law and not these agreements (K. van Raad, *Five Fundamental Rules in Applying Tax Treaties,* Liber Amicorum Luc Hinnekens (J. F. Avery Jones et al. eds., Bruxelles Bruylant 2002), pp. 587-597, at pp. 587-589.

[47] According to Joanna Wheeler, "Treaties have to be capable of regulating the interface between (usually) two states, which may have quite different legal traditions and domestic tax systems. They are therefore formulated in general, abstract terms, which also enable them to adapt to the continuing changes in the domestic law of the states that have concluded a treaty". (Wheeler, *supra* n. 44, p. 1.). In the same sense, Gilbert Tixier, Guy Gest and Jean Kerogues: "Les conventions

generally relate to: (i) basic elements of the tax liability (e.g. taxable base, taxpayer, tax rates, calculation and, in some cases, attribution of the income), which determination tax treaties do not provide since, as already noted, these agreements are generally made to relieve from tax and not to tax, and (ii) the definition of a great number of treaty terms, since, from a practical perspective, tax treaties are not able to define the meaning of all terms used[48]. These areas of relative freedom are however not limited to these scenarios. They may relate in fact to a number of situations that are simply not covered by the treaty - the reader will later see, in Chapter 3 of this thesis that the identification of "treaty gaps" allows the delimitation of situations in which tax treaty dodging may occur.

The result is that most of the gaps left by tax treaties need to be filled in by other means. These other means may be, for example, the use of domestic law for the determination of the basic elements of the tax liability and the interpretation according to domestic law for undefined treaty terms.[49] As a consequence, tax treaties end up having a greater connection with internal law than most other types of treaty.[50] It is, for instance, domestic law that determines whether a state can impose a tax liability on a person in respect of a certain item of income[51] simply because tax treaties do not cover this aspect. Likewise, most terms used in tax treaties are not therein defined and, in the absence of a standard international tax language, recourse to domestic law is necessary in many cases, as expressly instructed in certain treaty articles, including article 3(2) of the OECD Model Convention (2017).[52] In reality, tax treaties leave more spaces open than they actually cover, so that in the end they act "like a stencil that is placed over the pattern of domestic law and covers over *certain parts*".[53]

The fact that these gaps need to be completed by domestic law in order for tax treaties to function in practice is a key premise to have in mind for understanding the tax treaty dodging rationale. Or even, that these gaps offer contracting states a certain freedom to act, to undertake actions (not necessarily

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sont nécessairement des oevres imparfaites car elles consistent à rapprocher et à concilier des systèmes fiscaux nationaux (...)" (G. Tixier, G. Gest & J. Kerogues, *Droit Fiscal International* (Litec 1979), p. 169).

[48] Vogel and Prokisch explain that the use of domestic law "prevents the overloading of double taxation conventions with definitions that would render the application of conventions difficult" (Vogel & Prokisch, *supra* n. 19, p. 77).

[49] "When double taxation conventions contain no specific provision, whether this is the case because the contracting parties did not intend to cover a certain area or because the possibility of overlap was not identified, domestic tax laws of the respective Contracting State take hold" (Vogel & Prokisch, *supra* n. 19, pp. 74-75). See also Vogel et al., *supra* n. 36, p. 215, marginal n. 74. As regards definition of treaty terms, see also *OECD Model Tax Convention on Income and on Capital* art. 3(2) (21 November 2017), Models IBFD.

[50] J. F. Avery Jones et al., *supra* n. 46, at p. 17. See also J. Wouters & M. Vidal, *The International Law Perspective*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, p. 15; B. Castagnède, *Précis de Fiscalité Internationale* (Presses Universitaires de France, 2eme ed. 2006), p. 258. They are though comparable to two types of bilateral convention which are also closely related to domestic law: treaties of reciprocal establishment and treaties on the competence of tribunals or administrative authorities in judicial matters (Lenz, *supra* n. 45, p. 294).

[51] Wheeler, *supra* n. 44, p. 13.

[52] *OECD Model Tax Convention on Income and on Capital* art. 3(2) (21 November 2017), Models IBFD.

[53] Vogel, *supra* n. 36, p. 32, marginal n. 56 (emphasis added).

the enactment of domestic legislation only) or incur in omission when action is needed[54] as long as this is within the limits of the areas not covered by tax treaties. In other words, due to the lack of self-sufficiency of tax treaties, contracting states have the right to act or make use of domestic law whenever they are expressively allowed or simply not forbidden by the text of these agreements. On the other hand, contracting states may also exercise this right in a manner that affects the performance of tax treaties to the point that the outcome of these agreements is modified for their own benefit. For example, by the appropriate formulation of domestic law in conformity with treaty provisions, contracting states may extend the advantages of existing agreements by broadening the scope of circumstances in which they are normally allowed to tax.[55] The relevant question, which will only be dealt with in Chapter 4 of this thesis, is whether despite its conformity with the text of treaties, this practice could be considered, from the perspective of international rules governing the good usage of tax treaties, a prohibited behaviour.

Contracting states may thus achieve the same effects of a direct infringement of treaty provision without violating the wording or tax treaties; quite the opposite, as Michael Rigby describes, they achieve this by "designing domestic legislation that complies technically with treaty obligations but which effectively allows those obligations to be avoided".[56] The fact that these gaps allow states to "have some flexibility in ensuring that their tax treaties are properly applied"[57] is the reason why tax treaty dodging is a convenient solution for mischievous countries.

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[54] See Chapter 3 for the different types of tax treaty dodging involving also administrative acts and legislative omissions, for example.

[55] According to Vogel, "(...) legislatures too, by appropriate formulation of new legislation are able to increase the benefits of existing tax treaties for their national tax coffers while decreasing the disadvantages" (Vogel, *supra* n. 36, p. 65, marginal n. 125). John F. Avery Jones indicates that "(...) a State could modify the effect of a treaty by changing its internal law" and follows recalling a statement from Thomas More in Utopia that "[states] always retain the right to rob one another, in so far as the drafters of the treaty have expressly failed to include enough provisions to the contrary" (Avery Jones, *supra* n. 46, p. 40). For Edwin van der Bruggen, "the system of referral to domestic law for treaty interpretation and application makes double taxation conventions vulnerable to unilateral intentional dodging and unintentional hollowing out of treaty obligations by contracting states (...)". (E. van der Bruggen, *"Good Faith" in the Application and Interpretation of Double Taxation Conventions*, British Tax Review 1, (Sweet & Maxwell 2003), pp. 25-68, at p. 39). In the same sense, Rigby also indicates that the reference to domestic law at the time the treaty is applied "allows scope for changes in domestic law to alter the effect of a treaty" (Rigby, *supra* n. 27, p. 386). Michael Lang also explains that "(...) states can deliberately so organize their domestic legislation that all tax rights granted them by DTC are undermined" (IFA, *Abusive Application of International Tax Agreements* – 25b Proceedings of a Seminar held in Munich in 2000 during the 54th Congress of the International Fiscal Association (IFA) (Kluwer 2001), p. 24). In the same sense, see J. F. Avery Jones, *The Interaction between Tax Treaty Provisions and Domestic Law*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, p. 133; L. de Broe, *International Tax Planning and Prevention of Abuse* (IBFD 2008), Doctoral Series, p. 272; F. Engelen, *Interpretation of Tax Treaties under International Law* (IBFD 2004), Doctoral Series, p. 490; F. A. Garcia Prats, *Abuse of Tax Law: Prospects and Analysis*, Essays in International and European Tax Law (G. Bizoli ed., Jovene 2010), pp. 74-75; Comments by L. Rao in IFA, *ibid.*, pp. 21-23. For further references in the same direction, see Section 2.3.

[56] Rigby, *supra* n. 27, p. 385.

[57] Rigby, *supra*. 27, p. 386.

It is possible that, at the same time the phenomenon of tax treaty dodging starts to take form, the reader may start recalling a more familiar mechanism which is in fact a well known practice in international tax scenarios: tax avoidance. Due to the fact that avoidance by taxpayers has occupied an increasingly large space in the literature and because not much has been said on how contracting states can operate in a similar way, there is a tendency to connect only to taxpayers the mechanism of circumventing legal obligations by taking advantage of legal loopholes. This was the point made by Peter Essers when he remarked "talking about abusive use of DTCs [double taxation conventions], we usually mean abusive use of tax treaties by taxpayers (…)" just before introducing the topic entitled "*Is abusive application of DTCs [double taxation conventions] by states possible?*" at a seminar held at the 54th Congress of the International Fiscal Association.[58] A similar observation was made by the, at the time, United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters in the sense that "normally the term "treaty abuse" is used to refer to situations in which the taxpayer is seeking to circumvent the law" when in fact considerations should also be taken, according to the Ad Hoc Group, to contracting states' similar practices.[59] Indeed, tax treaty dodging is many times referred to as "abuse by states" or "abuse by governments" in literature[60][61] - however, the author prefers to not

[58] Comment by P. Essers in IFA, *supra* n. 55, p. 21.

[59] UN, Ad Hoc Group of Experts on International Cooperation in Tax Matters, *Report of Proceedings 15 December 2003, Eleventh Meeting - Geneva*, 15-19 December 2003, ST/SG/AC.8/2003/L.11 (15 December 2003), para. 25.

[60] Comments in IFA, *supra* n. 55, pp. 21-24; Garcia Prats indicates that "a distinction can be made between (a) abuse of the agreed terms of the tax treaty by one of the contracting Parties, that is, a State, and (b) abuse of the treaty provisions by persons (natural or juridical), who may or may not be the intended beneficiaries of the treaty (...)" (Garcia Prats, *supra* n. 55, p.74). In the same direction, Rigby defends that "(...) treaties can be abused, both by taxpayers and by governments" (Rigby, *supra* n. 27, p. 425). For more references of expressions using the term "abuse", see Section 2.4.

[61] The United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters also referred to the mechanism herein studied as "abuse by the contracting state" in the Report of Proceedings 15 December 2003: "Normally the term "treaty abuse" is used to refer to situations in which the taxpayer is seeking to circumvent the law. But considerations should be taken to cases in which one of the Contracting States takes advantage of the good faith of the other Contracting state of the Treaty, by making a future amendment of the law or by administrative practices that lead to significant losses of resources of the other Contracting State. The two situations – abuse by the taxpayer and abuse by the Contracting State – should be distinguished in framing the rules used to determine the existence of abuse, in identifying the bodies that would declare the existence of an abuse, and in establishing the legal consequences of a finding of an abuse" (UN, *supra* n. 59, para. 25). The topic "Abuse by one of the contracting states" had been presented to the Ad Hoc Group in a previous report prepared by Francisco Alfredo Garcia Prats on 24 June of the same year (UN Ad Hoc Group of Experts on international Cooperation in Tax Matters, *Abuse of Tax Treaties and Treaty Shopping*, ST/SG/AC.8/2003/L.3, 24 June 2003, paras. 12-16). The topic was further referred to as "abuse by a contracting state" in subsequent reports prepared by the United Nations Committee of Experts on International Cooperation in Tax Matters from 2005 to 2008: UN Committee of Experts on International Cooperation in Tax Matters, *Abuse of Tax Treaties and Treaty Shopping, First Session – Geneva 5-9 December 2005*, E/C.18/2005/2 (15 November 2005), p. 11, para. 20; UN Committee of Experts on International Cooperation in Tax Matters, Subcommittee on Treaty Abuses and Treaty Shopping, *Treaty Abuse and Treaty Shopping, Second Session – Geneva, 30 October- 3 November 2006*, E/C.18/2006/2 (16 October 2006), paras. 10-17; UN Committee of Experts on International Cooperation in Tax Matters, *Improper Use of Tax Treaties, Third Session – Geneva 29 October – 2 November 2007*, E/C.18/2007/CPR.2 (22 October 2007), paras. 8-9; UN Committee of Experts on International Cooperation in Tax Matters, Subcommittee on Improper Use of Tax Treaties, *Note by the Coordinator of the Subcommittee on*

refer to the phenomenon herein studied as "abuse" by contracting states, for the reason indicated in Section 2.4. of this Chapter.

The method of minimizing disadvantages through actions that comply with the wording of legal provisions is normally attributed to taxpayers and little attention has been given to the fact that, as correctly pointed out by Klaus Vogel, "much as taxpayers arrange their legal relationships to decrease their taxable income or even to eliminate tax liability (i.e. they use tax planning), legislatures too, by appropriate formulation of new legislation are able to increase the benefits of existing tax treaties for their national tax coffers while decreasing the disadvantages".[62] In the same sense, Michael Lang also recognizes the possibility of this phenomenon if one acknowledges tax avoidance: "just as a taxpayer can arrange his affairs to be beyond the reach of a tax provision in order not to trigger a certain tax liability, so a contracting state can arrange its national law within the limits defined by the treaty so that the treaty does not prevent the state from imposing tax".[63]

What is studied in this thesis as tax treaty dodging can be regarded as a method equivalent to tax avoidance, but undertaken by a different subject and for a comparable purpose. If in one hand the wish to decrease the tax liability may lead taxpayers to make use of business arrangements that work through the loopholes of legal provisions, contracting states may too wish, in their cases, to increase their tax revenue through arrangement of domestic law that fits the gaps left by tax treaties. It is true, though, that tax treaty dodging and tax avoidance should be distinguished in terms of the legal rules used to determine the existence of a possible abuse and in terms of identifying the legal consequences of such an action.[64] But they both do entail the same line of thought and strategy for comparable purposes.

For example, in the same way taxpayers may maneuver their taxable profits or income by attributing all or part of them to a related person over which they have control and of which the tax burden is reduced,[65] contracting states can attribute, under domestic law, income to a person over which they can exercise their taxing rights according to tax treaties. In the same way taxpayers may chose legal

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Improper Use of Treaties: Proposed Amendments, Fourth Session – Geneva 20-24 October 2008, E/C.18/2008/CPR.2 (17 October 2008), para. 6).

[62] Vogel et al., *supra* n. 36, p. 65, marginal n. 125.

[63] M. Lang, *CFC Regulations and Double Taxation Treaties*, 57 Bull. Intl. Taxn. 2 (IBFD 2003), Journals IBFD, pp. 51-58, at p. 57.

[64] The UN Ad Hoc Group of Experts on International Cooperation in Tax Matters indicates the differences between "abuse by taxpayer" and "abuse by contracting states" (UN Ad Hoc Group of Experts on International Cooperation in Tax Matters, *supra* n. 61 (24 June 2003), para. 25).

[65] More on the ways taxpayers may attribute profits or income to another person in UN, *supra* n. 61 (16 October 2006), paras. 47-57. See also A. Candu, *Abuse of Tax Treaties*, Fundamental Issues and Practical Problems in Tax Treaty Interpretation (M. Schilcher & P. Weninger eds., Linde 2008), 54 Series on International Tax Law, pp. 187-213, at p. 197 and P. Baker, *Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion*, United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries (A. Trepelkov, H. Tonino & D. Halka eds., United Nations 2013), pp. 383-400 at pp. 392-393.

forms for transactions in order to change the character of the income to a type over which a reduced treaty rate applies,[66] contracting states may, through fictions and deeming provisions in domestic law, modify the nature of the income to a type over which they are granted tax rights in tax treaties.

Although not commonly discussed in literature, tax treaty dodging is not a new phenomenon; it has been detected by scholars at least since the 1960s. In the next section, the records of the phenomenon in literature throughout these decades and how the perception of the tax treaty dodging evolved during this time is presented. The material collected shows how the subject has not always been analysed from the same perspective, how the concept is neither yet clear nor systematically presented and the methods used by contracting states not completely identified.

2.3. Observation of the phenomenon throughout the decades: a historic study of the literature

The phenomenon of tax treaty dodging has been detected by scholars in the past decades. However, it has not always been observed, analysed or referred to in the same manner. Throughout the years, scholars have been addressing the same problem without, many times, realizing it, simply because the phenomenon has been labelled in different ways or analysed from different perspectives. In many cases, the different approaches on the problem seem to be a consequence of the fact that analysis were made within different contexts or focused on distinct aspects. The fact that the problem is not always analysed in existing literature from the perspective of tax treaty dodging (as understood in this thesis) did not allow the development of a consistent understanding of the phenomenon. This study makes an attempt to untie this knot by presenting the records of the phenomenon in literature for the past 55 years[67] and by pointing out the origins and nature of conflicting views on the topic.

The 1960s and 1970s

The danger of tax treaty dodging seems to have been first detected in international tax literature in the context of the discussions surrounding the possible use of clauses referring back to domestic law of one state (the so-called *renvoi* clauses) as a general solution for defining undefined treaty terms. The general *renvoi* clause similar to the current article 3(2) of the OECD Model Convention (2017) was not introduced by any of the League of Nations or OEEC Models.[68] It was first included in the United

[66] More on the ways taxpayers may change the character of income (e.g. from gains from real property to gains from shares, from dividends to capital gains, from dividends to interest) in UN, *supra* n. 61 (16 October 2006), paras. 58-67. See also Candu, *ibid.*, pp. 198-200 and Baker, *ibid.*, p. 394.

[67] The findings herein presented are the result of the author's best efforts taking into consideration limitations in regard to time, language and resources.

[68] Avery Jones et al., *supra* n. 46, p. 18.

States-United Kingdom Income Tax Treaty signed in 1945[69] before being used by almost all common law countries and by civil law countries like France, Netherlands and Sweden in the late 1940s and the beginning of the 1950s.[70] But it was the possible inclusion of this general *renvoi* clause in the 1963 OECD Model Convention[71] that instigated more concrete discussions on the convenience of the solution and the problems involved. These discussions raised topics like to which domestic law countries must refer to (i.e. to the one of the source or of the residence state), but also revealed the concerns on the impact caused on the application of tax treaties.

At the 14th Congress of the International Fiscal Association held in Basel in 1960, the national reporters of Netherlands, Sweden and Switzerland, as well as the general reporter Raoul Lenz, expressed the opinion that the general clause of *renvoi* to the fiscal legislation of the other contracting state would "unduly restrict their discretionary power to apply the agreements".[72] The general reporter goes further in the analysis and foresees the possibility of what this thesis refers to as tax treaty dodging when he indicates that "by changing its domestic tax legislation a country may also be in a position to change or modify unilaterally the field of application of an agreement".[73] Although the danger of allowing the use of domestic definitions for treaty terms continued to be referred to in literature in the following years, a higher degree of attention was given to this topic towards the early 1980's, as explained further in this section.

Still during the 1960's and 1970's, the danger of tax treaty dodging was again observed, but in relation to another topic. Scholars started to detect the danger in the context of new anti-avoidance rules that started to be implemented at the time, without, though, connecting it to the issues detected during the discussions on domestic definitions and the *renvoi* clause. The way contracting states may affect the application of tax treaties not necessarily through domestic definitions of treaty terms was detected by the German reporter Helmut Debatin at the 18th Congress of the International Fiscal Association held in Hamburg in 1964. He realized that contracting states could simply attribute income to a resident person in order to be able to tax it, such as in the case of attributing the income of the non-resident company to the resident shareholder[74] - the so called Controlled Foreign Corporation (hereinafter CFC) rules. Helmut Debatin considered that this method was not prevented by rules of

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[69] *Convention between the United States of America and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, art. 2(3) (16 April 1945), Treaties IBFD. See Avery Jones et al., *supra* n. 46, p. 18.

[70] Avery Jones et al., *supra* n. 46, p. 18; G. K. Ahlm, *The Interpretation of Double Taxation Conventions - Suède*, XLII IFA Cahiers de Droit Fiscal International (IFA 1960), p. 261; M. R. Reuvers, *The Interpretation of Double Taxation Conventions - Holland*, XLII IFA Cahiers de Droit Fiscal International (IFA 1960), p. 230.

[71] *OECD Model Tax Convention on Income and on Capital* (30 July 1963), Models IBFD.

[72] Lenz, *supra* n. 45, p. 297.

[73] *Ibid*.

[74] H. Debatin, *Rapports Pour le XVIII Congrès International de Droit Financier et Fiscal - La Délimitation des Pouvoirs Fiscaux du Pays du Siège ou du Domicile et les Pouvoirs des Autres Pays, en ce qui concerne les Sociétés de Capitaux et leurs Actionnaires - Allemagne*, XLIXb IFA Cahiers de Droit Fiscal International (IFA 1964), pp. 122 and 129.

international law[75] and that there would be no violation of tax treaties, since the determination of the tax liability of resident persons is left for the domestic law of the residence country.[76] However, he wondered if this would be questionable, as these rules would, on the other hand, nullify the effects of the recognition by the treaty of the legal independence of a non-resident company: "Wenn das Abkommen diese Gesellschaft als rechtlich selbständig anerkennt und in seine Regelungen einbezieht, so wird für alle Einkünfte, für die der Wohnsitzstaat steuerberechtigt ist, diese Rechtswirkung praktisch ausgehöhlt".[77]

It is clear that, at the same time Helmut Debatin recognizes the general view that the attribution of income to a person is part of the tax liability (which determination is left by tax treaties to domestic law and, thus, no violation of the agreement could be immediately identified), he is troubled by the fact that the measure undertaken by the contracting state in practice empties the effects of the treaty provision.[78] Heinz Flick[79] and Horst Vogel[80] also shared Helmut Debatin's view on this.

Although no direct reference is made to the CFC rules at the time as a method used by contracting states to modify the treaty outcome without direct violation of its provisions (i.e. violation of the text of the treaty),[81] the basis of this rationale is to a certain extent identified by Helmut Debatin. The author believes that the reason why Helmut Debatin and the other German authors did not make a link, at that time, between the issues related to CFC rules and the issues related to undefined treaty terms was simply the fact that they were not focusing on understanding the relation "compliance with the wording of a treaty - modification of its effects", but rather analysing the topic in the context of how the modification of the outcome of the treaty could be considered a reason to condemn CFC rules from a tax treaty perspective.

The 1980s

It was only in the 1980s that the link between the two subjects started to be realized by some scholars. In addition, a more comprehensive understanding of the core problem started to emerge from the discussions. It was in this decade that the rationale behind tax treaty dodging started to be presented in a more direct way and that some scholars started to see it more as a general mechanism which could

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[75] He says, however, that shareholders should not be exposed to conflicts of obligations. The author disagrees that some of these actions are not prevented by international law. This topic is analyzed in Chapter 4 of this thesis.

[76] Debatin, *supra* n. 74, p. 124.

[77] *Ibid.*

[78] See again Debatin on the analysis of CFC rules and the non-recognition of the legal independence of the foreign entity few years later in H. Debatin, *Leitsätze für ein Gesetz zur Wahrung der Steuerlichen Gleichmässigkeit bei Auslandsbeziehungen und zur Verbesserung der Steuerlichen Wettbewerbslage bei Auslandsinvestitionen*, 59 Deutsche Steuer-Zeitung Ausgabe A 6 (1971), pp. 89-102.

[79] H. Flick, *Vereinbarkeit des Steuerfluchtgesetzes mit Doppelbesteuerungsabkommen*, Der Betriebs-Berater 6 (1971), pp. 250-251, at p. 250.

[80] H. Vogel, *Aktuelle Fragen des Aussensteuerrechts, insbesondere des "Steueroasengesetzes" unter Berücksichtigung des neuen Doppelbesteuerungsabkommens mit der Schweiz*, Der Betriebs-Berater 27 (1971), pp. 1185-1192, at p. 1189.

[81] For the analysis of CFC rules as a method of tax treaty dodging, see Chapter 3, Section 3.3.1.1.

be, as already practiced by taxpayers, used by contracting states in different situations, rather than seeing it just as a side problem exclusively related to article 3(2) of the OECD Model Convention or CFC legislation. However, it was also in the 1980's that an important distinction started to emerge in literature, as some scholars started to treat the subject under the perspective of treaty override, while others insisted on the importance of differentiating the two subjects.[82]

The first step towards this broader view of the problem seems to have been made by Charles I. Kingson, when he wrote in 1981 a comprehensive study[83] on how countries could take advantage of one another (and especially of the United States) in an international tax scenario, such as in the case of resident countries lowering tax rates or reducing taxable base in order to serve as a conduit for treaty shopping purposes.[84] Although the study did not focus on discussions related to undefined terms or CFC rules, nor presented the dodging rationale in a more direct way, it may be still considered a valuable contribution to the development of the topic in the sense that it showed different ways in which states could affect the treaty outcome without contradicting its wording, and how states could be driven not only by tax revenue motivations but also by interest in attracting foreign investments.[85] However, this contribution seems to have passed unnoticed by those focused on the discussions related to article 3(2) of the OECD Model Convention and CFC legislation until its relevance was finally realized by Michael Rigby and Klaus Vogel in the 1990s (see further below).

The dodging rationale started to appear in a more direct way - although not yet as a general mechanism but still in connection to the specific cases of undefined terms - as a consequence of the decision issued by the Supreme Court of Canada in the case *Melford* (1982).[86] The case brought up the discussion, until then not relevant,[87] on whether, for tax treaty purposes, reference should be made to the law of contracting state at the time when the treaty was concluded (static interpretation) or to the law at the time when the treaty was applied (ambulatory interpretation). Contrary to the prevailing views at the time, the Supreme Court of Canada decided in this case for the static interpretation and justified its decision on the fact that reference to domestic law as amended would offer the opportunity for a unilateral change of the tax treaty by a contracting state as their domestic needs may dictate. The case concerned the term "interest" which was not defined in the Canada-Germany Income Tax Treaty

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[82] For the opinion of the author on this, see Chapter 4, Section 4.4.

[83] C. I. Kingson, *The Coherence of International Taxation*, 81 Columbia Law Review 6 (Columbia Law Review Association 1981), pp. 1151-1289.

[84] *Ibid.*, pp. 1277-1280.

[85] For possible tax treaty dodging case motivated by interest in attracting foreign investments, see Chapter 3, Section 3.3.2. (passive dodging: tolerating treaty shopping schemes).

[86] CA: SCC, 28 September 1982, *Her Majesty the Queen v. Melford Developments Inc.*, Tax Treaty Case Law IBFD. Full text of the decision available at http://scc-csc.lexum.com/decisia-scc-csc/scc-csc/scc-csc/en/item/5509/index.do?r=AAAAAQAHTWVsZm9yZAAAAAAB (accessed 29 Nov. 2019). For the analysis of the decision, see Chapter 3, Section 3.3.1.2.

[87] Until the early 80's the issue static v. ambulatory was rarely discussed, as the static/ambulatory alternatives had not been considered to be a problem and reference was normally made to the law as it stood (Vogel et al., *supra* n. 36, p. 64, marginal n. 124c).

(1956).[88] Treating it as override, the Supreme Court of Canada seems to have spotted a tax treaty dodging case: as Canada was allowed by a treaty provision equivalent to article 3(2) to use its domestic law definition of interest, the effective use of such definition could not be considered a violation of the wording of the agreement; on the other hand, the amendment of the domestic law after the signature of the treaty modified the outcome of the treaty provision. To avoid such an outcome, the Supreme Court of Canada decided to apply a radical measure and forbid the reference to domestic law amendments made after the signature of the treaty, closing the door to any attempt in this sense.

The decision instigated further discussion on the topic, at least for a certain period. In the following year, in 1983, Klaus Vogel presented the, by then, more systematic formulation of the phenomenon herein studied, which he referred to under the topic "*Umgehung durch die Vertragsstaaten*"[89] – avoidance or circumvention by contracting states.[90] Although the method is described only in two (long) paragraphs of the first edition of his book, Klaus Vogel seems to be the first to observe the phenomenon in a more coherent and comprehensive way. He does not treat the topic as a side subject in the analysis of specific and independent cases, as generally done so far by scholars in the context of discussions over article 3(2) of the OECD Model Convention and CFC rules. He inverts the order of importance of the subjects and focuses instead on the phenomenon itself as a constructed method that could be undertaken by contracting states in different situations, and cases like CFC rules and *Melford* (1982) were cited as mere examples of this mechanism. He seems to be the first to bring attention to the pattern followed by contracting states of respecting the wording of tax treaties but changing the direction of their outcome. Klaus Vogel clearly states that contracting states could circumvent tax treaties by designing domestic legislation in accordance with their wording with the effect of avoiding undesirable treaty consequences or of creating convenient treaty situations for that state.[91]

He is also the first to make a parallel between taxpayers' and contracting states' comparable actions, i.e. between tax avoidance and tax treaty dodging, as he uses the same term to address both practices

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[88] *Convention between Canada and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (4 June 1956), Treaties IBFD.

[89] K. Vogel et al., *DBA Doppelbesteuerungsabkommen Kommentar* (Verlage C. H. Beck München, 1983), p. 43, marginal n. 75.

[90] Free translation by the author. In the second edition of his book, Klaus Vogel continued to use the expression "*Umgehung durch die Vertragsstaaten*" as the title of the topic. This expression was however translated as "*Avoidance by the Contracting States*" in the title of the topic in the English version of this second edition. On the other hand, in the text of this edition, the verb *umgehen* is also referred to as *to circumvent* (e.g. "*Auch Staaten können Doppelbesteuerungsabkommen umgehen*" translated as "*States, too, can circumvent tax treaties*" - K. Vogel et al., *DBA Doppelbesteuerungsabkommen Kommentar* (Verlag C. H. Beck München, 1990), p. 65, marginal n. 125; K. Vogel et al., *Klaus Vogel on Double Taxation Conventions* (Kluwer Law and Taxation Publishers, 1991), p. 57, marginal n. 125).

[91] "Auch Staaten können Doppelbesteuerungsabkommen umgehen, wenn sie Gesetze schaffen, die Zwar nach ihren Buchstaben bestimmte Abkommenstatbestände und dadurch deren für sie ungünstige Rechtsfolgen vermeiden (oder umgekehrt günstige Rechtsfolgen herbeiführen), der sachliche Gehalt der Gesetze dem Abkommen jedoch nicht entspricht" (Vogel, *supra* n. 89, p. 43, marginal n. 75).

- "*Umgehung durch Steuerpflichtige*"[92] (avoidance by taxpayers) and "*Umgehung durch die Vertragsstaaten*"[93] (avoidance by contracting states) - and indicates that states *too* can circumvent tax treaties,[94] immediately after the conclusion of the tax avoidance topic.

In the second edition of his book,[95] Klaus Vogel continues to address the subject in a similar manner,[96] and finds in the study of Charles I. Kingson (see above) support for his idea of how "by such legislation, the material content of a treaty, though not its wording, may be infringed".[97] He is also more direct in the way he presents the parallel between taxpayers' and contracting states' actions when he states that "the legal consequences of such 'treaty circumvention' by States cannot basically be different from those of avoidance by taxpayers".[98]

Another relevant consequence of the *Melford* (1982) case was the conclusion, in 1984, of a special project[99] by "The International Tax Group"[100] under the coordination of John F. Avery Jones, where the effects of changes in internal law was addressed as far as it concerned article 3(2) of the OECD Model Convention. In the study, the group recalls the *Melford* (1982) case and makes an interesting distinction between treaty override and the effects of the ambulatory interpretation[101] and how the Supreme Court of Canada had wrongly considered these two subjects being the same thing.[102] They then consider the possibility of tax treaty dodging when they observe that "a State could modify the effect of the treaty by changing its internal law"[103] and that "(...) the ambulatory interpretation means that it [state] can modify the effect of a treaty in its own favour".[104] The static interpretation was,

[92] Vogel, *supra* n. 89, p. 39, marginal n. 67.
[93] Vogel, *supra* n. 89, p. 43, marginal n. 75.
[94] "Auch Staaten können Doppelbesteuerungsabkommen umgehen (...)" (Vogel, *supra* n. 89, p. 43, marginal n. 75).
[95] K. Vogel et al., *supra* n. 90 (1990). English version: K. Vogel et al., *supra* n. 90 (1991).
[96] "States, too, can circumvent tax treaties. They can do so by drafting laws that, according to their wording, avoid certain treaty situations, though in substance the treaty situation is present, because they want to avoid certain consequences (i.e. treaty consequences) which they may consider undesirable. Or, conversely, they may draft laws that artificially create treaty situations which the law-making State considers desirable" (Vogel, *supra* n. 90 (1991), p. 57, marginal n. 125).
[97] Vogel, *supra* n. 90 (1991), p. 57, marginal n. 125.
[98] Vogel, *supra* n. 90 (1991), p. 57, marginal n. 125.
[99] J. F. Avery Jones et al., *supra* n. 46; J. F. Avery Jones et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model – II*, British Tax Review 2 (1984), pp. 90-108.
[100] John F. Avery Jones, Charles J. Berg, Henri-Robert Depret, Maarten J. Ellis, Pierre Fontaneau, Raoul Lenz, Toshio Miyatake, Sidney I. Roberts, Claes Sandels, Jakob Strobl and David A. Ward.
[101] Avery Jones et al., *supra* n. 46, pp. 25-28.
[102] This point is analyzed in details in Chapter 3, Section 3.3.1.2. On the topic of treaty override v. tax treaty dodging, see Chapter 4, Section 4.4.
[103] Avery Jones et al., *supra* n. 46, p. 40.
[104] Avery Jones et al., *supra*, p. 46. They also indicate this point was previously made by Vogel.

though, considered to be a too rigid solution to be acceptable[105] and the study concludes in favour of the application of the ambulatory interpretation coupled with an express or implied limitation.[106]

The following year, John F. Avery Jones chaired a panel discussion based on the 1984 project at the International Fiscal Association Congress held in London, with the participation of Sir Ian Sinclair, David Ward, Klaus Vogel and Kees van Raad.[107] The topic herein studied as tax treaty dodging was touched on at several points during the discussions on the ambulatory interpretation, and the general conclusion was that the ambulatory interpretation should be adopted with limitations such as the context and the object and purpose of treaties, in view of the effects amendments in domestic law could have on tax treaties. On the topic of conflicts caused by reference to internal law, Klaus Vogel made again a more direct reference to the tax treaty dodging rationale during a criticism on the proposal of David Ward for adoption of the qualification given in the source state. He points out the possibility that this "would indeed avoid double non-taxation, but the awkward consequence of this rule is that the state whose internal law attributes the broader definition to the term in question always would have an advantage" and that "states could abuse it by deliberately extending certain of their internal law definitions".[108]

Indeed, Klaus Vogel seems to be the one more inclined to develop the concept of tax treaty dodging itself rather than to only discuss it as a secondary topic linked to the main issue of article 3(2) and ambulatory v. static interpretation. In 1985 he makes a deeper analysis[109] of the topic than the one in the first edition of his book. In this study, he indicates that the stronger relevance of the "ordinary meaning" in article 31 of the UN Vienna Convention on the Law of Treaties (hereinafter Vienna Convention (1969))[110] makes tax treaties more vulnerable to structures aiming at circumventing the agreement,[111] which could be performed by both taxpayers and contracting states. In this sense, he acknowledges as a fact that contracting states can amend their domestic law in order to improve their treaty position: "Doppelbesteuerungsverträge berechtigen und verpflichten zunächst die

[105] Avery Jones et al., *supra* n. 46, p. 48.

[106] The express limitation refers to the "context otherwise requires" and the implied limitation to a proposal at the time to be included in the OECD Model Commentary (and later adopted). See more on the limitations to tax treaty dodging in Chapter 4.

[107] Transcripts of the panel discussions prepared by John Avery Jones were published in 1986: J. F. Avery Jones, *supra* n. 107.

[108] Avery Jones, *supra* n. 107, p. 79.

[109] K. Vogel, *Steuerumgehung nach Innerstaatlichem Recht und nach Abkommensrecht*, 62 Steuer und Wirtschaft 4 (1985), pp. 369-381.

[110] UN, *Vienna Convention on the Law of Treaties* (23 May 1969), Treaties IBFD.

[111] "Im Vordergrund steht hiernach der Wortlaut, die 'gewöhnliche Bedeutung' der 'Ausdrücke'. Er ist zwar nicht allein massgebend, sondern 'im Lichte von Gegenstand und Zweck' des Abkommens zu verstehen. Dennoch ist die Bindung an den Wortlaut strenger, als es deutscher Übung bei innerstaatlichen Gesetzen entspricht. (...) Damit kann es sich bei Doppelbesteuerungsabkommen noch eher als nach innerstaatlichen Recht ergeben, dass eine den allgemeinen Auslegungsgrundsätzen entsprechende Auslegung des Abkommens im Hinblick auf eine von den Beteiligten bewusst gestaltete Rechtslage zu Ergebnissen führt, die dem Gerechtigkeitsziel des Abkommens deutlich wiedersprechen" (Vogel, *supra* n. 109, pp. 372-373).

vertragschliessenden Staaten; es soll deshalb hier als erstes der Fall betrachtet werden, dass einer der Vertragsstaaten durch oder bei der Umgestaltung seines innerstaatlichen Rechts seine Vertragsposition zu verbessern sucht. Das ist kein theoretischer Fall".[112]

Klaus Vogel describes the *Melford* (1982) decision as in some ways too radical and in others not sufficient[113] and uses, for the first time, the term "*unterlaufen*"[114] – later translated as "*dodging*" in the English version of the third edition of his book[115] – to refer to contracting states' actions that circumvent tax treaties. He further discusses the possible legal basis on which tax treaty dodging could be prohibited and how standards still need to be developed on this matter.

The German literature seemed particularly interested in the topic as in the following years other German authors brought it up in a similar way to Klaus Vogel. In this sense, Jörg Weigell clearly indicates the possibility of circumvention of tax treaties by contracting states through the design of domestic law and also compares these actions to taxpayer's artificial arrangements: "Staaten können – genau wie auch Steuerpflichtige – Abkommen umgehen. Während Steuerpflichtige durch bestimmte Gestaltungen einzelne Vorschriften umgehen können, können Staaten Gesetze schaffen, deren sachlicher Gehalt dem Abkommen nicht entspricht, obwohl diese Gesetze nach ihrem Wortlaut bestimmte Abkommenstatbestände und dadurch deren für die Staaten ungünstige Rechtsfolgen vermeiden".[116] He analyses the decision on *Melford* (1982) and arrives at a conclusion similar to the one expressed by John F. Avery Jones et al. in the sense that the Supreme Court of Canada had not based its decision on the "circumvention of the treaty by the contracting state" line of thought supported by literature and by the lower court decision in the case, but rather on the unilateral change of the scope of the treaty by domestic law amendment.[117]

Walter Leisner also identifies the problem when analysing the compatibility of CFC rules with tax treaties.[118] He concludes that the attribution of profits to the resident entity is clearly a circumvention of the treaty by legislators and that such legislative maneuver would give them liberty to run tax treaties in any desired direction and, as a result, the treaty outcome would always become unpredictable to treaty partners.[119]

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112 Vogel, *supra* n. 109, p. 375.
113 *Ibid.*
114 *Ibid.*
115 See further in this section, under *The 1990s*.
116 J. Weigell, *Das Verhältnis der Vorschrift des §2a EStG zu den Doppelbesteuerungsabkommen*, 33 Recht der Internationalen Wirtschaft: Betriebs-Berater International 2 (1987), pp. 122-140, at p. 126.
117 *Ibid.*, pp. 126-127.
118 W. Leisner, *Abkommensbruch durch Aussensteuerrecht? - Bilanz der Diskussion um die Novelle des Aussensteuergesetzes von 1992*, 39 Recht der Internationalen Wirtschaft: Betriebs-Berater International 12 (1993), pp. 1013-1020.
119 "Dies wäre eine eindeutige 'Abkommensumgehung' seitens des Gesetzgebers: Die DBA würden gegen ihren Primärsinn ausgelegt, die Doppelbesteuerung zu vermeiden. Durch einen derartigen gesetzgeberischen Etikettenschwindel – denn die 'Zugriffsbesteuerung' unterscheidet sich gerade nicht von der Besteuerung der Ausschüttungen – stünde es dem deutschen

The relationship between tax treaties and domestic law and the discussions on the ambulatory or static interpretation were also addressed in debates led by the International Fiscal Association. In a seminar held in Rio de Janeiro in 1989 during the 43th Congress, the topic "Tax Treaties and Domestic Legislation" was covered, but the focus of the discussion was on the hierarchy of treaties and domestic law and not much was said on the possibility of circumvention of the treaty by contracting states through domestic law. A more general comment was made by Lüthi in his report in the sense that a treaty may lose its substance by means of a change of the scope of a term in domestic law.[120] However, he does not seem to focus on the point made by few scholars like John F. Avery Jones on the *Melford* (1982) case, as he later refers to the redefinitions of terms by domestic law as treaty override.[121] The same link to treaty override is made by Volker L. Ludwigshafen[122] when analysing the core question of the decision of the Supreme Court of Canada. The reader will see in what follows that the observation of the phenomenon by some scholars from the perspective of treaty override continues through the following decades. The author wonders whether this oversight (in respect of the difference between treaty override and the effects of the ambulatory interpretation, as pointed by John F. Avery Jones) is due to the fact that the possible distinction between acts violating the wording of treaties and an indirect alternative as tax treaty dodging was not relevant in the context of the analysis made by those scholars, or if this may have been a consequence of their effective position in the sense that the mechanism applied by contracting states could not be qualified as a different subject but rather as a clear treaty override. The first view is supported by the fact that no direct counter-argument is normally presented by those scholars, whenever discussing topics like the *Melford* (1982) case, against the distinction made by the group represented by John F. Avery Jones. No matter what the reason is, this possible oversight may have been one of the elements that prevented the development of a systematic theory on tax treaty dodging as an autonomous and separate subject from treaty override.[123]

By the end of the 1980s, it is clear that, even on occasions where the discussions were motivated by specific topics like CFC legislation, some scholars started to analyse the problem herein studied from a more general perspective. This allowed a more systematic understanding of the phenomenon to the point that broader observations could be made, such as the one allowing the parallel between contracting states' and taxpayers' actions. However, not all studies followed this path and, despite the effort of scholars like Klaus Vogel, many continued to analyse the problem only in the context of narrower subjects, such as article 3(2). The *Melford* (1982) decision and the discussions that followed

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Steuergesetzgeber frei, DBA in jeder gewünschten Richtung beliebig und für den Vertragspartner völlig unvorhersehbar zu unterlaufen" (*Ibid.*, p. 1016).

[120] Lüthi, *supra* n. 27, p. 8.

[121] "Turning to the meaning of treaty law under domestic law, he [Lüthi] said that terms were often defined in the treaty itself; however, income streams, for example, could be recharacterised by domestic law subsequently to the treaty, and this constituted a treaty override" (J. B. Bracewell-Milnes, *Summary of the Proceedings of the Seminar "Tax Treaties and Domestic Legislation"*, Tax Treaties and Domestic Legislation – 14b Proceedings of a Seminar held in Rio de Janeiro in 1989 during the 43rd Congress of the International Fiscal Association (IFA) (Kluwer 1991), pp. 45-51, at p. 47).

[122] For instance, V. L. Ludgwigshafen, *The Overriding of Tax Treaties by National Legislation or: The Melford Case Revisited – a German View*, Intertax 1 (1987), pp. 4-8.

[123] See more on this in Chapter 4, Section 4.4.

also called attention to an important aspect of the analysis, which is the distinction between actions in direct violation of the treaty (i.e. violation of the text of the treaty) and actions having an effect similar effect but allowed by the text of these agreements. Nevertheless, this distinction was not always made in literature and the diverging views that emerged in the 1980s continue to follow a distinct path throughout the following decades.

The 1990s

It was about time for the OECD to start addressing the topic under discussion. Although only in regard to undefined terms, the OECD did acknowledge the possibility of tax treaty dodging in the commentary on article 3 of the 1992 OECD Model Convention: "the wording of the Article [3(2)] therefore allows the competent authorities some leeway" and that "a state should not be allowed to empty a convention of some of its substance by amending afterwards in its domestic law the scope of terms not defined".[124] The inclusion of new paragraphs in the commentary on article 3 in 1992 seemed to be a consequence of the discussion raised by the case *Melford* (1982) and subsequent literature. It also came as an official support to the ambulatory interpretation by the OECD. However, the new commentary was criticized by John F. Avery Jones when he again reminded in a new publication the danger of an unlimited ambulatory interpretation and how contracting states could rewrite the effect of tax treaties in their own favour by defining any type of income over which they have full right to tax.[125] He mentions that the 1992 commentary draws attention to the fact that the reference to internal law is subject to the context not otherwise requiring and that this result would become thus impossible. However, he considers this part of the commentary "unsatisfactory" or even worthy of a "prize for unhelpfulness to taxpayers" by telling them too little on the limits of the ambulatory interpretation, and that, instead, a more honest conclusion from the OECD should have been the one admitting that the limits of the ambulatory interpretation were in fact uncertain.[126]

On the other hand, the OECD seems to have understood the reasons behind the criticism made by some scholars, and especially by the International Tax Group in 1984, in the sense that the Supreme Court of Canada had wrongly treated a treaty dodging case as a treaty override. This can be concluded from the OECD Report on Treaty Overrides (OECD 1989),[127] where contracting states' actions qualified by the author as treaty dodging are referred to by the OECD as situations which should be distinguished from the treaty override addressed in the report, despite involving, or being similar to it, and having the same effect.[128]

[124] OECD *Model Tax Convention on Income and on Capital: Commentary on Article 3(3)* paras. 12-13 (1 September 1992), Models IBFD.

[125] J. F. Avery Jones, *The 1992 OECD Model Treaty: Article 3(2) of the OECD Model Convention and the Commentary to It: Treaty Interpretation*, 33 Eur. Taxn. 8 (IBFD 1993), Journals IBFD, pp. 252-257, at p. 253.

[126] *Ibid.*, pp. 253-254.

[127] OECD, *Report on Tax Treaty Overrides* (OECD 1989), International Organizations' Documentation IBFD.

[128] “At the outset, however, the kind of treaty override primarily addressed in this note should be distinguished from other situations, which either involve or are similar to treaty override and may have the same effects. Three of these situations

In the early 1990s, Michael Rigby presented a comprehensive study on tax treaties as a jurisdictional coordination mechanism,[129] where the phenomenon herein studied was presented as a subtle approach through which contracting states could produce the same effects as treaty override.[130] He first observes that states may adopt by design domestic legislation that "complies technically with treaty obligations but which effectively allows those obligations to be avoided".[131]. In this context, he analyses the decision on the *Melford* case (1982) and agrees with scholars in the sense that the decision confused the problems caused by the ambulatory interpretation and treaty override.[132] But Michael Rigby also contributed to the discussion in a way similar to Klaus Vogel and Charles I. Kingson, when he acknowledges the possibility of dodging in cases not necessarily related to undefined terms, such as in the case of the dividend withholding payment regime in New Zealand[133] and in cases where states set themselves up as treaty shopping conduits – which he refers to as "abuse by governments".[134] In general, he shows that tax treaties can be circumvented wherever they are flexible, which includes whenever "treaties do not prevent countries from changing their definitions of income" but also when they do not prevent states "from changing the rules governing the treatment of losses, or from introducing or removing tax incentives".[135]

At this time, Klaus Vogel published the third edition of his book.[136] This time he dedicates few more paragraphs to the subject and continues to draw a parallel between contracting states' and taxpayers' actions.[137] He also refers to the study made by Michael Rigby (above)[138] and no longer treats the subject under the topic "*Umgehung durch die Vertragsstaaten*" (avoidance or circumvention by contracting states), as in the previous editions, but under "*Verletzung der Zielsetzung von Doppelbesteuerungsabkommen* –

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are described below and comments are made on them either below or later in this note. a) (…) b) A State may change the definition of a term used in its domestic legislation which is also used in treaty provisions but which is not specifically defined for the purposes of the treaty. In this case there is no override where the treaty contains a provision essentially similar to that embodied in Article 3, paragraph 2, of the 1977 OECD Model Double Taxation Convention which provides that, as regards the application of a treaty by a Contracting State, any term not defined in the treaty shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the treaty applies. It cannot have been contemplated that, having once entered into a treaty, a State would be unable to change definitions of terms used in its domestic law provided such changes were compatible with the context of the treaty; c) (…)" (*Ibid.* para. 4).

[129] Rigby, *supra* n. 27.

[130] *Ibid.*, p. 385.

[131] Rigby, *supra* n. 27, p. 385.

[132] Rigby, *supra* n. 27, pp. 387-389.

[133] Rigby, *supra* n. 27, pp. 392-400. For more details, see Chapter 3, Section 3.3.1.2.

[134] Rigby, *supra* n. 27, pp. 421-424. For more details, see Chapter 3, Section 3.3.2.

[135] Rigby, *supra* n. 27, p. 386. For details, see Chapter 3.

[136] K. Vogel et al., *DBA Doppelbesteuerungsabkommen Kommentar* (Verlage C. H. Beck München, 1996).

[137] "Much as taxpayers arrange their legal relationships to decrease their taxable income or to even eliminate tax liability (i.e. they use tax planning), legislatures too, by appropriate formulation of new legislation are able to increase the benefits of existing tax treaties for their national coffers while decreasing the disadvantages. This practice does not happen every day, it is true. Not infrequently, though, legislation is enacted with at least a view towards existing tax treaties" (K. Vogel et al., *supra* n. 36, p. 65, marginal n. 125).

[138] Though he believes the conclusions of Rigby go too far.

'Unterlaufen' von Abkommen",[139] later translated as "*Infringing the objectives of Double Taxation Conventions – 'Treaty Dodging'*" in the English version of the book.[140] The fourth[141] and fifth[142] editions of his book follow this same line.

R. T. Bartlett also observes that in recent years "concern has been expressed about a worrying development whereby changes in the terms of a treaty have been made unilaterally through new tax legislation in the partner country".[143] Unfortunately, he, as many, only acknowledges the danger in regard to undefined terms. One interesting element of Bartlett's study is that, although he still relates the specific mechanism herein referred to as treaty dodging to treaty override, he realizes the special features of the dodging mechanism and decides to broaden the scope of treaty override in order to cover, as he said, a "multitude of occasions".[144] In this sense, he argues that treaty override situations would vary in a scale from, at the bottom, "unilateral modification by domestic law which was acceptable to the partner country but not in fact negotiated with it", through specific overrides, overrides which would not amount to a breach of treaty, and general treaty overrides breaching the treaty, the latter being placed at the top of the scale.[145] This approach to broaden the scope of treaty override to include situations presented in this study was again used, though in a more elaborated way, in 2013 by Carla de Pietro[146]. As the reader will read further in Chapter 4, the differentiation made by Barlett (i.e. that the mechanism of the practice under study is not the same as a direct breach of the treaty) is in the end what matters for the author's analysis, irrespective of naming it treaty override or not.

The subject was again not discussed by the International Fiscal Association during the 47th Congress held in Florence in 1993, where the topic "Interpretation of Double Taxation Conventions" was addressed. In the General Report, Klaus Vogel and Rainer Prokisch observe that the implied limitation is demanded by many national reporters in order to avoid the risk of changes in signed treaties due to amendments in domestic law and significant changes in case law[147]; however, the phenomenon of tax treaty dodging itself was not further addressed.

The 2000s and 2010s

During the last two decades, more concrete examples of tax treaty dodging cases outside the scope of CFC rules and undefined terms were observed in literature, such as exit taxes, tax credits and deduction

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[139] Vogel et al., *supra* n. 136, p. 161, marginal n. 125.

[140] Vogel et al., *supra* n. 36, p. 65, marginal n. 125.

[141] K. Vogel et al., *DBA Doppelbesteuerungsabkommen Kommentar* (Verlage C. H. Beck München, 2003), p. 180, marginal n. 188.

[142] K. Vogel et al., *DBA Doppelbesteuerungsabkommen Kommentar* (Verlage C. H. Beck München, 2008), p. 168, marginal n. 188.

[143] R. T. Bartlett, *The Making of Double Taxation Agreements*, British Tax Review 3-4 (1991), pp. 76-85, at p. 83.

[144] *Ibid.*, p. 84.

[145] Bartlett, *supra* n. 143, p. 84.

[146] See further in this section under "The 2000s and 2010s".

[147] Vogel & Prokisch, *supra* n. 19, p. 80.

of expenses. Further studies on the topic also identified the possibility of treaty dodging through actions not necessarily undertaken by legislatures. It seems that tax treaty dodging need not be limited to the use of domestic legislation, as so far understood, as practices other than the issuing of laws could equally comply with the wording but affect the application of tax treaties. The parallel between taxpayers' and contracting states' actions also becomes more evident during the 2000s and, as a result, some scholars start to refer to the topic as a type of "abuse" committed by contracting states. This allowed the analysis of the topic from a broader perspective and made its distinction from the traditional treaty override more obvious.

The first relevant discussion on the topic was during a seminar held in Munich at the 54th Congress of the International Fiscal Association in 2000, where the subject "Abusive Application of International Tax Agreements" was addressed. Under the topic "*Is abusive application of DTCs [double taxation conventions] by states possible?*". Lalithkumar Rao defends that contracting states can abuse tax treaties when the application is contrary to the purpose of the treaty. After explaining different types of abuse carried out by states, such as exit taxes,[148] he makes a parallel, in the same way as by Klaus Vogel, between taxpayers' and contracting states' actions[149] and concludes that "treaty abuse occurs when, despite adherence to the letter, there is a violation of the purpose of the treaty, either by the taxpayer, or by the state. Abuse engaged in by the taxpayer is done by adoption of artificial devices lacking substance. Abuse engaged in by the state can be either active or passive. Active abuse comprises passing legislation going counter to the purposes of the treaty, while not violating the letter. Passive abuse comprises issuing instructions that result in tacitly acquiescing in abuse by the taxpayer".[150] An interesting point is made by Lalithkumar Rao, when he indicates the possibility of an abuse by a contracting state through actions engaged in not by the legislative but by the executive power, such as in the case of circulars issued by authorities in Mauritius to facilitate taxpayers' treaty shopping practices.[151]

In this discussion, Michael Lang agrees that "states can deliberately so organize their domestic legislation that all tax rights granted them by a DTC are undermined", but concludes that "this is just as legitimate as when taxpayers organize their affairs with a view to the applicable treaty rules" and

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[148] For more detail on exit taxes as tax treaty dodging, see Chapter 3, Section 3.3.1.1.
[149] "To conclude, if the taxpayer, while strictly adhering to the form of the treaty, violates the substance by adoption of devices or artifices, this amounts to treaty abuse by taxpayer. This would generally happen when the reduction of tax liability was the primary purpose of the application, and any business purpose (if it all present) was insignificant. When the state subverts the very purpose of the treaty by passing domestic legislation that runs counter to that purpose, this amounts to active abuse of the treaty by the state. When the sate subverts the purpose of the treaty by issuing executive instructions that tacitly approve treaty abuse by the taxpayer, then such acquiescence amounts to passive abuse of the treaty by the state" (Comments by L. Rao in IFA, *supra* n. 55, pp. 22-23).
[150] *Ibid.*, p. 23.
[151] Comments by L. Rao in IFA, *supra* n. 55, p. 22. A similar type of dodging had been also identified by Michael Rigby, when he explained how states could abuse treaties by setting themselves up as treaty shopping conduits. For more details on this method, see Chapter 3, Section 3.3.2.

that interpretation could be used in both cases to combat such arrangements[152] - he would later repeat his thoughts in another publication under the topic "*Abuse of the Treaty by the Contracting States*".[153] On the other hand, during the discussions on the topic led by Lalithkumar Rao, Franz Wassermeyer disagrees with the idea of abuse by states and argues that the issue would rather be whether treaties safeguard against the specific measures undertaken by states; in case not, the issue of abuse would not arise.[154]

It is interesting to observe that Franz Wassermeyer takes a different approach on another occasion, when he expresses the opinion that CFC rules do not formally violate tax treaties but circumvent those agreements[155] just before presenting his general thought on the topic under "*Gesetzumgehung des Gesetzgebers*" (circumvention by legislatures).[156] Wassermeyer seems not to correlate the "abuse by states" subject discussed by Lalithkumar Rao in that seminar with the "circumvention by legislature" (*Gesetzumgehung des Gesetzgebers*) topic he himself raised in another publication.

While John F. Avery Jones continues to indicate that the commentary is not clear in determining the limits of the ambulatory interpretation and to present treaty override and changes in domestic law under article 3(2) as separate issues,[157] participants[158] of the seminar "Tax Treaties in the 21st Century" held in 2001 at the International Bureau of Fiscal Documentation (IBFD) in Amsterdam seemed concerned, when discussing the relationship between domestic tax systems and tax treaties, that "giving too much importance to the domestic law meaning of a treaty term might allow some countries to circumvent their treaty obligations".[159] However, they seem to link the issue to treaty override.[160]

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[152] Comments by M. Lang in IFA, *supra* n. 55, p. 24. For details on the role of interpretation for the assessment of tax treaty dodging as a possible illegitimate act, see Chapter 4, Section 4.2.1.

[153] Lang, *supra* n. 63, p. 57. He again refers to the possibility of circumvention of treaties by contracting states and that this issue must be resolved through the interpretation of the provision, such as it should be the case when the circumvention is done by taxpayers. He further makes the parallel: "Just as a taxpayer can arrange his affairs to be beyond the reach of a tax provision in order not to trigger a certain tax liability, so a contracting state can arrange its national law within the limits defined by the treaty so that the treaty does not prevent the state from imposing tax" (Lang, *supra* n. 63, p. 57).

[154] Comments by Wassermeyer in IFA, *supra* n. 55, p. 23.

[155] "Sie soll einmal den Schutz der DBA unterlaufen, der formell zugunsten der ausländischen Gesellschaft besteht und dort den steuerlichen Zugriff verhindert. (...) Da die DBA nur die im Ausland ansässige Gesellschaft, nicht aber den im Inland unbeschränkt steuerpflichtigen Anteilseignern Schutz bieten, scheinen die DBA-Bestimmungen zumindest formell nicht tangiert." (F. Wassermeyer, *Aussensteuerrecht Kommentar* (H. Flick, F. Wassermeyer & H. Baumhoff eds., Verlag Dr. Otto Schmidt 2003), §§ 7-14, marginal n. 3).

[156] *Ibid*., marginal n. 4.

[157] J. F. Avery Jones, *The Relationship between Domestic Tax Systems and Tax Treaties*, 56 Bull. Intl. Taxn. 6 (2002), Journals IBFD, pp. 268-270, at p. 270.

[158] Twenty-nine tax treaty experts participated in the seminar, including Hugh Ault, John Avery Jones, Patricia Brown, Robert Couzin, Maarten Ellis, Michael Lang, Guglielmo Maisto, Kees van Raad and Jacques Sasseville.

[159] B. J. Arnold, J. Sasseville & E. M. Zolt, *Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century*, 56 Bull. Intl. Taxn. 6 (2002), Journals IBFD, pp. 233-245, at p. 243.

[160] "The link with the treaty override issue was expressly made when one participant asked what principles should be used to distinguish between a treaty override and a legitimate reference to the domestic law of the source state" (*Ibid*., p. 243).

Peter Wattel and Otto Marres also observe the phenomenon when they detect the issue of whether article 3(2) of the OECD Model Convention in combination with the ambulatory interpretation would give contracting states the power to influence the treaty allocation of income by introducing posterior fictions in their domestic law.[161] They consider that "renegotiations of treaties (...) is preferable to the inelegant legislative makeshift on the basis of conceptually cumbersome fictions in domestic law aimed at one-sided influencing of treaty characterization and allocation" and also call the attention to the fact that "exit taxes usually have a legislative design that makes them escape from treaty rules altogether: they generally connect the design taxable event to a moment immediately prior to the emigration".[162] They conclude by suggesting the inclusion of specific provisions in the OECD Model Convention for fictitious income and urge for an official position from the OECD on exit taxes.

The United Nations (hereinafter referred to also as UN) also acknowledged the phenomenon – and in a more comprehensive way than ever done by the OECD – in the studies prepared by the "Subcommittee on Improper Use of Tax Treaties" (previously named "Subcommittee on Treaty Abuses and Treaty Shopping") of the Committee of Experts on International Cooperation in Tax Matters (previously named "Ad Hoc Group of Experts on International Cooperation in Tax Matters"[163]), under the coordination of Kyung Geun Lee.[164] The Subcommittee was created in 2005, after a pre-discussion of the topic in the 11th (and last) meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters in December 2003,[165] with the purpose of studying the issue

[161] P. Wattel & O. Marres, *Characterization of Fictitious Income under OECD-Patterned Tax Treaties*, 43 Eur. Taxn. 3 (2003), pp. 66-79. See also P. Wattel & O. Marres, *The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties*, 43 Eur. Taxn. 7/8 (2003), pp. 222-235.

[162] Ibid., (*Characterization of Fictitious Income Fictitious Income under OECD-Patterned Tax Treaties*), p. 79

[163] The Ad Hoc Group of Experts on International Cooperation in Tax Matters was renamed Committee of Experts on International Cooperation in Tax Matters in 2004. Amongst other tasks, the Committee is in charge of reviewing and updating the UN Model Convention and its commentaries. For further information on the Committee, see https://www.un.org/esa/ffd/ffd-follow-up/tax-committee.html (accessed 29 Nov. 2019).

[164] Members of the subcommittee were: Erwin Silitonga, Lara Yaffar, Le-Yin Zhang, Tizhong Liao (replacing Zhiyong Zhang in 2006), Francisco Alfredo Garcia Prats and Jacques Sasseville. See http://www.un.org/esa/ffd/tax/subcommittee/Treaties.htm (accessed 12 Sep. 2013).

[165] The issues of abuse of tax treaties and treaty shopping were discussed at the 11th meeting on the basis of a study prepared by Francisco Alfredo Garcia Prats (UN, *supra* n. 59). The issue of abuse of tax treaties had been discussed by the Ad Hoc Group on three previous occasions: (i) in the first meeting of the Ad Hoc Group in December 1981 (UN Ad Hoc Group of Experts on International Cooperation in Tax Matters, *Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters of its First Meeting* (United Nations 1984)), on the basis of a study prepared by N. M. Qureshi (UN Ad Hoc Group of Experts on International Cooperation in Tax Matters, *International Tax Evasion and Avoidance – Geneva 7-18 December 1981*, ST/SG/AC.8/L.33 (21 August 1981); (ii) in the second meeting of the Ad Hoc Group in 1983 (UN Ad Hoc Group of Experts on International Cooperation in Tax Matters, *Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters of its Second Meeting* (United Nations 1984)) which led to the formulation of the UN *Guidelines for International Cooperation ggainst the Evasion and Avoidance of Taxes (with Special Reference to Taxes on Income, Profits, Capital and Capital Gains)*, United Nations 1984; and (iii) in the fourth meeting of the Ad Hoc Group in 1987 (UN Ad Hoc Group of Experts on International Cooperation in Tax Matters, *Adoption of the Agenda – Geneva 30 November – 11 December 1987*, ST/SG/AC.8/L.49 (21 September 1987)), based on a report prepared by Maurice Collins (UN Ad Hoc Group of Experts on International Cooperation in Tax Matters, *Prevention of Abuse of Tax Treaties – Geneva 30 November - 11 December 1987*,

of improper use of treaties and proposing suitable methods to combat treaty abuses. Before its dissolution in 2008, the Subcommittee presented its final report[166] with the final proposals for a new text for the commentary on article 1 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (hereinafter UN Model Convention), which was finally agreed by written procedure in 2009.[167]

Although tax treaty dodging was not covered in the final report,[168] the first two versions prepared by the subcommittee in 2005[169] and 2006[170] did cover the subject. The 2005 version recognized that normally the term abuse is referred to situations in which taxpayers are seeking to circumvent the law, but that consideration should also be given to contracting states acting in a similar way.[171] The report indicates that abuse by taxpayers and abuse by contracting states should be distinguished in the framing of the rules used to determine the existence of abuse,[172] and even proposes, in the end, the inclusion in the commentary on article 1 of the UN Model Convention of a paragraph with an optional provision for states wishing to "prevent abuses of their conventions involving provisions introduced by a Contracting State after the signature of the Convention".[173]

ST/SG/AC.8/L.50 (26 June 1987)). Different from the study of Garcia Prats (see details further in this Section), these documents only cover the abusive practices (including those related to tax treaties) by taxpayers. A brief comment was made in the report prepared by Maurice Collins on anti-abusive legislation prepared by states as possible treaty override (Ad Hoc Group of Experts on International Cooperation in Tax Matters, *ibid* (26 June 1987), p. 10, para. 35).

[166] The final report of the subcommittee was presented to the Ad Hoc Group of Experts during the fourth and last session held from 20 to 24 October 2008, after inclusion of the changes proposed during the third session held from 29 October to 2 November the previous year. The final report (UN, *supra* n. 61 (17 October 2008)) is available at https://www.un.org/esa/ffd/wp-content/uploads/2014/10/4STM_EC18_2008_CRP2.pdf (accessed 29 Nov. 2019).

[167] P. Baker & T. Liao, *Improper Use of Tax Treaties: The New Commentary on Article 1 and the Amended Article 13(5)*, 66 Bull. Intl. Taxn. 11 (IBFD 2012), Journals IBFD.

[168] The final report actually refers to the topic only to indicate it was out of the scope of the study of the subcommittee, since it focused only on the improper use of tax treaties by taxpayers: "As was already noted in the previous version of this report, the subcommittee did not examine situations where one of the Contracting States makes changes to its domestic law for purposes of circumventing the intended effect of the provisions of a tax treaty or where a State, in order to attract certain taxpayers or activities, introduces preferential regimes that give unintended treaty benefits (...). These two situations have sometimes been referred to as "treaty abuse by a State" but the first issue is also related to the issue of treaty overrides. The subcommittee considered that these issues were outside the mandate that was given to it by the Committee since they did not relate to the improper use of tax treaties by taxpayers" (UN, *supra* n. 61 (17 October 2008), para. 6).

[169] UN, *supra* n. 61 (15 November 2005), p. 11, para. 20 and p. 17.

[170] UN, *supra* n. 61 (16 October 2006), para. 10-17.

[171] UN, *supra* n. 61 (15 November 2005), p. 11, para. 20.

[172] *Ibid.*

[173] The proposed paragraph says: "States may wish to prevent abuses of their conventions involving provisions introduced by a Contracting State after the signature of the Convention. The following provision aims to protect a Contracting State from having to give treaty benefits with respect to income benefiting from a special regime for certain offshore income introduced after the signature of the treaty: 'The benefits of Articles 6 to 22 of this Convention shall not accrue to persons entitled to any special tax benefit under: a) a law of either one of the States which has been identified in an Exchange of

The 2006 version of the report treats the subject in more detail to the point that a full section is dedicated to it under the title "Abuse by One of the Contracting States".[174] The section defines abuse of a tax treaty by a contracting state as being "a situation where one of the Contracting States, through the subsequent exercise of its domestic power of taxation, modifies the obligations previously assumed by that State towards the other State and upsets the balance in the division of taxing powers expressed in the tax treaty concluded between these States". It further presents different types of abuses, such as in the case of a state introducing a 1% tax creditable against the registration fees of companies for the sole purpose of allowing them to qualify as resident for treaty purposes,[175] or in the case where a state defines shares as immovable property in order to tax it without any limit under the respective treaty article.[176] On the top of abuse through domestic law, and similar to the ideas previously expressed by Michael Rigby and Lalithkumar Rao, the report also refers to administrative practices of contracting states permitting the disregard of the object and purpose of the treaty by defining the conditions for treaty access by persons who were not originally intended to benefit from it.[177] Most of the content of the report is based on a report prepared by Francisco Alfredo Garcia Prats[178] in 2003 for the 11th meeting of the Ad Hoc Group of Experts on international Cooperation in Tax Matters in 2003,[179] which ideas were later published in 2010 as a paper addressing abuse of tax law, including abuse of tax treaties by contracting states.[180]

The 2006 version of the report prepared by the subcommittee continues by proposing steps to be followed by the offended state[181] and concludes by recommending that another subcommittee be set up with a view to develop mechanism for the verification of the abuse by states and the determination of proper measures to counter such abuse.[182] However, not only does the proposed subcommittee seem never to have been created, but also the subject of abuse of tax treaties by contracting states was in fact dropped by the subcommittee as from the third version of the report in 2007, since it was considered that "this issue was outside the mandate that was given to it by the Committee as it did not relate to the improper use of tax treaties by taxpayers".[183] The decision of the subcommittee seems to

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Notes between States; or b) any substantially similar law subsequently enacted' [para. 21.5.]'" (UN, *supra* n. 61 (15 November 2005), p. 17). See more on this and other proposals in Chapter 6.

[174] UN, *supra* n. 61 (16 October 2006), p. 6.

[175] For more details on treaty dodging through the use of taxes, see Chapter 3, Section 3.3.1.1.

[176] For more details on treaty dodging cases involving domestic definitions of immovable property, see Chapter 3, Section 3.3.1.2.

[177] UN, *supra* n. 61 (16 October 2006), p. 6.

[178] Francisco Alfredo Garcia Prats has been involved in the 2001 update and elaboration of the United Nations Model Convention as observer and adviser of the UN Ad Hoc Group of Experts on International Cooperation in Tax Matters from 1995 until 2008.

[179] UN, *supra* n. 59.

[180] Garcia Prats, *supra* n. 55, pp. 21-23. See also *supra* n. 165.

[181] The proposed steps are: to ask for explanations from the abusing state, to start a dispute settlement procedure and to apply unilateral measures against the improper application of the treaty. For more details on these steps, see Chapter 5.

[182] UN, *supra* n. 61 (16 October 2006), para. 16-17.

[183] UN, *supra* n. 61 (22 October 2007), p. 4, para. 9. See also *supra* n. 168.

have been adequate not only from a formal perspective – as the subject was outside the mandate -, but also in the sense that, although equivalent, the two methods (i.e. abuse by taxpayer and abuse by contracting states) do require a different type of analysis, as briefly indicated in section 2.2.2. But this did not prevent the subcommittee from recognizing the relevance of the topic and from suggesting further study on the matter by another committee, which was not followed up by the United Nations.

By this point in time, the topic seems to be acknowledged by a larger number of scholars. In a study on good faith in the application and interpretation of tax treaties, Edwin van der Bruggen covers the topic when he discusses good faith when the operation of the treaty is conditioned by the rules of domestic law.[184] In this study, he considers it obvious that contracting states may use domestic laws or regulations, intentionally or not, to escape international obligations[185] and observes that "the system of referral to domestic law for treaty interpretation and application makes double taxation conventions vulnerable to unilateral intentional dodging and unintentional hollowing out of treaty obligations by the contracting states"[186]. He considers good faith a tool precluding a "contracting state from enacting legislation in view of rendering the treaty in fact inoperative even though the domestic legislation is not literally and directly contrary to the treaty",[187] since not only treaty override would be against this principle, but also "less explicit state measures".[188] He observes dodging practices not only in relation to domestic anti-avoidance rules, but also in respect of domestic legislation covering foreign tax credits and head office expenses.[189]

In 2004, Frank Engelen treats the subject under the topic "later changes in domestic law",[190] where he recognizes that a state making the treaty partially inoperative by amending afterwards in its legislation the scope of terms not defined in the convention would constitute an abuse of rights also limited by the principle of good faith.[191] He further analyses related cases decided by the Dutch Supreme Court.[192] He devotes more attention to the topic in another study published in 2006,[193] where the application of good faith in Dutch treaty case law reveals further treaty dodging cases in the Netherlands.[194]

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[184] van der Bruggen, *supra* n 55.
[185] van der Bruggen, *supra* n 55, p. 39.
[186] *Ibid.*
[187] van der Bruggen, *supra* n 55, pp. 50-51.
[188] van der Bruggen, *supra* n 55, p. 52.
[189] van der Bruggen, *supra* n 55, pp. 52-54 and pp. 60-62.
[190] Engelen, *supra* n. 55, pp. 489-502.
[191] Engelen, *supra* n. 55, p. 490.
[192] Engelen, *supra* n. 55.
[193] F. Engelen, *On Value and Norms. The Principle of Good Faith in the Law of Treaties and the Law of Tax Treaties in Particular* (Kluwer 2006).
[194] *Ibid.*, pp. 17-33. For more details on and analysis of the cases, see Chapter 3.

Jan Wouters and Maarten Vidal,[195] Anthony C. Infanti,[196] Augusto Fantozzi,[197] Maarten J. Ellis,[198] Nicolas Message[199] and, again, John Avery Jones[200] also acknowledged tax treaty dodging practices in a publication edited by Guglielmo Maisto in 2006.[201] In the same direction, Luc de observes the phenomenon during the analysis of the limitations to the ambulatory interpretation and of the

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[195] "(...) if a State abuses its discretion to develop a proper domestic terminology for tax purposes, and artificially construes the terms of a treaty with the aim or the effect of seriously altering the equitable distribution of tax revenue, it fails to carry out the treaty in good faith. There should not be a blind preference over domestic-law-oriented interpretation, but a balanced choice in each individual case, based on the paramount principle of good faith. (...) Vogel (...) draws an interesting parallel between this type of abuse of the principle of ambulatory interpretation - which he calls 'treaty dodging' - with the non-recognition under national law of artificial arrangements obviously motivated only by tax considerations" (J. Wouters & M. Vidal, *supra* n. 50, at pp. 16-18).

[196] "A legislative treaty override occurs when Congress enacts a law that is intended 'to have effects in clear contradiction to international treaty obligations'. In contrast, where the treaty itself authorizes Congress to alter the application of the treaty, legislation enacted within the scope of that authority will in no sense be overriding a treaty. For example, although some terms used in tax treaties are specifically defined in the text of the treaty, many other terms are left undefined" (Infanti, *supra* n. 33, p. 361).

[197] He seems to acknowledge the difference between tax treaty dodging and treaty override during the discussions at the roundtable, especially after the comments made by John Avery Jones and Maarten J. Ellis (see *supra* n. 28). Augusto Fantozzi concludes: "(...) it appears from the discussions during the seminar that there is a difference between 'treaty override' and 'interpretation', or, even better, between 'treaty override' and 'overcoming treaty override through interpretation'" (Comments by A. Fantozzi in B. J. Arnold & al., *supra* n. 28, pp. 403-404).

[198] "In the Dutch experience we have attempts of what I call 'backdoor' overrides; we cannot do this by the front door because we are a monist country. The first is, in my view, the use of Art. 3(2) of the OECD Model Convention: introducing definitions, re-characterization, fictions, etc. into domestic law - and hope that these will work through into the treaties. (...) The second possibility is to extend (or stretch) your anti-abuse provisions in such a way that you can introduce anti-abuse rules to mitigate the undesirable effects of the treaty. And the third opportunity – which is exceptionally important - is the use of deemed realization, shifting the timing of recognition of income to a time when the taxpayer is resident in your country so you can tax him. I am referring particularly to exit taxes" (Comments by M. J. Ellis in B. J. Arnold & al., *supra* n. 28, p. 394).

[199] "(...) the Conseil d'Etat asked that when a dispute relating to a tax treaty is submitted to it, the judge must first examine domestic law to determine whether taxation was legally established (...). The importance of this decision appears to be in the field of the characterization and definition of income. The characterization of an income is derived first from domestic law and the reconciliation of this definition with treaty provisions is only made "if necessary" (...). However, pushing this reasoning to its limits would make tax treaties become devoid of meaning by leaving a clear field to domestic law, which could modify the solutions by correcting its own characterizations and definitions" (N. Message, *France*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, pp. 218-219).

[200] "The limit to changes in internal law that affect the treaty is important to states' acceptance of the merits of the reference to internal law in Art. 3(2). The commentary seems to find that everything is for the best without explaining the limits to the leeway given to States in changing internal law. (...) It should be noted that this issue is unrelated to treaty override. Here the treaty contemplates changes in internal law and so such changes are not an override but are in accordance with the treaty. (...) With override the change in law breaches the treaty, which is the opposite" (Avery Jones, *supra* n. 55, p. 133). "I do not regard Art. 3(2) as connected in any way with treaty override, because if Art. 3(2) says it's the internal law as from time to time in force, you're giving effect to the treaty when internal law changes, up to, of course, the point where internal law changes too far. (...) Therefore article 3(2) and treaty override are entirely different subjects" (Comments by J. F. Avery Jones in B. J. Arnold & al., *supra* n. 28, pp. 395-396).

[201] G. Maisto, *Tax Treaties and Domestic Law,* EC and International Law Series (IBFD 2006).

relationship between article 3(2) of the OECD Model Convention and domestic anti-avoidance rules in his book published in 2008.[202] He observes that "the fact that a treaty permits an interpretation of undefined terms in accordance with domestic law of the State applying the treaty carries the inherent danger that a State could make the treaty partially inoperative by subsequently amending its domestic laws (in casu the scope of the undefined treaty terms) in such a way that it distorts the treaty equilibrium. A state could manipulate the effect of a treaty in its own favor by defining in its domestic law any type of income over which it has full (or limited) taxing rights under the treaty, but that is undefined by the treaty. In defining such types of income subsequent to entering into the treaty this State could recover taxing rights over items of income which the treaty has allocated to the other State and upset the treaty bargain and balance".[203] He further presents cases judged by the Belgian and Dutch Supreme Court where Belgium and the Netherlands, after having entered into a treaty, changed their domestic law with a view to recover taxing rights over items of income that were taxable in the other contracting state according to the treaty.[204]

Sergio André Rocha also seems to understand the rationale of tax treaty dodging when he analyses Brazilian cases that he qualifies as "interpretative override".[205] He also makes an interesting remark in the sense that not only these attempts could be made by tax authorities – as also noted by Michael Rigby and Lalithkumar Rao (see above) – but also that they could be executed by means of interpretation – therefore, not necessarily through the issuing of circulars. In this regard, his approach fits the general idea of dodging through "administrative practices" proposed by the UN Committee of Experts and by Francisco Alfredo Garcia Prats (see above). Sergio André Rocha further indicates that it is possible that "state organs of application (...) interpret the provisions of the DTC [double taxation convention] in a manner evidently beyond the limits of its textual framework".[206] He makes readers aware that "we are not dealing here with mere hermeneutic conflicts, but with a manipulation of the interpretative process in such a way as to create a legal rule that evidently cannot be extracted from the treaty" and concludes that "(...) Brazilian tax authorities tried to bypass obligations undertaken in DTCs [double taxation conventions]".[207] Although Sergio André Rocha does not present the topic as tax treaty dodging nor as an ambulatory issue, it is clear that his observations on the Brazilian attempts follow the same line of thought.

The International Fiscal Association had initially provided two opportunities where the topic of tax treaty dodging could have been addressed: during the 64th Congress of the International Fiscal Association in Rome, in 2010, under the subject "Tax Treaties and Tax Avoidance: Application of Anti-avoidance Provisions", and during the 66th Congress of the International Fiscal Association in

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[202] Broe, *supra* n. 55, pp. 272-290.

[203] *Ibid.*, p. 272.

[204] Broe, *supra* n. 55, pp. 279-283. For details on the cases, see Chapter 3.

[205] S. A. Rocha, *Interpretation of Double Taxation Conventions – General Theory and Brazilian Perspective* (Kluwer Law International 2009), p. 161. For more details on the cases, see Chapter 3, Section 3.3.2.

[206] *Ibid.*

[207] For the Brazilian cases, see Chapter 3, Sections 3.3.1.1. and 3.3.2.

Boston, in 2012, at the seminar "Article 3(2) and the Scope of Domestic Law". However, despite the efforts made in the past decades by scholars like Klaus Vogel and John F. Avery Jones to separate the two subjects, on both occasions treaty dodging cases were analysed from the perspective of treaty override.[208] For example, the panel members at the seminar "Article 3(2) and the Scope of Domestic Law" in Boston addressed the ambulatory interpretation issue without taking into account the points made by several scholars in the past regarding the leading case on the topic, the *Melford* (1982) case, since they refer to the many solutions proposed for the ambulatory interpretation issue as being solutions to treaty.[209] The subject seems to have been analysed from the same perspective by Frank Engelen (chair of the seminar) and Anna Gunn (panel member) in a paper featuring this seminar session, published few months earlier[210]. It is interesting to notice that, as was also the case for Franz Wassermeyer (see *The 2000s and 2010s*), Frank Engelen does not seem, in the author's opinion, to treat treaty dodging as treaty override in his previous book,[211] as he does not refer to "override" in any of the 14 pages dedicated to the topic. Quite the opposite, he indicates that the use of article 3(2) to change the allocation of taxing rights would "constitute an abuse of rig*ht*".[212] However, as previously indicated (see *The 1980s*), this may have been a consequence not of contradicting positions but of the fact that any possible distinction between the two concepts was simply not relevant in the context of those discussions.

More recently, the IFA Congress in London in 2019 gave more attention to the topic under the seminar "Unilateral Treaty Override", where the interaction between domestic anti-abuse provisions

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[208] According to a report written by Frans Vanistendael on the discussions held in the plenary session "Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions in Rome", in 2010, when CFC is deemed dividend income, "this may be a treaty override but is permissible (RA 2008 ref. 24, Sweden in a ruling decision)". In addition, it was reported that the question of whether domestic fictions introduced by France should be followed by the treaty was raised, because, according to the discussions, "treaty overrides are illegal under the French Constitution". Reference was made to "treaty abuse by State" only as a topic that was excluded by the UN in the context of the commentary on article 1 of the UN Model Convention (F. Vanistendael, *IFA 64th Congress in Rome – Subject I: Plenary Session – Tax treaties and tax avoidance: application of anti-avoidance provisions* (30 August 2010), News IBFD). See also S. van Weeghel*, Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions – General Report*, 95a IFA Cahiers de Droit Fiscal International (IFA 2010), p. 28. In the seminar "Article 3(2) and the Scope of Domestic law" held in Boston in 2012, the changes in domestic law regarding undefined terms, deemed provisions and anti-abuse rules were addressed, but, contrary to the points made by several scholars in the past in relation to the *Melford* (1982) case, they were treated as treaty override cases.

[209] "Goradia mentioned that the risks of using that provision [art. 3(2)] in association with domestic unilateral instruments (as technical explanations). For those cases, a statutory delimitation would be advisable to avoid cases of treaty override. Matteotti stressed that article 3(2) can be dangerous if used in combination with deemed provisions or other anti-abuse rules which conflict with the ordinary meaning and lead to treaty override. The context and the good faith principle could be used to prevent those cases of treaty override" (J. F. Nogueira, *IFA 66th Congress in Boston - Seminar D: Article 3(2) and the Scope of Domestic Law* (3 October 2012), News IBFD).

[210] "Can the meaning of treaty terms be changed simply by changing their domestic law meaning? If not, how can we distinguish between a prohibited 'treaty override' and other changes of domestic law which are allowed to affect the meaning on undefined terms?" (F. Engelen & A. Gunn, *Article 3(2) of the OECD Model Tax Convention and the Scope of Domestic Law*, 66 Bull. Intl. Taxn. 9 (IBFD 2012), Journals IBFD).

[211] Engelen, *supra* n. 55.

[212] Engelen, *supra* n. 55, p. 494.

and tax treaties and the possible treaty override by unilateral measures addressing the digitalized economy were discussed.[213] In addition, the OECD also acknowledged the impact on the application of treaties caused by domestic law (specifically in respect of domestic anti-abuse rules), in Action 6 of the Base Erosion and Profit Shifting Project (BEPS Project), and reflected it in the commentary on article 1 of the OECD Model Convention (2017): "(...) many provisions of the Convention depend on the application of domestic law. (...) More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the Convention. In many cases, therefore, the application of specific anti-abuse rules found in domestic law will have an impact on how the treaty provisions are applied rather than produce conflicting results".[214]

What now?

The observation of the phenomenon of tax treaty dodging in literature evolves in an inconsistent and uncoordinated way. While some scholars only bring up the topic as a side subject when discussing narrower matters, others try to call attention to the fact that this would be a more complex and general mechanism that could be put into practice in innumerable different ways. Some treat it as a separate subject from treaty override, while others address it as such. It seems that, in most cases, this non coordination is not necessarily a consequence of misunderstandings or unawareness of essential points made by scholars like John F. Avery Jones, but rather a natural result of the different contexts on which individual analysis were built or of the particular elements they focused on.

The relevant point for the purpose of this study is that, although fundamental (but contextually justified) discrepancies may have not negatively impacted the individual analysis and conclusions made by scholars in regard to their particular aims, they have driven the underlining idea as perceived by the author and some scholars towards different or even opposite directions and may have obstructed the development of a systematic understanding of the phenomenon in literature.

The lack of a consistent view has the effect of immersing the topic in a vast grey area where questions related to the most fundamental aspects of the phenomenon are left unanswered. What are the basic elements of tax treaty dodging? Can it be qualified as treaty override? Does this qualification matter? In which ways contracting states do dodge tax treaties? Is it limited only to the issuing of domestic law by legislatures, or are other instruments, such as circulars and instructions, able play the same role? Does it include general administrative practices and can it be executed purely on the basis of interpretation? Can the executive or judicial power can dodge tax treaty obligations? Can tax treaty dodging be qualified as a breach of treaty, or, even, is it to be legally condemned at all? If yes, to which

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[213] IFA, *Unilateral Treaty Override*, Report – Summary of Proceedings, London Congress 2019 (IFA). On the creation redesign and creation of taxes as amethod of tax treaty dodging, see Chapter 3, Section 3.3.1.1.

[214] OECD/G20 *Base Erosion and Profit Shifting Project, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6: 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD, p. 83; *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 73 (21 November 2017), Models IBFD.

extent and on which basis? Are there ways to avoid or reduce this problem, and are they effective? Are there better ways to address this issue? It seems that, after 60 years of discussions, tax treaty dodging remains an intriguing and unexplored subject.

2.4. Why labelling the phenomenon and why labelling it "improper use of tax treaties by contracting states: tax treaty dodging"

The behaviour of contracting states observed in this chapter follows a certain pattern, which is the one of impacting the effects of tax treaties through actions (or omissions) complying with the wording of these agreements. The fact that these actions (or omissions) follow a pattern allows them to be grouped as a phenomenon under a specific label. Labelling a phenomenon has the advantage of allowing its immediate identification in a discussion without the need to refer back to its initial description.

Few attempts were made in literature in this regard, but in most cases expressions were used randomly and in an inconsistent way. While some scholars referred to these actions by using expressions always in connection to the term "abuse" (e.g. "abuse by the state",[215] "abuse by one of the contracting states",[216] "abuse of the treaty by the contracting states",[217] "abuse by governments"[218]), others addressed it as "treaty evasion",[219] "backdoor overrides",[220] or simply as "treaty override".[221] More elaborated expressions were also used, such as "overcoming treaty override through interpretation"[222] or "interpretative override"[223] and expressions as "*Umgehung durch die Vertragsstaaten*",[224] or "avoidance by the contracting state",[225] and "*Gesetzumgehung des Gesetzgebers*"[226] (circumvention by legislatures) also appeared in German literature in connection to the phenomenon herein presented. The German

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[215] Expression used by L. Rao in IFA, *supra* n. 55, p. 21. For more details, see Section 2.3.

[216] Expression used in various documents of the UN Committee Of Experts on International Tax Matters, as indicated in Section 2.3., and by Francisco Alfredo Garcia Prats (Garcia Prats, *supra* n. 55, p. 74). For more details, see Section 2.3.

[217] Expression used by Michael Lang (M. Lang, *supra* n. 63, p. 57). For more details, see Section 2.3.

[218] Expression used by Michael Rigby in Rigby, *supra* n. 27, p. 421. For more details, see Section 2.3.

[219] Expression used by the Dutch Council of State in its official report to refer to a dodging provision introduced in the Netherlands (Comments by M. J. Ellis in B. J. Arnold & al., *supra* n. 28, p. 395).

[220] Expression used by Maarten. J. Ellis in B. J. Arnold & al., *supra* n. 28, p. 394. For more details, see Sections 2.2.1. and 2.3.

[221] Expression used by different scholars throughout the decades. For more details, see Section 2.3. and Chapter 3.

[222] Expression used by Augusto Fantozzi in B. J. Arnold & al., *supra* n. 28, p. 404). For more details, see Section 2.3.

[223] Expression used by Sergio André Rocha in Rocha, *supra* n. 205, p. 161. For more details, see Section 2.3.

[224] German expression used by Vogel et al. in the German versions of the first and second editions of Vogel's book, later translated as "avoidance by the contracting state" (K. Vogel et al., *supra* n. 89, p. 43, marginal n. 75; K. Vogel et al., *supra n.* 90 (1990), p. 65, marginal n. 125). For more details, see Section 2.3.

[225] Expression used by Klaus Vogel et al. (K. Vogel et al., *supra* n. 90 (1991), p. 57, marginal n. 125). For more details, see Section 2.3.

[226] Expression used by Wassermeyer in Wassermeyer, *supra* n. 155, marginal n. 4. For more details, see Section 2.3.

expression "*Unterlaufen*" or "*Unterlaufen von Abkommen",* later translated as "Treaty Dodging"[227], was first used by Klaus Vogel in an article published in 1985[228] and later repeated in the third and following editions of his book.[229]

The result of such a variety of terms being randomly used is that no expression was sufficiently and consistently repeated in literature to the point of becoming an "official designation" of the phenomenon. While the simple reference to expressions like "tax avoidance" or "treaty shopping" is able to immediately connect one's mind to the related concepts without much effort, none of the expressions listed in the previous paragraph is able to lead one's thoughts to the subject herein presented without the need for, at least, a general description of the phenomenon or rationale behind.

But the lack of a label for the phenomenon is not only a consequence of a wide variety of expressions being randomly used in literature. It is also due to the fact that the concept itself has never been developed in a coherent manner in the first place, as demonstrated in Section 2.3. Because scholars addressed the topic from different, and sometimes from conflicting perspectives, the harmonization of expressions used became even more difficult. The challenge to build up a more consistent concept and systematic understanding of tax treaty dodging is taken up by the author in the following chapters of this thesis. It may be the case that limiting references of the phenomenon to a single uniform expression may also contribute to the development of the theory in a more consistent and coherent way in the future. For this, the author decided to choose the English expression "tax treaty dodging" as the only label to be referred to when dealing with the phenomenon throughout this study.

The author considers Klaus Vogel's "tax treaty dodging" the most suitable expression for the phenomenon, as the basic elements of the theory developed in this thesis are in line with most of the ideas he defended on the subject, as the reader will see in the following chapters.

Likewise, the author also finds the expression "improper use of tax treaties" suitable (as a general reference as compared to "tax treaty dodging") provided that it is followed by the indication that it is performed "by contracting states", since the expression alone is already commonly understood in practice as being actions performed by taxpayers. The improper use of tax treaties (by taxpayers) has been widely addressed in literature and by courts worldwide. However, a precise definition of the expression is not yet unanimous for it is dependent on what the "proper" use of tax treaties means. The author agrees with Stef van Weeghel in the reasoning that "proper" use of tax treaties by taxpayers

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[227] The first translation of the term appeared in the English version of the third edition of Klaus Vogel et al.'s book (Vogel et al., *supra* n. 36, p. 65, marginal n. 125). See also reference to the expression in Wouters & Vidal, *supra* n. 50, p. 18. For more details, see Section 2.3.

[228] "*Unterlaufen*" (Vogel, *supra* n. 109, p. 375). The term "*unterlaufen"* was also used by Walter Leisner (Leisner, *supra* n. 118, p. 1016). For more details, see Section 2.3.

[229] "*Unterlaufen von Abkommen"* (Vogel et al., *supra* 136, p. 161, marginal n. 125; Vogel et al., *supra* n. 141, p. 180, marginal n. 188; Vogel et al., *supra* n. 142, p. 168, marginal n. 188). For more details, see Section 2.3.

can be understood as actions that are in accordance with or not contrary to the purpose of treaties.[230] Under this approach, "a taxpayer who violates the purpose of the treaty or who does not use that treaty in accordance with expectations of the contracting states makes improper use of that treaty".[231] In this same direction, Francisco Alfredo Garcia Prats indicates that the abuse of treaties "can be contrasted with the straightforward and correct use of a treaty. Treaty abuse implies, then, an "incorrect" use of a treaty, without, however, necessarily involving an illegal act or a formal breach of the treaty. Hence, it is sometimes referred to instead as "improper use" of a treaty. The reference to the improper use of a treaty implies a use of the treaty that is contrary to its spirit, object and purpose".[232] The problem is that, to date, the (object and) purpose of treaties is still a matter of discussion,[233] what consequently prevents a consensus on the (precise) definition of "improper use of tax treaties" by taxpayers. The same obstacle exists for the use of the expression in this thesis, that is, for contracting states; and in this sense, the author agrees that the delimitation of "improper" on the basis of what the purpose of tax treaties is is also essential for defining "improper use of tax treaties by contracting states". Despite this, the fact that improper use of a treaty generally implies a treaty being used in a way contrary to its spirit, object and purpose, makes it a suitable (despite not entirely precise) expression for the phenomenon herein study. In fact, the same applies to "tax treaty dodging", as this expression is not unanimous and precisely defined to this date. In this respect, the author believes that the assessment of legal limitations to contracting states actions (including the object and purpose of tax treaties) presented in Chapter 4 of this thesis may help developing a more precise understanding and delimitation of the "improper use of tax treaties by contracting states" and "tax treaty dodging", which is actually one of the main purposes of this study (i.e. drawing a clearer dividing line between what is considered a legitimate exercise of rights and what is regarded as an illegitimate[234] practice of contracting states, as indicated in Chapter 1).

Finally, the author also considers convenient the fact that both expressions do not include the term "override" or "abuse". These absences bring the advantage of disconnecting the subject to the direct breach of treaty normally implied by the concept of treaty override and disconnecting it to the not yet harmonized and still inconveniently blurred concept of abuse. Although the "improper use of tax treaties by contracting states" is an expression the author considers suitable for the practice object of this study, for practical reasons, the author will refer to this phenomenon throughout this thesis as simply "tax treaty dodging".

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[230] "The difficulty starts if the acts of the taxpayers are in compliance with the provisions of the treaty and the domestic laws of the contracting states, but the result does not square with the purpose of the treaty or with the intentions of the contracting state. In this sense, correctness and living up to a required standard by taxpayer might be translated as acting in accordance with or not contrary to the purpose of the treaty, living up to the intentions of the contracting states" (S. van Weeghel, *The Improper Use of Tax Treaties: with particular reference to the Netherlands and the United States* (Kluwer Law International 1998, p. 97).

[231] *Ibid.*

[232] Garcia Prats, *supra* n. 55, p. 72

[233] See more on this in Chapter 4, Section 4.3.1.

[234] See *supra* n. 1 and 2.

2.5. Concluding remarks

In this chapter, the reader was presented to the phenomenon of tax treaty dodging as a subtle backdoor alternative through which contracting states interfere in the performance of tax treaties. In order to avoid the downsides of a direct override of the treaty, or whenever this option is not available within the national system, states can resort to a mechanism already known to taxpayers, which is the one of creating a new and more favourable treaty outcome through actions (or omissions) that comply with the wording of tax treaties. Contracting states are thus able to avoid undesirable treaty consequences and create new favourable treaty situations such as they would have in the case of direct override, but without a violation of the wording of treaty provisions.

From the development of literature throughout the decades, it is clear that, although the phenomenon of tax treaty dodging has been acknowledged by many scholars, it is far from being a clear and uniform concept. As its observation is not always made from the same perspective, but according to a particular context or intended purpose, important aspects raised by some scholars – and essential for the present study – seem to have attracted little attention. As a result, the development of the concept has occurred amid uncertainty and fundamental questions related to the topic remain unanswered.

As indicated in Chapter 1, this study seeks to develop a coherent and systematic understanding of tax treaty dodging by clarifying important aspects and assessing the extent of its illegitimacy[235], if any. The first phase of the study, which has started in this Chapter 2, continues to be executed in Chapter 3 with the presentation of the first part of the analysis on how tax treaty dodging operates. For that, Chapter 3 will first detect the conditions of the phenomenon by observing the scenarios where tax treaty dodging is possible. From the possible ways the jurisdictional competence of a state can be exercised (i.e. through acts of legislative, executive and judicial branches), the author will derive, using a deductive methodology, the possible types of tax treaty dodging. Further, from observing how these competences can be exercised in practice in the context of tax treaties, the author will derive the different methods of tax treaty dodging, this time on the basis of an inductive methodology.

[235] *Ibid.*

Chapter 3 - A Phenomenology: the Functioning of Tax Treaty Dodging

3.1. Introduction

This chapter continues the factual-analysis stage of the study, which is necessary for the general understanding of the phenomenon, by observing how tax treaty dodging operates in practice and by trying to categorize the phenomenon into different types and methods. For that, the author first identifies the conditions necessary for a scenario where contracting states become able to dodge tax treaties (Section 3.2.). The reader will see how the tax treaty gaps together with the ambulatory interpretation reveals to be a combination that may open doors to dodging practices. Contracting states exercising sovereign rights through actions performed (or omissions) after the signature of treaties and within the treaty gap areas may do it in such a manner as to impact the outcome of these agreements.

By observing scenarios meeting these conditions, the author delimitates the scope of the study in order to identify therein the different ways in which tax treaty dodging may be exercised. These different ways are initially categorized, under a deductive methodology, as the different *types* of tax treaty dodging on the basis of the authorities competent to exercise the jurisdictional competence of a state in the context of tax treaties. Further, by observing different areas of relative freedom to act and mechanisms used by contracting states in cases of potential tax treaty dodging identified by this study, the author further categorizes, under an inductive methodology, the practice into different *methods* of tax treaty dodging, grouped according to their common elements (Section 3.3.).

Finally, the chapter concludes by revealing the effects of tax treaty dodging, how this practice may have an impact on the allocation of taxing rights between states and how taxpayers may also suffer the consequences by supporting the burden of international double taxation (Section 3.4.). At this stage, the reader will have reached a general understanding of the phenomenon that is necessary for the next phase of the study (i.e. the assessment of tax treaty dodging from the perspective of international law), developed in Part II.

3.2. The conditions for the phenomenon: an open door to tax treaty dodging practices

The identification of the scenarios where tax treaty dodging may happen is an important phase of this study. It not only provides a better understanding of the rationale behind the phenomenon, but also allows the delimitation of the scope for the investigation presented in the next sections. For this purpose, this section presents the two basic conditions for the phenomenon of tax treaty dodging to happen, that is, the conditions creating the scenarios where contracting states find themselves in a position to dodge tax treaties.

The areas not covered by tax treaties (i.e. treaty gaps) are presented as first condition for the phenomenon of tax treaty dodging. The reader will see that, because tax treaties are not self-sufficient,[236] the text of these agreements offers contracting states a wide measure of freedom and discretion to act. Contracting states are thus able to exercise their sovereign rights in a wide range of occasions. It is within this vast area of relative freedom that the phenomenon of tax treaty dodging may emerge: contracting states exercising sovereign rights within the limits imposed by the text of tax treaties may do it in a manner to impact the outcome of these agreements (Section 3.2.1.).

The existence of treaty gaps is however not enough for creating a scenario vulnerable to dodging practices. In this sense, the reader is further introduced to the ambulatory interpretation as the second necessary condition for the phenomenon of tax treaty dodging (Section 3.2.2.). Since treaty dodging should lead to an outcome that is beyond the common and reasonable expectation of the treaty partner,[237] only actions (or omissions) that are performed after the conclusion of a tax treaty and that are taken into consideration when applying the agreement (under an ambulatory interpretation) are able to qualify as a dodging practice. Actions performed (or omissions) before the signature of the treaty would never result in an unexpected outcome because they would have been - or should have been - already taken into account by treaty partners when concluding the treaty.

This section concludes by acknowledging that contracting states may find themselves in a position to dodge tax treaties whenever they perform, through their legislative or executive powers, actions (or omissions) after the signature of the treaty that are not limited by the text of treaty provisions and which are taken into account when applying these agreements. The reader should always have in mind, though, that the existence of the two conditions does not unavoidably amount to a case of tax treaty dodging. The existence of the two conditions indicates only that the related scenario is vulnerable to dodging practices. On the other hand, it also means that any contracting states' action performed outside this scenario will in no way characterize a tax treaty dodging practice and, therefore, will not be observed in this study.

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[236] Not self-sufficient in the sense that tax treaties are generally not able to provide all elements necessary for their own application and, therefore, they need to be complemented by other rules normally existing in domestic laws – see details in Chapter 2, Section 2.2.2. and also Section 3.2.1. in this Chapter 3.

[237] See details in Section 3.4.

3.2.1. Tax treaty gaps (as first condition)

This section presents the tax treaty gaps as first condition for tax treaty dodging. In this sense, the reader will be explained that contracting states exercising sovereign rights within the treaty gap areas may be able to make use of dodging practices. These actions may not be in conflict with the wording of treaties for they are exercised within the gap areas – however, the author will further analyse, in Chapter 4 of this study, whether they may be in conflict with international law.

For this purpose, this section starts by demonstrating the current predominant view that international law is able to limit sovereignty on the basis of the coexistence of equal sovereign states and of the will of the community as a whole to assure a balanced coexistence. As limitations imposed by traditional customary international law and by states themselves are not enough to fully guarantee the sovereign equality of states and prevent all types of overlaps (Section 3.2.1.1.), countries resort to tax treaties to limit contracting states' sovereign rights and eventually avoid or reduce international double taxation. The reader will see that the limitation which is determinant for scoping dodging practices, and consequently the relevant one for the purpose of identifying the first condition for tax treaty dodging, is the text of tax treaties (Section 3.2.1.2.).

It will follow that tax treaties are simple non-self-sufficient agreements that are not able to cover all aspects of all different international tax relations and, therefore, the limitations imposed by these agreements reveal to be less extensive than those normally figuring in other types of international treaties. As a consequence, a large area of relative freedom - the "treaty gaps" - is left for contracting states to exercise rights on the grounds of sovereignty. These sovereign rights may be exercised by legislative or executive branches of the state – although sovereign rights may also be exercised by judicial courts, this branch of the state is more limited in respect of actively committing a tax treaty dodging act, as it will be further explained.[238] It is within this vast area of relative freedom that the phenomenon of tax treaty dodging may emerge: contracting states exercising sovereign rights through their legislative or executive branches, and within the limits imposed by the text of tax treaties, may do it in a manner to be able to affect the outcome of these agreements (Section 3.2.1.3.).

3.2.1.1. State sovereignty limited by customary international law and by self-imposed unilateral limitations

Sovereignty refers to the bundle of rights and competences that go to make up the nation state. Among this bundle of rights there are particular rights, namely jurisdictional competence or simply *jurisdiction*, that refer to judicial, legislative and administrative competences of a state[239] and their right to regulate

[238] See details in Section 3.3.3.

[239] Brownlie, *supra* n. 16, p. 300.

the conduct or consequences of events.[240] This state's authority is exercised in various ways, which may involve the power to prescribe rules (legislative or prescriptive jurisdiction),[241] to enforce them (enforcement jurisdiction) and the power to receive, try and determine cases referred to states' courts (jurisdiction to adjudicate).[242] Therefore, jurisdiction is subsumed within and sourced in sovereignty.

Because jurisdiction is a corollary of sovereignty, the jurisdiction of a state cannot extend further than its sovereignty,[243] which means that limitations on state sovereignty imposed by international law (i.e. international treaties, customs and principles)[244] consequently limit state jurisdiction. On the other

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[240] "'Jurisdiction' is a term that describes the limits of the legal competence of a State or other regulatory authority (such as the European Community) to make, apply, and enforce rules of conduct upon persons. It 'concerns essentially the extent of each state's right to regulate conduct or the consequence of events'" (V. Lowe, *Jurisdiction*, International Law (M. Evans ed., Oxford University Press 2006, p. 335). See also R. J. Jeffrey, *The Impact of State Sovereignty on Global Trade and International Taxation* (Kluwer Law International 1999), Series on International Taxation n. 23, p. 26; Brownlie, *supra* n. 16, p. 299.

[241] Already in 1572, Jean Bodin, in his book *Methodus ad facilem Historiarum Cognitionem. Ab ipso recognita et multo quam antea locupletior*, indicates the "ordaining and repealing of laws" as one of the five constituent elements of sovereignty (Isenbaert, *supra* n. 14, p. 21).

[242] Lowe, *supra* n. 240, pp. 338-339; Bownlie, *supra* n. 16, p. 299.

[243] S. Douma, *Optimization of Tax Sovereignty and Free Movement* (IBFD 2011), p. 79; Jeffrey, *supra* n. 240, p. 27.

[244] Limitation of sovereignty cannot be determined on the basis of the will of states; it is rather derived from the coexistence of equal sovereign states and from the will of the international community as a whole to maintain this coordinated coexistence. The binding force of international law would be based, thus, on this coexistence of equal sovereign states and on the consent and recognition given by states for this purpose in the form of treaties, customs and principles ("There is no reason why the original hypothesis in international law should not be that the will of international community must be obeyed. (...) the organs of the formation of the will of the international community are, in the absence of an international legislature, States themselves, their consent being given by custom or treaty, and being capable of impartial ascertainment and interpretation by international tribunals. An initial hypothesis expressed in the terms of voluntas civitatis maximae est servanda would point, as the source of law, to the will of the international society expressing itself in contractual agreements between its constituent members, in their customs, and in general principles of law which no civilized community can afford to ignore" (H. Lauterpacht, *The Function of Law in the International Community* (Oxford Univeristy Press 2011), pp. 429-430); "(...) sovereignty has to be inherently limited by the sovereignty of the other states and by the obligation to respect their sovereignty; the freedom of action and the subjective rights of each sovereign state have to be constrained by the rights of the other states arising from their sovereignty (...)" (F. X. Perrez, *Cooperative Sovereignty: from Independence to Interdependence in the Structure of International Environmental Law* (Kluwer Law International 2000), p. 61); "(...) it does not follow that a sovereign state is free to do what it wishes. The sovereign equality of states is equally a fundamental principle of international law. Claims by one state to prescribe rules for persons in another state encroach upon the right of the state where those persons are based itself to exercise jurisdiction over those persons within its territory" (Lowe, *supra* n. 240, pp. 341-342); "(...) it appears that the underlying principle behind such rules [rules governing the relations among the actors of a given society] and their functioning is precisely that of sovereign equality of states. It represents and empirical phenomenon exemplified by a political and legal concept which may be regarded as the grund-norm of modern international law, insofar as it provides the factual and legal basis for the coming into being of the ancillary constitutional rules on the sources of international law" (A. Tanzi, *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, 12 International Community Law Review 2 (2010), pp. 145-169, at p. 150). Sovereignty means therefore a relative supremacy, subject to and limited by international law (L. Wildhaber, *Sovereignty and International Law*, The Structure and Process of International Law (R. St. J. Macdonald & D. M. Johnston eds., Martinus Nijhoff Publishers 1983, p. 438). This view has also been accepted by international tribunals and courts since the beginning of the 20th

hand, states may chose not to fully exercise the jurisdiction they are entitled to.[245] In this sense, if in one hand jurisdiction cannot expand beyond sovereignty, it can certainly be more restrictive as a result of self-imposed unilateral limitations, that is, limitations imposed by states themselves.[246]

The predominant view in international law literature is that jurisdiction is limited by, or determined on the basis of, connecting factors established by traditional customary international law.[247] In this sense, two traditional approaches[248] determine the extent to which states can exercise their jurisdiction: the territorial and the personal bases of jurisdiction. Under these international customary rules, a state may extend its laws to any person, things or relationships, provided that one of two connecting factors exists. These connecting factors upon which states are entitled to exercise jurisdiction are *territoriality* (under the territorial base of jurisdiction) and *nationality or domicile (*under the personal base of

century. In this respect, decisions given by international arbitral courts, the Permanent Court of International Justice and by the International Court of Justice portray the limitation of sovereignty to state territory, the subjection of sovereignty to treaty law and general international law and the inclusion of the obligation to respect others' sovereignty in the principle of sovereignty (Perrez, *supra* n. 244, p. 55). See also Perrez, *supra* n. 244, pp. 55-61. The predominant view today is, thus, that international law is able to limit sovereignty on the basis of the coexistence of equal sovereign states and of the will of the community as a whole to assure a balanced coexistence.

[245] Douma, *supra* n. 243, p. 86; Isenbaert, *supra* n. 14, p. 66 and 67.

[246] Douma, *supra* n. 243, p. 93.

[247] Lowe, *supra* n. 240, p. 342; I. Brownlie, *supra* n. 16, p. 299; "(...) the rules of legislative jurisdiction under international law (...), along with the provision of treaties, form the most important limitations on State freedom of action" (Jeffrey, *supra* n. 240, p. 42). "To say that enforcement jurisdiction is the prime regulator in international law is to confuse theory with practice. Just because a law cannot in practice be enforced does not in any way relate to its legality or otherwise. The view that fiscal jurisdiction is unlimited is not supported by international law and should be rejected." (Jeffrey, *supra* n. 240, p. 43); Douma, *supra* n. 243, pp. 83-85; M. Lang, *Introduction to the Law of Double Taxation Conventions* (IBFD Linde, 2013), p. 27, marginal n. 1; Hohenwarter, *supra* n. 19, p. 161.

[248] That is, the ones generally accepted by states. Other approaches have been advanced by states, through which they consider that the link between them and the conduct that they seek to regulate is enough to warrant the exercise of the legislative jurisdiction. However, they have found no general acceptance (Lowe, *supra* n. 240, p. 321).

jurisdiction).[249] Accordingly, states may exercise their jurisdiction within its geographical boundaries[250] or over persons linked by their domicile or nationality, wherever they may be. States are therefore not entitled to extend the application of their laws outside these limits in view of the lack of a connecting factor under customary international law, for which they would face related international legal consequences.[251]

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[249] "The best view is that it is necessary for there to be some clear connecting factor, of a kind whose use is approved by international law, between the legislating State and the conduct that it seeks to regulate. This notion of the need for a linking point, which has been adopted by some prominent jurists, accords closely with the actual practice of States. If there exists such a linking point, one may presume that the State is entitled to legislate; if there does not, the State must show why it is entitled to legislate for anyone other than persons in its territory and for its nationals abroad (who are covered by the territorial and the national principles respectively). There are two of these linking points, or 'Bases of Jurisdiction' of 'principles of jurisdiction' (these terms mean the same thing) that are firmly established in international law: territoriality and nationality." (Lowe, *supra* n. 240, p. 342). See also Brownlie, *supra* n. 16, p. 299. Especially on tax legislative jurisdiction: "The traditional approach to establishing jurisdiction is founded on the territorial and personal bases of jurisdiction. (...) the fundamental jurisdiction connection is the territorial basis. This will be understood here to refer to jurisdiction over persons, matters and things within the geographical boundaries of a state. An illustration of this in relation to fiscal jurisdiction is the taxation of income having its source, or derived by a person residing, within the territory. The other jurisdictional connection is the personal one based on nationality or domicile of a person as a connecting factor. The US, most notably, taxes its citizens wherever they may be, on their worldwide income. Other countries, such as the UK and Australia, include domicile as one of the connecting factors for establishing jurisdiction" (Jeffrey, *supra* n. 240, p. 44); from an older perspective: "Le droit international classique a reconnu une seule véritable limitation à la liberté des gouvernements en matière fiscale. Cette limitation était, à vrai dire, la limite extrême de ces compétences: un gouvernement n'a le droit de frapper d'impôt que les personnes ou les biens qui sont attachés par certains liens directs à son territorire. Les principaux critères en étaient la nationalité (...) ou la situation des biens. Dans ces limites, la souvraineté fiscale absolute était reconnue aux gouvernement étatiques" (A-C. Kiss, *L'Abus de Droit en Droit International* (Librairie Générale de Droit et de Jurisprudence 1953), p. 80); see also Douma, *supra* n. 243, pp. 83-85. The grouping of the connecting factors is presented by Michael Lang as follows: "Not all situations can be taxed. There must be a personal or objective nexus, or connection, between the taxpayer and the state. With respect to a personal connecting factor, it is sufficient that this exists with respect to the person concerned. Connecting factors for individuals frequently include domicile, residence or citizenship. For legal entities, the factors usually include the place of incorporation and the place of effective management. With regard to an objective connecting factor, it is sufficient that parts of the transaction or activity involve the taxing state or that the object of the action is somehow connected to the taxing state" (Lang, *supra* n. 247, p. 27, marginal n. 1).

[250] States may impose the entirety of their laws (criminal, economic, social, etc.) upon everyone within its territory, but in practice they exercise this power with moderation. For example, laws may be drafted in a way to exempt visitors to comply with certain obligations, such as the one to perform compulsory military service, or to exclude them from certain rights, such as to vote (Lowe, *supra* n. 240, p. 342).

[251] States may indeed face international legal consequences for breaching customary international law when applying its law in the absence of a connecting factor. However, states may also use more indirect techniques to circumvent those limitations without a clear and direct breach of the bases of jurisdiction rule, in a way similar to the dodging technique applied to circumvent tax treaties, object of the present study. This was detected by the United States in regard to actions of the Turkish government as described in an official complaint presented by the American State Department in 1885 (*Note du Département d'État du 8 juin 1885, n. 293, Moore: Digest, vol. III, pp. 691-692 et vol. IV, pp. 21-22*). According to the American government, the Turkish government imposed a heavy fine to the parents of a Turkish who had emigrated to the United States and who had become an American citizen. Although the fine was imposed on the parents of the new American citizen – therefore without a direct breach of the nationality and territoriality principles - the American government considered it a dodging measure that aimed at the American citizen resident in the United States. Eventually,

In respect of tax jurisdiction, for instance, a state may, as commonly done, tax income sourced in its territory (the so-called source jurisdiction of taxation[252]) or tax income derived by a person residing within its territory (the so-called residence jurisdiction of taxation[253]), both on the grounds of the territorial base of jurisdiction. A state may also, although rarely applied by states in practice,[254] extend the application of its tax laws on the grounds of the personal base of jurisdiction in order to tax income derived by its citizens or domiciled persons wherever they are located.[255]

However, the traditional approaches to establish jurisdiction, including tax jurisdiction, are considered inadequate to deal with complex situations arising in the context of contemporary international economic integration.[256] One of the reasons is that the limitation of sovereignty provided by these customary international rules is not coordinated in a way to avoid the overlap of jurisdictions in the context of cross-border transactions or situations.[257] The overlapping - or *concurrent jurisdiction* - may happen when, for instance, one state has the right to apply its laws to its national citizen on the grounds of a personal base of jurisdiction, while another state has the right to apply its laws to the same person in view of a territorial connection. In an international tax scenario, this may be the case where income derived by a taxpayer is subject to taxation at the state of his nationality - where the nationality base of jurisdiction applies - and also at the state where the national citizen is a resident or where the source of the income is located - where territoriality base of jurisdiction applies. The concurrent jurisdiction is not a consequence only of the overlap between the personal and the territorial bases of jurisdiction;

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the Turk government accepted the arguments brought by the American government (*Rapport du Chargé d'Affaires américain à Constantinople à Bayard, Secrétaire d'État, 23 juin 1885*) – references, further analysis and other similar cases are provided by Kiss, *supra* n. 249, pp. 80-85. Although this case refers to a possible dodging technique, it falls out of the scope of this thesis, since it does not relate to the dodging of tax treaties but the dodging of the bases of legislative jurisdiction as established by customary international law.

[252] The source jurisdiction of taxation, according to which a state may base its right to tax on the fact that the source of the income is located within its territory, is grounded on the territorial base of jurisdiction rule of international law. This type of jurisdiction typically subjects to tax the income that arises from sources within that state, whether derived by resident or non-resident taxpayers (Russo et al., *Fundamentals of International Tax Planning* (IBFD 2007), p. 5; K. Holmes, *International Tax Policy and Double Tax Treaties – an Introduction to Principles and Application* (IBFD 2007), pp. 19-21).

[253] The residence jurisdiction of taxation, according to which a state may base its right to tax on the fact that the person deriving the income is a resident of that state, is grounded on the territorial base of jurisdiction rule of international law. This type of jurisdiction typically subjects to tax the worldwide income of the person resident in that jurisdiction for tax purposes (Russo et al., *ibid.*, p. 5; K. Holmes, *ibid.*, p. 21-22).

[254] Few states, such as the United States and Mexico (nationality as connecting factor), the United Kingdom and Australia (domicile as connecting factor), resource to it (Jeffrey, *supra* n. 240, p. 44; Vogel et al, *supra* n. 36, p. 10, marginal n. 2a).

[255] On the inconvenience of nationality and domicile as connecting factors for fiscal jurisdiction, see Jeffrey, *supra* n. 240, pp. 49-51.

[256] Jeffrey, *supra* n. 240, p. 51.

[257] "As economic activity is no longer self-contained, operating and structured within national boundaries, but is integrated on a global basis, it is more likely that an internal exercise of jurisdiction will have repercussions beyond the national borders" (Jeffrey, *supra* n. 240, p. 56). See also Lowe, *supra* n. 240, p.p. 354-356; Brownlie, *supra* n. 16, p. 299; Douma, *supra* n. 243, p. 87; Hohenwarter, *supra* n., p. 161.

it may also occur as a result of the conflicting rules within the same base of jurisdiction, such as in the case of double nationality. In respect of the overlaps within the territorial base of jurisdiction, they are commonly referred to in international tax law as source-source conflict, residence-residence conflict and source-residence conflict.[258] In the first two scenarios, the conflict arises due to the fact that international law leaves states free to determine who their residents are and when an item of income is sourced within their territory.[259] Therefore, two states may assert, in terms of their domestic law, that each, at the same time, is the state of source of an income or, that each, at the same time, is the state of residence of a taxpayer.[260] In the case of source-residence conflicts, a clash between the source and residence jurisdiction of taxation within the territorial base of jurisdiction leads to one of the most common situations in international tax where one state asserts its right to tax on a worldwide basis an item of income as the taxpayer's state of residence while another state asserts to tax the same item of income as the state of source.[261]

Whichever type of conflict is, the point is that in all cases the limitation provided by customary international law is not enough to prevent the overlap of state jurisdictions and, in terms of international taxation, its consequent international juridical double taxation (hereinafter referred to simply as double taxation).[262] States may, however, avoid these overlaps by simply not fully exercising the jurisdiction they are entitled to under customary international law – in other words, as referred to above, by self-imposing unilateral limitations. This is the case when, for example, most states do not fully apply their worldwide jurisdiction on the basis of nationality[263] or when they apply a certain basis of jurisdiction or connecting factor only to either individuals or companies.[264]

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[258] Other ways of referring to these conflicts exist, such as the one used by Michael Lang: conflict of full tax liability (worldwide taxation) in two states, full limited liability (source taxation) in two states and conflict between full tax liability and limited tax liability (Lang, *supra* n. 247, pp. 27-29, marginal n. 4-11).

[259] Jeffrey, *supra* n. 240, p. 45; Lowe, *supra* n. 240, p. 345; Russo, *supra* n. 252, p. 7; Holmes, *supra* n. 252, p. 23; Douma, *supra* n. 243, p. 84; Vogel et al., *supra* n. 36, p. 10, marginal n. 2a.

[260] Holmes, *supra* n. 252, p. 23; Vogel et al., *ibid.*

[261] Holmes, *supra* n. 252, p. 24; Vogel et al., *supra* n. 36, pp. 9-10, marginal n. 2.

[262] "International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter for identical periods" (*OECD Model Tax Convention on Income and on Capital: Introduction* para. 1 (21 November 2017), Models IBFD). As explained by Vogel et al., "(...) customary international law does not forbid double taxation. Double taxation resulting from the interaction of the domestic laws of two (or more) states will be consistent with international law as long as each individual legislation is consistent with international law. (...) international law can decrease the incidence of double taxation only through the introduction of rules establishing which of the states involved must withdraw its tax claim. General international law does not as yet contain such rules. For the most part, only bilateral double tax treaties exist to fulfil this role" (Vogel et al., *supra* n. 36, p. 12, marginal n. 8). See also Hohenwarter, *supra* n. 19, pp. 161-162.

[263] Most states do not tax their nationals wherever they are; an exception to this is, for example, the United States, which, in principle, taxes its nationals on their worldwide income (Douma, *supra* n. 243, p. 86).

[264] The Netherlands applies the personal basis for jurisdiction (incorporation principle) to companies (but also exercises jurisdiction if the company is resident there because its central management and control is in the Netherlands) and France does not make use of its unlimited fiscal jurisdiction with regard to resident companies, as it operates the source jurisdiction

Yet, the existing self-imposed unilateral limitations on jurisdiction are not enough to fully guarantee the sovereign equality of states and prevent all types of overlaps. In this sense, despite reasonable benefits brought by both unilateral and customary international law limitations, international double juridical taxation resulting from the non-covered jurisdiction overlaps still remains as one of the most discussed problems in international tax law.

3.2.1.2. State sovereignty and the text of tax treaties

The economic burden of double taxation caused by the overlap of jurisdictions on cross-border transactions is with no doubt an obstacle to the development of economic relations between countries. Since customary international law and self-imposed unilateral limitations are not enough to prevent all cases the overlap of jurisdictions and the consequent international double taxation (see Section 3.2.1.1.), many countries consider other available ways to limit state tax jurisdiction. This is the case when they resort to tax treaties,[265] since international agreements have the power to limit state sovereignty[266] and, consequently, jurisdiction. In this respect, tax treaties aim at avoiding international double taxation by (i) addressing the origin of the problem (i.e. concurrent jurisdiction) through the allocation of jurisdiction to tax[267] among the contracting states and by (ii) solving the consequence of

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of taxation (territorial principle) through which account is only taken of profits realized in undertakings operating in France or liable in France by virtue of a tax treaty (Douma, *supra* n. 243, p. 86).

265 Already in 1953 Alexandre-Chales Kiss identified this solution: "La doctrine du droit international a peu contesté jusqu'ici l'exclusivité et le caractère absolu des compétences étatiques en matière fiscale. Cependant, l'importance de plus en plus croissante du commerce international met au premier plan ce problème intimement lié à la vie économique de la communauté internationale. (...) Le développement récent du droit conventionnel souligne ces faits, tendant à restreindre de plus en plus la liberté jadis incontestable des Etats en matière fiscale" (Kiss, *supra* n. 249, p. 70); Vogel et al., *supra* n. 36, p. 12, marginal n. 8; Lang, *supra* n. 247, p. 30, marginal n. 16; Douma, *supra* n. 243, p. 93; Hohenwarter, *supra* n.19, p. 162.

266 See *supra* n. 244.

267 Klaus Vogel et al. have a different opinion on this. They argue that tax treaties do not allocate jurisdiction to tax to contracting states, as this is already done by constitutional laws and public international laws. Instead, they only establish a mechanism to avoid double taxation through the restriction of tax claims in areas where overlaps are expected or are theoretically possible (Vogel et al, *supra* n. 36, pp. 26-27, marginal n. 45b-46). The author disagrees, in part, with this view because (i) the fact that the original jurisdiction is dictated by customary international law does not prevent countries to make use of other means capable of limiting sovereignty to limit or reallocate jurisdiction (ii) as described in Section 3.2.1.1., international agreements are capable of limiting state sovereignty and, consequently, legislative jurisdiction in order to resolve the overlap caused by the original allocation under customary international law; (iii) since treaties are also able to extend jurisdiction (on treaty-based extensions of jurisdiction, see Lowe, *supra* n. 240, pp. 349-351), they should be also capable of limiting or relocating it; and (iv) if states are able to self-impose unilateral limitations on their legislative jurisdiction, treaties could also be seen as a type of self-imposed limitation, since they are decided by the state itself, only not unilaterally. The author agrees, though, with the view that contracting states do not allocate jurisdiction but "*waive tax claims*" in what concerns the elimination of double taxation through the exemption and credit methods in articles 23A and 23B of the OECD Model Convention (2017), since these articles do not resolve the concurrent jurisdiction, but aim at solving its tax consequences (i.e. international double taxation).

the overlaps through the implementation of tax technical methods of elimination of double taxation.[268] In the first case,[269] contracting states contractually agree to grant exclusive right to tax certain items of income and capital to only one contracting state[270] (generally to the residence state), preventing or solving thus the overlap of jurisdictions and consequently avoiding international double taxation.[271] However, in some other cases both contracting states are given full right to tax or a limited right to tax in the case of the source state,[272] so that the original overlap of tax jurisdictions remains. In these cases, international double taxation is relieved through the use of the exemption or the credit methods provided by the treaty[273] - the relief of international double taxation may also be unilaterally granted by states via domestic legislation irrespective of tax treaties.[274]

The extent to which tax treaties effectively limit states jurisdiction is not always easy to determine. However, it is a common understanding in international law that limitations on sovereignty cannot be presumed.[275] This understanding is based on the *Lotus principle*[276], according to which any attempt to constrain the state's freedom of action in the absence of an explicit legal prohibition is considered a

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[268] These two categories of rules for avoiding double taxation are indicated in the introduction of the OECD Model Convention as follows: "For the purpose of elimination double taxation, the Convention establishes two categories of rules. First, Articles 6 to 21 determine, with regard to different classes of income, the respective rights to tax of the State of source or situs and of the State residence, and Article 22 does the same with regard to capital. (...) Second, insofar as these provisions confer on the State of source or situs a fill or limited right to tax, the State of residence must allow relief so as to avoid double taxation; this is the purpose of Articles 23A and 23B. The Convention leaves it to the Contracting States to choose between two methods of relief, i.e. the exemption method and the credit method" (*OECD Model Tax Convention on Income and on Capital: Introduction* para. 19 (21 November 2017), Models IBFD).

[269] Articles 6 to 21 of the OECD Model Convention (2017) (*OECD Model Tax Convention on Income and on Capital* arts. 6-21 (21 November 2017), Models IBFD).

[270] Cases where treaties indicate that the income or capital in question "*shall be taxable only*" in one contracting state.

[271] "In case of a number of items of income and capital, an exclusive right to tax is conferred on one of the Contracting States. The other Contracting State is thereby prevented from taxing those items and double taxation is avoided. As a rule, this exclusive right to tax is conferred on the State of residence" (*OECD Model Tax Convention on Income and on Capital: Introduction* para. 19 (21 November 2017), Models IBFD).

[272] Cases where treaties indicate that the income or capital in question "*may be taxed*" in the other contracting state as well.

[273] Under the principle of exemption, the state of residence does not tax the income which according to the tax treaty may be taxed in the other contracting state. The income may (exemption with progression) or may not (full exemption) be taken into consideration by the resident state when determining the tax to be imposed on the rest of the income. Under the principle of credit, the state of residence calculates its tax on the total income and allows a deduction from its own tax for the tax paid in the other contracting state. The residence state can allow the deduction of the total amount of tax paid in the other contracting state (full credit) or may restrict the deduction to the part of its own tax which is appropriate to the income which may be taxed in the other contracting state (*OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B* para. 12-16 (21 November 2017), Models IBFD).

[274] Vogel et al., *supra* n. 36, p. 16, marginal n. 16; Hohenwarter, *supra* n. 19, p. 162

[275] "Les limitations de souveraineté ne se présument pas" (Nguyen Quoc, Daillier & Pellet, *supra* n. 16, p. 394); "Restrictions upon the independence of States cannot therefore be presumed" (Lowe, *supra* n. 240, p. 341).

[276] The Lotus principle originated from a decision of the Permanent Court of International Justice in the Lotus Case Lotus case of 7 September 1927, published in the reports of the International Court of Justice 1927, Serie A, n. 10.

violation of the state sovereignty.[277] If limitations on sovereignty cannot be presumed, the one certain and undeniable limitation to be derived from tax treaties is the text of the agreement. It is thus not surprising that the text of the treaty, being the explicit limitation of states' sovereign rights, is considered today the main and prevailing element in the process of interpretation.[278] As summarized

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[277] Douma, *supra* n. 243, p. 80. See also the comments of Bin Cheng on the North Atlantic Coast Fisheries Case (1910), where the Permanent Court of Arbitration emphasizes the need for explicit limitation when it said that "a line which would limit the exercise of sovereignty of a State within the limits of its own territory, can be drawn only on the ground of express stipulation, and not by implication from stipulations concerning a different subject matter" (B. Cheng, *General Principles of Law as Applied by International Courts and Tribunals* (Grotius Publications Limited 1987), p. 124). However, see in Chapter 4, Section 4.2.2., the developments of the Court's thoughts in the sense that the non-limitation of sovereign when no express stipulation of limitation is made is only apparent.

[278] Amid disagreements between the different school of thoughts on interpretation of treaties, which approaches vary according to the emphases given to the intention of the parties (i.e. the aim of interpretation is to ascertain the intention of the parties), to the text of the treaty (i.e. a presumption exists in the sense that that the intention of the parties are reflected in the text) or to the object and purpose of the treaty (i.e. the object and purpose must be first ascertain before interpretation of the text), the International Law Commission decided to adopt a more textual approach – although still keeping all three methods as not mutually exclusive - when drafting article 31 of the Vienna Convention (1969). "The Commission's proposals (which were adopted virtually without change by the Conference and are now reflected in Articles 31 and 32 of the Convention) were clearly based on the view that the text of a treaty must be presumed to be the authentic expression of the intention of the parties; the Commission accordingly came down firmly in favour of the view that 'the starting point of interpretation is the elucidation of the meaning of the text, not an investigation ab initio into the intention of the parties'" (I. Sinclair, *The Vienna Convention on the Law of Treaties* (Manchester University Press 1984), p. 115); "The Commission and the Institute of International Law have taken the view that what matters is the intention of the parties *as expressed in the text*, which is the best guide to the more recent common intention of the parties. The alternative approach regards the intentions of the parties as an independent basis of interpretation. The jurisprudence of the International Court supports the textual approach, and it is adopted in substance in the relevant provisions of the Vienna Convention" (Brownlie, *supra* n. 16, p. 631); "The general rule of interpretation is stated in Article 31(1) of the Vienna Convention (...). Note that this general rule places firm emphasis on the text of the treaty as an authentic expression of the intentions of the parties. This is broadly consistent with the view of the late Lord McNair, a former president of the International Court of Justice, who suggested that the main task involved in the process of interpretation is to give effect to the expressed intentions of the parties, that is to say, 'their intention as expressed in the words used by them in the light of the surrounding circumstances'" (comments by Sir Ian Sinclair in Avery Jones, *supra* n. 107, p. 76). "(...) the interpretation of double taxation conventions must aim to avoid these problems and – within the limits of the text of such an agreement – must try to achieve equal interpretation of terms in both Contracting States" (...) "The text of Double Taxation Conventions must be presumed to be the authentic expression of intentions of the two Contracting States and, therefore, the starting point of interpretation is the elucidation of the meaning of the text, not an investigation ab initio into the intentions of the parties" (Vogel & Prokisch, *supra* n. 19, pp. 55 and 83); "Le texte est l'objet même de l'interprétation; il est aussi l'élément qui reflète le mieux les intentions des parties contractants (...). La solution la plus évidente est celle qui consiste à interpréter le moins possible et à s'en tenir au 'sens ordinaire' des mots (...)" (Nguyen Quoc, Daillier & Pellet, *supra* n. 16, pp. 239-240); "We submit that the true duty of the judge is to search for the common intention of the parties in using the language of the text" (McNair, *supra* n. 9, p. 373); "Interpretation involves an elucidation of the meaning of the text, not a fresh investigation as to the supposed intentions of the parties. (...) in practice, having regard to the object and purpose is more for the purpose of confirming an interpretation. (...) although paragraph 1 contains both the textual (or literal) and the effectiveness (or teleological) approaches, it gives precedence to the textual" (Aust, *supra* n. 16, pp. 187-188); See also R. X. Resch, *Not in Good Faith—A Critique of the Vienna Convention Rule of Interpretation Concerning its Application to Plurilingual (Tax) Treaties*, British Tax Review 3 (2014), p. 312.

by Klaus Vogel et al.: "in interpreting international agreements according to these rules the text of the treaty is of primary importance; i.e. the 'ordinary meaning' of the terms, and the wording not of the individual provision, but that of the entire agreement in context. The older view that primarily looked for the subjective intent of the parties to the treaty is thereby rejected. (...) Purpose is subordinated to the wording of the treaty by the rule of Article 31 that the purpose shall influence interpretation merely by giving 'light' to the terms of the treaty. (…) The intention of the parties (...) is only significant to the degree to which it has been expressed in the text of the agreement. The view that the 'basic aim of treaty interpretation is to ascertain the intention of the parties' is thus contrary to current international law as established in both VCLT [Vienna Convention on the Law of Treaties] (...). Excluded, therefore, is only an interpretation which, though corresponding to the intent of the parties, is in no way supported by the wording of the treaty".[279]

Although other limitations may play a role when applying tax treaties,[280] the point of interest for the purpose of determining the first condition for a scenario where tax treaty dodging is possible (and for limiting the scope of this study) is the fact that the text of tax treaties is an explicit and undeniable limitation of contracting states' sovereign rights and, therefore, any action not in line with the wording of these agreements would be easily concluded as being in direct contradiction with the treaty (i.e. contradiction with the wording of the treaty). On the other hand, actions performed (or omissions) within the areas not limited by the text of tax treaties, where states are relatively free to act – the "treaty gaps" –, would not entail a contradiction with the wording of these agreements so that its legitimacy could be in some cases reasonably defended. It is, therefore, within these areas that the phenomenon of tax treaty dodging emerges.

3.2.1.3. Exercise of sovereign rights within the treaty gaps

International law is often expressed in general terms while details are left for states to provide. As pointed out by Hans Kelsen, "the norms of international law are mostly incomplete norms; they require completion by norms of national law. The international legal order presupposes the existence of the national legal orders. Without the latter, the former would be inapplicable fragment of a legal order. Hence, reference to national law is inherent in the meaning of the norms of international law. In this sense, the international legal order 'delegates' to the national legal orders the completion of its

[279] Vogel et al., *supra* n. 36, p. 37, marginal n. 69-69a.

[280] Customs and principles, for instance, as part of international law, are also capable of limiting sovereignty, as indicated in this Section. For details on how these limitations may play a role in the application of tax treaties, see Chapter 4.

norms".[281] International law thus offers States a wide measure of freedom and discretion to act.[282] This is not different for tax treaties. In fact, limitations on sovereignty generally provided in tax treaties are less extensive than those normally figuring in other types of international treaties. Tax treaties are, in reality, very simple agreements with fewer provisions by far than most domestic laws.[283]

As indicated in Chapter 2,[284] it is understandable that tax treaties are simple non-self-sufficient agreements. First, it would not be practical for these agreements to cover all aspects of all different international tax relations; second, they are generally made to relieve from tax - from international double taxation - and not to charge a tax[285]; and last, tax treaties need a certain degree of flexibility in order to accommodate the differences between states and the development of society in general. According to Joanna Wheeler, "treaties have to be capable of regulating the interface between (usually) two states, which may have quite different legal traditions and domestic tax systems. They are therefore formulated in general, abstract terms, which also enable them to adapt to the continuing changes in the domestic law of the states that have concluded a treaty".[286]

In principle, contracting states have the right to exercise their sovereignty whenever they are expressly allowed or simply not forbidden by tax treaties. They are thus able to exercise their sovereign rights and dictate rules in a wide range of occasions, simply because, as said, tax treaties are understandably simple non-self-sufficient agreements that impose a low degree of limitation on state sovereignty. It is within this vast area of relative freedom that the phenomenon of tax treaty dodging may emerge: contracting states exercising sovereign rights within the limits imposed by the text of tax treaties may do it in a manner to affect the outcome of these agreements. This may happen in respect of a number of areas referred to throughout this thesis as "treaty gaps". These areas include, for instance, the definition of a great number of treaty terms and expressions since, from a practical perspective, tax treaties are not able to define the meaning of all terms and expressions used. Treaty gaps may also include the determination of the basic elements of the tax liability normally not provided by tax treaties, as these agreements are generally made to relieve from tax and not to charge a tax. The OECD has already referred specifically to this gap area where states are allowed to dictate rules when stating

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[281] Kelsen, *supra* n. 12 (2006), p. 348. In the same direction: "The foregoing analysis of international law has shown that most of its norms are incomplete norms which require implementation by norms of national law" (Kelsen, *supra* n. 12 (1952), p. 403); "international law delegates to the national legal orders the completion of its incomplete norms" (Jeffrey, *supra* n. 240, p. 39).

[282] Jeffrey, *supra* n. 240, p. 38.

[283] Wheeler, *supra* n. 44, p. 1.

[284] See Chapter 2, Section 2.2.2.

[285] Different views have been expressed on this point, but the majority of authorities that have taken a view on this point consider that (in the absence of specific domestic legislation in the contrary) tax treaties may only relieve from tax and not impose a higher charge than under domestic law (Baker, *supra* n. 65, p. B-1, marginal n. B.02).

[286] Wheeler, *supra* n. 44, p. 1. In the same sense, Gilbert Tixier, Guy Gest and Jean Kerogues: "Les conventions sont nécessairement des oevres imparfaites car elles consistent à rapprocher et à concilier des systèmes fiscaux nationaux (...)" (G. Tixier, *supra* n. 47, p. 169).

that basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability are neither addressed in nor affected by treaties.[287]

These areas of relative freedom are not limited to scenarios where contracting states may act through domestic law. They relate in fact to a number of situations that are simply not covered by the treaty and on which sovereignty exercised in any form (e.g. executive actions or omissions) is consequently not limited by the text of the treaty. These areas where contracting states have a relative freedom to act because not limited by the wording of tax treaties, i.e. the treaty gaps, are the areas in which tax treaty dodging may occur.

In brief, the first condition for a scenario where the phenomenon of tax treaty dodging may occur is the existence of tax treaty gaps through which states may exercise sovereign rights; in such cases, sovereign rights are considered to be exercised within the limits imposed by the text of tax treaties – because within the treaty gaps. Under this reasoning, the phenomenon of tax treaty dodging would never emerge in a scenario where contracting states actions are exercised outside the treaty gaps, that is, exercised in areas covered by the treaty, as these actions may extrapolate the limits imposed by the text of tax treaties; such actions would be considered a direct violation of these agreements (i.e. violation of the wording of these agreements).

3.2.2. Ambulatory interpretation (as second condition)

The use of domestic law for the purpose of application of tax treaties necessarily leads to the question of whether reference should be made to domestic law at the time when the treaty was concluded (static interpretation) or to domestic law at the time when the treaty is applied (ambulatory interpretation). This question is of major importance to the topic herein discussed, since tax treaty dodging may only be executed through actions that take place after the signature of the agreement, therefore, only under

[287] "As indicated in paragraph 22.1 below, the answer to that second question is that to the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 9 (26 July 2014), Models IBFD). This line of thought was reaffirmed in the new commentaries of article 1 issued in 2017: "(…) many provisions of the Convention depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person (see paragraph 1 of Article 4), the determination of what is immovable property (see paragraph 2 of Article 6) and the determination of when income from corporate rights might be treated as a dividend (see paragraph 3 of Article 10). More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the Convention. In many cases, therefore, the application of specific anti-abuse rules found in domestic law will have an impact on how the treaty provisions are applied rather than produce conflicting results" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 73 (21 November 2017), Models IBFD).

an ambulatory approach.[288] This conclusion is based on the fact that, in order for actions to produce a treaty outcome which is different from the one reasonably expected by treaty partners, they must have been performed after the signature of the treaty. In this sense, when discussing the principle of good faith under international law, Bin Cheng recognizes that advantages not predictable to treaty partners at the time of the conclusion of the treaty should not be seen as good practice when he states that the principle of good faith "prohibits a party from exacting from the other party advantages which go beyond their common and reasonable intention at the time of the conclusion of the treaty, as for example, by invoking the treaty to cover cases which could not reasonable have been in the contemplation of the parties at the time of its conclusion".[289] In contrast, actions performed before the signature of the treaty, such as an amendment to domestic law prior to the conclusion of the treaty, would never result in an unexpected outcome because they would have been, or at least should have been, already taken into consideration by treaty partners when concluding the treaty.

Doubts may rise, however, on deciding the exact point of reference after which such actions could be considered a possible dodging. For example, would changes on domestic law made after the signature of the treaty be a potential tax treaty dodging or only those made after the ratification of the treaty? In this respect, Bin Cheng indicates that, although the greater number of treaties is binding only by virtue of their ratification - as also confirmed by the International Court of Justice[290] - yet it may well be asked whether before ratification such a treaty is of absolutely no effect. He points out that the signing of the treaty at least establishes, in the words of the International Court of Justice, "*a provisional status*" between the signatories, which would terminate either if the signature is not followed by ratification or when treaty becomes effective on ratification.[291] In this sense, it is expected that the status quo between the time of the signature and the time of the exchange of ratification is maintained. He concludes, after analysing relevant international court cases,[292] that "pending the ratification of the

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[288] The ambulatory approach is by analogy used here in reference not only to domestic law (amendments after the signature of the treaty), but also in respect of any action resulting from the exercise of sovereign rights through legislative and executive branches of a state, performed after the signature of the treaty.

[289] Cheng, *supra* n. 277, p. 118 (emphasis added).

[290] The *International Commission of the River Oder Case* (1929) and the *Ambatielos Case* (1952) are cited by Bin Cheng (Cheng, *supra* n. 277, p. 109).

[291] Cheng, *supra* n. 277, p. 109.

[292] Bin Cheng cites the *Iloilo Claims* (1925), where a counsel of the United States maintained before the British-United States Claims Arbitral Tribunal that "when there still remains ratification and exchange of ratification or deposit of ratification as the case may be, it is utterly meaningless to say that a treaty is binding from the time of signature" but admitted that there may be "some questions that may seem a little vexatious as to the effect of the signing of a treaty. (...) If Germany by treaty cedes territory to Poland or to France, obviously Germany cannot prior to ratification proceed to cede that territory to some other nation, even though the treaty obviously is not, in accordance with its terms, in effect". Cheng further indicates the following cases: *German Interests in Polish Upper Silesia* (1926), where the Permanent Court of International Justice seems to have indirectly indicated that parties must not act against the principle of good faith between the signature and ratification of the treaty; *Megalidis Case* (1926), where the Umpire Lieber of the Mexican-United States Claims Commission gave the opinion that making grants, before the ratification of the treaty, of land which is to be ceded according to the signed treaty, is a fraudulent and invalid transaction (Cheng, *supra* n. 277, pp. 109-111).

treaty (...) the principle of good faith requires that each party should abstain from acts which would prejudice the rights of the other party, as established by the signed treaty".[293]

Indeed, under article 18 of the Vienna Convention (1969), contracting states are obliged not to defeat the object and purpose of a treaty prior to its entry into force. In this respect, a state is obliged to refrain from acts which would defeat the object and purpose of a treaty when (i) it has signed the treaty or has exchanged instruments constituting the treaty subject to ratification, acceptance or approval (and until it shall have made its intention clear not to become a party to the treaty) or (ii) when it has expressed its consent to be bound by the treaty, pending the entry into force of the treaty and provided that such entry into force is not unduly delayed. The Draft Articles of the Vienna Convention with Commentaries (1966) explain that "an obligation of good faith to refrain from acts calculated to frustrate the object of the treaty attaches to a State which has *signed* a treaty subject to ratification appears to be generally accepted".[294]

The author agrees that the signature of the treaty would already impose obligations to the treaty partners, as referred to in the Vienna Convention (1969). Therefore, the exact point of reference for considering possible cases of tax treaty dodging is the signature of the treaty, also because the assessment of the new outcome as to whether it is considered or not beyond the common and reasonable expectations of the treaty parties can only be made on the basis of what was written at the conclusion (signature) of the treaty and not on the basis of what was possibly intended at the moment of the ratification of the treaty - which is, in fact, difficult to assess. As a consequence, it can be stated that tax treaty dodging may only happen when actions (or omissions) of contracting states' legislative or judicial branches[295] are performed after the signature of the treaty and provided that such actions are indeed taken into account when applying the treaty. This leads to the conclusion that the second condition of the phenomenon is the ambulatory interpretation.[296] This ambulatory approach is by analogy used here in reference not only to domestic law (amendments after the signature of the treaty), but also in respect of any action (or omissions) resulting from the exercise of sovereign rights within the treaty gap areas, through legislative and executive branches of a state, performed after the signature of the treaty.

The danger caused by the ambulatory interpretation was already detected in the 1980's, as a consequence of the decision by the Supreme Court of Canada in the case *Melford* (1982).[297] To avoid the modification of the treaty outcome caused by amendments to domestic law, the Supreme Court

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[293] Cheng, *supra* n. 277, p. 111.

[294] UN, *Draft Articles on the Law of Treaties with Commentaries* (1966), at commentary on art. 15 (current art. 18), para. 1 (emphasis added).

[295] Although sovereign rights may also be exercised by judicial courts, this branch of the state is more limited in respect of actively committing a tax treaty dodging act – see details in Section 3.3.3.

[296] See *supra* n. 288.

[297] See Melford (1982), *supra* n. 86. For the analysis of the decision, see Section 3.3.1.2. See also Chapter 2, Section 2.3.

of Canada decided to apply a radical measure of forbidding reference to domestic law amendments made after the signature of the treaty, closing therefore the door to any attempt in this sense. In this regard, the Court supported the static interpretation as a way to avoid the dangers brought by the ambulatory interpretation.

Indeed, during the discussions raised on the debate static v. ambulatory, it has been recognized that "there is a strong argument of principle in favour of the static interpretation, which is that if it did not apply, a State could modify the effect of the treaty by changing its internal law".[298] As indicated by Jacques Sasseville, "the preoccupation of the Court was a legitimate one and is probably the most serious argument in favor of a static approach in deciding to which temporal version of domestic law Art. 3(2) makes reference".[299] However, the solution of simply closing the door to any kind of attempt in this sense was considered to be too rigid and, as a result, the decision given by the Supreme Court of Canada in favour of the static interpretation eventually had no "wide acceptance internationally, although it does adequately limit a State from unilaterally expanding its taxing power by cleverly worded statutory amendments".[300] Despite being a very effective measure against treaty dodging attempts, the static interpretation was not strongly supported and a general preference for the ambulatory interpretation by a number of states was expressed at the time.[301] In the same direction, the special project[302] concluded by "The International Tax Group" in 1984 under the coordination of John F. Avery Jones[303] recognized that "(...) the ambulatory interpretation means that it [the state] can modify the effect of a treaty in its own favour".[304] The studies conclude, however, for the application of the ambulatory interpretation,[305] as the static interpretation was considered a too rigid solution to be acceptable.[306]

Despite the general preference for the ambulatory interpretation in view of the undeniable practical advantage of avoiding dependence on and research for outdated concepts[307], scholars continued to remind the danger inherent to this approach.[308] As indicated by John F. Avery Jones et al., "even the

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[298] Avery Jones et al., *supra* n. 46, p. 40.

[299] J. Sasseville, *Temporal Aspects of Tax Treaties*, Tax Polymath – A Life in International Taxation (P. Baker & C. Bobbett eds., IBFD 2010), pp. 37-61, at pp. 39-40.

[300] Comments by David Ward in Avery Jones, *supra* n. 107, p. 82.

[301]Avery Jones, *supra* n. 107, p. 82.

[302] J. F. Avery Jones et al., *supra* n. 107; Avery Jones et al., *supra* n. 99.

[303] For details, see Chapter 2, Section 2.3.

[304] Avery Jones et al., *supra* n. 46, p. 40. They also indicate this point was previously made by Vogel.

[305] Coupled with an express or implied limitation. The express limitation refers to the "context otherwise requires" and the implied limitation to a proposal at the time to be included in the OECD Model Commentary (and later adopted). See more on the limitations proposed in Chapter 4.

[306] Avery Jones et al., supra N. 46, p. 48.

[307] For more details on this, see Chapter 5, Section 5.2.8.

[308] For example: "(...) states could abuse it by deliberately extending certain of their internal law definitions. This, of course, presupposes that the reference to internal law in the treaty is ambulatory, rather than static" (Comments by Klaus Vogel in Avery Jones, supra n. 107, p. 79); "It is apparent, however, that the ambulatory interpretation cannot be taken to its logical conclusion, otherwise a state could rewrite the effect of a treaty in its in its own favour by defining any type of

most enthusiastic supporters of the ambulatory interpretation must admit that some alterations go too far".[309] The OECD itself, although officially supporting the ambulatory interpretation,[310] recognized the possibility of tax treaty dodging as a result of the approach when it warned that "a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention".[311]

The statements in favour of application of amended domestic law and the recognition of its inherent danger normally comes along with the solution proposed by F. Avery Jones et al. of coupling the ambulatory interpretation with express and implied limitations.[312] However, this chapter does not focus on the limits proposed for the better functioning of the ambulatory interpretation, which consequently limit the possibility of tax treaty dodging practices[313]; it aims at identifying the how the phenomenon functions in practice. In particular, this section presents the ambulatory interpretation

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income as, for example, income from immovable property" (Avery Jones, *supra* n. 125, p. 253); "The fact that a treaty permits an interpretation of undefined terms in accordance with the domestic law of the State applying the treaty carries the inherent danger that a State could make the treaty partially inoperative by subsequently amending its domestic law in such a way that it distorts the treaty equilibrium" (de Broe, supra n. 55, p. 272); "It is generally accepted that undefined terms in tax treaties are interpreted in accordance with the domestic law of the country concerned at the time that the treaty is applied. This allows scope for changes in domestic law to alter the effect of a treaty" (Rigby, supra n. 27, p. 386); "Another danger is caused by the fact that if the reference made to internal tax law is ambulatory, this may have as an effect that treaty relief can be influenced easily through a change in internal law" (B. Peeters & T. Hermie, *Belgium: Foreign Tax Credit Rules in the Case of Differing Income Characterization*, Tax Treaty Case Law Around the Globe – 2011 (M. Lang et al. eds., Wolters Kluwer, 2012, pp. 391-411, at p. 402); "The right of a contracting State to refer to the relevant provisions of its domestic law, as modified from time to time (...) must be exercised in good faith (...). (...) this means that a contracting State is not allowed to make a treaty partially inoperative by amending afterwards in its domestic law the scope of terms not defined therein" (F. Engelen, *supra* n. 55, p. 490); See also: Garcia Prats, *supra* n. 55, pp. 74-75; Wattel & Marres, *supra* n. 161 (*Characterization of Fictitious Income under OECD-Patterned Tax Treaties*), p. 71; Vogel, *supra* n. 109, p. 375; Hohenwarter, *supra* n. 19, p. 176; van der Bruggen, *supra* n. 55, pp. 41-43; Wouters & Vidal, *supra* n. 50, p. 16; Weigell, *supra* n. 116, pp. 126-127; Bracewell-Milnes, *supra* n. 121, p. 47. For more references on literature, see throughout Section 2.3. in Chapter 2.

309 Avery Jones et al., *supra* n. 46, p. 47.

310 In 1995, the OECD introduced the express reference to the use of the domestic law of the time of the application of the treaty in the text of article 3(2) of the OECD Model Convention. The commentary on Article 3(2) confirms this official position: "(...) the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the convention was signed or that in force when the Convention is being applied, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the latter interpretation should prevail, and in 1995 amended the Model to make this point explicitly" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 3(2)* para. 11 (21 November 2017), Models IBFD). Even before that, the OECD had already indirectly indicated its support to the ambulatory interpretation in its Report on Tax Treaty Overrides by stating that "It cannot have been contemplated that, having once entered into a treaty, a State would be unable to change definitions of terms used in its domestic law provided such changes were compatible with the context of the treaty" (para. 4(b)).

311 *OECD Model Tax Convention on Income and on Capital: Commentary on Article 3(2)* para. 13 (21 November 2017), Models IBFD.

312 Avery Jones et al., *supra* n. 46, p. 48.

313 For this analysis, see Chapter 5, Section 5.2.8.

as the second condition for the phenomenon. The analysis of the limitations on the ambulatory interpretation, their effectiveness and relevance for the present study are object of Chapter 4, while the use of static interpretation as one of the available measures to prevent tax treaty dodging is presented in Chapter 5 of this thesis.

For the reasons explained in this section, the author concludes that the second condition for the phenomenon of tax treaty dodging is the ambulatory interpretation, in the sense that contracting states find themselves in a position to dodge tax treaties whenever they perform, after the signature of the treaty, actions with an impact on these agreements and which are taken into account when applying tax treaties. Contracting states adopting the static approach will in no way be able to dodge tax treaties. Therefore, cases contracting states' actions performed before the signature of the treaty are outside the scope of this research and, therefore, are not observed in this study. The reader should also have in mind that the existence of these two conditions does not amount to tax treaty dodging per se. It means only that the scenario where these conditions exist are vulnerable to dodging practices.

3.3. Types of tax treaty dodging

The phenomenon of tax treaty dodging may only occur under specific conditions. The two conditions necessary for a scenario where contracting states are able to dodge tax treaties were presented in the previous section. The reader saw how the exercise of sovereign rights within the treaty gap areas together with the ambulatory approach reveals to be a combination that may open doors to dodging practices. Contracting states exercising sovereign rights through actions performed (or omissions) after the signature of the treaties and within the limits imposed by the text of these agreements (i.e. within the treaty gap areas) may do it in such a manner to affect the treaty outcome. It should be kept in mind that the existence of the two conditions does not amount to a tax treaty dodging. The existence of the two conditions indicates only that the related scenario becomes vulnerable to dodging practices. On the other hand, it also means that contracting states' actions performed outside this scenario, that is, actions under an static interpretation or in clear contradiction with the wording of treaties, will in no way characterize a tax treaty dodging.

The observation of tax treaty dodging in a logical and structured manner may facilitate the understanding of the phenomenon. Since there are different ways in which tax treaty dodging may be exercised, the author decided to present the phenomenon under different categories determined on the basis of common elements. The same was done by few authors in the past. For example, Francisco Alfredo Garcia Prats classified what he referred to as abuse of tax treaties by contracting states[314] in two groups: the one resulting from post-treaty amendment of domestic tax law and the one resulting

[314] For details, see Chapter 2.

from administrative practice of contracting states.[315] In the same direction, during discussions on the possibility of abusive application of tax treaties by states at a seminar held the 54th Congress of the International Fiscal Association in 2000, Lalithkumar Rao indicated two possible types of abuse by a contracting states: *active abuse*, which would refer to a state passing legislation in line with the wording of the treaty but going counter the purpose of the treaty, and *passive abuse*, through the issuing of instructions and circulars that would result in tacitly acquiescing in abuse by the taxpayer.[316]

The author follows to a certain extent[317] the rationale used by Garcia Prats and Lalithkumar Rao to initially classify tax treaty dodging in different categories as *types of tax treaty dodging* determined according to the main actors through which dodging can be operated. In this regard, the exercise of the sovereign rights within the treaty gap areas may be done in different ways and by a number of different actors. As said in the previous section, sovereignty refers to the bundle of rights and competences that go to make up the nation state. Among this bundle of rights there is *jurisdiction*, which refers to legislative, administrative and judicial competences of a state.[318] The legislative, executive and judicial branches or powers are therefore the competent authorities to exercise the jurisdictional competence of a state, within the limits imposed by customary international law and by self-imposed unilateral limitations. When tax treaties exist, legislative and executive powers may try to exercise this competence within the limits imposed by the text of tax treaties (i.e. within the treaty gaps) but in a way to circumvent treaty obligations - although sovereign rights may also be exercised by judicial courts, this branch of the state is more limited in respect of actively committing a tax treaty dodging act, as explained further in Section 3.3.3. The ways in which legislative and executive branches may act are, for instance, through the enactment of legislation or the issuing of administrative circulars within the limits imposed by the text of tax treaties but having an impact on their outcome. It may also be, as previously indicated by the author, through actions not necessarily linked to domestic law, such as executive circulars, or even through an omission rather than an action. Legislature and executive organs are, therefore, the main actors through which contracting states can operate tax treaty dodging.

As a result, the types of tax treaty dodging qualified by the author in this study are: (i) *legislative dodging* for actions executed (or omissions) by the legislative branch and (ii) *executive dodging* for actions executed (or omissions) by the executive power (Sections 3.3.1. to 3.3.3.), while the possibility of qualification of judicial actions as tax treaty dodging is questioned by the author (Section 3.3.3.). During the description of legislative and executive tax treaty dodging, actual examples will be presented as illustration of possible dodging attempts - "possible" in the sense that they could be qualified as such because impacting the outcome of treaties without contradicting the text of the

[315] Garcia Prats, *supra* n. 55, p. 75. This second method of dodging through administrative practices is also referred to in the report of the UN Committee of Experts on International Cooperation in Tax Matters of 2006 (UN, *supra* n. 61 (16 October 2006), p. 6).
[316] Comments by L. Rao in IFA, *supra* n. 55, pp. 22-23.
[317] To the extent that a distinction is made on the basis of the type of act used by the state: legislative or executive act.
[318] Brownlie, *supra* n. 16, p. 300.

agreement; however their actual qualification as illegitimate[319] actions (that is, as an actual tax treaty dodging) can only be made on the basis of whether these actions violate international law (this analysis is presented in Chapter 4). The examples of possible cases of tax treaty dodging in this Section 3.3. are grouped by the author as different methods of tax treaty dodging according to their common elements.

In this section, the reader will also observe that the methods engaged by contracting states may have an impact in the outcome of treaties in a way to: (i) modify the allocation of taxing rights to the (tax revenue) benefit of these states (by either applying a different and more convenient treaty article, circumventing obstacles initially imposed or stretching the advantages given by a treaty provision), (ii) prevent the application of tax treaties to the (tax revenue) benefit of these states, or (iii) allow the application of tax treaty benefits in scenarios where treaty benefits are normally denied, to the (economic) benefit of these states. The different forms of impact are summarized in Section 3.4., as part of the effects of tax treaty dodging.

3.3.1. Legislative dodging

The author agrees with Klaus Vogel et al. when pointed out that "much as taxpayers arrange their legal relationships to decrease their taxable income or even to eliminate tax liability (i.e. they use tax planning), legislatures too, by appropriate formulation of new legislation are able to increase the benefits of existing tax treaties for their national tax coffers while decreasing the disadvantages".[320] Indeed legislatures are one of the actors through which tax treaty dodging can be operated. In this regard, legislatures may draft legislation within the limits imposed by the text of tax treaties but in a way to modify the outcome of these agreements. Legislation may be issued in respect of subjects falling within the treaty gap areas. This may be in respect of the basic elements of the tax liability, which determination is not provided by tax treaties as these agreements are generally made to relieve from tax and not to charge a tax (section 3.3.1.1.). It may also be in respect of the definition of a great number of treaty terms and expressions, since from a practical perspective tax treaties are not able to define the meaning of all terms and expressions used (section 3.3.1.2.). Legislatures may also omit themselves, when required to act, in a way to impact signed tax treaties, such as when they do not properly incorporate tax treaties into domestic law - the so-called treaty “underride” (section 3.3.1.3.). The identification of these areas where legislatures have a relative freedom to act because they are not limited by the wording of tax treaties are recognized and categorized in the sections below as the different methods of legislative dodging.

3.3.1.1. Re-determination of constitutive elements of the tax liability (as first legislative dodging method)

[319] See *supra* n. 1 and 2.

[320] Vogel et al., *supra* n. 36, p. 65, marginal n. 125.

There are areas which international law decides not to regulate, in most cases because it is best suited to regulation by states; the so-called *reserved domain*.[321] For example, affairs such as the choice of a political, economic, social and cultural system, or the formulation of foreign policy, are generally protected by the principle of non-intervention and are areas delimitated by international law where states' responsibility is not bound by it.[322] In respect to tax treaties, the reserved domain is intrinsically connected with the fact that tax treaties are generally made to relieve from tax - from international double taxation - and not to charge a tax.[323] According to Kees van Raad, "taxation is based on internal tax law while a tax treaty may restrict such taxation. The issue is therefore not whether a tax treaty contains any rule that permits the imposition of tax, but whether anything in the treaty prohibits the unrestricted application of the internal law".[324] This is the reason why one must first determine whether the domestic law provides for taxation in a country to only then verify whether any applicable treaty imposes a restriction on such taxation.[325] In this sense, domestic legislation that is made to charge a tax, and on which taxation is based in the first place, is expected to determine the constitutive elements of the tax liability, as this is best suited to regulation by states.[326] It is, for instance, domestic law that determines whether a state wishes to impose a tax liability on a person in respect of a certain item of income.[327] As summarized by Joanna Wheeler, one of the fundamental principles underlying treaties is that "the imposition of a tax is a matter of domestic law; it is domestic law that determines in each state when and how income is taxable, in whose hands it is taxed and whether it is taxable at all".[328] Indeed, when describing the reserved domain, Ramon Jeffrey indicates that it includes "such matters as the determination of which persons and transactions will be taxable and the types and rates of taxes that will be imposed".[329]

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[321] "The reserved domain is the domain of state activities where the jurisdiction of the state is not bound by international law: the extent of this domain depends on international law and varies according to its development" (Brownlie, *supra* n. 16, p. 293); Jeffrey, *supra* n. 240, p. 38; Douma, *supra* n. 243, p. 92; Fitzmaurice, *supra* n. 16, p. 64; Perrez, *supra* n. 244, p. 59; Nguyen Quoc, Daillier & Pellet, *supra* n. 16, pp. 396-400.

[322] Perrez, *supra* n. 244, p. 59.

[323] Avery Jones et al., *supra* n. 46, p. 17.

[324] van Raad, *supra* n. 46, pp. 588. According to him, the first fundamental rule in this respect is that tax treaties restrict the application of internal law (p. 587-590).

[325] van Raad, *supra* n. 46, p. 588; Message, *supra* n. 199, pp. 218-219. In France, the so-called *principe de subsidiarité* (see B. Castagnède, *Précis de Fiscalité Internationale* (Presses Universitaires de France, 2eme ed. 2006), pp. 256-257). However, discussions exist in literature on whether tax treaties are able to increase the tax burden of taxpayers, but this topic is outside the scope of this thesis - for the principle of non-aggravation, see P. Martin, *Interaction Between Tax Treaties and Domestic Law*, 65 Bull. Intl. Taxn. 4/5, Sec. 2.5. (IBFD 2011), Journals IBFD.

[326] "(...) the true reserved domain, that area where international law does not want to regulate because it is best suited to regulation by States operating independently of its prescriptions. This would include such matters as the determination of which persons and transactions will be taxable and the types and rates of taxes that will be imposed" (Jeffrey, *supra* n. 240, p. 38).

[327] Wheeler, *supra* n. 44, p. 13.

[328] Wheeler, *supra* n. 44, p. 55.

[329] Jeffrey, *supra* n. 240, p. 38.

In this sense, constitutive elements of the tax liability should be understood as the basic elements necessary for a tax to be levied. In general, these elements include the determination of *taxable events*, *taxable persons*, *attribution of income*, *taxable period*, *tax rates* and *types of taxes* that will be imposed. In this respect, the study conducted by Paul McDaniel and Stanley Surrey on tax expenditure[330] indicates that one of the two components of the tax system is represented by structural provisions necessary to implement income tax, or the so-called normative tax structure. Indeed, they confirm that these provisions compose the revenue-raising aspects of the tax and that they generally relate to the base of the tax, the rate structure, the taxable units liable to tax, the time period for the imposition of tax and the implementation of tax on international transactions.[331]

In this direction, Luc de Broe indicates that "it is the sovereign right of each state to freely determine the taxable object (the taxable income), the taxable subject to whom that income will be attributed (the taxpayer), the taxable event, the timing when the income will be taxed, etc." and that "income attribution rules belong to the sphere of domestic law and that they are not addressed in tax treaties".[332] In a similar way, Sjoerd Douma confirms that "states are free to exempt persons or entities from income tax, to define the concept of income and to determine the tax rate including, for example, a withholding tax rate to be withheld at source".[333] He also indicates that "(...) national states are competent to determine the objectives of their respective tax systems. (...) Internal objects include the way in which the tax is levied: the definition of the taxable persons, tax base and tax rate. External objectives include fiscal incentives that are granted to foster objectives outside the scope the tax system itself, such as the promotion of the environment".[334]

Each of these constitutive elements of the tax liability involves a number of aspects that are to be determined by domestic law. For example, provisions necessary for the determination of the taxable base generally include the definition of income, establishment of depreciation rules, deductions, specific accounting rules and calculations, etc.[335] In this respect, Peter Wattel and Otto Marres confirm that "OECD-type treaties provide allocation rules for income, but do not provide rules for the determination or calculation of the income thus allocated (...). The contracting states themselves have the authority to determine the method of calculating the income items allocated to them".[336] Or even, as explained by Michael Rigby, that treaties "do not prevent countries from amending their domestic law in many ways that change the calculation of income or of tax liabilities. For example, treaties do

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[330] P. R. McDaniel & S. S. Surrey, *International Aspects of Tax Expenditures: A Comparative Study* (Kluwer 1985), Series on International Taxation.
[331] *Ibid.*, p. 9; Douma, *supra* n. 243, p. 94.
[332] de Broe, *supra* n. 55, p. 605.
[333] Douma, *supra* n. 243, p. 96.
[334] Douma, *supra* n. 243, p. 93.
[335] McDaniel & Surrey, *supra* n. 330, p. 21; Douma, *supra* n. 243, p. 94.
[336] Wattel & Marres, *supra* n. 161 (*Characterization of Fictitious Income under OECD-Patterned Tax Treaties*), p. 67.

not prevent countries from changing their definitions of income, from changing the rules governing the treatment of losses, or from introducing or removing tax incentives".[337]

In terms of the calculation of the tax liability, tax rates are also not affected by tax treaties to the extent that they are not reduced by limitations provided in these agreements, as in the cases of articles 10(2) and 11(2) of the OECD Model Convention (2017). As Michael Rigby correctly noted, "a simple change in the rate of a company taxation or in rates of depreciation can alter the tax calculation process in a way that is unaffected by the existence of a treaty. Treaties therefore do not provide insulation against these types of changes".[338]

Provisions necessary for the determination of the taxable period may also address issues concerning not only the period itself, but also carryover and carry-back rules, the assignment of receipts and expenditures to a tax period, etc.[339] Provisions on taxable events and taxable persons include the determination of the events and persons to be taxed, not subject to taxation or exempt. The determination of who the taxable person is may also include rules related to the attribution of income which are eventually used when applying tax treaties since, as explained in the previous section, treaty definitions of connecting terms in the treaty, which if existed would apply instead of domestic connecting factors, are lacking in these agreements.[340]

It is thus not surprising that the OECD has argued that "such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability"[341] and consequently concluded that "these rules are not addressed in tax treaties and are therefore not affected by them".[342] The OECD further explains that, to the extent that the application of domestic rules results in a re-characterization of income or in a redetermination of the taxpayer who is considered to derive such income, tax treaties "will be applied taking into account these changes".[343] This position was also reaffirmed by the OECD under Action 6 of the Base Erosion and Profit

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337 Rigby, *supra* n. 27, p. 386.

338 Rigby, *supra* n. 27, p. 407.

339 McDaniel & Surrey, *supra* n. 330, p. 22.

340 In this sense, Michael Lang explains that "the attribution of income is not a matter of actuality. Rather, legal systems determine this. It is in the hands of the legislature which (...) may either follow the civil law attribution or establish independent attribution criteria. The legislature is even responsible for deciding who will be considered a taxable person in the first place – and thus a subject for the attribution of the income" (Lang, *supra* n. 63, pp. 53-54). In the same direction, see H. J. Aigner, U. Scheuerle & M. Stefaner, *General Report*, CFC Legislation – Domestic Provisions, Tax Treaties and EC Law (M. Lang et al. eds., Linde 2004), pp. 13-52, at p. 33; L. Favi, *National Report Italy*, CFC Legislation – Domestic Provisions, Tax Treaties and EC Law (M. Lang et al. eds., Linde 2004), pp. 349-390, at pp. 363-364; A. Rust, *National Report Germany*, CFC Legislation – Domestic Provisions, Tax Treaties and EC Law (M. Lang et al. eds., Linde 2004), pp. 255-279, at p. 267).

341 *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 22.1 (15 July 2014), Models IBFD.

342 *Ibid*.

343 *Ibid*. See also Wheeler, *supra* n. 44, pp. 17-18.

Shifting Project (BEPS Project)[344], and reflected in the commentary on article 1 of the OECD Model Convention (2017): "(...) many provisions of the Convention depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person (...), the determination of what is immovable property (...) and the determination of when income from corporate rights might be treated as a dividend (...). More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the Convention. In many cases, therefore, the application of specific anti-abuse rules found in domestic law will have an impact on how the treaty provisions are applied rather than produce conflicting results".[345] This line of thought is indeed defended by a large number of scholars[346] and is further discussed in this thesis.

The author believes that, to a certain extent, the OECD could have not indicated otherwise. These elements do constitute the tax liability and are indeed part of the normative tax structure of a country. Tax treaties do not address such aspects but, rather, apply to an event which elements forming the tax liability have been already determined by domestic law in the first place. Each country deploys its own sovereign rights to determine what it considers to be the facts giving rise to tax liability.[347] The natural consequence, which has been acknowledged by the OECD, would be that no conflict could exist between domestic provisions and tax treaties in this respect; or, at least, in the view of the author, not in clear contradiction with the text of these agreements. Yet, questions may be raised in respect of whether the exercise of these sovereign rights would be in conflict with other rules and principles of international law, which involves a different and separate analysis, presented in Chapter 4.

Having all this in mind, the author presents below potential legislative dodging cases in which legislatures of contracting states amended, after the signature of treaties, domestic legislation concerning the determination of constitutive elements of the tax liability, which eventually had an impact on the outcome of these agreements.

Re-attribution of income

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[344] OECD/G20, *supra* n. 214, p. 83

[345] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 73 (21 November 2017), Models IBFD.

[346] For example, Michael Lang defends that "tax treaties do not take any independent attribution decisions. Instead, treaties allow the entities that are residents to enjoy the benefits of the treaty, which also requires that the entities be the bears of fiscal rights and duties in at least one of the states. This is also in line with teleological considerations: the object and purpose of treaties is to limit existing tax obligations. As a result, the provisions of tax treaties must apply to the entities that have become the subject of income attribution in accordance with the domestic laws of contracting states. (...) Tax treaties are hence based on the domestic attribution decision, and they provide legal consequences for the attribution subjects of the contracting states when the entity in question has the required close relationship to one of the two contracting states" (Lang, *supra* n. 63, p. 53-55). See also: Aigner, Scheuerle & Stefaner, *supra* n. 340, p. 33; Favi, *supra* n. 340, pp. 363-364; A. Rust, *supra* n. 340, p. 267.

[347] de Broe, *supra* n. 55, p. 576.

As explained, the attribution of income is an element of the tax liability which determination is naturally in the hands of contracting states as part of the revenue-raising aspects of taxes. This could have turned out differently if connecting terms existing in tax treaties such *as paid to* and *derived by* were defined in these agreements. But in the absence of such definitions, contracting states are relatively free to determine which persons income is attributable to and consequently taxed.[348] As Michael Lang explains, "the attribution of income is not a matter of actuality. Rather, legal systems determine this. It is in the hands of the legislature which (...) may either follow the civil law attribution or establish independent attribution criteria. The legislature is even responsible for deciding who will be considered a taxable person in the first place – and thus a subject for the attribution of the income".[349] As a consequence, it is possible to imagine that in the same way taxpayers may maneuver their taxable profits or income by attributing all or part of them to a related person over which they have control and of which the tax burden is reduced, contracting states may too attribute, under domestic law, income to a person over which they can exercise their taxing rights according to tax treaties. Attempts in this direction are illustrated by the author in a series of cases explained below.

The first example illustrating how contracting states may play with attribution of income in order to modify the effects of existing tax treaties for their own benefit is the one concerning CFC legislations based on the *attribution of profit approach*. The French CFC legislation introduced by the French Finance Law for 1980[350] may serve as an example in this respect. This legislation allowed the taxation in France of a resident entity holding a controlled interest in a subsidiary located in a low tax jurisdiction in proportion to its participation. This French CFC rule, which was in fact similar to a number of CFC rules in other countries, would not be in direct conflict with the business profit article of treaties signed (i.e. conflict with the text of the provision), simply because by attributing the profits of the CFC entity to the controlling companies resident in France, and consequently taxing it separately at their level, the rule avoided the direct taxation of the CFC entity with no permanent establishment in France – which would be a scenario resulting in a clear violation of the business profit provision in treaties. Indeed, "Where a 'transparency approach' is adopted and the profit of the CFC is attributed to the shareholder, a literal interpretation of Art. 7(1), giving effect to the ordinary meaning of its terms, does not lead to the conclusion that the CFC rule infringes Art. 7(1)".[351] Therefore, by attributing the profits

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[348] According to Kees van Raad, the fifth fundamental rule in applying tax treaties indicates that tax treaties do not deal with the question to which person the item of income is to be taxed, as the terminological links employed in the distributive treaty articles between the taxpayer and the item of income (i.e. "derived by", "paid to", "receives" and "of") are not defined (van Raad, *supra* n. 46, p. 598). See also, Lang, *supra* n. 63, pp. 53-56. On the link missing in tax treaties between the person claiming treaty benefits and the specific item of income in question, see Wheeler, *supra* n. 44.

[349] Lang, *supra* n. (2003), pp. 53-54. In the same direction, see H. J. Aigner, U. Scheuerle & M. Stefaner, *General Report*, CFC Legislation – Domestic Provisions, Tax Treaties and EC Law (M. Lang et al. eds., Linde 2004), pp. 13-52, at p. 33; L. Favi, *National Report Italy*, CFC Legislation – Domestic Provisions, Tax Treaties and EC Law (M. Lang et al. eds., Linde 2004), pp. 349-390, at pp. 363-364; A. Rust, *National Report Germany*, CFC Legislation – Domestic Provisions, Tax Treaties and EC Law (M. Lang et al. eds., Linde 2004), pp. 255-279, at p. 267).

[350] Castagnède, *supra* n. 325, p. 114, para. 111

[351] de Broe, *supra* n. 55, p. 634.

to a different person under domestic law, the French CFC legislation modified the outcome of existing treaties from a scenario where no French tax could be levied to the one where France would be entitled to tax in accordance with the very same treaty article. In other words, through re-attributing income to specific persons, France was able to circumvent the obstacles of the treaty article and recover taxing rights over items of income that it had agreed to allocate to its treaty partner when signing the treaty.

In 2002, the issue of whether the French CFC legislation was or not compatible with the business profit article in the France-Switzerland Income and Capital Tax Treaty (1966),[352] which prevented the taxation in France of profits of a Swiss company without a permanent establishment therein,[353] reached the French *Conseil d'État* as the *Schneider Electric* (2002) case.[354] The French *Conseil d'État* held that the taxation of the CFC profits in France was incompatible with the business profit article of the treaty. The position of the French Court in this case, which is that CFC rules are not compatible with tax treaties, is criticized by scholars who defend the idea that the attribution of income to a person does belong to the contracting state's sovereign rights[355] and, therefore, taxing the income attributed to a resident person would be in line with the business profit article. As explained before, this is also the position of the OECD. For some scholars,[356] the French *Conseil d'État* incorrectly supposed that the income subject to taxation under the CFC rule was the income of the Swiss company. It was argued that this could only be based on the wrong assumption that there would be an independent attribution rule in tax treaties (or that the Swiss attribution rule would be binding on France).[357] The author agrees with the underlying arguments of this the criticism to the extent that attribution of income is indeed not given by tax treaties but is an element of the tax liability which determination is a right of the contracting states, as already demonstrated. Once attributed to a resident person, this income can be taxed in the residence state according to the wording of the treaty[358] so that no direct

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[352] *Convention between the French Republic and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (9 September 1966), Treaties IBFD.

[353] "The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein" (*Ibid*., article 7(1)).

[354] FR:CE, 28 June 2002, 232 276, Tax Treaty Case Law IBFD.

[355] See for example, Aigner, Scheuerle & Stefaner, *supra* n. 340, pp. 31-32; Lang, *supra* n. 63, pp. 53-55; Rust, *supra* n. 340, pp. 267-268; Favi, *supra* n. 340, pp. 363-364; to a certain extent, de Broe, *supra* n. 55, p. 605.

[356] Aigner, Scheuerle & Stefaner, *supra* n. 340, p. 33; Lang, *supra* n. 63, p. 55-56.

[357] Aigner, Scheuerle & Stefaner, *supra* n. 340.

[358] Luc de Broe makes a good explanation of this reasoning: From the perspective of the French parent company: "The profits of an enterprise of France shall be taxable only in France unless the enterprise carries on business in Switzerland through a permanent establishment situated therein". From the perspective of the Swiss CFC it reads: "The profits of an enterprise of Switzerland shall be taxable only in Switzerland unless the enterprise carries on business in France through a permanent establishment situated therein". The term "enterprise of France" used in Art. 7 is defined in Art. 3(1)(g) as "an enterprise carried on by a resident of France". Because of this reference to a French resident (i.e. a person liable to tax in France under one of the criteria of Art. 4(1) of the treaty), the profits of an enterprise resident of France in the meaning of Art. 7(1) are the profits attributed to that enterprise in accordance with the French domestic tax laws applying to French residents. Under French CFC legislation, these profits happen to be the same profits as those that have been taxed in the name of the Swiss subsidiary under Swiss tax law. The Swiss subsidiary (not having a French permanent establishment) is, however, itself not taxed in France. Consequently, a literal reading of Art. 7(1), giving effect to the ordinary meaning of its

conflict exists. The question for the author is, however, whether this could be in line with international law protecting the good usage of treaty rules (see this analysis in Chapter 4). In this respect, it is interesting to note that the French *Conseil d'État* did not qualify the action of the French legislature as a treaty override, but implicitly as a circumvention of the provisions in the treaty and the obligations undertaken by France there under.[359]

Surprisingly, the French *Conseil d'État* took a different position when judging the case *Aznavour* (2008).[360] The case concerned an individual resident of Switzerland who performed a concert in France, for which compensation was paid by the French company to a promoter company, resident of the United Kingdom, who ultimately paid the service to the individual. In order to neutralize the use of conduit artiste companies, French domestic law introduced in 1972[361] considered that income received by a foreign entity for services provided by individuals in France was deemed to be taxable in France in the hands of the individual. By attributing the income to the individual, taxation in France became allowed by the artistes and sportsmen article in the France-Switzerland Income and Capital Tax Treaty (1966),[362] under which income derived by a an entertainer may be taxed in the state where the performance took place - it should be noted that this treaty does not have a provision similar to article 17(2) of the OECD Model Convention (2014), where taxing rights are allocated to the country of performance even in cases where the income accrues not to the individual performer but to another person, such as conduit artiste companies. The taxpayer argued that the provisions of the France-United Kingdom Income Tax Treaty (1968)[363] had priority over the French domestic law that attributed the income to the individual.[364] Under this perspective, the business profit article in this treaty would be applicable to deny taxation in France, as the UK promoter company receiving the payment did not have a permanent establishment in France.

As opposed to the reasoning in the case *Schneider Electric* (2002), where the French *Conseil d'État* assumed that the income subject to taxation under the CFC rule was the income of the Swiss company as if there would be an independent attribution rule in tax treaties, this time the court observed that taxable events and taxable persons have to be first determined on the basis of domestic law.[365] As the French domestic law deemed the individual resident in Switzerland to be liable to tax for his

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terms, does not preclude the taxation of the parent under the French CFC regime on the undistributed profit of the Swiss CFC" (de Broe, *supra* n. 55, pp. 608-609).

359 de Broe, *supra* n. 55, p. 611.

360 FR: CE, 28 March 2008, 271366, Tax Treaty Case Law IBFD.

361 Art. 155A of the French Tax Code (Code Général des Impôts (CGI)), first introduced by Law 872-I 121 of 20 December 1972. In a decision n. 2010-70 QPC of 26 November 2010, the Conseil Constitutionnel held that the provision is in line with the French constitution if it does not result in double taxation with respect to the same tax.

362 *Convention between the French Republic and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital*, art. 19(1) (9 September 1966), Treaties IBFD.

363 *Convention between the United Kingdom of Great Britain and Northern Ireland and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (22 May 1968), Treaties IBFD.

364 Azanavour (2008), supra n. 360.

365 Azanavour (2008), supra n. 360.

performance in France, the court decided that the France-Switzerland treaty and not the France-United Kingdom treaty was applicable and, thus, the income would be taxable in France as allowed by the artistes and sportsmen provision of that treaty. By attributing income to specific persons under domestic law and consequently shifting from one treaty article to a more favourable one, France broadened the scope of circumstances in which it was allowed to tax under the treaty.

A similar case where income paid for the activity of an individual was attributed to this individual even though paid to a company was judged by the Federal Court of Australia. The case *Russell* (2012)[366] concerned an individual resident in Australia, who provided services through a company incorporated in New Zealand, which formally employed him.[367] The company fulfilled all the conditions for qualification as a personal services company in Australia, which rules introduced in 2000 determined that the amount of any personal services income received must be attributed to the individual.[368] As a result, payments made by an Australian client to the company in New Zealand were directly attributed to the individual in Australia as personal service income and taxed in Australia. The taxpayer argued that the income assessed in his hands was in fact profits of the entity in New Zealand and, therefore, taxation of those profits in Australia in the absence of a permanent establishment was contrary to the therefore applicable business article in the Australia-New Zealand Income Tax Treaty (1995).[369] However, the Federal Court of Australia ruled in favour of the tax authorities in the sense that, by virtue of application of the Australian personal service income rules which attributed the income to the taxpayer, the Australian tax liability on the individual did not constitute taxation of the company that was prohibited by the treaty[370]; the treaty forbade Australian taxation only in respect of income forming part of the company's profits. In this case, the re-attribution of income under domestic rules again broadened the scope of circumstances in which Australia was allowed to tax without infringing the wording of the treaty by circumventing the obstacles imposed by the business profit article on Australia.

Redesign and creation of taxes

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[366] AU: HCA, 10 February 2012, *Anthony Whitworth Russell v. Commissioner of Taxation of Commonwealth of Australia*, Tax Treaty Case Law IBFD.

[367] Wheeler, *supra* n. 44, p. 116.

[368] The rules apply from 1 July 2000 and are included in Part 2042 of the Income Tax Assessment Act 1997. Australian domestic law provides that "personal services income" is included in the income of the worker (and excluded from the income of the company), even if the amounts are paid to a company pursuant to a contract between the client and the company. These rules serve against diverting employment and services income into companies and splitting labor income with other entities (Anthony Whitworth Russell v. Commissioner of Taxation of Commonwealth of Australia, *supra* n. 366). For a comment on the Australian legislation, see S. Pennicot, *Resolving the Personal Services Income Dilemma in Australia: An Evaluation of Alternative Anti-Avoidance Measures*, Journal of Australian Taxation, 2007(10) 1, p. 53.

[369] *Agreement between the Government of Australia and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (27 January 1995), Treaties IBFD.

[370] Wheeler, *supra* n. 44, p. 117.

Another possible way of extending taxing rights beyond what can reasonably be foreseen by treaty partners at the conclusion of treaties is through the redesign of taxes. Article 2 of the OECD Model Convention (2017) delimitates the scope of application of tax treaties in respect of taxes covered. It also determines that treaties apply also to any identical or substantially similar taxes that are imposed in addition to, or in place of, existing taxes, when they are introduced after the signature of the treaty.[371] However, contracting states may try to redesign existing taxes normally falling in the scope of the treaty in a way to escape from the application of this rule. By restructuring an existing tax normally covered by the treaty, a contracting state may be able to circumvent the application of the taxes covered article so that the new or redesigned tax is no longer subject to the limitations imposed by treaty provisions. In such cases, contracting states may be able to prevent, or circumvent, the application of tax treaties by creating a new scenario that falls out of scope of these agreements.

However, contracting states need not only to escape from the application of the general rule of the taxes covered article, but also from the safeguard rule under which any identical or substantially similar taxes introduced in addition to or in place of existing taxes after the signature of the treaty falls in the scope of the treaty. For this, contracting states may not only attribute different characteristics to the redesigned tax but also establish its liability on different a taxpayer so that it may result in a purely domestic issue outside the scope of tax treaties. By these appropriate adjustments on taxes, contracting states are able to increase the benefits of existing tax treaties.

In this regard, the case of the Brazilian contribution for the intervention in the economic domain (*Contribuição de Intervenção no Domínio Econômico*, CIDE - hereinafter referred to as CIDE contribution) may be used as an example. In Brazil, the outbound payment of royalties was subject to income tax withheld at source at the rate of 15% rate according to domestic law.[372] In 2000, an amendment to domestic law increased this withholding tax from 15% to 25% for taxable events occurring as of 1 January 2001[373] - in this respect, it is important to have in mind that tax treaties signed by Brazil limit in general withholding taxes on certain royalties remittances to 15%, so that Brazil generally has a revenue loss of 10% when remittances are made to a country with which it has signed a tax treaty. However, Brazilian legislation predicted a reduction of the 25% withholding tax to 15% in case the CIDE contribution was implemented.[374] Indeed, later that year a new law was introduced with the implementation of the CIDE contribution, which would be levied on such remittances at the rate of 10%.[375] In addition, the law did not qualify the non-resident receiving the remittance as the taxpayer of such contribution, but the paying source in Brazil. As a result, the CIDE is not withheld at source.

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[371] *OECD Model Tax Convention on Income and on Capital* art. 2(4) (21 November 2017), Models IBFD.

[372] Medida Provisória 1,459/1996 and article 710 of the Brazilian Income Tax Regulation (Decree 3,000/1999).

[373] Article 3(1) of Medida Provisória 2,062-60/2000.

[374] *Ibid.*, article 3(2).

[375] Law 10,168/2000. A year later, Law 10,332/2001 enlarged the CIDE taxable base to include payments of technical services, administrative assistance and similar services to non-resident beneficiaries.

It is possible to conclude, in view of the sequence of events of the withholding tax reduction automatically linked with the CIDE contribution and the determination of who the taxpayer is under domestic law, that Brazil tried to recover the revenue loss of 10% by re-characterizing this lost income tax as a 10% contribution which would not fall in the scope of tax treaties. In this respect, it would be difficult to defend the CIDE contribution as a levy similar to income tax. While the revenue collected as income tax goes to the general state budget, the CIDE revenue has a special destination, which is the financing of the technology development in Brazil.[376][377] Even if one could still consider such contribution similar to income tax, the determination by domestic law that the resident payer (and not the non-resident beneficiary) is the taxpayer of CIDE contribution made it a domestic payment that is not subject to international double taxation and to which application of the treaty in not required the first place. According to Hiromi Higuchi et al., Brazilian tax authorities are in a good position to argue that tax treaties do not apply to CIDE because this contribution is charged on the Brazilian source.[378] If this contribution were charged on the non-resident beneficiary, it would be more difficult to defend this position.[379] Indeed, the fact that the CIDE burden is allocated to the paying domestic entity in Brazil makes this a purely domestic issue.

A similar levy was introduced by France in 2012 as an additional contribution to the standard corporate income tax due by resident companies.[380] This contribution is due by resident companies at the rate of 3% on the payment of dividends or repatriation of profits. Similar to the Brazilian CIDE contribution, French legislators structured the 3% contribution as a tax imposed on the resident distributing company, rather than on the non-resident shareholder.[381] This charge may have been created to compensate the contracting state for the loss resulting from the limitation of withholding taxes normally imposed by treaties on the payment of cross-border dividends, such as done by Brazil

[376] The CIDE finances the Incentive Program for the Interaction between University and Companies for the Support of Innovation (*Programa de Estímulo à Interação Universidade-Empresa para o Apoio à Inovação*), which main object is to stimulate technology development in Brazil though research and development programs carried by universities, research centers and the business sector (Article 1 of Law 10,168/2000).

[377] There is a significant agreement on a concept of tax that requires the levy proceeds to be used for public purposes "without regard to the particular benefit received by the taxpayer (unrequited payment)", although this may vary between jurisdictions (M. Helminen, *The Notion of Tax and the Elimination of Double Taxation or Double Non-Taxation – General Report*, 101b IFA Cahiers de Droit Fiscal International (IFA 2016), p. 159, p. 161). In Brazil, this requirement exists for the purpose of qualifying a levy as tax (*imposto*) as opposed to other types of levy that are charged to finance a specific benefit to the taxpayer, such as the case of contributions. This is also in line with the OECD position in the sense that it excludes from the scope of article 2 social security charges or any other charge where there is a direct connection between the levy and the individual benefits to be received (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 2(2)* para. 3 (21 November 2017), Models IBFD). See also M. Helminen, *supra* n. 377, p. 171.

[378] H. Higuchi, F. H. Higuchi & C. H. Higuchi, *Imposto de Renda das Empresas – Interpretação e Prática* (IR Publicações LTDA 2009), p. 949.

[379] *Ibid.*

[380] Introduced by article 6 of the Second French Rectifying Finance Act (2012-958) of 16 August 2012, codified in the new article 235 *ter* ZCA of the French tax code (*Code Général des Impôts*).

[381] F. van Nus & C. Philibert, *Has the French 3% Contribution Become Compatible with EU Law and Tax Treaties?*, 22 EC Tax Review 5 (Kluwer Law International 2013), pp. 213-221, at p. 220.

with the CIDE contribution for the loss over the limitation on of withholding taxes on royalties. In other words, the withholding tax limited by the treaty may have been redesigned into the 3% contribution that falls out of the scope of the treaty. As indicated by Frank van Nus and Cédric Philibert, "ingeniously qualified by the French legislator as an additional contribution to CIT [corporate income tax] in a way not to be a withholding tax, this contribution nonetheless raises some doubts about its compatibility with EU law as well as with provisions of the various tax treaties that France has entered into".[382]

Another similar case was spotted by Michael Rigby during the analysis of the New Zealand's dividend withholding payment regime.[383] In his view, it is possible that this regime had been introduced in order to circumvent treaty provisions requiring New Zealand to exempt from tax dividends derived by companies resident in that country.[384] Under the dividend withholding payment regime, companies resident in New Zealand that received dividends from non-resident companies were required to deduct an amount by way of a dividend withholding payment from those dividends.[385] According to Rigby, "whether the dividend withholding payment regime successfully circumvents the treaty exemptions for inter-corporate dividends depends on whether it imposes a tax that is covered by the treaties in question".[386] In his analysis, he demonstrates that several features of the dividend withholding payment regime support the view that the regime does not impose an income tax or a tax substantially similar to an income tax.[387] However, he concludes by saying that even in this case, i.e. the case where the regime does not indeed impose an income tax, it can be argued that despite not directly breaching New Zealand's treaty obligations, the regime may have been introduced in violation to good faith, context and/or object and purpose of treaties.[388]

This method of preventing the application of tax treaties may be achieved not only through the redesign of existing taxes as a way to compensate for the loss of the former tax resulting from the application of treaty limitations, but also through the creation of brand new taxes which may be specifically designed to fall out of the scope of the treaty. As spotted by Marjana Helminen, "different types of new taxes with non-traditional tax bases or names may even be introduced deliberately either

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382 *Ibid.*, pp. 213-221, at p. 213.

383 Rigby, *supra* n. 27, pp. 392-400.

384 *Ibid.*

385 Rigby, *supra* . 27, p. 394.

386 Rigby, *supra* n. 27, p. 393-394.

387 For details on this, see Rigby, *supra* n. 27, p. 395-398.

388 Rigby, *supra* n. 27, pp. 398-399. Also: "the conclusion that the dividend withholding payment regime may result in a breach of New Zealand's treaty obligations to exempt inter-corporate dividends is based on a broad reading of the nature of those obligations. If this broad reading is incorrect, so that the application of the dividend withholding payment regime does not breach treaty obligations, it is clear that the dividend withholding payment regime at least operates in a manner which is contrary to the spirit of the treaties in question. Therefore, even if no obligations are breached it can be concluded that New Zealand is not acting in good faith as treaty partner in applying dividend withholding payment regime in cases where dividends are entitled to treaty exemption" (Rigby, *supra* n. 27, p. 400).

in order for the tax to fall under the scope of tax treaties or in order to avoid their applicability".[389] The recent types of "digital taxes" created by some countries as unilateral measures to solve the problem of taxation of the digitalized economy may also reflect this practice.

For example, in 2018 the UK announced its plan to implement a digital services tax at a rate of 2% on the UK revenues of digital businesses that are considered to derive significant value from the participation of their users. In a consultation launched by the UK HM Revenue and Customs on 7 November 2018,[390] it was stated that some countries had questioned the compatibility of the proposed digital services tax with tax treaties, one of the issues being the question of whether it would be a tax covered by these agreements. In this document, the UK HM Revenue and Customs expresses its position in the sense that this tax is neither a listed tax, an identical or substantially similar to any listed taxes, nor meets the general definition of a tax on income,[391] and therefore would fall out of the scope of treaties. The argument of not meeting the general definition of tax on income in treaties was based on the fact that: (i) the OECD Model Convention does not have a definition of income tax or income; (ii) that "income is commonly understood to be a measure of the net accretion to a taxpayer's economic wealth between two points in time, which is generally calculated by taking a measure of the taxpayer's gross receipts and then deducting relevant costs and expenses incurred in generating those receipts" and (iii) the new tax "would be levied on gross receipts from certain digital business activities, that only takes account of the costs incurred in generating those revenues in the application of the safe-harbour provision, which will only apply in exceptional cases where the tax could otherwise have a disproportionate effect".[392] It is further added that "there are examples of taxes applied to gross receipts that are nonetheless determined to meet the definition of an income tax. However, the government believes that this is only the case where the taxation of gross receipts is designed to approximate and substitute for the taxation of income i.e. the tax on gross receipts is a tax in lieu of income. (…) Despite the DST [digital service tax] being justified on concerns regarding the corporation tax system, the government does not believe that the DST [digital service tax] can be classified as a tax in lieu of corporate tax given that it will apply separately to, and not in place of, corporate tax".[393]

Indeed, in the absence of a common definition of what tax on income means, countries have sovereign powers to determine which taxes are regarded as taxes on income[394] and, by doing so, they may design

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[389] Helminen, *supra* n. 377, p. 159.

[390] UK, *UK Digital Service Tax: Consultation*, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/754975/Digital_Services_Tax_-_Consultation_Document_FINAL_PDF.pdf (accessed 19 Jan. 2019).

[391] *Ibid.*, p. 32.

[392] *Ibid.*

[393] UK, *supra* n. 390, pp. 32-33.

[394] "(…) there is no universal definition of the notions of a "tax on income" or a "tax on capital". In the end the determination of the tax objects that are subject to income tax and the tax objects that are subject to tax on capital is a political decision. (…) It is evident that a tax which is considered to be an income tax (or a capital tax) in a certain state

new taxes falling outside the scope of tax treaties. They would be then circumventing tax treaties without breaching the letter of those agreements. Whether these actions are inconsistent with other rules and principles of international law is another question, which is discussed under Chapter 4 of this thesis.

A similar debate happened in respect of the UK diverted profit tax (the so-called "Google tax") implemented in 2015 and levied at a 25% rate on profits generated by multinationals from economic activity in the UK which were artificially shift out of the country ("diverted profits").[395] The HM Revenue and Customs also argued that this tax falls outside the scope of tax treaties for being a new separate tax[396], that is, that is not merely an extension of the taxes covered by tax treaties: "DPT [diverted profit tax] is a separate, stand-alone charge on diverted profits. It is not income tax, capital gains tax, or corporation tax and is not covered by double taxation treaties".[397] However, in this case the HM Revenue and Customs could not argue that the new tax is not levied on net income (but on revenue) and therefore could not be considered similar to the corporation tax levied (and covered by treaties), as done in the case of the digital service tax. However, there may still be arguments to sustain this tax as not substantially similar to corporation tax for being levied only to diverted profits and only to particular taxpayers, as well as being subject to different procedural rules and method of charging.[398] The author is of the opinion that the diverted profit tax can be qualified as a substantially similar tax in view of the fact that it is charged to a similar taxable base, as the diverted profits are "defined in terms of profits that would otherwise be chargeable to corporation tax".[399] The fact that one considers the diverted profit tax as substantially similar to the corporation tax or not is crucial for assessing whether it is a tax treaty dodging practice: if substantially similar to the standard income tax levied, the non application of tax treaties to the new tax amounts to a direct breach of article 2(4) of the OECD Model Convention (2017) (i.e. breach of the wording of the provision) and, thus, not to a tax treaty dodging action; otherwise, the lack of a direct breach indicates a possible tax treaty dodging action which legitimacy could still be assessed on the basis of rules and principles of international law.[400]

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may not be treated as such in another state. Each state has the sovereign powers to decide which foreign levies qualify as taxes on income or as taxes on capital for its domestic law purposes. Irrespective of its name, a levy of one state may or may not be regarded as a tax on income or a tax on capital in another state for domestic law or for tax treaty purposes" (M. Helminen, *supra* n. 377, pp. 162-163).

[395] The tax targets two specific behaviours: (i) exploitation of mismatches between the tax systems to make use of deductions in the UK not matched by a corresponding increase in the profits of related non-resident entities and (ii) the artificial avoidance of a permanent establishment in the UK.

[396] HMRC, *Diverted Profit Tax* (2015), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/400340/Diverted_Profits_Tax.pdf (accessed 20 Jan. 2019).

[397] HMRC, *Diverted Profit Tax: Guidance*, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/768204/Diverted_Profits_Tax_-_Guidance__December_2018_.pdf (accessed 20 Jan. 2019), p. 83.

[398] M. Helminen, *supra* n. 377, p. 186.

[399] *Ibid.*

[400] See Chapter 4.

In all those cases, it can be argued that the redesign of existing taxes or creation of new ones were possibly made as an attempt to broaden the scope of circumstances in which countries are allowed to tax by circumventing or preventing the application of treaties through the creation of scenarios falling outside the scope these agreements.[401] A similar move was attempted by the Australian tax authorities when they tried to interpret a domestic legislation in a way to present an existing tax as a capital gain tax when in substance it was an income tax, in order to circumvent or prevent the application of treaties that did not cover taxes on capital gains. As this was an attempt by the executive branch, and not by legislatures, this method is explained further in Section 3.3.2., under executive interpretative dodging.

Change of tax rates

As explained, the constitutive elements of the tax liability include revenue-raising aspects of the tax. Tax rates are among these aspects and are therefore determined by domestic law of contracting states. Tax treaties generally limit the application of domestic tax rates in certain cases, such as in the case of passive income. Whenever not limited by the treaty, the applicable domestic rates are those determined by domestic law.

In this sense, it is possible for contracting states to introduce changes related to tax rates in order to modify the outcome of treaties. For example, contracting states may change domestic tax rates in order to stretch the benefits of tax sparing clauses.[402] This possibility was raised by the OECD in its report "*Tax Sparing – a Reconsideration*" issued in 1998.[403] In this report, the OECD lists different reasons why, under its perspective, countries should avoid the inclusion or limit the effects of tax sparing clauses in tax treaties.[404] One of the main reasons was that tax sparing clauses would open new possibilities for tax evasion and other types of abuse.[405] According to the report, one type of "*abuse of tax sparing provision*" was the "*potential government abuse of tax sparing*". Under this topic, the OECD affirms that "tax sparing provisions also create an incentive for host countries to maintain artificially high rates of tax. In some cases 'special' tax rates appear to have been designed primarily to secure greater tax

[401] The prevention or circumvention of treaties is also seen in legislature omissions (see Section 3.3.1.3.).

[402] In cases where contracting states have opted for the credit method to avoid double taxation, tax incentives granted by the source state are nullified by the fact that the resident state only allows a credit equivalent to the tax effectively paid in the source state. This converts the tax incentives offered by source states into a benefit for resident states. Tax sparing clauses were created to give effect to developing countries' tax policy, through which the investor is able to receive in the residence state a tax credit equivalent to the tax which would have been paid in the source state had the incentive not been granted. By doing this, the benefit of the fiscal waiver would revert to the taxpayer, and not to the residence state, and would serve as a measure to attract foreign investment (V. Arruda Ferreira & A. Trindade Marinho, *Tax Sparing and Matching Credit: From an Unclear Concept to an Uncertain Regime*, 67 Bull. Intl. Taxn. 8 (2013), Journals IBFD, pp. 397-413, at p. 398.

[403] OECD, *Tax Sparing – a Reconsideration* (OECD 1998), International Organizations' Documentation IBFD.

[404] *Ibid.*, pp. 21-30. See also Arruda Ferreira & Trindade Marinho, supra n. 402, pp. 398-399.

[405] OECD, *supra* n. 403, pp. 28-30.

sparing credit benefits for foreign investors of credit countries".[406] The OECD does not elaborate on this affirmative and a more detailed explanation of how this abusive mechanism is conducted by states is missing in the report. The author suspects that the "abuse of tax sparing by government" referred by the OECD would happen in the case where, in order to stretch the benefit of tax sparing clauses, countries may create, after the conclusion of a treaty with a tax sparing clause, high artificial standard rates which would eventually not apply in practice in view of a tax incentive granted under domestic law. By doing so, treaty partners would have to grant a credit to the investor equivalent to the "artificial" higher standard rate that would have been implemented in theory (but not applied in practice in view of the incentive) only for the purpose of tax sparing clauses.[407]

The increase of standard rates in order to stretch the advantages of tax sparing clauses was also acknowledged by Edwin van der Bruggen as a method arguably not in accordance with the legitimate expectation of treaty partners.[408] He also concludes that, with tax sparing clauses in mind, "the developing country may be tempted to raise the overall corporate income tax rate, in a way that it in fact only affects foreign companies or companies with foreign shareholders".[409]

Yet, he also alerts another way of stretching of tax sparing credits, this time through redefinition of treaty terms. The concern that developing countries might abuse the notion of "tax incentives similar to those currently in force" to expand the scope of conventional tax sparing credits was well observed not only by Edwin van der Bruggen, but also by the OECD itself in its report Tax Sparing – A Reconsideration.[410] However, this method does not entail the redetermination of elements of the tax liability, but the redefinition of terms not defined in the treaty, which is object of the analysis under Section 3.3.1.2.

Exit taxes on substantial shareholding

When discussing the different attempts of what he indicates as "*backdoor override*", Maarten Ellis gives the example of the "use of deemed realizations, shifting the timing of recognition of income to a time when the taxpayer is resident in your country so you can tax him".[411] Maarten Ellis is referring to exit taxes[412] as a method of circumventing tax treaty obligations. Indeed, since the moment when the

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[406] OECD, *supra* n. 403, pp. 29-30.

[407] For example, with an existing tax sparing clause in the back of its mind, a country applying a standard rate of 15% for a certain type of income may decide to amend its domestic law to (artificially) increase this standard rate to 25% and simultaneously grant an exemption to his type of income, so that the treaty partner would be obliged under the tax sparing clause to grant a 25% credit instead of 15% under the treaty.

[408] van der Bruggen, *supra* n. 55, pp. 52-53.

[409] van der Bruggen, *supra* n. 55, p. 53.

[410] van der Bruggen, *supra* n. 55, p. 53. OECD, *supra* n. 403, p. 28.

[411] Comments by M. J. Ellis in J. Arnold & al., *supra* n. 28, p. 394.

[412] Exit taxes are levied upon emigration. Some countries apply exit taxes on substantial shareholding, for example. In this case, countries normally apply the fiction that the shares are being disposed of at their market value at the date of the

taxable event is recognized is not indicated by tax treaties,[413] but rather determined by contracting states under their domestic law as an aspect of the tax liability, contracting states may exercise this right in a manner to modify the outcome of treaties for their own benefit. In this respect, exit taxes could be regarded as a tax treaty dodging method through which a contracting state can modify its domestic law to consider the taxable event "occurred" at the moment when taxing rights belong to such country either because the treaty so determines (for those supporting the application of the treaty in such situation) or because no treaty restriction would exist due to its non-applicability at the moment prior to emigration.[414] For example, a taxpayer may be deemed to realize, just prior to emigration, capital gains on the unrealized profit of shareholdings, so that the country of emigration is able to tax this income according to article 13(5) of the OECD Model Convention (2017),[415] which allocates taxing rights to the resident state, or that it is able to tax it in view of the non-application of the agreement if one so believes[416]. If the taxable moment would be considered as occurred at the moment of the actual alienation, the taxation of the related capital gains would be granted to the country of emigration, as the new residence state of the taxpayer.

The question of whether exit taxes could be qualified as an abusive application of tax treaties by contracting states was raised, for example, during a seminar held in Munich at the 54th Congress of the International Fiscal Association in 2000.[417] Lalithkumar Rao defended the introduction of an exit tax after the conclusion of a treaty as an abusive behaviour of the contracting state and reminded that treaty abuse - according to him adherence to the letter of the treaty but in violation of the purpose of the treaty - is always an abuse "whether this is done by the taxpayer or by the state".[418] He further indicates that exit tax, as a measure intended to get around treaty obligations, may happen only when

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transfer of residence and the accrued capital gain is subject to tax (L. de Broe, *Hard Times for Emigration Taxes in EC*, A Tax Globalist (IBFD 2005), pp. 210-236, at p. 2010).

[413] In this respect, the term "*alienation*" referred to in article 13 of the OECD Model Convention (2017) could give some guidance in respect of whether, for instance, income accrued but not yet paid would be covered. However, this term in not defined by treaties (C. de Pietro, *supra* n. 33, p. 92; R. Krever, *Discussion of Stefano Simontacchi's Paper on Article 13 OECD Model Convention*, Source versus Residence – Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives (Lang et al. eds., Kluwer 2008), pp. 175-184, at p. 183).

[414] One may understand that exit taxes are levied by residence states just before emigration and thus at the time he is not yet a resident of the other state. At the time of the assessment the treaty is not yet applicable and, consequently, it cannot restrict the taxing rights of that state in a pure domestic situation.

[415] "Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the contracting state of which the alienator is a resident" (*OECD Model Tax Convention on Income and on Capital* Art. 13(5) (21 November 2017), Models IBFD).

[416] See *supra* n. 414.

[417] See IFA, *supra* n. 55.

[418] Comments by L. Rao IFA, *supra* n. 55, p. 65. Franz Wasserneyer, Philip West disagreed with the position of L. Rao. Michael Lang agreed with his position to a certain extent, as follows: "I do, however, agree with Dr. Rao, to the extent that if, as I say, one assumes that there exists a concept of abuse at all, then it should be applied to states. But as I believe that one does not get any further with considerations of abuse with taxpayers, I would like to be fair and say that one also does not get far with such considerations and concepts for states" (Comments by M. Lang in *supra* n. 55, p. 68).

it is implemented after the conclusion of a treaty[419] and that, by such levy, a state "takes back with the left hand what it would have been obliged to give away with the right hand".[420] Lalithkumar Rao qualifies exit taxes as an "*active abuse by the state*", through which a state, after having committed itself by treaty to forgo some revenue, attempts though a domestic device to get back some or all of that revenue which it agreed to forgo.[421]

The widely discussed cases concerning the Dutch exit tax on substantial shareholdings would be a good illustration of this. Under the rules governing substantial shareholdings, the Dutch Income Tax Act (2001)[422] introduced the concept of notional alienation by determining that alienation of stock or profit-sharing certificates would also result from ceasing to be a taxpayer in respect of Dutch domestic taxes, including no longer being a resident of the Netherlands.[423] The Act also indicates that, in such cases, the moment of realization is considered to be the one immediately preceding the moment of no longer being a resident taxpayer.[424] The payment of the tax is however deferred for a 10-year period after emigration so that the tax levied upon emigration is in the nature of an assessment which preserves Netherlands taxing rights for these following years.[425] If a tainted action takes place within this period, the tax is effectively collected; otherwise, the assessment is waived.[426]

The Dutch rule on exit tax on substantial shareholding and its effect on tax treaties first reached the Dutch courts in three cases[427] concerning taxpayers emigrating to Belgium, United States and United Kingdom. The argument raised by the taxpayers was that the Dutch rule was in contradiction with the

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[419] L. Rao emphasizes this when commenting on the position of Franz Wassermeyer, who had stated that "I consider that it is not a matter of abusive application of the DTC [double taxation convention] between A and B by state A, but only whether teh A-B DTC [double taxation convention] is an obstacle to the state A's exit charge" (Comments by F. Wassermeyer in *supra* n. 55, p. 64). L. Rao explains that "Professor Wassermeyer's point is that at the point when the exit charge is levied there is no double tax treaty applicable and, therefore, the question of whether this is an abuse of the double tax treaty cannot arise. (...) I am assuming in the example, the illustration that has been given, that the levy of the exit charge is not something that existed in the national law from time immemorial. I am assuming that the exit charge has been imposed by the state merely to get around what is perceived by state A as an abuse by the treaty of state B" (Comments by L. Rao in IFA, *supra* n. 55, pp. 65-66).

[420] Comments by L. Rao in *supra* IFA, *supra* n. 55, p. 66.

[421] Comments by L. Rao in IFA, *supra* n. 55, pp. 21-22.

[422] NL: Income Tax Act, 2001 (amended 2013), National Legislation IBFD.

[423] Article 4.16(1)(h) of the Dutch Income Tax Act.

[424] Article 4.46(2) of the Dutch Income Tax Act.

[425] L. de Broe & K. Willoqué, *Exit Taxes on Substantial Shareholdings and Pension Claims: The Dutch Supreme Court's Interpretation of Arts. 13, 15 and 18 of the OECD Model*, Tax Polymath – A Life in International Taxation (P. Baker & C. Bobbett eds., IBFD 2010), pp. 227-248, at p. 229). Art. 2.8 (2) of Dutch Income Tax Act.

[426] Tainted actions include the alienation of the shares, reimbursement of the shareholder's capital contribution and liquidation of the company or discontinuation of its activity together with the distribution of retained earnings (*Ibid*., p. 229). The taxes upon emigration of a substantial shareholder differ from the other emigration taxes in one respect. The source state (in this case the Netherlands) grants a credit for the tax due on the substantial shareholding in the residence state, i.e. a reverse credit (F. P. G. Pötgens, *The Relationship between Preservative Tax Assessments and Netherlands Tax Treaties: Not Always Pacta Sunt Servanda?*, 50 European Taxation 5 (IBFD 2010), pp. 183-191, at p. 184).

[427] NL:HR, 20 February 2009, 07/12314; 42.701; 43.760, Tax Treaty Case Law IBFD.

tax treaties signed with those countries before the implementation of the exit tax. The various courts of appeals in the three cases handed down different decisions: in favour of tax authorities in the case involving the United States, and in favour of the taxpayers in the cases involving Belgium and the United Kingdom - in the latter, however, the question of tax treaty application was not at all addressed, since the court decided that the exit tax was in conflict with European Union law in the first place.[428] In the case involving Belgium, the court of appeals concluded that a state does not apply its treaty commitments in good faith if it encroaches on the taxing rights which it agreed to convey to its treaty partner. In the case, the court considered that Netherlands had unilaterally extended its taxing rights on potential Dutch-source dividends to the detriment of Belgium as the state of residence of the shareholder, as the Dutch exit tax had the effect of taxing potential dividends (the company's retained earnings) which Belgium would be entitled to tax under article 10(1) of the Belgium-Netherlands Income and Capital Tax Treaty (1970).[429] The Dutch exit tax was therefore considered contrary to the treaty. However, as a result of the appeals lodged by the defeated parties in those cases, the Supreme Court decided in 2009 that the provisions of the tax treaties concerned did not prevent the Netherlands exit tax from being levied, simply because the taxable gain under domestic law was deemed to have been derived before his emigration, that is, at a time when no treaty was applicable.[430]

This line of thought emphasizes the fact that exit taxes are imposed just before emigration and, therefore, at a time when treaties cannot restrict the state's taxing rights because they are not applicable to this pure domestic issue. This argument was also expressed in the opinion of the Advocate General in the three cases at the Dutch Supreme Court,[431] by the Canadian Federal Court of Appeal in the *Davis* case (1980)[432] and is generally used as the traditional reasoning for those arguing that exit taxes do not override tax treaty provisions.[433] Indeed, exits taxes generally "fit" tax treaties, because the determination of the moment where the taxable event occurs for tax purposes is not given by these agreements but rather left for states to decide as part of the elements of the tax liability. As a result,

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428 *Ibid.*

429 de Broe & Willoqué, *supra* n. 425, p. 230. *Convention between the Government of the Kingdom of the Netherlands and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (18 October 1970), Treaties IBFD.

430 de Broe & Willoqué, *supra* n. 425, p. 230.

431 *Ibid.*, p. 244.

432 *Ibid.* CA: FCA, 15 January 1980, A-399-78, Tax Treaty Case Law IBFD. The case concerned a Canadian exit tax provision which was retroactive and whether it would be in conflict with the capital gains article of the Canada –US Income Tax Treaty (1942).

433 de Broe & Willoqué, *supra* n. 425, p. 243. "Legislators of the emigration countries believe that the introduction of exit taxes is not prohibited by the DTCs [double taxation conventions] and thus does not constitute a treaty override. Several arguments are advanced. Because exit taxes are assessed just before the tax liability based on residence ceases, the main argument is that at the time of imposition of the exit tax the taxpayer is a resident of the country imposing the tax, not of the other contracting state. So the levy of an exit tax cannot be in conflict with a DTC [double taxation convention]. It is further argued that DTCs [double taxation convention] allocate taxing rights in the case of alienation of assets, while exit taxes are not imposed on the occasion of the alienation. It is also claimed that no double taxation occurs since double taxation implies that two different countries tax the same income at the same time." (L. de Broe, *The Tax Treatment of Transfer of Residence by Individuals - General Report*, 87b IFA Cahiers de Droit Fiscal International (IFA 2002), p. 65).

under this line of thought, a taxable event considered by domestic law as occurred at a moment when the state's taxing rights is not limited by the treaty could not be regarded as contradicting that agreement. If one follows this rationale, it means that the impact of contracting states' action is the shifting of the taxable event to a moment where the treaty is not yet applicable; the action therefore circumvents or prevents the application of the treaty by transforming the situation into a purely domestic issue, such as done by Brazil in the CIDE contribution case previously explained[434] and in other cases presented in the next sections.[435]

It is important to observe that although tax treaties generally do not deal with exit taxes, one of the tax treaties discussed before the Dutch Supreme Court did include a provision that dealt with tax issues relating to emigration, i.e. the Belgium-Netherlands Income and Capital Tax Treaty (1970) recognized Netherlands taxing rights in respect of exit taxes, but limited it to a period of 5 years after emigration.[436] However, the Dutch rule preserves Netherlands taxing rights for 10 years, that is, 5 years in addition the period allowed under the treaty. In this case, the author believes that the extra 5 years under the Dutch rule was in contradiction with the wording of the treaty (which allowed only 5, not 10 years) and, therefore, cannot be qualified as a tax treaty dodging as a breach of the treaty wording. This was neither the case however for the other two remaining cases nor is for any case where tax treaties follow the OECD Model Convention, that is, where exit taxes are not addressed.

Although the scenario created by exit taxes, in which a tax is considered due by a country at a moment where a taxpayer is resident thereof, is in line with the wording of those agreements, it does, on the other hand, modify the effects of treaties to the benefit of the country applying the exit tax. As indicated by the Dutch court of appeals, the country of emigration transforms a potential dividend after emigrating (allocated to the country of immigration) into a capital gain derived before emigration (allocated to the country of emigration).[437] Or, from a different perspective, it allocates to the country of emigration taxing rights over capital gains that in the future, when eventually and effectively realized, would belong to the country of immigration as the new country of residence. In addition,

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[434] See under *redesign of taxes*.

[435] For example, treaty underride in Section 3.3.1.3.

[436] "The provision of paragraph 4 shall not affect the right of the Netherlands to tax according to its national law gains realized from the alienation of shares or participation rights -- not forming part of the business assets of an enterprise -- in a company whose capital is divided into shares and such company is resident in the Netherlands, by an individual resident in Belgium, who possesses the Netherlands nationality and who was resident in the Netherlands at any time during the five years prior to the alienation of the shares or participation rights, if these shares or participation rights have been part, during the above-mentioned period of time, of a substantial holding in the meaning of the Netherlands income tax legislation. However, the tax shall not exceed 20%" (art. 13(5) of the Netherlands-Belgium Income and Capital Tax Treaty (1970)).

[437] Pijl, *supra* n. 33, p. 299.

despite different opinions,[438] double taxation may exist in cases where no reverse tax credit[439] is granted by the country of emigration.[440] Luc de Broe and Katrien Willoqué define it as a "legislative trick by which states try to set aside their treaties and to circumvent their obligations under international law"[441] by imposing a tax a "split second before the transfer of residence"[442] and conclude that "a one-side enactment of an exit tax subsequent to a treaty, the purpose of which is to recover taxing rights over items of income that given their actual nature are only taxable in the state of which the taxpayer is a resident when he actually enjoys the benefit of the income, is not in accordance with the principle of good faith".[443] Indeed, the Dutch Supreme Court went on in the three cases to hold that the exit tax might nevertheless be in conflict with the good faith, but eventually concluded that there was no such a breach.[444]

The author believes that the main point to have in mind here – and which is also valid for all dodging cases – is that an agreement on whether or not countries may impose exit taxes in the context of tax treaties could not be reached if the opposite parties approach the subject from different perspectives. It seems that it is a right of contracting states to determine under their domestic law an aspect of the tax liability which is not indicated by tax treaties, such as in the case of the recognition of the moment

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[438] It is claimed that no double taxation occurs since double taxation implies that two different countries tax the same income at the same time; tax treaties allocate taxing rights on the occasion of alienation while exit taxes are not imposed at this moment (de Broe, *supra* n. 433, p. 65). In this respect, the author agrees with Luc de Broe in the sense that such definition of double taxation is too narrow: "what matters is not that two taxes are imposed in the same year, but that such taxes relate to income that accrued during identical periods" (de Broe, *supra* n. 433, p. 66).

[439] "A credit granted by the source state for taxes imposed by the residence state. It may be contrasted with the more traditional form of foreign tax credit where the source state has the primary taxing right and the credit is granted by the residence state. An example of a reverse credit would be where a state retains the right under a particular treaty to tax its former residents in respect of sales of shares in companies resident in that state and grants a credit for tax imposed on such sales by the new residence state. Another example would be a credit for residence state taxation of pension income where the source state has retained non-primary taxing rights under a treaty" (IBFD, International Tax Glossary (ed. J. Rogers-Glabush, IBFD), Online Books IBFD).

[440] The Netherlands offers a reverse tax credit. This is one for the reasons why the Dutch Supreme Court did not consider that the good faith principle was breached by the Netherlands. However, the author considers that the granting of such a credit does not erase the fact that the allocation of taxing rights has been modified in the first place; and, as Luc de Broe and Katrien Willoqué stated, "the principle is violated if application of the tax leads to taxation of a gain on which the taxing rights would, given the actual nature of the gain, normally be allocated to the immigration state". They further continue: "we submit that a state, which enacts an exit tax subsequent to the treaty (...) with a view to frustrating the normal application of Art. 13(5) or Art. 18 and to recover taxing rights which the state has abandoned to its treaty partner, does not observe the international law principle of good faith. This is all the more true if the state does not provide for a unilateral measure to relieve double taxation, i.e. where it does not grant a reverse tax credit" (de Broe & Willoqué, *supra* n. , pp. 230 and 245).

[441] de Broe & Willoqué, *supra* n. 425, pp. 245-246.

[442] de Broe & Willoqué, *supra* n. 425, p. 244.

[443] de Broe & Willoqué, *supra* n. 425, p. 246. See also conclusions by Luc de Broe in de Broe, *supra* n. 433, p. 65.

[444] The conclusion was based on the fact that the exit tax taxed capital gains (and not potential dividends) accrued to the taxpayer while resident in the Netherlands (see details on the reasoning of the court in de Broe & Willoqué, *supra* n. 425, pp. 230-231 and 246).

of the taxable event. Any argumentation in the sense that this directly violates a treaty provision (i.e. violates the wording of the provision) may be easy to oppose with coherent arguments, as did the OECD in respect of the discussion over the compatibility of CFC legislation and tax treaties.[445] Having said that, if one keeps on defending the direct breach of a treaty provision as a rationale for argumentation, the reaction will always be given from the same perspective, that is, that the treaty provision per se does not forbid such behaviour and, therefore, it is a right of contracting states as *"part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability"*,[446] as the OECD has reasonably argued. For the author, the subject should be addressed, therefore, from a different angle: by agreeing the provision is not directly breached (i.e. the wording is not breached) but at the same time questioning whether, by modifying the outcome of the treaty to its own benefit and in detriment of treaty partners, contracting states go too far in the exercise of this right; in other words, whether the way countries exercise this sovereign right not limited by the wording of treaties (i.e. within the treaty gap areas) could be considered a condemnable behaviour, not in view of a violation of a treaty provision which does not literally forbid such right, but on the basis violation of public international law rules and principles that govern the good usage of treaties. This topic will be further developed in chapter 4.

Another common type of exit tax is the one levied on pension claims. In this respect, a good example may be the one under Belgian domestic law,[447] according to which payments of pension income to taxpayers who have moved residence abroad prior to such payments are deemed to have taken place on the day before the emigration, that is, at a time when the taxpayer was still a Belgian resident so that Belgium is allowed to tax such income in accordance with the pension income provision (or equivalent) in the treaty, which allocates taxing rights to the residence state - or because no treaty restriction exists due to its non-applicability at the moment prior to emigration.[448] This provision also raised questions and provoked discussions at Belgian courts similar to the ones regarding the exit tax on substantial shareholding and the circumvention of treaty obligations.[449] In respect of a similar

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[445] The OECD answered to those alleging the breach of treaties by CFC legislation by arguing that "such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability" and consequently concluded that "these rules are not addressed in tax treaties and are therefore not affected by them". The OECD further explains that, to the extent that the application of domestic rules results in a re-characterization of income or in a redetermination of the taxpayer who is considered to derive such income, tax treaties "will be applied taking into account these changes" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 22.1 (15 July 2014), Models IBFD). This position was also reaffirmed by the OECD under Action 6 of the BEPS Project, and reflected in the commentary on article 1 of the OECD Model Convention (2017): "(...) many provisions of the Convention depend on the application of domestic law. (…) In many cases, therefore, the application of specific anti-abuse rules found in domestic law will have an impact on how the treaty provisions are applied rather than produce conflicting results" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 73 (21 November 2017), Models IBFD).

[446] *Ibid.*

[447] Article 364 *bis* of the Belgian Income Tax Code.

[448] See *supra* n. 414.

[449] For example, this domestic provision was taken to court by a taxpayer who had moved his residence to France a year prior to receiving his pension income as a one-off payment. This income was subject to Belgian withholding tax on the basis of such domestic rule, which was introduced after the conclusion of the 1964 Belgium-France Income Tax Treaty.

Dutch exit tax on pension claims, the Court of Appeals of Arnhem held that as the value of the pension rights was taxed at the moment when the taxpayer was still a resident of the Netherlands, there was no cross-border situation and therefore the treaty was not applicable. However, the Dutch Supreme Court eventually decided that the Dutch rule was in conflict with good faith towards the treaty partner.[450]

These are examples of how contract states may try to, through the implementation of exit taxes, recover taxing rights they had given up to their treaty partners when signing the treaty. In these cases, contracting states increase their tax revenue advantages by shifting of the taxable event to a moment when the treaty is considered not yet applicable (thus preventing or circumventing the application of the treaty) or, depending on one's view, to a moment when they become entitled to tax according to the treaty provision (thus circumventing the obstacles initially imposed by the treaty provision). But exit taxes may also involve the shifting of the moment of the taxable event in combination with re-characterizations. Cases where the re-characterization is the determinant cause for the modification of the effects of the treaty (and not the timing) are presented in Section 3.3.1.2., as part of the treaty dodging method executed through redefinitions of undefined treaty terms.

Foreign tax credits

The OECD Model Convention offers methods for contracting states to eliminate international double taxation. One of the methods is the granting of a deduction from the tax due in the resident state of an amount equal to the tax paid in the other state, i.e. the so called credit method.[451] However, a contracting state may subject the granting of a foreign tax credit to its own relevant laws and regulations.[452] This is because, as indicated by the commentary on article 23B of the OECD Model Convention (2017), tax treaties set out the main rules regarding the credit method, but they do not give detailed rules on the computation and operation of the credit.[453] This is therefore left for states to determine. A state could however also create conditions and exclusions in domestic law so that the elimination of double taxation would become, as stated by Edwin van der Bruggen, in effect impossible.[454] Under the topic "domestic law restricting the scope of foreign tax credits", Edwin van

The issue analyzed by the court was whether the domestic fiction under which a pension payment made after emigration and deemed to have taken place on the day before such emigration violated the 1964 Belgium-France Income Tax Treaty, which allocated exclusive taxing rights to the residence state. The Supreme Court decided to confirm the decision given by the Court of Appeal in the sense that fictions introduced to erode the attribution of powers violated the treaty and good faith (BE: SC, 5 December 2003, F.02.0042.F, Tax Treaty Case Law IBFD).

[450] NL: HR, 13 May 2005, 39.144, Tax Treaty Case Law IBFD.

[451] *OECD Model Tax Convention on Income and on Capital* art. 23B (21 November 2017), Models IBFD.

[452] van der Bruggen, *supra* n. 55, p. 52.

[453] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23B* para. 60 (21 November 2017), Models IBFD. According to Edwin van der Bruggen, another reason for the need to refer to domestic law is to safeguard the application of internal anti-abuse measures concerning foreign tax credits (van der Bruggen, *supra* n. 55, p. 52).

[454] van der Bruggen, *supra* n. 55, p. 52.

der Bruggen indicates that "introducing domestic measures with respect to foreign tax credits after the conclusion of a double taxation agreement that go far beyond what is the prevailing practice in the international community of nations" would not be in line with the principle of good faith and neither in accordance with the "legitimate expectation of the treaty partner".[455] In the same sense, Bernard Peeters and Thomas Hermie call the attention to the danger of ambulatory interpretation in respect of foreign tax credits, when they indicate that it may have the "effect that treaty relief can be influenced easily through a change in internal law".[456]

The restriction of foreign tax credits by domestic law was discussed by the Belgian Supreme Court in a case[457] where a Belgium resident receiving dividends from Dutch sources was denied the corresponding credit in view of a change of the Belgian Income Tax Code introduced in 1988,[458] that is, after the conclusion of the Belgium-Netherlands Income and Capital Tax Treaty (1970). In this respect, the domestic amendment limited the granting of credit for foreign taxes withheld on dividends to cases where dividends were paid by investment companies.[459] In the case, the taxpayer argued that the Belgian law in force at the time the treaty was signed had to be applied, as the Law of 7 December 1988 amounted to a unilateral amendment of the treaty by Belgium.[460] However, the Belgian Supreme Court observed that in view of the reference to domestic law by article 24(2)(b) of the treaty, which expressly indicated that "the credit shall be given in accordance with the conditions and at the rate determined in that law",[461] the extent to which the credit was available could in fact be defined by the Belgian legislator.[462] The court concluded that the treaty did not restrict the power of the Belgian

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455 van der Bruggen, *supra* n. 55, p. 52.

456 Peeters & Hermie, *supra* n. 55, p. 391.

457 BE: SC, 16 June 2000, F.98.0029.N, Tax Treaty Case Law IBFD.

458 Law of 7 December 1988 amended the rule currently in article 285 of the Belgian Income Tax Code, which reads now as follows: "Pour ce qui concerne les revenus de capitaux et biens mobiliers et pour ce qui concerne les revenus divers visés à l'article 90, 5° à 7°, une quotité forfaitaire d'impôt étranger est imputée sur l'impôt lorsque ces revenus ont été soumis à l'étranger à un impôt analogue à l'impôt des personnes physiques, à l'impôt des sociétés ou à l'impôt des non-résidents, et lorsque lesdits capitaux et biens sont affectés en Belgique à l'exercice de l'activité professionnelle. Par dérogation à l'alinéa 1er, une quotité forfaitaire d'impôt étranger n'est imputée, pour ce qui concerne les dividendes, que lorsqu'il s'agit de dividendes alloués ou attribués par des sociétés d'investissement, et dans la mesure où il est établi que ces dividendes proviennent de revenus que satisfont aux conditions définies à l'alinéa 1er et à l'article 289" (Article 285 of the Belgian Income Tax Code, available at http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&nav=1&id=953816fd-c5fe-4a27-a9c7-c7bacd0c842a&disableHighlightning=true#findHighlighted, accessed 5 Nov. 2014).

459 *Ibid.*

460 BE: SC, 16 June 2000, F.98.0029.N, Tax Treaty Case Law IBFD

461 Art. 24(2)(b) of the treaty deviates from the OECD Model Convention (2017) and reads as follows: "With respect to dividends, interest and royalties, to which paragraph 2 of Article 10, paragraphs 2 and 8 of Article 11 and paragraph 4 of Article 12 respectively apply, the fixed amount of the foreign tax for which provision is made in Belgian law, shall be credited in accordance with the conditions and at the rate determined in that law, either against the individual income tax connected with those dividends, or against the individual or company tax connected with those interest and royalties" (article 24(2)(b) of the Belgium-Netherlands Income and Capital Tax Treaty (1970)).

462 *Ibid.*

legislature to adapt or amend the credit system after the signature of the treaty and, therefore, the amendment of the credit system had not violated the treaty[463] - the Court of First Instance in Liège came to the opposite decision in a case of dividends received by a Belgian taxpayer under the 1970 treaty with United States because the avoidance of double taxation provision of that treaty did not contain a reference to the Belgian domestic law.[464]

Therefore, by appropriate formulation of domestic legislation concerning foreign tax credits, contracting states may be able to increase the benefits of existing tax treaties for their own benefit by preventing or circumventing the full application of a specific treaty provision. It goes without saying that the interest in restricting the scope of foreign tax credits belongs to residence states, in this case, Belgium.[465]

But re-determining the elements of the tax liability is not the only way legislatures may try to dodge tax treaties. Domestic law may be drafted within the limits imposed by the text of tax treaties but in a way to modify the outcome of these agreements in respect of any subject falling within the treaty gap areas. This may be in respect of the definition of a great number of treaty terms and expressions, since from a practical perspective tax treaties are not able to define the meaning of all terms and expressions used, explained in the next section as the second legislative dodging method.

3.3.1.2. Redefinition of undefined treaty terms (as second legislative dodging method)

In the same way taxpayers may chose legal forms for transactions in order to change the character of the income to a type over which a reduced treaty rate applies,[466] contracting states may, through fictions and deeming provisions in domestic law, modify the nature of the income to a type over which they are granted taxing rights under tax treaties. That would amount to the second method of legislative dodging: redefinitions of undefined treaty terms.

The fact that "international law delegates to the national legal orders the completion of its incomplete norms"[467] is particularly true in respect of treaty terms and expressions, where "a large area not

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463 *Ibid.*

464 Court of First Instance Luik 14 October 2003, in Fiscale Rechtspraak/Jurisprudence Fiscale 2004, n. 285.

465 However, source states may also be interested in changing the scope of tax credits, but in the opposite direction, that is, to expand the scope of the foreign tax credits. Edwin van der Bruggen deals with this source states attempts under the topic "domestic law enlarging the scope of foreign tax credits" (van der Bruggen, *supra* n. 55, pp. 52-53). In this thesis, the present author decided to describe this attempt under the method "*change of tax rates*" (above in this section), since the mechanism in this case is operated not through the changing on the rules governing the tax credit itself (as done in case of residence countries trying to restrict its scope), but through changes in respect of domestic rates.

466 More on the ways taxpayers may change the character of income (e.g. from gains from real property to gains from shares, from dividends to capital gains, from dividends to interest) in UN, *supra* n. 61 (16 October 2006), paras. 58-67. See also Candu, *supra* n. 65, pp. 198-200 and Baker, *supra* n. 65, p. 394.

467 Jeffery, *supra* n. 240, p. 39.

expressly defined is left".[468] Indeed, most terms used in tax treaties are not therein defined and, in the absence of a standard international tax language, recourse to domestic law is necessary in many cases, as dictated by specific treaty articles (e.g. articles 4(1) and 6(2) of the OECD Model Convention (2017)[469]) in addition to the general rule of *renvoi* to the domestic legislation of contracting state if the context does not require otherwise, provided in article 3(2) of the OECD Model Convention (2017).[470] In this sense, the OECD itself recognizes that the referral to domestic law in respect of undefined terms "allows the competent authorities some leeway".[471]

As already noted, it seems this could not be otherwise. If all terms and expressions were to be defined in the text of tax treaties, these agreements would become extremely complex and difficult to apply in practice.[472] As a consequence, contracting states are relatively free to operate within a large area in what regards tax treaties definitions: not only treaties do not provide the definition of most of the existing terms – including relevant ones such as *derived by* and *paid to*[473] – but also the ones in theory defined in these agreements but which definition is not always considered complete or exhaustive enough to limit entirely the use of domestic law. This lack of treaty definitions offers states a large space to maneuver and bring the risk of questionable practices. Whenever the use of domestic law meaning of terms is not limited by a treaty definition, contracting states may have the opportunity to play within this vast area by exercising their sovereign rights in a questionable manner.

It is not surprising that this danger was acknowledged by several scholars in the past, as indicated throughout Chapter 2.[474] For example, Klaus Vogel and Rainer Prokisch confirm that "double taxation conventions embody a large number of indefinite terms, which renders them much more open to interpretation than domestic tax law which usually is very specific. (...) This has two consequences: first, that interpretation will have a natural tendency to be biased in favor of the perspective or interests

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[468] Transcribed by Avery Jones from the comments by Upjohn J. on the case *Ostime v. Australian Mutual Provident Society*, in Avery Jones et al., *supra* n. 46, p. 21.

[469] *OECD Model Tax Convention on Income and on Capital* art. 3(2) (21 November 2017), Models IBFD.

[470] *OECD Model Tax Convention on Income and on Capital* art. 3(2) (21 November 2017), Models IBFD. For a short background on the rule, see Chapter 2, Section 2.3.

[471] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 3(2)* para. 12 (21 November 2017), Models IBFD.

[472] Vogel and Prokisch explain that the use of domestic law "prevents the overloading of double taxation conventions with definitions that would render the application of conventions difficult" (Vogel & Prokisch, *supra* n. 19, p. 77). In terms of definitions, for instance, "*a large area not expressly defined is left*" (Avery Jones on the comments of Upjohn J. in an English case, in Avery Jones et al., *supra* n. 46, p. 21); R. Lenz, *supra* n. 45, pp. 295 and 298; Aniceto da Silva, *supra* n. 45, p. 337.

[473] According to Kees van Raad, the fifth fundamental rule in applying tax treaties indicates that tax treaties do not deal with the question to which person the item of income is to be taxes, as the terminological links employed in the distributive treaty articles between the taxpayer and the item of income (i.e. "derived by", "paid to", "receives" and "of") are not defined (van Raad, *supra* n., p. 598). See also, Lang, *supra* n. 63, pp. 53-56. On the link missing in tax treaties between the person claiming treaty benefits and the specific item of income in question, see Wheeler, *supra* n. 44.

[474] For an overview of how literature has observed the connection between the referral to domestic law in respect of undefined terms carries and the danger of tax treaty dodging, see Chapter 2, Section 2.3.

of the State applying the convention, and secondly, that references in double taxation conventions to domestic law cannot be avoided".[475] In this sense, Edwin van der Bruggen is more direct by indicating that the system of referral to domestic law for the meaning of terms as dictated by Article 3(2) of the OECD Model Convention (2017) "makes double taxation conventions vulnerable to unilateral intentional dodging and unintentional hollowing out of tax treaty obligations by the contracting states".[476]

Ramon Jeffery also spots this danger when he indicates the definition of residence as an example of how international law, by delegating to national orders the completion of its incomplete norms, gives states a certain measure of discretion.[477] In this regard, he indicates that "the residence of a taxpayer within the territory of a State is one of the main bases for exercising fiscal jurisdiction as recognized under customary international law. (...) International law leaves it to particular States which are subject to the treaty to characterise who exactly shall be a resident for the purposes of the treaty".[478] He further questions whether the discretion given to national law to fill in international norm gaps are indeed unfettered and whether the way in which states characterize residence can be considered a valid basis, such as in the case of provisions deeming off-shore companies to be resident.[479]

The author briefly mentioned in the previous section one case of possible tax treaty dodging entailing the redefinition of undefined treaty terms in the context of tax sparing clauses[480]. Below, the author presents a series of cases as potential legislative dodging in which legislatures of contracting states amended, after the signature of treaties, domestic legislation to redefine treaty terms, which eventually had an impact on the outcome of these agreements. Before discussing these cases, the author finds important to make some preliminary remarks on the delimitation of area of study for this method (that is, the scenarios vulnerable to tax treaty dodging actions engaged through redefinition of undefined treaty terms under domestic law) taking into account the first condition necessary for tax treaty dodging to occur (i.e. exercise of sovereign rights not limited by the text of tax treaties (i.e. within the treaty gap areas)).[481]

Scope of the method: actions in line with the context in article 3(2)

In Section 3.2.1. of this Chapter, the author explained that the phenomenon of tax treaty dodging may emerge when contracting states exercise sovereign rights within the limits imposed by the text of tax treaties (i.e. within the treaty gaps) but in a manner to affect the outcome of these agreements. These

[475] Vogel & Prokisch, *supra* n. 19, p. 55.
[476] van der Bruggen, *supra* n. 55, pp. 38-39.
[477] Jeffrey, *supra* n. 240, p. 39.
[478] *Ibid.*
[479] *Ibid.* The views of Ramon Jeffrey on possible limits are presented in Chapter 5.
[480] Developing countries might abuse the notion of "tax incentives similar to those currently in force" to expand the scope of conventional tax sparing credits – see Section 3.3.1.1.
[481] See details on this first condition in Section 3.2.1.

areas where contracting states have a relative freedom to act because not limited by the wording of tax treaties, i.e. the treaty gaps, are the areas in which tax treaty dodging may occur. The author concluded in that section that the first condition for a scenario where the phenomenon of tax treaty dodging may occur is the existence of treaty gap areas and, therefore, the phenomenon of tax treaty dodging would never emerge in a scenario where contracting states actions are exercised in areas ruled by treaties, as these actions could extrapolate the limits imposed by the text of tax treaties. Such actions would be considered a direct violation of these agreements (i.e. violation of the wording of these agreements).

Having said that, the scenarios in which tax treaty dodging could occur through the use of domestic law redefinitions of treaty terms would be those in which contracting states would not violate the text of tax treaties, including the text of article 3(2). In this respect, considering that the text of this article expressly prohibits the use of domestic meaning contrary to what *the context requires* (or to what is agreed by the competent authorities pursuant to the provisions of Article 25),[482] contracting states actions violating what the context requires (or the different meaning agreed by the competent authorities) would not amount to a tax treaty dodging as understood in this thesis, but to a violation of the text of the treaty provision (or to a direct treaty override as understood by some)[483]. Tax treaty dodging could only occur through actions not contradicting what the context in article 3(2) requires (or what is agreed by the competent authorities) but having an impact on the outcome of treaties (and eventually violating other rules and principles of international law, as discussed in Chapter 4). This not only reduces considerably the scope of the method but also makes it challenging to delimitate the field of study due to difficulties in determining when the "context otherwise requires".

The assessment of whether an action is or not in line with the context within the meaning of article 3(2) depends on the understanding of the interpreter of the meaning of the "context". The "context" in article 3(2) as understood by the interpreter has an impact on the threshold for tax treaty dodging; the higher this threshold is, smaller is the scope of the method and field of study. In fact, the commentary on article 3(2) of the OECD Model Convention (2017) suggests that, because reference to domestic law is made unless the context otherwise requires, the result of a state rewriting the effects of a treaty in its own favour through domestic redefinitions (that is, a tax treaty dodging) would then become impossible.[484] Notwithstanding, John F. Avery Jones considers (quite rightly) this part of the commentary "unsatisfactory" or even worthy of a "prize for unhelpfulness to taxpayers" by telling too

[482] "As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a different meaning pursuant to the provisions of Article 25, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State" (*OECD Model Tax Convention on Income and on Capital* art. 3(2) (21 November 2017), Models IBFD.

[483] See more on the direct violation of the text of the treaty and treaty override as opposed to tax treaty dodging in Chapter 4, Section 4.4.

[484] Avery Jones, *supra* n. 125, p. 253.

little on the limits of the ambulatory interpretation, and that, instead, a more honest conclusion from the OECD should have been the one admitting that the limits of the ambulatory interpretation were in fact uncertain.[485] The author agrees with his opinion that the commentary seems to find that everything is for the best without explaining the limits to the leeway given to the states in changing domestic law.[486] Although the OECD admits that contracting states should not be allowed to empty a convention of some of its substance,[487] it fails to indicate which limit should not be exceeded.

Indeed, the commentary suggests that the context in article 3(2) of the OECD Model Convention (2017) would ensure the permanency of commitments entered into by states when signing a convention by preventing amendments to the scope of terms not defined in the agreement and the consequent partial non-operation of the treaty. However, since the meaning of the "context" is still a matter of debate to this date, the extent of that limitation proposed by the OECD (i.e. the context) remains to a certain extent uncertain.[488]

According to the commentary on article 3(2) of the OECD Model Convention (2017), the context is determined in particular by the intention of the contracting states when signing the treaty as well as the meaning given to the term in question in the legislation of the other contracting state (an implicit reference to the principle of reciprocity).[489] The commentaries go further to state that the wording of article 3(2) "provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided)".[490]

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485 Avery Jones, *supra* n. 125, pp. 253-254.

486 Avery Jones, *supra* n. 55, p. 133.

487 When acknowledging in the commentary on article 3 of the OECD Model Convention (2017) the possibility of tax treaty dodging in respect of undefined terms, the OECD recognizes that contracting states should not exceed certain limits when exercising this right by stating that "the wording of the Article [3(2)] therefore allows the competent authorities some leeway" but that "a state should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 3(3)* paras. 12-13 (1 September 1992), Models IBFD) - the inclusion of this idea in the commentary on article 3 in 1992 seemed to be a consequence of the discussion raised by the case *Melford* (1982) and subsequent literature. It also came as an official support to the ambulatory interpretation by the OECD. For details, see Chapter 2.

488 E. van der Bruggen, *Unless the Vienna Convention Otherwise Requires: Notes on the Relationship between Article 3(2) of the OECD Model Tax Convention and Articles 31 and 32 of the Vienna Convention on the Law of Treaties*, 43 Eur. Taxn. 5 (2003), Journals IBFD, p. 144.

489 *OECD Model Tax Convention on Income and on Capital: Commentary on Article 3(2)* para. 12 (21 November 2017), Models IBFD.

490 *OECD Model Tax Convention on Income and on Capital: Commentary on Article 3(2)* para. 13 (21 November 2017), Models IBFD.

Some may consider the "context" in article 3(2) of the OECD Model Convention (2017) in its most narrow sense, that is, that it means the text immediately preceding and following the term that needs interpretation, preferably in the same sentence[491]; others may consider it as having the same meaning as of the "context" in the Vienna Convention (1969)[492] (see Chapter 4, Section 4.3.2.), while perhaps the majority may understand it as being any permitted interpretative material in the Vienna Convention (1969), which is wider than the "context" in the Vienna Convention (1969) itself.[493] The OECD has also recently added to the introduction to the OECD Model Convention (2017) the statement that "since the title and preamble form part of the context of the Convention and constitute a general statement of the object and purpose of the Convention, they should play an important role in the interpretation of the provisions of the Convention",[494] which would be more aligned with the wider meaning of the "context" in the Vienna Convention (1969). According to John F. Avery Jones, "there seems no need to limit the meaning of "context" in respect of article 3(2) of the OECD Model. Any relevant material that throws light on whether or not domestic law should not be used should, therefore, be considered".[495] The commentary on article 3 of the OECD Model shows that the meaning may be even wider by including as context "the meaning given to the term in the legislation of the other Contracting State (an implicit reference to reciprocity on which the Convention is based)".[496]

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[491] van der Bruggen, *supra* n. 488, p. 143.

[492] "Another possibility has been discussed, particularly in light of the definition of "context" offered by the VCLT [Vienna Convention o the Law of Treaties]. Perhaps "context" must (at least at present) be understood as limited to the description given in Art. 31(2) of the VCLT. Internationalists would perhaps observe that "unless the context otherwise requires" in Art. 3(2) may lead to an absurd result if "context" is taken to have the same meaning as in Art. 31 of the VCLT, because Art. 3(2) is part of what international law considers "context" (to the term in dispute) in the first place" (van der Bruggen, *supra* n. 488, p. 144). According to John F. Avery Jones, "The term 'context in article 3(1) and (2) of the OECD Model cannot have the same meaning as in the Vienna Convention (1969) (…), where it is defined for the purpose of separating primary material to be used for interpretation from secondary material, a distinction that has no relevance to the question whether or not the domestic law meaning of a term should be used" (Avery Jones, *Treaty Interpretation*, Global Tax Treaty Commentaries (R. Vann ed., IBFD 2019), Online Books IBFD, section 5.1.1.).

[493] Avery Jones, *supra* n. 492, section 5.1.1.; "Yet another possibility is that "context", as used in Art. 3(2), comprises more elements and instruments than in Art. 31(2) of the VCLT [Vienna Convetion on the Law of Treaties]. After all, even identical terms in different treaties with an entirely different object and purpose may well deserve a very different interpretation. In that respect, it seems quite acceptable that the meaning of the term "context" in a bilateral tax treaty would differ from that of the same term in a multilateral convention that codified and further developed the international law of treaties. It is also true that "context" at times comprises more elements than those listed in Art. 31(2) of the VCLT, especially in English jurisprudence with respect to statutory interpretation. Some see the historical background of Art. 3(2) in English law thus as confirmation of this possibility" (van der Bruggen, *supra* n. 488, p. 144).

[494] *OECD Model Tax Convention on Income and on Capital* Introduction para. 16.2. (21 November 2017), Models IBFD.

[495] Avery Jones, *supra* n. 492, section 5.5.1.

[496] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 3(2)* para. 12 (21 November 2017), Models IBFD; Avery Jones, *supra* n. 492, section 5.5.1.; "The reference to the principle of reciprocity is unhelpful. If one wants real reciprocity one would not have article 3(2) at all" (Avery Jones, *supra* n. 125, p. 253).

Some authors and court decisions[497] go even further to emphasize that the treaty should, to the greatest possible extent, be interpreted according to its context *first* and not by reference to domestic law. However, the author does not share this view (of resorting first to the context rather than to domestic law) but supports the one that states that it is impossible to infer this conclusion from the wording of article 3(2) of the OECD Model Convention, which indicates the use of the context only when "*required*".[498]

According to John F. Avery Jones, "there seems no need to limit the meaning of "context" in respect of article 3(2) of the OECD Model"[499] and therefore that "any relevant material that throws light on whether or not domestic law should not be used should, therefore, be considered".[500] This would mean, for example, that the OECD commentaries existing at the time of conclusion of a treaty (the provisions of which are derived from the OECD Model Convention) would probably be considered a source of material requiring or not the use of domestic law definitions for the purpose of that treaty[501]. In this case, it is interesting to note that not only the OECD commentaries could refute the

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[497] "German BFH [Bundesfinanzhof – the federal tax court] and the Swiss courts. For instance, in a German case, a German resident employed by a German company who worked in Spain for a Spanish company for less than 183 days, continued to be paid by the German company which recharged the cost to the Spanish company. The issue was whether or not the Spanish company was his employer for the purposes of article 15(2)(b) of the OECD Model. While the Spanish company would probably not have been his employer in German domestic law, the BFH applied an economic meaning of employer and concluded that it was his employer on the basis of the context of the Germany-Spain Income and Capital Tax Treaty (1966). The BFH considered that, in the context of the tax treaty, Spain should have the right to tax, as the salary was deductible there. In doing so, the BFH applied the following sequence for interpreting treaties: (1) applying the definition given by the treaty itself; (2) in the absence of a treaty definition by considering the context of the treaty clause concerned; and (3) if the context does not indicate the meaning of the word, by referring to domestic law. The Swiss Tribunal Fédéral (Federal Supreme Court, TF) has applied a similar approach. A similar approach has been advanced by the Swedish RÅ. (…) This has also been proposed by Lang (2000)" (Avery Jones, *supra* n. 492, section 5.1.2.2.5.).

[498] "It is impossible to infer from art. 3(2) a systematic preference for interpretation from the context over interpretation by reference to national law" (Vogel et al., supra n. 213, marginal n. 70); "'Requires' is a reasonably strong word that conveys that there must be a good reason to displace the defined meaning or the domestic law meaning. This means no more than if both possibilities are equally probable, the defined meaning or domestic law will prevail" (Avery Jones, *supra* n. 492, section 5.1.1.); "Article 3(2) clearly states that one has to refer to domestic law as being authoritative if the convention does not contain a definition of the term in question. Only as a secondary option the interpreter may refer to the context of the convention" (Vogel & Prokisch, supra n., p. 81); "It follows from Art. 3(2) OECD that one should not use the domestic law meaning of a term if the context 'requires' so. This is e.g. not the same as saying 'unless the context suggests otherwise' or 'the context allows another interpretation'. Several authors have therefore suggested that 'requires' is 'a word of some force' and that the context, in the broad sense as argued above, 'must therefore be reasonably strong for the internal law meaning to be ousted'. I agree with these authors" (de Broe, *supra* n. 55, p. 277).

[499] Avery Jones, *supra* n. 492, section 5.5.1.

[500] *Ibid.*

[501] "It is our view, as well, that where an undefined treaty term is explained or defined in the commentary existing at the time the treaty was concluded, although it may also have a particular meaning in the internal law of the state applying the treaty, as the meaning in the commentary may be said to be part of the context of the treaty, if the relevant commentary is unambiguous in the meaning it ascribes to the term we are of the view that the internal law definition could be ignored ad the commentary then would govern the interpretation of the undefined term" (D. A. Ward & al., *The Interpretation of Income Tax Treaties with Particular Reference to Commentaries on the OECD Model* (IFA/IBFD 2005), p. 112); "In the interest of

use of domestic definitions but also in certain cases confirm the domestic meaning. In this respect, the OECD commentary on article 1 would, for example, possibly allow the use of domestic definitions for undefined treaty terms in certain domestic anti-abuse measures even if this would affect the application of treaties, since the commentary confirms that these domestic changes do not conflict with treaties.[502] Thus, under this reasoning, the use by contracting states of domestic definitions in some domestic anti-abuse rules would not be in conflict with the text of article 3(2) and, therefore, would fall into the scope of this study as a possible tax treaty dodging case when modifying the effects of the treaty.[503]

Considering the lack of consensus on what the "context otherwise requires" in article 3(2) means, it is difficult to determine with certainty which cases would fall outside the scope of this thesis because directly violating the text of article 3(2). For this reason, the cases selected and discussed below are borderline scenarios where it could be to a certain extent concluded that the contracting states' actions involved were not in conflict with what the context requires but nevertheless had an impact on the application of the treaty.

Residence

The term *resident of a contracting state* is formally defined in Article 4(1) of the OECD Model Convention (2017). However, this article does not bring the treaty meaning of the term, but refers instead to the

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consistency of interpretation and application of such treaties, consideration of the 'context' of the use of a term in a tax treaty should lead to its being interpreted in the light of the Commentaries where these contain a discussion of its meaning, rather than in accordance with the meaning that they or analogous terms might have under domestic law" (M. Waters, *The Relevance of the OECD Commentaries in the Interpretation of Tax Treaties*, Praxis des Internationalen Steuerrechts, Festschrift für Helmut Loukota (M. Lang & H. Jirousek eds, Linde Verlag Wien 2005), pp. 671-689, at p. 675); "The Commentaries existing when a bilateral tax treaty is concluded, the provisions of which are derived from the OECD Model, will (drawing on the interpretive rules applied to statutes in municipal law which can also legitimately or properly be used in interpreting treaties) form part of the "legal context" (that is to say, the legal background, or "external context", not textual context as defined by Art. 31(2) of the Vienna Convention (1969)) and have "high persuasive value" in interpreting that treaty, to cite the analysis of the Supreme Court of Canada in The Queen v. Crown Forest Industries" (D. A. Ward, *Is There an Obligation in International Law of OECD Member Countries to Follow the Commentaries on the Model?*, The Legal Status of the OECD Commentaries - Is There an Obligation in International Law of OECD Member Countries to Follow the Commentaries on the Model? (S. Douma & F. Engelen eds. IBFD 2008), Online Books IBFD, sec. 12.).

[502]"(…) many provisions of the Convention depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person (see paragraph 1 of Article 4), the determination of what is immovable property (see paragraph 2 of Article 6) and the determination of when income from corporate rights might be treated as a dividend (see paragraph 3 of Article 10). More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the Convention. In many cases, therefore, the application of specific anti-abuse rules found in domestic law will have an impact on how the treaty provisions are applied rather than produce conflicting results" *(OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 73 (21 November 2017), Models IBFD).

[503] The assessment of whether these types of actions overstep other limitations under international law (in which case the actions are no longer a "possible" but an actual tax treaty dodging) is presented in Chapter 4.

criteria under which the domestic law of one or both contracting states establishes the tax liability of a person specifically connected with these states.[504] It is thus for contracting states to determine who is a resident for the purpose of tax treaties. The OECD has recently confirmed this in respect of residence in Action 6 of the BEPS Project: "(...) many provisions of the Convention depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person (...). More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the Convention".[505] Only in case of double residence, i.e. in case a person falls under the definition of resident of the domestic laws of both contracting states, the tie-breaker rules in Article 4(2) and (3) of the OECD Model Convention (2017) should indicate which country is to be considered the country of residence for the purpose of the application of the treaty.

In this sense, persons who are liable to tax under domestic law by reason of domicile, residence, place of management or any other criterion of a similar nature (excluding persons who are liable to tax in the state in respect only of income from sources in that state or capital situated therein) are considered resident for the purpose of tax treaties. A contracting state may as a result try to introduce broad definitions of persons liable to tax by reason of residence, for instance, in order to possibly become the country of residence for treaty purposes and consequently benefit from articles allocating taxing rights to the resident state. This may be the case of a deemed residence rule introduced by Portugal on 1 January 2001, but eventually removed from the legislation. The domestic rule considered resident in Portugal for tax purposes all members of a household in case at least one member in charge of the household (i.e. one of the spouses) was a resident (under the ordinary rules, i.e. not though the deemed residence) of Portugal.[506] Therefore, a person living abroad became automatically a resident of Portugal once he or she married to someone who was "effectively" a resident of Portugal. Gustavo Lopes Courinha correctly classified this as a pure legal fiction, "as if contaminated by some sort of contagious virus, all the members of the household are automatically deemed resident, irrespective of their physical connection with (geographical location in) the Portuguese territory".[507]

This legal fiction was not, of course, in the back of the mind of negotiators of tax treaties signed with Portugal before 2001, simply because it did not exist at that time. The fact that the Portuguese deemed residence did not directly violate the text of article 4(1) of the OECD Model Convention (2014) makes it a potential case of tax treaty dodging towards treaties signed after the amendment of the law by Portuguese legislators. This is the case, for instance, of the Portugal-Germany Income and Capital Tax

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[504] The Commentary on article 4 confirms that "the definition refers to the concept of residence adopted in the domestic laws" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 4* para. 8 (21 November 2017), Models IBFD). See also Vogel et al., *supra* n. 36, p. 223, marginal n. 8; Jeffrey, *supra* n. 240, p. 39; Holmes, *supra* n. 252, p. 129.

[505] OECD/G20, *supra* n. 214, p. 83.

[506] Article 16(2) of the Personal Income Tax Code (*Código de Imposto sobre o Rendimento das Pessoas Singulares*).

[507] G. Lopes Courinha, *Portugal: Deemed Residence – The Case of Household in the Light of Article 4(1) OECD MC*, Tax Treaty Case Law Around the Globe – 2011 (M. Lang et al. eds., Wolters Kluwer, 2012), pp. 71-81, at p. 74.

Treaty (1980),[508] signed on 15 July 1980. It is not surprising that several cases concerning the deemed residence rule and this treaty were brought to courts in Portugal.[509] The cases mainly dealt with individuals who had left Portugal to live in Germany, but who were still considered residents of and liable to tax in Portugal under domestic law in view of their spouses, who stayed behind and were still living in Portugal. The taxpayers argued that the deemed residence rule could not be used for treaty purposes - and even if it could be, that both their centre of vital interests and habitual abode were in Germany. Portuguese tax authorities claimed that these individuals were resident of Portugal for treaty purposes, as a result of the application of domestic law as allowed by the text of article 4(1) (and of the tie-breaker rule in article 4(2)) and, therefore, would be taxable in Portugal in respect of the income derived in Germany. In this respect, the OECD commentary on article 4(1) states: "(...) the definition aims at covering the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax). It also covers where a person is deemed, according to the taxation laws of a State, to be a resident of that State and on account thereof is fully liable to tax therein (e.g. diplomats or other persons in government service)".[510] It further emphasizes this by stating that "conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the contracting states laying down the conditions under which a person is to be treated fiscally as 'resident' and, consequently, is fully liable to tax in that state. They do not lay down standards which the provisions of the domestic laws on 'residence' have to fulfil in order that claims for full tax liability can be accepted between the contracting states. In this respect the states take their stand entirely on domestic laws".[511]

In these cases, the Administrative Supreme Court in Portugal decided that the deemed residence rule was not subsumed under the notion of residence in the treaty and that article 4(1) does not accept unreservedly any domestic rule. The court observed that the criteria mentioned in article 4(1) of domicile, residence, place of management or any other criterion of a similar nature unambiguously meant that there should be a real and effective connection with the Portuguese territory. In other words, the court regarded article 4(1) as containing requirements regarding residence, and therefore, a benchmark to determine whether a rule of domestic law which treats a person as residence also characterizes this person as resident for treaty purposes.[512] The restriction brought by the court is therefore based on the interpretation of the criterion of residence stated in the treaty. That is, the meaning of residence as requiring a real and effective connection with a territory is not found in the

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[508] *Convention between the Federal Republic of Germany and the Portuguese Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (15 July 1980), Treaties IBFD.

[509] For example: PT:STA, 25 March 2009, 068-09, Tax Treaty Case Law IBFD; PT:STA, 8 September 2010, 0461/10, Tax Treaty Case Law IBFD; PT:STA, 12 January 2011, 0882/10, Tax Treaty Case Law IBFD; PT:STA, 24 February 2011, 876/10, Tax Treaty Case Law IBFD.

[510] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 4(1)* para. 8 (21 November 2017), Models IBFD.

[511] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 4(1)* para. 4 (21 November 2017), Models IBFD.

[512] Editor's notes in PT:STA, 8 September 2010, 0461/10, Tax Treaty Case Law IBFD; PT:STA, 12 January 2011, 0882/10, Tax Treaty Case Law IBFD; PT:STA, 24 February 2011, 876/10, Tax Treaty Case Law IBFD.

text of the treaty, but was based on the conclusion made by the court in respect of how the residence criterion should be interpreted.[513]

The fact that the domestic definition of residence did not directly violate the text of article 4(1) and that this rule had an impact on the outcome of the treaty that could not be foreseen by negotiators of tax treaties signed after the domestic amendment was introduced, the Portuguese deemed residence rule can be considered a potential tax treaty dodging case. Through the introduction of broad definitions of persons liable to tax by reason of residence, contracting states may thus stretch the advantages of treaty article by figuring as the country of residence for treaty purposes and consequently benefit from a more favourable allocation of taxing rights. Another discussion could be initiated, though, in respect of whether principles of public international law, such as the interpretation rule under the Vienna Convention (1969), could limit the actions of Portugal in this regard. This point will be discussed during the legal assessment of the phenomenon in Chapter 4.

Immovable Property

Article 6(2) of the OECD Model Convention (2017) does not bring the treaty meaning of the term *immovable property*. It refer instead to "the meaning which it has under the laws of the Contracting State in which the property in question is situated"[514] with the addition of certain mandatory items listed in this article, which must be in any case always regarded as immovable property[515], and with the exclusion of ships, boats and aircraft. This right to determine the meaning of immovable property was also recently mentioned by the OECD in Action 6 of the BEPS Project: "(...) many provisions of the Convention depend on the application of domestic law. This is the case, for instance, for (...) the determination of what is immovable property (...). More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the Convention".[516]

Article 6(1) also determines that income derived by a resident of a contracting state from immovable property situated in the other contracting state may be taxed in that other state. In order to be allowed to tax income from immovable property under the treaty, a contracting state may make use of the right to define this term in a manner to include items situated in its territory which are not commonly or reasonably seen as immovable property. This danger was also identified by Andrew Ogutu, who

[513] "The decision erodes Portugal's tax jurisdiction (or the residence state's jurisdiction) to an extent far beyond what is agreed in the treaty" (*Ibid.*). "The Supreme Administrative Court used a too far broad interpretation of Art. 4(1) disregarding that it clearly refers to national law, rendering, with this approach, Art. 4(2) [especially designed to tackle situations as the one under discussion] utterly useless" (Editor's notes in PT:STA, 25 March 2009, 068-09, Tax Treaty Case Law IBFD).

[514] *OECD Model Tax Convention on Income and on Capital* art. 6(2) (21 November 2017), Models IBFD.

[515] These items are already treated as immovable property by most OECD member countries (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 6* para. 2 (21 November 2017), Models IBFD).

[516] OECD/G20, *supra* n. 214, p. 83.

explained that "since Art. 6(2) gives the source country the liberty to define immovable property under its law and also allocates the taxing rights to the same source country, the source country appears to have an advantage under this article, since it can develop a wide definition of immovable property and consequently grant itself taxing rights even where the ordinary nature of the property in question will fail to fall under immovable property".[517]

John F. Avery Jones also called the attention to the possibility that a state could "rewrite the effect of a treaty in its own favour by defining any type of income as, for example, income from immovable property, which it has the full right to tax" when the ambulatory interpretation is taken to its logical conclusion.[518] In the same direction, when acknowledging the lack of case law in the subject, Hans Pijl stated that "only a speculative answer to the question on how the courts would deal with matters of dynamics can be given, if the Netherlands (in breach of the good faith principle) would bring certain elements under 'immovable property' in its domestic law, therewith annexing taxation rights, which it previously did not have".[519] In his view, it is expected that the courts would confirm that the Netherlands would have extended its taxing rights in breach of good faith.[520]

A case that has not reached judicial courts occurred in respect of a provision on income of immovable property in the tax treaty negotiated by Austria and Belarus.[521] In this case, the Austrian authorities had negotiated with Belarus a treaty provision similar to the one of article 6(2) of the OECD Model Convention (2017), that is, granting taxing rights and the right to define the term *immovable property* to the source country. However, the Austrian authorities were taken aback when Belarus later included *gambling machines* in its domestic definition of immovable property.[522] This inclusion happened at the time when there was an Austrian company with gambling machines in Belarus, and the income from the gambling machines was taxed in Austria as operations of the Austrian company under the business profit article.[523] By broadening the definition of immovable property to include gambling machines, Belarus shifted the related income from scope of the business profit article, which granted taxing rights to Austria, to the income of immovable property article, which allowed taxation in Belarus.

Although the definition given by Belarus was in conformity with the text of treaty provisions, it affected the application of the treaty in such a way that the new treaty outcome became more

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[517] A. H. Ogutu, *The relevance of Domestic Law of the Source State in the Interpretation of Distributive Rules under special consideration of Art. 6 para. 2 and Art. 10 para. 3 of the OECD-MD*, Fundamental Issues and Issues and Practical Problems in Tax Treaty Interpretation (M. Schilcher & P. Weninger eds., Linde 2008), 54 Series on International Tax Law, pp. 267-286, at p. 275.
[518] Avery Jones, *supra* n. 125, p. 253.
[519] Pijl, *supra* n. 33, p. 298.
[520] *Ibid.* The connection of tax treaty dodging and the principle of good faith is analyzed in detail during the legal assessment of the phenomenon in Chapter 4.
[521] Source of the case in Ogutu, *supra* n. 517, p. 284. See also comments on the case in R. Lang, *Income from Immovable Property: Article 6 para. 1 OECD Model Convention in the Light of Equity*, Source versus Residence in International Tax Law (Aigner & Loukota eds., Linde 2005), pp. 73-97, at p. 77.
[522] *Ibid.*
[523] *Ibid.*

favourable than the one that would have resulted if no amendment to the law were introduced. As pointed by Roman Lang, the extension of domestic definitions without limits by declaring an asset or right to be immovable property just to establish taxing rights for the own state would undermine the balance of the treaty as a whole.[524] On this case, Andrew Ogutu comments that this would be in conflict with the spirit of the treaty, "as it is unlikely that at the time of signing the treaty, the treaty partners intended to give immovable property such wide scope as to include gambling machines".[525] In this respect, the role of the principle of good faith and the object and purpose of the treaty will be discussed during the legal assessment of the phenomenon in Chapter 4.

Dividend

The OECD commentary on article 10(3) indicates that it is impossible to define the term *dividends* fully and exhaustively and that the treaty definition in this case merely enumerates examples.[526] It further explains that "in the course of the revision of the 1963 Draft Convention, a thorough study has been undertaken to find a solution that does not refer to domestic laws. This study has led to the conclusion that, in view of the still remaining dissimilarities between Member countries in the field of company law and taxation law, it did not appear to be possible to work out a definition of the concept of dividends that would be independent of domestic laws".[527]

The definition of dividends in the OECD Model Convention (2017) is therefore partly autonomous partly dependent on domestic legislation.[528] Indeed, the provision indicated that the term "dividends" as used in this article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, "as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident".[529] It means that contracting states' right to use the domestic meaning of the term is limited only in the first part of the provision.

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[524] Lang, *supra* n. 521, pp. 76-77.
[525] *Ibid.*
[526] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 10(3)* para. 23 (21 November 2017), Models IBFD.
[527] *Ibid.*
[528] de Broe, *supra* n. 55, pp. 620-621 and 411; Vogel et al., *supra* n. 36, pp. 648-649, marginal ns. 184-186, and p. 656, marginal n. 199; Lang, *supra* n. 247, pp. 99-100, marginal n. 279-280; Hohenwarter, *supra* n. 19, pp. 175-176; Rust, *supra* n. 19, p. 235; Pietro Bracco indicates that the definition of dividend includes one part referring to notions found in the majority of countries' domestic laws and another referring to a general formula that leaves to the domestic laws the duty to identify the income deriving from other corporate rights that must be qualified as dividends (Bracco, *supra* n. 19, p. 269). In the same direction, Hans Pijl affirms that "other corporate rights" refers to income which is treated as dividend under domestic laws (Pijl, *supra* n. 33, p. 299).
[529] Article 10(3) of the OECD Model Convention (2017).

As a result of the decision in the case *Schneider Electric* (2002) in the sense that the French CFC rule at the time (i.e. based on a attribution of income approach) was not compatible with tax treaties (see section 3.3.1.1.), French legislators amended domestic legislation in an attempt to render CFC rules compatible with tax treaties (from the perspective of the *Conseil d'État* line of thought) and consequently allow taxation in France by shifting from an *attribution of profit approach* to a *deemed dividend approach* rule.[530] Under the deemed dividend approach, the CFC income is deemed to be a *dividend* and is deemed to be *paid* to the shareholder. Consequently, the income would fall in the scope of the dividend article of treaties, which allows taxation at the state of the shareholder.

As explained, the definition of the term dividend in the OECD Model Convention (2017) is partly autonomous and partly dependent on domestic legislation. The part dependent on domestic law (*renvoi* clause) refers to "income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident".[531] The author agrees with scholars[532] like Michael Lang[533] who understand that the income concerned in the deemed dividend CFC rule involves income from shares in the company and that "the fact that originally the drafters of the OECD Model possibly did not consider the taxation of undistributed profits of a foreign corporation does not alter the fact that the existence of a share in a company is causal".[534] Michael Lang further explains that the second requirement of the *renvoi* clause of equal treatment with income form shares in the company's residence state is also met, since there is no deductibility from the foreign company's taxable base.[535] The author agrees with his line of thought and, therefore, considers that the domestic definition of the CFC income as divided (or deemed dividend) is, at first, a right of the contracting state because not limited by the wording of the treaty provision.

The OECD confirms this specific right in respect of the definition of dividends in Action 6 of the BEPS Project*:* "(...) many provisions of the Convention depend on the application of domestic law. This is the case, for instance, for (...) the determination of when income from corporate rights might be treated as a dividend (...). More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the Convention. In many cases, therefore, the application of specific anti-abuse rules found in domestic law will have an impact

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[530] The French CFC rules were substantially amended by article 104 of Finance Law 2005, which applied as from 1 January 2006. However, before the legislative branch resorted to this strategy, the French tax authorities tried a executive interpretative dodging. See details in section 3.3.2.

[531] Article 10(3) of the OECD Model Convention (2017).

[532] G. Maisto, *Taxation of Intercompany Dividends under Tax Treaties and EU Law*, EC and International Tax Law Series Vol. 8, p. 259. Contra: Luc de Broe (*supra* n. 55, p. 621), who believes that the reference to domestic law in this case is not needed because the autonomous part of the "dividend" definition would be in itself sufficient to include deemed dividends. Doubts are expressed by D. Sandler, *Tax treaties and Controlled Foreign Companies Legisation, Pushing the Boundaries* (Kluwer Law international 1998), p. 101.

[533] Lang, *supra* n. 63, pp. 55-56.

[534] *Ibid.*

[535] *Ibid.*

on how the treaty provisions are applied rather than produce conflicting results. This would be the case, for example, if a domestic law provision treats the profits realised by a shareholder when a company redeems some of its shares as dividends: although such a redemption could be considered to constitute an alienation for the purposes of paragraph 5 of Article 13, paragraph 28 of the Commentary on Article 10 recognises that such profits will constitute dividends for the purposes of Article 10 if the profits are treated as dividends under domestic law".[536]

The second analysis necessary to confirm if the CFC rule would fall in the scope of the dividend article is whether the deemed divided is "paid by a company which is a resident of a contracting state to the resident of the other contracting state", as required by article 10(1) of the OECD Model Convention (2017). CFC rules using a deemed dividend approach normally consider deemed dividends to be paid to the shareholders at a certain point in time not necessarily coinciding with the actual payment of the income. For example, the rule may consider a deemed distribution to happen upon closing of the annual accounts of the CFC or the next day.[537] As indicated by Luc de Broe, "where a state enacts fictitious income provisions it will typically simultaneously provide for a timing fiction to allow taxation in the taxable period during which the taxpayer is deemed to have earned or derived such income".[538] The question resumes, then, to whether the deemed divided not actually distributed but *deemed to be distributed* can be considered as having being *paid* as required by article 10.

The term *paid* is not defined by tax treaties and, therefore, reference to domestic law would be required.[539] CFC rules using a deemed dividend approach normally consider deemed dividends to be paid to the shareholders at a certain point in time not necessarily coinciding with the actual payment of the income. For example, the rule may consider a deemed distribution to happen upon closing of the annual accounts of the CFC or the next day.[540] As indicated by Luc de Broe, "where a state enacts fictitious income provisions it will typically simultaneously provide for a timing fiction to allow taxation in the taxable period during which the taxpayer is deemed to have earned or derived such income".[541] By redefining the income as deemed dividend and by shifting the timing of its recognition so that is considered as being paid, a contracting state makes the dividend article of tax treaties (and no longer the business profit article) applicable and, consequently, taxation in the country of the

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[536] OECD/G20, *supra* n. 214, p. 83.

[537] de Broe, *supra* n. 55, 623.

[538] de Broe, *supra* n. 55, p. 623.

[539] Klaus Vogel et al. explain that the term *paid* should be given a broad interpretation and that the commentary on article 10 makes clear that processes apparently not covered, but similar from an economic point of view, are not meant to be excluded (Vogel et al., *supra* n. 36, p. 587, marginal n. 22). For example, the prevailing view is that hidden dividends may also fall in the scope of article 10, even though they are by no means inevitably linked to a payment procedure (Lang, *supra* n. 63, p. 56). Michael Lang argues that this also suggests that other types of income that are not based on a payment flow are subject to article 10. According to him "the legal capacity of a corporation and the attribution of income to it are also the result of a decision by the legislature and not merely a fact that the legislature had to accept; thus there is no reason to apply art. 10 only to actual payment procedures" (Lang, *supra* n. 63, p. 56.) Contra: de Broe, *supra* n. 55, p. 625).

[540] de Broe, *supra* n. 55, p. 623.

[541] *Ibid.*

shareholder allowed in accordance with the text of the treaty. In other words, the *deemed dividend* type of CFC rule allows contracting states to modify the outcome of the treaty without having a direct conflict with the treaty (i.e. conflict with the wording of the treaty).

This type of attempt, which was made by the French legislator through the amendment of the CFC rules, was recognized by Luc de Broe when he states that "(...) a State adopting a 'transparency' approach under the 'entity' method could be inclined to change its system and switch over to a 'deemed dividend' approach. To that effect, such State must enact new attribution and timing fictions in its domestic law. France has done so as a reaction to the decision in Schneider". He further concludes that "in my view, the case of France is an example where a State after conclusion of the treaty and by way of unilateral amendment of domestic law, affects the scope of distributive treaty provisions (Art. 10/21) in such a way that it claims taxing rights over items of income which, upon entering into the treaty, it had relinquished to the other State as long as such income is not distributed (Art. 7)".[542]

The redefinition of income into dividends under domestic rules was also discussed by a Canadian tax court in the case *Equilease* (1997).[543] The case concerned transactions carried out by the US corporation Equilease to convert what would be proceeds received on a liquidation of Equilease's Canadian subsidiaries into a capital gain from the alienation of the shares of those subsidiaries.[544] However, under Canadian domestic income tax law,[545] proceeds received on a liquidation would result in a substantial deemed dividend in the hands of Equilease[546] and would therefore be subject to a 10% withholding tax under article 10 of the Canada–United States Income and Capital Tax Treaty (1980).[547] If the income would be qualified as a capital gain, the gain would be exempt in Canada under article 13 of the treaty. The dispute was brought to the Canadian tax court, which eventually considered that the definition of dividends in the treaty was broad enough to include a capital gain re-characterized as a dividend under the Canadian domestic law. The court also concluded that the intentions of the

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542 de Broe, *supra* n. 55, pp. 635-636. In the same direction, Nicolas Message refers to the French case as an "indirect override": "It could be argued, however, that the reference to concepts and definitions derived from domestic law to determine the applicable provision in a tax treaty, as exemplified in the Schneider case, could lead to an indirect override" (...) "(...) in particular the new wording of Sec. 209 of the FGTC [French General Tax Code] adopted to circumvent Art. 7 of the OECD Model Convention" (Message, *supra* n. 199, p. 223 and footnote 25).

543 CA: TCC, 10 April 1997, *RMM Enterprises Inc. and Equilease Corporation v. Her Majesty the Queen*, Tax Treaty Case Law IBFD.

544 de Broe, *supra* n. 55, 431; *Ibid.*

545 Subsection 84(2) and Section 212 of the Canadian Income Tax Act.

546 Subsection 84(2) of the Canadian Income Tax Act reads as follows: "Where funds or property of a corporation resident in Canada have…been distributed or otherwise appropriated in any manner whatever…on the winding-up, discontinuance or reorganization of its business, the corporation shall be deemed to have paid at that time a dividend on the shares of that class equal to the amount, if any, by which (a) the amount or value of the funds or property distributed or appropriated…exceeds (b) the amount, if any by which the paid-up capital in respect of the shares of that class is reduced on the distribution or appropriation, as the case may be, and a dividend shall be deemed to have been received…." (*RMM Enterprises Inc. and Equilease Corporation v. Her Majesty the Queen*, *supra* n. 543).

547 *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital* (26 September 1980), Treaties IBFD.

United States and Canada was that a treaty should not be interpreted in a way to permit its abuse and therefore the provisions of the treaty could not be applied to prevent Canada from applying anti-avoidance rules to re-characterize the transaction.[548] Indeed, as affirmed Luc de Broe, "the definition of the term "dividends" as used in the United States–Canada tax treaty and which departs from the classical definition of the term "dividends" as used in art. 10 OECD MC is broad enough to include the result of the recharacterization of the capital gain in a dividend under the Canadian GAAR. From that perspective there is no reason to disagree with the Court. Provisions of a treaty should not be construed in such a way that they conflict with each other or make others provision meaningless. Including the recharacterized gain in the Dividend Article avoids such results and gives effect to the alleged treaty objective of the prevention of tax avoidance. Such a result is to be preferred over one that perpetrates tax avoidance or treaty abuse".[549] The redefinition of the term dividends seems therefore to be in line with the wording of the treaty. However, the question to be raised is whether it would also be in line with the object and purpose of the treaty – what is defended by Luc de Broe – or with public international law principles. This subject is dealt with in Chapter 4.

In 1993 the Dutch Supreme Court analysed a case[550] concerning a domestic re-characterization of capital gains into dividends also under a *fraus legis* rule[551] and whether the term *dividends* in article 7(1) of the Netherlands-United States Income Tax Treaty (1948) could be regarded to include this re-characterized income. The Dutch tax authorities argued that where the treaty did not provide for a definition of the term dividend, a broad interpretation under domestic law was justified. Different from the Canadian court in the previous case, the Dutch Supreme Court considered that neither the text of the treaty[552] nor the clarifications given by the contracting states supported the view that the contracting states had the common intention when applying article VII(1) to interpret the term *dividends* as including income which, for domestic tax purposes, is reclassified by applying the *fraus legis* doctrine and is taxed in the same way as dividends. According to Kees van Raad, "the court was very prudent in deciding whether there was any room for the application of the re-characterization rule it had developed for domestic purposes. Apparently, the court felt that if a country like Holland wants

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548 de Broe, *supra* n. 55, p. 435; *RMM Enterprises Inc. and Equilease Corporation v. Her Majesty the Queen*, *supra* n. 543.

549 de Broe, *supra* n. 55, p. 435-436.

550 NL: SC, 15 December 1993, 29.269, Tax Treaty Case Law IBFD.

551 "Under Article 49(1)(c) IITA 1964, profits on the sale of a substantial holding realized by non-residents were, as far as relevant here, taxable in the Netherlands only if the holding was held in a company resident in the Netherlands. (...) The tax rate in both cases was 20%. In certain cases, however, repurchase of its shares by the company and the sale of shares shortly before liquidation to an enterprise, the difference between the (re)purchase price and the average paid-in capital on the shares would be deemed income from investment subject to a rate of up to 45%, even if the shares formed part of a substantial interest" (*Ibid.*).

552 The author disagrees with the court in this regard. The fact that article 7 of the treaty had no definition of the term *dividends* could only lead to the conclusion (in the opposite direction of the one taken by the court) in the sense that no limitation was imposed by the text of the treaty when defining the term, so that the inclusion of other elements of income in the definition of dividends was not restricted by the wording of the treaty.

to apply a treaty differently than what the treaty says, Holland should get together with the other country and amend the treaty".[553]

Interest

An interesting case is also the one of *interest*, which is defined in Article 11(3) of the OECD Model Convention (2017). The Commentary on article 11(3) indicates that: "the definition of interest in the first sentence of paragraph 3 is, in principle, exhaustive. It has seemed preferable not to include a subsidiary reference to domestic laws in the text; this is justified by the following considerations: a) the definition covers practically all the kinds of income which are regarded as interest in the various domestic laws; b) the formula employed offers greater security from the legal point of view and ensures that conventions would be unaffected by future changes in any country's domestic laws; c) in the Model Convention references to domestic laws should as far as possible be avoided".[554] Generally, literature also agrees that the treaty definition as from 1977 is comprehensive and exhaustive.[555] A different position was taken, though, by the French *Conseil d'État*, which considered that reference to domestic law was necessary, since the definition of interest included undefined terms as *income from debt-claims.*[556] Indeed the fact that a large autonomous definition of interest – by referring to income from debt-claims of *every kind,* for instance – seems to have been intentionally drafted in order to cover practically all kinds of income which are defined as interest in the various domestic laws.[557]

In this respect, a Mexican provision enacted in 2002[558] introduced a definition of "income from debts of every kind" by listing different types of income to be qualified as such. Before this provision, no reference as to what Mexican domestic law considered to be income from debt claims of every kind

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553 Comments by K. van Raad in IFA, *How Domestic Anti-Avoidance Rules Affect Double Taxation Conventions* – 19c Proceedings of a Seminar held in Toronto, Canada, in 1994 during the 48th Congress of the International Fiscal Association (Kluwer Law International), p. 33.

554 *OECD Model Tax Convention on Income and on Capital: Commentary on Article 11(3)* para. 21 (21 November 2017), Models IBFD.

555 See Vogel et al, *supra* n. 36, p. 732, marginal n. 59; Avery Jones et al., *supra* n. 46, p. 36. See also the case IN: CHC, 20 March 2013, *Commissioner of Income Tax v. Vijay Ship Breaking*, Tax Treaty Case Law IBFD.

556 FR: CE, 27 July 2001, 215124, Tax Treaty Case Law IBFD. See also comments by Daniela Hohenwarter in this sense (Hohenwarter, *supra* n. 19, pp. 175-176).

557 This can be confirmed by the Commentary on article 11(3): "the definition covers practically all the kinds of income which are regarded as interest in the various domestic laws" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 11(3)* para. 21(a) (21 November 2017), Models IBFD). The Gujarat High Court also had the view that the definition of interest covers practically all the kinds of income which are regarded as interest in the various domestic laws and that the formula employed offers security from the legal point of view (*Commissioner of Income Tax v. Vijay Ship Breaking* (2013), *supra* n. 555).

558 Article 210(VII) of the Mexican Income Tax Law: "Regarding interest, the income established under articles 195, 196, 198 and 199, which will be considered as income from debt claims of every kind" (L. R. Lara Ramos, *Treaty Override and the Proper Interpretation of Terms with Particular Reference to Mexican Tax Legislation*, 64 Bull. Intl. Taxn. 12 (2010), Journals IBFD, pp. 620-625, at p. 624).

existed.[559] The new definition raised some questions in respect of some items of income listed, as it could be argued that they could not properly be considered to be "income from debt claims", but rather as a fee.[560] This is a reason for which some supported the static view in respect of the domestic concept of "income from debt claims" in the Mexican legislation, so that it could not apply to income from the acceptance as a co-signer or warrantor derived before 2002[561].

However, the use or not of domestic law in respect of the meaning of *interest* was not always controversial. Early treaties normally included express reference to domestic law and the OECD Model Convention of 1963 itself included a definition of the term *interest* which allowed it to be complemented by domestic legislation: "the term "interest" as used in this Article means income from Government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt-claims of every kind as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises".[562] Under this text, the definition of interest was partially autonomous partially dependent of contracting state's domestic legislation,[563] meaning that contracting states' sovereign rights were only partially limited and, thus, space was left for contracting states to act. This was exactly the case of *Melford* (1982),[564] which concerned term "interest" not defined in the Canada-Germany Income Tax Treaty (1956).[565]

In the case, a taxpayer resident of Canada made a payment to a German bank to guarantee a loan. The Canadian tax authorities claimed that the payment was subject to withholding tax under a domestic law enacted in 1974,[566] which deemed it to be a payment of interest rather than business profit. The taxpayer argued that the deeming provision was enacted subsequent to the Canada-Germany Income Tax Treaty (1956) and that it could not override the treaty, under which the payment would be viewed as business profit and would not be subject to tax in the absence in Canada of a permanent establishment of the German bank.

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[559] *Ibid.*

[560] Such as in the case of commissions paid when a debt is granted or guaranteed and payments to third parties in view of their acceptance as warrantor payments to third parties. Because of their acceptance as a co-signer or warrantor, it could be argued that such income cannot properly be considered to be "income from debt claims", as the payment refers to a fee from the acceptance as a co-signer or warrantor (Lara Ramos, *supra* n. 558, p. 624).

[561] "In this scenario and under a proper interpretation of the tax treaty, the concept of "income from debt claims" as stated since 2002 in the MITL [Mexican Income Tax Law] should not apply to the previously noted income derived from the acceptance as a co-signer or warrantor" (Lara Ramos, *supra* n. 558, p. 624).

[562] *OECD Model Tax Convention on Income and on Capital* art. 11(3) (30 July 1963), Models IBFD.

[563] Vogel et al, *supra* n. 36, p. 732, marginal n. 58.

[564] Melford (1982), *supra* n. 86. Full text of the decision available at http://scc-csc.lexum.com/decisia-scc-csc/scc-csc/scc-csc/en/item/5509/index.do?r=AAAAAQAHTWVsZm9yZAAAAAAB (accessed 31 Jan. 2014).

[565] *Convention between Canada and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (4 June 1956), Treaties IBFD.

[566] Paragraphs 212(1)(b) and 214(15)(a) of the Canadian Income Tax Act.

The Supreme Court of Canada found that the treaty provision equivalent to article 3(2) did not allow Canada or Germany to unilaterally amend the treaty from time to time as their domestic needs may dictate and, therefore, decided that the domestic provision could not override the treaty. As explained in Chapter 2, this case brought up the discussion, until then not relevant,[567] on whether, for tax treaty purposes, reference should be made to the law of contracting state at the time when the treaty was concluded (static interpretation) or to the law at the time when the treaty was applied (ambulatory interpretation). Contrary to the prevailing views at the time, the Supreme Court of Canada decided in this case for the static interpretation and justified its decision on the fact that reference to domestic law as amended would offer the opportunity for a unilateral change of the tax treaty by a contracting state as their domestic needs may dictate. As indicated by Jacques Sasseville, "the preoccupation of the court was a legitimate one and is probably the most serious argument in favour of a static approach in deciding to which temporal version of domestic law art. 3(2)".[568]

Despite (in the opinion of some scholars,[569] mistakenly) treating it as override, the Supreme Court of Canada seems to have spotted a tax treaty dodging case: as Canada was allowed by a treaty provision equivalent to article 3(2) to use its domestic law definition of interest, the effective use of such definition could not be considered a violation of the wording of the agreement; on the other hand, the amendment of the domestic law after the signature of the treaty modified the outcome of the treaty provision. To avoid such an outcome, the Supreme Court of Canada decided to apply a radical measure and forbid the reference to domestic law amendments made after the signature of the treaty, closing the door to any attempt in this sense.

In the same direction, the Dutch Supreme Court held[570] that the Netherlands could not tax a notional interest on a loan on which no interest is paid. The Court held decisive that the notional interest under the 1970 treaty with Belgium was to be taxed as dividends or capital gains and that the Dutch domestic provision was introduced after the signature of the treaty. The Court was firm in pointing out that article 3(2) would not allow a state to re-define treaty notions through domestic fictions to the extent that items of income which are governed by a particular treaty provision would come under the scope of another treaty provision on the basis of which a state obtains a taxing right that would otherwise belong to its treaty partner state.

Royalties

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[567] Until the early 80's the issue static v. ambulatory was rarely discussed, as the static/ambulatory alternatives had not been considered to be a problem and reference was normally made to the law as it stood (Vogel et al., *supra* n. 36, p. 64, marginal n. 124c).

[568] J. Sasseville, *supra* n. 299, pp. 39-40.

[569] For example, "The International Tax Group" under the coordination of John F. Avery Jones expressed the view made an interesting distinction between treaty override and the effects of the ambulatory interpretation[569] and how the Supreme Court of Canada had wrongly considered these two subjects being the same thing. For details, see Chapter 2.

[570] NL: HR, 18 June 2004, 39.385, Tax Treaty Case Law IBFD.

The definition of *royalties* is a less straight forward case. Article 12(2) of the OECD Model Convention (2017) brings the following definition for the term: "(...) payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience". This definition is considered to be, in principle, an autonomous and exhaustive definition that would not depend on domestic legislation of contracting states.[571] However, when defining the term royalties, the OECD Model Convention (2017) makes reference to other terms which have not been defined elsewhere in the convention, such as copyright of literary, artistic or scientific work, patent, trade mark, design, etc. In this respect, it can be argued that the autonomous and exhaustive definition of *royalties* would become in practice dependent on domestic legislation because it contains undefined terms. Scholars support this position by indicating that the use of domestic law in the case of *royalties* is not excluded to interpret the terms used within its treaty definition.[572]

An example of how relevant domestic law is for the interpretation of undefined terms within the treaty definition of royalties (and thus how vulnerable it is to treaty dodging practices) is the Spanish case concerning the qualification of payments made for the rights to use and distribute computer software. Before 2003, the Spanish Non-Resident Income Tax Act[573] had a general definition of royalties, with no distinction made between the different types of royalties.[574] However, article 12(2) of the Spain-United States Income Tax Treaty (1990)[575] imposes different withholding tax limitations according to the type of royalties paid. In this respect, royalties paid for copyrights of literary work would be taxed at the maximum rate of 5%, while royalties for copyright of scientific work at a maximum rate of 8% and other royalties at 10%. In view of the broad and single concept of royalties under Spanish domestic law, questions arose in respect of whether payments for the rights to use and distribute computer software would qualify as "literary work" or as "scientific work". The Spanish courts issued decisions in 2002[576] confirming the interpretation that these payments would qualify as "literary work" and

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[571] According to Klaus Vogel et al, the definition of royalties in the treaty "precludes any interpretation of the term by reference to domestic law" (Vogel et al., *supra* n. 36, p. 785, marginal n. 38) – see however footnote below on his further comments.

[572] "Not excluded, however, is the use of domestic law to interpret terms used by Art. 12(2) to define 'royalty'" (Vogel et al., *supra* n. 36, p. 786, marginal n. 38); Luc de Broe considers the undefined parts in the treaty definition of royalty as "terms" in the sense of "any term not defined therein", as stated in article 3(2), for which meaning reference to domestic law is necessary (de Broe, *supra* n. 55, p. 265).

[573] Law 41/1998.

[574] The concept of royalties before 2003 was as follows: "1. Se consideran rentas obtenidas en territorio español las siguientes: e) Los intereses, cánones y otros rendimientos del capital mobiliario, satisfechos por personas o entidades residentes en territorio español o por establecimientos permanentes situados en el mismo, o que retribuyan prestaciones de capital utilizadas en territorio español" (National Court Madrid, Roj: SAN 1545/2010 - Recurso 440/2008, p. 6).

[575] *Convention between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (22 February 1955), Treaties IBFD.

[576] For example, decisions issued on 4 July 2002, 16 July 2002 and 28 September 2002 – see references in National Court Madrid, Roj: SAN 1545/2010 - Recurso 440/2008, p. 3.

therefore would be subject to withholding taxes at the rate of 5%, in accordance with the Spain-United States Income Tax Treaty (1990).

However, Law 46/2002 of 8 December 2002, effective as of 1 January 2003, amended the Spanish Non-Resident Income Tax Act to define royalties in different categories, as follows: (i) rights of literary, artistic or scientific work including cinematograph films; (ii) patents, trademarks, trade name, designs, drawings, secret formulas or procedures; (iii) software copyright; (iv) information concerning industrial, commercial or scientific experience; (v) personal rights susceptible of assignment, such as image rights; and (vi) other similar rights.[577] According to this new domestic definition, royalties for the rights to use and distribute computer software would belong to a different category from literary or scientific work. As a result, Spanish tax authorities argued that these payments would no longer qualify as "literary work". They would rather qualify as "other royalties", subject to a maximum withholding tax rate of 10%.

Despite the arguments brought by the taxpayer in the sense that the this domestic amendment amounted to an "inadmissible" unilateral change of the treaty, the Spanish Supreme Court accepted the Spanish tax authorities arguments in the case IBM Spain (2010).[578] The court confirmed that the amendment of the Spanish domestic law did not modify article 12 of the Spain-United States Income Tax Treaty (1990). According to the court, the amendment had just defined computer programs as something different from literary or scientific work without altering the rule for royalties in the treaty.[579] In other words, by amending the domestic definition of royalties, Spain modified the outcome of existing treaties by shifting the income from the application of a provision section to another section in the same provision that was more beneficial, without entering into a conflict with the wording of these agreements.

Income from employment and pension income

Similar attempts in regard to income from employment were observed in a series of cases analysed by the Belgian and Dutch Supreme Courts, where Belgium and the Netherlands, after having entered into a treaty, changed their domestic law with a view to recover taxing rights over items of income that were taxable in the other contracting state according to the treaty.[580]

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[577] Article 13 of the amended Spanish Non-Resident Income Tax Act (free translation by the author).

[578] National Court Madrid, Roj: SAN 1545/2010 - Recurso 440/2008

[579] "Tampoco puede aceptarse que la nueva redacción del artículo 12 de la LIRNR examinado modifique la norma del convenio, puesto que el art. 12 del referido Convenio con los Estados Unidos no menciona los programas de ordenador como categoría específica de los cánones, siendo así que lo único que hace la norma interna es definir a los programas de ordenador como algo distinto a una obra literaria o científica, sin alterar en forma alguna la regulación que de los cánones se hace en el Convenio" (National Court Madrid, Roj: SAN 1545/2010 - Recurso 440/2008, p. 9).

[580] de Broe, *supra* n. 55, p. 279.

Maarten J. Ellis explains the attempts made by the Netherlands involving the pension income article, article 18 of the OECD Model Convention (2017), which in most Dutch treaties allocates right to tax pensions to the resident state as follows: "Many years ago, our courts had already ruled that the redemption of a pension is a similar payment and therefore is also taxable only in the resident State. The build-up of a pension is normally tax deductible. But if you are a "cold" country, many of your pensioners are normally resident elsewhere when they are taking their pensions and some leave early to draw their pensions. So the legislators devised a system in 1995/1997 whereby the redemption was deemed to be a repayment of the premium, a clawback of premium deducted in the past. Therefore, you paid premiums when you were a resident of the Netherlands and when you left the country you were deemed to have received back the premiums that you deducted and those are taxed as deferred income from current employment. Article 15, therefore, not Art. 18. This, the court said very simply, is an attempt to erode the treaty. Consequently, it did not work".[581]

A similar case[582] concerned a taxpayer, resident of Singapore, who was employed by a company resident in the Netherlands and who performed the work both in the Netherlands and outside. During his employment, the taxpayer participated in his employer's pension plan. Prior to the termination of his employment, the taxpayer requested to redeem his pension rights insofar as they related to employment exercised outside the Netherlands. The request was granted and a lump sum was paid to the taxpayer. On this lump-sum, Dutch wages tax was withheld based on a domestic rule added in 1994,[583] which stipulated that if a pension claim is commuted in whole or in part in consideration for a lump-sum payment, it is no longer the lump sum that is taxed. Instead, the fair market value of the total claim is taxed as income from employment. In addition, this reclassified income from former employment is deemed to have been enjoyed at the time immediately preceding the commutation. As pointed out by Frank Pötgens, "the consequence of applying these fictions (…) to the 1971 Netherlands–Singapore tax treaty would be that the lump sum at issue would not fall under Art. 18 (pensions) but under Art. 15 (income from employment). This type of shift in the allocation of taxation rights is incompatible with the good faith principle".[584] Indeed, in this case the Dutch Supreme Court held that the exclusive authority to tax pensions and other similar remuneration under article 18 of the Netherlands–Singapore Income and Capital Tax Treaty (1971)[585] could not be eroded or evaded as a result of the source state subsequently enacting a domestic law provision that operates at the treaty level after that treaty's conclusion.[586]

The same issue existed in respect of emigrating employees resident in the Netherlands. In that case, a preserving assessment was issued on the fair market value of the pension and/or annuity. The

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581 Comments by Ellis in J. Arnold & al., *supra* n. 28, p. 394.

582 NL: HR, 5 September 2003, 37.657, Tax Treaty Case Law IBFD.

583 Article 11c was added to the Dutch Wages Tax Act 1964 in 1994 and was applicable as from 1 January 1995.

584 Pötgens, *supra* n. 426, p. 186.

585 *Convention between the Government of the Kingdom of the Netherlands and the Government of the Republic of Singapore for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (19 February 1971), Treaties IBFD.

586 Pötgens, *supra* n. 426, p. 185-186.

Supreme Court held, with respect to various tax treaties, that this was incompatible with the treaty, using similar arguments.[587]

Another case[588] relates to a taxpayer resident of Belgium who was director and single owner of a company resident in the Netherlands, which seat was eventually transferred to Belgium. The company held a pension reserve for the benefit of the taxpayer. According to applicable Netherlands domestic tax law, a deferral of income tax had been allowed during the built-up of the pension reserve: the assigning of pension rights was left tax-free and pension premiums paid were allowed as a tax deduction, in exchange for full taxability of later pension payments. The tax deferral, however, was recouped, since the company's pension plan stopped qualifying for tax deferral due to the transfer of the company seat from the Netherlands. This was affected by taxing the economic value of the pension rights as employment income of the taxpayer, deemed to be derived at the time immediately preceding the company seat's transfer.

The Dutch Supreme Court rejected the argument raised by the State Secretary for Finance that the objective of the Netherlands tax charge would be a belated taxation of the previous assignment of pension rights, which would have meant that the income from employment article of the tax treaty applied. In the Court's opinion, the Netherlands tax law would unilaterally effect a change in treaty classification, moving income from article 18 (pension income) to article 15 (income from employment) and, thereby, making the relevant taxing right shift to the Netherlands. The Court condemned this unilateral change as being in conflict with the good faith to be observed in the application of treaties[589] and, as article 18 attributed the sole taxing right to Belgium as the pensioner's state of residence, it denied the Netherlands tax claim. Again, according to Frank Pötgens, the case involves "a circuitous characterization of income categories with a view to unilaterally influencing the tax treaty allocation. Consequently, this characterization could not be effectuated under the tax treaty in question because of the shift in the allocation of taxation rights resulting there from".[590]

[587] Decisions of 19 June 2009, n. 43978 ECLI:NL:HR:2009:BC5201, n. 44050 ECLI:NL:HR:2009:BC4725 and n. 07/13267 ECLI:NL"HR:2009:BI8563 under treaties with France, Belgium and Korea (rep.) respectively, published in BNB 2009/263, 264 and 265.

[588] NL: HR, 13 May 2005, 39.610, Tax Treaty Case Law IBFD.

[589] It referred to its decision of 5 September 2003, No. 37.657, where it had explained its views in this respect for the first time.

[590] Pötgens, *supra* n. 426, p. 187, footnote 20.

In two other cases[591], the Netherlands Supreme Court held that an unlimited application of the Dutch fictitious wage concept[592] to the Belgium–Netherlands Income and Capital Tax Treaty (1970)[593] would result in the classification of fictitious income under article 15 (employment income) or 16 (directors' fees) of that treaty. Such reclassification would assign the taxation right to the Netherlands, whereas the income would normally accrue to the substantial shareholder as a dividend (article 10) or capital gain (article 13), which allocated taxing rights to Belgium, resulting in extended taxing right to the Netherlands in a way not intended by the treaty. As correctly indicated by Pötgens, this fiction would bring about a shift in taxing rights between the Netherlands and Belgium.[594]

It is interesting to point out that later on, the Dutch Court of Appeal The Hague decided for the compatibility of the Dutch domestic rule, because it concerned the new Belgium–Netherlands Income and Capital Tax Treaty signed in 2001, that is, after the domestic amendment[595] (and therefore not meeting the ambulatory condition for a tax treaty dodging case, as explained in Chapter 2). The court rejected the taxpayer's argument that the deemed wage tax provision constituted a unilateral extension of the taxing rights of the Netherlands with reference to the decisions of the previous cases.[596] For that, the court held as decisive that in the Explanatory Memorandum to the new treaty, it was indicated that the deemed wage tax provision was discussed during the treaty negotiations and thus can be applied.[597]

Another case involving redefinition of income from employment involves Austria and its attempt to enlarge its taxing rights over the income of foreign visiting professors without a fixed base in the country.[598] Until 1997, the income of a visiting professor in Austria, who only lectured from time to time and was not a member of the permanent staff of the university, fell under the provisions of income from independent service and would be thus governed by article 14 of the treaty, which meant

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591 NL: HR, 5 September 2003, 37.651, Tax Treaty Case Law IBFD; NL: HR, 5 September 2003, 37.670, Tax Treaty Case Law IBFD.

592 As from 1 January 1997, section 12a of the Netherlands Wage Tax Act 1964 stipulates that the salary of employees who are also substantial shareholders of entities should be considered to be at least 70% of the salary which is customary for similar employment in similar entities. In the two cases under discussion, the taxpayers, both resident of Belgium, were the sole shareholders and also respective directors. One of them was not paid any remuneration and the other was paid the amount of NLG 78,000. The tax authorities used this provision to adjust the salaries of the taxpayers to NLG 150,000.

593 *Convention between the Government of the Kingdom of the Netherlands and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (18 October 1970), Treaties IBFD.

594 Pötgens, *supra* n. 426, p. 186.

595 In the case *X. v. the Tax Administration* (No. BK-09/00475) – R. Offermanns, *2001 Treaty between Netherlands and Belgium – Court of Appeal The Hague holds deemed wage provision in Netherlands Wage Tax Act compatible with treaty* (5 April 2011), News IBFD.

596 R. Offermanns, *2001 Treaty between Netherlands and Belgium – Court of Appeal The Hague holds deemed wage provision in Netherlands Wage Tax Act compatible with treaty* (5 April 2011), News IBFD.

597 *Ibid.*

598 E. Freddo, *The Relevance of Art. 23 A/B (1) OECD MC in the Case of Qualification Conflicts*, Fundamental Issues and Issues and Practical Problems in Tax Treaty Interpretation (M. Schilcher & P. Weninger eds., Linde 2008), 54 Series on International Tax Law, pp. 413-438, at p. 434.

that all taxing rights were allocated to the country of residence of the visiting professor, and not Austria.[599] In 1997 the Austrian Ministry of Finance issued a decree ruling that the income of visiting professors fell under the provisions of employment income.[600] The legality of the decree was challenged and the Supreme Constitutional Court ruled that it was not in accordance with the law.[601] However, the Ministry of Finance had close ties with the legislator and soon after the court ruling the law was changed to qualify the income of a visiting professor as employment income under the Austrian Individual Income Tax Act.[602] As a result, the employment income article, and no longer the former independent personal services article, would be generally applicable because, in the opinion of the Austrian tax authorities, of the reference to domestic law under article 3(2) and of the context not requiring otherwise.[603] However, the tax authorities went a step further to apply the government service article (article 19 of the OECD Model Convention (2014)) as a *lex specialis* to article 15 if the remuneration received by the visiting professor for lecturing at an Austrian University was paid by the government.[604] The result of the application of the government service article was taxing rights being granted to Austria.

The author closes this section by concluding that the second situation in which contracting states exercise sovereign rights not limited by the text of these agreements (i.e. within the treaty gap areas) and, as a consequence, find themselves in a position to impact treaties, is whenever they are dealing with the meaning of terms not defined by tax treaties. In this sense, any action of contracting states in regard to the meaning of terms which are on the other hand defined by tax treaties will in no way characterize a tax treaty dodging and, therefore, are not observed in this study.

3.3.1.3. Legislature omission: treaty underride (as third legislative dodging method)

The last method of legislative dodging detected by the author is through legislature omission having an impact on signed tax treaties. This may happen, for example, in states where the incorporation of treaties in domestic law is necessary in order to give effect to these agreements and to affect taxpayers, such as in the United Kingdom. This omission of legislature in respect of the proper incorporation of tax treaties is referred to in literature as "treaty underride", a name originally given to this specific practice by Richard Vann.[605] In the United Kingdom, where this type of dodging has been detected,

[599] W. Gassner & M. Lang, *Double Non-Taxation of a Belgian Tax Law Professor Lecturing in Vienna*, Liber Amicorum Honouring Luc Hinnekens (F. Vanistendael ed., Bruylant 2002), pp. 219-230, at p. 220.

[600] Bundesgesetzblatt, 287/1998 (*Ibid*, p. 221).

[601] *Ibid*.

[602] Gassner & Lang, *supra* n. 599, p. 222.

[603] Gassner & Lang, *supra* n. 599, p. 223. E. Freddo, *supra* n. 598, pp. 413-438, at p. 434.

[604] Gassner & Lang, *supra* n. 599, p. 223.

[605] "A completely different problem – which causes us trouble in the UK – is the possibility that the treaty may not have been incorporated fully into internal law, for which Prof. Richard Vann has coined the phrase 'treaty underride'" (Avery Jones, *supra* n. 55, p. 135); "Richard Vann has termed this failure to implement all of the

domestic legislation is necessary for giving effect to treaty provisions. This effect is given by Section 788(3) of the UK Income and Corporation Tax Acts of 1988, but provided that the treaty provision deals with the subjects listed in this article.[606] This means that, for other treaty subjects not covered therein, effect is not automatically given. This is the case, for example, of treaty provisions referring to "substantially similar taxes" (as in article 2(4) of the OECD Model Convention) or "taxes of every kind and description" (as in article 24(6) of the OECD Model Convention), since the UK legislation limits the effects to income tax and corporation tax (and capital gain tax).[607] The omission of the UK legislature in incorporating and subsequently giving effect to the treaty subjects not covered in Section 788(3) resulted in a number of cases discussed by UK courts, mostly on the lack of effect given to non-discrimination provisions in signed tax treaties in respect of taxes other than income tax and corporation tax.[608]

According to Hans Pijl, this problem is not restricted to countries where domestic law is necessary for giving effect to treaties. He indicates that "such issue also arises in states with a monistic system, e.g. where an international instrument requires the implementation of certain rules into the domestic legal order and this was not done at all or not on a timely basis".[609] The author agrees with this and considers that this may be the case where domestic legislation is required for the proper implementation of, for example, the mutual agreement procedure foreseen in many treaty provisions. The omission of legislatures in implementing and, thus, creating this formal procedure and making it available for taxpayers is in reality preventing the actual application of article 25 of the OECD Model Convention (2017).

Another example of treaty underride may be the case of the omission of the Portuguese legislature in ratifying a new tax treaty signed with Finland in 2016[610], which eventually led the Finnish authorities

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treaty provisions "treaty underride", to distinguish the more typical case of legislative override where treaty provisions are given effect in domestic law but then are overridden by some other provision of domestic legislation." (I. Roxan, *United Kingdom*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series, pp. 313-354, at p. 323, footnote 47).

[606] "Subject to the provisions of this Part, the arrangements shall, notwithstanding anything in any enactment, have effect in relation to income tax and corporation tax in so far as they provide (a) for relief from income tax, or from corporation tax in respect of income or chargeable gains; or (b) for charging the income arising from sources, or chargeable gains accruing on the disposal of assets, in the United Kingdom to persons not resident in the United Kingdom; or (c) for determining the income or chargeable gains to be attributed (i) to persons not resident in the United Kingdom and their agencies, branches or establishments in the United Kingdom; or (ii)to persons resident in the United Kingdom who have special relationships with persons not so resident; or (d)for conferring on persons not resident in the United Kingdom the right to a tax credit under section 231 in respect of qualifying distributions made to them by companies which are so resident" (Section 788(3) of the Income and Corporation Tax Acts of 1988).

[607] Avery Jones, *supra* n. 55, p. 135.

[608] For a list of cases and comments, see Avery Jones, *supra* n. 55 and Roxan, *supra* n. 605.

[609] H. Pijl, *State Responsibility in Taxation Matters*, 60 Bull. Intl. Taxn. 1 (2006), Journals IBFD, pp. 38-51, p. 38

[610] *Convention between the Government of the Republic of Finland and the Portuguese Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (7 November 2016), Treaties IBFD.

to terminate the previous tax treaty of 1970,[611] which had been in force until then. Article 18 of the tax treaty of 1970 granted exclusive taxing rights over pension income to the resident state of pensioners. In view of a special regime implemented by Portugal in 2009, under which a 10-year exemption was granted to foreign pension income derived by individuals moving to Portugal,[612] a number of high net-worth Finnish pensioners decided to reside in Portugal in order to make use of the benefit provided by the Portuguese domestic law, which was secured by the exclusive taxing rights allocated to that country by the treaty in force at the time. In view of the public pressure caused by newspapers' reports on the benefits enjoyed by the Finnish high net-worth pensioners, Finland decided to initiate treaty negotiations with Portugal.[613] After long negotiations, Finland and Portugal signed a new treaty in November 2016[614], which amends the allocation of taxing rights over private pensions so to prevent the double non-taxation. Finland ratified the new treaty immediately after its conclusion, on 21 December 2016. However, more than a year passed with no further action from the Portuguese legislature in respect of the ratification of the treaty. As a result, on 12 April 2018, the Finnish government presented to the parliament a law proposal to terminate the treaty in force at the time and issued a press release indicating that the country was dissatisfied that Portugal had not taken measures for the implementation of the new treaty; it also indicated that, by terminating the treaty in force at the time, Finland wanted to ensure that it could apply its domestic law instead of treaty provisions that were no longer in line with the country's policy.[615] The treaty was eventually terminated by Finland, with effect from 1 January 2019. Currently, no tax treaty between Finland and Portugal is effective and, after three years from its conclusion, the new treaty signed in 2016 is still pending final approval by the Portuguese legislature.

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[611] *Convention between the Government of the Government of Finland and the Government of Portugal for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital* (27 April 1970), Treaties IBFD.

[612] Under the Portuguese non-habitual resident regime, a beneficial tax treatment is offered for 10 years to individuals who become tax resident in Portugal, but who were not tax resident of Portugal in any the previous 5 years. Among the benefits is the exemption of foreign pension income (article 18(6) of the individual income tax code – Código do Imposto sobre o Rendimento das Pessoas Singulares).

[613] "On 14 August 2015, the Finnish government announced that the Finnish Minister of Finance met with the Portuguese Minister of Finance in Brussels to discuss the future of the Finland - Portugal Income and Capital Tax Agreement (1970) (the Treaty). The primary reason for the discussions is because Finland has been negotiating with Portugal to conclude a new tax treaty. Recently, public pressure regarding the Treaty has increased in Finland after newspapers reported a number of high net-worth Finnish pensioners moving to Portugal. Under article 18 of the Treaty, the residence state is granted the exclusive taxing right over private pensions. Portugal, under its domestic law, offers a 10-year tax exemption for private pensions for pensioners who move to Portugal. Finland regards such double non-taxation of private pensions as an unintended effect of the Treaty and wants to abolish the tax incentive of moving from Finland to Portugal. Finland's goal is that the negotiations would result in a new treaty by the end of 2015. The Finnish Minister does not exclude the possibility of terminating the Treaty if the negotiations do not lead to a satisfactory result" (L. Ambagtsheer-Pakarinen, *Treaty between Finland and Portugal: Ministers of Finance discuss future of treaty* (14 August 2015), News IBFD).

[614] *Supra* n. 610.

[615] L. Ambagtsheer-Pakarinen, *Treaty between Finland and Portugal: Proposal terminating treaty presented to Finnish parliament* (13 April 2018), News IBFD.

This type of legislative dodging has the effect of preventing or circumventing the application of signed tax treaties without breaching the wording of their provisions, such as the case of exit taxes and the redesign of taxes.[616] This omission may however violate principles of international law, as explained further in Chapter 4.

3.3.2. Executive dodging

The second type of tax treaty dodging determined on the basis of the main actors through which it can be operated is the executive dodging, that is, the authorities competent to exercise the jurisdictional competence of a state in the context of tax treaties. As much as legislatures do, the executive power may try to exercise the jurisdictional competence of a state within the limits imposed by the text of tax treaties but in a way to circumvent treaty obligations through the issuing of circulars, instructions and other interpretative acts.[617] The author presents below potential executive dodging cases in which the executive power of contracting states issued, after the signature of treaties, acts in line with the wording of treaty provisions but which eventually had an impact on the outcome of these agreements.

Passive dodging: tolerating treaty shopping schemes

In Chapter 2, the reader saw that Lalithkumar Rao explained that the abusive application of a treaty by a state could also be executed in a passive manner.[618] He referred to contracting states deliberately tolerating treaty shopping schemes by taxpayers in order to increase their attractiveness.[619] Michael Rigby seemed to acknowledge a similar type of conduct when he explained how states could abuse treaties by setting themselves up as "treaty shopping conduits".[620] In both cases, to which real practical examples follow below, actions performed by contracting states after the signature of tax treaties and in line with their wording seem to modify the effects of these agreements by allowing benefits to be granted to persons who would normally not be entitled to them if such actions were not executed.

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[616] See section 3.3.1.1.

[617] Indeed, although more difficult to identify, treaty interpretation or interpretation of existing domestic law may also create opportunities for contracting states to dodge tax treaties through executive branches. In this regard, Klaus Vogel and Rainer Prokisch confirm that "double taxation conventions embody a large number of indefinite terms, which renders them much more open to interpretation than domestic tax law which usually is very specific. (...) This has two consequences: first, that interpretation will have a natural tendency to be biased in favor of the perspective or interests of the State applying the convention, and secondly, that references in double taxation conventions to domestic law cannot be avoided" (Vogel & Prokisch, *supra* n.19, p. 55). This would need to be distinguished from mere justifiable conflict of interpretation based on reasonable grounds. As Sergio André Rocha explains, "we are not dealing here with mere hermeneutic conflicts, but with a manipulation of the interpretative process in such a way as to create a legal rule that evidently cannot be extracted from the treaty" (Rocha, *supra* n. 205).

[618] See Chapter 2, Section 2.3.

[619] Comments by Rao in IFA, *supra* n. 55, p. 22.

[620] Rigby, *supra* n. 27, p. 423.

The case indicated by Michael Rigby, where contracting states may "abuse" treaties by setting themselves up as treaty shopping conduits, may reflect the case involving Mauritius' efforts to set itself as an attractive route for companies to invest in India in view of the benefits granted by the India-Mauritius Income Tax Treaty (1982).[621] In this respect, article 13(4) of this treaty provides that capital gains derived by a resident of a contracting state are generally taxable only in that state.[622] However, Mauritius has no domestic tax on capital gains, thereby making gains derived by resident persons exempt.[623] After the signature of the treaty, Mauritius amended its domestic law[624] to allow companies holding investments in India to migrate to Mauritius as "international companies" and to subsequently be converted into "offshore companies" without having any capital gains implications in India.[625] In this sense, these companies would benefit from article 13(4) of the India-Mauritius Income Tax Treaty (1982) as persons resident of Mauritius.

Despite the fact that Mauritius' actions were harmful towards India's tax interests, the reaction of India was interesting from a treaty point of view, as explained below, and was used by Lalithkumar Rao as an example of how contracting states can abuse treaties by deliberately tolerating treaty shopping schemes in order to increase their attractiveness. Indeed, to take advantage of favourable provisions in this treaty, a large number of investors resident in third countries incorporated Mauritius offshore companies, which subsequently made investments into India. These companies were incorporated in Mauritius, but were effectively managed and controlled from the investing countries. To determine whether the treaty was being abused by the investors, Indian revenue officers made enquires in a number of cases, to ascertain the extent of management, if any, in Mauritius.[626] Particularly, the Indian tax authorities issued "show cause notices" to foreign institutional investors requesting them to "show cause" why they should not be taxed on income accruing in India.[627] The "show cause notices" resulted in fear and the consequent withdraw of the funds from India by the investors.[628] On 4 April 2000, the Indian Finance Minister issued a press note clarifying that the views adopted by some revenue officers

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[621] *Convention between the Government of the Republic of India and the Government of Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains* (24 August 1982), Treaties IBFD. Indeed, according to statistics provided by the Indian Department of Industrial Policy and Promotion, 36% of the foreign direct investments made from 2000 to 2014, into India flowed from Mauritius, making this country figure as number one in the list of top investing countries in India (Department of Industrial Policy & Promotion, *Fact Sheet on Foreign Direct Investment (FDI) From April 2000 to July 2014* (2014), available at http://www.dipp.nic.in/English/Publications/FDI_Statistics/2014/india_FDI_July2014.pdf, accessed 24 Sep. 2014). Mauritius has recently become a popular routing also for investing into African countries.

[622] *Convention between the Government of the Republic of India and the Government of Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains* art. 13(4) (24 August 1982), Treaties IBFD.

[623] P. Sharma, *The Intentional Use of the India-Mauritius (1982) and India-Singapore (1994) Tax Treaties to Promote Foreign Direct Investments in India*, 66 Bull. Intl. Taxn. 12 (2002), Journals IBFD, pp. 623-636, at p. 633.

[624] Mauritius Offshore Business Activities Act 1992 (Act No. 18 of 1992) (MOBAA), National Legislation IBFD and The International Companies Act 1994 (*ibid*, p. 633).

[625] Sharma, *supra* n. 623, at p. 633.

[626] Comments by Rao in IFA, *supra* n. 55, p. 22.

[627] Sharma, *supra* n. 623, p. 634.

[628] *Ibid*.

did not represent the policy of the Indian government with regard to the denial of the treaty benefits to foreign investors. In addition, the Indian Central Board of Direct Taxes determined, through Circular 789/2000,[629] that wherever certificate of residence issued by the Mauritian authorities would always constitute sufficient evidence for accepting the status of residence as well as of beneficial ownership for applying tax treaties. By imposing this rule, the circular simply instructed Indian officers not to investigate any claim of residence in Mauritius and to accept the claim if based on incorporation certificate.[630] The position of the tax authorities seems to be the one of allowing, or at least tolerating, treaty shopping in order to attract investments. This was eventually confirmed by the Indian Supreme Court in the case *Azadi Bachao Andolan* (2004)[631] involving the same India-Mauritius Income Tax Treaty (1982), where the certificate was regarded by the court as a valid conclusive evidence of residence status and that in the absence of a limitation on benefits provision,[632] the benefits of the treaty were applicable.[633] In its decision, the court also emphasized that treaty shopping was often tolerated in developing countries as an incentive to attract scarce foreign capital or technology.[634] In

[629] Circular 789/2000 states the following: "734. Clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius Double Tax Avoidance Convention (DTAC) 1. The provisions of the Indo-Mauritius DTAC of 1983 apply to 'residents' of both India and Mauritius. Article 4 of the DTAC defines a resident of one State to mean "any person who, under the laws of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other crite-rion of a similar nature." Foreign Institutional Investors and other investment funds, etc., which are operating from Mauritius are invariably incorporated in that country. These entities are 'liable to tax' under the Mauritius Tax law and are, therefore, to be considered as residents of Mauritius in accordance with the DTAC. 2. Prior to 1-6-1997, dividends distributed by domestic companies were taxable in the hands of the shareholder and tax was deductible at source under the Income-tax Act, 1961. Under the DTAC, tax was deductible at source on the gross dividend paid out at the rate of 5% or 15% depending upon the extent of sharehold-ing of the Mauritius resident. Under the Income-tax Act, 1961, tax was deductible at source at the rates specified under section 115A, etc. Doubts have been raised regarding the taxation of dividends in the hands of investors from Mauritius. It is hereby clarified that wherever a Certificate of Residence is issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly. 3. The test of residence mentioned above would also apply in respect of income from capital gains on sale of shares. Accord-ingly, FIIs, etc., which are resident in Mauritius would not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of article 13. Circular: No. 789, dated 13-4-2000" (Circular 789, dated 13 Apr 2000, available at http://law.incometaxindia.gov.in/DIT/File_opener.aspx?page=CIR&schT=&csId=952f7443-2ab3-4ba5-b6b8-76f40acfbac0&crn=789&yr=2000&sch=&title=Taxmann%20-%20Direct%20Tax%20LawsLife, accessed 12 Sep 2014).

[630] Comments by Rao in IFA, *supra* n. 55, p. 22.

[631] IN: SC, 7 Oct. 2003, *Union of India and another v. Azadi Bachao Andolan and another*, Tax Treaty Case Law IBFD.

[632] In this respect, a Joint Commission was set up in 2010 by India and Mauritius for the purposes of reviewing the treaty and a proposal to amend the treaty by introducing a limitation on benefits clause was made by Mauritius. Proposals and counter proposals are still under analysis. The inclusion of a limitation on benefits clause in the treaty would lead to the consequence of businesses looking for investment into India having to demonstrate sufficient substance in Mauritius in order to be entitled to treaty benefits (R. Hamzaoui, *Treaty Between India and Mauritius – Renegotiations to Introduce LOB Clause* (22 July 2013), News IBFD).

[633] *Ibid.*

[634] L. Freitas de Moraes e Castro, *US Policy to Counter Treaty Shopping – From Aiken Industries to the Anti-Conduit Regulations: A Critical View of the Current Double-Step Approach from the Perspective of Treaty Objectives and Purpose*, 66 Bull. Intl. Taxn. 6 (2012), Journals IBFD, pp. 300-312, at p. 301

2012, the Indian Supreme Court also confirmed in the case *Vodafone International Holdings B.V.* (2012)[635] that tax planning was not illegal, therefore effectively upholding the use of holding structures in other jurisdictions to invest in India.

According to Rao, "this circular sets the seal of approval on opportunities for treaty abuse by taxpayer. Tacit approval of such abuse would be tantamount to a passive abuse by the state itself, as the state's acquiescence is counter to the purpose of the treaty".[636] In his view, this would be one of the abusive cases of states adhering to the form of treaties but subverting the very purpose of these agreements.[637] It is interesting to observe that, contrary to actions that intend to prevent the application of tax treaties,[638] in this case contracting states see advantages in going in the opposite direction, that is, in applying the treaty in a scenario where treaty benefits would normally be denied.

It is interesting to point that the 2006 version of the report prepared by the UN Subcommittee on Improper Use of Tax Treaties[639] also refers to administrative practices of contracting states permitting the disregard of the object and purpose of the treaty by defining the conditions for treaty access by persons who were not originally intended to benefit from it[640] and mentions the case of a state introducing a 1% tax creditable against the registration fees of companies for the sole purpose of allowing them to qualify as resident for treaty purposes.[641]

Dodging through public-private agreements

The exploration and exploitation of oil and gas (upstream business activities) in Indonesia is carried out by entities on the basis of cooperation contracts signed with the Indonesian government. These cooperation contracts can be drafted in the form of production sharing contracts, under which both parties agree to take a split of the production measured in revenue, determined on the basis of a production split formula. The production split formula agreed between entities and the Indonesian government typically takes into account the Indonesian branch profit tax applicable on non-resident contracted entities at the standard rate of 20%.

However, in some cases the applicable branch profit tax is reduced due to benefits granted under tax treaties signed with Indonesia. Since any reduction in the branch profit tax rate results in practice into

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[635] IN: SC, 20 Jan. 2012, *Vodafone International Holdings B.V. v. Union of India*, Tax Treaty Case Law IBFD.

[636] Comments by Rao in IFA, *supra* n. 55, p. 22.

[637] Comments by Rao in IFA, *supra* n. 55, pp. 22-23.

[638] For example, such as in the case of redesigned taxes and exit taxes (if one follows the view that treaties are not applicable) - see details in section 3.3.1.1. – as well as in the cases of Indonesia's production share increase and the Australian capital gain tax - see in this section under *Dodging through private agreements* and *Executive Interpretative Dodging – Australia*.

[639] See details on the subcommittee and the versions of the report in Chapter 2, Section 2.3. (*The 2000s and 2010s*).

[640] UN, *supra* n. 61 (16 October 2006), p. 6.

[641] *Ibid*.

an increase of the entity's after-tax production share, the Indonesian Ministry of Finance issued in 1999 an instruction[642] determining that the government's production share should be increased to compensate for contracted entities making use of treaty benefits, particularly the reduction of the branch profit tax. By increasing its production share, the Indonesian government is in practice transforming a benefit that these entities would have right to according to treaties into revenue for the country. In other words, the increase of Indonesia's production share is in reality equivalent to the charge of the branch profit tax at its standard rate, as if no treaty existed. In this sense, the Indonesian instruction restricted the effects of existing treaties without a infringing the wording of these agreements.[643] The effect of the action undertaken by Indonesia if the transformation of a tax normally limited by treaties into a charge that is out of the scope of these agreements and, therefore, circumvented or prevented the application of tax treaties.

Executive Interpretative Dodging - Brazil

The first example of what the author refers to as executive interpretative dodging is the one of the Brazilian tax authorities and its former interpretation, presented in 2001, of an existing domestic legislation which had an impact on the application of tax treaties. The issue relates to Interpretative Declaratory Act COSIT 01/2000,[644] through which Brazilian tax authorities presented the, at the time,

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[642] PP 55/2009 on Profit Share Contracts.

[643] In more recent production sharing contracts, special provisions have been included to adjust the split formula in order to maintain the same net income after-tax for all the parties in case taxation is reduced in view of the application of tax treaties. Typical provisions in recent production sharing contracts read as follows: "BPMIGAS and CONTRACTOR agree that all of the percentages appearing in Section VI of this CONTRACT have been determined on the assumption that CONTRACTOR is subject to final tax on profits after tax deduction under Article 26(4) of the Indonesia Income Tax Law and is not sheltered by any tax treaty to which the Government of the Republic of Indonesia has become a party. In the event that, subsequently, CONTRACTOR under this CONTRACT becomes not subject to a tax treaty, all of the percentages appearing in Section VI of this CONTRACT, as applicable to the portions of CONTRACTOR and BPMIGAS so affected by the non applicability of such final tax deduction or the applicability of a tax treaty, shall be adjusted accordingly in order to maintain the same net income after-tax for all contractor's portion of Petroleum produced and saved under this CONTRACT" (*Oil and Gas in Indonesia*, PwC Investment and Taxation Guide 2012 5th edition (PWC 2012), p. 78, available at http://www.google.com/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=3&ved=0CCMQFjAC&url=http%3A%2F%2Fwww.pwc.com%2Fid%2Fen%2Fpublications%2Fassets%2Foil-and-gas-guide_2012.pdf&ei=vUIpVMOMGMzsaKuNgoAL&usg=AFQjCNELFpw3zFUb0xpFzJWOu0vXUmhz7g&bvm=bv.76247554,d.bGQ (accessed 28 Sept. 2014)).

[644] Declaratory Act COSIT 01 of 5 January 2000, which reads as follows: "(…) I – Remittances under contracts for the provision of technical assistance and technical services without the transfer of technology are subject to taxation in accordance to article 685(II)(a) of Decree 3,000 of 1999; II – In the conventions for the avoidance of double taxation signed by Brazil, this income is classified under the Other Income article and, consequently, is taxed under item I, which is also the case when the convention does not include this article. (...)" (free translation by the author). The last part of the sentence means that this income is subject to taxation at source in Brazil even in cases where the other income article does not exist in tax treaties. This interpretation seems odd at first, but makes sense if one follows the reasoning of the Declaratory Act that this type of income is not dealt with in any article other than the other income article. In case the other income article does not exist, the income would not be covered by the treaty at all and would therefore be taxable according to domestic law. This is in fact the case of the Brazil-France Income Tax Treaty (1971), which does not

new interpretation that remittances for the payment of the provision of technical assistance and technical services without the transfer of technology would fall under the scope of the other income article of tax treaties signed by Brazil – therefore, not under the business profit provision. The other income article in treaties signed by Brazil normally deviates from the OECD Model Convention (2017)[645] by granting unlimited taxing rights to the source state[646] and, thus, subjecting this income to withholding tax according to Brazilian domestic law.

The position of the Brazilian tax authorities adopted at that time on the application of the other income article was based on a new interpretative argument: since the expression "*business profit*" was not defined by tax treaties, the meaning to be considered would be the one under domestic law. In this sense, "*profit*" under Brazilian domestic law (i.e. "*lucro real*" or "*real profit*") does not cover payments of technical services and technical assistance without the transfer of technology, because the domestic definition of "profit" refers to net profit *adjusted by additions, deductions and compensations* authorized by Brazilian tax legislation.[647] At the moment of the remittance, the payment for technical services and technical assistance without the transfer of technology would be technically considered a mere payment of "*revenue*"; only at a second stage, at the moment of the assessment made by the non-resident service provider in the residence state, it would finally become a "*profit*".

This unorthodox interpretation modified the application of tax treaties in the sense that not only there was a shift of the income from the business profit article to the other income article,[648] but also that the business income article would in fact hardly ever be applicable.[649] It is interesting to see that the

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contemplate such a provision. This treaty was object of a court decision in a case involving other 11 tax treaties signed by Brazil. In this decision, the court decided for the application of the business profit articles in those treaties. For details, see: BR:TRF, 26 January 2012, 0024461-74.2005.0.03.6100, Tax Treaty Case Law IBFD.

645 Article 21 of the OECD Model Convention (2017) grants exclusive taxing rights to the residence state.

646 It adopts therefore a UN Model Convention oriented provision.

647 Real profit is defined as net profits adjusted by additions, deductions and compensations authorized by Brazilian tax legislation (Article 6 of Decree-law 1,598/77 and Decree 3,000/1999): "Lucro real é o lucro líquido do exercício ajustado pelas adições, exclusões ou compensações prescritas ou autorizadas pela legislação tributária" (Article 6 of Decree-law 1,598/77).

648 It should be noted that, in the past, many attempts to include the payment for the provision of technical services and technical assistance in the scope of the royalties article of tax treaties (Article 12 of the OECD Model Convention (2017)) had been made by the Brazilian tax authorities, since it had been (and still is) a policy of Brazilian tax treaty negotiators to normally include "technical services and technical assistance" within the scope of this article. Although different opinions were issued in consultations submitted by taxpayers on the topic, the Brazilian tax authorities took the position that the expression "technical services and technical assistance" in the royalties article would only cover income from the rendering of services in which technology is transferred (for details, see V. Arruda Ferreira, *Service Income under Brazilian Tax Treaties: The Possible End of the Article 7 v. Article 21 Battle, but the Start of a New Old One?*, 42 Intertax 6&7 (Kluwer Law International 2014), pp. 427-432).

649 If one follows the interpretation of the Brazilian tax authorities, no payment of any remuneration abroad would ever be qualified as profit, as the adjustments required under Brazilian domestic law for such a qualification are only made by the non-resident service provider in the residence country and at a later stage (i.e. at the end of their assessment period) and not at the moment when the treaty is applied (i.e. the moment of the remittance). This would lead to the unreasonable result that the business profit article in tax treaties would never be applicable (Arruda Ferreira, *supra* n. 648, p. 429).

impact in the treaty was not caused by a change in the domestic law, which was never amended, but by a change in the interpretation by tax authorities of this existing law. In this sense, the change in the interpretation of the domestic law was not in clear conflict with the wording of tax treaties signed before 2001 but had an impact in their application for the benefit of Brazil, which could have not been foreseen by treaty partners. This could, therefore, be a possible case of tax treaty dodging through interpretation.

Brazilian tax authorities eventually abandoned this interpretation in 2014,[650] in view of the possible termination of treaties by treaty partners[651] and in view of an unfavourable decision given by the Brazilian Supreme Court in the case *Copesul* (2012).[652]

Executive Interpretative Dodging - France

In the context of the discussions over the French CFC rule and its possible conflict with tax treaties, the French tax authorities eventually tried to defend, due to the lack of success of the re-attribution of income argumentation[653] and before effectively amending the legislation in another dodging

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[650] The position now, published through Interpretative Declaratory Act 5/2014, is that such income falls within: (i) the royalties article, when the corresponding protocol establishes that technical services and technical assistance are subject to the same tax treatment as royalties; (ii) the article dealing with independent professional services and independent workers when the technical services or technical assistance involves technical skills of a person or group of persons; or (iii) the business profits article, except when item (i) or (ii) above applies. See an analysis of this new position in V. Arruda Ferreira, *The new Brazilian position on service income under tax treaties: if you can't beat 'em, join 'em*, 43 Intertax 3 (Kluwer Law International 2015), pp. 255-262.

[651] This suspected reason was in fact confirmed in the case of the Brazil-Finland Income Tax Treaty (1996). Although this treaty was not denounced, the Finish government officially manifested its intention to denounce it in view of the position of the Brazilian Federal Revenue Office on the treatment of technical services provided by residents of Finland (According to Normative Opinion 2,363/2013 (*Parecer* PGFN/CAT 2,363/2013), issued by the General Office of the National Treasury's Attorney *(Procuradoria-Geral da Fazenda Nacional* – PGFN), the Finish government sent an official notification, dated 27 February 2013, to the Brazilian government in which it is expressed the intention of the former to denounce the Brazil-Finland tax treaty if the Brazilian Federal Revenue Office confirms its position in favor of the taxation at source of remittances for the payment of technical services. It is suspected that this was one of the reasons that led the German government to seek renegotiation of the Brazil-Germany Income and Capital Tax Treaty (1975) (see: Rocha, *supra* n. 11, p. 166; W. Oepen, *A Alemanha Denuncia seu Tratado de Dupla Tributação com o Brasil – Razões e Consequências da Denúncia do Tratado sob um Ponto de Vista Alemão*, Revista de Direito Tributário Internacional (Quartier Latin 2005), pp. 209-226, at pp. 217-218; N. Dagnese, *Is Brazil "Developed"? Termination of the Brazil-Germany Tax Treaty*, 34 Intertax 4 (2006), pp. 195-198, at p. 196). As a result of the unsuccessful renegotiations, the treaty was finally denounced by the German authorities and eventually terminated in 2005 (Rocha, *supra* n. 11, p. 166; W. Oepen, *ibid*., pp. 217-218; N. Dagnese, *ibid*., p. 196)

[652] Copesul (2012), *supra* n. 19. In 2012, the case Copesul (2012) reached the Superior Court of Justice (Superior Tribunal de Justiça – STJ), where an unanimous decision was given in favor of the application of the business profit article in the Brazil-Canada Income Tax Treaty (1984) and in the (terminated) Brazil-Germany Income and Capital Tax Treaty (1975).

[653] See details in Section 3.3.1.1.

attempt,[654] that the CFC *attribution of income*-type rule in France at the time[655] did not impose tax on the profits of the Swiss company, but on the *proceeds of a shareholding* in this company.[656] This argument, presented at the tax authorities' appeal in the case *Schneider Electric* (2002),[657] implicitly suggested that the dividend article in the France-Switzerland treaty was the one applicable[658] and, under this article, France was allowed to tax Swiss-sourced dividends.

It is clear that the French tax authorities tried to give a specific interpretation to the existing CFC rule so that it could shift the income from the scope of the business profit article (which would not allow taxation in France) to the scope of the dividend article (which would allow the application of the French CFC rules). The *Conseil d'État* did not agree with this interpretation and stated that the object of the French CFC rules was to permit the taxation in France of the profits arising from the business of a company established abroad and not to tax deemed dividend distributions to the French resident.[659] Indeed, the wording of article 209B of the French General Tax Code at the time referred to the *profitable results* ("*résultat bénéficiaire*") of an entity abroad being considered as a *result* of the French company ("*est réputé constituer un résultat de cette personne morale*"). The French tax authorities tried, therefore, to picture a CFC *attribution of income*-type rule as a CFC *deemed dividend*-type rule to the Court in order to be able to shift from the scope of the business income article to the dividend article and, thus, may have attempted an interpretative dodging of the treaty.

Executive Interpretative Dodging - China

Another executive interpretative dodging case could possibly be illustrated by the Chinese Case *PanAmSat* (2002).[660] In 1996, PanAmSat, a company resident in the United States, entered into a

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[654] The French legislator amended domestic legislation in an attempt to render CFC rules compatible with tax treaties (from the perspective of the *Conseil d'État* line of thought) and consequently allow taxation in France by shifting from an *attribution of profit approach* to a *deemed dividend approach* rule. For details, see section 3.3.1.2.

[655] The French CFC legislation introduced by the French Finance Law for 1980, which was based on the attribution of profit approach, attributed the profits of the CFC entity to the controlling companies resident in France, and consequently taxing it separately at their level. See details in Section 3.3.1.1.

[656] The French tax authorities brought this interpretation when appealing the case *Schneider* to the Conseil d'État. According to the tax authorities "even if the treaty is at sake, the Court of Appeal has misinterpreted Art. 7(1) thereof (qualified as an error of law) as Art. 209B does not impose tax on the profit of an enterprise but on the proceeds of a shareholding of the Swiss company. The latter argument implicitly suggests that Art. 10 ("dividends") is controlling" (de Broe, *supra* n. 55, p. 600).

[657] *Ibid.*

[658] *Ibid.*

[659] "The Court concludes its internal law analysis with the finding that the objective of Art. 209 B is to permit taxation in France of profits arising from the business of a company established abroad. Its purpose is not, contrary to the submission of the tax authorities, to tax deemed dividend distributions by the foreign subsidiary to its French resident shareholder" (de Broe, *supra* n. 55, p. 601).

[660] CN: HPCB, 20 December 2002, Gaoxingzhongzi (2002) No. 24 (*PanAmSat v Beijing State Administration of Taxation*), Tax Treaty Case Law IBFD.

"*Digital Compression Television Fulltime Satellite Transmission Services Agreement*" with China Central Television (CCTV). Under that agreement, PanAmSat provided compressed digital television satellite transmission services to CCTV, for which CCTV paid service and equipment fees, which were taxed as business profit under the China-Unites States Income Tax Treaty (1984).[661]

However, in 1998 the Chinese tax authorities issued Circular 201 entitled "*Taxing Foreign Enterprises' Income from Leasing Satellite Communication Lines*", through which they communicated the interpretation that all income received by foreign companies from Chinese entities for the use of satellite facilities would be classified as rental income for leasing equipment under article 19 of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises. The Circular did not explain why the use of foreign-owned satellites would be treated as a leasing activity rather than active transmission service provided by the foreign satellite owner. According to the Chinese Implementing Rules for the Foreign Enterprise Income Tax Law,[662] income derived by foreign entities from rentals of property leased to and used by lessees in China is taxable in China.

In 1999, Chinese tax authorities notified CCTV to withhold taxes from the payments made to PanAmSat, based on Circular 201. According to Chinese tax authorities, since those payments were classified as rental income under the new interpretation, they would no longer fall in the scope of the business profit article in the China-United States Income Tax Treaty (1984), but rather in the royalties article, which allowed taxation in China. For that, the Chinese tax authorities concluded that rental income would qualify as "the use of, or the right to use, industrial, commercial or scientific equipment", which was covered by the royalties article in the treaty.[663]

PanAmSat took the position that the payments were not rental income, since outer satellites and ground facilities located within the United States were operated by PanAmSat itself.[664] As a result, no transfer of the right to possess or the right to use either the satellite or the ground facilities existed. In addition, PanAmSat argued that the use of and the right to use industrial equipment under the royalties article should be interpreted as positive and actual use, which was absent in the case.[665] The tax authorities disagreed and argued that the term "use" under the royalties article referred to the use of both tangible and intangible property and, therefore, was not necessarily limited to the effective operation of the object.[666] The term "use" should be, according to tax authorities, interpreted as availing of the functions of a certain object to achieve one's objectives. Under the Agreement,

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[661] *Agreement between the Government of the United States and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income* (30 April 1984), Treaties IBFD.

[662] Promulgated by the State Council on 30 June 1991 and abolished on 1 January 2008.

[663] Gaoxingzhongzi (2002), *supra* n. 660.

[664] *Ibid.*

[665] *Ibid.*

[666] *Ibid.*

PanAmSat's satellite and ground facilities were available for CCTV to transmit its television signals. This meant that CCTV had the right to use the satellite transponders owned by PanAmSat.[667]

The Chinese Supreme Court confirmed the lower court decision in favour of the tax authorities. According to the understanding of the courts, article 11(3) of the treaty did not require the actual possession of the equipment.[668] In this regard, CCTV had the right to use PanAmSat's satellites because CCTV had the right to use the bandwidth of two satellite transponders. In addition, the courts understood that PanAmSat's services were subordinated to CCTV's right to use PanAmSat's equipment and, consequently, these services were in reality preparation, repair and maintenance services that a lessor provides to a lessee under a leasing agreement.[669] Therefore, the Courts concluded that the payments to PanAmSat for the services provided were recognized as payment received as consideration for the right to use industrial, commercial or scientific equipment within the meaning of royalties under the treaty.

Executive Interpretative Dodging - Australia

In 1985, Australia introduced a "capital gains tax" through an amendment to the Income Tax Assessment Act of 1936.[670] The amendment did not introduce a separate capital gain tax as such, but simply included in the income tax legislation a set of rules ensuring that a net capital gain made by a taxpayer during a tax year was included in the taxpayer's assessable income for that year. Article 2 of treaties concluded by Australia prior to this amendment did not cover capital gains tax, but only Australian income tax and substantially similar taxes.[671] According to the Australian tax authorities in a ruling issued on the topic,[672] since treaties signed prior to such amendment only covered income tax and similar taxes, these agreements could not limit Australia's rights in respect of capital gains tax, as follows: "It is the ATO [Australian Taxation Office]'s view that there was no agreement in Australia's pre-CGT [capital gain tax] treaties to cover capital gains (other than 'borderline gains') and that an application of the rules of treaty interpretation adopted internationally and by Australian courts demonstrates this. Australia did not have a comprehensive CGT regime at the time the pre-CGT

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[667] *Ibid.*

[668] *Ibid.*

[669] *Ibid.*

[670] Ruling TR 2001/12 of the Australian Tax Office, available at http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR200112/NAT/ATO/00001&PiT=20011219000001 (accessed 19 Aug. 2014); AU:FCA, 10 October 2008, *Virgin Holdings SA v. Federal Commissioner of Taxation*, Tax Treaty Case Law IBFD.

[671] For example, article 2 of the treaty with Switzerland departed from the OECD Model Convention by not including the two first paragraphs, in which reference to covered income tax is made as including taxes on capital gains. In this treaty, article 2 refers only to "the Australian income tax, including the additional tax upon the undistributed amount of the distributable income of a private company and also income tax upon the reduced taxable income of a non-resident company" and to "any identical or substantially similar taxes which are imposed after the date of signature" (Ruling TR 2001/12 of the Australian Tax Office, *supra* n. 670, para. 25-26).

[672] *Ibid.*

treaties were negotiated and such a regime was not in contemplation. While the treaties provide a mechanism for extension of treaty coverage to taxes not in existence at the time of signature, that extension is limited to similar taxes".[673] In this sense, they argued that Australia did not have a comprehensive capital gains tax regime at the time these treaties were negotiated and that such a regime was not in contemplation.[674] In addition, tax authorities defended that while treaties provided a mechanism for extension of treaty coverage to taxes not in existence at the time of signature, that extension was limited to similar taxes[675] and, according to the tax authorities, the Australian capital gains tax could not be considered similar to an Australian income tax.

As a result, the case *Virgin Holdings* (2008),[676] concerning the Australia-Switzerland Income Tax Treaty (1980), was brought to the Federal Court of Australia. The court held that the Australian capital gains tax was substantially similar, if not identical, to the income tax for the purposes of article 2(2) of the treaty. The court also observed that the tax authorities presented its arguments always with references to a "capital gains tax", as if capital gains were subject to a separate tax rather than falling into and forming part of assessable, and then taxable, income subject to income tax.[677] It seems that the tax authorities tried to interpret the legislation in away to present the tax as a capital gain tax when in substance it was an income tax, so that it could circumvent or prevent the application of the treaty.

3.3.3. Judicial dodging?

The author is if the opinion that, differently from the cases of legislatures and executive power, judicial courts are not able to engage in an active tax treaty dodging action as they are limited to endorsing or rejecting an existing legislative or executive dodging act. Courts normally decide on existing cases presented by taxpayers or the tax administration and, thus, their actions are restricted to confirming or not the application of a determined rule or interpretation. In the case of tax treaty dodging, they are restricted to either condemning a dodging act (which was the case of many courts decisions mostly issued on the basis of the principle of good faith, indicated in sections 3.3.1. and 3.3.2.) or endorsing it, but never actively committing one. For this reason, the author believes that this type of dodging, i.e. judicial dodging, would not happen in practice and therefore is not discussed in this thesis.

3.4. Effects of tax treaty dodging

[673] Ruling TR 2001/12 of the Australian Tax Office, *supra* n. 670, para. 15.

[674] *Ibid.*

[675] *Ibid.*

[676] *Virgin Holdings SA v. Federal Commissioner of Taxation*, *supra* n. 670.

[677] *Ibid.* (full decision), para. 32.

The phenomenon of tax treaty dodging is observed in this chapter as actions performed (or omissions) after the conclusion and in accordance with the wording of tax treaties, but having an impact on their outcome. In Action 6 of the BEPS Project and in the commentary on article 1 of the OECD Model Convention (2017), the OECD recognized, specifically in respect of domestic anti-abuse rules, that the application of some domestic rules do not conflict with treaties, but do have an impact on how treaty provisions are applied: "(...) many provisions of the Convention depend on the application of domestic law. (...) More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the Convention. In many cases, therefore, the application of specific anti-abuse rules found in domestic law will have an impact on how the treaty provisions are applied rather than produce conflicting results".[678] Indeed, the actions (and omissions) presented under Section 3.3 do not conflict with the wording of tax treaties, but they do have an impact on how they apply in practice - the question of whether this impact is permitted under public international law is discussed in Chapter 4 of this thesis.

In the previous sections, the author identified the conditions for the phenomenon to exist and the ways in which contracting states could perform them in practice. The last aspect identified, before moving to a legal analysis in the next chapter, is the effect or consequences of the phenomenon. In this respect, the fundamental effect of tax treaty dodging is the impact in the outcome of tax treaties by either: (i) modifying the allocation of taxing rights to the (tax revenue) benefit of the contracting states making use of this method by changing the current scenario to a new one that either requires the application of a different (and more favourable) treaty article, that circumvents obstacles imposed or artificially stretches advantages granted by applicable treaty provisions, (ii) preventing the application of tax treaties to the (tax revenue) benefit of the contracting states making use of this method by changing the current scenario to a new one that falls out of scope of the application of the treaty, or (iii) allowing the application of tax treaty benefits in scenarios where treaty benefits are normally denied, to the (economic) benefit of the contracting state making use of this method. As the reader had the opportunity to observe, these effects were continually present in the cases explained in the previous sections.

The new outcome resulting from tax treaty dodging has an impact on persons involved. First, the application of a different treaty article or the application of the original article but circumventing the obstacle initially imposed on the contracting state or extending its advantages may result in the shifting of the allocation of taxing rights initially predicted or intended by treaty partners at the conclusion of the agreement[679] and, consequently, in a monetary disadvantage for the treaty partner. In this respect, it should be said that the reasonable or legitimate expectations of treaty partners at the time of the

[678] OECD/G20, *supra* n. 214, p. 83; *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 73 (21 November 2017), Models IBFD.

[679] "It can therefore in my view be said that even when a tax treaty refers to the domestic law of one state, or is applied subject to the provisions of its domestic law, there may be situations where the other state may legitimately expect that state to align itself with the prevailing practice on that particular issue or interpretation of a treaty term in the international community of nations" (van der Bruggen, *supra* n. 55, p. 34).

conclusion of the treaty is seen by some as a principle recognized by the WTO Dispute Settlement Body,[680] included in the considerations of the International Court of Justice in the judgment of the *Fisheries Jurisdiction* case[681] and referred to in the meetings of the delegates to the special committee formed while drafting the Vienna Convention (1969).[682] The effect of legitimate expectations would be, according to Edwin van der Bruggen, the need for treaty partners to honour "the internationally prevailing standards and practice by the community of nations in the application and interpretation of double taxation agreements".[683] It should, however, be in mind that "the conclusion of a treaty always creates expectations in the eyes of the treaty partners, but not all expectations are 'legitimate' and have to be honored by the other state (…)".[684]

In cases where source states engage in dodging actions, it is possible that the residence states bearing the monetary disadvantage may, in retaliation to these practices and as a way to regain its taxing rights, refuse to grant relief from double taxation (i.e. application of the credit or exemption methods) on the basis of the commentary on articles 23A and 23B of the OECD Model Convention (2017), which states that "Article 23A and Article 23B, however, do not require that the State of residence eliminate double taxation in all cases where the State of source has imposed its tax by applying to an item of income a provision of the Convention that is different from that which the State of residence considers to be applicable".[685] In other words, the monetary disadvantage in such a case would be transferred from the treaty partner to taxpayers in the form of double taxation that is not relieved. This can be done on the basis of the exceptions on the obligation to follow the qualification of the source state for double taxation relief purposes (i.e. different interpretation of facts or different interpretation of the provisions of the convention).[686]

Indeed, Elisa Freddo reminds that contracting states may refuse to eliminate double taxation by considering that certain amendments to domestic law, engaged after the treaty is concluded, may extend taxing rights of the source state at the expense of the residence state and, therefore, be

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[680] As indicated by van der Bruggen, in the India-Patent Protection for Pharmaceutical and Agricultural Chemical Products, WTC doc no. WT/DS50/R at 47-49 para. 22-23 (van der Bruggen, supra n. 55, p. 33, footnote 60).

[681] van der Bruggen, *supra* n. 55, p. 33.

[682] As indicated by van der Bruggen, the member Reuter noted that: "(…) when a state definitively expressed its will to be bound, it created a certain expectation in its partners and that it was the non-fulfillment of that expectation that was incompatible with good faith" (van der Bruggen, *supra* n. 55, p. 33).

[683] van der Bruggen, *supra* n. 55, p. 32.

[684] van der Bruggen, *supra* n. 55, pp. 33-34

[685] *OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B* (21 November 2017), Models IBFD, para. 32.5.

[686] The commentary on article 23A and 23B say that in case differences in domestic law qualification would make the source state apply a different article, this would still be considered an application in accordance with the treaty as interpreted by the source state and, therefore, the resident state would be obliged to grant the relief. However, the commentary makes an exception where the resident state is not obliged to grant relief in case the conflict results from different interpretation of facts or different interpretation of the provisions of the convention (*OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B* (21 November 2017), Models IBFD, para. 32.5.).

considered not taxed "in accordance with the provisions of this convention", as required by the wording of articles 23 A and 23 B of the OECD Model Convention (2017)[687] - this may be the case of refusal to grant relief, for example, in view of the application of a treaty article that is different from the one reasonably expected by the resident state or in respect of the levy taxes which taxable events were shifted to a moment when the treaty was not yet applicable - or, if considered applicable, to a moment when the contracting state engaging the action became entitled to tax according to the treaty provision (e.g. exit taxes[688]).

Switzerland took a more strict approach by making an observation on article 23 of the OECD Model Convention (2017) to expressly reserve the right not to follow the rules laid down in cases where a qualification conflict results from amendments to domestic law by the source country after the conclusion of the treaty. However, if in the one hand the refusal to grant double taxation relief would, to a certain extent, preserve the taxing rights of these residence states and their national tax revenue, on the other it creates for taxpayers the problem of double taxation which treaties are intended to prevent in the first place.

Taxpayer may also be negatively affected by tax treaty dodging practices in the form of a higher tax burden resulting from the levy of taxes conveniently redesigned to no longer fall into the scope of tax treaties (and consequently their limitations). In such cases, taxpayers may consequently have to support the burden of an extra charge that did not exist before the contracting state's measure, such as in the case of resident taxpayers having to pay a new charge which was in reality transferred to them as a result of the redesigning of withholding taxes normally charged to non-resident persons and consequently limited by treaties (e.g. the cases of the Brazilian CIDE contribution or the French 3% dividend contribution).[689] Taxpayers may also face an extra burden in view of the redesigning of a tax they were subject to (but waived from in view of the treaty) into a charge that is no longer covered by that agreement and therefore charged to that taxpayer (e.g. Indonesia's increase of government's production share to compensate the reduction of branch profit tax by tax treaties),[690] or of the creation of new taxes specifically designed to fall outside the scope of treaties (e.g. UK digital service tax), or in view of the non application of beneficial treaty provisions resulting from the legislature omission in properly implementing these agreements into domestic law (i.e. treaty underride).[691]

3.5. Concluding remarks

[687] E. Freddo, *supra* n. 598, at p. 433. See also Letter No. 03-03-06/4/44331 issued on 23 October 2013 by the Russian Ministry of Finance where Russia denied a credit related to corporate income tax withheld in Bulgaria and considered not in accordance with the tax treaty (T. Kogut, *Treaty between Russia and Bulgaria – Russian MoF clarifies that tax withheld not in accordance with the tax treaty cannot be credited in Russia* (21 Nov 2013), News IBFD).

[688] See Section 3.3.1.1.

[689] See Section 3.3.1.1.

[690] See Section 3.3.2.

[691] See Section 3.3.1.3.

The first phase of the study (Part I) is concluded in this Chapter 3 with the observation of how tax treaty dodging operates. The identification of the conditions for the phenomenon of tax treaty dodging, made in the beginning of this chapter, allowed the delimitation of the scope of study. In this sense, scenarios where contracting states, through acts engaged after the signature of these agreements, exercise their sovereign rights in accordance with the text of the treaty (i.e. within the treaty gap areas) but in a way to impact their outcome were observed in this chapter as vulnerable to dodging practice. Consequently, scenarios where contracting states act in direct contradiction with the text of tax treaties - and therefore not exercising sovereign rights within the limits imposed by the text of treaty provisions -, or where no act is performed after the signature of the treaty, are in no way vulnerable to tax treaty dodging practices and fall outside the scope of the present study.

Within the scenarios meeting the conditions previously identified, the author observed the phenomenon in the different ways in which it may be exercised. In order to present the tax treaty dodging in a structured manner, the author classified it under different categories determined on the basis of the the authorities competent to exercise the jurisdictional competence of a state in the context of tax treaties ((i) *legislative dodging* for actions executed (or omissions) by the legislative branch and (ii) *executive dodging* for actions executed by the executive power) and presented potential tax treaty dodging cases. Through the analysis of the cases, the author demonstrated that contracting states' actions (or omissions) may impact the outcome of treaties without contradicting their wording by: (i) modifying the allocation of taxing rights to their (tax revenue) benefit by changing the current scenario to a new one that either requires the application of a different (and more favourable) treaty article, that circumvents obstacles imposed or artificially stretches advantages granted by applicable treaty provisions, (ii) preventing the application of tax treaties to their (tax revenue) benefit by changing the current scenario to a new one that falls out of scope of the application of the treaty, or (iii) allowing the application of tax treaty benefits in scenarios where treaty benefits are normally denied, to their (economic) benefit. Finally, the chapter concluded this first factual-analysis stage necessary for the general understanding of the phenomenon by detecting the consequences of tax treaty dodging practices for treaty partners (tax revenue disadvantage) and taxpayers (increased tax burden).

The next chapter introduces the second phase of this study (Part II) which aims at presenting the legal assessment of the phenomenon. In this Chapter 3, the reader was presented with the possibility of contracting states making use of tax treaty gaps in order to exercise rights after the conclusion of treaties that may adversely impact the outcome of treaties. This is not in violation of the wording of treaty provisions, but the author now questions whether these actions or omissions may violate international law. In this respect, Chapter 4 initiates Part II of this study by addressing the research question of this thesis (i.e. *on what legal basis the exercise of rights by contracting states in conformity with the wording of tax treaties but having an impact on the outcome of such agreements to their own benefit could be qualified as an illegitimate act? If such legal basis exists, where is the dividing line between a legitimate exercise of rights by contracting states and such illegitimate acts under international law?").*

Part II

The Legal Assessment of Tax Treaty Dodging

Chapter 4 - Tax Treaty Dodging From the Perspective of International Law

4.1. Introduction

The previous chapter concluded the factual phase of this study, which focused on detecting the phenomenon of tax treaty dodging in practice. This Chapter 4 initiates the second and analytical phase of the research by presenting a legal assessment of the phenomenon. For this, the author examines tax treaty dodging from the perspective of international law in order to answer the research question of this thesis.

In the first part, the chapter investigates whether tax treaty dodging could be qualified as an illegitimate act[692] with the view of addressing the first part of the research question of this study, which is: *on what legal basis the exercise of rights by contracting states in conformity with the wording of tax treaties but having an impact on the outcome of such agreements to their own benefit could be qualified as an illegitimate act*? For this purpose, the author tries to identify the legal sources of international law governing the relation between sovereign states which may impose limitations on the exercise of rights by contracting states and on the basis of which actions (or omissions) overstepping such limitations could be considered an illegitimate behaviour named as "tax treaty dodging" in this thesis (Section 4.2.).

The chapter further analyses the extent to which contracting states are limited by such legal bases in order to answer, to the extent that is possible, the sub-question of the research question of this study, which is: *if such legal basis exists, where is the dividing line between a legitimate exercise of rights by contracting states and such illegitimate acts under international law?* The extent to which contracting states may act without overstepping limits imposed by certain international legal rules and principles is assessed by the author on the basis of elements provided by these very same legal bases (Section 4.3.).

Before concluding the chapter, the author analyses tax treaty dodging as opposed to actions violating the wording of tax treaties and discusses the relevance of such distinction. This analysis necessarily involves comments on the topic sometimes addressed in literature of the relation between tax treaty dodging and tax treaty override (Section 4.4.).

4.2. Tax treaty dodging as an illegitimate act

[692] See *supra* n. 1 and 2.

In the first phase of this research, the reader observed that, when certain conditions are met, contracting states may be able to modify the outcome of tax treaties to their own benefit without contradicting the wording of these agreements. The fact that these actions (or omissions) do not conflict with the wording of treaties may raise questions in regard as to whether or not this behaviour could be seen as an illegitimate[693] behaviour. Answering this question means assessing whether legal rules and principles governing the good usage[694] of treaties, on the basis of which tax treaty dodging could be qualified as an illegitimate act, exist. The first legal assessment of the phenomenon of tax treaty dodging focuses, therefore, on the identification of possible legal rules and principles imposing limits on the phenomenon herein assessed with the view of answering the first part of the research question of this study, which is: *on what legal basis the exercise of rights by contracting states in conformity with the wording of tax treaties but having an impact on the outcome of such agreements to their own benefit could be qualified as an illegitimate act?*

The following sub-sections analyse possible legal rules and principles on the basis of which tax treaty dodging could be qualified as an illegitimate behaviour. Since tax treaty dodging relates to actions undertaken (or omissions) by contracting states, the author made the assessment of possible legal rules and principles limiting such behaviour by investigating sources of international law governing the relation between sovereign states (i.e. international conventions, international custom, general principles of law recognized by civilized nations and subsidiary means for the determination of rules of law).[695] As correctly pointed out by Ramon Jeffrey "where a discretion is given to national law to fill in gaps the exercise of such discretion is not unfettered. On the contrary, it is subject to, and has to be exercised within the parameters of international law".[696]

4.2.1. The principles of interpretation of treaties in international law as a limitation to tax treaty dodging

Under international law, there are three basic approaches to treaty interpretation: (i) one that focuses on the actual text of the agreement and emphasises the words used (objective or textual approach); (ii) one that looks to the intention of the parties as the solution to ambiguous provisions (subjective approach); and (iii) one that emphasizes the object and purpose of the agreement (teleological

[693] See *supra* n. 1 and 2.
[694] See *supra* n. 1.
[695] The traditional sources of international law are listed in article 38 of the Statute of the International Court of Justice as follows: "1. The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply: a. international conventions, whether general or particular, establishing rules expressly recognized by the contesting states; b. international custom, as evidence of a general practice accepted as law; c. the general principles of law recognized by civilized nations; d. subject to the provisions of Article 59, judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law. 2. This provision shall not prejudice the power of the Court to decide a case *ex aequo et bono*, if the parties agree thereto" (ICJ, *Statute of the International Court of Justice*, art. 38, available at http://www.icj-cij.org/documents/?p1=4&p2=2 , accessed 10 July 2015).
[696] Jeffrey, *supra* n. 240, p. 39.

approach).[697] It is believed that any true interpretation of a treaty in international law has to take into account all aspects of the agreement, from the words employed to the intention of the parties and object and purpose of the treaty,[698] so that it "gives effect to the expressed intention of the parties, that is, their intention as expressed in the words used by them in the light of the surrounding circumstances".[699]

Article 31(1) of the Vienna Convention (1969) states the general principle of interpretation of treaties as follows: "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".[700] Article 31(3) brings elements that must be taken into account together with the context for the purpose of interpretation (i.e. subsequent agreement between the parties, subsequent practice in the application of the treaty and any relevant rules of international). Article 32 brings the supplementary means of interpretation by stating that, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to such article leaves the meaning ambiguous or obscure or leads to a result which is manifestly absurd or unreasonable, the supplementary means of interpretation should be used, which includes "the preparatory work of the treaty and the circumstances of its conclusion".[701] The application of this article is more limited in the sense that interpretation should be based first on article 31 of the Vienna Convention (1969) without the use of supplementary means of interpretation.[702] Article 33 of the Vienna Convention (1969) deals with the interpretation rule in respect of treaties authenticated in two or more languages.[703]

These rules in the Vienna Convention (1969) constitute a general expression of principles of customary international law relating to treaty interpretation[704]. In this respect, it should be noted that

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[697] Shaw, *supra* n.16, pp. 932-933; "On the one hand, there are those who assert that the primary, and indeed only, aim and goal of treaty interpretation is to ascertain the intention of the parties. There are others who start from the proposition that there must exist a presumption that the intentions of the parties are reflected in the text of the treaty which they have drawn up, and that the primary goal of treaty interpretation is to ascertain the meaning of the text. Finally, there are those who maintain that the decision-maker must first ascertain the object and purpose of the treaty and then interpret it so as to give effect to that object and purpose" (Sinclair, *supra* n. 278, pp. 114-115).

[698] Shaw, *supra* n. 16, p. 933; "They [the different approaches] are not, of course, mutually exclusive" (Sinclair, supra n. 278, p. 115); "With the help of all interpretation methods, the meaning of DTC [double taxation convention] rules is to be derived exclusively from the convention. One interpretation method does not prevail over another. Which argument is most convincing must be decided on a case-by-case basis" (Lang, *supra* n., 247, p. 41, marginal n. 64).

[699] McNair, *supra* n. 9, p. 365.

[700] Article 31(1) of the Vienna Convention (1969).

[701] Article 32 of the Vienna Convention (1969).

[702] Avery Jones, *supra* n. 492, section 3.3.

[703] For a critical view on this topic, see R. X. Resch, *The Interpretation of Plurilingual Tax Treaties: Theory, Practice, Policy* (Tredition Gmbh 2018).

[704] Sinclair, *supra* n. 278, p. 153.

the interpretation of tax treaties follows the principles of interpretation of treaties in international law.[705]

Although still keeping all three methods (objective, subjective and teleological) as a single whole and not mutually exclusive, the conclusion of the International Law Commission was that the interpretation rule in the Vienna Convention (1969) is "clearly based on the view that the text must be presumed to be the authentic expression of the intention of the parties" and that, as a consequence, "the starting point of interpretation is the elucidation of the meaning of the text, not an investigation ab initio into the intentions of the parties".[706] The International Law Commission seems to have thus

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[705] Lang, *supra* n. 247, p. 41, marginal n. 62; "Therefore, the rules of the Vienna Convention are used in case law on the interpretation of double taxation treaties today as a basis even with regard to states which have not yet ratified the Vienna Convention" (Vogel et al., *supra* n. 36, p. 35, marginal n. 68); "International tax scholars commonly accept that tax treaties are to be interpreted according to the rules of interpretation found in articles 31 et seq. of the VCLT (...)" (G. Maisto, *Domestic Anti-Abuse Rules and Bilateral Tax Conventions in the Light of Public International Law*, Essays on Tax Treaties: a Tribute to David A. Ward (G. Maisto, A. Nikolakakis & J. M. Ulmer eds., IBFD 2012), pp. 325-34, at pp. 332-333).

[706] I. Sinclair, *supra* n. 278, p. 115: "The Commission's proposals (which were adopted virtually without change by the Conference and are now reflected in Articles 31 and 32 of the Convention) were clearly based on the view that the text of a treaty must be presumed to be the authentic expression of the intention of the parties; the Commission accordingly came down firmly in favour of the view that 'the starting point of interpretation is the elucidation of the meaning of the text, not an investigation ab initio into the intention of the parties'" (I. Sinclair, *supra* n. 278, p. 115); "The Commission and the Institute of International Law have taken the view that what matters is the intention of the parties as expressed in the text, which is the best guide to the more recent common intention of the parties. The alternative approach regards the intentions of the parties as an independent basis of interpretation. The jurisprudence of the International Court supports the textual approach, and it is adopted in substance in the relevant provisions of the Vienna Convention" (Brownlie, *supra* n. 16, p. 631; emphasis added); "The general rule of interpretation is stated in Article 31(1) of the Vienna Convention (...). Note that this general rule places firm emphasis on the text of the treaty as an authentic expression of the intentions of the parties. This is broadly consistent with the view of the late Lord McNair, a former president of the International Court of Justice, who suggested that the main task involved in the process of interpretation is to give effect to the expressed intentions of the parties, that is to say, 'their intention as expressed in the words used by them in the light of the surrounding circumstances'" (comments by Sir Ian Sinclair in Avery Jones, *supra* n. 107, p. 76). "(...) the interpretation of double taxation conventions must aim to avoid these problems and – within the limits of the text of such an agreement – must try to achieve equal interpretation of terms in both Contracting States" (...) "The text of Double Taxation Conventions must be presumed to be the authentic expression of intentions of the two Contracting States and, therefore, the starting point of interpretation is the elucidation of the meaning of the text, not an investigation ab initio into the intentions of the parties" (Vogel & Prokisch, *supra* n.19, pp. 55 and 83); "Le texte est l'objet même de l'interprétation; il est aussi l'élément qui reflète le mieux les intentions des parties contractants (...). La solution la plus évidente est celle qui consiste à interpréter le moins possible et à s'en tenir au 'sens ordinaire' des mots (...)" (Nguyen Quoc, Daillier & Pellet, *supra* n. 16, pp. 239-240); "We submit that the true duty of the judge is to search for the common intention of the parties in using the language of the text" (McNair, *supra* n. 9, p. 373); "Interpretation involves an elucidation of the meaning of the text, not a fresh investigation as to the supposed intentions of the parties. (...) in practice, having regard to the object and purpose is more for the purpose of confirming an interpretation. (...) although paragraph 1 contains both the textual (or literal) and the effectiveness (or teleological) approaches, it gives precedence to the textual" (Aust, *supra* n.16, pp. 187-188); "In interpreting international agreements according to these rules the text of the treaty is of primary importance; i.e. the 'ordinary meaning' of the terms, and the wording not of the individual provision, but that of the entire agreement in context. The older view that primarily looked for the subjective intent of the parties to the treaty is thereby rejected. (...) Purpose is subordinated to the wording of the treaty by the rule of Article 31 that the purpose shall influence interpretation

adopted a more textual approach in the sense that the wording of the treaty should define not only the starting point for interpretation but also its limits.[707] Should the wording be unclear, even after considering all possible means of interpretation or even if it should lead to an unreasonable result, national courts may not replace the wording of the text with supposed intentions of the contracting parties.[708] The jurisprudence of the International Court,[709] as well as the international tax community,[710] also follows this reasoning.

Although the text of the treaty is considered a prevailing element in the process of interpretation, an undeniable fact is that the principles of interpretation of treaties in international law as expressed in the Vienna Convention (1969) do take into account other factors too, such as good faith, context and object and purpose of the treaty, thus reducing the room for a pure literal application of international agreements. This is an important aspect for the purpose of the present study, since the more literal an interpretation is, the more exposed tax treaties become to tax treaty dodging practices. As indicated by Klaus Vogel, the stronger relevance of the literal meaning in the concept of the ordinary meaning in the process of interpretation makes tax treaties more vulnerable to structures aiming at

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merely by giving 'light' to the terms of the treaty. In other words, 'purpose' is not in itself an independent means of interpretation. The intention of the parties, according to Art. 31 of VCLT [Vienna Convention on the Law of Treaties] (...), is only significant to the degree to which it has been expressed in the text of the agreement. The view that the 'basic aim of treaty interpretation is to ascertain the intention of the parties' is thus contrary to current international law as established in both VCLT and the Restatement Third. (...) If such a meaning is clearly established, then the intent of the contracting parties must of course be observed as in this particular case it is expressed in the wording of the treaty. Excluded, therefore, is only an interpretation which, though corresponding to the intent of the parties, is in no way supported by the wording of the treaty. It is even less acceptable for a court to use as a basis of interpretation that which it presumes the parties must have intended. This is even true in cases where the interpretation of the treaty according to its wording may lead to non-logical result"[706] (Vogel et al., *supra* n. 36, p. 37, marginal n. 69-69a); See also Vogel & Prokisch, *supra* n. 19, p. 73; Resch, *supra* n. 278, p. 312.

[707] See *supra* n. 706.

[708] Vogel & Prokisch, *supra* n.19, p. 73. Therefore, an interpretation going beyond what is expressed or implied in the actual terms of a treaty so as to give effect to its object and purpose, for example, is not considered in accordance with the rule of interpretation of treaties in article 31(1) of the Vienna Convention (1969). This means that the object and purpose of a treaty can only be given effect in so far as this does not violate the text of the treaty (Engelen, *supra* n., pp. 172-173). The interpretation in the light of the object and purpose of tax treaties does not mean, thus, that a treaty should always be interpreted so that double taxation is avoided even if this would mean going beyond what is expressed or necessarily implied in the terms of the treaty (Englen, *supra* n.55, p. 429).

[709] "The Commission and the Institute of International Law have taken the view that what matters is the intention of the parties as expressed in the text, which is the best guide to the more recent common intention of the parties. The alternative approach regards the intentions of the parties as an independent basis of interpretation. The jurisprudence of the International Court supports the textual approach, and it is adopted in substance in the relevant provisions of the Vienna Convention" (Brownlie, *supra* n. 16, p. 631).

[710] "(...) the interpretation of double taxation conventions must aim to avoid these problems and – within the limits of the text of such an agreement – must try to achieve equal interpretation of terms in both Contracting States" (...) "The text of Double Taxation Conventions must be presumed to be the authentic expression of intentions of the two Contracting States and, therefore, the starting point of interpretation is the elucidation of the meaning of the text, not an investigation ab initio into the intentions of the parties" (Vogel & Prokisch, *supra* n. 19, pp. 55 and 83).

circumventing the agreement – either by taxpayers or contracting states.[711] Therefore, any element reducing the weight of a literal interpretation of the treaty is consequently limiting the scope for tax treaty dodging practice. In this sense, by incorporating other elements in the process of interpretation, such as good faith, the context and the object and purpose of treaties, the general principle of interpretation balances the relevance of the ordinary meaning of terms and consequently reduces the chances of application of treaties under a purely textual interpretation.

Indeed, in a discussion chaired by John F. Avery Jones at the International Fiscal Association Congress held in London with the participation of Sir Ian Sinclair, David Ward, Klaus Vogel and Kees van Raad, the general conclusion reached was that the ambulatory interpretation (in the sense of the discussion in this study) should be adopted with limitations such as the context and the object and purpose of treaties, in view of the effects amendments in domestic law could have on tax treaties.[712] Similarly, other international tax scholars refer to good faith, the context and the object and purpose of treaties in article 31(1) of the Vienna Convention (1969) as a limitation to tax treaty dodging practices.[713] The Dutch Supreme Court has already used these elements of interpretation as a limitation to tax treaty dodging when it held in two cases[714] that an unlimited application of the Dutch fictitious wage concept would lead to double taxation and would therefore be contrary to the purpose and the intention of the treaty.

As a result, the author concludes that the principles of interpretation of treaties in international law are a legal basis on which actions overstepping the limits there from derived (i.e. tax treaty dodging)

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[711] Vogel indicates that a stronger relevance of the "ordinary meaning" in article 31 of the Vienna Convention (1969) makes tax treaties more vulnerable to structures aiming at circumventing the agreement: "Im Vordergrund steht hiernach der Wortlaut, die 'gewöhnliche Bedeutung' der 'Ausdrücke'. Er ist zwar nicht allein massgebend, sondern 'im Lichte von Gegenstand und Zweck' des Abkommens zu verstehen. Dennoch ist die Bindung an den Wortlaut strenger, als es deutscher Übung bei innerstaatlichen Gesetzen entspricht. (...) Damit kann es sich bei Doppelbesteuerungsabkommen noch eher als nach innerstaatlichen Recht ergeben, dass eine den allgemeinen Auslegungsgrundsätzen entsprechende Auslegung des Abkommens im Hinblick auf eine von den Beteiligten bewusst gestaltete Rechtslage zu Ergebnissen führt, die dem Gerechtigkeitsziel des Abkommens deutlich wiedersprechen" (Vogel, *supra* n. 109, pp. 372-373).

[712] Transcripts of the panel discussions prepared by John Avery Jones were published in Avery Jones, supra n. 107, pp. 75-85.

[713] When analyzing the New Zealand's dividend withholding payment regime, which according to him was possibly introduced in order to circumvent treaty provisions (for details, see Chapter 3, Section 3.3.1.1.), Rigby argued that, despite not directly breaching New Zealand's treaty obligations, the regime may have been introduced in violation to good faith, context and/or object and purpose of treaties (Rigby, supra n. 27, pp. 398-399); Klaus Vogel et al. indirectly refers to the infringement of the object and purpose of the treaty when they describe treaty dodging under the title "*Infringing on the objects of Double Taxation Conventions ('Treaty Dodging')*" (Vogel et al., *supra* n. 36, p. 65, marginal n. 125). For references specifically on good faith, see Section 4.2.2; Lalithkumar Rao considers actions such as the introduction of an exit tax or issuance of certain circulars after the conclusion of a treaty as an abusive behavior of the contracting state, which would adhere to the letter of the treaty but would violate of the purpose of the treaty – for details see Chapter 3, Sections 3.3.1. and 3.3.2. (Comments by L. Rao in IFA, *supra* n. 55, p. 22 and 65).

[714] NL: HR, 5 September 2003, 37.651, Tax Treaty Case Law IBFD; NL: HR, 5 September 2003, 37.670, Tax Treaty Case Law IBFD. For details on the cases, see Chapter 3, Section 3.3.1.2.

can be qualified as an illegitimate behaviour. The question that follows is, thus, how far contracting states could go without overstepping this limitation. In other words, where is the line dividing the legitimate exercise of rights and the illegitimate act of tax treaty dodging. This question will be further addressed under Section 4.3. of this chapter.

4.2.2. The principle of good faith as a limitation to tax treaty dodging

Good faith is recognized as one of the most important general principles underpinning many international legal rules.[715] This principle, enshrined in the United Nation Charter[716] and acknowledged by international courts and tribunals,[717] is expressly mentioned in several parts of the Vienna Convention (1969).[718] While the preamble of the Vienna Convention (1969) refers to the principle of good faith as a universally recognized principle,[719] article 26 announces this principle as an integral part of the principle of *pacta sunt servanda* by stating the rule that "every treaty in force is binding upon the parties to it and must be performed by them in good faith"[720] (good faith governing the performance of treaties). In addition, article 31(1) of the Vienna Convention (1969) also requires a general principle of interpretation under which treaties shall be interpreted in good faith[721] (good faith as a mode of treaty interpretation).

The principle of good faith requires parties to a transaction to deal honestly and fairly with each other, to represent their motives and purposes truthfully, and to refrain from taking unfair advantage that might result from a literal and unintended interpretation of the agreement between them.[722] It requires

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715 Shaw, *supra* n. 16, p. 103.

716 "All members, in order to ensure to all of them the rights and benefits resulting from membership, shall fulfill in good faith the obligations assumed by them in accordance with the present Charter" (UN, *Charter of the United Nations,* art. 2(2) (26 June 1945), available at https://www.un.org/en/documents/charter/ (accessed 2 Dec. 2019)).

717 For a list of cases, see van der Bruggen, *supra* n. 55, p. 26, footnotes 3 and 4.

718 Good faith is mentioned in the preamble and in articles 26 (*pacta sunt servanda*), 31 (general rules of interpretation), 41 (provisions of internal law) and 69 (consequences of invalidity) of the Vienna Convention (1969).

719 "(...) Noting that the principles of free consent and of good faith and the *pacta sunt servanda* rule are universally recognized (...)" (Preamble of the Vienna Convention (1969)).

720 Article 26 of the Vienna Convention (1969). See also M. Fitzmaurice, *The Practical Working of the Law of Treaties* (M. Evans ed., Oxford University Press 2006), pp. 187-213, at p. 196. See also J. F. O'Connor, *Good Faith in International Law* (Dartmouth 1991), p. 107. The International Law Commission cited ample jurisprudence of international tribunals for the proposition that the principle of good faith is a legal principle that forms an integral part of the rule *pacta sunt servanda* (D. Ward, *Abuse of Tax Treaties*, Essays on International Taxation (Kluwer Law and Taxation Publishers 1993), pp. 397-409, at p. 400).

721 "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose" (Article 31(1) of the Vienna Convention (1969)). See also Section 4.2.1.

722 A. D'Amato, *Good Faith*, Encyclopedia of Public International Law (1992), p. 599-601, at p. 599; Engelen, *supra* n. 55, p. 126.

that "one party should be able to place confidence in the words of the other, as a reasonable man might be taken to have understood them in the circumstances"[723]. It is defined by O'Connor as "a fundamental principle from which the rule of *pacta sunt servanda* and other legal rules distinctively and directly relate to honesty, fairness and reasonableness are derived, and the application of these rules is determined at any particular time by the compelling standards of honesty, fairness and reasonableness prevailing in the international community at any time".[724]

In this sense, tax treaties are, just as any other international agreement, subject to the principle of good faith.[725] The OECD itself recognizes the obligation to interpret tax treaties in good faith when addressing the improper use of the convention by taxpayers in the commentary on article 1 of the OECD Model Convention (2017).[726] It also relies on good faith in the commentary on article 25 of the OECD Model Convention (2017) as a basis for the need for states to notify partners in respect to any subsequent unexpected changes in domestic law that would alter mutual agreements, as well as a basis to seek a revised or new mutual agreement in this regard.[727] The OECD Report on Treaty Overrides (1989)[728] also recalls it when referring to *pacta sunt servanda* as one of the fundamental universally recognised principles of the law of treaties on the basis of which treaties are required to be performed in good faith.[729] In this report the OECD gives a very restrictive interpretation of good faith as meaning simply that "international law requires states to implement the provisions of a treaty".[730] This more restrictive interpretation is recognized in public international law as the secondary

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723 Cheng, supra n. 277, p. 107.

724 O'Connor, *supra* n.720, p. 124.

725 van den Bruggen, *supra* n. 55, p. 26.

726 "Other States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties)" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 59 (21 November 2017), Models IBFD).

727 "As tax conventions are negotiated against a background of a changing body of domestic law that is sometimes difficult to predict, and as both parties are aware of this in negotiating the original Convention and in reaching mutual agreements, subsequent unexpected changes that alter the fundamental basis of a mutual agreement would generally be considered as requiring revision of the agreement to the extent necessary. Obviously where there is a domestic law development of this type, something that should only rarely occur, good faith obligations require that it be notified as soon as possible, and there should be a good faith effort to seek a revised or new mutual agreement, to the extent the domestic law development allows. In these cases, the taxpayer's request should be regarded as still operative, rather than a new application's being required from that person" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 25* para. 29 (21 November 2017), Models IBFD).

728 OECD, *supra* n. 127.

729 "The obligation "*pacta sunt servanda*" is one of the fundamental, universally recognised principles of the law of treaties, which has been codified in the preamble and in Article 26 of the Vienna Convention, which reads as follows: "Every treaty in force is binding upon the parties to it and must be performed by them in good faith" (OECD, *supra* n. 127, p. (8)-6, para. 9).

730 "It must be performed in good faith' means that international law requires States to implement the provisions of a treaty" OECD, *supra* n. 127 p. (8)-6, para. 10).

notion of good faith[731] and is specifically relevant for this study in respect of the legislature omission type of dodging.[732]

Indeed, the principle of good faith may be analysed from different perspectives and may play a role in different manners in respect of treaties. The other aspect of this principle that is relevant for the present study relates to the question of whether good faith should play a role in regard to acts that do observe the literal wording of treaty provisions but modify the effects of the respective agreements, consequently altering their balance. This point was spotted by Sir Gerald Fitzmaurice, when he asked the question of whether states must at all times act in good faith, in a manner consistent with the spirit of the system, and, on this basis, avoid action which is abusive in character, even though technically within the right of the state and not positively prohibited by any rule of the system.[733] In this respect, Fitzmaurice defends that one should not go too far as to require states always to adduce positive legal justification for their actions (under the theory that presumption of illegality)[734], but it may also not suffice for them merely not to contravene international law (under the theory that presumption of legality)[735], so that what is incumbent on them is behaviour governed by the principle of good faith.[736]

In this respect, the principle that treaty obligations should be fulfilled in good faith and not merely in accordance with the letter of the treaty has been acknowledged by international tribunals.[737] In the case *Island of Timor* (1914), decided by the Permanent Court of Arbitration, it was observed that "good faith prevailing throughout this subject, treaties ought not to be interpreted exclusively according to the letter, but according to their spirit".[738] According to Cheng, "this means, essentially, that treaty obligations should be carried out according to the common and real intention of the parties at the time the treaty was concluded, that is to say, the spirit of the treaty and not its mere literal meaning".[739]

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731 "A secondary notion of good faith in the context of explicit agreements pertains to the duties of signatories to a treaty prior to ratification. The early rule of international law to the effect that states had an obligation to ratify treaties that their diplomatic agents had signed has been replaced since the 18th century by the concept of discretionary ratification. (...) Yet the new concept of discretionary ratification carried over the old notion to the extent that the executive branch, having signed the treaty through its agents, now had an obligation to make every effort in good faith to obtain the consent of the sovereign, and not to act in the interim period in such a way as to prejudice the unperfected rights of the signatories of the treaty" (D'Amato, *supra* n.722, p. 599).

732 Or treaty underride – see Chapter 3, Section 3.3.1.3.

733 Fitzmaurice, *supra* n. 16, p. 51.

734 Under this theory, states must be able to adduce positive justification for their actions under international law, that is, the action of the state will be deemed to be illegal unless capable of such positive justification, which means broadly, unless it is in accordance with a permissive rule (Fitzmaurice, *supra* n. 16, pp. 50-51).

735 Under this theory, states are free to act as they please except to the extent that international law may prevent them from doing so that is, the action of the state will be deemed to be lawful in all cases where it is not forbidden by any rule of international law, or contrary to (or not in conformity with) any rule prescribing particular action (Fitzmaurice, *supra* n. 16, p. 51).

736 Fitzmaurice, *supra* n. 16, p. 66.

737 Cheng, *supra* n. 277, p. 114.

738 Cheng, *supra* n. 277, p. 115.

739 Cheng, *supra* n. 277, pp. 114-115. See also O'Connor, *supra* n. 720, pp. 108-109.

Therefore the performance of a treaty obligation in good faith means carrying out the substance of this mutual understanding, honestly and loyally.[740]

From the view that it is the common intention of the parties or the spirit of the treaty that has to be respected, it follows that it is not permissible, while observing the letter of the agreement, to evade treaty obligations by what the Permanent Court of International Justice has called *indirect means.*[741] These indirect means were condemned by the Court in the case *Oscar Chinn* (1934), where it was considered that if, for instance, it is the intention of the parties that freedom of navigation and commerce should be established in certain parts of their territory, it could not be permissible for one party, while respecting the letter of the agreement, to evade its obligations in effect by an *exaggerated exercise of its right* to manage its national shipping.[742] Similarly, McNair acknowledges that a state may take certain actions which, though not in a form of a breach, are such as their effect are equivalent to a breach of treaty.[743] He further indicates that "in such cases a tribunal demands good faith and seeks for the reality rather than appearance".[744]

In the same direction, in the case *North Atlantic Coast Fisheries* (1910), it was acknowledged that if a state has, by means of a treaty with a second state, granted to the inhabitants of this second state the right to fish in certain parts of its coastal waters in common with its own nationals, and to enter its bays and harbours for the purpose or repairs, the first state may not, by an *unreasonable exercise of its sovereign right* to legislate for the preservation and protection of its fisheries, deprive the grant of its practical effect.[745] In this case, Permanent Court of Arbitration emphasized the need for explicit limitation when it said that "a line which would limit the exercise of sovereignty of a State within the limits of its own territory, can be drawn only on the ground of express stipulation, and not by implication from stipulations concerning a different subject matter".[746] However, the court added that "the line in question is drawn according to the principle of international law that treaty obligations are to be executed in perfect good faith, therefore (...) limiting the exercise of sovereignty of the state bound by a treaty with respect to that subject-matter to such acts as consistent with the treaty",[747] and thus acknowledging the limitation imposed by the principle of good faith on the top of the explicit limitation in the treaty. According to Cheng, "the unreasonable exercise of a right in such cases constitutes an abuse of right, which being an act that is inconsistent with the duty to carry out the treaty in good faith, is considered as unlawful".[748]

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[740] Cheng, *supra* n. 277, p. 115.
[741] Cheng, *supra* n. 277, p. 117.
[742] *Ibid.*
[743] McNair, *supra* n. 9, p. 540.
[744] *Ibid.*
[745] Cheng, *supra* n. 277, p. 117.
[746] Cheng, *supra* n. 277, p. 124.
[747] *Ibid.*
[748] Cheng, *supra* n. 277, p. 117.

In the 1971 commentary to the draft articles on the law of treaties, the International Law Commission, when discussing the principle of good faith, stated that the Permanent Court of International Justice, in applying treaty clauses prohibiting discrimination against minorities, insisted in a number of cases that the clauses must be so applied as to ensure the absence of discrimination in fact as well as in law, and that this meant that "the obligation must not be evaded by a merely literal application of the clauses".[749]

The limiting role of the principle of good faith on the exercise of rights, also recognized by some scholars as the theory prohibiting abuse of rights,[750] has been demonstrated by international tribunals in a number of cases.[751] According to Cheng, by application of this principle, "international law prohibits the evasion of a treaty obligation under the guise of an alleged exercise of right".[752] The principle of good faith thus requires every right to be exercised honestly and loyally, so that any fictitious exercise of a right for the purpose of evading either a rule of law or a contractual obligation may not be tolerated.[753]

The United Nations also refers to the principle of good faith as a limitation to abusive actions undertaken by states: "considering that the tax treaty is a kind of treaty, general principles of international law should be respected in the determination of whether an abuse has occurred or how to sanction such abuse. More precisely, Article 26 of the Vienna Convention of the Law of Treaties (VCLT) of 1969, which requires the parties to a treaty to perform it in good faith, and Article 38 of the Statute of the International Court of Justice, which states that the Court shall apply the general principles of law recognized by civilized nations should be governing principles in dealing with issues of the abuse by a State".[754]

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[749] S. van Weeghel & A. Gunn, *A General Anti-Abuse Principle of International Law: Can It Be Applied in Tax Cases?*, Essays on Tax Treaties: a Tribute to David A. Ward (G. Maisto, A. Nikolakakis & J. M. Ulmer eds., IBFD 2012), pp. 305-323, at pp. 312-313.

[750] For the prevention of abuse of rights by the principle prohibiting abuse of right itself and its interaction with good faith, see Section 4.2.3. "The theory of abuse of rights (*abus de droit*), recognized in principle both by the Permanent Court of International Justice and the International Court of Justice, is merely an application of this principle [good faith] to the exercise of rights" (Cheng, *supra* n. 277, p. 121).

[751] In the case *Fur Seal Arbitration* (1893), the Arbitral Tribunal pointed out that the malicious exercise of a right was unlawful; in the case Walter F. Smith (1929), the Permanent Court of International Justice the principle of good faith precluded the law from being used to cover the commission of what in fact was an unlawful act (O'Connor, *supra* n. 720, p. 111; Cheng, *supra* n. 277, pp. 121-123). See also van Weeghel & Gunn, *supra* n. 749, pp. 312-313.

[752] Cheng, supra n. 277, p. 123. In the case *Free Zones* (1932), where France was under a treaty obligation to maintain frontiers with Switzerland free from customs barriers, the Permanent Court of International Justice recognized that France had the sovereign right to establish a police cordon at the political frontier, but held that "a reservation must be made as regards the case of abuses of a right, since it is certain that France must not evade the obligation to maintain the zones by erecting a custom barrier under the guise of a control cordon" (Cheng, *supra* n. 277, p. 123).

[753] Cheng, *supra* n. 277, p. 123.

[754] UN, *supra* n. 61 (16 October 2006), pp. 6-7.

As is the case in respect of international agreements, the limitation imposed by the principle of good faith on contracting states acts which are in line with the wording of tax treaties but contrary to their spirit or intention of the parties is also confirmed by international tax law scholars[755] and domestic court decisions (see further below) in respect of tax treaties.

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[755] "I suggest that the logical limit to changes in internal law is that defined by the requirement of good faith in Art. 26 of the Vienna Convention on the Law of Treaties (...)" (Avery Jones, *supra* n. 55, p. 133); "Legislation and case law combat construction by private persons of legal arrangements, created without a rational business purpose, designed exclusively for the avoidance of tax consequences as 'abuse', '*abus de droit*', *'fraus legis'*, *'Mißbrauch'* or similar terms. A state acting correspondingly infringes on its international legal duty to fulfill the treaties which it concluded in good faith (Art. 23 VCLT)" (Vogel et al., *supra* n. 36, p. 66, marginal n. 125b); "A state could manipulate the effect of a treaty in its own favour by defining in its domestic laws any type of income over which it has full (or limited) taxing rights under the treaty, but that is undefined in the treaty. In defining such types of income subsequent to entering into the treaty this State could recover taxing rights over items of income which the treaty has allocated to the other State and upset the treaty bargain. In my view there are two restrictions to such post-treaty changes to domestic law which set the limits to the ambulatory interpretation of undefined treaty terms. The first one is implicitly provided in tax treaties and follows from Art. 31 VC and the second one follows from the express terms of Art. 3(2) OECD MC [model convention] itself. Both, however, achieve the same result and preclude a State from utilizing a domestic law meaning. (...) A contracting state does not apply a treaty in good faith and thus erodes or evades its obligation under the treaty when after signing of the treaty it modifies the meaning of undefined treaty terms through amendments of its domestic law (whether by way of new definitional provisions, fictions or otherwise) which the treaty partner could not reasonably foresee when signing the treaty" (de Broe, *supra* n. 55, pp. 272-273); "We submit that if a state abuses its discretion to develop a proper domestic terminology for tax purposes, and artificially construes the terms of a treaty with the aim of the effect of seriously altering the equitable distribution of tax revenue, it fails to carry out the tax treaty interpretation in good faith of treaty obligations. (…) There should not be a blind preference for a domestic-law-oriented interpretation, but a balanced choice in each individual case, based on the paramount principle of good faith" (Wouters & Vidal, *supra* n. 50, pp. 16-17); "The principle of good faith puts a limit on the reference to domestic law for the purpose of the interpretation and application of a tax treaty and prevents a contracting state from eroding or evading its obligations under the treaty by subsequently amending in its domestic law the scope of terms not defined in the treaty, either by means of legal definition or otherwise" (Engelen, *supra* n. 55, p. 502); "A better approach is to recognize that Art. 3(2) allows the treaty to evolve in parallel with changes to domestic laws, provided that such changes are not disguised attempts to modify the treaty. This latter restriction is simply an application of the principle of good faith incorporated in Art. 26 of the Vienna Convention on the Law of Treaties" (Sasseville, *supra* n. 299, p. 40); "It can therefore in my view be said that even when a tax treaty refers to the domestic law of one state, or is applied subject to the provisions of its domestic law, there may be situations where the other state may legitimately expect that state to align itself with the prevailing practice on that particular issue or interpretation of a treaty term in the international community of nations. In more than one way, the principle of good faith will protect the reasonable or legitimate expectations of states, but problems will arise when expectations of states diverge, as they occasionally do" (van der Bruggen, *supra* n. 55, p. 34); "The conclusion that the dividend withholding payment regime may result in a breach of New Zealand's treaty obligations to exempt inter-corporate dividends is based on a broad reading of the nature of those obligations. If this broad reading is incorrect, so that the application of the dividend withholding payment regime does not breach treaty obligations, it is clear that the dividend withholding payment regime at least operates in a manner which is contrary to the spirit of the treaties in question. Therefore, even if no obligations are breached it can be concluded that New Zealand is not acting in good faith as treaty partner in applying dividend withholding payment regime in cases where dividends are entitled to treaty exemption" (Rigby, *supra* n. 27, p. 400); "The determination that an abuse has occurred and the means of sanctioning it must be strictly consistent with public international treaty law, in particular article 26 of the Vienna Convention on the Law of treaties of 1969, which requires the parties to a treaty to perform it in good faith, and article 38 of the Statute of the International Court of Justice, which

With a significant consensus, tax treaty dodging practices are generally considered contrary to the principle of good faith and, therefore, qualified as prohibited acts from the perspective of international law by international tax literature.[756] The same consensus is not, however, observed among domestic courts, which decisions go in both directions, to either endorse actions of contracting states qualified herein as tax treaty dodging - under the argument that they do not contradict the treaty - or to condemn such practices on the basis of, amongst other reasons, the violation of the principle of good faith.[757] The number of decisions condemning tax treaty dodging is, however, significant enough to demonstrate that the principle of good faith plays an important role as a limitation to contracting states' sovereign rights when exercised in a questionable manner and that it has played a role as legal basis to deny effects to contracting states' dodging actions in practice.[758]

The Dutch Courts have issued a number of decisions on cases considered by the author as tax treaty dodging cases, where the principle of good faith was used as legal basis against these practices. For example, the Dutch Court of Appeal concluded that a state does not apply its treaty commitments in good faith if it encroaches on the taxing rights which it agreed to convey to its treaty partner.[759] The court considered that Netherlands had unilaterally extended its taxing rights on potential Dutch-source dividends to the detriment of Belgium as the state of residence of the shareholder, as the Dutch exit tax had the effect of taxing potential dividends (the company's retained earnings) which Belgium would be entitled to tax under the treaty. In the same direction, the Dutch Supreme Court held, in another case,[760] that the exclusive authority to tax pensions and other similar remuneration under article 18 of a treaty could not be eroded or evaded as a result of the source state subsequently enacting a domestic law provision that operates at the treaty level after that treaty's conclusion. The Dutch Supreme Court ruled that this practice of the Dutch tax authorities was in breach of the principle of good faith in the Vienna Convention (1969). According to the court, a treaty is not interpreted in good faith when a contracting state after signing a treaty under which a taxation right is granted to the other contracting state, amends its domestic legislation in such a way that the division of taxation rights, as agreed upon between the states, is unilaterally amended.

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states that the Court shall apply the general principles of law recognized by civilized nations. It follows that the adjustment and resolution of such situations must be subject to and decided in accordance with the rules of international law (...)" (Garcia Prats, *supra* n. 55, p. 75). "(…) good faith precludes a contracting state from enacting legislation in view of rendering the treaty in fact inoperative even though domestic legislation is not literally and directly contrary to the treaty. (…) a contracting state may be violating the principle of good faith if it introduces legislation that results in a hollowing out of its tax treaty obligations, or that is manifestly at odds with the treaty object and purpose. (…) states are indeed free to change their domestic law, but in more than one way such changes may put them on a collision course with respect of the bona fide observance of tax treaties" (van der Bruggen, *supra* n. 55, pp. 50-51).

[756] See *supra* n. 755.

[757] For an overview of all decisions, see Chapter 3, Section 3.3.

[758] See also Chapter 6. Section 3.3. Decisions condemning tax treaty dodging practices declared with no effect the dodging actions so that tax treaties applied as if no action would have been taken by the dodging country.

[759] NL:HR, 20 February 2009, 42.701, Tax Treaty Case Law IBFD. For details on this case, see Chapter 3, Section 3.3.

[760] NL: HR, 5 September 2003, 37.657, Tax Treaty Case Law IBFD. For details on this case, see Chapter 3, Section 3.3

The Dutch Supreme Court also condemned a unilateral change made by the Netherlands which resulted in taxation in the Netherlands as being in conflict with the good faith to be observed in the application of treaties in respect of notional income from private pension rights which taxation was attributed to Belgium by the treaty as the pensioner's state of residence.[761] The Dutch Supreme Court has also already held that the Dutch rule under which pension rights were taxed in the Netherlands at the moment when the taxpayer was still a resident of the country was in conflict with good faith towards the treaty partner who expected to be granted taxing rights under the treaty.[762]

Similarly, the Belgian Supreme Court confirmed a decision given by the Court of Appeal in the sense that fictions introduced to erode the attribution of powers violated the treaty and good faith.[763] When commenting decisions given by the Belgian and Dutch Supreme courts on the matter, Luc de Broe summarizes that "according to this jurisprudence of the Belgian and Dutch Supreme Courts where changes in domestic law result in a shift of the allocation of taxing rights and in potentially unresolved double taxation and accordingly seriously impair the balance and the primary objective of the treaty, the exception laid down in Art. 3(2) ("unless the context otherwise requires") as well as the principle of good faith set forth in Art. 31 VC [Vienna Convention] and the provisions of Arts. 26 and 27 prevent a contracting state from effectively applying its new domestic law definitions or fictions for purposes of interpreting undefined terms".[764]

The principle may also serve as a limitation to a particular type of tax treaty dodging, that is, legislature omission (or simply treaty underride)[765]. This can be based on the restrictive interpretation recognized in public international law as the secondary notion of good faith[766], also referred to by the OECD in

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[761] NL: HR, 13 May 2005, 39.610, Tax Treaty Case Law IBFD. "It is by now an established view in the Netherlands jurisprudence that it is at variance with good faith (cf. Art. 31(1) of the Vienna Convention on the Law of Treaties) that amendments made to domestic tax law posterior to the conclusion of a tax treaty affect treaty interpretation. Prior to this decision, the Supreme Court denied on the same grounds taxation of notional income from private pension rights in the case of redemption of the pension rights by the pensioner after his emigration. And in its subsequent decisions in the above-mentioned cases 37.651 and 39.385 the Supreme Court denied taxation of notional salary and notional interest, respectively, again with reference to the condition of good faith". (NL: HR, 13 May 2005, 39.610, Tax Treaty Case Law IBFD, editor's note). For details on this case, see Chapter 3, Section 3.3.

[762] NL: HR, 13 May 2005, 39.144, Tax Treaty Case Law IBFD. For details on this case, see Chapter 3, Section 3.3.

[763] BE: SC, 5 December 2003, F.02.0042.F, Tax Treaty Case Law IBFD. For details on this case, see Chapter 3, Section 3.3.

[764] de Broe, *supra* n. 55, p. 281.

[765] Or treaty underride – see Chapter 3, Section 3.3.1.3.

[766] "A secondary notion of good faith in the context of explicit agreements pertains to the duties of signatories to a treaty prior to ratification. The early rule of international law to the effect that states had an obligation to ratify treaties that their diplomatic agents had signed has been replaced since the 18th century by the concept of discretionary ratification. (...) Yet the new concept of discretionary ratification carried over the old notion to the extent that the executive branch, having signed the treaty through its agents, now had an obligation to make every effort in good faith to obtain the consent of the sovereign, and not to act in the interim period in such a way as to prejudice the unperfected rights of the signatories of the treaty" (D'Amato, *supra* n. 722, p. 599).

the Report on Treaty Overrides (1989)[767] as meaning that "international law requires states to implement the provisions of a treaty".[768]

As a result, the author concludes that the principle of good faith, in its both roles as governing the performance of treaties (article 26 of the Vienna Convention (1969)) and as a mode of interpretation (article 31(1) of the Vienna Convention (1969)), is a principle of international law that imposes a limitation on the exercise of rights by contracting states. Once this limitation is overstepped through dodging actions (or omissions), this principle plays role as a legal basis on which tax treaty dodging can be qualified as an illegitimate and therefore a condemnable behaviour, as it has been condemned in existing case law. As summarized by Cheng, "(...) the principle of good faith governing the exercise of rights, sometimes called the theory of abuse of rights, while protecting the legitimate interests of the owner of the right, imposes such limitations upon the right as will render its exercise compatible with the party's treaty obligation, or, in other words, with the legitimate interests of the other contracting party. Thus a fair balance is kept between the respective interests of the parties and a line is drawn delimiting their respective rights. Any overstepping of this line by a party in the exercise of his right would constitute a breach of good faith, an abuse of right, and a violation of his obligation".[769]

Indeed, contracting states' actions (or omissions) overstepping the limits imposed by the principle of good faith may be qualified as illegitimate acts. The remaining question is how far contracting states can go without overstepping this limitation. In other words, where is the line dividing the legitimate exercise of rights and the illegitimate act of tax treaty dodging when one considers the principle of good faith. This question is addressed in Section 4.3. of this chapter.

4.2.3. The principle prohibiting abuse of rights as a limitation to tax treaty dodging

In public international law, abuse of rights generally refers to a state exercising a right either in a way that impedes the enjoyment by other state of their own rights or for an end different from that for which the right was created, to the injury of another state.[770] It presupposes an action strictly within

[767] OECD, *supra* n. 127.

[768] "'It must be performed in good faith' means that international law requires States to implement the provisions of a treaty" (OECD, *supra* n. 127, p. (8)-6, para. 10).

[769] Cheng, *supra* n. 277, 129.

[770] Kiss, *supra* n. 769, para. 1; "There is such an abuse of rights each time the general interest of the community is injuriously affected as the result of the sacrifice of an important social or individual interest to a less important, though hitherto legally recognized, individual right" (Lauterpacht, *supra* n. 244, p. 294); "As a tentative proposition, it may be said to consist of the prohibition of the exercise of a right for an end different from that for which the right was created, to the injury of another person or the community" (B. O. Iluyomade, *The Scope and Content of a Complaint of Abuse of Right in International Law*, 16 Harvard International Law Journal 47 (1975), pp. 47-92, at p.48); "Des definitions généralement proposes dans la doctrine se dégagent trois elements qui doivent nécessairement se trouver dans tout *abus de droit*. Premièrement, l'abus résulte de l'exercice d'un droit; en second lieu, il porte atteinte à certains interest d'autrui, autrement dit, il cause un dommage; enfin, l'acte possède un caractère particulier lié soit aux intentions de son auteur, soit aux modalities ou effets de l'acte lui-même, en vertu duquel il constitue un abus" (J.-D. Roulet, *Le Caractère Artificiel de la Théorie de l'Abus de Droit en*

or in conformity with the letter of the law, but with an ulterior motive of achieving an illegal end or injuring another person.[771]

The question - first addressed in the context of international law in a series of lectures given in 1925 by Politis at The Hague Academy of International Law[772] - of whether abuse of rights is forbidden in international relations has been widely discussed by the international community. In this respect, different aspects have been taken into account by international scholars in order to answer this question. The first aspect is that article 38(1) of the Statute of the International Court of Justice lists among the sources of international law the general principles of law recognized by civilized nations.[773] Many authors came to the conclusion that, since in civil law countries the abuse of rights was prohibited and that some common law countries accepted the theory to a certain extent,[774] it could be said that abuse of rights was a general principle of law and, therefore, a general principle of international law.[775]

Droit International Public (Editions de la Baconnière, 1958), p. 56); "Abuse of rights refers to a state exercising a right either in a way which impedes the enjoyment by other states of their own rights or for a purpose different from that for which the right was created, to the injury of the other states" (de Broe, supra n. 55, p. 302); "Qu'est l'abus de droit en général? La notion comporte deux éléments: l'existence de certains droits et l'exercice de ces droits qui est contraire à certaines règles fondamentales. En autres mots: un sujet de droit exerce les competences don't il est habilité de façon à causer des dommages à un autre sujet de droit" (Kiss, *supra* n. 249, p. 11); see also: M. Byers, *Abuse of Rights: An Old Principle, A New Age*, 47 McGill Law Journal 3 (2002), pp. 389-431, at p. 391.

771 Iluyomade, *supra* n. 770, p. 48.

772 Kiss, *supra* n. 249, p. 9. Professor Politis attempted to show, in a series of lectures in July 1925 at The Hague Academy of International Law, that the doctrine of *abus de droit* as applied by French courts and developed in detail by French writers constitutes a general principle of law which as such has a place in international law and is capable of application by international courts (Lauterpacht, *supra* n. 244, p. 294).

773 "1. The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply: a. international conventions, whether general or particular, establishing rules expressly recognized by the contesting states; b. international custom, as evidence of a general practice accepted as law; c. the general principles of law recognized by civilized nations; d. subject to the provisions of Article 59, judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law. 2. This provision shall not prejudice the power of the Court to decide a case *ex aequo et bono*, if the parties agree thereto" (ICJ, *supra* n. 695, art. 38).

774 "It is seen therefore that although in traditional fields of private law the concept of abuse of rights has consistently been rejected by the courts in England and the Commonwealth, it has to a considerable extent been accepted and applied by American courts" (D. A. Ward et al., *The Business Purpose Test and Abuse of Rights*, 68 British Tax Review (1985), pp. 68-123, at p. 84). "As far as common law countries are concerned, it was submitted that, although a decision in a given case may be based upon principles of the law of torts, when a court looks into the motives of an actor, the legal theory applicable is indistinguishable from that of abuse of rights" (Kiss, *supra* n. 769, para. 9) – however, in most cases motive is irrelevant in tort. The only time one may meet abuse of rights in the United Kingdom is via European law in relation to VAT.

775 For examples of authors defending abuse of rights as a general principle of international law, see footnote 789 in this thesis.

Another important aspect is the fact that certain international treaties and conventions may enunciate the principle of abuse of rights.[776] The most explicit recognition of abuse of rights is to be found in article 300 of the United Nations Convention on the Law of the Sea (UNCLOS): "states parties shall fulfil in good faith the obligations assumed under this Convention and shall exercise the rights, jurisdictions and freedoms recognized in this Convention in a manner which would not constitute an abuse of right".[777]

Moreover, it has also been concluded that, since article 26 of the Vienna Convention (1969) requires states to perform obligations which they assumed by concluding treaties in good faith, this provision would give support to the conclusion that an abuse of rights principle is recognized in international law.[778] In this sense, according to the International Law Commission, the application of the principle of good faith may lead to the conclusion that the obligation must not be evaded by a merely literal application of the clauses.[779] This means, on the one hand, that powers must be exercised reasonably

[776] For instance: bilateral and multilateral conventions on utilization of natural resources shares by states, article 33 of the Convention on the Conservation and Management of Highly Migratory Fish Stocks in the Western and Central Pacific Ocean, article 2(2)(c) of the Helsinki Convention on the Protection and Use of Transboundary Watercourses and International Lakes, etc. For more examples, see Kiss, *supra* n. 769, para. 15-21.

[777] UN, *Convention on the Law of the Sea - UNCLOS* (10 December 1982), available at http://www.un.org/depts/los/convention_agreements/convention_overview_convention.htm (accessed 10 June 2015).

[778] Ward, *supra* n. 720, p. 400; "The principle of abuse of rights may be also characterized as an application of the principle of good faith to concrete situation concerning the exercise of rights" (V. Paul, *The Abuse of Rights and Bona Fides in International Law*, 28 Österreichische Zeitschrift für öffentliches Recht und Völkerrecht (1977), pp. 107-130, p. 127); "La limite qui sépare l'abus de droit d'une violation de la bonne fois est fréquemment ardue, parfois meme impossible à definer exactement. (...) Il n'est dès lors pas exclu qu'en raison de certaines similitudes, la théorie de l'abus s'introduise un jour en droit international, subrepticement, sous le couvert de la bonne fois" (Roulet, *supra* n. 770, p. 109); "Parfois même, il est impossible de distinguer clairement les deux concepts, de sorte que l'on a pu considerer l'abus comme l'expression né gative du principe de la bonne fois. (...) Aussi n'est il pas étonnant que la majorité de la doctrine les mentionne côte à côte ou les étudie à la meme enseigne." (Roulet, *supra* n. 770, p. 124); "The principle of good faith (...) controls also the exercise of rights by states. The theory of abuse of rights (...) is merely an application of this principle to the exercise of rights. (...) the principle of good faith governing the exercise of rights, sometimes called the theory of abuse of rights (...)" (Cheng, *supra* n. 277, p. 121 and 129); "It should be noted that the principle of good faith also governs the exercise of rights, and that the doctrine of abuse of rights, which is recognized by the ICJ, is but an application of the same principle" (Engelen, *supra* n. 55, pp. 126-127).

[779] "In the 1971 commentary to the draft articles of the VCLT [Vienna Convention on the Law of Treaties], the International Law Commission (ILC) noted that '[t]here is much authority in the jurisprudence of international tribunals for the proposition that in the present context the principle of good faith is a legal principle which forms an integral part of the rule *pacta sunt servanda*. Thus, speaking of certain valuations to be made under articles 95 and 96 of the Act of Algeciras, the Court said in the Case concerning Rights of Nationals of the United States of America in Morocco (Judgment of 27 August 1954): "The powers of making the valuation rests with the Customs authorities, but it is a power which must be exercised reasonably and in good faith." Similarly, the Permanent Court of International Justice, in applying treaty clauses prohibiting discrimination against minorities, insisted in a number of cases, that the clauses must be so applied as to ensure the absence of discrimination in fact as well as in law; in other words, the obligation must not be evaded by a merely literal application of the clauses'" (van Weeghel & Gunn, *supra* n. 749, pp. 312-313).

and in good faith and, on the other hand, that an obligation must not be evaded by a merely literal application of the clause.[780]

For these reasons, some scholars defend that abuse of rights by states is prohibited by international law. If this prohibition exists under international law in regard to international agreements, a natural conclusion would be that it also applies to tax treaties[781] in regard to abusive actions engaged by states that are parties to the treaty.[782] Under this rationale, contracting states acting in conformity with the wording of tax treaties but in a way to modify the effects of these agreements – in other words, states engaging in dodging actions as discussed in this study - would be committing an abuse of rights as understood and prohibited by international law. Few scholars,[783] as well as the United Nations,[784] have

[780] van Weeghel & Gunn, *supra* n. 749, p. 313.

[781] "In light of the fact that the International Court of Justice has already given recognition to the principle of abuse of rights in interpreting treaties generally, that Article 23 of the Vienna Convention requires parties to perform the treaties in good faith, that the principle of the abuse of rights has been incorporated in the Convention of the Law of the Sea and, more specifically in a tax context, that anti-abuse principles have developed judicially or been enacted by statute in a great number of countries (...), one can say that an anti-abuse rule in taxation matters is one of the 'general legal principles recognized by civilized nations'. From this one may argue that a general anti-abuse doctrine should be recognized by tax administrations and courts generally in interpreting and applying tax treaties" (Ward, *supra* n. 720, p. 403).

[782] Discussions exist regarding the application of the principle to tax treaties in respect of actions performed by taxpayers (e.g. treaty shopping), in view of the fact that the principle takes the form of a ban imposed on states and not on individuals. However, this discussion has no impact on the present study, since tax treaty dodging regards actions performed by states that are signatories of and, therefore, parties to the treaty. See: van Weeghel, *supra* n. 230, p. 100; Comments by Lowe in IFA, *supra* n. 553, p. 8; van Weeghel & Gunn, *supra* n. 749, pp. 310-311); Maisto, *supra* n. 705*,* pp. 326-327.

[783] When criticizing David Ward's proposal for adoption of the qualification given in the source state, Klaus Vogel points out the possibility that this "would indeed avoid double non-taxation, but the awkward consequence of this rule is that the state whose internal law attributes the broader definition to the term in question always would have an advantage" and that "states could abuse it by deliberately extending certain of their internal law definitions" (Avery Jones, *supra* n. 107 (1986), p. 79); Michael Rigby acknowledges the possibility of attempts qualified as dodging in this study by referring to them as “abuse by governments” (Rigby, *supra* n. 27, pp. 421-424); Lalithkumar Rao defended that contracting states can abuse tax treaties when the application is contrary to the purpose of the treaty. After explaining different types of abuse carried out by states, he made a parallel, in the same way as by Klaus Vogel, between taxpayers' and contracting states' actions and concluded that "treaty abuse occurs when, despite adherence to the letter, there is a violation of the purpose of the treaty, either by the taxpayer, or by the state. Abuse engaged in by the taxpayer is done by adoption of artificial devices lacking substance. Abuse engaged in by the state can be either active or passive. Active abuse comprises passing legislation going counter to the purposes of the treaty, while not violating the letter. Passive abuse comprises issuing instructions that result in tacitly acquiescing in abuse by the taxpayer" (Comments by Rao in IFA, *supra* n. 55, pp. 22-23); In a study on abuse of tax law, Francisco Alfredo Garcia Prats includes an analysis on abuse of tax treaties by contracting states (Garcia Prats, *supra* n. 55, pp. 21-23); "(...) the behaviour by a state party which would undermine the effect of a treaty and an abuse of rights by that state are - at the very least - close relatives" (van Weeghel & Gunn, *supra* n. 749, p. 314). For more on the topic, see Chapter 2, Sections 2.3. and 2.4.

[784] The United Nations also acknowledged the phenomenon – in a more comprehensive way than ever done by the OECD – in the studies prepared by the "Subcommittee on Improper Use of Tax Treaties" (previously named "Subcommittee on Treaty Abuses and Treaty Shopping") of the Committee of Experts on International Cooperation in Tax Matters (previously named "Ad Hoc Group of Experts on International Cooperation in Tax Matters"). The first two versions of the final report, prepared by the subcommittee in 2005 and 2006, did cover the subject recognized that normally the term abuse is referred to situations in which taxpayers are seeking to circumventing the law, but that consideration should also

indeed recognized or even named tax treaty dodging attempts as "abuse" by states - this reference to abuse committed by contracting states under tax treaties is particularly noticeable after the moment when the parallel between taxpayers' and contracting states acts circumventing the treaty is made.[785] Frank Engelen clearly indicates that attempts by contracting states to make the treaty partially inoperative by amending afterwards in its legislation the scope of terms not defined therein "would clearly constitute an abuse of right"[786] and that "the principle of good faith and the doctrine of abuse of right distinctively and directly related to sets a limit with respect to the references to domestic laws of the contracting state for purposes of interpretation".[787]

If tax treaty dodging can be recognized as abuse of rights by contracting states in respect to tax treaties, an applicable principle prohibiting abuse of rights in international law would consequently play a role as a limitation and, therefore, as a basis on which tax treaty dodging would be qualified as an illegitimate[788] act. However, there is no unanimity amongst authors on whether abuse of rights by states is after all recognized as a general principle of (international) law.[789] In addition, it is possible to

be given to contracting states acting in a similar way (UN, *supra* n. 61 (15 November 2005), p. 11, para. 20). The 2006 version of the report treats the subject in more detail to the point that a full section is dedicated to it under the title "Abuse by One of the Contracting States" (UN, *supra* n. 61 (16 October 2006), p. 6). The section defines abuse of a tax treaty by a contracting state as being "a situation where one of the Contracting States, through the subsequent exercise of its domestic power of taxation, modifies the obligations previously assumed by that State towards the other State and upsets the balance in the division of taxing powers expressed in the tax treaty concluded between these States". It further presents different types of abuses by states. The subject of abuse of tax treaties by contracting states was eventually dropped by the subcommittee as from the third version of the report in 2007, since it was considered that "this issue was outside the mandate that was given to it by the Committee as it did not relate to the improper use of tax treaties by taxpayers" (UN, *supra* n. 61 (22 October 2007), p. 4, para. 9). The decision of the subcommittee seems to have been adequate not only from a formal perspective – as the subject was outside the mandate -, but also in the sense that, although equivalent, the two methods (i.e. abuse by taxpayer and abuse by contracting states) do require a different type of analysis. But this did not prevent the subcommittee from recognizing the relevance of the topic and from suggesting further study on the matter by another committee, which was not followed up by the United Nations. For details on the work of this subcommittee on the topic, see Chapter 2, Section 2.3 (under *The 2000s and 2010s*).

[785] The parallel tax avoidance and treaty shopping/contracting states' actions became more evident in literature during the 2000s. For details, see Chapter 2, Section 2.3.

[786] Engelen, supra n. 55, p. 490. He repeats: "However, this is not to say that article 3(2) always permits the meaning of a term not defined in the convention to be ascertained by reference to the meaning that it has under the domestic law of contracting state, as modified from time to time, even if this would change the allocation of taxing rights originally agreed to by the contracting states at the time of the conclusion of the convention on the basis of the legislation in force. There can be no doubt that such an application of article 3(2) would constitute an abuse of right" (Engelen, *supra* n. 55, p. 494).

[787] *Ibid.*

[788] See *supra* n. 1 and 2.

[789] de Broe, *supra* n. 55, p. 306; on abuse of rights as a general principle of international law: "A la première question, relative à l'existence meme d'une interdiction frappant l'exercice abusive des competences étatiques, nous croyons pouvoir répondre par l'affirmative: le nombre et la valeur des precédents internationaux semblent autoriser une telle réponse. Plusieurs auteurs on tune opinion contraire, selon eux le principe de l'abus de droit ne fait pas encore partie du droit international" (Kiss, *supra* n. 249, p. 179 and footnote 1); "In conclusion, it may be said that the doctrine is a useful agent in the progressive development of the law, but that, as a general principle, it does not exist in positive law" (Brownlie, *supra* n. 16, pp. 444-445); "(...) the prohibition of abuse of rights is a general principle of law. In view of its general recognition

affirm that the direct application of the principle in an international scenario has had limited support from international tribunals[790] and has been mostly rejected by common law countries.[791]

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by almost all systems of law the objection that it is a purely natural law doctrine is hardly convincing" (Lauterpacht, *supra* n. 244, p. 306); "As a result, due largely to its widespread existence in national legal systems, many states, judges, arbiters, and authors have considered abuse of rights to be part of international law, whether as a general principle of law or as a part of customary international law" (Byers, *supra* n. 770, p. 397); "There seems to be support and authority in international law to give recognition to the abuse of rights principle and to widespread use of domestic anti-abuse principles by most countries which leads one to believe that these principles could be recognized internationally as the appropriate principles to be used in the interpretation and application of tax treaties" (D. A. Ward, *supra* n. 720, p. 408); "The decisions of some international tribunals and the practice of a number of states reveal that the principle of abuse of right has become accepted as part of international law and that states may, and often do, invoke the principle as the basis for an international claim. There is no substantial reason to exclude the application of the principle from international law" (Iluyomade, *supra* n. 770, p. 72); "(...) a strong position can be maintained that at least between states who are parties to a treaty, the doctrine of abuse of rights has been recognized as part of international law" (Ward, *supra* n. 720, p. 400); Nguyen, Daillier & Pellet, *supra* n. 16, p. 321; / Contra: "(...) the prohibition of abuse of rights does not find unanimous support, but a fully negative approach is hardly to be seen. (...) What is more important, however, is the fact that in the practice of states there have not been enough cases and of such results, that a conclusion may be drawn that the practice of states proves the existence of a corresponding norm of customary international law. (...) we may arrive at the conclusion that a norm of international law, prohibiting abuse of rights, has not yet come into being or may be found in statu nascendi" (V. Paul, *supra* n. 778, p. 128); "Il paraît donc difficile s'inclure l'abus de droit au nombre des principles généraux de droit reconnus par les nations civilises, pour la raison indiquée que ce concept ne jouit pas d'une popularité et d'une généralité suffisament étendues parmi les orders juridiques internes" (J.-D. Roulet, *supra* n. 770, p. 109); authors indicated by Alexander Kiss as not recognizing the principle of abuse of rights as part of international law: Strupp, *Le Droit du Juge International de Statuer Selon l'Equité*, Rec. A.D.I. 1933/III, t. 33, p. 475; Strupp, *Grundzüge des Positiven Völkerrechts*, p. 120; R. Ago, *Le Délit International*, Rec. A.D.I. 1939/II, t. 68, pp. 442-444; Schwarzenberger: *International Law* (1945), pp. 333, 394, 396; Cavaglieri, *Corso di Diritto Internazionale* (Second Edition, 1934), pp. 507-509; Cavaglieri, *Nuovi Studi Sull'intervento* (1928), p. 46.

[790] Brownlie, *supra* n. 16, p. 444. "Recently the doctrine of abus des droits seems to have secured some measure of recognition on the part of the Permanent Court of International Justice which has twice had the occasion to refer to it in its judgments. In Judgment No. 7, in the case concerning certain German interests in Polish Upper Silesia (...) the court added that 'such misuse cannot be presumed' and that it rests with the party who states that there has been such misuse to prove this statement'. (...) The same terms were used in the Court's Order of 6 December 1930 in the case between Switzerland and France (....). The Court held that, subject to specific obligations, France was entitled to apply her fiscal legislation in the territory of the free zones in the same manner as in any other part of French territory. But it added the caveat that 'a reservation must be made as regards the cases of abuses of a right [pour le cas d'abus de droit]. As in Judgment No. 7, the court added that such an abuse or rights could not be presumed. However, long before the doctrine of abuse of rights had been introduced, international tribunals applied it in substance in a number of cases" (Lauterpacht, *supra* n. 244, pp.296-297); "The principle has been mentioned in several cases as a possible basis for a condemnation for violation of international law, but without having been actually used for that purpose" (Kiss, *supra* n. 769, para. 12); "To date, there are not many instances where courts have, in fact, used these principles and, in each case, the principles that have been used appear to be those developed in domestic law rather than a concept of abuse supported as to its substantive terms and limitations by international law" (Ward, *supra* n. 720, p. 408); Professor Politis attempted to show, in a series of lectures in July 1925 at The Hague Academy of International Law, that the doctrine of *abus de droit* as applied by French courts and developed in detail by French writers constitutes a general principle of law which as such has a place in international law and is capable of application by international courts (Lauterpacht, *supra* n. 244, p. 294); Paul, *supra* n. 778, pp. 112-117.

[791] See more on the rejection of abuse of rights by common law country in the comparative study Ward et al., *supra* n. 775.

One relevant objection against the recognition of a principle of abuse of rights in international law is the fact that so far there is no uniform concept of the abusive character among states.[792] In the words of David Ward, "an attempt to reach international consensus on how a universally accepted anti-abuse should be formulated and when it should be applicable to transactions involving tax treaties would appear to be an impractical utopian hope".[793] Indeed, today the concept of "abuse" or even "treaty abuse" is still under considerable debate, and although the OECD Committee on Fiscal Affairs recognized that treaty abuse frequently occurs and that it exists as a phenomenon, general consensus on its meaning has not been yet reached.[794] Even among writers who accept the principle prohibiting abuse of rights there is no agreement on the analysis of its significance and theoretical basis,[795] which eventually leads to legal uncertainty.[796]

On the top of that, others consider the principle of abuse of rights to be lacking in value as an independent rule, as it would consist essentially of an application of already uncontested concepts and

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[792] "Even though there were some attempts to formulate the concept of treaty abuse, it has often proved difficult to arrive at a definition acceptable for all actors" (Candu, *supra*, n. 65, p. 190); "The idea that a subject of rights and competences can misuse them seems to be inherent to legal thinking and to have roots in all legal systems and leads to the establishment of controls on the use of recognized rights. The prohibition of abuse of rights in international law is, however, problematic because of differences in the content of the concept itself (...)" (Kiss, *supra* n. 769, para. 34); "Other authors deny that the principle has any validity in international law because of its imprecise character. Georg Schwarzenberger and E.D. Brown wrote that 'it is difficult to establish what is supposed to amount to an abuse, as distinct from a harsh but justified use, of a right under international law'. Jean-David Roulet considered that such a flexible and imprecise principle could not hope to remedy the primitive an imprecise character of international law'. Gutteridge went so far as to suggest that the principle 'may get out of hand and result in serious inroads on individual rights, thus becoming an instrument of dangerous potency in the hands of demagogue and the revolutionary'" (Byers, *supra* n. 770, pp. 412-413); "Looking at the issue from the point of view of legal practice, one must keep clearly in mind that the states give widely differing answers to the abuse question. (...) For this reason, classic cases of abuse can hardly be solved in a uniform way through a principle that is unwritten and therefore necessarily unclear in its content" (Comments by Wassermeyer in IFA, *supra* n. 55, p. 19); "Divergence of opinion results at least partly from the different forms in which the exercise of right can cause injury to another state, some object to its lack of precision for practical use" (Kiss, *supra* n. 769, para. 10); "Neither the OECD Model nor the then existing DTC [double taxation convention] allows a sufficiently clear answer to the question of what is the minimum content of the expression "treaty abuse" (Comments by Wassermeyer in IFA, *supra* n. 55, p. 20).

[793] Ward, *supra* n., p. 404.

[794] Candu, *supra* n. 65, p. 190.

[795] Kiss, *supra* n. 769, para. 10.

[796] "It is not unreasonable to regard the principle of abuse of rights as a general principle of law. However, while it is easy to sympathize with exponents of the doctrine, the delimitation of its functions is a matter of delicacy" (Brownlie, *supra* n. 16, p. 444); "(...) the principle itself has not been without controversy. As Verzijl observes: 'Turning now to the "abuse of right(s)" conceived as an independent and supposedly indispensable complementary "general principle of law" on the world-wide international level, I feel very strongly that this concept is open to two different and very grave objections, namely, (a) that it has such a wide scope and is so completely impossible to define that it bristles with dangers to the certainty of the law in the international community, and (b) that so far it is confined within reasonable bounds, it is largely superfluous since the situations which it is intended to remedy are in very many cases covered by positive rules of international law'. Verzijl recognizes that the introduction of a principle of abuse in international law is not without a risk. Potentially, it could seriously undermine legal certainty within the international legal order" (van Weeghel & Gunn, *supra* n. 749, pp. 311-321)

principles such as good faith, reasonableness, good neighbourliness or even equity.[797] Ian Brownlie summarizes this by saying that "when the criteria of good faith, reasonableness, normal administration, and so on are provided by an existing legal rule, reference to 'abuse of rights' adds nothing".[798]

The author disagrees with this argument and rather follows the rationale put forward by Jean-David Roulet in the sense that the principle of good faith does not eliminate but only reduces the applicability and usefulness of the principle prohibiting abuse of rights.[799] The main reasons for that is the fact that abuse of rights can be founded on objective criteria,[800] while good faith focuses on the subjective aspect of the act when takes into consideration the intention and motives of the actor.[801] Michael Byers also spotted this difference when he stated that "abuse of rights may also provide an advantage over

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[797] Kiss, *supra* n. 769, para. 10.

[798] Brownlie, *supra* n. 16, p. 445. In the same direction: "It is also possible to argue that abuse of rights is redundant because it is itself only a more specific expression of a broader principle, namely that of good faith" (Byers, *supra* n. 770, p. 411); "Good faith may be said to cover the somewhat narrower doctrine of 'abuse of rights', which holds that a state may not exercise its international rights for the sole purpose of causing injury, nor fictitiously to mask an illegal act or to evade an obligation. While these specifications would indeed appear to follow from the principle of good faith, perhaps the better view is there is no need for an independent, even if subsidiary, concept of abuse of rights" (D'Amato, *supra* n. 722, p. 600); "Pourquoi invoquer un principe nouveau puisque les règles existantes remplissent pafaitement la meme function? (...) A notre avis, ce recours à la théorie de l'abus est inutile et injustifié, pour des raison qui d'ailleurs découlent de l'argumentation meme des partisans de ce raisonnement (...). Point n'est alors besoin de recourir à l'exception artificielle du principe de l'abus de droit, car celui de la bonne fois, d'ailleurs incorporé dans une norme spécifique de la Charte, permet d'aboutir au meme résultat" (...) En résumé, nous constatons que les rapports entre bonne fois et abus de droit sont relativement complexes. Issus de considérations morales identiques, ces principles possèdent cependant une portée inégale. S'ils se recouvrent, l'abus de droit perd alors de son importance, en raison de l'existence de l'obligation incontestée de se conformer aux règles de la bonne fois, laquelle conduit exactement au meme résultat. (...) Le principe de la bonne fois permet donc de limiter une fois de plus le champ d'application de l'abus de droit. Certes, comme nous l'avons admis plus haut, il ne permet pas d'éliminer, mais réduit dans une mesure considerable ses possibilities d'application" (Roulet, *supra* n. 770, pp. 126-127). Contra: "(...) the principle of abuse of rights is not redundant. Instead it is, in one small but important respect, supplemental to the principle of good faith: it provides the threshold at which a lack of good faith gives rise to a violation of international law, with all the attendant consequences. (...) Abuse of rights may also provide an advantage over the principle of good faith in that, at least international law, one need not imply malice in order to establish that an abuse has occurred" (Byers, *supra* n. 770, p. 411-412); See also some arguments in Roulet, *supra* n. 770, p. 125.

[799] Roulet, *supra* n. 770, p. 127.

[800] Louis Josserand indicates that one of the most controversial questions among those who discuss abuse of rights is to know whether this theory has an objective or subjective nature, is of a moral and psychological level or of social and economic. He states that the doctrine seems to be divided on this, as it depends on the notion one follows for the abusive criteria: whether to refer to a subjective criteria, purely intentional, or to a more objective criteria, where the economic interest or the social function plays a big role. Josserand supports a double characteristic for abuse of rights: an objective element (so intended and non-intended acts could fall under the abuse of rights theory) determined by the finalistic criteria, while some subjective elements would also need to be analyzed. He mentions that many abandon the theory of abuse of rights because of the difficulty in practice to prove intention. However, he explains that this difficulty is only faced by those who sustain a purely subjective concept of the abusive character (L. Josserand, *De l'Esprit des Droits et de leur Relativité – théorie dite de l'abus des droits* (Dalloz 2006), pp. 366-414 and 429). Jean-David Roulet chooses a more objective criterion when he describes the large definition of the abusive character as whenever there is a manifestly chocking exercise of right (Roulet, *supra* n. 770, p. 75).

[801] Roulet, *supra* n. 770, p. 125.

the principle of good faith in that, at least in international law, one need not imply malice in order to establish that an abuse has occurred".[802] In this sense, if one follows the concept of abuse of rights based on objective criteria,[803] it can be said that not all abuse of rights would result in a breach the principle of good faith. The exercise of rights not motivated by malicious reasons (i.e. actions not exercised in bad faith) but still causing damage to others would not infringe the principle of good faith, but could violate the principle prohibiting abuse of rights. In this case, the principle prohibiting abuse of rights would not be redundant, as it would serve as a legal basis on which those actions falling outside the scope of good faith could still be condemned.

Therefore, for the author, the best view in this respect is the one concluding that whenever there is an overlap of both principles, which would happen in cases of abusive exercise of rights motivated by malice intentions, the already so well-established and uncontroversial principle of good faith would be enough to condemn such actions and, thus, the principle prohibiting abuse of rights would indeed add nothing.[804] In this sense, the principle of good faith limits the scope of applicability of the principle preventing abuse of rights[805]; it does not limit, however, its applicability in respect of exercise of rights causing damages to other parties, although not motivated by malice intentions.

The author on the other hand agrees that no uniform concept of the abusive character has been so far achieved, so that even if the principle prohibiting abuse of rights still adds something to the principle of good faith, it "is still in a rudimentary condition in international law, both as to its content and the method of its application".[806] As a result, the author believes that, despite the theoretical suitability in regard to the phenomenon herein studied, the principle prohibiting abuse of rights has not yet reached a consistent position in international law to figure as a legal basis on which tax treaty dodging could be qualified as an illegitimate act.

4.2.4. The principle of reciprocity as a limitation to tax treaty dodging

[802] Byers, *supra* n. 770, p. 412.

[803] See *supra* n. 800.

[804] "Lorsque les deux principles se recouvrent, il est en fait inutile de recourir à la notion de l'abus de droit, car l'obligation ancienne et incontestée de respecter la bonne foi suffit à engager la résponsabilité de l'auteur de l'acte incriminé" (Roulet, *supra* n. 770, pp. 125-126); "Issus de considerations morales identiques, ces principes possèdent cependant une portée inégale. S'ils se recouvrent, l'abus de droit perd alors de son importance, en raison de l'existence de l'obligation incontestée de se conformer aux règles de la bonne foi, laquelle conduit exactement au meme résultat. Ainsi en est-il chaque fois qu'un Etat exerce un droit de mauvaise foi, dans l'intention de nuire ou en détournant sciemment le but dans lequel la disposition a été adoptée" (Roulet, *supra* n. 770, p. 127).

[805] "Le principe de la bonne foi permet donc de limiter une fois de plus le champ d'application de l'abus de droit. (...) il ne permet pas d'éliminer, mais réduit dans une mésure considerable ses possibilities d'application" (Roulet, *supra* n. 770, p. 127).

[806] Fitzmaurice, *supra* n. 16, p. 54

The principle of reciprocity governs every international agreement[807] and, therefore, is also applicable to tax treaties. In this regard, reciprocity has a relevant and particular role when it comes to tax treaty dodging. In a case judged by the Dutch Supreme Court,[808] it was recognized that, where a contracting state after signing a treaty widened the scope of its domestic law so that it becomes equivalent to that of the other contracting state that had previously also changed its domestic law after signing the treaty, changes in domestic law are to be given effect for treaty purposes, even if that results in a shift of allocation of taxing rights.[809] Although still condemning later amendments to domestic law that have the effect of modifying the allocation of taxing rights, the Court indicated that the situation would be different where the other contracting state has also changed its domestic law; in such case, the equilibrium of the convention is not disturbed.[810]

The decision of the Dutch Supreme Court is a simple result of the application of reciprocity to tax treaty dodging cases. Accordingly, contracting states actions performed after the conclusion of tax treaties and in line with their wording, but modifying their effects, would not be an illegitimate act in case the treaty partner would also subsequently undertake an equivalent action. The role of reciprocity in this regard would be the one of creating an exception where, although having all elements for qualifying as tax treaty dodging, the action would not be condemnable, but rather justified in view of an equivalent dodging engaged by the treaty partner. In other words, the principle of reciprocity elevates the threshold for the qualification of the action as an illegitimate action.

Luc de Broe criticizes the position of the Dutch Supreme Court and the effects of the application of the reciprocity in this context. He alerts to the fact that a position in favour of the application of reciprocity in this regard would be an open invitation to retaliation measures, that is, to allow one state to respond to an earlier tax treaty dodging with another tax treaty dodging, and both dodging actions

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[807] B. Simma, *Reciprocity*, Max Planck Encyclopedia of Public International Law (Oxford University Press 2015), para. 4.
[808] NL: HR, 5 September 2003, 37.651, Tax Treaty Case Law IBFD. For details on the case, see Chapter 3, Section 3.3.1.2.
[809] de Broe, *supra* n. 55, p. 281.
[810] Engelen, supra n. 55, p. 494. "The question was whether, through the application of Art. 3(2) of the treaty, these undefined treaty terms could be given their meaning by reference to the notional employment compensation rules under Dutch domestic tax law. The Hoge Raad decided that such would be the case, unless the domestic rule would cause the income to be governed by another treaty article than would normally be the case for the type of income at issue, because in that case a shift in the right to tax the income could occur and such shift would not be consistent with the permanency of commitments that should result from the treaty. However, it is interesting to note that the Hoge Raad also expressly considered that the shift in the right to tax the income could not result from a change in law that occurred after the treaty was concluded and which would not have an equivalent in the domestic law of the other State, thereby implying that the notional income rules could have treaty effect if either (i) they existed when the treaty was concluded, or (ii) the other country would have an equivalent rule. That decision begs the question whether the application of *fraus legis* under domestic law could have treaty effect if the particular application thereof existed when the treaty was concluded, or if the recharacterization would equally take place in the other contracting State under its domestic and/or treaty rules" (B. J. Arnold & S. van Weeghel, *The Relationship between Tax Treaties and Domestic Anti-Abuse Measures*, Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), EC and International Law Series).

being eventually validated by the court.[811] According to him – and in spite of naming tax treaty dodging practices as treaty override - "treaty override is not a legitimate way by which a state can protect itself against override by another state".[812]

However, the effect allowing a retaliation of an infringement with another is an aspect which is inherent to reciprocity in itself. This means that this effect is not a particular downside effect when reciprocity is applied to tax treaty dodging cases, but it is an effect once applied in any international case. Rejecting the application of reciprocity for tax treaty dodging purposes under this argument means rejecting the application of the principle of reciprocity at all. As explained by Bruno Simma, "reciprocity as such has been transformed and developed into the sanctioning mechanisms of retorsion, countermeasures (reprisals), and non-performance of treaties due to breach. (...) Such action would be illegal if a previous internationally wrongful act had not furnished the ground for it, the aim being to compel the offending State to make reparation and/or desist from further illegal acts".[813] However, it is indeed understood that this effect of reciprocity is considered a serious threat to the stability of international law. It reveals the Janus-face of the concept: the potential of the same idea both to serve as a propelling force in the making and application of the law, and also to trigger the breakdown of international order.[814]

Luc de Broe also finds odd that a right to tax in one state revives because of a legislative action undertaken by another state. For him, it is not because one state aligns its tax legislation to that of the other state that taxpayers must submissively undergo the change in the domestic law and the shift in the allocation of taxing rights.[815] However, this is also a natural consequence of the application of the principle of reciprocity in regard to any legislative action – therefore, not necessarily in respect of legislative dodging. For example, in the same way a right to tax in one state revives because of a legislative action undertaken by another state in tax treaty dodging cases, a right to unilateral elimination of double taxation may revive because of a legislative action undertaken by another state in case of states conditioning the unilateral relief to reciprocity.[816]

The author believes that the relevant aspect to be taken into account when assessing whether reciprocity should or not make an exception in terms of illegitimacy of dodging actions (or omissions) is the potential of this principle to eventually nullify the effects of tax treaty dodging. As explained in Chapter 3,[817] dodging practices may result in the shifting of the allocation of taxing rights initially

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811 de Broe, supra n. 55, p. 282. He refers though to the measures as treaty override.
812 de Broe, supra n. 55, p. 283.
813 Simma, *supra* n. 807, para. 14-15.
814 Simma, *supra* n. 807, para. 16.
815 de Broe, *supra* n. 55, p. 283.
816 "Unilateral relief from international double taxation is sometimes granted subject to reciprocity (e.g. Brazil)" (Lang, *supra* n. 247, p. 31, marginal n. 19).
817 Section 3.4.

predicted or intended by treaty partners at the conclusion of the agreement.[818] However, as the Dutch Supreme Court correctly pointed out, when the equivalent dodging action (or omission) is undertaken by the treaty partner, the equilibrium of the convention is not disturbed. In other words, the allocation of taxing rights is re-equalized.

Another effect of tax treaty dodging is that residence states may refuse to grant relief from double taxation on the basis of the commentary on articles 23A and 23B of the OECD Model Convention (2017), that is, on the basis of the exceptions on the obligation to follow the qualification of the source state for double taxation relief purposes. This refusal to grant double taxation relief would create the problem of international double taxation for taxpayers. Again, in case the treaty partner implements an equivalent measure, it will be not only accepting but also interpreting and applying the treaty in the same manner as the other state.[819] It will consequently have no grounds to refuse the relief from double taxation originated from the same dodging actions. As a result, the application of reciprocity leads not only to the rebalance of the allocation of taxing rights, but also to the avoidance of double taxation.

As a result, the author concludes that the principles on interpretation of treaties in international law are a legal basis on which actions overstepping the limits there from derived (i.e. tax treaty dodging) can be qualified as an illegitimate behaviour. The question that follows is, thus, how far contracting states could go without overstepping this limitation. In other words, where is the line dividing the legitimate exercise of rights and the illegitimate act of tax treaty dodging. This question will be further addressed under Section 4.3. of this Chapter.

4.2.5. Obligation not to defeat the object and purpose of a treaty prior to its entry into force as a limitation to tax treaty dodging

Under article 18 of the Vienna Convention (1969), contracting states are obliged not to defeat the object and purpose of a treaty prior to its entry into force. In this respect, a state is obliged to refrain from acts which would defeat the object and purpose of a treaty when (i) it has signed the treaty or has exchanged instruments constituting the treaty subject to ratification, acceptance or approval (and until it shall have made its intention clear not to become a party to the treaty) or (ii) it has expressed its consent to be bound by the treaty, pending the entry into force of the treaty and provided that such entry into force is not unduly delayed.[820] This rule is particularly relevant for the assessment of the tax

[818] "It can therefore in my view be said that even when a tax treaty refers to the domestic law of one state, or is applied subject to the provisions of its domestic law, there may be situations where the other state may legitimately expect that state to align itself with the prevailing practice on that particular issue or interpretation of a treaty term in the international community of nations" (van der Bruggen, *supra* n. 55, p. 34).

[819] "(...) where both states operate a treaty in the same way after the treaty has been concluded, the result is the same as if they had agreed that this was its interpretation (...)" (Avery Jones, supra n. 492, section 3.4.7.).

[820] Art. 18 of the Vienna Convention (1969).

treaty dodging method by omission of legislatures (i.e. treaty underride), discussed in Chapter 3, Section 3.3.1.3. As explained in that Chapter, by not taking measures to properly incorporate or ratify tax treaties and subsequently give them effect, contracting states may prevent or circumvent the application of these signed agreements without breaching the wording of their provisions.

In Section 4.2.2., the author indicated that the principle of good faith may serve as a limitation to this tax treaty dodging method, on the basis of the secondary notion of good faith, under which international law requires states to implement the provisions of a treaty. This requirement is emphasized by article 18 of the Vienna Convention (1969), which goes further to specify that contracting states should refrain from acts that would defeat the object and purpose of a treaty that is signed (but not yet in force). Besides good faith (and taxpayer's fundamental rights, as described in Section 4.2.6.), this rule would serve as a legal basis, for example, against the omission of the Portuguese legislature in ratifying the new treaty signed with Finland or against the omission of the British legislatures in implementing treaty provisions that required domestic law for having effect in practice.[821] Indeed, the Draft Articles of the Vienna Convention with Commentaries (1966) explain that "an obligation of good faith to refrain from acts calculated to frustrate the object of the treaty attaches to a State which has signed a treaty subject to ratification appears to be generally accepted".[822]

The author concludes, therefore, that the obligation not to defeat the object and purpose of a treaty prior to its entry into as stated in article 18 of the Vienna Convention (1969) is a legal basis on which tax treaty dodging through legislature omission (i.e. treaty underride) can be qualified as an illegitimate behaviour.

4.2.6. Taxpayers' fundamental rights as a limitation to tax treaty dodging

As explained in Chapter 3,[823] taxpayers may suffer international double taxation as consequence of tax treaty dodging practice by states, as treaty partners may refuse to grant relief from double taxation on the basis of the commentary on articles 23A and 23B of the OECD Model Convention (2017),[824] that is, on the basis of the exceptions on the obligation to follow the qualification of the source state for double taxation relief purposes (i.e. different interpretation of facts or different interpretation of the provisions of the convention).[825] Taxpayer may also be negatively affected by tax treaty dodging

[821] For both cases, see Chapter 3, Section 3.3.1.3.
[822] UN, *supra* n. 294, commentary on art. 15 (current art. 18), para. 1 (emphasis added).
[823] Section 3.4.
[824] *OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B* (21 November 2017), Models IBFD, para. 32.5.
[825] The commentary on article 23A and 23B says that in case differences in domestic law qualification would make the source state apply a different article, this would still be considered an application in accordance with the treaty as interpreted by the source state and, therefore, the resident state would be obliged to grant the relief. However, the commentary makes an exception where the resident state is not obliged to grant relief in case the conflict results from

practices in the form of a higher tax burden resulting from the levy of taxes conveniently redesigned to no longer fall into the scope of tax treaties (and consequently their limitations). These consequences for taxpayers may be considered an infringement to their fundamental rights granted in a number of constitutions and human rights treaties so that they may be regarded as a legal basis on which tax treaty dodging may be considered an illegitimate behaviour.

In this respect, it has been argued that the fundamental right of enjoyment of property normally granted to taxpayers in many constitutions and human rights treaties could maybe impose on contracting states the duty to relieve double taxation which, once not complied with, would result in the infringement of such right.[826] For example, article 1 of the First Protocol to the European Convention of Human Rights lays down the general rule of protection of property by stating that "every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law".[827] It has been discussed whether the states signatories of this convention, and who have also adopted this protocol,[828] would have been under the obligation to relieve double taxation. The question would be the same for equivalent provisions in constitutions and other treaties on the subject, such as article 21 of the American Convention on Human Rights, which has a similar provision on the right to property.[829]

The European Commission of Human Rights and the European Court of Human Rights have already recognized that the imposition of an excessive tax burden in a way to fundamentally interfere with the person's financial position may constitute an infringement of the right to property.[830] However, cases are rare where the taxpayer has actually shown that the domestic tax law of a country had infringed this principle.[831] This excessive burden of tax could be considered as being the case of the extra charge

different interpretation of facts or different interpretation of the provisions of the convention (*OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B* (21 November 2017), Models IBFD, paras. 32.3. and 32.5).

826 P. Baker, *Double Taxation Conventions and Human Rights*, Tax Polymath – A Life in International Taxation (P. Baker & C. Bobbett eds., IBFD 2010), pp. 63-78.

827 *European Convention on Human Rights* (Council of Europe) - available at http://www.echr.coe.int/Documents/Convention_ENG.pdf, accessed 2 Feb. 2018), Protocol 1.

828 The European Convention on Human Rights is an international treaty between the states members of the Council of Europe. The protocols to the convention are optional, so member states may choose whether to accept them or not through ratification.

829 "Article 21. Right to Property. 1. Everyone has the right to the use and enjoyment of his property. The law may subordinate such use and enjoyment to the interest of society. 2. No one shall be deprived of his property except upon payment of just compensation, for reasons of public utility or social interest, and in the cases and according to the forms established by law. 3. Usury and any other form of exploitation of man by man shall be prohibited by law" (OAS, *American Convention on Human Rights*" (available at http://www.hrcr.org/docs/American_Convention/oashr.html , accessed on 2 Feb. 2018)).

830 For example, Kaira v. Finland (Application No. 27109/95) (available on HUDOC) and Wasa Liv v. Sweden (Application No. 13013/87), 58 DR 163 at 177-178 (Baker, *supra* n. 826, p. 74, footnote 25).

831 "An unusual, recent example was the case of Di Belmonte v. Italy (Application No. 72638/01) where a delay in payment of compensation meant that the payment was subject to a withholding tax which would not have been the case if the

levied with the view of escaping the application of treaties and of international double taxation that is not relieved by the state,[832] especially when this state has made a commitment to eliminate this double taxation under a signed a tax treaty.

However, the question is whether this consideration would remain valid when the treaty allows the state not to grant the relief in exceptional situations (for example, on the basis different interpretation of facts or different interpretation of the provisions of the convention). In other words, if a contracting state refuses to grant double taxation relief to a taxpayer under the argument that the treaty partner is engaged in treaty dodging practice, as explained in Chapter 3,[833] and that that state is in fact only reacting to a tax treaty dodging on the basis of the exception allowed by the treaty in order to preserve its taxing right, would this contracting state be nevertheless still violating the taxpayer's fundamental right of property?

The author believes that, despite being an interesting question (see more in Chapter 5)[834], it directly concerns the relationship between the taxpayer and the (offended) treaty partner, and not the taxpayer and the state engaged in dodging practices. Therefore, if the answer to this question is yes (that is, a violation of the taxpayer's fundamental right), the infringement of the fundamental right over property would be attributed directly to the (offended) treaty partner when reacting to treaty dodging (i.e. the offended state refusing to eliminate the double taxation), rather than to the state actually engaged in treaty dodging. In other words, tax treaty dodging itself does not violate taxpayer's fundamental rights directly; rather, the reaction of treaty partners does. In this sense, it is possible to argue that tax treaty dodging is *indirectly* violating taxpayers' fundamental right, because it is the original and only cause for the subsequent double taxation directly caused by the reaction of the offended state. Notwithstanding, the author believes that, in respect of the consequence of double taxation produced on the taxpayer, treaty partners denying the relief (i.e. the offended resident states) are accountable to a certain extent, as these states could make use of other measures available in order to prevent the other state from continue with the dodging action (see these available measures in Chapter 5), instead of simply transferring the burden (resulting from lost taxing rights it considered entitled to) to the taxpayer by not granting relief from double taxation and carry on with the application of the treaty.

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payment had been promptly made. The ECtHR held that the circumstances imposed an excessive and individual burden on the taxpayer concerned, and interfered with his right to property" (Baker, *supra* n. 826, p. 74, footnote 26).

[832] "Suppose, however, that the combined effect of two countries' tax laws, including the absence of effective measures to relieve double taxation, have exactly that effect. Neither country has individually imposed an excessive burden; in combination, however, the domestic tax laws of the countries and the lack of effective means of relieving double taxation have resulted in an excessive burden. This is not to impose on states a positive duty to avoid an overlap in tax jurisdiction, but rather to ensure that their tax system contains effective measures to relieve any double taxation which may result from claims to tax cross-border transactions. Perhaps there is at least some obligation on states to include unilateral provisions for the relief of double taxation in their laws or to seek to enter into a network of double taxation conventions" (Baker, *supra* n. 826, p. 74, footnote 26).

[833] Chapter 3, Section 3.4.

[834] Chapter 5, Sections 5.3.2. and 5.3.3.

On the other hand, such discussion does not exist in respect of the excessive burden directly caused by the state engaged in tax treaty dodging through the creation of extra charges falling out of the scope of treaties (by either redesigning the tax into a charge out of scope of the treaty or into a charged in a purely domestic scenario); that is, the violation in such cases would not be caused by a refusal of relief by the treaty partner, as no treaty relief applies in the first place. The direct connection between the tax treaty dodging action of the offending state and the effect on taxpayers makes it easier to argue that taxpayers' fundamental rights serve as a limitation for the redesign of taxes in a way to circumvent the application of the treaty. Taxpayer's fundamental rights may also serve as a legal basis limiting contracting states in respect of legislature omission: the non-implementation of treaty provisions into domestic law (treaty underride)[835] may prevent taxpayers from making use of rights granted to them in these agreements, such as elimination of double taxation; this would lead to an excessive tax burden directly cause by the omission of that state.

In brief, the author believes that the fundamental right over property granted under human rights treaties and several constitutions may not serve as a legal limitation to tax treaty dodging in cases where the effect on taxpayers is caused by the treaty partner (and not by the offending state) – but they do play an important role in those cases as a legal basis for taxpayers to request relief from double taxation, as explained in Chapter 5.[836] However, these rights may serve as a legal limitation to tax treaty dodging resulting in double taxation caused by legislature omission (treaty underride) and resulting in the excessive burden of a new redesigned charge.

4.2.7. Bilateral investment treaties as a limitation to tax treaty dodging

Like tax treaties, bilateral investment treaties play a relevant role in promoting cross-border investments, especially concerning those in developing countries. By creating a legal framework that intends to provide foreign investors with an adequate level of legal certainty and with a number of key investment-related guarantees, these treaties have become an important tool also in respect of tax matters. Some of the bilateral investment treaties' clauses are also relevant for this study as they may serve as a legal basis on which certain tax treaty dodging actions (those affecting non-resident investors) could be qualified as an illegitimate behaviour, for they may be violating obligations firmed and rights granted under bilateral investment treaties. In this sense, Arno Gildemeister acknowledged that "the incorrect application of rules contained in the tax treaty could (or could be alleged to) breach the obligations enshrined in the investment treaty".[837]

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[835] Chapter 3, Section 3.3.1.3.

[836] Chapter 5, Sections 5.3.2. and 5.3.3.

[837] A. E. Gildemeister, *Germany*, The Impact of Bilateral Investment Treaties on Taxation (M. Lang et al. eds., IBFD 2017), Online Books IBFD, section 12.2.

Bilateral investment treaties may though exclude certain matters from their scope of application through the so-called carve-out clauses. A number of treaties do include carve-out clauses specifically drafted to exclude tax matters from treaty protection - this means that, in the absence of these clauses, taxation is regarded as covered in its entirety by bilateral investment treaties.[838] However, the way carve-out clauses are drafted varies considerably so that, in practice, many tax-related matters claims are being adjudicated by international arbitral tribunals on the basis of bilateral investment treaties even in cases where those treaties contain such provisions.[839] First, many of the carve-out provisions in treaties are not applicable to expropriation,[840] so that tax matters may be considered to violate bilateral investment treaties despite the existence of carve-out clauses to the extent that they can be qualified as expropriation.[841] Also, according to Daniel Uribe and Manuel Montes, "the broad language and lack of clarity in the drafting of such provisions have effectively allowed Investor-State Dispute Settlement (ISDS) tribunals to scrutinize tax measures adopted by States, and even determine that such measures resulted in a breach of State's obligations under the agreement".[842] In such cases, the interpretation of what the term "tax measures" means and the broad interpretation of other bilateral investment treaty clauses allowed arbitral tribunals to exclude a tax measure from the scope of the tax carve-out provision.[843] For example, in the case *Occidental v. Ecuador*,[844] an Ecuadorian law (Law 42) which required all companies operating under participation contracts to pay a windfall profits tax (i.e. at a 50% rate on their windfall revenues) was considered to be in breach of the fair and equitable treatment clause as a measure "tantamount to expropriation",[845] even though a carve-out clause

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[838] P. Pistone, *General Report*, The Impact of Bilateral Investment Treaties on Taxation (M. Lang et al. eds., IBFD 2017), Online Books IBFD), sec. 1.3.1. One of the main reasons for tax carve-outs to be included in bilateral investment treaties is the understanding that taxation is a sovereign right that should only be restricted in extremely exceptional cases (P. H. M. Simonis, *BIT and Taxes*, 42 Intertax 4 (Kluwer Law International 2014), pp. 234-274, at p. 239; M. Davie, *Taxation-Based Investment Treaty Claims*, Journal of International Dispute Settlement 8, (Oxford University Press 2015), pp. 202-227, at pp. 218-219). It has also been argued that another reason is the fact that mutual agreement procedures granting taxpayers the right to bring claims before the contracting states have been already incorporated in most tax treaties (D. Uribe & M. F. Montes, *Building a Mirage: The Effectiveness of Tax Carve-out Provisions in International Investment Agreements*, Investment Policy Brief 14 (South Centre 2019), p. 1).

[839] Uribe & Montes, *supra* n. 838, p. 1. According to a recent study prepared by the Transnational Institute and Global Justice Now, 28 tax-related dispute procedures have been brought against states by private investors on the basis of bilateral investment treaties; all of them contained tax carve-out clauses (Uribe & Montes, *supra* n. 838, p. 6).

[840] Simonis, *supra* n. 838, p. 253.

[841] See J. Bédard et al., *The 'Law 42' Arbitrations Against Ecuador and the Importance of BIT Language* (Skadden's Insights 2015), available at https://www.lexology.com/library/detail.aspx?g=cfade941-dd9a-46a0-b937-6b88f7733721 (accessed 4 Dec. 2019).

[842] *Ibid.* For a list of tax 'carve-out' clauses in different bilateral investment treaties used as basis for claims on tax-related cases, see Uribe & Montes, *supra* n. 838, annex.

[843] Uribe & Montes, *supra* n. 838, p. 6. See also decision in *Occidental v. Ecuador* (footnote 844).

[844] ICSID *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. The Republic of Ecuador,* Case ARB/06/11 (5 October 2012), available at https://www.italaw.com/cases/767 (accessed 5 Dec. 2019).

[845] "876. For all of the foregoing reasons, and rejecting all submissions and contentions to the contrary, the Tribunal DECLARES, AWARDS and ORDERS as follows in respect of the issues arising for determination in these proceedings: (i) Ecuador acted in breach of Article II.3(a) of the Treaty by failing to accord fair and equitable treatment to the Claimants' investment, and to accord the Claimants treatment no less [favourable] than that required by international law; (ii) Ecuador

excluded taxation-based claims from that standard. A similar example of the relative effectiveness of tax carve-out clauses is the case *Yukos,*[846] where the tribunal indicated that the carve-out clause of the treaty could only apply to bona fide taxation actions.[847]

Considering the scenario where a bilateral investment treaty is applicable to tax matters (either in the absence of tax carve-out clauses or by way of interpretation of the relevant clauses), these treaties may be considered to be violated by tax treaty dodging practice. This may be the case of provisions in bilateral investment treaties aiming at providing additional protection to foreign investors and at safeguarding the obligations host states have made in respect of the investment (i.e. the "umbrella clauses"). Although these clauses are quite frequent in modern bilateral investment treaties, the language used may vary considerably[848] so that each particular clause may have a specific scope and effect. However, most of these clauses generally use a mandatory language (e.g. "states shall observe" or "states shall do all in its power") and refer to obligations undertaken by the contracting state.[849] The scope of these clauses has been object of discussions for decades, but the interpretation given by the majority of arbitral tribunals in respect of umbrella clauses drafted in broad and inclusive terms is in the sense that they are comprehensive enough to cover all state obligations.[850] It has not only been recognized that these clauses affect tax matters[851] but also that the double taxation caused when a state fails to apply a tax treaty or overrides it by national legislation could potentially be conceived by investors as violation of the umbrella clause.[852] Indeed, as explained in Chapter 3,[853] taxpayers may be subject to double taxation or simply higher tax burden as consequence of tax treaty dodging and,

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acted in breach of Article III.1 of the Treaty by expropriating the Claimants' investment in Block 15 through a measure "tantamount to expropriation"" (*Ibid.* para 876). See also comments on this decision in Bédard et al., *supra* n. 841.

[846] "The Yukos case was the subject of several judgments, namely RosInvestCo UK Ltd. v. Russian Federation, SCC, Final Award of 12 Sep. 2010; Quasar De Valores SICA S.A., et al. v. Russian Federation, SCC, Award of 20 July 2012 (formerly known as Renta 4 S.V.S.A., et al. v. Russian Federation; Hulley Enterprises Limited (Cyprus) v. Russian Federation, PCA Case No. AA 226, Final Award of 18 July 2014; Veteran Petroleum Limited (Cyprus) v. Russian Federation, PCA Case No. AA 228, Final Award of 18 July 2014; and Yukos Universal Limited (Isle of Man) v. Russian Federation, PCA Case No. AA 227, Final Award of 18 July 2014. See also the decision of setting aside: Yukos Universal Limited (Isle of Man) v. The Russian Federation, Decision of Antwerp Court of First Instance, 24 June 2016" (Pistone, *supra* n. 838, footnote 116)

[847] Accordingly, the tax carve-out clause "can apply only to bona fide taxation actions, i.e., actions that are motivated by the purpose of raising general revenue for the State. By contrast, actions that are taken only under the guise of taxation, but in reality aim to achieve an entirely unrelated purpose (such as the destruction of a company or the elimination of a political opponent) cannot qualify for exemption from the protection standards of the ECT under the taxation carve-out in Article 21(1)" (Pistone, *supra* n. 838, sec. 1.6.2.).

[848] Some clauses cover disputes relating to an "obligation under this treaty", others extend the jurisdiction to "any dispute relating to investments", while others create an international law obligation for host states to "observe any obligation it may have entered to" or "constantly guarantee the observance of the commitments it has entered into", etc. (K. Yannaca-Small*, Interpretation of the Umbrella Clause in Investment Agreements*, OECD Working Papers on International Investment n. 2006/03 (OECD 2006), p. 3).

[849] *Ibid*, p. 9.

[850] Yannaca-Small, *supra* n. 848, p. 22.

[851] Pistone, supra n. 838, section 1.3.3.

[852] Gildemeister, *supra* n. 837, section 12.2.

[853] Section 3.4.

therefore, this state practice could amount to a violation of the guarantee provided to foreign investor under the umbrella clause in bilateral investment treaties.

Two other clauses in bilateral investment treaties that may be considered to be violated by tax treaty dodging practices are the fair and equitable treatment clause and, to a certain extent, the expropriation clause. The fair and equitable treatment clause has served as a basis for taxpayers to bring claims against tax measures in a number of cases.[854] The different ways in which the fair and equitable treatment clauses are formulated in bilateral investment treaties result in different interpretations given by governments. However, an analysis by an OECD paper[855] on opinions of arbitral tribunals identified elements which, in isolation or combination, have been treated as encompassed in the standard treatment.[856] These elements can fall into the five following categories: obligation of vigilance and protection (i.e. obligation to exercise due diligence in protecting foreign investment, including full protection and security), due process (i.e. protection against denial of justice), transparency, good faith (as combination of legitimate or basic expectations, transparency and lack of arbitrariness), and autonomous fairness elements.[857] Most of these elements, which are already grounded in international customary law, may limit tax treaty dodging actions (or omissions) affecting non-resident investors, since this practice leads to the unfair outcome of double and/or higher taxation that is beyond the reasonable expectation of the foreign investor at the moment when investing in the host country. As confirmed by Arno Gildemeister, "if a state fails to apply a tax treaty or overrides it by national legislation, this can have detrimental effects (such as double taxation) for individual investors. Such double taxation could potentially be conceived of by investors as violation of a BIT [bilateral investment treaty]; e.g. of the FET [fair and equitable treatment] standard ('a breach of legitimate expectations') or of an umbrella clause".[858]

The double taxation and higher tax burden as consequences of tax treaty dodging may be considered an infringement to taxpayers' fundamental right of enjoyment of property granted in a number of constitutions and human rights treaties, as explained in Section 4.2.6. The same rationale applies in respect of the right against expropriation under bilateral investment treaties, with the remark that taxation may indirectly[859] result in expropriation to the extent that the imposition of tax causes a substantive deprivation of the investment or makes it impossible for the investor to continue his

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[854] Uribe & Montes, *supra* n. 838, p. 7.
[855] OECD, *Fair and Equitable Treatment Standard in International Investment Law*, OECD Working Papers on International Investment n. 2004/03 (OECD 2004).
[856] *Ibid.*, p. 40.
[857] OECD, *supra* n. 855, pp. 26-39.
[858] Gildemeister, *supra* n. 837, section 12.2.
[859] When a state interferes in the enjoyment of an investment, strongly depreciating its economic value without a direct taking of property (UN Committee of Experts on International Cooperation in Tax Matters, *Secretariat Paper: The Interaction of Tax Trade and Investment Agreements – Eighteenth session 23-26 April 2019*, E/C.18/2019/CRP.14 (8 April 2019), p. 13).

activity[860], as was in the cases *Yukos*,[861] *Antoine Goetz & consorts v. République du Burundi* (1999)[862] and to a certain extent, *Lone Star*.[863] Notwithstanding, expropriation has been recognized in tax matters when such matters are found to be abusive[864] (which may be the case of taxes levies as a result of tax treaty dodging practices), so that could be possible to argue that the level of deprivation (quantitative limit) is alone not determinant of expropriation, but rather that other aspects should also be considered. In this direction, an OECD paper on the topic concludes that relevant jurisprudence reveals the following criteria used by tribunals to distinguish indirect expropriation and non-compensable regulatory measures: "i) the degree of interference with the property right, ii) the character of governmental measures, i.e. the purpose and the context of the governmental measure, and iii) the interference of the measure with reasonable and investment-backed expectations determining whether a measure falls into the category of indirect expropriation has required tribunals to undertake a thorough case-by-case examination and a careful consideration of the specific wording of the treaty".[865]

Although not common, tax stabilization guarantees that may be provided in those treaties may also offer legal protection to investors against changes in tax legislation or against "adverse changes" in tax regimes.[866] They may thus be considered breached by, for example, a legislative dodging. The aim of

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860 Pistone, *supra* n. 838, sec. 1.6.1. "Confiscatory taxation should, however, not be assimilated to expropriation under investment law. Indeed, the application of high taxes to items of income or capital under the tax laws of the host state would not necessarily amount to an expropriation under BITs, in the absence of specific circumstances establishing the specific hindrance to the investment" (E. Traversa & I. Richelle, *Belgium*, The Impact of Bilateral Investment Treaties on Taxation (M. Lang et al. eds., IBFD 2017 Online Books IBFD, section 4.6).

861 See *supra* n. 846.

862 "(...) the Burundi administration withdrew the investor's license to operate in an economic free zone. The license provided entitlement to tax and import duty rebates. The withdrawal was found by the Tribunal to result in an indirect expropriation under the Belgium-Luxembourg Burundi BIT" (Traversa & Richelle, *supra* n. 860, section 4.6.).

863 "At stake is the determination of Lone Star subsidiaries' fiscal residence: the company claims that the Korean tax administration characterized the entity investing in the country differently (first as a US company, then a Korean one) according to the investment carried out, so as to maximize the tax due" (*Ibid.*)

864 Pistone, *supra* n. 838, sec. 1.6.1. In the case UNCITRAL, *Link-Trading Joint Stock Company v. Department for Customs Control of the Republic of Moldova*, (16 February 2001) (available at https://www.italaw.com/cases/628, accessed 5 Dec. 2019) the decision included the following: "The question is then 'what constitutes indirect expropriation?'. Here, the BIT [bilateral investment treaty] gives little guidance and it is necessary to consider international law and practice. (...) precedents do exist in international practice that would consider a State's disregard of legislatively granted rights as tantamount to expropriation. (...) The tribunal does not attempt at this stage in the proceedings to make any finding as to the soundness of Claimant's allegation that the stabilization guarantees in the Moldovan regulations prohibited a change in the customs exemption applicable to purchases within the FEZ [free economic zone]. Nor do we address the question of whether the changes in exemptions were of such a magnitude as to constitute an indirect expropriation *per se*. It might in this connection be relevant to consider whether the measures taken were reasonable and usual in the light of general practice in other countries of the world, whether the measures had a discriminatory character or were of general application, and other specific facts related to the present circumstances." (pp. 9-10).

865 OECD, *"Indirect Expropriation" and the "Right to Regulate" in International Investment Law*, OECD Working Papers on International Investment n. 2004/04 (OECD 2004), p. 22.

866 Uribe & Montes, *supra* n. 838, p. 8; Pistone, *supra* n. 838, section 1.3.3. "For example, in the Duke Energy International Peru Investments case an investment tribunal applied the umbrella clause to protect the investor after tax authorities had recharacterized a merger as a sham transaction concluded solely for tax benefits" (Pistone, *supra* n. 838, section 1.3.3.).

such clauses is to restrain the right of a state to modify its legislation in order to increase the predictability of the regulatory environment in which the investor will operate (e.g. protecting royalty rates, repatriation, limiting tax reforms, etc.).[867]

The author concludes, therefore, that the umbrella clauses, the fair and equitable treatment clauses, the expropriation clauses and tax stabilization clauses in bilateral investment treaties may serve as a legal basis on which tax treaty dodging targeting foreign investors may be qualified as an illegitimate behaviour. For example, in the case of executive dodging through public-private agreements, such as the one where Indonesia issued an instruction increasing its production share in the production sharing contracts signed with foreign investors in order to compensate for the charge of the branch profit tax at a lower rate under a tax treaty – therefore, restricting in practice the effect of the benefit granted under the treaty (see details in Chapter 3, Section 3.3.2.) – could be considered a violation of a bilateral investment treaty signed by the host state.

Finally, bilateral investment agreements may also provide taxpayers with the possibility of solving tax treaty dodging disputes through a more advantageous international arbitration procedure and of demanding adequate compensatory measures, as explained further in Chapter 5, Section 5.3.1.

4.2.8. Answer to the first part of the research question

On what legal basis the exercise of rights by contracting states in conformity with the wording of tax treaties but having an impact on the outcome of such agreements to their own benefit could be qualified as an illegitimate[868] act?

On the basis of the principles of interpretation of treaties in international law, the principle of good faith, the principle of reciprocity, the obligation not to defeat the object and purpose of a treaty prior to its entry into force, taxpayers' fundamental rights granted by international treaties and constitutions, and bilateral investment treaties, the exercise of rights by contracting states in conformity with the wording of tax treaties but having an impact on the outcome of such agreements to their own benefit may be qualified as an illegitimate act, referred to as tax treaty dodging in this study. In other words, the exercise of rights by contracting states in conformity with the wording of tax treaties but having an impact on the outcome of such agreements in a way that violates the principles of interpretation of treaties in international law, the principle of good faith, the principle of reciprocity, the obligation not to defeat the object and purpose of a treaty prior to its entry into force or taxpayers' fundamental

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Stabilization clauses have however rarely been used by developed countries in view of possible unconstitutionality in that they go against the widely accepted principle that one legislature cannot bind a future legislature, and that an executive act of government cannot bind a legislative body (Pistone, *supra* n. 838, footnote 26).

[867] Uribe & Montes, *supra* n. 838, p. 8.

[868] See *supra* n. 1 and 2.

rights granted by international treaties and constitutions, and bilateral investment treaties, is considered an illegitimate act qualified in this thesis as a tax treaty dodging.

4.3. Tax treaty dodging *v* legitimate exercise of rights: the dividing line

The first part of the research question addressing the legal basis on which tax treaty dodging practices could be qualified as an illegitimate behaviour was answered in the previous section. That section concluded that the principles of interpretation of treaties in international law, the principle of good faith, the principle of reciprocity, the obligation not to defeat the object and purpose of a treaty prior to its entry into force, taxpayers' fundamental rights and bilateral investment treaties are principles and rules able to limit the exercise of rights by contracting states and, thus, may serve as legal bases for condemning actions (or omissions) overstepping these limits.

The question remaining after the identification of the legal bases qualifying tax treaty dodging as an illegitimate act is how far contracting states can go without overstepping the limitations imposed. This section intends to identify, therefore, the extent to which contracting states are limited by the legal bases identified in the previous section in order to answer, to the extent that is possible, the sub-question of the research question of this study, which is: *where is the dividing line between a legitimate exercise of rights by contracting states and such illegitimate*[869] *acts under international law?*

The extent to which contracting states may act without overstepping limits imposed by certain rules and principles must be assessed on the basis of the elements provided by the very same rules and principles. For instance, if a state's action may be considered as illegitimate by a specific rule, it is expected that such rule spell out the limits to be observed. In the next sections, the author investigates the elements provided by the principles of interpretation of treaties in international law, the principle of good faith, the principle of reciprocity, the obligation not to defeat the object and purpose of a treaty prior to its entry into force, taxpayers' fundamental rights and by bilateral investment treaties for the assessment of the line dividing the legitimate exercise of rights by contracting states and illegitimate acts herein referred to as tax treaty dodging. The reader will see that some elements derived from these legal bases may offer some guidance to interpreters for the assessment, on a case-by-case basis, of whether states have gone too far when exercising rights in the context of tax treaties.

4.3.1. Good faith, context, subsequent agreements and practice, object and purpose, reciprocity and supplementary means of interpretation (as elements from the principles of interpretation of treaties in international law)

The first legal basis providing elements for assessing the line dividing legitimate exercise of sovereign rights and tax treaty dodging is the principles of interpretation of treaties in international law.

[869] See *supra* n. 1 and 2.

However, as indicated by John F. Avery Jones, "essentially, (...) these provisions, while limiting the material that may be used in coming to the primary interpretation under article 31 of the Vienna Convention (1969), do not tell the interpreter how to use them, apart from saying that the treaty is to be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context (as so defined), and in the light of its object and purpose (necessarily also determined by its terms). A great deal of leeway is, therefore, left to the interpreter".[870] In this respect, the author agrees that the main elements in the principle of interpretation have limitations in providing a clear and precise pre-determined threshold. However, the author investigated each principle of interpretation and made efforts to derive from these rules all elements that could serve as relevant guidance for interpreters when assessing the dividing line between legitimate exercise of rights by states and tax treaty dodging.

Good faith

The analysis on the principle of good faith is presented in the section 4.3.2. This analysis also applies for article 31 of the Vienna Convention (1969), so that it can be concluded that good faith found within the principles of interpretation of treaties delimitates illegitimate tax treaty dodging as being contracting states' actions that intentionally go beyond what is honest, reasonable and fair considering the circumstances of the case.

Context

On the other hand, the context within the meaning of article 31 of the Vienna Convention (1969) brings a more objective element for the assessment of a threshold. The context in this article comprises, in addition to the text (including its preamble and annexes), any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty and any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.[871] According to this rule, the text of the treaty must be read as a whole – and not focusing on a paragraph, article or any other part[872] - and in connexion with other related instruments.[873] In case of tax treaties, these related instruments normally include notes and letters exchanged at the time of the conclusion of the treaty.[874] Therefore, for determining whether contracting states went too far on the basis of the context in the principle of interpretation of treaties, one must observe instruments and agreements related to the treaty under

[870] Avery Jones, *supra* n. 492, section 3.3.
[871] Article 31(2) of the Vienna Convention (1969). Unilateral documents cannot be regarded as forming part of the context unless they were made in connection with the conclusion of the treaty and their relationship to the treaty was accepted in the same manner by the other parties (UN, *supra* n. 294, at commentary on art. 27 (current art. 31), para. 13).
[872] Sinclair, *supra* n. 278, p. 127.
[873] Sir Ian Sinclair explains that these related instruments must be concerned with the substance of the treaty and clarify concepts of the treaty or limit its application. He adds that any instrument fulfilling these requirements are to be seen not as part of the *travaux préparatoires*, but rather as an element in the general rule of interpretation (Sinclair, *supra* n. 278, p. 129).
[874] Vogel et al., *supra* n. 36, p. 37, marginal n. 70a.

analysis. Related instruments may be helpful, for instance, to indicate the meaning treaty partners may have had in mind for a certain undefined term.

Subsequent agreements

Article 31(3) of the Vienna Convention (1969) brings other elements that must be taken into account together with the context for the purpose of interpretation. The first element is any subsequent agreement signed by the contracting parties regarding the interpretation of the treaty or the application of its provisions. In this respect, for assessing whether contracting states went too far in their actions, not only the interpreter must take into account any agreement or instrument relating to the treaty and in connexion with its conclusion (the context itself – see above), but also any agreement signed *after* the conclusion of the treaty, regarding its interpretation. For example, article 25(3) of the OECD Model Convention (2017) on the mutual agreement procedure indicates that "the competent authorities of the contracting states shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention". This mutual agreement may be considered a subsequent agreement signed by the contracting parties regarding the interpretation of the treaty or the application of its provisions.

Only interpretative agreements are considered within the scope of article 31(3) of the Vienna Convention (1969). As a result, agreements that do not interpret but modify the treaty cannot be qualified as subsequent agreements for the purpose of this rule.

Subsequent practice

The second element to be taken into account together with the context is the subsequent practice in the application of the treaty. Subsequent practice in the application of a treaty may establish the understanding of the parties regarding its interpretation according to the wording of article 31(3) of the Vienna Convention (1969).[875] This is particularly relevant in the case of tax treaty dodging, since if a state has abstained from protesting against a consistent practice of another state in the application of a treaty, or against a notified significant change in domestic law,[876] it could be assumed this silence to configure sufficient practice that would establish agreement by that state. In other words, the lack of an official protest[877] may lead to a change in the understanding of the parties regarding the

[875] "There shall be taken into account, together with the context: (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation; (c) any relevant rules of international law applicable in the relations between the parties" (Article 31(3) of the Vienna Convention (1969)).
[876] Article 2(4) of the OECD Model Convention (2017) provides for the notification by a contracting state of significant changes made to its taxation laws. This means that the treaty partner must be thus aware of them and has the opportunity to protest.
[877] On official protest in case of tax treaty dodging, see Chapter 5, Section 5.2.1.

interpretation of the treaty[878] so to legitimate a potential dodging act. According to Alexander Rust, "if a domestic provision is not in line with a treaty provision, the subsequent agreement of the contracting States that the domestic provision does not violate will change the treaty so that the domestic provision no longer is in contradiction to the treaty. The same is true if one contracting State enacts a provision contrary to a treaty and the other contracting State does not object. After a certain amount of time has elapsed, the treaty overriding domestic provision turns into a treaty respecting domestic provision since the content of the treaty has changed".[879]

That was the case of the judgement by the United Kingdom Supreme Court on whether or not a European Arrest Warrant that had been issued by a Swedish public prosecutor had been issued by a "judicial authority" in accordance with legal requirements.[880] Since there had been no evidence that any executing state objected to surrendering a person on the grounds that a warrant issued by a public prosecutor, it was considered that that lack of objection would constitute sufficient practice establishing an agreement by the states.[881] As explained by one of the judges: "this is powerful evidence that even those Member States whose issuing judicial authorities are judges acquiesce in EAWs [European Arrest Warrants] being issued in other Member States by public prosecutors. That is a sufficient practice to establish agreement by the Member States".[882]

However, the question regarding the extent to which a lack of objection would constitute a subsequent practice capable of establishing an agreement or understanding on treaty interpretation is also pertinent in the present case. A dissenting opinion raised this aspect by stating that the lack of objection was not sufficient to establish the agreement of the parties: "while the practice need not be that of all the parties to the treaty (as in this case it obviously is not) the practice has to be such as to establish the agreement of all the parties as to its interpretation. Given the lack of common or concordant practice between the parties, is the failure to date of those countries which do not authorise prosecutors and other bodies to object to those who do sufficient to establish their agreement? Nobody in this country seems to have addressed their mind to the issue until it arose in this case. Failure to address minds to an issue is not the same as acquiescence in a particular state of affairs".

[878] "Not objecting to a treaty override not only means loss of rights under Art. 60 VCLT but can also lead to a change in the content of the tax treaty. According to Art. 31 (3) lit. b VCLT, any subsequent practice in the application of the treaty that establishes the agreement of the parties regarding its interpretation shall be taken into account for purposes of interpreting the treaty. Subsequent practice can influence the content of a treaty. If a domestic provision is not in line with a treaty provision, the subsequent agreement of the contracting States that the domestic provision does not will change the treaty so that the domestic provision no longer is in contradiction to the treaty. The same is true if one contracting State enacts a provision contrary to a treaty and the other contracting State does not object. After a certain amount of time has elapsed, the treaty overriding domestic provision turns into a treaty respecting domestic provision since the content of the treaty has changed" (Rust, *supra* n. 19, pp. 241-243).

[879] *Ibid.*

[880] Avery Jones, *supra* n. 492, section 3.4.7., on the case *Assange v. The Swedish Prosecution Authority* (30 May 2012), [2012] UKSC 22.

[881] *Ibid.*

[882] Avery Jones, *supra* n. 492, section 3.4.7., citing the case *Assange v. The Swedish Prosecution Authority* (30 May 2012), [2012] UKSC 22.

The author believes that one must take into account the importance, recurrence and notoriety of the dodging practice for establishing whether it could be reasonably expected from an offended state to be in the position to officially protest against such act – see more on this in Chapter 5, Section 5.2.1.

In addition to the omission of a state (i.e. lack of protest) being able to configure sufficient practice that would establish agreement by that state in respect with the dodging action (or omission) of the treaty partner, subsequent practice may also legitimate dodging behaviour through an action (or omission) of the offended state. According to John F. Avery Jones, "where both states operate a treaty in the same way after the treaty has been concluded, the result is the same as if they had agreed that this was its interpretation, they saw no need to agree the interpretation as such. It should be noted that the rule is limited to subsequent practice that establishes the agreement of the parties regarding its interpretation, so that both (or all in a multilateral treaty) states must adopt the same practice, or at least knowingly accept the other state(s) doing so if the practice is inapplicable to one state".[883] In this respect, for instance, it may be argued that a change in domestic law undertaken by a state equivalent to a previous change in domestic law implemented by its treaty partner could be seen as a subsequent practice establishing an agreement between these two states on the interpretation and application of the treaty and, therefore, this change must be given effect.[884] Following this line of thought, if the change in domestic law would qualify as a tax treaty dodging, for instance, the dodging practice would have to be given effect as an exception, much as - and under the same rationale as - it would be accepted as an exception on the basis of the principle of reciprocity explained in Sections 4.2.4. and 4.3.3. However, the author understands that a change in domestic law undertaken by a state equivalent to a previous change in domestic law implemented by its treaty partner does not necessarily mean an agreement between those states on the interpretation and application of the treaty. A careful analysis case by case is needed in order to verify whether the subsequent change by the offended state was in fact implemented as a countermeasure (see Section 5.2.7.) rather than an agreement on the interpretation of the offending state.

Therefore, subsequent practice is also an important element provided by the principles of interpretation of treaties for the delimitation of tax treaty dodging, since it elevates the threshold (i.e. makes it more difficult) for actions (or omissions) to be qualified as illegitimate acts. In other words, certain practices in principle meeting conditions for being considered tax treaty dodging may eventually be legitimated in view of subsequent practice. The author believes that this second element to be taken into account with the context plays a special role in the assessment of the dividing line and should always be observed by interpreters before concluding on whether states went or not too far when exercising their rights.

R*eciprocity*

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[883] Avery Jones, *supra* n. 492, section 3.4.7.

[884] de Broe, *supra* n. 55, p. 283.

The last element to take into account together with the context in the process of interpretation is any relevant rules of international law applicable in the relations between the parties. For the purpose of this study, the author identified *reciprocity* as a relevant rule of international law for the assessment of the dividing line between the legitimate exercise of rights and tax treaty dodging. This is dealt with under reciprocity as an element from the principle of reciprocity, in Section 4.3.3.

Object and purpose

Besides good faith and the context (as well as the elements to be taken into account with the latter), article 31 of the Vienna Convention (1969) refers to the object and purpose of treaties as part of the general principle of interpretation. The object and purpose is considered as secondary or ancillary in the application of the general principle of interpretation.[885] According to Sir Ian Sinclair: "the initial search is for the 'ordinary meaning' to be given to the terms of the treaty in their 'context'; it is in the light of the object and purpose of the treaty that the initial and preliminary conclusion must be tested either confirmed or modified (...). The text is the expression of the intention of the parties; and it is to that expression of intent that one must first look".[886] It is therefore necessary to first start with the words of the text, considered in its (documentary) context (e.g. contemporaneous and subsequent agreements and practice), and then look at this material in the light of the object and purpose of the treaty as a whole.[887]

However, the object and purpose, which may be elucidated in the preamble of the treaty, may be perceived in different manners. As already remarked, "the taxpayer hopes the treaty will prevent the double taxation of his income; the tax gatherer hopes the treaty will prevent fiscal evasion; and the politician just hopes".[888] Indeed, taxpayers, governments and international organisations may have different views on what the object and purpose of tax treaties is.

[885] Sinclair, *supra* n. 278, p. 130.
[886] Sinclair, *supra* n. 278, pp. 130-131. In the same direction: "(...) such purpose is subordinated to the wording of the treaty by the rule of article 31 that the purpose shall influence interpretation merely by giving 'light' to the terms of the treaty. In other words, 'purpose' is not itself an independent means of interpretation" (Vogel et al., *supra* n. 36, p. 37, marginal n. 69); "This is also necessarily a secondary consideration to the text and context, which are to be interpreted in the light of its (the treaty's) object and purpose. Logically, therefore, it is necessary to start with the words of the text that is being interpreted, which is considered at the same time in its (documentary) context, which, in turn, because of the definition of context, may include material not forming part of the treaty, such as contemporaneous agreements and subsequent agreements and practice, and then look at this material in the light of the object and purpose of the treaty as a whole as demonstrated by those documents" (Avery Jones, *supra* n. 492, section 3.4.10.).
[887] Avery Jones, *supra* n. 492, section 3.4.10.
[888] A. McKie at the 22nd Tax Conference of the Canadian Tax Foundation, quoted by P. Gravelle, Tax Treaties: Concepts, Objectives and Types, Bull. IBFD (1988 IBFD), quoted from P. Baker, *Double Taxation Conventions: A Manual on the OECD Model Tax Convention on Income and on Capital* (Thomson/Sweet & Maxwell 2019), p. B-3, marginal n. B.06.

The determination of what the object and purpose of the treaty means is important in the sense that it may determine which interpretation should be followed and, consequently, whether a certain contracting state action (or omission) is or not allowed, despite not contradicting the wording of the treaty. For example, if one understands the object and purpose of treaties as including the prevention of tax avoidance and evasion, certain domestic anti-avoidance rules would be seen as being in line with the object and purpose of tax treaties, and therefore tax treaties would in principle not be an impediment to the application of these rules.[889]

Statements from government officials and courts generally focus on the object and purpose of tax treaties of avoiding double taxation and preventing fiscal evasion.[890] They may also add, as it was later done by the United Nations, the provision of exchange of information and mutual assistance in the collection of taxes, elimination of discriminatory taxation, etc. as also being purposes of tax treaties.[891] Taxpayers, on the other hand, may see tax treaties as providing some guidance and limited guarantee on tax treatment when investing in other countries, as protecting against double taxation and as providing exemptions and reductions of tax.[892]

According to the OECD, the *main* object and purpose of tax treaties was (and may continue to be irrespective of the changes resulted from BEPS Project – see further below) the elimination of international juridical double taxation as an obstacle to international trade and investment.[893] The OECD later indicated in the commentaries that the prevention of tax avoidance and tax evasion (sometimes referred to also as prevention of double non-taxation) was also a purpose of tax treaties, while keeping the avoidance of double taxation still as the main purpose of treaties.[894] By then, the

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[889] "(...) an underlying assumption of treaties is that they are only intended to benefit bona fide residents (...). Thus, I think the override was justified because it is consistent with the underlying purpose of the treaties. (...) Again, I believe that since the underlying assumption of treaties (embodied in Art. 1) is that they are only intended to benefit bona fide residents, the override was justified because it is consistent with the underlying purpose of treaties. (...) I believe the override was justified because the purpose of tax treaties is to prevent double taxation and not enable double non-taxation" (Avi-Yonah, *supra* n. 34, pp. 76-78); Baker, *supra* n. 888, p. F-9, marginal n. F.08.

[890] Baker, *supra* n. 888, p. B-4, marginal n. B-07.

[891] Baker, *supra* n. 888, pp. B-5 and B-6, marginal n. B.08 and B.09.

[892] Baker, *supra* n. 888, p. B-7, marginal n. B-10.

[893] The OECD Model referred to the elimination of international juridical double taxation as the *main* or *principal* purpose of treaties (*OECD Model Tax Convention on Income and on Capital* Introduction (15 July 2014), Models IBFD, para. 1-3 and *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 7 (15 July 2014), Models IBFD). "The UN Group of Experts in 1979 considered that the purpose of double taxation conventions was to remove impediments to the flow of trade and investment by elimination of international double taxation" (Baker, *supra* n. 888, p. B-05, marginal n. B.08).

[894] "The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchange of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 7 (15 July 2014), Models IBFD). The introduction of the model continues to refer to the elimination of double taxation as the main purpose of treaties (see *OECD Model Tax Convention on Income and on Capital* Introduction para. 1-3 (15 July 2014), Models IBFD).

OECD stated that states could follow the widespread practice of including in the title of the treaty a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.

More recently, the OECD proposed, under the BEPS Project, to amend the title of the model and to include a preamble in order to recognise that the purposes of the treaty are not limited to the elimination of double taxation and that states do not intend treaty provisions to create opportunities for non-taxation or reduced taxation through tax evasion and avoidance:[895] "In order to provide the clarification required by Action 6, it has been decided to state clearly, in the title recommended by the OECD Model Tax Convention, that the prevention of tax evasion and avoidance is a purpose of tax treaties. It has also been decided that the OECD Model Tax Convention should recommend a preamble that provides expressly that States that enter into a tax treaty intend to eliminate double taxation without creating opportunities for tax evasion and avoidance. Given the particular concerns arising from treaty shopping arrangements, it has also been decided to refer expressly to such arrangements as one example of tax avoidance that should not result from tax treaties".[896] According to the BEPS report on Action 6, these changes constitute a general statement of the object and purpose of the treaty that plays an important role in the interpretation of treaty provisions.[897] As a result, the title and preamble of the OECD Model were accordingly amended in 2017[898] and changes were also made to the introduction and commentary on article 1 to ensure that "treaties do not inadvertently prevent the application of such domestic anti-abuse rules".[899] The commentaries on article 1 of the OECD Model Convention (2017) now explain that some domestic anti-abusive rules are already specifically allowed by tax treaties[900] and that some others, which are dependent on

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[895] "First, it is recommended to include in the title and preamble of tax treaties a clear statement that the Contracting States, when entering into a treaty, wish to prevent tax avoidance and, in particular, intend to avoid creating opportunities for treaty shopping (...). (...) PREAMBLE TO THE CONVENTION (State A) and (State B), Desiring to further develop their economic relationship and to enhance their cooperation in tax matters, Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States) Have agreed as follows: (...)" (OECD/G20 *Base Erosion and Profit Shifting Project, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 deliverable, 16 September 2014* (OECD 2014), International Organizations' Documentation IBFD, p. 22 and 99)

[896] OECD/G20, *supra* n. 214, p. 91, para. 72.

[897] *Ibid.*, p. 93.

[898] "Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance" (OECD Model Tax Convention on Income and on Capital Title of the convention (21 November 2017), Models IBFD). "(State A) and (State B), Desiring to further develop their economic relationship and to enhance their cooperation in tax matters, Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States), Have agreed as follows:" (*OECD Model Tax Convention on Income and on Capital* Preamble to the convention (21 November 2017), Models IBFD).

[899] OECD/G20, *supra* n. 214, p. 10.

[900] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 72 (21 November 2017), Models IBFD. See also OECD/G20, *supra* n. 214, p. 82.

domestic law, may have an impact but not a conflict with treaties[901] - in the same line as the previous commentary on article 1 of the OECD Model Convention (2014).[902] The introduction of the OECD Model Convention (2017) was also amended to indicate now the elimination of double taxation and the prevention of tax evasion and avoidance as "the main purposes" of the convention,[903] as opposed to the previous version where the elimination of double taxation was referred to as the (only) "main purpose" of the convention[904] - while the prevention of tax evasion and avoidance are referred to as (also) *a* purpose of treaties in the commentary to article 1.[905] However, it is interesting to see a contradiction between the new introduction and the new commentaries on article 1 of the OECD Model Convention (2017): whereas the introduction refers to both elimination of double taxation and prevention of tax evasion and avoidance as the *main purposes* of the treaty[906] (thus suggesting that the two purposes have the same importance), the commentary on article 1 still indicates that the *main* purpose of the convention is the elimination of double taxation and that "it is also a part of the purposes of tax conventions to prevent tax avoidance and evasion"[907] (thus suggesting the latter to have a more secondary place, as also done in the previous version of the model).

However, although the view that the object and purpose of tax treaties includes the prevention of tax avoidance and evasion is supported by the OECD and most government officials and courts,[908] it has been argued that it would still be contrary to the principle of good faith if domestic anti-avoidance measures were allowed to interfere with the common intent of the treaty as a whole (which would include avoidance of double taxation).[909] In this sense, Edwin van der Bruggen explains that, on the basis of article 44 the Vienna Convention (1969),[910] contracting states do not have the freedom to

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[901] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 73 (21 November 2017), Models IBFD. See also OECD/G20, *supra* n. 214, p. 83.

[902] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 9.2. and 22.1. (15 July 2014), Models IBFD.

[903] *OECD Model Tax Convention on Income and on Capital* Introduction para. 2-3 (21 November 2017), Models IBFD.

[904] *OECD Model Tax Convention on Income and on Capital* Introduction para. 2-3 (15 July 2014), Models IBFD.

[905] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 7 (15 July 2014), Models IBFD.

[906] *OECD Model Tax Convention on Income and on Capital* Introduction para. 2-3 (21 November 2017), Models IBFD.

[907] "The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. As confirmed in the preamble of the Convention, it is also a part of the purposes of tax conventions to prevent tax avoidance and evasion."*OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 54 (21 November 2017), Models IBFD.

[908] See details in Section 4.2.1.

[909] van der Bruggen, *supra* n. 55, p. 60.

[910] "Separability of treaty provisions 1. A right of a party, provided for in a treaty or arising under article 56, to denounce, withdraw from or suspend the operation of the treaty may be exercised only with respect to the whole treaty unless the treaty otherwise provides or the parties otherwise agree. 2. A ground for invalidating, terminating, withdrawing from or suspending the operation of a treaty recognized in the present Convention may be invoked only with respect to the whole treaty except as provided in the following paragraphs or in article 60. 3. If the ground relates solely to particular clauses, it may be invoked only with respect to those clauses where: (a) the said clauses are separable from the remainder of the treaty with regard to their application; (b) it appears from the treaty or is otherwise established that acceptance of those clauses was not an essential basis of the consent of the other party or parties to be bound by the treaty as a whole; and (c) continued performance of the remainder of the treaty would not be unjust. 4. In cases falling under articles 49 and 50 the

select which part or purpose of the treaty they wish to observe and disregard the rest of the treaty.[911] That would be contrary to good faith, which requires the observance of the whole agreement. As a consequence, state conduct that is in line with one objective of the treaty (e.g. prevention of tax avoidance and evasion), but at odds with another (e.g. avoidance of double taxation), would still be a failure to comply with the treaty as a whole.[912] In this respect, existing case law (mainly from Belgium and the Netherlands[913]) on tax treaty dodging executed through the use of domestic anti-avoidance rules support the view that the need to counter tax avoidance would not justify dodging practice[914] - it should be noted though that these decisions were issued before the changes included in the OECD Model Convention (2017).

The author believes that, in cases where it is certain that the object and purpose of a treaty includes also the prevention of tax avoidance (for example, when it is clearly expressed in a preamble), the argument in the sense that treaty partners should observe the treaty as a whole and not simply observe one object and purpose (prevention of tax avoidance) while disregarding the other (i.e. avoidance of double taxation) does not justify the refusal of the anti-avoidance rule which would be in line with the first object and purpose; it would rather be a reason to demand from treaty partners the relief from double taxation resulting from the application of such anti-avoidance rule when not properly coordinated between the states, so that both object and purpose could co-exist. If a state agrees to include the prevention of tax avoidance as one object and purpose besides the avoidance of double taxation, it means it is aware, at the conclusion of this agreement, that domestic measures to counter tax avoidance may be introduced by its treaty partner and that the allocation of taxing rights may be changed. There is thus little scope for arguing that good faith would disallow such domestic measures, as neither states would be acting in bad faith nor their partners would be facing unexpected results. It is for the contracting states involved to act in order to also comply with the purpose of avoidance of double taxation by agreeing on how the relief is to be granted so that the re-allocation of taxing rights is put into effect rather than a double granting of taxing rights that is eventually supported by taxpayers. In case of anti-avoidance measures targeting double non-taxation opportunities created by tax treaties, this adjustment would of course not be necessary for the compliance with the object and purpose of avoidance of double taxation.

Under this scenario, the author considers that the object and purpose including the prevention of tax avoidance may be give grounds to allow states to introduce domestic anti-abusive measures without overstepping the limitation imposed by this element of the principle of interpretation of treaties. Likewise, but with an opposite result, the object and purpose including the prevention of tax avoidance

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State entitled to invoke the fraud or corruption may do so with respect either to the whole treaty or, subject to paragraph 3, to the particular clauses alone. 5. In cases falling under articles 51, 52 and 53, no separation of the provisions of the treaty is permitted" (Article 44 of the Vienna Convention (1969)).

[911] van der Bruggen, *supra* n. 55, pp. 60-61.

[912] van der Bruggen, *supra* n. 55, p. 61.

[913] For the cases, see Chapter 3, Section 3.3.

[914] de Broe*, supra* n. 55, p. 279.

may be a legal limitation allowing the qualification of actions engaged by countries with the purpose of tolerating tax treaty shopping (passive dodging) as illegitimate. On the other hand, where it is not certain that the object and purpose includes the prevention of tax avoidance, this illegitimacy is more difficult to argue on the basis of this element of limitation (i.e. object and purpose). For example, in the case of India's actions in respect of investments made through Mauritius,[915] the Indian Supreme Court in the case *Azadi Bachao Andolan* (2004)[916] indicated that maybe India and Mauritius did intend, at the time when the treaty was concluded, to tolerate tax avoidance in the interest of long-term development. Indeed, this idea may be supported by the preamble of the India-Mauritius Income Tax Treaty (1982) itself, which not only does not refer to the prevention of tax avoidance (only to tax evasion) but also states that both countries desired concluding the treaty "for the encouragement of mutual trade and investment".[917] However, the policy option of exploiting tax treaties to attract investment from third countries may have been restricted by Action 6 of the BEPS Project.[918]

For determining whether contracting states went too far on the basis of the object and purpose in the principle of interpretation of treaties, one must have in mind the secondary role it has in the process of interpretation and that a dividing line between legitimate and illegitimate actions on the basis of this element if highly dependent on the scope of the object and purpose of the specific treaty being interpreted and the interpreter's view of it.

Supplementary means of interpretation

As explained in section 4.2.1., article 32 of the Vienna Convention (1969) brings the supplementary means of interpretation to be used in order to confirm the meaning resulting from the application of the general principle of interpretation in article 31, or to determine the meaning when the interpretation according to such article leaves the meaning ambiguous or obscure or leads to a result which is manifestly absurd or unreasonable. The interpretation of treaties must thus first be determined on the basis of the elements in the general principle of interpretation, while the supplementary means of interpretation should be used only in these two specific circumstances.

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[915] See Chapter 3, section 3.3.2.

[916] IN: SC, 7 Oct. 2003, *Union of India and another v. Azadi Bachao Andolan and another*, Tax Treaty Case Law IBFD.

[917] "Desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment, have agreed as follows (…)" (*Convention between the Government of the Republic of India and the Government of Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains* (24 August 1982), Treaties IBFD).

[918] "The members of the Inclusive Framework have effectively given up the possibility to use a treaty with one or more particular countries to attract investment from third countries. If they wish to reduce tax for inbound investment, they will have to do so by amendment of their domestic law or entering into a larger number of tax treaties than would otherwise have been the case. One could say that, in this respect, the minimum standard of BEPS Action 6 has reduced their policy options" (S. van Weeghel, *A Deconstruction of the Principal Purposes Test*, 1 Bull. World Tax J. 1 (2019), Journals IBFD, footnote 66).

Supplementary means of interpretation in the sense of article 32 of the Vienna Convention (1969) comprise the preparatory work of the treaty or *travaux preparatoires* (negotiating history) and the circumstances of a treaty's conclusion (the historical background). However, the article covers only material that evidence the common intention of the parties (e.g. earlier drafts discussed by both parties or an exchange of letters between them), while unilateral preparatory work (e.g. statements or reports made by one party) representing the reasons and goals of only one contracting party may not be regarded as a supplementary means of interpretation.

Nevertheless, both *travaux preparatoires* and the circumstances of a treaty's conclusion have been understood as having little relevance when it comes to tax treaties, as these types of agreements are normally negotiated in secret with no related background document being published, and also for the reason that these agreements are usually not entered into because of a particular historical imperative.

Other possible supplementary means of interpretation that may be more relevant in the case of tax treaties include foreign court decisions which do not fall under article 31 of the Vienna Convention (1969) and the literature produced by experts (e.g. the work of Klaus Vogel has been widely cited by courts).

As a conclusion for this sub-section, it can be indicated that the elements provided by the principles of interpretation of treaties in the Vienna Convention (1969) for the assessment of the dividing line between the legitimate exercise of contracting states' rights and tax treaty dodging are: (i) honesty, reasonableness, fairness and malicious intention (good faith); (ii) agreements relating to the treaty which were made between all the parties in connexion with the conclusion of the treaty and instruments which were made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty (context); (iii) subsequent agreements signed by the contracting parties regarding the interpretation of the treaty or the application of its provisions and subsequent practice in the application of the treaty (elements to be considered with the context); (iv) the object and purpose of the treaty; and (v) supplementary means of interpretation.

4.3.2. Honesty, reasonableness, fairness and intention (as elements from the principle of good faith)

Under public international law, when deciding whether a contracting state's action is exercised in good faith one must make an assessment on the basis of the moral values constituting the core of this principle, such as honesty, fairness and reasonableness.[919] These, by their very nature, cannot be defined or specified in greater detail themselves.[920] The manner in which a treaty in force must be performed is also defined by what honesty, reasonableness and fairness require of the parties in the

[919] See details in Section 4.2.2.

[920] Engelen, *supra* n. 193, p. 10.

specific circumstances of the case.[921] It is therefore difficult to derive from the principle of good faith a clear, objective and precise pre-determined threshold between tax treaty dodging and the legitimate exercise of rights by contracting states. This assessment is dependent on subjective criteria and on what the judge or interpreter understands as being honest, reasonable and fair considering the circumstances of the specific case.

In addition to these elements, the characterization of an illegitimate act under the principle of good faith may also be dependent on the role of another subjective element: the intention. The main question involved is whether tax treaty dodging condemnable under the principle of good faith would cover only contracting states' actions (or omissions) intended to circumvent the treaty and to consequently recover taxing rights, or if it would also include unintentional actions (or omissions) in view of the (unintended) consequences of the act to treaty partners and taxpayers.

The relevance of the intention for the characterization of tax treaty dodging as an illegitimate act has been object of disagreement among international tax scholars. Some international tax scholars consider the role of the intention as irrelevant, which means that condemnable acts under this principle would cover not only actions aiming at but also just having the effect of altering the balance of the treaty. That is the view of J. Wouters & M. Vidal: "(...) if a State abuses its discretion to develop a proper domestic terminology for tax purposes, and artificially construes the terms of a treaty with the aim <u>or</u> the effect of seriously altering the equitable distribution of tax revenue, it fails to carry out the treaty in good faith".[922] In the same direction, Luc de Broe seems to understand the intention as a non determinant factor which would only have the effect of "colouring" the behaviour: "Such will occurs where the change to domestic law permits a State to recapture taxing rights which it had forgiven to its treaty partner upon concluding the treaty. Such fact is colored if the change is made intentionally to override the treaty".[923]

However, some scholars may consider the intention to dodge the treaty as a necessary condition for the characterization of an illegitimate act under the principle of good faith. In this direction, Edwin van der Bruggen explains that on the basis of the principle of good faith: "it can happen that changes in domestic law lead to an unforeseen, possibly unintended impact on the 'equilibre' of the treaty, and such is not necessarily contrary to good faith. In other words, not every explanation of treaty terms along the lines of domestic tax law will be contrary to the principle of good faith. As is by definition the case with respect to good faith, much will depend on the circumstances".[924]

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[921] Engelen, *supra* n. 193, p. 10.

[922] J. Wouters & M. Vidal, *supra* n. 50, p. 16 (emphasis by the author).

[923] de Broe, *supra* n. 55, p. 278. However, in other passages of his book, Luc de Broe seems to take into consideration the intention to circumvent the treaty when he indicates that a contracting state does not apply a treaty in good faith, and thus erodes or evades its obligation under the treaty, when the *"state's sole or main motive"* in making an amendment to domestic law is to recover taxing rights which it has given up to its treaty partner when signing the treaty and thus overrides the treaty (de Broe, *supra* n. 55, pp. 272-273).

[924] van der Bruggen, *supra* n. 55, p. 41.

Indeed, it seems to the author that for an act to be condemned on the basis of *this principle* it would need to be undertaken in a dishonest manner. The principle of good faith requires parties to act honestly so that the principle prohibits, by definition, acts with malicious intentions. This means that actions undertaken without a view to circumvent the treaty or to recover taxing rights - but modifying anyway (and unpredictably) the effects of tax treaties - would not be considered as in "bad faith" and, therefore, not an illegitimate dodging *on the basis of the principle of good faith*.[925]

Resorting to subjective elements such as intention is considerably difficult when it relates to moral persons, particularly when these persons are sovereign states. As reminded by Klaus Vogel et al., "through a change of its domestic laws a contracting state is able to broaden the scope of circumstances which it is allowed to tax under a treaty. Whether such result is the purpose of a legislative change or whether it is an unintended *side-effect of changes occasioned by other reasons cannot be always determined*".[926] However, it seems that the intention to circumvent treaties may be spotted, for example, when a state makes changes to domestic law in order to affect non-residents adversely *only*, as already suggested by John F. Avery Jones.[927] In this respect, he supports the idea that domestic changes should only be considered valid when affecting both residents and non-residents.[928] Nonetheless, as it is the case for the other elements derived from good faith such as honesty, reasonableness and fairness, it can be said that the assessment of the intention is, in any case, still considerably dependent on the subjective analysis of the judge or interpreter in regard to the state's actions and the circumstances of the case.

The author concludes, therefore, that the threshold provided by the principle of good faith is built on very subjective pillars: it delimitates illegitimate tax treaty dodging as being contracting states' actions (or omissions) that intentionally go beyond what is honest, reasonable and fair considering the circumstances of the case.

4.3.3. Reciprocity (as an element from the principle of reciprocity)

In international law, reciprocity may be understood as the status of a relationship between two or more states under which a certain conduct by one party is in one way or another juridical dependent upon that of the other party.[929] Such conduct will in most instances, but not necessarily, amount to

[925] Actions undertaken without a view to circumvent the treaty and to recover taxing rights, but modifying anyway (and unpredictably) the effects of tax treaties, may however be considered as an illegitimate dodging on the basis of other legal bases – see Sections 4.3.1. to 4.3.4.
[926] Vogel et al., supra n. 36, p. 65, marginal n. 125.
[927] "If a state makes a change to the definition of a type of income in order to affect non-residents adversely it should not apply to the treaty, but if it is tidying up the edges of a definition as it affects residents and non-residents alike, it should apply to the treaty. It would be helpful for the Commentary to spell out the limits." (Avery Jones, *supra* n. 55. p. 133).
[928] *Ibid.*
[929] Simma, *supra* n. 807, para. 2.

identical or equivalent treatment.[930] Most attempts to define reciprocity add the element of a subjective interrelation of action and counteraction according to which the conduct of one party, whether consummated or expected, provides the motivation for that of the other.[931] In this sense, for assessing whether a contracting state should be condemned for a tax treaty dodging practice, interpreters should also analyse whether the offended state subsequently undertook an equivalent action which could exclude the illegitimacy of the dodging measure, as a result of reciprocity. This means that contracting states actions performed after the conclusion of tax treaties and in line with their wording, but modifying their effects, would not be an illegitimate act in case the treaty partner would also engage in the same practice. The element of reciprocity would create an exception where, although having all elements for qualifying as tax treaty dodging, the action would not be condemnable, but rather justified in view of an equivalent dodging undertaken by the treaty partner. Reciprocity would, as much as the element of *subsequent practice* (see Section 4.3.1.), higher the threshold for actions (or omissions) to be qualified as a condemnable tax treaty dodging by allowing exceptions in terms of illegitimacy. The author is, however, of the opinion that reciprocity should not be used as a tool to fight against tax treaty dodging. As long as double taxation is not created, both contracting states may agree and accept a new division of taxing rights, even through reciprocity.

Reciprocity should therefore be taken into account by courts and interpreters when assessing whether or not effect should be given to contracting states' actions (or omissions) even though initially characterized as dodging practices.

4.3.4. Excessive tax burden (as element from taxpayers' fundamental rights and expropriation clauses in bilateral investment treaties)

In the specific case of contracting states redesigning existing taxes normally limited by tax treaties into charges falling outside the scope of treaties (for being not covered charged or for being levied in a purely domestic scenario),[932] as well as in cases where taxpayers are prevented from making use of treaty rights in view of the non implementation of these agreements, taxpayers may use taxpayers' fundamental rights granted by international treaties and constitutions as legal basis for condemning such practice. The prohibition of excessive tax burden normally derived from these types of rules, as well as from the impossibility to make use of treaty benefits such as relief from double taxation, may be taken into consideration by interpreters and judges when determining the legitimacy or not of these actions. In this respect, as explained in section 4.2.6., the European Commission of Human Rights and the European Court of Human Rights have already recognized that the imposition of an excessive tax burden in a way to fundamentally interfere with the person's financial position may constitute an

[930] *Ibid.*

[931] Simma, *supra* n. 807, para. 2.

[932] See Chapter 3, sections 3.3.1.1., 3.3.1.3., 3.3.2. and 3.3.3.

infringement of the right to property.[933] Likewise, many constitutions provide for a similar protection to taxpayers.

An excessive tax burden may be considered in the case of, for example, the increase of Indonesia's production share in replacement of the branch profit tax that used to be subject to (and reduced by) the tax treaty,[934] or in the case of the Brazilian CIDE contribution levied from resident taxpayers in view of the limitation of the withholding tax levied on outbound payment of royalties.[935] Although these charges may not be considered literally excessive in their amounts, they may be considered a burden that is unjustified and abusive, and therefore in excess of what the taxpayer should have been fairly subjected to.

The excessive tax burden from double taxation or increase in taxes as a result of tax treaty dodging may also determine whether the offending state has breached the right against expropriation under bilateral investment treaties (see Section 4.2.7.). Although expropriation and confiscatory taxation are closely related, as they deprive persons of their own property and income, expropriation clauses in bilateral investment treaties are directly linked to the impact on the investment.[936] Also, in the case of expropriation, the tax burden should be at a level that causes a substantive deprivation of the investment or makes it impossible for the investor to continue his activity[937], as was in the cases *Yukos*,[938] *Antoine Goetz & consorts v. République du Burundi* (1999)[939] and to a certain extent, *Lone Star*[940]. However, indirect expropriation has been recognized in tax matters when such matters are found to be abusive,[941] so that it could be possible to argue that, as for confiscatory taxation, not only the quantitative limits but also other elements, such as whether the levying of the tax is arbitrary, should be considered.[942]

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933 "See, for example, Kaira v. Finland (Application No. 27109/95) (available on HUDOC) and Wasa Liv v. Sweden (Application No. 13013/87), 58 DR 163 at 177-178" (Baker, *supra* n. 826, pp. 63-78, at p. 74, footnote 25).

934 See Chapter 3, section 3.3.2.

935 See Chapter 3, section 3.3.1.1.

936 Pistone, *supra* n. 838, sec. 1.6.3.

937 Pistone, *supra* n. 838, sec. 1.6.1. "Confiscatory taxation should, however, not be assimilated to expropriation under investment law. Indeed, the application of high taxes to items of income or capital under the tax laws of the host state would not necessarily amount to an expropriation under BITs, in the absence of specific circumstances establishing the specific hindrance to the investment" (Traversa & Richelle, *supra* n. 860, section 4.6).

938 See *supra* n. 846.

939 See *supra* n. 862.

940 "At stake is the determination of Lone Star subsidiaries' fiscal residence: the company claims that the Korean tax administration characterized the entity investing in the country differently (first as a US company, then a Korean one) according to the investment carried out, so as to maximize the tax due" (*Ibid.*)

941 Pistone on the case *Link-Trading Joint Stock Company v. Department for Customs Control of the Republic of Moldova*, UNCITRAL, Award of 16 Feb. 2001 (Pistone, *supra* n. 838, sec. 1.6.1.).

942 Pistone, *supra* n. 838, sec 1.6.3.

4.3.5. Legitimate expectation (as an element from the principle of good faith, from article 18 of the Vienna Convention (1969) and from bilateral investment treaties)

When discussing the principle of good faith under international law, Bin Cheng recognized that advantages not predictable to treaty partners at the time of the conclusion of the treaty should not be seen as good practice. In this sense, he indicates that the principle of good faith "prohibits a party from exacting from the other party advantages which go beyond their common and reasonable intention at the time of the conclusion of the treaty, as for example, by invoking the treaty to cover cases which could not reasonable have been in the contemplation of the parties at the time of its conclusion".[943] In the same direction, Edwin van der Bruggen indicates that "introducing domestic measures with respect to foreign tax credits after the conclusion of a double taxation agreement that go far beyond what is the prevailing practice in the international community of nations" would not be in line with the principle of good faith and neither in accordance with the "legitimate expectation of the treaty partner".[944] Legitimate expectations of treaty partners is therefore an element derived from the principle of good faith which may help in drawing the line dividing the legitimate exercise of rights by contracting states and the illegitimate act of tax treaty dodging. Interpreters should therefore consider whether the new outcome resulting from those actions was beyond the reasonable expectation of treaty partners at the moment of conclusion of the treaty. In this respect, the internationally prevailing standards and practice in the application and interpretation of tax treaties should be a guiding benchmark.[945]

The secondary notion of good faith, which requires states to implement the provisions of a treaty and which is emphasized by article 18 of the Vienna Convention (1969) (through the obligation therein stated for states not to defeat the object and purpose of a treaty prior to its entry into force),[946] protects the legitimate expectation of treaty partners even before treaties enter into force and, therefore, should also be taken into consideration for the assessment of treaty dodging through legislature omission.[947] The legitimate expectations of treaty partners at the time of the conclusion of the treaty is also seen by some as a principle recognized by the WTO Dispute Settlement Body,[948] included in the considerations of the International Court of Justice in the judgment of the *Fisheries Jurisdiction* case[949]

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[943] Cheng, *supra* n. 277, p. 118.

[944] van der Bruggen, *supra* n. 55, p. 52.

[945] The effect of legitimate expectations would be, according to Edwin van der Bruggen, the need for treaty partners to honour "the internationally prevailing standards and practice by the community of nations in the application and interpretation of double taxation agreements" (van der Bruggen, *supra* n. 55, p. 32).

[946] See Section 4.2.5.

[947] See Chapter 3, Section 3.3.1.3.

[948] As indicated by van der Bruggen, in the India-Patent Protection for Pharmaceutical and Agricultural Chemical Products, WTC doc no. WT/DS50/R at 47-49 para. 22-23 (van der Bruggen, *supra* n. 55, p. 33, footnote 60).

[949] van der Bruggen, *supra* n. 55, p. 33.

and referred to in the meetings of the delegates to the special committee formed while drafting the Vienna Convention (1969).[950]

Legitimate expectation is also referred to in the context of tax treaties. In this respect, "a taxpayer who violates the purpose of the treaty or who does not use that treaty in accordance with expectations of the contracting states makes improper use of that treaty".[951] The author believes that the same rationale should apply for equivalent measures engaged by contracting states; that is, contracting states not applying the treaty in accordance with expectations of treaty partners should be considered to be making an improper use of that treaty as well.

The legitimate expectation of taxpayers is also relevant for the assessment of tax treaty dodging in respect of discussions initiated on the basis of the fair and equitable treatment and tax stabilization clauses in bilateral investment treaties.[952] Indeed, one of the main objectives of bilateral investment treaties is to create a legal framework that intends to provide foreign investors with an adequate level of legal certainty. Tax treaty dodging measures leading to unfair double and/or higher taxation which go beyond the reasonable expectation of the foreign investor at the moment when deciding to invest in the host country may violate the objectives of such agreements. International tribunals have recognised that the investor's legitimate expectations are protected under the fair and equitable treatment clause against "any unfair, unreasonable or inequitable exercise of the State's legislative power or from any disproportionate change that 'suddenly and unpredictably eliminates the essential characteristics of the existing regulatory framework'".[953]

However, the assessment of whether states actions are considered illegitimate on the basis of legitimate expectation of treaty partners or taxpayers should be done with caution by interpreters, as "the

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[950] As indicated by van der Bruggen, the member Reuter noted that: "(…) when a state definitively expressed its will to be bound, it created a certain expectation in its partners and that it was the non-fulfillment of that expectation that was incompatible with good faith" (van der Bruggen, *supra* n. 55, p. 33).

[951] *Ibid.*

[952] See Section 4.2.7.

[953] Uribe & Montes, *supra* n. 838, p. 7, on the cases *Eiser Infrastructure Limited and Energía Solar Luxembourg S.à r.l. v. Kingdom of Spain* (ICSID Case No. ARB/13/36) Award, 4 May 2017, para. 387. and *Charanne B.V. and Construction Investments S.a.r.l. v. Spain* (SCC Case No. 062/2012) Award, 21 January 2016, para. 517. Also: "Although, it might be argued that such standard has evolved, according to the United Nations Conference on Trade and Development (UNCTAD), the content of FET [fair and equitable treatment], as applied and interpreted by ISDS [investor-state dispute settlement] tribunals, includes foreign investors' legitimate expectations, denial of justice and due process, arbitrariness in decision making, discrimination and abusive treatment and therefore no longer circumscribes only to the concept of minimum standard of treatment" (Uribe & Montes, *supra* n. 838, p. 7). On the investor's obligation for the legitimate expectation standard to be properly applied: "(…) even if States allow their tax regimes to be reviewed by such tribunals, it would be indispensable to include the "due diligence" obligation by the investor regarding the knowledge of the legal framework of the country before, during and after certain investment is established in a particular jurisdiction. This would entail a comprehensive understanding of how legislative measures can be drafted, adopted, amended or abolished in such jurisdiction. Only then could the standard of 'legitimate expectations' be applied" (Uribe & Montes, *supra* n. 838, pp. 8-9).

conclusion of a treaty always creates expectations in the eyes of the treaty partners, but not all expectations are 'legitimate' and have to be honored by the other state (…)".[954] The assessment should take into consideration the circumstances of each case and what could be reasonably expected on the basis of prevailing standards in international tax law and practice.[955]

4.3.6. Answer to the sub-question of the research question

If such legal basis exists, where is the dividing line between a legitimate exercise of rights by contracting states and such illegitimate acts under international law?

The line dividing legitimate exercise of rights by contracting states and the illegitimate act of tax treaty dodging cannot be identified as a pre-determined formula for being highly dependent on a case-by-case analysis, that is, on subjective criteria or the circumstances of each case. However, when facing actual cases, the interpreter may use the following elements as a guidance to determine whether contracting states went too far in their respective actions (or omission): (i) agreements relating to the treaty which were made between all the parties in connexion with the conclusion of the treaty, instruments which were made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty, subsequent agreements signed by the contracting parties regarding the interpretation of the treaty or the application of its provisions, subsequent practice in the application of the treaty, the object and purpose of the treaty and supplementary means of interpretation (for condemning the action or omission on the basis of the principles of interpretation in the Vienna Convention (1969)); (ii) honesty, reasonableness, fairness and malicious intention (for condemning the action or omission on the basis of good faith); (iii) reciprocity (for condemning the action or omission under the principle of reciprocity); (iv) excessive tax burden (for condemning the action or omission under taxpayers' fundamental rights or expropriation clauses in bilateral investment treaties); and (v) legitimate expectation (for condemning

[954] van der Bruggen, *supra* n. 55, pp. 33-34. On the limits of legitimate expectation: "The leap from a minimum standard of treatment under international law to a broader concept of 'legitimate expectations' has direct implications on the rights of States to regulate. Even if it has been generally argued that, in the absence of specific commitments and stabilization clauses in investment contracts, States have the power to lawfully manoeuvre, modify or issue regulations pursuing public objectives, such argument could be wrongly interpreted as limiting the power of States to regulate in the face of such specific commitments or even make permissible a broader interpretation of 'legitimate expectations' of investors to allow claims on the basis of FET [fair and equitable treatment] for the change on the tax regime in the country" (Uribe & Montes, *supra* n. 838, p. 8).

[955] In respect of the legitimate expectation of taxpayers, Uribe & Montes also refer to the analysis of the relation between the aim pursued by the legislative measures and their effects on the investment such analysis should be built on the criteria normally applied by administrative, constitutional and human rights courts (Uribe & Montes, *supra* n. 838, p. 9).

the action or omission on the basis of good faith, article 18 of the Vienna Convention (1969) or bilateral investment treaties).

4.4. Tax treaty dodging *v* direct violation of the wording of tax treaties

The phenomenon of tax treaty dodging is observed in this chapter as actions performed (or omissions) by contracting states after the conclusion and in accordance with the wording of tax treaties, but having an impact on their outcome to the state's own benefit. The distinction between tax treaty dodging and a more direct violation of the tax treaties has been relatively little addressed in literature, most likely in view of the fact that both have similar effects. However, when arguing the relevance of making such a distinction, some authors often emphasize that a difference exists between actions (or omissions) herein referred to as tax treaty dodging and actions directly violating the wording of the treaty – the latter referred by many in this context as tax treaty override. In this sense, some authors have directly or indirectly indicated tax treaty dodging and tax treaty override as unrelated subjects.[956] This discussion seems to have first started as consequence of the decision given in the case Melford (1982).

The origins of the discussions: the case Melford (1982)

The possible distinction between tax treaty dodging and direct violation of the wording of the treaty – the latter being referred to in those discussions as tax treaty override - was brought to the attention of the tax community in the 1980's during the discussions over the decision given by the Supreme Court of Canada in the case *Melford* (1982).[957] The case concerned the undefined term "interest" in the Canada-Germany Income Tax Treaty (1956).[958] The Supreme Court decided for the application of the static rather than the ambulatory interpretation, under the argument that reference to domestic law as amended would offer the opportunity for a unilateral change of the tax treaty by a contracting state as their domestic needs may dictate. To avoid such an outcome, the Supreme Court of Canada decided to apply a radical measure and forbid the reference to domestic law amendments made after the signature of the treaty, closing the door to any attempt in this sense. An important point to have in mind for the discussion which is about to follow is that no definition of the term "interest" was given in the treaty and reference to its meaning under domestic law was allowed by a treaty provision equivalent to article 3(2) of the OECD Model Convention.[959]

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[956] See Section 2.3. of Chapter 2 and throughout this section.
[957] *Melford* (1982), *supra* n. 86. See also Chapter 2, Section 2.3. under *The 1980's*.
[958] *Convention between Canada and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (4 June 1956), Treaties IBFD. For the analysis of the decision, see Chapter 3.
[959] Article 2(2) of the Canada-Germany Income Tax Treaty (1956).

As described in Chapter 2, a special project,[960] created in 1984 and conducted by "The International Tax Group"[961] under the coordination of John F. Avery Jones, analysed the effects of changes in internal law as far as it concerned article 3(2) of the OECD Model Convention. The project concluded for the application of the ambulatory interpretation coupled with an express or implied limitation, as the static interpretation was considered to be a too rigid solution to be acceptable.[962] In the study, the group indicates that the first point to be made clear in such an analysis is that the question on whether reference to the meaning of a term in domestic law should be made under the static or the ambulatory interpretation "has no connection with the question of whether internal law can validly, as mater of internal law as opposed to international law, override a treaty".[963] However, according to the group, "the Canadian Supreme Court did not keep the two separate"[964] and the static-ambulatory issue which was expected to be resolved in the case *Melford* (1982) "became confused with the override of treaties by internal law".[965]

The point made by John F. Avery Jones et al. was that the court appeared to have considered that the ambulatory interpretation would authorize a "unilateral amendment" of the treaty and, therefore, a static interpretation of article 3(2) would be necessary to preserve the precedence of the treaty over internal law.[966] In other words, the court considered that the answer to the static-ambulatory issue followed from the answer to the treaty override issue. However, from the reasoning of the International Tax Group, it can be concluded that the static v. ambulatory discussion only plays a role when the use of domestic law is *authorized* by the treaty. In other words, the question of whether the domestic law to be considered should be the one at the time when the treaty is concluded or the one at the time when the treaty is applied would only make sense if domestic law could be used in the first place. If the use of domestic law is not allowed by the treaty, the static v. ambulatory issue can be never raised. This was also the point made by Michael Rigby, who, as other scholars,[967] agreed with the conclusions of the International Tax Group in regard to the case *Melford* (1982): "the Court confused that article 3(2) is ambulatory with the argument that the extension to the meaning of 'interest' overrode the treaty (...) if the legislation actually overrode the treaty, the question of whether a static or ambulatory interpretation was correct would be irrelevant. That question becomes relevant

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[960] J. F. Avery Jones et al., *supra* n. 46 and J. F. Avery Jones et al., *supra* n. 99.

[961] John F. Avery Jones, Charles J. Berg, Henri-Robert Depret, Maarten J. Ellis, Pierre Fontaneau, Raoul Lenz, Toshio Miyatake, Sidney I. Roberts, Claes Sandels, Jakob Strobl and David A. Ward.

[962] Avery Jones et al., *supra* n. 46, p. 48. The express limitation refers to the "context otherwise requires" and the implied limitation to a proposal at the time to be included in the OECD Model Commentary (and later adopted).

[963] Avery Jones et al., *supra* n. 46, p. 25 (emphasis added).

[964] Avery Jones et al., *supra* n. 46, p. 27.

[965] Avery Jones et al., *supra* n. 46, p. 43.

[966] Avery Jones et al., *supra* n. 46, pp. 27-28.

[967] Jörg Weigell, for instance, analyzed the decision and arrived at a conclusion in the sense that the Supreme Court of Canada had not based its decision on the "circumvention of the treaty by the contracting state" line of thought supported by literature, but rather on whether the unilateral change of the scope of the treaty by domestic law amendment (W. Leisner, *supra* n. 118, p. 1016).

only if the treaty is not overridden".[968] In this respect, David Ward seems to agree with this line of thought when concluding that the case may have been correctly decided, *but for the wrong reasons*.[969]

Indeed, the Canada-Germany Income Tax Treaty (1956) did not present any definition of the term "interest" and reference to its meaning under domestic was allowed by a provision similar to article 3(2). Negotiators agreed, therefore, to not include a treaty definition for the term and to leave a "treaty gap" to be filled in by the domestic law of one of the contracting states. As a result, a treaty override would not, according to this line of thought, be possible because the use of domestic law is already authorized by the treaty to start with. In this sense, the remaining question in the case *Melford* (1982) was limited to whether the domestic law to be used (as allowed by the treaty) would be the one of the time of the conclusion of the treaty or the one of the time of the application of the treaty. However, the court re-introduced the treaty override topic to the discussion at the moment it qualified the amendment to the domestic law as an amendment to the treaty.[970] However, according to the International Tax Group, "the result of the ambulatory interpretation may be similar to a power to amend a treaty, but the inclusion of later definitions on the basis that the treaty negotiators wanted them to be included is quite different in nature from an unilateral amendment; it is, as the taxpayer correctly pointed out, at most changing the <u>effect</u> of the treaty".[971] In the same direction, David Ward indicates that a later amendment of domestic law in this case would not have the effect of amending the treaty; it would amend *its application*.[972]

The International Tax Group further indicates that the difference between later law having effect by overriding a treaty and having effect because of the ambulatory interpretation was well illustrated by a United States Revenue ruling,[973] where the later law was applied under the ambulatory interpretation but the statute in question was expressed not to override treaty obligations because the treaty was silent on the matter.[974] In addition, they demonstrated that the result of an override was not necessarily

[968] Rigby, *supra* n. 27, pp. 387-388.

[969] Comments by D. Ward in Avery Jones, *supra* n. 107, p. 83. According to him, "although article 3(2) could have been found to be ambulatory, the recharacterization of a guarantee fee which is part of the business profit of a bank, as a payment of interest is so radical and therefore so unforeseeable, that the court might have found that the context would require that the amendment should be adopted for purposes of the treaty".

[970] *Melford* (1982), *supra* n. 86. See also Chapter 2, Section 2.3. under *The 1980's*.

[971] Avery Jones et al., *supra* n. 46, p. 28 emphasis added).

[972] Comments by D. Ward in Avery Jones, *supra* n. 107, p. 82.

[973] Revenue Ruling 80-243 1980-3 C.B. 413.

[974] Avery Jones et al., *supra* n. 46, p. 27. The issue of the case was whether a United Kingdom corporation with a permanent establishment in the United States was entitled to deduct, in computing its taxable income in the United States, the United Kingdom income tax paid that was attributable to operations of its United States permanent establishment. This deduction was allowed by the United States domestic law at the time when the treaty was signed, but since the treaty was silent about what deductions were allowed, there was no override of the treaty in denying the deduction in accordance with the amended domestic law. According to the ruling "Article III(3), as previously indicated, does not elaborate on what income tax expenses are allowed as deductions and section 906(b)(1)(B) is, therefore, not contrary to the Old Convention. Similarly, the provisions of section 906(b)(1)(B) are not contrary to Article 7(3) of the New Convention, which also does not address what income tax expenses are deductible" (Revenue Ruling 80-243 1980-3 C.B. 413).

the same as under an ambulatory interpretation.[975] The example used was a United States case law[976] where the issue was whether the reference in the United States-Italy Inheritance Tax Treaty (1955)[977] to a specific exemption continued to apply after the replacement of an exemption by a credit. According to the Group,[978] the effect of an override was to deny the taxpayer the exemption. The ambulatory interpretation of which the court found in favour was to give the taxpayer the credit as the current equivalent of the former exemption. An alternative ambulatory interpretation for which the Internal Revenue Service contented was to say that there was no current internal law exemption and therefore the taxpayer was not entitled to any relief.

Accordingly, since (i) no overriding of treaties would be possible when the use of the domestic law is authorized by the agreement itself, and (ii) considering that, despite being similar in certain situations, the result of the ambulatory interpretation could not be qualified as an amendment to the treaty, the court should have never answered the static v. ambulatory question from the perspective of a treaty override. Rather, it should have assessed whether any legal limitation outside the treaty text could exist in cases as such, where the application of domestic law would result in the modification of the effect of the treaty. This was exactly what did the International Tax Group after balancing the pros and cons of each approach. They finally concluded for the application of the ambulatory interpretation coupled with an express or implied limitation to diminish the downsides of this approach.

Beyond Melford

The distinction between tax treaty dodging and a violation of the wording of the treaty continued to be discussed in literature in the years following the case *Melford* (1982). After the conclusion of the project by the International Tax Group, John F. Avery Jones continued to insist on the importance of differentiating the two subjects in respect of article 3(2) of the OECD Model Convention: "The limit to changes in internal law that affect the treaty is important to states' acceptance of the merits of the reference to internal law in Art. 3(2). (...) it should be noted that this issue is unrelated to treaty override. Here the treaty contemplates changes in internal law and so such changes are not an override but are in accordance with the treaty".[979] In this sense, domestic law which use is authorized by the treaty and having an effect on its application as a result of the ambulatory interpretation would not be overriding the agreement because it would, in the words of Maarten J. Ellis, simply "work through into the treaties".[980]

During the discussions at the round table on the topic Improving the Relationships Between Tax Treaties and Domestic Law, John F. Avery Jones again raises the argument: "I do not regard Art. 3(2)

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[975] Avery Jones et al., *supra* n. 46, p. 27, footnote 52.
[976] US: USTC, 11 April 1983, *Estate of Charlotte H. Burghardt v. Commissioner of Internal Revenue*, Tax Treaty Case Law IBFD
[977] *Convention between the United States of America and the Italian Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Estates and Inheritances* (30 March 1955), Treaties IBFD.
[978] Avery Jones et al., *supra* n. 46, p. 27, footnote 52.
[979] Avery Jones, *supra* n. 55, p. 133 (emphasis added).
[980] *Ibid.*

as connected in any way with treaty override, because if Art. 3(2) says it's the internal law as from time to time in force, you're giving effect to the treaty when internal law changes, up to, of course, the point where internal law changes too far. (...) Therefore article 3(2) and treaty override are entirely different subjects".[981] In the same occasion, Augusto Fantozzi seems to acknowledge the difference between tax treaty dodging and a direct violation of the treaty (i.e. violation of the wording of the treaty): "(...) it appears from the discussions during the seminar that there is a difference between 'treaty override' and 'interpretation', or, even better, between 'treaty override' and 'overcoming treaty override through interpretation".[982]

The argument that no override could be claimed when the use of domestic law is authorized by the treaty is also defended by Anthony C. Infanti: "A legislative treaty override occurs when Congress enacts a law that is intended 'to have effects in clear contradiction to international treaty obligations'. In contrast, where the treaty itself authorizes Congress to alter the application of the treaty, legislation enacted within the scope of that authority will in no sense be overriding a treaty. For example, although some terms used in tax treaties are specifically defined in the text of the treaty, many other terms are left undefined. To fill in this lacunae, treaties indicate domestic law. Therefore, a law enacted that changes the definition of a term not defined in the treaty will normally not constitute a treaty override, because the treaty generally accords the state the power to fix the meaning of undefined terms".[983]

The fact that in the scenario of a tax treaty dodging the use of the domestic law is allowed by the treaty leads to the conclusion, supported by some scholars, that in those circumstances there would be no actual or direct "breach" of the treaty. When describing tax treaty dodging, Klaus Vogel et al. bring this argument when they indicate that: "(...) the standard international sanctions against treaty infringements may not be readily applied to such behaviour. They are styled on the 'breach' of a treaty (Art. 60 VCLT): the open contravention or non-fulfilment of a dutifully owed obligation. In the type of cases discussed here, in contrast, <u>the treaty is not actually 'broken'. Rather, attempts are made to 'circumvent' or to 'dodge' the treaty</u>".[984] When differentiating the two subjects, John F. Avery Jones also seems to go in this same direction when he explains that in the ambulatory interpretation changes are made in accordance with the treaty while "with override the change in law breaches the treaty, which is the opposite".[985] Although referring to it as an override, Michael Rigby seems to see the point in respect of the breach of treaties when he indicates that "legislation that effectively overrides treaty obligations might be designed so that it can be argued that there is no technical breach of those obligations"[986]. Notwithstanding, if one follows this reasoning, it is possible to argue that, even though most tax treaty dodging actions violate international law rules and principles and not directly a treaty provision, they can be considered equivalent to a material breach of the treaty provision for the

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981 Comments by J. F. Avery Jones in Arnold & al., *supra* n. 28, pp. 395-396.
982 Comments by A. Fantozzi in Arnold & al., *supra* n. 28, pp. 403-404.
983 Infanti, *supra* n. 33, p. 361.
984 Vogel et al., *supra* n. 36, p. 66, marginal n. 125b (emphasis added).
985 Avery Jones, *supra* n. 55, p. 133.
986 Rigby, *supra* n. 27, p. 400.

purpose of application of article 60 of the Vienna Convention (1969). As a consequence, contracting states could invoke the dodging actions as a material breach of the treaty in order to terminate or suspend the operation of the treaty.[987]

Other scholars seem to indirectly differentiate both subjects when they present tax treaty dodging as an "abuse" rather than an "override" of the treaty. This is the case of Lalithkumar Rao,[988] Francisco Alfredo Garcia Prats,[989] Frank Engelen[990] and of the Subcommittee on Improper Use of Tax Treaties of the Committee of Experts on International Cooperation in Tax Matters of the United Nations.[991] As described in Chapter 2, the idea brought by some scholars that tax treaty dodging practices are qualified as abuse by contracting states is based on the fact that these attempts are in accordance with the wording of the treaty but have an effect on the application of the treaty which is not in line the purpose of the agreement.[992]

The OECD also seems to differentiate actions that are in direct conflict with the treaty (i.e. conflict with the wording of the treaty) and those that may have an impact on treaty application but are not prohibited by the treaty provision, when addressing the use of domestic anti-abuse rules in the context of tax treaties. In the previous versions of the OECD Model Convention, the OECD already recognized that, to the extent that anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them.[993] In Action 6 of the BEPS Project and in the commentary on article 1 of the OECD Model Convention (2017), the OECD again emphasized, specifically in respect of domestic anti-abuse rules, that the application of some domestic rules do not conflict with treaties despite having an impact on how treaty provisions are applied: "In many cases, therefore, the application of specific anti-abuse rules found in domestic law will have an impact on

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987 See Chapter 5, Section 5.2.3.1.

988 Comments by L. Rao in IFA, *supra* n. 55, pp. 21-23. See details in Chapter 2, Section 2.3. under *The 2000's and 2010's*.

989 Garcia Prats, *supra* n. 55. See details in Chapter 2, Section 2.3. under *The 2000's and 2010's*.

990 As explained in Chapter 2, Section 2.3. under *The 1980'*s and *The 2000's and 2010's*, Frank Engelen does not seem to treat treaty dodging as treaty override, since he does not refer to the use of article 3(2) to change the allocation of taxing rights as "*override*", but as "*an abuse of right*" (Engelen, *supra* n. 55, p. 494). However, he later deals with the problem by referring to it as "treaty override" (see *supra* n. 210). The author believes, as indicated in Chapter 2, Section 2.3., that this may have been a consequence of the fact that a possible distinction between the two concepts was simply not relevant in the context of his discussions.

991 See reports in Chapter 2, Section 2.3. under *The 2000's and 2010's*.

992 "(...) treaty abuse occurs when, despite adherence to the letter, there is a violation of the purpose of the treaty, either by the taxpayer, or by the state" (Comments by L. Rao in IFA, supra n. 55, p. 23); "Just as a taxpayer can arrange his affairs to be beyond the reach of a tax provision in order not to trigger a certain tax liability, so a contracting state can arrange its national law within the limits defined by the treaty so that the treaty does not prevent the state from imposing tax" (Lang, *supra* n. 63, p. 57).

993 *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 9.2. and 22.1. (26 July 2014), Models IBFD.

how the treaty provisions are applied rather than produce conflicting results".[994] A similar differentiation can be spotted in the OECD Report on Treaty Overrides, where the OECD differentiates treaty override from actions engaged by states that, despite involving or being similar to override, have the same effect.[995]

On the other hand, most scholars do not make a distinction between the two concepts and normally analyse dodging practices from the perspective of a treaty override.[996] The author believes that, in some cases, the distinction between a direct violation of the treaty and actions having a similar effect but exercised in line with the wording of these agreements was not made by scholar simply because such differentiation was not relevant for the purpose of their discussions (much likely because of the similar or equivalent effects). This may have been just a natural result of the different contexts in which individual analyses were built on, and not necessarily a disagreement with the essential points made by scholars like John F. Avery Jones. This can be concluded from the fact that many scholars do not present a direct counter-argument against the arguments previously made by the International Tax Group. Rather, they focus on the analysis of the elements of the cases and its consequences, while the qualification of the practice as a treaty override is most of the times made without a deeper analysis of the concept itself.

However, some scholars do focus on the qualification of those practices as treaty override based on more comprehensive analysis of the concept. That was the case of scholars like Carla de Pietro[997] and, in a lesser degree, by R. T. Bartlett[998]. At the same time, they seem to recognize, to a certain extent, that these practices are not placed at the same level as the more orthodox override mechanisms, since they generally need to depart from a broad definition of tax treaty override in order to be able cover such types of attempts.[999] For instance, when discussing the "worrying development whereby changes

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[994] OECD/G20, *supra* n. 214, p. 83; *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 73 (21 November 2017), Models IBFD.

[995] "At the outset, however, the kind of treaty override primarily addressed in this note should be distinguished from other situations, which either involve or are similar to treaty override and may have the same effects. Three of these situations are described below and comments are made on them either below or later in this note. a) (…) b) A State may change the definition of a term used in its domestic legislation which is also used in treaty provisions but which is not specifically defined for the purposes of the treaty. In this case there is no override where the treaty contains a provision essentially similar to that embodied in Article 3, paragraph 2, of the 1977 OECD Model Double Taxation Convention which provides that, as regards the application of a treaty by a Contracting State, any term not defined in the treaty shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the treaty applies. It cannot have been contemplated that, having once entered into a treaty, a State would be unable to change definitions of terms used in its domestic law provided such changes were compatible with the context of the treaty; c) (…)" OECD, *supra* n. 127, para. 4.

[996] For examples, see Chapter 1, Section 2.3.

[997] de Pietro*, supra* n 33. See more in Chapter 2, Section 2.3. under *The 2000's and 2010's*.

[998] Bartlett, *supra* n. 143. See details in Chapter 2, Section 2.3. under *The 1990's*.

[999] The approach used by Carla de Pietro, and more generally by R. T. Bartlett, is a possible way of dealing with the override-dodging issue. However, the author believes that some of the few existing legal features delimiting tax treaty override – especially the ones contained in the OECD Report on Treaty Overrides (*supra* n. 127) – would prevent such an

in the terms of a treaty have been made unilaterally through new tax legislation",[1000] R. T. Bartlett explains that treaty override covers "*a multitude of occasions*"[1001] which would evolve from the weakest to the strongest sense of the term: "as its weakest, the term could be used to apply to a unilateral treaty modification by domestic law which was acceptable to the partner country but not in fact negotiated with it. Next up the scale comes specific treaty override. This is illustrated by the case where the domestic law overrides only particular and named aspects of treaties. (..) Next on the rising scale comes the general treaty override which amounts to a treaty breach".[1002] Unfortunately, he does not provide the legal source for this scaled classification. Carla de Pietro[1003] develops an interpretative model to identify override cases and derives from this her own definition of tax treaty override. The definition that emerges from this process is broad enough to cover cases herein studied as tax treaty dodging.

Scholars who have been trying to differentiate contracting states' actions directly contradicting the wording of tax treaties - whether or not referring to them as treaty override – and contracting states' actions allowed by the wording of these agreements, but modifying their effects, do have a point. For the author, the point is to understand the distinction between contracting states' actions contradicting the wording of tax treaties (call it or not treaty override) and contracting states' actions (or omissions) allowed by that wording but modifying its effects, as much as scholars and practitioners understand the need to differentiate tax evasion from tax avoidance. If one makes such difference in respect to taxpayers' actions, the same reasoning necessarily needs to be applied in respect of contracting states' actions. It is simply incoherent to argue, on the one hand, that taxpayers can commit either abusive tax avoidance or tax evasion – making therefore a distinction between taxpayer's actions in conflict with the wording of laws or treaties and those in line with their texts but contradicting only the their spirit - and, on the other hand, not admit such distinction for contracting states' equivalent practices.[1004]

This point was also made by Michael Lang during a seminar held in Munich at the 54th Congress of the International Fiscal Association in 2000, where the subject "Abusive Application of International Tax Agreements" was addressed. Following a discussion on the topic "*Is abusive application of DTCs*

approach (for more details, see Chapter 3). In addition, as indicated further in this section, the author considers it incoherent to argue, on the one hand, the distinction between taxpayer's action in conflict with the wording of laws or treaties and those contradicting only the their object and purpose and the spirit of the treaty (tax avoidance or improper use of tax treaties), and, on the other hand, not applying such a distinction for contracting states' equivalent practices.

1000 Bartlett, *supra* n. 143, p. 83.

1001 *Ibid*., p. 84

1002 *Ibid*.

1003 de Pietro, *supra* n. 33.

1004 As explained in Section 2.2.2. of Chapter 2, tax treaty dodging can be regarded as a method equivalent to tax avoidance, but undertaken by a different subject and for a comparable purpose. If in one hand the wish to decrease the tax liability may lead taxpayers to make use of business arrangements that work through the loopholes of legal provisions, contracting states may too wish, in their cases, to increase their tax revenue through arrangement of domestic law that fits the gaps left by tax treaties. Although that tax treaty dodging and tax avoidance should be distinguished in terms of the legal rules used to determine the possible existence of a possible abuse and in terms of identifying the legal consequences of such an action, they both do entail the same line of thought and strategy for comparable purposes.

[double taxation conventions] by states possible?", Michael Lang suggests that if one defends the concept of abuse in respect of taxpayers, the same must be done for states: "I do, however, agree with Dr. Rao, to the extent that if, as I say, one assumes that there exists a concept of abuse at all, then it should be applied to states. But as I believe that one does not get any further with considerations of abuse with taxpayers, I would like to be fair and say that one also does not get far with such considerations and concepts for states".[1005]

The author believes that tax treaty dodging and the direct violation of the wording of treaties are unrelated subjects in the sense that they are, by definition, different methods to interfere with the performance of treaties, although having similar or equivalent effects.[1006] This differentiation does not necessarily lead to the conclusion that tax treaty dodging is not (a type of) tax treaty override. This conclusion depends on one's understanding of what tax treaty override is, which, as said, may vary considerably in view of the lack of one standardized accepted definition of the concept of tax treaty override. Some may include actions herein qualified as tax treaty dodging as a treaty override based on a broad definition of the concept as opposed to others who have a more restrictive approach to the topic. Although the author agrees with the rationale behind the argumentation of scholars differentiating tax treaty dodging and tax treaty override - which is basically the need for differentiating actions authorized by the wording of tax treaties from the ones which are not - the promotion of tax treaty override as a concept covering *only* direct infringements of the wording of treaty provisions needs some careful thought. The investigation of the definition of tax treaty override and of whether it covers only actions violating the wording to tax treaties is however out of scope of this research. What is relevant for the present study is the acknowledgement that contracting states may make use of indirect ways to alter the balance of the treaty, which is referred to as tax treaty dodging in this study and which by definition is different from actions violating the wording of tax treaties.

4.5. Concluding remarks

In this chapter, the author presented the assessment of the phenomenon of tax treaty dodging from the perspective of international law. It is concluded that the principles of interpretation of treaties in international law, the principle of good faith, the principle of reciprocity and, to a certain extent (i.e. limited to certain tax treaty dodging methods), the obligation not to defeat the object and purpose of a treaty prior to its entry into force, taxpayers' fundamental rights granted by international treaties and constitutions and bilateral investment treaties are principles and rules that spell out the correct standards and guide the good usage of treaties so as to limit the exercise of rights by contracting states which are in line with the wording of tax treaties (i.e. within the treaty gaps) but impact their outcome to their own benefit. As a result, actions (or omissions) overstepping these limits, such as the case of

[1005] Comments by M. Lang in IFA, *supra* n. 55, p. 68.

[1006] See however the indication by John F. Avery Jones that the result of an override is not necessarily the same of the result of an ambulatory interpretation (Avery Jones et al., *supra* n. 46, p. 27, footnote 52).

tax treaty dodging practices, can be qualified as illegitimate acts. The extent to which contracting states may act without overstepping these limits (the dividing line between legitimate exercise of rights and the illegitimate act of tax treaty dodging) may be assessed by the interpreter on a case-by-case basis, on the basis of the elements derived by the author from these very same infringed rules and principles: good faith, context, subsequent agreements, subsequent practice, object and purpose, supplementary means of interpretation (under the principles of interpretation of treaties in international law), honesty, reasonableness, fairness and intention (under the principle of good faith), reciprocity (under the principle of reciprocity), excessive tax burden (under taxpayers' fundamental rights and the expropriation clauses in bilateral investment treaties) and legitimate expectation (under the principle of good faith, article 18 of the Vienna Convention (1969) and bilateral investment treaties).

The chapter also emphasized the importance of acknowledging the possibility for contracting states to make use of indirect ways as a particular method to discreetly alter the balance of the treaty. This acknowledgement necessarily leads to the conclusion that, despite having similar or equivalent effects, contracting states' actions contradicting the wording of tax treaties is, by definition, a method which is different from contracting states' actions (or omissions) allowed by that wording but modifying its effects as much as taxpayer's actions in conflict with the wording of laws (tax evasion) cannot be considered the same as those in line with their texts but contradicting their spirit (abusive actions such as tax avoidance).

The next chapter investigates, under international and domestic law, the legal measures currently available to treaty partners and taxpayers affected by tax treaty dodging.

Part III

The Way Forward: Addressing Tax Treaty Dodging

Chapter 5 - Available Measures

5.1. Introduction

The effects of tax treaty dodging were presented to the reader in Chapter 3.[1007] In that chapter, it was explained that tax treaty dodging has a considerable impact on treaty partners and taxpayers. Tax treaty dodging practice may result in the shifting of the allocation of taxing rights to the disadvantage of the offended treaty partner. It may also result in a higher tax burden on taxpayer in view of taxes redesigned to fall outside the scope of treaties or due to international double taxation of taxpayers, a problem treaties are intended to prevent in the first place.

This section investigates the measures available under international and tax treaty law to the two parties bearing the consequences of tax treaty dodging: Section 5.2. presents the options available to contracting states, while the possible measures to compensate or reduce the burden taxpayers are subjected to are explained in Section 5.3. The reader will see below that international and tax treaty law offer a relatively wide range of options to contracting states, from measures aiming at the cessation of the dodging practice (e.g. official protest, mutual agreement procedures, arbitration and suspension of the treaty) or even reparation (e.g. claims on the basis of state responsibility) to more drastic actions that intend to resolve the issue unilaterally, as is the case of termination of the treaty and the use of countermeasures. The options available to taxpayers are more restricted in number but are often very effective in practice, such as the case of claims presented before the courts of a contracting state.

This part of the study does not aim at elaborating or deeply analysing the content of each measure under international law or tax treaty law, but to verify the general aspects of each option and its suitability in the case of tax treaty dodging practices.

5.2. Measures available to contracting states

As explained,[1008] tax treaty dodging may result in the shifting of the allocation of taxing rights initially predicted or intended by treaty partners at the conclusion of the agreement and, consequently, in a monetary disadvantage for the national tax revenue of one of the contracting states. In those situations, offended states are often tempted to directly rely on unilateral countermeasures[1009] as a

[1007] Chapter 3, Section 3.4.

[1008] *Ibid.*

[1009] For details on countermeasures as a measure against tax treaty dodging, see Section 5.2.7.

remedy against tax treaty dodging, mostly in view of the fact that tax treaties – as well as the UN Model Convention (2017) and OECD Model Convention (2017) - generally do not provide a well-defined verification procedure by which the abuse of the treaty either by a state or a taxpayer can be identified or confirmed.[1010]

However, under international and tax treaty law a wide variety of measures that may and should be used before resorting to countermeasures are available to contracting states facing tax treaty dodging. In this sense, the UN Committee of Experts on International Cooperation in Tax Matters affirmed that sanctions against abuse by states are required to be in line with principles of international law and, as a result, if the offended state takes certain steps before resorting to sanctions, they would be regarded as faithful to those principles.[1011] The sub-sections below present the possible steps offended states could take and their suitability when facing tax treaty dodging.

5.2.1. Official protest by the offended state

In Chapter 2,[1012] the reader was presented to the studies developed by the United Nations on the issue of improper use of treaties and suitable methods to combat treaty abuses, conducted by its "Subcommittee on Improper Use of Tax Treaties" (previously named "Subcommittee on Treaty Abuses and Treaty Shopping") of the Committee of Experts on International Cooperation in Tax Matters (previously named "Ad Hoc Group of Experts on International Cooperation in Tax Matters"). As detailed in that chapter, before presenting its final report on a new text for the commentary on article 1 of the UN Model Convention, the Subcommittee prepared two versions of the report in 2005[1013] and 2006,[1014] where the topic of tax treaty dodging was discussed under the theme of abuse by contracting states. In the 2006 version, steps to be followed by the offended state were proposed.[1015] According to the report, the first step to be followed by the offended state is to make a first call to the abusing state with the purpose of asking for explanations of the supposed abuse.[1016] This means that

[1010] "(…) most tax treaties including UN or OECD Model Treaty do not provide a well-defined verification procedure by which the abuse of treaty either by a State or a taxpayer can be identified or confirmed. As a consequence, the offended States that wish to correct the situation soon are often tempted to directly rely on unilateral countermeasures" (UN, *supra* n. 61 (16 October 2006), p. 7, para. 14).

[1011] "However, the determination on sanctions against the abuse by a state is required to be in line with principles of international law as mentioned above. If the offended state takes the following steps before taking sanctions, it would be regarded as faithful to the principles of international law" (UN, *supra* n. 61 (16 October 2006), p. 7, para. 15).

[1012] Section 2.3.

[1013] UN, *supra* n. 61 (15 November 2005), p. 11, para. 20 and p. 17.

[1014] UN, *supra* n. 61 (16 October 2006).

[1015] *Ibid.*, para. 16.

[1016] "The first step: the offended state may make a first call to the abusing state in order to ask for explanations of the supposed abuse of the treaty as a result of a posterior action of the abusing state (legislative, applicative or interpretative action)" (UN, *supra* n. 61 (16 October 2006), p. 7, para. 16).

the contracting state may protest officially against the treaty dodging and may ask the offending state to stop the action and fulfil its treaty obligations.[1017]

Indeed, a form of official protest was put forward by Finland through a notification issued to the Brazilian authorities[1018] concerning the interpretation that remittances for the payment of the provision of technical assistance and technical services without the transfer of technology would fall under the scope of the other income article, which was spotted by this study as an executive interpretative dodging case - see details in Chapter 3.[1019] The notification was the immediate cause for the Brazilian authorities to initiate an internal review procedure of their contested interpretation, which eventually led to the change of the Brazilian position on the topic.[1020]

Despite examples of successful protests like the one of Finland, the effectiveness of official protest is in principle relatively low, since international law does not offer ways to enforce the request made by the offended state for the offending state to refrain from executing the act. Despite this relative lack of efficiency, the act of protesting still plays a relevant role in avoiding the effects of *acquiescence* and *subsequent practice*, outlined below.

5.2.1.1. Avoiding the effects of acquiescence

One of the aspects derived from the principle of good faith[1021] refers to the affirmative that "a man shall not be allowed to blow hot and cold – to affirm at one time and deny at another".[1022] This rationale is an expression of the principle mostly known as *estoppel*, which has its basis in common sense and justice[1023] and which has been applied in the international sphere in a variety of cases.[1024] Accordingly, if a state has consistently applied a certain treaty to its own advantage, it is stopped or precluded from later arguing that it is invalid when it comes to the performance of its obligations under that treaty.[1025] Analogous to estoppel is acquiescence[1026]: if a state has abstained from protesting against a consistent practice of another state in the application of a treaty between them, the former state must be considered to have *acquiesced* in that practice and, thus, be stopped or precluded from later arguing in good faith that this practice constituted a breach of the treaty.[1027]

1017 See also Lüthi, *supra* n. 27, p. 9; Rust, *supra* n. 19, p. 241.
1018 V. Arruda Ferreira, *supra* n. 648, p. 430.
1019 Section 3.3.2.
1020 See details in Chapter 3, Section 3.3.2.
1021 Engelen, *supra* n. 55, p. 129; Pijl, *supra* n. 33, pp. 305-306.
1022 Cheng, *supra* n. 277, pp.-141-142. Decision: England, Court of Exchequier: Cave v. Mills (1862) 7 Hurlstone & Norman, p. 913, at p. 927.
1023 Cheng, *supra* n. 277, p. 141.
1024For an overview of the cases, see Cheng, *supra* n. 277, pp. 142-149.
1025 Engelen, *supra* n. 55, p. 129
1026 Cheng, *supra* n. 277, p. 144; Pijl, *supra* n. 33, p. 306.
1027 Engelen, *supra* n. 55, p. 129.

Indeed, article 45(b) of the Vienna Convention (1969) determines that a state may no longer invoke a ground for invalidating, terminating, withdrawing from or suspending the operation of a treaty under articles 46 to 50 or articles 60 and 62 - which are measures available in case of tax treaty dodging as explained in Section 5.2.3. - if, after becoming aware of the facts, it can be considered as having acquiesced in the validity of the treaty or in its maintenance in force or in operation, as the case may be.

For example, it has been already held that a state cannot be heard to repudiate liability for a collision after its authorities on the spot had at the time admitted liability and sought throughout to make the most advantageous arrangements for the Government under the circumstances.[1028] Same, if a state, having been fully informed of the circumstances, has accepted a person's claim to the ownership of certain property and entered into negotiation with him for its purchase, it becomes "very difficult, if not impossible" for that state to subsequently allege that he had no title at the time.[1029]

Concerning this, it would be necessary to verify whether a contracting state suffering from a possible dodging practice in a constant way has abstained from protesting against this practice in such a way that it would be prevented from later arguing a breach of treaty or from making use of other remedies in international law.[1030] However, the author agrees with Cheng in the sense that the force of an admission may vary according to the circumstances. In his words, "an admission does not peremptorily preclude a party from averring the truth. It has rather the effect of an argumentum ad hominem, which is directed at a person's sense of consistency, or what in logic is paradoxically called 'the principle of contradiction'. An admission is not necessarily conclusive as regards the facts admitted. Its force may vary according to the circumstances".[1031] In the same direction, Hans Pijl indicates that acquiescence is flexibly weighted in international law and that "the decisive factor is whether the respondent state has suffered any prejudice as a result of the delay in the sense that the respondent could have reasonably expected that the claim would no longer be pursued".[1032] It is therefore a matter of assessing, on a case-by-case basis, whether the offended state was "inactive" enough to the point of being considered as having tacitly consented to the practice.

Whatever scope or force is given to *acquiescence*, it could be argued that to notify the offending state and present an official complain would be the most secure practice for offended states. Failure to take action through an official protest at some point could be understood to constitute acquiescence and the offended state may be prevented from later arguing in good faith that this practice constituted a

[1028] Cheng, *supra* n. 277, p. 144.

[1029] Cheng, *supra* n. 277, p. 144, on the case *Union Bridge Co. Case* (1924)

[1030] It is important to mention that acquiescence was not considered by the author as an element for assessing the threshold for illegitimate dodging in Chapter 4 because it does not have the effect of legitimating the action of the offending state; it has the effect of preventing the offended state from arguing in good faith a breach of the treaty.

[1031] Cheng, *supra* n. 277, p. 147.

[1032] Pijl, *supra* n. 33, p. 306.

breach of the treaty and consequently make use of other remedies available under international law.[1033] However, the author believes that it is difficult to determine the point at which the lack of protest could reasonably be enough to produce this effect in practice. It is not realistic to always expect countries to be fully aware of all practices of their treaty partners - what is more often in the case for taxpayers, who immediately become aware of dodging actions because are normally confronted with double taxation as a result of this practice; and not surprisingly taxpayers do often contest these actions through judicial courts. For example, the official protest by Finland to the Brazilian authorities[1034] is understandable because it was made in respect of a Brazilian practice that was held for more than a decade with effect on a common and important flow of income (fees for technical service and technical assistance), had already been widely discussed in literature and congresses and was possibly one of the causes for the termination of the treaty with Germany.[1035] The effects of acquiescence must therefore be carefully assessed taking into account the importance, recurrence and notoriety of the dodging practice as essential elements in establishing a reasonable expectation for an official protest by offended states.

5.2.1.2. Avoiding the effect of subsequent practice

The effect of subsequent practice was described in Chapter 4.[1036] In that chapter, the reader saw how the lack of an official protest may not only result in the loss of rights of later arguing a breach of treaty as explained in Section 5.2.1.1., but also lead to a change in the understanding of the parties regarding the interpretation of the treaty[1037] and consequently raise the threshold for an action (or omission) to

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[1033] "The non-breaching party has authority under Art. 60 VCLT to respond to the breach by terminating or suspending the treaty. If, however, no action is taken, this failure to act constitutes acquiescence. According to Art. 45 b VCLT, a non-breaching party cannot terminate or suspend a treaty if, by its conduct, the State acquiesced in the validity of the treaty. Without an official protest against the treaty override, the failure to take action at some point will constitute acquiescence". (Rust, *supra* n. 19, pp. 241-243).

[1034] See Section 5.2.1.

[1035] "In fact, it is suspected that this was one of the reasons that led the German government to seek renegotiation of the Brazil- Germany Income and Capital Tax Treaty (1975). As a result of the unsuccessful renegotiations, the treaty was finally denounced by the German authorities and eventually terminated in 2005 (…). On 7 Apr. 2005, Germany filed a termination notice of the Brazil-Germany tax treaty with Brazilian Ministry of Foreign Affairs. Germany found that the treaty no longer offered a balanced tax solution between the two countries nor did it offer judicial protection for German interests against double taxation" (Arruda Ferreira*, supra* n. 648, p. 430 and footnote 21).

[1036] Section 4.3.1.

[1037] "Not objecting to a treaty override not only means loss of rights under Art. 60 VCLT but can also lead to a change in the content of the tax treaty. According to Art. 31 (3) lit. b VCLT, any subsequent practice in the application of the treaty that establishes the agreement of the parties regarding its interpretation shall be taken into account for purposes of interpreting the treaty. Subsequent practice can influence the content of a treaty. If a domestic provision is not in line with a treaty provision, the subsequent agreement of the contracting States that the domestic provision does not violate the treaty will change the treaty so that the domestic provision no longer is in contradiction to the treaty. The same is true if one contracting State enacts a provision contrary to a treaty and the other contracting State does not object. After a certain

be qualified as tax treaty dodging.[1038] As explained, subsequent practice in the application of a treaty may establish the understanding of the parties regarding its interpretation according to the wording of article 31(3) of the Vienna Convention (1969).[1039] This is particularly relevant in the case of tax treaty dodging, since if a state has abstained from protesting against a consistent practice of another state in the application of a treaty, it could be assumed this silence to configure sufficient practice that would establish agreement by that state. In other words, the lack of an official protest could be understood as leading to a change in the understanding of the parties regarding the interpretation of the treaty[1040] so to legitimize a potential dodging act. The use of the official protest would therefore be essential for avoiding this undesirable effect. But the author believes that the same caution explained for concluding acquiescence from the lack of official protest (see section 5.2.1.1.) should be applied when assessing subsequent practice.

5.2.2. Mutual Agreement Procedure

According to the UN Committee of Experts on International Cooperation in Tax Matters, the second step that may be taken by the offended state before resorting to sanctions is the start of a dispute settlement through a mutual agreement procedure or other mechanism provided in the tax treaty.[1041] Indeed, article 25(3) and (4) of the OECD Model Convention (2017) allow competent authorities to deal directly with each other or through a joint commission consisting of themselves or their representatives for reaching an agreement on the interpretation or application of tax treaties. States may therefore take the initiative to resolve any interpretation and application problem irrespective of a case put forward by a taxpayer.[1042]

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amount of time has elapsed, the treaty overriding domestic provision turns into a treaty respecting domestic provision since the content of the treaty has changed" (Rust, *supra* n. 19, pp. 241-243).

[1038] See Chapter 4, section 4.3.1.

[1039] "There shall be taken into account, together with the context: (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation; (c) any relevant rules of international law applicable in the relations between the parties" (Article 31(3) of the Vienna Convention (1969)).

[1040] "Not objecting to a treaty override not only means loss of rights under Art. 60 VCLT but can also lead to a change in the content of the tax treaty. According to Art. 31 (3) lit. b VCLT, any subsequent practice in the application of the treaty that establishes the agreement of the parties regarding its interpretation shall be taken into account for purposes of interpreting the treaty. Subsequent practice can influence the content of a treaty. If a domestic provision is not in line with a treaty provision, the subsequent agreement of the contracting States that the domestic provision does not violate the treaty will change the treaty so that the domestic provision no longer is in contradiction to the treaty. The same is true if one contracting State enacts a provision contrary to a treaty and the other contracting State does not object. After a certain amount of time has elapsed, the treaty overriding domestic provision turns into a treaty respecting domestic provision since the content of the treaty has changed" (Rust, *supra* n. 19, pp. 241-243).

[1041] UN, *supra* n. 61 (16 October 2006), p. 7, para. 16.

[1042] M. Lang, *supra* n. 247, at p. 155, marginal n. 512.

Since mutual agreement procedures are meant to address issues of interpretation and application of tax treaties, this option could be regarded as an available measure for discussing tax treaty dodging and underlying issues - such as the interpretation of terms not defined by the treaty and subsequent changes in domestic law, as indicated by the commentaries. In fact, the paragraphs included in the OECD Model Convention (2017) explicitly refer to issues deriving from domestic definition of treaty terms: "Under paragraph 3, the competent authorities can, in particular, enter into a mutual agreement to define a term not defined in the Convention, or to complete or clarify the definition of a defined term, where such an agreement would resolve difficulties or doubts arising as to the interpretation or application of the Convention. Such circumstances could arise, for example, where a conflict in meaning under the domestic laws of the two States creates difficulties or leads to an unintended or absurd result".[1043]

Offended states may resort to mutual agreement procedure for discussions with treaty partners in respect of dodging practices. For example, where a state modifies the domestic definition of undefined treaty terms or modifies the constitutive elements of the tax liability determined in domestic law in a way that conflicts with the object and purpose of the convention,[1044] the offended state may try to agree with the offending state through a mutual agreement procedure possible solutions and a common interpretation.

Doubts in respect of whether tax treaty dodging, as a practice not in conflict with the wording of the provision of treaties, could be covered by this article and consequently be object of a mutual agreement procedure may be solved by reference to the statement in the commentaries regarding the scope of the mutual agreement procedure article: "this article institutes a mutual agreement procedure for resolving difficulties arising out of the application of the convention in the broadest sense of the term".[1045] A broad interpretation of "difficulties" arising out of the application of the convention could include cases of possible indirect violation of tax treaty.

However, the mutual agreement procedure has not been seen as an effective tool in tax treaty practice, partly because treaty partners are only expected to try (or "endeavour", as worded by article 25 of the OECD Model Convention) to compromise or avoid taxation not in accordance with the treaty.[1046] As indicated by Scott Wilkie, "this seemingly muted expectation of expending effort, but not necessarily reaching an outcome, may be because of the quasi-diplomatic nature of article 25 of the OECD Model".[1047] In addition, there are no criteria by which the interaction of treaty partners to deal with

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[1043] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 25* para. 6.1 (21 November 2017), Models IBFD.

[1044] See Chapter 3, Section 3.3.1.1. and Chapter 4, Section 4.3.1.

[1045] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 25* para. 1 (21 November 2017), Models IBFD.

[1046] J. Scott Wilkie, *Article 25: Mutual Agreement Procedure*, Global Tax Treaty Commentaries (R. Vann ed., IBFD 2017), Online Books IBFD, at section 1.1.2.5.

[1047] *Ibid.*

situations not provided for in the treaty (i.e. treaty gaps) would be expected to take place.[1048] These limitations may render mutual agreement procedure a (possible but) not very promising measure for offended states facing tax treaty dodging practices.

More recently, efforts to strengthen the effectiveness and efficiency of mutual agreement procedures were agreed in Action 14 of the OECD BEPS Project on "Making Dispute Resolution Mechanisms More Effective".[1049] The action proposes to "minimise the risks of uncertainty and unintended double taxation by ensuring the consistent and proper implementation of tax treaties, including the effective and timely resolution of disputes regarding their interpretation or application through the mutual agreement procedure".[1050]

One of the results of this action was the inclusion of the following paragraph in the commentary on article 25 of the OECD Model Convention (2017) in order to emphasize countries' obligation to seek resolution in mutual agreement procedure: "the undertaking to resolve by mutual agreement cases of taxation not in accordance with the Convention is an integral part of the obligations assumed by a Contracting State in entering into a tax treaty and must be performed in good faith. In particular, the requirement in paragraph 2 that the competent authority "shall endeavour" to resolve the case by mutual agreement with the competent authority of the other Contracting State means that the competent authorities are obliged to seek to resolve the case in a fair and objective manner, on its merits, in accordance with the terms of the Convention and applicable principles of international law on the interpretation of treaties".[1051]

To the author, this emphasis does not seem to result in the effective obligation for countries to reach an outcome in the process. The expression "obliged to seek to resolve" indicates how careful the OECD was not to imply a mandatory solution by states, which would have been the case if the wording "obliged to resolve" had been used in the paragraph. Despite the lack of obligation in this respect, mutual agreement procedures remain as a diplomatic option available to contracting states for trying to resolve tax treaty dodging cases.

5.2.3. Termination or suspension on the basis of the Vienna Convention (1969)

In case the states involved do not reach an agreement under mutual agreement procedure in respect of dodging actions, contracting states may resort to measures provided by the Vienna Convention

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[1048] *Ibid.*

[1049] OECD/G20 *Base Erosion and Profit Shifting Project, Making Dispute Resolution Mechanisms More Effective, Action 14: 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD.

[1050] *Ibid*, at p. 9.

[1051] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 25,* para. 5.1 (21 November 2017), Models IBFD.

(1969). Offended states may have the option to terminate or suspend the operation of the treaty in whole or in part as a consequence of its material breach (article 60 of the Vienna Convention (1969)), or to request termination or the withdrawing from the treaty in view of a fundamental change of circumstances (article 62 of the Vienna Convention (1969)). These two grounds supporting termination and suspension of a treaty as possible measures available against tax treaty dodging are outlined in more detail below.

5.2.3.1. Termination or suspension as a consequence of its material breach

The procedure to invoke the breach as a ground for terminating the treaty or suspending its operation is regulated by article 65 of the Vienna Convention (1969). Under this article, the non-breaching party must notify the breaching party of its claim and indicate the measure proposed with respect to the treaty and the reasons therefore. If the breaching party does not object within a period of three months, the non-breaching party may carry out the proposed measure (i.e. termination or suspension of the treaty). If the breaching party objects, the parties must seek a solution through the means indicated in article 33 of the Charter of the United Nations (i.e. negotiation, enquiry, mediation, conciliation, arbitration, judicial settlement, resort to regional agencies or arrangements, or other peaceful means of their own choice).[1052]

The suspension of the treaty does not affect the treaty regime itself, but releases temporarily the offended and the defaulting parties from the performance of treaty obligations until the latter party carries out its obligations, while the termination of the treaty brings the entire regime to an end.[1053]

Article 60(1) of the Vienna Convention (1969) states that "a material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part".[1054] Accordingly, a breach of the treaty gives grounds for contracting states to terminate or suspend the operation of a treaty in whole or in part. However, the breach of the treaty must be a material one and result in an essential violation that interferes with the purpose or main content of the treaty.[1055] This is determined by article 60(3) of the Vienna Convention (1969), which reads: "A material breach of a treaty, for the purposes of this article, consists in: (a) a repudiation of the treaty not sanctioned by the present Convention; or (b) the violation of a provision essential to the accomplishment of the object or purpose of the treaty".

[1052] "1. The parties to any dispute, the continuance of which is likely to endanger the maintenance of international peace and security, shall, first of all, seek a solution by negotiation, enquiry, mediation, conciliation, arbitration, judicial settlement, resort to regional agencies or arrangements, or other peaceful means of their own choice. 2. The Security Council shall, when it deems necessary, call upon the parties to settle their dispute by such means" (UN, *supra* n. 716, article 33).

[1053] M. E. Villiger, *Commentary on the 1969 Vienna Convention on the Law of Treaties* (Martinus Nijhoff Publishers 2009), p. 740.

[1054] Article 60(1) of the Vienna Convention (1969).

[1055] Lüthi, *supra* n. 27, pp. 8-9.

The International Law Commission used the term "material" instead of "fundamental" to avoid an understanding that only the violation of a provision directly touching the central purposes of the treaty could justify the termination or suspension of the operation of the treaty.[1056] The International Law Commission also understands that other provisions considered by a party to be essential to the effective execution of the treaty may have been very material in inducing it to enter into the treaty at all, even though these provisions may be of an ancillary character.[1057]

Article 60(3) of the Vienna Convention (1969) defines a material breach narrowly and exclusively, and *culpa* of the defaulting state is not mentioned as a requirement.[1058] The second case of material breach – which is the one relevant for this study – would be the case of the non-performance or incorrect performance of a certain treaty provision[1059] essential to the accomplishment of the object or purpose of the treaty.[1060]

It is important to mention that the International Court of Justice takes a restrictive approach to the application of article 60 of the Vienna Convention (1969) in the sense that the violation of another treaty or the violation of rules of general international law may justify the offended state to take other measures (such as countermeasures[1061]), but they do not constitute grounds for termination of treaties under the Vienna Convention (1969).[1062] This means, for instance, that the fact that tax treaty dodging violates the principle of good faith would not be enough for termination or suspension. Tax treaty dodging would justify the termination or suspension of the operation of the treaty under article 60 of the Vienna Convention (1969) only if it constitutes a material breach of a *treaty* provision. But tax treaty dodging does not entail a direct violation of a treaty provision (i.e. violation of the wording of the provision). The question is therefore whether the indirect violation of a treaty provision through tax treaty dodging would qualify as a material breach in the sense of article 60 of the Vienna Convention (1969).

This question was addressed by Lord McNair when he explained that there may be actions that do not constitute a direct breach but that may have the same effect: "a breach of a treaty may be direct, for instance, when a state declines to surrender an alleged criminal to another state in pursuance of an extradition treaty (...). But breaches are not usually so simple as that. A state may take certain action

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[1056] Sinclair, *supra* n. 278, pp. 189-190; Villiger, *supra* n. 1053, p. 743.

[1057] Sinclair, *supra* n. 278, p. 190; Villiger, *supra* n. 1053, p. 743.

[1058] Villiger, *supra* n. 1053, p. 472.

[1059] Villiger, *supra* n. 1053, p. 742.

[1060] Rust, *supra* n. 19, pp. 241-242.

[1061] See Section 5.2.7.

[1062] "It is certainly true that the ICJ takes a restrictive approach to the application of article 60. For example, in the Gabcikovo-Nagymaros case it responding to Hungary's claim that Slovakia's actions by saying that 'it is only material breach of the treaty itself, by a party to the treaty, which entitles the other party to rely on it as a ground for terminating the treaty'. The Court explained that, whilst the violation of any other treaty or rules of general international law might justify an injured state taking another measures, such as countermeasures, it did not constitute a ground for termination of the treaty under the law of treaties" (M. Fitzmaurice, *supra* n. 720, at p. 209); "*The violation of other rules, namely of general international law, is not covered by subpara. 3(b)*" (Villiger, *supra* n. 1053, p. 743).

or be responsible for certain inaction, which, though not in form a breach of treaty, is such that its effect will be equivalent to a breach of treaty; in such cases a tribunal demands good faith and seeks for the reality rather than the appearance".[1063]

He continues by reminding that, in several occasions, the at the time Permanent Court had made it clear that in considering whether treaty provisions had been violated or not it was not the actual text of a decree or regulation that matters but its actual effect.[1064] In the German Settlers in Poland case and the Treatment of Polish Nationals in Danzig case, the court stated that treaty obligations must be respected in fact as well as in law,[1065] otherwise there would be a violation of the treaty obligation. In the case Treatment of Polish Nationals in Danzig, it was stated by the court that: "(...) the prohibition against discrimination, in order to be effective, must ensure the absence of discrimination in fact as well as in law. A measure which in terms is of general application, but in fact is directed against Polish nationals and other persons of Polish origin or speech, constitutes a violation of the prohibition".[1066] Reports[1067] listed by Lord McNair also illustrate the necessity, in ascertaining whether or not a breach has occurred, of going beneath the surface and finding what has really taken place.[1068]

Lord McNair also refers to the Panama Canal Tolls controversy between the United Kingdom and the Unites States, which might have involved an "indirect breach of the treaty".[1069] In the case, certain legislative and executive actions proposed by the United States were designed to afford preferential treatment to American shipping without infringing the letter of the Hay-Pauncefote Treaty, which provided for the free circulation of vessels of all nations in the Panama Canal on terms of entire equality and, consequently, of no discrimination against any nation.[1070]

The British Government found that the proposal of the United States that the tolls paid by American vessels for the use of the canal would be refunded to them by the American Government was "an

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1063 McNair, *supra* n. 9, p. 540.
1064 McNair, *supra* n. 9, p. 541.
1065 In the Advisory Opinion on the German Settlers in Poland the court said: "there must be equality in fact as well as ostensible equality in the sense of absence of discrimination in the words of the law". In the Advisory Opinion on the Treatment of Polish Nationals in Danzig, the court said: "(...) the prohibition against discrimination, in order to be effective, must ensure the absence of discrimination in fact as well as in law. A measure which in terms if of general application, but in fact is directed against Polish nationals and other persons of Polish origin or speech, constitutes a violation of the prohibition" (McNair, *supra* n. 9, p. 541).
1066 *Ibid.*
1067 Report by the King's Advocate dated 11 September 1834, Report of 27 January 1866 entitled 'Most Favoured Nation Treatment Clauses' and Report on Congo-Balolo mission (for references and details, see McNair, *supra* n. 9, pp. 541-547).
1068 McNair, *supra* n. 9, p. 541.
1069 McNair, *supra* n. 9, p. 547.
1070 Article 3(1) of the Hay-Pauncefote Treaty of 18 November 1901 stated that: "The Canal shall be free and open to the vessels of commerce and of war of all nations observing these Rules, on terms of entire equality, so that there shall be no discrimination against any such nation, or its citizens or subjects, in respect of the conditions or charges of traffic or otherwise. Such conditions and charges of traffic shall be just and equitable" (McNair, *supra* n. 9, p. 547).

attempt to comply with the letter of the treaty whilst contradicting its spirit".[1071] While there was nothing in the treaty precluding the United States from subsidizing its shipping, a subsidy based upon the amount of the user of the canal by the subsidized vessels would amount to an attempt to evade the obligations of the treaty. The case did not reach the court, because the United States accepted the British view of the legal situation and the controversy was settled,[1072] and no position on whether an indirect breach would be considered a violation of a treaty provision in the sense of article 60 of the Vienna Convention (1969) was submitted.

However, in a decision given in the North Atlantic Coast Fisheries case, the tribunal held that "the right to make reasonable regulations, not inconsistent with the obligations of the treaty (…) is not a restriction of or an invasion of the liberty granted to the inhabitants of the United States (…). (…) from the treaty results an obligatory relation whereby the right of Great Britain to exercise its sovereignty by making regulations is limited to such regulations as are made in good faith, and are not in violation of the treaty".[1073] Lord McNair concludes from this that the making of regulations that in substance destroyed or frustrated the right of the other contracting state would be a breach of good faith *and of the treaty*.

If one follows this reasoning, it is possible to argue that, even though most tax treaty dodging actions violate international law rules and principles and not directly a treaty provision (i.e. the wording of the treaty provision), they can be considered equivalent to a material breach of the treaty provision for the purpose of application of article 60 of the Vienna Convention (1969). As a consequence, contracting states could invoke the dodging actions as a material breach of the treaty in order to terminate or suspend the operation of the treaty.[1074] If one does not find sufficient grounds to support the other types of tax treaty dodging actions as a material breach of a treaty provision, there is still the option of terminating or suspending the operation of the treaty on the basis of fundamental changes of circumstances, as explained in the next sub-section.

[1071] McNair, *supra* n. 9, p. 547.

[1072] McNair, *supra* n. 9, p. 549.

[1073] McNair, *supra* n. 9, p. 550.

[1074] "Injured states can either submit the dispute to an international dispute settlement mechanism, and in this regard, it has to be stressed that at least theoretically the International Court of Justice has jurisidiction over a quite a number of possible tax treaty disputes. Since, however, (quasi-) judicial dispute settlement is scarce in general and almost non-existent in the field of tax treaty disputes, injured states may have to resort to self-help, which can result in countermeasures commensurate (i.e. economically more or less equivalent) with the wrongful act (i.e. with the consequences of the application of the treaty overriding legislation by the other state), or even in termination or (partial) suspension of the tax treaty if the treaty override can be qualified as a material breach" (J. Wouters & M. Vidal, *An International Law Perspective on Tax Treaties and Domestic Law*, Working Paper 90 (Instituut voor Internationaal Recht 2006), available at https://www.law.kuleuven.be/iir/nl/onderzoek/working-papers/WP90e.pdf, accessed 1 Oct. 2018, para. 38).

5.2.3.2. Termination or suspension as a consequence of fundamental change of circumstances

Contracting states may also request termination or the withdrawal from the treaty on the grounds of fundamental change of circumstances as indicated in article 62(1) of the Vienna Convention (1969): "A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless: (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and (b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty". The justification for such a rule is the fact that, if the circumstances change substantially, the equivalence of treaty obligation may become imbalanced and treaties would lose their object and purpose, so that it would appear unduly formalistic to expect the parties to continue to perform the treaty.[1075]

The modern approach to the *rebus sic standibus* – a doctrine according to which a party to an agreement may terminate or withdraw from it in case there has been a fundamental change of circumstances - is to admit its existence but severely restrict its scope.[1076] This is why article 62(1) of the Vienna Convention (1969) is formulated in the cautious and negative form to propose the application of the doctrine in exceptional circumstances, that is, only when the former circumstances constituted an essential basis of the consent of the parties and that the change transforms the extent of the treaty

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[1075] Villiger, *supra* n. 1053, p. 769.

[1076] Shaw, *supra* n. 16, p. 950; "All international lawyers are aware of the pitfalls surrounding the application of the clausula rebus sic standibus and the controversies which have raged as to its admissibility as a ground for the unilateral denunciation or termination of a treaty. The concept that (whether by an implied term or otherwise) a treaty may become inapplicable by reason of a fundamental change in circumstances obviously presents serious dangers to the security of treaties. (...) diplomatic practice in the nineteenth century (...) began to demonstrate some of the dangers inherent in the notion of the clause (...). The rebus doctrine has never been applied eo nomine by the International Court of Justice or its predecessor. (...) Against this background, the Commission approached the formulation of a text on rebus sic standibus with considerable caution" (Sinclair, *supra* n. 278, pp. 192-193); "Fundamental change of circumstances as a ground for termination of a treaty is controversial. The principle of stability of contractual obligations and the conviction that 'it is a function of the law to enforce contracts or treaties even if they become burdensome for the party bound by them' militates against it (...) but this needs to be balanced against the view that 'one could not insist upon petrifying a state of affairs which had become anachronistic because it is based on a treaty which either does not contain any specific clause as to its possible termination or which even proclaimed itself to be concluded for all times to come' (...). VCLT Article 62 takes a particularly cautious approach. It accepts that termination on these grounds is possible, but it is of limited scope". (Fitzmaurice, *supra* n. 720, pp. 210-211); "Although most modern jurists accept the existence in international law of the principle of rebus sic standibus, they nevertheless emphasize the need to confine its scope within narrow limits by regulating the conditions under which it may be invoked" (T.O. Elias, *The Modern Law of Treaties* (Oceania Publications 1974), p. 120); "Most governments commenting on the Draft of 1963 endorsed the principle, while fearing an impact on the stability of treaties and, therefore, urging some form of independent adjudication. (...) A large majority of states accepted the possibility of a fundamental change of circumstances, albeit under strict conditions" (Villiger, *supra* n. 1053, pp. 768-769).

obligations to be performed. Court practice, doctrine and the *travaux préparatoires* confirm that the exceptional conditions in article 62 of the Vienna Convention (1969) are to be interpreted narrowly.[1077]

In the Gabcikovo-Nagymaros Project and Fisheries Jurisdiction cases, the International Court of Justice concluded that the change of circumstances must radically transform the extent of the obligations to be performed, that it must have been unforeseen and that the existence of the circumstances at the time of the treaty's conclusion must have constituted an essential basis of the consent of the parties to be bound by the treaty.[1078] The court also confirmed that the negative and conditional wording of article 62 of the Vienna Convention (1969) is a clear indication that the plea of fundamental change of circumstances should be applied only in exceptional cases.[1079]

The conditions for the application of article 62 of the Vienna Convention (1969) could be then summarized as follows: (i) a substantial change of circumstances of considerable importance (i.e. not a mere change); (ii) which was not foreseen by the parties, so that the change must have occurred to circumstances existing at the time of the conclusion; (iii) the existence of the circumstances constituted an essential basis for the consent of the parties to be bound to the treaty, so that if the parties would have foreseen the subsequent change, they would have not committed themselves or would have drafted the treaty in different terms; (iv) the change substantially hinders the further realisation of the treaty's object and purpose or renders the performance of the treaty obligations essentially different from what was originally undertaken.[1080] A fundamental change of circumstances may not be invoked, however, if the treaty established a boundary or if it is the result of a breach by the party invoking it, either of an obligation under the treaty or of any other international obligation owed to the other treaty party.[1081]

There is an understanding that a change in domestic law can neither be invoked as a fundamental change of circumstance as a result of article 27 of the Vienna Convention (1969),[1082] which states that "a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty". However, this limitation applies only if it is the state invoking the change of circumstances that has made the change in its domestic law.[1083] Therefore, an offended state would not be prevented by article 27 of the Vienna Convention (1969) from invoking a legislative dodging committed by its treaty partner as a fundamental change of circumstances.

Actions (or omissions) qualified in this study as tax treaty dodging are performed by contracting states after the signature of the treaty,[1084] could not have been foreseen by the other parties involved and

[1077] Villiger, *supra* n. 1053, p. 770.
[1078] Shaw, *supra* n. 16, p. 951; Fitzmaurice, *supra* n. 720, p. 211.
[1079] Shaw, *supra* n. 16, p. 952.
[1080] Villiger, *supra* n. 1053, pp. 771-775.
[1081] Article 62(2) of the Vienna Convention (1969).
[1082] Villiger, *supra* n. 1053, p. 773.
[1083] *Ibid.*
[1084] See Chapter 3, Section 3.2.2.

have a considerable impact on these agreements. These changes can be considered substantial and of considerable importance because they modify the outcome initially expected by treaty partners at the moment of signature of the treaty, that is, they render the performance of treaty obligations essentially different from what was originally anticipated. If such changes were known at the time of signature of the agreement, the offended state would probably advocate different terms. These are considerations that support the qualification of tax treaty dodging actions as fundamental changes of circumstances allowing the termination or suspension of the treaty on the basis of article 62(1) of the Vienna Convention (1969). This seems to have been the case of the termination by Finland of the tax treaty signed with Portugal in view of the Portuguese legislature omission in ratifying the new treaty signed – see details in Chapter 3, Section 3.3.1.3.

Contracting states may also have the option of terminating a tax treaty without the need to invoke article 60 or article 62 of the Vienna Convention (1969). This is because tax treaties can also be terminated on the basis of specific termination clause existing in these types of treaty and which is suggested by the OECD Model Convention (2017) itself, as outlined below.

5.2.4. Termination on the basis of article 32 of the OECD Model Convention

In addition to the possibility of terminating treaties on the basis of the Vienna Convention (1969), contracting states may have the option of terminating treaties on the basis of a specific clause included in the treaty itself.[1085] In the case of tax treaties, termination may be requested on the basis of a provision following article 32 of the OECD Model Convention (2017), which determines that the treaty remains in force "until terminated by a contracting state" and that "either contracting state may terminate the convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year (...)".

Article 32 does not provide further details on the termination of the treaty, but the commentary on articles 31 and 32 indicates that the provision is "drafted for bilateral conventions and correspond to the rules usually contained in international treaties".[1086] The rules applicable under international law and explained under Section 5.2.3. are thus applicable. According to Klaus Vogel et al., the purpose to be served by the termination clause in tax treaties is to offer states a possibility of disengaging in an orderly manner from their commitments under the treaty in case the treaty cease to provide a reasonable balance[1087] - which is the case when one party dodges its obligation.

[1085] "A treaty may be terminated or suspended in accordance with a specific provision in that treaty, or otherwise at anytime by consent of all parties after consultation" (Shaw, *supra* n. 16, p. 945).

[1086] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 31 and 32,* para. 1 (21 November 2017), Models IBFD.

[1087] Vogel et al., *supra* n. 36, p. 1488, marginal n. 26.

5.2.5. The ILC Draft Articles on Responsibility of States for Internationally Wrongful Acts (and bringing a claim at the International Court of Justice)

Acts or omission by a state resulting in a breach of a legal obligation gives rise to responsibility under international law, whether the obligation rests on treaty, custom or on another basis.[1088] This common understanding is reflected[1089] in article 1 of the International Law Commission Draft Articles on Responsibility of States for International Wrongful Acts (UN 2001) (hereinafter referred to as ILC Draft Articles), which provides that every internationally wrongful act of a state entails the international responsibility of that state.[1090]

The international responsibility of a state arises from the commitment of an internationally wrongful act. An internationally wrongful act presupposes that there is conduct consisting of an action or omission that (a) is attributable to a State under international law and (b) constitutes a breach of the international obligations of the State. International courts and tribunals have affirmed that the fulfilment of these conditions is in principle sufficient for the constituting international responsibility.[1091] In some cases, however, the respondent state may justify its non-performance invoking, for example, self-defence or force majeure. In international law such defences or excuses are termed "circumstances precluding wrongfulness".[1092]

There was a major debate on whether international law has also a general requirement of fault or intention for the purpose of state responsibility. There were theories as to whether responsibility of the state for unlawful acts or omissions is strict or whether it is necessary to show some fault or

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[1088] Brownlie, *supra* n. 16, pp. 436-437. "A dispute between two States concerning the breach of an international obligation, whether customary or deriving from treaty, concerns international responsibility (...)" (Crawford & Olleson, supra n., p. 455); "On the international plane, responsibility is the necessary corollary of obligation: every breach by a subject of international law of its international obligations entails its international responsibility. (...) The law of State responsibility enunciates the consequences of a breach by a State of an international obligation (...)" (J. Crawford & S. Olleson, *The Nature and Forms of International Responsibility, International Law* (M. Evans ed., Oxford University Press 2006), pp. 451-477, at p. 451).

[1089] "That every internationally wrongful act of a State entails the international responsibility of that State, and thus gives rise to new international legal relations additional to those which existed before the act took place, has been widely recognized, both before and since article 1 was first formulated by the Commission" (ILC *Draft Articles on Responsibility of States for International Wrongful Acts* (UN 2001), commentary on article 1, para. 3).

[1090] "Article 1. Responsibility of a State for its internationally wrongful acts. Every internationally wrongful act of a State entails the international responsibility of that State" (ILC, *supra* n. 1089, art. 1).

[1091] Crawford & Olleson, *supra* n. 1088, p. 459.

[1092] 1092 Crawford & Olleson, *supra* n. 1088, p. 459. "States may be able to rely on some defence or excuse: in the ILC's Articles these are collected under the heading 'Circumstances precluding wrongfulness' in Chapter V of Part One. Chapter V is essentially a catalogue or compilation of rules that have been recognized by international law as justifying or excusing non-compliance by states with its international obligations, and it is not exclusive" (Crowford & Olleson, *supra* n. 1088, pp. 467-468).

intention on the part of the officials concerned[1093]. According to the principle of objective responsibility, the liability of the state is strict, that is, once an unlawful act has taken place, which has caused injury and which has been committed by an agent of the state, the acting state is responsible in international law to the state suffering the damage irrespective of good or bad faith.[1094] Under the subjective responsibility, the element of intentional (dolus) or negligent (culpa) conduct on the part of the state concerned is necessary before this state can be rendered liable for any injury caused.[1095]

The practice of states and the jurisprudence of arbitral tribunals and the International Court have followed the theory of objective responsibility as a general principle.[1096] Also, the ILC Draft Articles confirm that it is only the act of the state that matters, independently of any intention.[1097] Therefore, in international law the fact that an act is accompanied by malice, that is, an intention to cause harm without regard to whether or not the law permits the act, does not affect the responsibility of the state.[1098] Indeed, the principle of objective responsibility dictates the irrelevance of intention to harm, dolus, as a condition of liability,[1099] so that the only requirements are the attributability to a state, the

[1093] Shaw, *supra* n. 16, p. 783.

[1094] *Ibid.*

[1095] *Ibid.*

[1096] Brownlie, *supra* n. 16, p. 437-438; "There has been a major debate about whether international law has a general requirement of fault. (...) The case law tends to support the objective school" (Crawford & Olleson, *supra* n. 1088, pp. 464-465); "The relevant cases and academic opinions are divided on this question, although the majority tends towards the strict liability, objective theory of responsibility" (Shaw, *supra* n. 16, p. 783); "A considerable number of writers support this point of view, either explicitly, or implicitly, by considering the questions of imputability, causation, and legal excuses without adverting to the question of culpa or dolus. At the same time certain eminent opinions have supported the Grotian view that culpa or dolus malus provide the proper basis of state responsibility in all cases. A small number of arbitral awards give some support at the culpa doctrine" (Brownlie, *supra* n. 16, p. 438); "Much overgeneralization has been involved in the doctrinal dispute as to the type of advertence required to prove an international claim. In nearly all the arguments, there has been a failure to indicate whether proof of intention is a necessary condition for the establishment of responsibility or, indeed, whether it is a sufficient condition. The view that a subjective element of intention to commit a wrongful act (culpa or dolus) must be present has sometimes been advanced. However, the majority of modern writers and some international tribunals have held to the view that the intent is objective" (Iluyomade, *supra* n. 770, p. 77); "Certains auteurs (Strupp) soutiennent que la responsabilité repose sur une faute des sujets du droit international. La doctrine dominante et, à sa suite, les travaux de codification s'opposent à une telle explication. (...) Si les auteurs de la première tendence retiennent comme faute un comportement marquée d'une intention malveillante, leur approche doit être écartée. Elle est à la fois trop étroite et ambiguë. Faire appel à des elements aussi subjectifs est difficilement compatible avec la responsabilité de personnes morales, surtout lorsqu'il s'agit d'États souverains. Un tel fondament limite à l'excès la portée de la responsabilité international et les conditions de sa mise en oeuvre. Cette manière de voir n'est pas retenue dans la pratique international ni dans la jurisprudence dominante" (Nguyen Quoc, Daillier & Pellet, *supra* n. 16, p. 675, para. 480).

[1097] "A related question is whether fault constitutes a necessary element of the internationally wrongful act of a State. This is certainly not the case if by "fault" one under- stands the existence, for example, of an intention to harm. In the absence of any specific requirement of a mental element in terms of the primary obligation, it is only the act of a State that matters, independently of any intention" (ILC, *supra* n. 1089, Chapter II, commentary on art. 2, para 10).

[1098] Brownlie, *supra* n. 16, 441.

[1099] Brownlie, *supra* n. 16, p. 441. "(...) and yet general propositions of this sort should not lead to the conclusion that dolus cannot play a significant role in the law. Proof of dolus on the part of leading organs of the state will solve the problem of

commitment of a breach and the absence of any valid justification for the non-performance of the obligation.

State responsibility does not deal with the continual or binding effect of the primary rules (that is, of the norms created by treaty or customary law as opposed to the rules on state responsibility, i.e. secondary rules), but with the question of whether the conduct inconsistent with those rules can be excused and, if not, what consequences of such conduct are.[1100]

The international responsibility of a state that is entailed by an internationally wrongful act in accordance with the provisions of the ILC Draft Articles involves legal consequences. A state responsible for the internationally wrongful act is under an obligation of (i) cessation of the act and its non-repetition,[1101] (ii) reparation for the injury caused[1102] through the forms[1103] of restitution[1104],

'imputability' in the given case, and, in any case, the existence of a deliberate intent to injure may have an effect on remoteness of damage as well as helping to establish the breach of duty" (Brownlie, *supra* n. 16, p. 441).

1100 "The relationship between the material breach of a treaty and the law of State responsibility, and particularly with countermeasures, is extremely problematic. Although not resolved by the ILC in its work on the law of treaties, it appears that its intention was that the two regimes should co-exist and the ILC's Commentary to its Articles on State Responsibility reflect this, indicating that State responsibility does not deal with the 'consequences of breach for the continual or binding effect of the primary rules (e.g., the right of an injured State to terminate or suspend a treaty for material breach, as reflected in article 60 of the Vienna Convention on the Law of Treaties). The Special Rapporteur, James Crowford, explained that: 'There is thus a clear distinction between action taken within the framework of the law of treaties (as codified in the Vienna Convention) and conduct raising questions of State responsibility (which are excluded from the Vienna Convention). The law of treaties is concerned essentially with the content of primary rules and with the validity of attempts to alter them; the law of State responsibility takes as given the existence of primary rules (whether based on a treaty or otherwise) and is concerned with the question of whether the conduct inconsistent with those rules can be excused and, if not, what consequences of such conduct are. Thus it is coherent to apply the Vienna Convention rules as to the materiality of the breach and the severability of provisions of a treaty in dealing with issues of suspension, and the rules proposed in the Draft articles as to proportionality etc, in dealing with countermeasures'" (Evans, *supra* n., p. 210).

1101 "Article 30. Cessation and non-repetition. The State responsible for the internationally wrongful act is under an obligation: (a) to cease that act, if it is continuing; (b) to offer appropriate assurances and guarantees of non-repetition, if circumstances so require" (ILC, *supra* n. 1089, art. 30).

1102 "Article 31. Reparation. 1. The responsible State is under an obligation to make full reparation for the injury caused by the internationally wrongful act. 2. Injury includes any damage, whether material or moral, caused by the internationally wrongful act of a State" (ILC, *supra* n. 1089, art. 31).

1103 "Article 34. Forms of reparation. Full reparation for the injury caused by the internationally wrongful act shall take the form of restitution, compensation and satisfaction, either singly or in combination, in accordance with the provisions of this chapter" (ILC, *supra* n. 1089, art. 34).

1104 "Article 35. Restitution. A State responsible for an internationally wrongful act is under an obligation to make restitution, that is, to re-establish the situation which existed before the wrongful act was committed, provided and to the extent that restitution: (a) is not materially impossible; (b) does not involve a burden out of all proportion to the benefit deriving from restitution instead of compensation" (ILC, *supra* n. 1089, art. 35).

compensation[1105] and/or satisfaction[1106]. Interest on the principle amount due may also be payable if necessary.[1107]

State responsibility has been addressed by courts and tribunals in different scenarios related to taxation. For example, a number of case law of the Dispute Settlement Body of the World Trade Organization relates to state responsibility in taxation matters.[1108] In the case Brinkmann Tabaksfabriken v. Skatteministeriet, the European Court of Justice avoided state responsibility only because the breach was considered to be not sufficiently serious.[1109] State responsibility was also considered by the London Court of International Arbitration in respect of bilateral investment treaties (see also Section 5.3.1.), and the International Tribunal of the Law of the Sea decided a taxation matter in the case Saiga-2 in the context of state liability.[1110] According to Hans Pijl, "denying the applicability of the doctrine of state responsibility in taxation matters would be short-sighted" and "tax cases on state responsibility do belong to international law".[1111]

In respect of tax treaties, it is reasonable to say that if a dodging action meets the requirements of an internationally wrongful act as foreseen in the ILC Draft Articles, it would give rise to state responsibility for the offending state. According to article 4(1) of the ILC Draft Articles, "the conduct of any State organ shall be considered an act of that State under international law, whether the organ exercises legislative, executive, judicial or any other functions, whatever position it holds in the organization of the State, and whatever its character as an organ of the central Government or of a territorial unit of the State". As confirmed by its commentaries, article 4 covers organs whether they exercise legislative, executive, judicial or any other functions.[1112] Therefore, instances of legislative or

[1105] "Article 36. Compensation 1. The State responsible for an internationally wrongful act is under an obligation to compensate for the damage caused thereby, insofar as such damage is not made good by restitution. 2. The compensation shall cover any financially assessable damage including loss of profits insofar as it is established" (ILC, *supra* n. 1089, art. 36).

[1106] "Article 37. Satisfaction. 1. The State responsible for an internationally wrongful act is under an obligation to give satisfaction for the injury caused by that act insofar as it cannot be made good by restitution or compensation. 2. Satisfaction may consist in an acknowledgement of the breach, an expression of regret, a formal apology or another appropriate modality. 3. Satisfaction shall not be out of proportion to the injury and may not take a form humiliating to the responsible State" (ILC, *supra* n. 1089, art. 37).

[1107] "Article 38. Interest. 1. Interest on any principal sum due under this chapter shall be payable when necessary in order to ensure full reparation. The interest rate and mode of calculation shall be set so as to achieve that result. 2. Interest runs from the date when the principal sum should have been paid until the date the obligation to pay is fulfilled" (ILC, *supra* n. 1089, art. 38).

[1108] Pijl, *supra* n. 609, at p. 38.

[1109] *Ibid.*

[1110] *Ibid.*

[1111] *Ibid.*

[1112] ILC, *supra* n. 1089, commentary on article 4(1)(2), para 6.

executive dodging all meet the subjective test of attribution to a state, as these conducts are undertaken by organs of that state.[1113]

The second requirement for the qualification of an act or omission by a state as internationally wrongful act for the ILC Draft Articles purpose is the constitution of such act or omission as a breach of an international obligation of the state. International obligations may be established by a customary rule of international law, by a treaty or by a general principle applicable within the international legal order.[1114] The question would therefore be whether tax treaty dodging could be qualified as a breach of an international obligation as determined by the ILC Draft articles. The topic of breach was discussed in Section 5.2.3.1. of this chapter, however restricted to the qualification of tax treaty dodging as a material breach of a bilateral treaty for the purpose of applying article 60 of the Vienna Convention (1969) (termination or suspension of the operation of the treaty).

The breach in article 12 of the ILC Draft Articles is broader than the one concerning the application of article 60 of the Vienna Convention (1969) in the sense that it relates to a breach of an *international obligation* - therefore, not necessarily of a treaty. Therefore, the direct violation of the *other international legal basis* affected in tax treaty dodging cases (e.g. principle of good faith, the principles of interpretation of treaties in international law, the obligation not to defeat the object and purpose of a treaty prior to its entry into force and human rights), as discussed in Chapter 4, would qualify as a breach of an international obligation for the purpose of state responsibility.

If none of the circumstances precluding wrongfulness determined by articles 20 to 25 of the ILC Draft Articles (i.e. valid consent, self-defence, countermeasures, force majeure, distress and necessity) is proven by the offending state, tax treaty dodging could result in state responsibility and one (or more) of its consequences (i.e. cessation of the act and its non-repetition, reparation for the injury caused through the forms of restitution, compensation and/or satisfaction) could be eventually imposed. In tax matters, reparation would normally not cause much problems, as the material damage can be assessed, for example, by the calculation of the amount of tax imposed as a consequence of the dodging action or omission, plus interest and penalties possibly charged.

The questions arising in respect of tax treaties (and consequently tax treaty dodging) are: who would be legally entitled to bring such a claim (i.e. the treaty partner or the taxpayer, or both?) and which court or tribunal such claim could be presented to, since there is no competent international tribunal for tax treaty cases.

[1113] "(…) the general rule is that the only conduct attributed to the State at the international level is that of its organs of government, or of others who have acted under the direction, instigation or control of those organs, i.e. as agents of the State" (ILC, *supra* n. 1089, Chapter II, commentary, para 2).

[1114] ILC, *supra* n. 1089, commentary on article 12, para 3.

Article 42 of the ILC Draft Articles is straightforward when stating that "a State is entitled as an injured State to invoke the responsibility of another State". In addition, states are also entitled to bring a claim on behalf of individuals or legal entities, provided that they have also suffered damage as a consequence of the breach of the international obligation[1115] – see details in Section 5.3.2.

When it comes to claims and settlement of disputes regarding tax treaty matters, states are normally restricted to arbitration boards (when a mutual agreement procedure is not successful). However, the scope of tax treaty arbitration is normally limited to interpretation and application of tax treaties,[1116] i.e. interpretation and application of the *primary rules*. Claims involving the interpretation and application of the *secondary rules* (e.g. state responsibility) would thus be excluded from this forum.

The use of the International Court of Justice for tax treaty cases has been debated for decades. The possibility of using the International Court of Justice for tax treaty claims is foreseen in article 41(5) of the Germany-Sweden Income, Capital, Gift and Inheritances Tax Treaty (1992).[1117] The absence of such explicit reference in the text of all other tax treaties does not mean that the International Court of Justice may not obtain jurisdiction over tax treaty disputes. According to article 36(2) of the Statute of the International Court of Justice, states recognize the jurisdiction of this court in all legal disputes concerning the interpretation of a treaty, any question of international law, the existence of any fact which, if established, would constitute a breach of an international obligation, the nature or extent of the reparation to be made for the breach of an international obligation.[1118] It is therefore reasonable to argue that, if states have accepted to be sued before this court for all kinds of legal disputes related to treaties and international obligations that would include tax treaty conflicts as well.[1119] In addition,

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1115 "Financially assessable damage encompasses both damage suffered by the State itself (to its property or personnel or in respect of expenditures reasonably incurred to remedy or mitigate damage flowing from an internationally wrongful act) as well as damage suffered by nationals, whether persons or companies, on whose behalf the State is claiming within the framework of diplomatic protection" (ILC, *supra* n. 1089, commentary on article 36, para 5).

1116 "(…) some countries started to introduce arbitration provisions in their tax treaty network on a bilateral basis. (…) There is a great uniformity in the wording of these provisions. They usually offer arbitration for any difficulties or doubts arising as to the interpretation or application of the DTC which could not be solved in a mutual agreement procedure if both competent authorities and the taxpayer agree" (M. Züger, *Settlement of Disputes in Tax Treaty Law – General Report*, Settlement of Disputes in Tax Treaty Law (M. Lang & M. Züger eds., Linde Verlag Wien and Kluwer International Law 2002), pp. 15-47, at p. 31).

1117 *Convention between the Kingdom of Sweden and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital Gains as well as on Inheritances and Gifts, and Concerning Mutual Administrative Assistance in Tax Matters* (14 July 1992), Treaties IBFD.

1118 ICJ, *supra* n. 695.

1119 Züger, *supra* n. 116*,* p. 38. "Injured states can either submit the dispute to an international dispute settlement mechanism, and in this regard, it has to be stressed that at least theoretically the International Court of Justice has jurisidiction over a quite a number of possible tax treaty disputes. Since, however, (quasi-)judicial dispute settlement is scarce in general and almost non-existent in the field of tax treaty disputes, injured states may have to resort to self-help, which can result in countermeasures commensurate (i.e. economically more or less equivalent) with the wrongful act (i.e. with the consequences of the application of the treaty overriding legislation by the other state), or even in termination or (partial) suspension of the tax treaty if the treaty override can be qualified as a material breach" (Wouters & Vidal, *supra* n. 1074, para. 38).

the court may obtain jurisdiction over a dispute in a non-compulsory manner by agreement of the parties to submit the case on an *ad hoc* basis.[1120]

Moreover, if tax treaty dodging was previously recognized, for example by an arbitration body, the claim for related state responsibility would only require the interpretation and application of the ILC Draft Articles (secondary rules) for the assessment of the existence of state responsibility conditions (i.e., attribution to the state, breach of an international obligation and absence of circumstances precluding wrongfulness) and its consequences (i.e. cessation of the act and its non-repetition, reparation for the injury), and not the interpretation and application of the tax treaty itself. The author is of the opinion that this would make the claim at the International Court of Justice more likely to be received, as it would involve the discussion of public international law only.

Another possible option – though not used in practice – is for states to claim state responsibility in the context of tax treaties before the domestic courts of the offending state, as explained in the next sub-section.

5.2.6. Bringing a claim before the court of the offending state

In around 30 to 40 states courts frequently give effect to international law, and in about 40 more courts occasionally give effect to international law.[1121] Across the world, national courts have been given or have assumed the power to review acts of the executive or legislative branches of their state against international law to a point that the volume of national case law on international law matters out-numbers the decisions of international courts and tribunals.[1122] International law, however, does not provide states with the right to bring an action against a foreign state that allegedly acted in violation of international law, nor does it oblige states to provide for such a right in their national

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[1120] E. van der Bruggen, *About the Jurisdiction of international Courts to Settle Tax Treaty Disputes*, Settlement of Disputes in Tax Treaty Law (M. Lang & M. Züger eds., Linde Verlag Wien and Kluwer International Law 2002), pp. 501-531.

[1121] A. Nollkaemper, *National Courts and the International Rule of Law* (Oxford University Press 2011), p. 7.

[1122] Nollkaemper, *supra* n. 1121, pp. 7-8. "May national courts apply international law? (...) According to the monist approach, those rules of international law that intend to govern the conduct of State organs and individuals are directly applicable to their addresses irrespective of any intermediary role played by municipal laws. On the contrary, dualists consider State organs to be sheltered from international law, which becomes relevant in the State organ's perspective only by means of a rule pertaining to the municipal system" (Gaja, *supra* n. 13, p. 59); "International law serves the domestic judge in reasoning his way out of the national legal box and enables him to serve the citizens by being a defender of justice and as interpreter as well as critic of value judgments. (...) In practice, international law here is a source of morality: as objectified, positive morality. International law as principles and common values may be conceived of as to express the moral commitments of the international community as well as the national communities. This is not a negation of international law or of its legal role in national order – like it was in the 19th century – rather we observe an additional role next to its formal or direct binding force" (J. Nijman & A. Nollkaemper, *Beyond the Divide*, New Perspectives on the Divide Between National & International Law (J. Nijman & A. Nollkaemper eds., Oxford University Press 2007), pp. 341-360, at p. 358).

legislation; it leaves the question of whether or not a state can bring such claims before the court of a foreign state to national law.[1123]

But even when a state can file a claim against another state that allegedly did not perform an international obligation, this option is not commonly used.[1124] As explained by Andre Nollkaemper, states may find it incompatible with sovereign equality, or even their dignity, to subject themselves to the courts of a foreign state and may doubt that they will receive a sufficiently dispassionate and neutral assessment of its claim there.[1125] It can be concluded, as did Nollkaemper, that "the almost complete absence of interstate claims in domestic courts casts serious doubts on the degree to which the major actors in the international legal order see domestic courts as institutions that can be relied upon to make a significant and trustworthy contribution to the international rule of law".[1126] Bringing a claim before the court of the dodging state is thus a measure that is in principle available to contracting states but unlikely to be opted in practice.

5.2.7. Unilateral measures: countermeasures and retorsion

As mentioned in Section 5.2.1., the 2006 report prepared by the United Nations Subcommittee on Improper Use of Tax Treaties of the Committee of Experts on International Cooperation in Tax Matters proposed steps to be followed by the offended state.[1127] According to the report, the first steps are: (i) making a first call to the abusing state with the purpose of asking for explanations of the supposed abuse (official protest) and (ii) to resort to mutual agreement procedure, both dealt with in previous sub-sections. In case the cooperative mechanism of the tax treaty does not lead to a settlement of the dispute and the offended state still considers the treaty to have been abused, the report refers to unilateral measures against the improper application of the treaty,[1128] which would be done after notification to the other contracting state and in accordance with international law, case law and standards established in the ILC Draft Articles.[1129] The report further explains that "unilateral reaction may consist of retorsion or countermeasures proportionate with the injury suffered, allowing the other state to fulfil the affected obligations again".[1130]

1123 Nollkaemper, *supra* n. 1121, pp. 95-97.

1124 An example is the Italian case of Milde, for example, Germany appealed in the Italian courts a judgment in which it was identified as bearing joint and several civil liability for the damages victims gad incurred as a result of a massacre in 1944, and was ordered to pay compensation and part of the litigation expenses (Nollkaemper, *supra* n. 1121, pp. 95-97).

1125 Nollkaemper, *supra* n. 1121, p. 96.

1126 Nollkaemper, *supra* n. 1121, p. 97

1127 UN, *supra* n. 61 (16 October 2006), p. 7, para. 16.

1128 *Ibid.*

1129 *Ibid.*

1130 *Ibid.*

Indeed, the ILC Draft Articles[1131] deal with conditions for and limitations concerning the use of countermeasures,[1132] which are methods that would otherwise be contrary to the international obligations if they were not taken in response to an internationally wrongful act in order to procure cessation and reparation.[1133] They are basically temporary measures taken to achieve a specified end, the justification for which terminates once the end is achieved.[1134] They are not intended as a form of punishment for the wrongful conduct, but as a way to induce the responsible state to comply with its obligation.[1135] Countermeasures would therefore be a legitimate measure provided that the tax treaty dodging practice is qualified as an internationally wrongful act (for this qualification, see Section 5.2.5.).

Governments and decisions of international tribunals recognize that countermeasures are justified under certain circumstances.[1136] In this sense, countermeasures are strictly limited to the requirements of the situation and: (i) concern only non-forcible countermeasures; (ii) are directed at the responsible state and not third parties; (iii) proportionate; (iv) must not involve any departure from certain basic obligations (e.g. to protect fundamental human rights, of a humanitarian character prohibiting reprisals, under peremptory norms of general international law).[1137]

Article 49(1) of the ILC Draft Articles determines that an injured state may only take countermeasures against a state that is responsible for an internationally wrongful act in order to induce that state to comply with its obligations. In addition, article 51 determines that countermeasures must be commensurate with the injury suffered, taking into account the gravity of the internationally wrongful act and the rights in question. Proportionality must be assessed taking into account not only the purely 'quantitative' element of the injury suffered, but also qualitative factors such as the importance of the interest protected by the rule infringed and the seriousness of the breach. Article 51 relates proportionality primarily to the injury suffered but "taking into account" two further criteria: the gravity of the internationally wrongful act and the rights in question. Before taking countermeasures, an injured state is required to call on the responsible state to comply with its obligations as well as to notify the responsible state that it intends to take countermeasures while offering to negotiate.[1138] The injured state may however take certain urgent countermeasures to preserve its rights if necessary.[1139]

Retorsion, on the other hand, is a form of unilateral measure that is not covered by the ILC Draft Articles and, therefore, is not necessarily taken in response to an international wrongful act - even

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[1131] See section 5.2.5.

[1132] A state which resorts to countermeasures based on its unilateral assessment of the situation does so at its own risk and may incur responsibility for its own wrongful conduct in the event of an incorrect assessment (ILC, *supra* n. 1089, commentary on article 49, para. 3).

[1133] ILC, *supra* n. 1089, commentary on Chapter II, Part III, para. 1.

[1134] ILC, *supra* n. 1089, commentary on Chapter II, Part III, para 4.

[1135] ILC, *supra* n. 1089, commentary on article 49, para 1.

[1136] ILC, *supra* n. 1089, commentary on Chapter II, Part III, para 2.

[1137] ILC, *supra* n. 1089, commentary on Chapter II, Part III, para. 6.

[1138] ILC, *supra* n. 1089, commentary on article 52, para 1.

[1139] *Ibid.*

though it may be used as a response to it. It is an "unfriendly" conduct not inconsistent with any international obligation of the state engaging in it[1140] and largely operated below the radar of international law.[1141] Acts of retorsion may include the prohibition of or impositions of limitations on normal diplomatic relations or other contacts, embargoes of various kinds or withdrawal of voluntary aid programmes.[1142]

These forms of unilateral measures are also available to contracting states as a response to tax treaty dodging and as a way to induce the dodging state to refrain from acting, provided that, in the case of countermeasures, the dodging action is qualified as an internationally wrongful act and the measure is in line with the conditions of the ILC Draft Articles.[1143]

5.2.8. Static interpretation

The author explained in Chapter 3[1144] that the second condition for the phenomenon of tax treaty dodging is ambulatory interpretation, in the sense that contracting states find themselves in a position to dodge tax treaties whenever they perform, after the signature of the treaty, actions with an impact on these agreements. Conversely, contracting states adopting the static approach will in no way be able to dodge tax treaties. This is because, in order for actions (or omissions) to produce a treaty outcome which is different from the one reasonably expected by treaty partners, they must have been performed after the signature of the treaty. In contrast, actions performed before the signature of the treaty, such as an amendment to domestic law prior to the conclusion of the treaty, would never result in an unexpected outcome because they would have been, or at least should have been, already taken into consideration by treaty partners when concluding the treaty.

The role of static interpretation as a limitation to tax treaty dodging was first detected in a decision issued by the Supreme Court of Canada in the case *Melford* (1982).[1145] To avoid the modification of the treaty outcome caused by amendments to domestic law, the Supreme Court of Canada decided to apply the radical measure of forbidding reference to domestic law amendments made after the

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[1140] ILC, *supra* n. 1089, commentary on Chapter II, para. 3.

[1141] T. Ruys, *Sanctions, Retorsions and Countermeasures: Concepts and International Legal Framework*, Research Handbook on UN Sanctions and International Law (L. van den Herik ed., Edward Elgar Publishing 2016), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2760853 (accessed 18 Feb. 2018), p.4.

[1142] *Ibid.*

[1143] "Since, however, (quasi-)judicial dispute settlement is scarce in general and almost non-existent in the field of tax treaty disputes, injured states may have to resort to self-help, which can result in countermeasures commensurate (i.e. economically more or less equivalent) with the wrongful act (i.e. with the consequences of the application of the treaty overriding legislation by the other state), or even in termination or (partial) suspension of the tax treaty if the treaty override can be qualified as a material breach" (Wouters & Vidal, *supra* n. 1074, para. 38).

[1144] Section 3.2.2.

[1145] *Melford* (1982), *supra* n. 86. For details of the case, see Chapter 3, Section 3.3.1.2.

signature of the treaty, closing therefore the door to any attempt in this sense. In this regard, the Court supported the static interpretation of tax treaties as a way to avoid the dangers brought by ambulatory interpretation.

During the discussions on static v. ambulatory interpretation it has been recognized that "there is a strong argument of principle in favour of the static interpretation, which is that if it did not apply, a State could modify the effect of the treaty by changing its internal law".[1146] As indicated by Jacques Sasseville, "the preoccupation of the Court was a legitimate one and is probably the most serious argument in favor of a static approach in deciding to which temporal version of domestic law Art. 3(2) makes reference".[1147] However, the solution of simply closing the door to any kind of attempt in this sense was considered to be too rigid and, as a result, the decision given by the Supreme Court of Canada in favour of the static interpretation eventually had no "wide acceptance internationally, although it does adequately limit a State from unilaterally expanding its taxing power by cleverly worded statutory amendments"[1148].

Despite being a very effective measure against treaty dodging attempts, the static interpretation was not strongly supported and a general preference for the ambulatory interpretation by a number of states was expressed at the time.[1149] In the same direction, the special project[1150] concluded by "The International Tax Group" in 1984 under the coordination of John F. Avery Jones[1151] recognized that "(...) the ambulatory interpretation means that it [the state] can modify the effect of a treaty in its own favour".[1152] The study concludes, however, for the application of the ambulatory interpretation to be preferable,[1153] as the static interpretation was considered a too rigid solution to be acceptable.[1154]

Despite recognizing the danger involved,[1155] the OECD officially positioned itself in favour of the ambulatory interpretation by introducing, in 1995, the express reference to the use of the domestic law of the time of the application of the treaty in the text of article 3(2) of the OECD Model Convention. The commentary on article 3(2) confirms this official position in favour of the ambulatory interpretation: "(...) the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the convention was signed or that in force when the Convention is being

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1146 Avery Jones et al., *supra* n. 46, p. 40.
1147 J. Sasseville, *supra* n. 299, pp. 39-40.
1148 Comments by David Ward in Avery Jones, *supra* n. 107, p. 82.
1149Avery Jones, *supra* n. 107, p. 82.
1150 J. F. Avery Jones et al., *supra* n. 46; Avery Jones et al., *supra* n. 99.
1151 For details, see Chapter 2, Section 2.3.
1152 Avery Jones et al., *supra* n. 46, p. 40. They also indicate this point was previously made by Vogel.
1153 Coupled with an express or implied limitation. The express limitation refers to the "context otherwise requires" and the implied limitation to a proposal at the time to be included in the OECD Model Commentary (and later adopted).
1154 Avery Jones et al., *supra* n. 46, p. 48.
1155 "A State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention" (*OECD Model Tax Convention on Income and on Capital: Commentary on Article 3(2)* para. 13 (21 November 2017), Models IBFD).

applies, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the latter interpretation should prevail, and in 1995 amended the Model to make this point explicitly".[1156] Even before that the OECD had already indirectly indicated its support to the ambulatory interpretation in its Report on Tax Treaty Overrides by stating that "It cannot have been contemplated that, having once entered into a treaty, a State would be unable to change definitions of terms used in its domestic law provided such changes were compatible with the context of the treaty".[1157]

The author agrees that, although the static interpretation would be the most effective limitation to tax treaty dodging to the point that it would actually eliminate any possibility for dodging actions, the ambulatory interpretation is still the preferable approach in view of the undeniable practical advantage of avoiding dependence on and research for out-dated domestic law terms. In view of the official position of the OECD and of most countries in favour of the application of the ambulatory interpretation, the role of the static interpretation as a limitation to tax treaty dodging is very restricted today. However, in the event that is actually used by a contracting state, its limitation to tax treaty dodging proves to be the most effective one.

5.3. Measures available to taxpayers

As explained in Chapter 3,[1158] taxpayers may suffer international double taxation as consequence of tax treaty dodging practice by states: when source states engage in dodging, it is possible that the residence states may refuse to grant relief from double taxation (i.e. application of credit or exemption) on the basis of the commentary on articles 23A and 23B of the OECD Model Convention (2017),[1159] i.e. on the basis of different interpretation of facts or different interpretation of the provisions of the convention.[1160] They are also prevented from making use of beneficial treaty provisions (e.g. for the relief of double taxation or use of mutual agreement procedure) in view of the legislature omission in properly implementing such agreements into domestic law (i.e. treaty underride).[1161] In addition, in cases where contracting states redesign taxes in a way to prevent the application of tax treaties, taxpayers may consequently have to support an extra charge which was normally levied on non-

[1156] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 3(2)* para. 11 (21 November 2017), Models IBFD.

[1157] OECD, *supra* n. 127, para. 4(b).

[1158] Section 3.4.

[1159] *OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B* (21 November 2017), Models IBFD, para. 32.5.

[1160] The commentary on article 23A and 23B say that in case differences in domestic law qualification would make the source state apply a different article, this would still be considered an application in accordance with the treaty as interpreted by the source state and, therefore, the resident state would be obliged to grant the relief. However, the commentary makes an exception where the resident state is not obliged to grant relief in case the conflict results from different interpretation of facts or different interpretation of the provisions of the convention (*OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B* (21 November 2017), Models IBFD, paras. 32.3. and 32.5).

[1161] See Chapter 3, Section 3.3.1.3.

resident persons and that were subsequently transferred to them (e.g. Brazilian CIDE contribution)[1162] or that are no longer covered by that agreement because transformed into another type of (non-covered) charge to that taxpayer (e.g. Indonesia's increase of government's production share to compensate the reduction of branch profit tax by tax treaties) [1163].

As persons affected by tax treaty dodging, taxpayers may make use of the measures indicated in this section as a way to compensate or reduce the tax burden they are subjected to.

5.3.1. Mutual Agreement Procedure and Arbitration (offered under tax treaties and bilateral investment treaties)

The possibility of using mutual agreement procedures by treaty partners for resolving tax treaty dodging cases was addressed in Section 5.2.2. According to article 25 of the OECD Model Convention (2017), the mutual agreement procedure may also be initiated by taxpayers who consider that the actions of one or both of the contracting states result or will result in taxation not in accordance with the provisions of the treaty, and irrespective of the remedies provided by domestic law. However, differently from the paragraph concerning the mutual agreement procedure initiated by states – which refers to "any difficulties or doubts arising as to the interpretation or application of the convention"[1164] and, thus, is broad enough to cover tax treaty dodging cases as explained in Section 5.2.2., article 25 (1) of the OECD Model Convention (2017) allows the initiation of such a procedure by taxpayers "where a person considers that the actions of one or both of the contracting states result or will result for him in taxation not in accordance with the provisions of the convention".[1165]

This may raise the question of whether tax treaty dodging, as a practice not in conflict with the wording of the provision of treaties, could be covered by this paragraph and consequently be object of a mutual agreement procedure initiated by taxpayers. As indicated in Section 5.2.2., the commentaries on the article state that "this article institutes a mutual agreement procedure for resolving difficulties arising out of the application of the convention in the broadest sense of the term".[1166] Since the commentary refers to the whole article, this could give support to a broad interpretation to include cases involving possible indirect violations of tax treaties also for mutual agreement procedure initiated by taxpayers. That being the case, taxpayers would also be entitled to start a mutual agreement procedure in either

[1162] See Chapter 3, section 3.3.1.1.

[1163] See Chapter 3, Section 3.3.2.

[1164] *OECD Model Tax Convention on Income and on Capital* art. 25(3) (21 November 2017), Models IBFD.

[1165] *Ibid.*, art. 25(1).

[1166] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 25* para. 1 (21 November 2017), Models IBFD.

state within three years from the first notification of the action resulting in taxation not in accordance with the tax treaty provision.

The competent authority shall then "endeavour" to resolve the case by mutual agreement with the competent authority of the other contracting state with a view to the avoidance of taxation that is not in accordance with the treaty. For the same reasons indicated in section 5.2.2., the effectiveness of the procedure initiated by taxpayers could be low in practice, since treaty partners are only expected to try to compromise or avoid taxation not in accordance with the treaty.[1167] However, for procedures initiated by taxpayers, article 25(5) of the OECD Model Convention (2017) determines that, in case competent authorities do not reach an agreement to resolve the case within two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities, the issue shall be submitted for arbitration if the person so requests in writing (except if a decision has been already issued by a court or administrative tribunal of either state).

Also as a result from Action 14 of the OECD BEPS Project[1168], a group of countries has committed to adopt and implement mandatory binding arbitration as a way to resolve disputes that otherwise prevent the resolution of cases through the mutual agreement procedure.[1169] The mandatory binding mutual arbitration provision was included in article 19 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Instrument)[1170] and has the potential to render mutual agreement procedures initiated by taxpayers more effective.

It is in principle possible to submit tax disputes (and consequently tax treaty dodging disputes) to international investor-state arbitration on the basis of bilateral investment treaties,[1171] especially when a satisfactory solution is not reached by means of mutual agreement procedures. In fact, the investor-state arbitration under bilateral investment treaties offers some advantages in comparison to the arbitration procedure based on tax treaties. Taxpayers generally have no comprehensive procedural rights under arbitration offered by tax treaties - such as the right to initiate arbitration against the common will of the states, the right to participate in the nomination of the arbitral tribunal, the right to be present at the hearing and be heard, etc.[1172] Indeed, the use of arbitration based on tax treaties may not be an effective mechanism so long as "the competent tax authorities are the master of these proceedings and can 'agree to disagree'".[1173] In addition, claims at arbitral tribunals on the basis of

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[1167] Scott Wilkie, *supra* n. 1046, section 1.1.2.5.

[1168] See Section 5.2.2.

[1169] OECD, *supra* n. 1049, p 41. The countries are: Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States

[1170] *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (7 June 2017), Treaties IBFD.

[1171] For the application of bilateral investment treaties to tax matters, see Chapter 4, Section 4.2.7.

[1172] Gildemeister, *supra* n. 837, sec. 12.2.

[1173] Gildemeister, *supra* n. 837, sec. 12.2.

bilateral investment treaties allow taxpayers to demand adequate compensatory measures, what is normally not covered in arbitration offered under tax treaties. For these reasons, the more advantageous dispute settlement mechanisms in bilateral investment agreements may be a more attractive alternative for taxpayers wishing to solve or receive compensation in tax treaty dodging disputes.

5.3.2. Bringing a claim before an international tribunal

Individuals and legal entities have generally very limited direct access to international tribunals, and violations of their international rights by states are more commonly addressed at national courts[1174] - for the topic of taxpayers bringing a claim before the court of a contracting state, see Section 5.3.3. The basic rule of exclusion of private persons from directly standing before international tribunals is found in article 34(1) of the Statute of International Court of Justice, which clearly states that "only states may be parties in cases before the Court". As summarized by Andre Nollkaemper, "the traditional perspective is therefore that 'the rights created or conferred by an international treaty belong exclusively to the sovereign countries which are the contracting parties to it'. In this (probably still dominant) position under general international law, 'individuals have no standing to challenge violations of international treaties', at least not in the absence of protest by the sovereign involved".[1175] He adds, however, that "the explanatory power of this traditional understanding of the entitlements of private persons is rather limited".[1176]

In this sense, it can be argued that when international law imposes obligation on states to respect certain rights or liberties, it grants these persons rights and the possibility for legal standing; in addition, courts may also infer from the fact that a treaty is intended to benefit a person, that the person has an implied correlative right against the state to rely on that provision.[1177] In the case of tax treaties, states are obliged to avoid double taxation and, consequently, taxpayers derive from this treaty obligation the right not to be subject to double taxation in a cross-border scenario.

[1174] "Sujets mineurs et dérivés du droit international, les particuliers n'ont pas, en principe, d'accès direct à des mécanismes internationaux leur permettant d'obtenir le respect des droits qui leur sont octroyés; ils ne bénéficient pas de l'immédiateté internationale. Si un État méconnaît les droits qui leur sont internationalement garantis, ils doivent utiliser les procedures nationales. Toutefois, si rien ne les y oblige, les États peuvent permettre aux particuliers, individus ou groupements, de recourir à des procedures non nationales, soit qu'ils signent un traité à cette fin, soit qu'ils instituent une procedure transnationale par un contrat les liant à une personne privée déterminée. (...) En principe, les tribunaux internationaux ne peuvent connaître des affaires le concernant que s'ils sont saisis par son État national pregnant fait et cause pour lui (protection diplomatique). Cette règle ne connaît que des exceptions rares et prudentes" (Nguyen Quoc, Daillier & Pellet, *supra* n. 16, p. 633, para. 453 and p. 637, para. 455).

[1175] Nollkaemper, *supra* n. 1121, p. 98.

[1176] *Ibid.*

[1177] Nollkaemper, *supra* n. 1121, pp. 99 and 102.

Indeed, exceptions do exist where individuals and legal entities may directly resort to international courts to protect internationally granted rights. Although it is generally accepted that the legal capacity granted to private persons is based on a treaty requiring consent of state for special purposes and exceptional cases,[1178] the participation of individuals and non-state entities can be considered a trend since the last half of the 20th century in international law.[1179]

Developments in human rights law marked the standing of individuals before judicial bodies like the European or Inter-American Court of Human Rights - the latter indirectly, through the intervention of the Inter-American Commission on Human Rights.[1180] The International Tribunal for the Law of the Sea is also open to individuals and legal entities under certain conditions (for example, in respect of cases submitted to the Seabed Disputes Chamber in connection with activities in the area).[1181] The legal standing of private persons is also recognized in cases involving investment disputes, like in the settlement concerning provisions of investment treaties by the International Centre for the Settlement of Disputes.[1182] International trade agreements may also occasionally grant private persons right for action on a regional basis (e.g. European Union).[1183]

The development of the legal standing rights of private persons before international courts has, therefore, been built on the basis of agreements by states for conferring such rights in specific cases. In general terms, "the instances of individual capacity under international law fall mainly within the area of international treaty law. States may, by bilateral or multilateral treaties, provide for the rights of individuals or even confer certain competences on international bodies for implementation of these rights. In particular, states may enable individuals to assert their rights before international bodies provided the state against which the complaint is filed has recognized the competence of the judicial or quasi-judicial body".[1184]

This is not however the case for tax treaties, where rights for legal standing of individuals and legal entities before international courts are not generally granted.[1185] Individuals and legal entities suffering

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[1178] A. Orakhelashvili, *The Position of the Individual in International Law*, 31 California Western International Law Journal (CWSL Scholarly Commons 2000), pp. 241-276, at p. 248.

[1179] F. Orrego Vicuña, *Individuals and Non-State Entities before International Courts and Tribunals*, 5 Max Planck Yearbook of United Nations Law (J.A. Frowein & R. Wolfrum eds. 2001), pp. 53-66, at p. 54.

[1180] *Ibid*., p. 55.

[1181] ITLS, *General Information of the International Tribunal for the Law of the Sea*, available at https://www.itlos.org/general-information/ (accessed 2 Feb. 2018).

[1182] Orrego Vicuña, *supra* n. 1179, p. 60.

[1183] Orrego Vicuña, *supra* n. 1179, p. 61

[1184] Orakhelashvili, *supra* n. 1178, at p. 253.

[1185] "Due to the lack of international standing in the case of bilateral tax conventions, taxpayers are not able to present their case – except in rare cases – to an international tribunal" (Pijl, *supra* n. 33, p. 292).

the consequences of tax treaty dodging have in principle no direct standing at international tribunals; except when a dodging case results in violation of human rights.[1186]

As indicated, individuals may present claims at international judicial bodies competent to judge violation of rights granted by a human rights treaty. For example, individuals who are victims of a violation of rights under the European Convention on Human Rights and Fundamental Freedoms may present a claim against the contracting state before the European Court of Human Rights.[1187] Individuals may also submit cases of violation of the American Convention on Human Rights to the Inter-American Court of Human Rights, although this can only be done via an autonomous organ of the Organization of American States, i.e. the Inter-American Commission on Human Rights.[1188]

Since tax treaty dodging may impact individuals[1189] and, as explained in Chapter 4,[1190] their rights under human rights treaties, these dodging cases could in principle be brought to the attention of international bodies competent to judge human rights violations. In the case of human rights treaties, the excessive burden caused by the levy of redesigned charges or by international double taxation could be regarded as a violation of the fundamental right of property granted in human rights treaties. In the case of double taxation, contracting states may still argue that their refusal to grant relief from double taxation would be allowed on the basis of the commentary on articles 23A and 23B of the OECD Model Convention (2017),[1191] that is, on the basis of the exceptions on the obligation to follow the qualification of the source state for double taxation relief purposes (i.e. different interpretation of facts or different interpretation of the provisions of the convention).[1192] Notwithstanding, in respect of the consequence of international double taxation on taxpayers, the author believes that treaty partners are still accountable to a very large extent, as these states could make use of other measures available in order to prevent the other state from continuing with the dodging action, instead of simply transferring the burden (resulting from the lost taxing rights it considered entitled to) to the taxpayer by not granting relief from double taxation and carrying on with the application of the treaty.

[1186] See Chapter 4, Section 4.2.6. "(...) apart from a number of modern treaties such as the bilateral investment treaties and human rights treaties, individuals and companies have no locus standi before international tribunals. Therefore, as long as no provision of such treaties that could apply on the tax case at hand (protection of property in most human rights treaties) is breached, a non-State party will not be admissible" (Pijl, *supra* n. 33, p. 306).

[1187] Council of Europe, *supra* n. 827, art. 34.

[1188] OAS, *supra* n. 829, art. 44.

[1189] On the impacts, see Chapter 3, Section 3.4.

[1190] Sections 4.2.6. and 4.3.4.

[1191] *OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B* (21 November 2017), Models IBFD, para. 32.5.

[1192] The commentary on article 23A and 23B says that in case differences in domestic law qualification would make the source state apply a different article, this would still be considered an application in accordance with the treaty as interpreted by the source state and, therefore, the resident state would be obliged to grant the relief. However, the commentary makes an exception where the resident state is not obliged to grant relief in case the conflict results from different interpretation of facts or different interpretation of the provisions of the convention (*OECD Model Tax Convention on Income and on Capital: Commentary on Articles 23A and 23B* (21 November 2017), Models IBFD, paras. 32.3. and 32.5).

The other area taxpayers (and, in this case, also including legal entities) could explore with the view of achieving compensation for double taxation or extra charges levied in view of tax treaty dodging is claiming state responsibility (for state responsibility resulting from tax treaty dodging and the possibility of qualification of tax treaty dodging as a breach in the sense of the ILC Draft Articles, see Section 5.2.5.). Article 33(2) of the ILC Draft Articles determines that the rules on state responsibility owed to another state are "without prejudice to any right, arising from the international responsibility of a State, which may accrue directly to any person or entity other than a state". The ILC did not develop the concept of legal injury in respect of the relations between states and private parties, but the ILC Draft Articles do acknowledge that international law may recognize such a legal injury.[1193] According to the commentaries on article 33 of the ILC Draft Articles: "in cases where the primary obligation is owed to a non-State entity, it may be that some procedure is available whereby that entity can invoke the responsibility on its own account and without the intermediation of any State. This is true, for example, under human rights treaties which provide a right of petition to a court or some other body for individuals affected. It is also true in the case of rights under bilateral or regional investment protection agreements. (…) The articles do not deal with the possibility of the invocation of responsibility by persons or entities other than States, and paragraph 2 makes this clear. It will be a matter for the particular primary rule".[1194]

Although the trend of direct legal stating of private persons at international tribunals has not yet reached the International Court of Justice, indirectly representation by the state has been a common practice in that forum.[1195] Also, and as indicated in Section 5.2.5., in the context of state responsibility, states are entitled to bring a claim on behalf of individuals and legal entities before the International Court of Justice, provided that the represented parties suffered damage as a consequence of the breach of the international obligation by a state.[1196] Moreover, the fact that states have accepted to be sued before the International Court of Justice for all kinds of legal disputes related to treaties and international obligations (which would include tax treaty conflicts, too),[1197] and that the claim would concern the application of the secondary rule (ILC Draft Articles), plays in favour of this possibility. States would be, in this case, entitled to bring state responsibility claims against dodging states (with a request, for example, for cessation of the act)[1198] on behalf of national taxpayers who have suffered monetary consequences (with a request, for example, for restitution of the amount paid).

1193 Nollkaemper, *supra* n. 1121, p. 98.

1194 ILC, *supra* n. 1089, commentary on Article 33, para. 4.

1195 Orrego Vicuña, *supra* n. 1179, pp. 56-57.

1196 "Financially assessable damage encompasses both damage suffered by the State itself (to its property or personnel or in respect of expenditures reasonably incurred to remedy or mitigate damage flowing from an internationally wrongful act) as well as damage suffered by nationals, whether persons or companies, on whose behalf the State is claiming within the framework of diplomatic protection" (ILC, *supra* n. 1089, commentary on article 36, para 5).

1197 Züger, *supra* n. 1116*,* p. 38.

1198 For details on the possibility of claiming state responsibility in tax treaty dodging cases, see Section 5.2.5.

5.3.3. Bringing a claim in the courts of a contracting state

As explained in Section 5.2.6., the volume of national case law on international law matters is significantly higher than the number of decisions given by international courts and tribunals.[1199] Indeed, domestic courts can be regarded as the immediate interpreters of international law when no centrally instituted judge exists, and they are often called upon to consider the conformity of the state's conduct with international law.

Unlike the case of states, which are often reluctant to present claims and submit themselves to decisions issued by judges in another jurisdiction,[1200] bringing a claim in the courts of the contracting state is a common practice for private persons. As stated by Andre Nollkaemper, "(…) altogether different scenario arises when a claim is presented not by an injured state, but by an injured private person. This is the normal situation that accounts for the overwhelming majority of decisions of national courts".[1201] This is also true in respect of tax treaty matters.

Taxpayers, being individuals or legal entities directly affected by the application of these agreements, do often engage in treaty disputes with states at domestic courts. This is not different for tax treaty dodging cases, which legal basis involved (as part of international, tax treaty law and even constitutional law for taxpayers' fundamental rights granted by constitutions) may be assessed and interpreted by a national judge in countries where this power is granted by the national legal system. In fact, many decisions on tax treaty dodging presented in Chapter 3 of this study were issued by domestic courts worldwide in cases put forward by individuals and legal entities – many of which with a positive outcome for taxpayers.

5.4. Concluding remarks

[1199] Nollkaemper, *supra* n. 1121, pp. 7-8. "May national courts apply international law? (...) According to the monist approach, those rules of international law that intend to govern the conduct of State organs and individuals are directly applicable to their addresses irrespective of any intermediary role played by municipal laws. On the contrary, dualists consider State organs to be sheltered from international law, which becomes relevant in the State organ's perspectiveonly by means of a rule pertaining to the municipal system" (Gaja, *supra* n. 13, p. 59); "International law serves the domestic judge in reasoning his way out of the national legal box and enables him to serve the citizens by being a defender of justice and as interpreter as well as critic of value judgments. (...) In practice, international law here is a source of morality: as objectified, positive morality. International law as principles and common values may be conceived of as to express the moral commitments of the international community as well as the national communities. This is not a negation of international law or of its legal role in national order – like it was in the 19th century – rather we observe an additional role next to its formal or direct binding force" (Nijman & A. Nollkaemper, *supra* n. 1122, p. 358).

[1200] See Section 5.2.6.

[1201] Nollkaemper, *supra* n. 1121, p. 97

In this chapter the author investigated the measures available to contracting states and taxpayers under international and tax treaty law to address tax treaty dodging. The measures herein studied offer different results, varying from the complete removal of conditions for dodging actions to reparation in the form of compensation for damages caused, claimed on the basis of state responsibility or tax stabilization clauses in bilateral investment treaties, although not all options prove to be efficient in practice.

Contracting states often underestimate the importance of an official protest in preventing the effects of acquiescence and subsequent practice – although these effects should be carefully assessed. The suspension and termination of treaties are options available to contracting states on the basis of a fundamental change of circumstances or material breach. Bringing a claim before the courts of the dodging state is not a popular alternative among contracting states, but is the most effective (and opted) measure offered to taxpayers. Mutual agreement procedures have limited effect in view of the lack of obligation for states to agree on a solution to the case and the application of the static interpretation is a possible but non-recommendable approach. However, the more advantageous arbitration procedure offered under bilateral investment treaties seems to increasingly attract taxpayers' interest as an effective way of solving tax treaty related disputes.

The qualification of the dodging practice as an internationally wrongful act under the ILC Draft Articles opens doors not only to the application of unilateral measures, but also for claims aiming the cessation of the act and reparation for injury caused through restitution, compensation and/or satisfaction. This option seems to be neglected by states and taxpayers, although it may have the potential to impact the behaviour of dodging countries. For this, international courts are still expected to play the role of ensuring accountability of states also in tax treaty matters.

Chapter 6 - Conclusion and Recommendations

6.1. Conclusion

The mechanism presented in this thesis seems to have emerged as a convenient alternative solution for states facing undesired effects of signed tax treaties but being reluctant to directly violate treaty provisions or to face the lengthy process of treaty renegotiation. This alternative has the appeal of being designed in a way that contracting states making use of it can reasonably argue that there is no breach or violation of the treaty. The method entails actions performed (or omissions) by contracting states after the signature of tax treaties and within the limits of the text of these agreements (the "treaty gaps" as defined in this thesis), but having an unexpected impact on their outcome by (i) modifying the allocation of taxing rights to the (tax revenue) benefit of the contracting states making use of this method, (ii) preventing application of tax treaties to the (tax revenue) benefit of the contracting states making use of this method, or (iii) allowing the application of tax treaty benefits in scenarios where treaty benefits are normally denied, to the (economic) benefit of the contracting state making use of this method. Contracting states may, therefore, exercise rights allowed by the text of treaties (i.e. within the treaty gap areas) in a manner to extend advantages by broadening the scope of circumstances in which they are allowed to tax or by allowing them to improperly make use of treaty rules to improve the (economic) attractiveness of their territory. These actions (or omissions), which may be performed by legislative or executive branches of the state (the judicial branch is limited to endorsing or rejecting existing legislative or executive actions), seem to comply technically with the wording of these agreements, but effectively allow treaty obligations to be avoided. This means that contracting states applying such method are able to avoid treaty consequences that they may consider undesirable and consequently create new treaty situations and cross-border scenarios that are more favourable for their revenue and economic interests without a direct violation of their provisions (i.e. violation of the wording of their provisions).

By making use of this mechanism, contracting states may recover taxing rights over items of income by artificially changing the current scenario to a new one that either (i) requires the application of a different (and more favourable) treaty article, (ii) that circumvents obstacles imposed or artificially stretches advantages granted by applicable treaty provisions, or (iii) that prevents the application of the treaty. Contracting states may, for example, shift technical service fees therein sourced from the business profit article to another article that allows source taxation by means of interpreting the domestic definition of profit used for treaty purposes to exclude gross fees payments. Likewise, by re-

attributing income from a non-resident to a resident person, contracting states may recover taxing rights under the business profit article, which would be denied by the application of the same treaty provision if no re-attribution were made. The circumvention of the obstacles in applicable provisions may be also seen through the shifting of the taxable event to a moment when the contracting state finds itself in a position to tax in accordance with the treaty (e.g. exit taxes). Contracting states may also circumvent the application of the treaty, for example, by conveniently redesigning taxes that are normally subject to treaties into new charges that fall out of the scope of these agreements (and consequently their limitation) - or by creating brand new taxes specifically designed to fall outside this scope, by not properly implementing into domestic law treaty provisions whenever it is so required (i.e. treaty underride), or by shifting the taxable event to a moment when the treaty is not yet applicable (and consequently escaping its limitation) - for those supporting the view of non-applicability of treaties in certain cases of exit taxes.

This mechanism may also be exercised in a passive manner and without the purpose of recovering taxing rights but with the aim of seeking economic rather than tax advantages. For this, contracting states may deliberately tolerate treaty shopping schemes to increase their attractiveness, for example, by accepting any type of certificate of residence issued by a treaty partner as evidence of status of residence and of beneficial ownership, and by instructing tax authorities not to investigate cases related to residence status and to accept any claim based on incorporation. As opposed to the method of preventing the application of the treaty, which may be used to increase countries' tax revenue, contracting states may make sure treaties benefits are applicable in scenarios where they would normally be denied in order to increase attractiveness and, consequently, investments.

These actions (or omissions) may be exercised by national legislators through the enactment of domestic legislation and by the executive branch through the issuing of circulars, instructions and other interpretative acts. Treaty partners may suffer the consequences of these actions (or omissions) by having to face tax revenue disadvantages resulting from the impact on the allocation of taxing rights to the benefit of the other state. In case these damaged treaty partners refuse, in retaliation to these practices, to grant relief from double taxation based on different interpretation of facts or different interpretation of the provisions of the convention, and in cases where the contracting state making use of this method successfully prevents the application of tax treaties, taxpayers may suffer international double taxation or an increase in their tax burden as a result from the absence of relief or the levy taxes designed to fall out of scope of treaties.

Although not directly violating the wording of tax treaties, these actions (or omissions) may though be in conflict with rules and principles of international law and, therefore, be considered illegitimate acts – "illegitimate" in the sense as commonly understood by the tax legal community.[1202] The author addressed this point in the first part of the research question asked in this thesis, which was:

[1202] See *supra* n. 1 and 2.

"*On what legal basis the exercise of rights by contracting states in conformity with the wording of tax treaties but having an impact on the outcome of such agreements to their own benefit could be qualified as an illegitimate act*?"

The analysis of the sources of international law governing the relation between sovereign states led to the result that these actions (or omissions) may violate the principles of interpretation of treaties in international law, the principle of good faith, the principle of reciprocity and, to a certain extent (i.e. limited to certain tax treaty dodging methods), the obligation not to defeat the object and purpose of a treaty prior to its entry into force, taxpayers' fundamental rights granted by international treaties and constitutions, and bilateral investment treaties. Actions overstepping these limits can be thus qualified as illegitimate acts under international law or, as referred to in this thesis, *tax treaty dodging* practices.

Therefore, the author concluded that **the improper use of tax treaties by contracting states, or tax treaty dodging, can be defined as the exercise of rights by contracting states in conformity with the wording of tax treaties (i.e. within the treaty gap areas) but having an impact on the outcome of such agreements in a way that violates the international law rules that spell out the correct standards and guide the good usage of treaties, that is, the principles of interpretation of treaties in international law, the principle of good faith, the principle of reciprocity, the obligation not to defeat the object and purpose of a treaty prior to its entry into force, taxpayers' fundamental rights granted by international treaties and constitutions, or bilateral investment treaties**.

The sub-question of the research question asked in this thesis was:

"*If such legal basis exists, where is the dividing line between a legitimate exercise of rights by contracting states and such illegitimate acts under international law?*"

The author concluded that the extent to which contracting states may act without overstepping these limits have to be assessed by the judge or interpreter on a case-by-case basis and taking into consideration the elements derived from the very same infringed rules and principles: good faith, context, subsequent agreements, subsequent practice, object and purpose, and supplementary means of interpretation (under the principles of interpretation of treaties in international law), honesty, reasonableness, fairness and intention (under the principle of good faith), reciprocity (under the principle of reciprocity), the excessive tax burden (under taxpayers' fundamental rights and the expropriation clauses in bilateral investment treaties) and legitimate expectation (under the principle of good faith, article 18 of the Vienna Convention (1969) and bilateral investment treaties). For example, some of the actions having an impact on the application of tax treaties are engaged by contracting states with the purpose of combating tax avoidance, while others are taken with the opposite aim of allowing taxpayers to commit tax treaty shopping. In such cases, the object and purpose of the impacted treaties including or not the prevention of tax avoidance has a relevant role

in determining whether these actions could be regarded as a condemnable act under international law. In the same way, this mechanism may be considered lawful, for example, on the basis of reciprocity if the treaty partners also undertake equivalent actions.

This thesis emphasized the importance of acknowledging the possibility for contracting states to make use of indirect ways as a particular method to impact treaty scenarios. Despite having similar or equivalent effects, contracting states' actions (or omissions) contradicting the wording of tax treaties is, by definition, a method which is conceptually different from contracting states' actions allowed by that wording but modifying its effects and, therefore, should not be treated equally or analysed from the same perspective, as much as taxpayer's actions in conflict with the wording of laws (tax evasion) are not qualified or treated in the same manner as those in line with their texts but contradicting their spirit (abusive actions such as tax avoidance). The assessment of the legitimacy of such actions (or omissions) should not be made on the basis of the treaty provisions dodged, but on the basis of rules and principles governing the relationship between states under international law. By approaching the subject from this perspective, one also avoids the argumentation in the sense that these actions (or omissions) only amount to exercise of states' rights in line with the wording of the treaty for being "part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability",[1203] as did the OECD in respect of the discussion over the compatibility of CFC legislation and tax treaties. A more appropriate and potentially successful approach to the subject seems to be the one questioning whether by modifying the outcome of tax treaties to their own benefit and in detriment of treaty partners and taxpayers contracting states go too far in the exercise of this right on the basis of public international law rules and principles, despite not contradicting the wording of these agreements.

6.2. Recommendations

The author finds considerably important for offended states to officially protest against tax treaty dodging practices. The official protest may not only lead to successful results as in the case of the one issued by Finland in respect of Brazil and its executive interpretative dodging - which eventually led to Brazilian tax authorities abandoning the practice - but also plays a relevant role in avoiding the effects of *acquiescence* and *subsequent practice* for offended states in future demands. Moreover, offended states seeking termination or suspension of a treaty in view of tax treaty dodging practices should be aware that resorting to this measure also on the basis of fundamental change of circumstances (rather than only on the basis of material breach) seems to be a wise strategy for avoiding the argumentation by the offending state in the sense that no breach exists because the wording of the treaty is not violated.

[1203] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* para. 22.1 (15 July 2014), Models IBFD.

Claims aiming the cessation of the tax treaty dodging practice and reparation for injury caused on the basis of the qualification of the practice as an internationally wrongful act are not pursued by states. However, the author sees this as an attractive alternative, especially in cases where tax treaty dodging has been previously recognized (for example, by an arbitration body). In such cases, the scope of the claim before the International Court of Justice would be restricted to the discussion of public international law only, that is, to the interpretation and application of the ILC Draft Articles (secondary rules) for the assessment of the existence of state responsibility conditions and its consequences, and not the interpretation and application of the tax treaty - which so far is unfortunately not dealt with by that court.

Despite the fact that taxpayers have generally limited direct access to international tribunals, and violations of their international rights by states are more commonly addressed at national courts, the author believes that these taxpayers should try to exploit the possibility of presenting claims at international judicial bodies competent to judge violation of rights granted by a human rights treaty. For example, individuals who are victims of a violation of rights under the European Convention on Human Rights and Fundamental Freedoms may present a claim against the contracting state before the European Court of Human Rights. Individuals may also submit cases of violation of the American Convention on Human Rights to the Inter-American Court of Human Rights, although this can only be done via an autonomous organ of the Organization of American States, i.e. the Inter-American Commission on Human Rights. In addition, in the context of state responsibility, states are entitled to bring a claim on behalf of individuals and legal entities before the International Court of Justice with a request, for example, for restitution of the amount paid, provided that the represented parties suffered damage as a consequence of the breach of the international obligation by a state. The advantageous arbitration procedure under bilateral investment treaties, which offers more procedural rights for the taxpayer as well as the possibility of monetary compensation, may also be an attractive dispute settlement alternative to the mutual agreement procedure and arbitration in tax treaties.

Contracting states may also seek preventive measures. The inclusion of provisions in tax treaty requiring communication and consultation between the contracting states on the possible actual effects of actions (or omissions) that may impact the outcome of treaties, and on the possible adjustments to the treaty in order to preserve the balanced allocation of taxing rights originally agreed, is recommended. For example, article 29 of the United States–Japan income tax treaty (2003) provides for such a clause, reading as follows:

> "*If a Contracting State considers that a substantial change in the laws relevant to this Convention has been or will be made in the other Contracting State, the first-mentioned Contracting State may make a request to that other Contracting State in writing for consultations with a view to determining the possible effect of such change on the balance of benefits provided by the Convention and, if appropriate, to amending the provisions of the Convention to arrive at an appropriate balance of benefits. The requested Contracting State shall enter into consultations with the requesting Contracting State within three months from the date on which the request is received by the requested Contracting State*".

This provision is however restricted to changes in domestic law, which means that other forms of tax treaty dodging as described in this thesis would not be covered. Notwithstanding, contracting states may broaden the scope of such clauses by including, for example, acts issued by the executive power of states having a similar effect. These treaty provisions may also directly refer to the principle of good faith as grounds for the consultation and/or for condemning tax treaty dodging practices, although the author is of the view that good faith being a universally recognized general principle leads to its application irrespective of being expressly mentioned in the treaty.

Changes in tax treaty models and commentaries to include preventive measures would also be welcome. In this respect, John Avery Jones already suggested the OECD to consider "some means of one state communication acceptance for treaty purposes of a change in the other state's law which has been communicated to it".[1204] While no reaction has so far been seen from the OECD, The United Nations went on to address the topic in the studies prepared by the former "Subcommittee on Treaty Abuses and Treaty Shopping" of the former "Ad Hoc Group of Experts on International Cooperation in Tax Matters" – currently the Committee of Experts on International Cooperation in Tax Matters, which is in charge, among other tasks, of reviewing and updating the UN Model Convention and its commentaries. As indicated in this thesis, the subcommittee was created in 2005 with the purpose of studying the issue of improper use of treaties and proposing suitable methods to combat treaty abuses. Although tax treaty dodging was not covered in the final report, the subject was initially addressed (under the topic of "abuse by one of the contracting states") and the 2005 version of the report proposed the inclusion in the commentary on article 1 of the UN Model Convention of a paragraph with an optional provision for states wishing to "avoid abuse of tax treaty by states through the introduction of preferential tax regimes after the signature of the treaty.[1205] The proposal, which is restricted to domestic legislation introducing preferential tax regime, reads as follows:

> "*States may wish to prevent abuses of their conventions involving provisions introduced by a Contracting State after the signature of the Convention. The following provision aims to protect a Contracting State from having to give treaty benefits with respect to income benefiting from a special regime for certain offshore income introduced after the signature of the treaty: 'The benefits of Articles 6 to 22 of this Convention shall not accrue to persons entitled to any special tax benefit under: a) a law of either one of the States which has been identified in an Exchange of Notes between States; or b) any substantially similar law subsequently enacted' [para. 21.5.]*"[1206]

Unfortunately, the subcommittee dropped the subject of abuse of tax treaties by contracting states, as the issue was considered to be outside the mandate given to the committee of addressing the improper use of tax treaties (only) by taxpayers. As indicated in this thesis, this did not prevent the subcommittee from recognizing the relevance of the topic and from recommending, in the 2006 version of the report, another subcommittee to be set up with a view to develop mechanism for the verification of the abuse

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[1204] Avery Jones, *supra* n. 107, p. 85

[1205] UN, supra n. 61 (15 November 2005), p. 17

[1206] *Ibid.*

by states and the determination of proper measures to counter such abuse: "It is recommended that a sub-committee under the Committee of Experts of the UN be set up with a view to developing mechanisms for the verification of the abuse by a State and the determination of proper measures to counter such an abuse. This job may be conducted as a part of the work of the development of the dispute settlement mechanism in general".[1207]

The author finds unfortunate that this recommendation was not followed up by the United Nations and considers that forming such a committee for studying the topic in the near future - whether by the United Nations, the OECD, or both - would be a positive response and a recommended action as first steps towards the better understanding and conduct of tax treaty dodging. In special, the author understands that the limitations of the inductive methodology used in this thesis for the purpose of identifying the methods of tax treaty dodging (i.e. categorization of common elements in the cases observed for the purpose of deriving the different methods) may have prevented the detection of other possible existing methods of tax treaty dodging. A complete overview of all cases worldwide is beyond the scope and means of this study. For this reason, the author believes that a work carried out by an international organisation would bring the advantage of reducing the shortcomings of inductive methodology by being able to cover a wider field of observation.

[1207] UN, *supra* n. 61 (16 October 2006), p. 7, para. 17

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