



27 May 2013

LUND UNIVERSITY
School of Economics and Management

Master in European and International Tax Law

HAR№60 European and International Taxation, Direct Taxation

MASTER THESIS
WHETHER THE DOMESTIC ANTI-ABUSE LEGISLATION APPLIES TO DENY THE
TAX TREATY BENEFITS

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Date: 27 May 2013

2012-2013

TABLE OF CONTENTS

1. INTRODUCTION.....	4
1.1. Background.....	4
1.2. Problem description.....	5
1.3. Purpose.....	6
1.4. Method and materials	6
1.5. Delimitations.....	6
1.6. Outline.....	7
2. INTERNATIONAL PUBLIC LAW APPROACH TO THE PROBLEM?.....	8
2.1. Is combating tax avoidance one of the purposes of tax treaties?.....	8
2.2. Pre-2003 OECD position.....	9
2.3. 2003 Revisions to the Commentary.....	10
2.4. Summary	11
2.5. Observations to the Commentary	12
3. ANTI-ABUSE LEGISLATION.....	13
3.1. Domestic anti-avoidance provisions (general).....	13
3.2. Domestic anti-avoidance provisions (specific).....	14
4. TREATY INTERPRETATION.....	17
4.1. Vienna Convention on the Law of Treaties.....	17
4.2. The role of the OECD Commentary in treaty interpretation.....	18
4.3. Summary.....	20
5. WHAT SHOULD PREVAIL IN CASE OF CONFLICT: TAX TREATY OR GAAR?.	21
5.1. Countries where the GAAR clearly overrides the Treaty.....	22
5.2. Countries where the Treaty overrides the GAAR.....	22
5.3. Countries where the GAAR will override the Treaty unless there is a clear conflict, in which case the Treaty prevails.....	23
5.4. Abuse of the tax treaty itself: domestic law principles or interpretation of the treaties?.....	24
5.5. Summary.....	26
6. CASE LAW: RUSSIA.....	27
6.1. Examination of cases.....	27
6.2. Conclusion.....	32
7. CONCLUSIONS.....	34
8. LIST OF REFERENCIES.....	36
9. Appendix #1	39

LIST OF ABBREVIATIONS

OECD – Organization for Economic Co-operation and Development

OECD Model – Model Tax Convention on Income and on Capital

Commentaries – Commentaries on the Articles of the Model Tax Convention

DTT – Double Tax Treaty

DTC – Double Tax Convention

VCLT – Vienna Convention on the Law of Treaties

IFA – International Fiscal Association

IBFD – International Bureau of Fiscal Documentation

GAAR – General Anti-Avoidance Rules

DAAR – Domestic Anti-Avoidance Rules

ITCIA – Income Tax Conventions Interpretation Act (Canada)

CFC – Controlled Foreign Corporations

Thin cap rules – Thin Capitalization Rules

RF – Russian Federation

1. INTRODUCTION

1.1. Background

In this age of globalization, international trade and multiple transactions continue to increase, so the role of tax treaties appears more significant today than ever before.¹ But, when talking about taxation, one may assume that there is very little international in the assessment and collection of taxes because each country levies taxes for its sovereign purposes and in any case aims to protect its tax base. Double tax treaties serve a purpose of eliminating double taxation by providing certainty with regard to different types of income. Naturally, taxpayers rely on such bilateral agreements to determine the tax outcome of their cross-border activities.²

In recent times, the problem of tax avoidance has become especially sharp due to sophisticated tax planning schemes. Often, taxpayers choose to create some artificial arrangements and sham transactions in order to receive additional tax benefits or to fall under preferential tax regimes. So, due to intersection of foreign and domestic tax systems and the fast growing bilateral tax treaty network the opportunities for tax avoidance dramatically increased. At the same time, countries are strictly constrained in their ability to gather information in foreign jurisdictions to reveal international tax avoidance schemes.³ Hopefully, not so long time ago tax treaties have launched a positive tendency in improving this information flow (including tax information exchange agreements)⁴. In an attempt to combat tax avoidance, most countries have developed special anti-abuse rules that can exist in a form of a general anti-avoidance rule, or specific legislative anti-avoidance provisions; or even in the form of developed judicial anti-avoidance doctrines elaborated by courts.⁵ The problem investigated by this paper is how domestic anti-avoidance rules affect double taxation conventions. The below investigation is complicated by the fact that anti-avoidance legislation has been developed differently in each state. Therefore, there are apparent differences between countries in the level of tolerance, which the revenue

¹ N. Goyette, *Tax Treaty Abuse: A Second Look*, Canadian Tax Journal, 2003, Vol.51 #2, p. 764.

² C. Elliffe, *International Tax Avoidance – the tension between protecting the tax base and certainty of law*, Journal of Business Law, 2011, 7, p. 647.

³ B.J. Arnold, *Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model*, Bulletin – Tax Treaty Monitor, June 2004, p. 244.

⁴ C. Elliffe, *International Tax Avoidance – the tension between protecting the tax base and certainty of law*, Journal of Business Law, 2011, 7, p. 647.

⁵ B.J. Arnold, *Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model*, Bulletin – Tax Treaty Monitor, June 2004, p. 244.

authorities and the courts exhibit while dealing with abusive transactions, especially those taking place on the international arena.⁶

Although concluded within the scope of international public law, double tax treaties have effect within national legal systems. Thus, after being signed and ratified, double tax conventions must be properly implemented within a national legal order. This process also varies depending on whether a jurisdiction is monistic or dualistic. Anyway, the treaty's life within the national legal system is quite distinct from that one within the framework of international public law. Various problems arise in connection with the domestic implementation of a treaty. Arguably, such problems can be entirely resolved by the adoption of anti-abuse rules or the elaboration of anti-abuse principles by the courts. The crucial question is whether such rules or principles are compatible with the double tax treaties?⁷

In most countries, tax treaties prevail over domestic tax laws in the event of a conflict. Taxpayers often rely on the provisions of a tax treaty according to the principles of legal certainty and legitimate expectations. The relationship between domestic anti-abuse legislation and double tax treaties, in particular the extent to which anti-avoidance legislation applies to deny tax treaty benefits, is of crucial value not only for the purpose of this thesis but also for the practical implementation of double tax conventions.⁸

1.2. Problem description

The question raised in this thesis – whether the domestic anti-abuse legislation applies to deny the tax treaty benefits – cannot be decided unambiguously. As controversial debate shows, it is rather difficult to elaborate the uniform international approach concerning this issue due to a number of arguments: the incorporation of double tax treaties into domestic law takes place differently in various countries; some countries do not have GAAR at all, while others have well developed doctrines or an express statutory provision, or even the combination of both; also, some states explicitly define the relationship between the tax treaties and the GAAR, whilst others do not. Therefore, it is quite logical that the problem in this thesis should be considered from two opposite angles: in general with regard to OECD guidance and specifically from the particular state perspective⁹.

⁶ IFA Congress Seminar Series, How domestic anti-avoidance rules affect double taxation conventions, Cahiers de Droit Fiscal International, 1994, Vol. 19.c, p. 4.

⁷ IFA Congress Seminar Series, How domestic anti-avoidance rules affect double taxation conventions, Cahiers de Droit Fiscal International, 1994, Vol.19.c, p.6.

⁸ B.J. Arnold, Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model, Bulletin – Tax Treaty Monitor, June 2004, p. 244.

⁹ C. Elliffé, International Tax Avoidance – the tension between protecting the tax base and certainty of law, Journal of Business Law, 2011, 7, p. 648.

1.3. Purpose

Through comparing and analyzing of the OECD approach to the problem in issue and particular country perspective, the author clearly realizes that it would be very difficult to come to the certain outcome of the assigned task. At the same time some common principles can be indentified in interaction between domestic GAARs and double tax conventions. It is also the purpose of the present work to determine whether OECD approach (the factual and interpretative one) fits adequately the real domestic situations in question. The paper seeks to identify the strengths and weaknesses of the three general categories of approaches that states have and suggest the most appropriate one. Our assessment is based on two fundamental. The first is the certainty of the law and *pacta sunt servanda*. The second is the purely domestic interests of each individual state purporting to protect its tax base. If certainty in tax outcome is to be preferred by a country, then the treaty should override the GAAR; if the prevention of tax abuse is the objective, then the GAAR should override the treaty. The third approach considered by this paper seems to be more compromise, permitting the GAAR to take precedence over the treaty, unless there is a conflict in which the treaty prevails.

1.4. Method and materials

The present research is based on the traditional legal approach. The thesis will analyze different sources of law and materials, such as international agreements, documents of international organizations, case law and scholars' articles in order to assess whether domestic anti-abuse legislation applies to deny tax treaty benefits. The elements of comparative studies and comparative methods will also play a significant role in achieving the goal of this thesis. The problem was analyzed from the OECD perspective and then compared as against domestic perspective of the chosen country. The author suggests that it could be more helpful for analysis to group the counties approaches into three general categories by means of precedence of the domestic GAARs and the tax treaties as against each other (Report to IFA 2010). The choice of case law is based on research of the IBFD tax treaty case law database and on the accessibility of cases in the domestic sources of law as well as on the relevance of the precedents to the topic discussed in this paper.

1.5. Delimitations

The problem this paper strives to resolve is very broad and complicated. The vast debate around the relationship between the domestic anti-abuse legislation and double tax treaties takes place for a long time among scholars and practitioners. The author is aware of various arguable issues that may arise while investigating the main question of this thesis, such as whether anti-abuse legislation has an international effect, or whether the universal anti-abuse rules should be

elaborated or not, and what is the relationship between the domestic anti-avoidance rules and those that are included in the treaties itself. But for the interests of this thesis the aforementioned questions are omitted. The focus of the present work is to investigate the relationship between domestic anti-abuse legislation and double tax treaties through the position of international public law, namely the OECD approach compared to the one from the states national perspective based on domestic legal order. Anti-avoidance rules included in the treaties do not fall within the scope of the present work either.

The particular Russian cases chosen for analysis mostly refer to the Russian thin cap rules. The choice of these cases explicitly reflects the trend chosen by Russian courts in a narrow area because Russia does not have well developed anti-abuse legislation. Since the Russian language is a native one for the author, the source of the references in the paper to the legal system of Russia has been taken from the original sources and therefore is presented in a non-official translation (done by the author) both against the original national laws and the precedent. The narration and comments about the facts of the cases and the approach taken by the national courts regarding each case is funneled towards the problem raised by this thesis because the legal issues considered by the courts have very broad nature and are very complicated due to the number of episodes within some cases.

1.6. Outline

In order to answer the main question posed in the Introduction and to receive a deeper and comprehensive understanding of the problem the thesis is structured in the following way: chapter 2 gets the reader acquainted with the OECD position towards the problem both before and after Revisions to the Commentary; chapter 3 corresponds about anti-abuse rules itself, both general and specific; then, in chapter 4 the thesis provides with an overview of methods of interpretation presented in the VCLT and the role of the OECD Commentary in tax treaty interpretation; chapter 5, that is the core part of the present work, touches upon the approaches that can be envisaged with regard to relationship between the domestic anti-abuse rules and tax treaties in case of conflict; chapter 6 examines case law and provides with analysis of the problem from the national perspective; and chapter 7 holds the overall analysis and conclusive remarks. The diagram over company structures regarding last considered case is presented in Appendix.

2. INTERNATIONAL PUBLIC LAW, APPROACH TO THE PROBLEM

Interestingly, while examining effective tax treaties one can find little about tax avoidance itself. More often, it states about prevention of fiscal evasion as used to be arguably indicated in the titles of double conventions.

2.1. Is combating tax avoidance one of the purposes of tax treaties?

The OECD's report on Harmful Tax Competition: An Emerging Global Issue of 1998 comprises definitions and most common features of tax heavens and preferential tax regimes, as well as its recommendations concerning both domestic legislation and practices, and tax treaties regarding counteracting harmful tax competition. As far as tax avoidance and tax treaties are concerned, one of the recommendations called upon the clarification of the status of domestic anti-abuse rules and doctrines in tax treaties. It aimed at the compatibility of domestic anti-abuse rules with the OECD Model, pursuing to take away any uncertainty or ambiguity.¹⁰ It proves to be not the only recommendation provided for in this Report that subsequently was embodied in the 2003 Revised Commentaries.

Even though various tax conventions contain the statement on elimination of double taxation and on the prevention of fiscal evasion, such title references were removed due to acknowledgment of other purposes towards the tax conventions are addressed.¹¹ As R. Russo argues in his book, there is a delicate difference between the notions of tax planning, tax avoidance and tax evasion. While tax planning and tax evasion are certainly legal or legitimate as well as criminal and directly violating appropriately, the tax avoidance is quite smooth term balancing between tax planning and tax evasion, and depending on many facts and circumstances tends to be justified as 'acceptable tax avoidance', namely tax planning, or otherwise is used to somehow mitigate tax evasion.¹² For many scholars it is rather controversial question whether tax evasion comprises tax avoidance or not. Most of countries' legislations distinguish these two terms inferring tax avoidance as not criminal, whilst the evasion is a subject to criminal conviction up to imprisonment.

As of 28th of January 2003 the Commentary on Art.1 to the OECD Model proclaims that the one of fundamental purposes of the OECD Model is preventing tax avoidance and evasion.¹³ Obviously, before that amendment to the Commentary on Art.1 it stated that tax treaties should not promote tax avoidance, therefore it can not be construed that tax avoidance prevention was particular purpose of OECD Model previously. Actually, some scholars interpreted the pre-2003

¹⁰ OECD, Harmful Tax Competition: an Emerging Global Issue, 1998, Ch.3, III, pp. 48-49.

¹¹ Para. 16 of the Introduction to the OECD Model.

¹² R.Russo, Fundamentals of International Tax Planning, 2007, p. 49-51.

¹³ Para. 7 of the Commentary on Art.1 to the OECD Model.

Commentary to mean that tax treaties could endure tax avoidance only until the treaty is supplemented with concrete anti-avoidance provisions. Thus, those countries that are preoccupied by tax avoidance issues to be adopted with domestic anti-avoidance rules should preserve directly its application in conventions.¹⁴

Thereby, alongside with the principal purpose of tax conventions to facilitate international trade and movement of capital and persons by eliminating international double taxation, the additional supplementary but equally important purpose is prevention of tax avoidance and evasion.¹⁵ Such proclaimed purpose to prevent tax avoidance directly refers to both the conventions' interpretation and application. Relying on Art.31(1) of the VCLT "*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*".¹⁶ Thereby, the articles of tax conventions should be interpreted to prevent tax avoidance. The only one country that put forward its observation against the newly proclaimed purpose of tax conventions such as combating tax avoidance was Switzerland.¹⁷ Therefore, there are no expectations that the Swiss revenue authorities will apply Switzerland's tax conventions to counter tax avoidance.

It can be erroneously believed that based on the principle of reciprocity other countries (Switzerland partners under bilateral treaties) are prevented from the application of such conventions to counter tax avoidance either. However, in practice the treaties' application is rarely reciprocal. Apparently, not only attractive but also correct view is that such countries are instead entitled to apply these tax conventions to prevent tax avoidance unless the treaty does not enclose a clear rule providing to the contrary. Naturally, the Switzerland has to accept the majority position that Switzerland's treaty partners do apply their conventions with Switzerland to prevent tax avoidance.¹⁸

2.2. Pre-2003 OECD position

Between 11th of April 1977 and 28th of January 2003, the OECD Model held an opinion that the core purpose of bilateral tax treaties was to promote the movement of capital and persons as well as exchanges of goods and services by eliminating double taxation, indicating that tax conventions "should not, however, help tax avoidance or evasion"¹⁹. Moreover, taxpayers could

¹⁴ B.J. Arnold, Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model, Bulletin – Tax Treaty Monitor, June 2004, p. 248.

¹⁵ Para. 7 of the Commentary on Art.1 to the OECD Model.

¹⁶ Art. 31 (1) of the VCLT.

¹⁷ Para. 27.9 of the Commentary to Art.1 of the OECD Model.

¹⁸ B.J. Arnold, Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model, Bulletin – Tax Treaty Monitor, June 2004, p. 246.

¹⁹ Para.7 of Commentary on Art.1 to the OECD Model (Full Version).

exploit differences in countries' tax levels, but *"[i]t is for the States concerned to adopt provisions in their domestic law to counter such maneuvers. Such states will then wish in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws"*²⁰.

Arguably, it can be inferred from aforementioned OECD statements that, as a general rule, the application of domestic anti-avoidance rules was impossible in order to deny tax treaty benefits as long as the contrary directly mentioned in the tax convention.

In Para.23, as it read between 23rd of July 1992 and 21st of September 1995, the Commentary tried to reconcile the discordant opinions concerning the status of CFC rules within domestic anti-avoidance concept. The position of the majority of the OECD Member States on the matter was that they *"[a]re part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. These rules are not addressed in tax treaties and are therefore not affected by them"*²¹. Fairly, the Commentary also recognized a dissenting viewpoint.

Thus, according to the majority view, if domestic anti-avoidance rules were given precedence over treaties, economic double taxation might arise, *"[t]he same income being taxed in the hands of two different taxpayers"*²². The opposite standpoint holds that *"[s]uch rules are subject to the general provisions of tax treaties against double taxation, especially where the treaty itself contains provisions aimed at counteracting its improper use"*²³.

Under Para.24 of the Commentary on Art. 1, *"[i]t is the view of the wide majority that such rules, and the underlying principles, do not have to be confirmed in the text of the convention to be applicable"*²⁴. Furthermore, pursuant to Para.26, *"[t]he majority of Member countries accept counteracting measures as a necessary means of maintaining equity and neutrality of national tax laws in an international environment characterized by very different tax burdens"*²⁵.

2.3. 2003 Revisions to the Commentary

Two main questions posed in the Para.9.1 on Art.1 of the Commentary are as follows:

- whether tax treaties can be interpreted and applied to deny treaty benefits with respect to abusive transactions; and

²⁰ Para.7 of Commentary on Art.1 to the OECD Model (Full Version).

²¹ Para.23 of Commentary on Art.1 to the OECD Model (Full Version).

²² Para.23 of Commentary on Art.1 to the OECD Model (Full Version).

²³ Para.23 of Commentary on Art.1 to the OECD Model (Full Version).

²⁴ Para.24 of Commentary on Art.1 to the OECD Model (Full Version).

²⁵ Para.26 of Commentary on Art.1 to the OECD Model (Full Version).

- whether domestic anti-avoidance rules conflict with, and their application is precluded by, tax treaties.²⁶

For the majority of countries the first approach was elaborated by the OECD Commentaries. Namely, the fact that taxes are eventually imposed through the provisions of domestic law by means of provisions of tax conventions leads to a presumption that any abuse of the provisions of a tax treaty can equally be considered as an abuse of the provisions of domestic law under which tax is imposed. In such a situation, the issue then funnels to whether the provisions of tax treaties may prevent the application of anti-abuse provisions of domestic law. As stipulated in Para. 22.1 of the Commentary, being part of the basic domestic rules established by domestic tax laws for determining which facts cause tax liability, such anti-avoidance rules are not affected by tax treaties. To conclude, usually there is no conflict between domestic anti-abuse rules and the provisions of tax treaties.²⁷

But, for other countries, though, abuses of a treaty are not automatically abuses of domestic law. They consider some abuses as being abuses of the tax treaty itself, separately from abuses of domestic tax provisions. *“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”*.²⁸

Despite having two various approaches with regard to anti-abuse provisions, the OECD holds the sole consistent position respecting transactions that comprise an abuse of the convention, namely, treaty benefits should not be granted then.²⁹ It is worth indicating, that it should not be only ‘lightly assumed’ that a type of transaction undertaken is abusive. It continues with ‘a guiding principle’ that restricts access to treaty benefits in case if the most crucial purpose for undertaking a transaction is to receive tax advantage or privilege tax treatment, which in these circumstances would contradict with the object and purpose of the relevant provisions.³⁰

2.4. Summary

In a nutshell, the pre-2003 Commentary on Art.1 dealing with the improper use of double tax treaties was not clear enough. On the one hand it considers domestic anti-abuse rules consistent with tax conventions provisions as against treaty abuse, but on the other hand pursuant to Para.10 on Art.1 *“[i]t may be appropriate for Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the*

²⁶ Paras. 9.1 of the Commentary on Art.1 to the OECD Model (Condensed Version), 2010.

²⁷ Paras.9.1, 9.2 and 22.1 of the Commentary on Art.1 to the OECD Model (Condensed Version), 2010.

²⁸ Para.9.3 of the Commentary on Art.1 to the OECD Model (Condensed Version), 2010.

²⁹ Para.9.4 of the Commentary on Art.1 to the OECD Model (Condensed Version), 2010.

³⁰ Para.9.5 of the Commentary on Art.1 to the OECD Model (Condensed Version), 2010.

*provisions of domestic laws against tax avoidance should not be affected by the Convention*³¹.

The author however considers 2003 Revisions as a clarification rather than a modification of the OECD position. Arguably, the OECD viewpoint can be changed without amendments to the OECD Model itself but to the Commentaries only.

The 2003 Revisions to the Commentary on Art.1 are helpful but they do not provide enough certainty with respect to several aspects. Even though Revisions clarify that one of the tax treaty purposes is to prevent tax avoidance and shed fresh light on the relationship between tax treaties and domestic anti-avoidance rules³², the clear method for the interpretation of the provisions of tax treaties to prevent abusive tax avoidance is not clarified so far. Para.22.2 leaves more room for maneuver rather than provides a straightforward reply *“Whilst these rules do not conflict with tax conventions, there is agreement that member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused*³³.

2.5. Observations to the Commentary

Several states put forward observations to the amended OECD Commentary to record their disagreement with the above statements. These are Chile, the Netherlands, France, Portugal, Belgium, Ireland and Mexico. Some of them, like Belgium, consider that *“the application of CFC is contrary to the provisions of paragraph 7 of Article 5, paragraph 1 of Article 7 and paragraph 5 of Article 10 of the Convention. That Contracting State thus disregards the legal personality of the foreign entity and therefore acts contrary to the Convention*³⁴. Ireland holds to more gentle opinion and argues that it is not always easy to come to consolidated view on the matter or that not each conflict should be decided in favour of domestic provisions³⁵. *“Luxembourg does not share the interpretation in paragraphs 9.2, 22.1 and 23 which provide that there is generally no conflict between anti-abuse provisions of the domestic law of a Contracting State and the provisions of its tax conventions. Absent an express provision in the Convention, Luxembourg therefore believes that a State can only apply its domestic anti-abuse provisions in specific cases after recourse to the mutual agreement procedure*³⁶. The Netherlands clearly indicated that *“[d]oes not adhere to the statements in the Commentaries that as a general rule domestic anti-avoidance rules and control foreign companies provisions do not*

³¹ Para.10 of Commentary on Art.1 to the OECD Model (Full Version).

³² B.J. Arnold, Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model, Bulletin – Tax Treaty Monitor, June 2004, p. 248.

³³ Para.22.2 of the Commentary on Art.1 to the OECD Model (Condensed Version), 2010.

³⁴ Para.27.4 of the Commentary on Art.1 to the OECD Model (Condensed Version), 2010.

³⁵ Para.27.5 of the Commentary on Art.1 to the OECD Model (Condensed Version), 2010.

³⁶ Para.27.6 of the Commentary on Art.1 to the OECD Model (Condensed Version), 2010.

*conflict with the provisions of tax conventions.*³⁷ So, the matter of interpretation by domestic courts of the revised commentaries should be decided for each jurisdiction separately.

3. ANTI-ABUSE LEGISLATION

3.1. Domestic anti-avoidance provisions (general)

R. Russo provides for the definition of GAAR as follows: these are domestic rules that permit the revenue authorities to recharacterize a transaction or several transactions that were undertaken with the only one or the main purpose of obtaining illegal tax advantages. Some countries incorporated such rules into tax codes, others □ simply follow the general principle of abuse of law, developed from their judicial doctrine.³⁸ For instance, Australia, New Zealand, Canada, South Africa, Ireland, Singapore and Malaysia include a statutory general anti-avoidance rule (GAAR). Continental European countries such as Spain, Germany, France and the Netherlands, have a similar rule or doctrine – *abus de droit*, *fraus legis* or *acte anormale de gestion*. A range of judicially developed doctrines comes from the United States and the United Kingdom that pass by the names such as the business purpose doctrine, step transactions doctrine, economic substance doctrine and substance over form doctrine³⁹. Such countries like Ukraine and Russia have no well developed anti-abuse legislation and instead have special anti-abuse provisions. Some countries like the USA and Canada have combination of different types of anti-avoidance rules.

Maybe, the simplest of these doctrines and probably the only universal one is sham. In this approach the true nature of legal transactions is determined. The contracting parties can pretend that they have entered into transaction or disguise the real transaction in the form of another one contained in the written contract. Usually, even in the most rigorous states the tax law will be applied in respect of the true legal relationship while the sham transaction will be void. Substance-over-form doctrine is widely used by various countries and is based on assessment of transactions according to their economic substance. Not so often used are *abus de droit* and *fraus legis* doctrines. These can mostly be found in civil law jurisdictions. Regarding the distinction between statutory and court developed anti-avoidance measures, the picture is not clear, although it is possible to define some common features required for their application:

- a transaction or set of transactions that is totally or chiefly purporting at tax avoidance;
- if given effect the object and purpose of the applicable tax law would be infringed.

³⁷ Para.27.7 of the Commentary on Art.1 to the OECD Model (Condensed Version), 2010.

³⁸ R.Russo, Fundamentals of International Tax Planning, 2007, p. 207.

³⁹ G.S.Cooper, The Design and Structure of General Anti-Tax Avoidance Regimes, Bulletin for International Taxation, January 2009, p. 26.

Usually, the sham and substance-over-form doctrines serve to detect the real facts with reference to which the relevant tax law is applied. In the case of statutory or court developed *abus de droit* and *fraus legis*, application of the doctrine may result in the recharacterization of facts that entail tax liability that would otherwise be avoided by the legal structure⁴⁰. “Without exception the GAARs can have international effect and there is no distinction in their application depending on the national or international effect”⁴¹.

Since GAARs are for those circumstances where the drafter has not foreseen what the taxpayer will do, G. Cooper defines the four different ways of conceptualizing tax avoidance that permeate the approaches commonly taken in a general rule:

- tax avoidance is something done deliberately;
- it usually menace a policy or purpose of the tax legislation;
- it is a scheme or transaction that depicts certain physical characteristics;
- is something that leads to an outcome in the form of inappropriate tax saving rather than the commercial result of the deal⁴².

With regard to general and specific anti-avoidance rules, the question can be posed whether and to what extent their application can be reconciled with tax treaty obligations. Does their application constitute a treaty override? Does their application coincide with the good faith requirement according to Art.31 of the VCLT?⁴³

3.2. Domestic anti-avoidance provisions (specific)

Not so long time ago the specific anti-avoidance provisions increased considerably. “Their features are varied and far-reaching: they impute income regardless of its realization, reattribute income, recharacterize income, disallow deductions, etc”.⁴⁴ With reference to specific anti-avoidance provisions in domestic law, the two types of them can be distinguished: provisions that apply to all taxable persons and categories of income and in fact are called upon to eliminate domestic tax avoidance and those that address cross-border situations. The first type is covered in the present work to the extent that the operation of these measures is likely to affect or to be affected by double tax treaties.⁴⁵ Specific anti-avoidance rules discussed below include

⁴⁰ S v. Weeghel, IFA General Report, 2010, p. 22.

⁴¹ S v. Weeghel, IFA General Report, 2010, p. 22.

⁴² G.S.Cooper, The Design and Structure of General Anti-Tax Avoidance Regimes, Bulletin for International Taxation, January 2009, p. 28.

⁴³ S v. Weeghel, IFA General Report, 2010, p. 22.

⁴⁴ S v. Weeghel, IFA General Report, 2010, p. 21.

⁴⁵ S v. Weeghel, IFA General Report, 2010, p. 22.

controlled foreign companies, thin capitalization, anti-debt creation, anti-dual resident, anti-hybrid and anti-tax haven rules.⁴⁶

A plenitude of specific anti-avoidance provisions address emigration of companies and individuals, redemption of pension entitlements, controlled foreign companies (CFCs) residing in low-tax jurisdictions, payments to companies that are non-resident or resident in low-tax jurisdictions, *etc.* For a number of these rules a great deal of commonality is present, e.g. exit taxes, CFC regimes and thin capitalization rules.

Other rules, however, are not broadly used by various countries, e.g. the denial of exemptions to non-resident companies that are owned by residents of the source country (Israel). “*Apart from the less prevalent measures, four groups of provisions can be distinguished: provisions focused on situations (a) where a person ceases to be a resident of a country, (b) where income is moved offshore, (c) where the tax base of a country is eroded, and (d) where the character of income is changed*”⁴⁷.

Transfer of residence

The brightest example addressing the transfer of residence are the provisions that entail fake (continued) residence upon the transfer of residence abroad (deeming provisions) and exit taxes.⁴⁸

Base companies

Definitely the most common rules addressing the offshore income of base companies are enshrined in CFC legislation. Such rules have two basic forms. “*They either attribute income earned by a CFC to the shareholder of that entity (the ‘lookthrough’ approach) or deem the shareholder to have received dividends from the entity (the ‘deemed dividend’ approach)*”⁴⁹. The CFC legislation may adopt a ‘designated jurisdiction’ (low-tax countries) or ‘effective-tax-rate’ approach (CFC rules apply to companies that, for whatever reason, pay less than a specified effective tax rate). Key points to be taken into account with reference to the application of CFC legislation are as follows:

- the definition of control for CFC purposes;
- when the income or the entity falls within its scope;
- whether any form of double tax relief is provided for the (low) tax paid overseas.⁵⁰

⁴⁶ R.Russo, *Fundamentals of International Tax Planning*, 2007, p. 207.

⁴⁷ S v. Weeghel, IFA General Report, 2010, p. 23.

⁴⁸ S v. Weeghel, IFA General Report, 2010, p. 23.

⁴⁹ S v. Weeghel, IFA General Report, 2010, p. 24.

⁵⁰ R.Russo, *Fundamentals of International Tax Planning*, 2007, p. 212-214.

*Other provisions addressing offshore income are so-called switchover clauses, in which the exemption for foreign dividend or branch income is substituted by a credit for foreign tax if the income is passive and/or lowly taxed or flat denial of an exemption without a credit in the case of lowly taxed foreign subsidiaries*⁵¹.

Base erosion

Obviously, the thin capitalization rules are the most widespread in this category. At the same time, earnings-stripping rules and rules limiting the deduction of interest payments to a percentage of assets take place often⁵². From a tax perspective, the treatment of the remuneration paid for the use of debt or equity is significantly distinct. Usually, interest is deductible at the level of the payer and subject to tax at ordinary rates in the hands of the recipient. Otherwise, dividends are basically non-deductible at the level of the payer and enjoy some form of relief from economic double taxation in the hands of the recipient. Thus, it is obvious that this differential treatment of dividends versus interest generates multiple opportunities. Crucial aspects to be taken into account when analyzing thin capitalization rules are:

- the scope of the provisions (both subjective and objective);
- the determination of the debt to equity ratio;
- the outcomes of the application of the provisions;
- the availability of safeguard clauses.⁵³

Particular jurisdictions, *e.g.* Belgium, restrict the deductibility of expenses paid to non-residents if they are residents in countries with low or no taxation or in countries with a preferential tax regime. To the contrary in Israel exemptions are allowed to non-resident companies. But in case if at least 25 per cent are held by the residents of Israel, the aforementioned exemptions are not applicable. Thin capitalization rules may recharacterize disallowed interest into dividend, but for withholding tax purposes dividend may be recharacterised into interest as well in Australia, for instance.⁵⁴

Miscellaneous

Apart from the above-mentioned domestic anti-avoidance provisions, there is a wide variety of less prevalent ones. Among them there are anti-dual resident rules, anti-hybrid rules, and anti-tax haven, etc. Several states have rules to prevent double utilization of losses, often through dual resident companies. The United States has similar rules that, broadly, prevent the deductibility of losses in the United States when the same losses have already been deducted in another

⁵¹ S v. Weeghel, IFA General Report, 2010, p. 23.

⁵² S v. Weeghel, IFA General Report, 2010, p. 24.

⁵³ R. Russo, *Fundamentals of International Tax Planning*, 2007, pp. 221-222.

⁵⁴ S v. Weeghel, IFA General Report, 2010, p 24.

jurisdiction. More recently, some states have introduced rules to counter the use of hybrid instruments and hybrid entities. Specifically, in 2005 the United Kingdom has introduced a complex set of rules, which, *inter alia*, can deny relief for any expense arising as part of a scheme involving hybrid entities or hybrid instruments. Quite interestingly, the Denmark introduced rules that address hybrid entities and hybrid instruments, which may cause the Danish tax rules to follow the foreign characterization of entities and/or instruments in order to prevent tax arbitrage, and others.

4. TREATY INTERPRETATION

4.1. Vienna Convention on the Law of Treaties

Being international agreements all treaties concluded between countries under public international law should be interpreted pursuant to international law principles⁵⁵. Some scholars argue that a double tax treaty can be effective only in case of uniform interpretation and similar application in both contracting states. It is crucial to have criteria for interpretation that would function as guidelines in order to support the interpreting procedure aiming at maintenance of legal certainty both for tax-payers and states to assure the non-arbitrary interpretation of DDT.⁵⁶ Article 31(1) reads 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 objects and purpose*”⁵⁷. Put it otherwise, “*This rule calls for a textual, a teleological and a systematic interpretation*”⁵⁸.

Art. 32 of the VCLT embodies the supplementary means of interpretation including the preparatory work of the treaty and the circumstances of its conclusion but only to support the meaning that is a result of interpretation from Art. 31 if it stays ambiguous or unreasonable⁵⁹.

B. Arnold in his article heavily criticizes⁶⁰ the interpretive approach taken by the states that consider abuses of a treaty separately from abuses of domestic law. According to Para.9.3 of the Commentary on Art.1 “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

⁵⁵ M. Lang, Introduction to the Law of Double Taxation Conventions, June 2010, Ch. IV, para.2.2.

⁵⁶ K. Vogel, R. Prokisch, General Report, IFA Cahiers, 1993, Vol.78a, pp. 55-56.

⁵⁷ Art. 31(1) of VCLT, 1969.

⁵⁸ P. Wattel, O. Marres, The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties, European Taxation, July/August 2003, Vol.43.#7, p.225.

⁵⁹ Art. 32 of the VCLT, of 23 May 1969.

⁶⁰ B.J. Arnold, Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model, Bulletin – Tax Treaty Monitor, June 2004, p. 249.

of tax conventions as well as the obligation to interpret them in good faith”⁶¹. Arnold argues that in such a case the reference to Art.31 of the VCLT is not enough effective and persuasive. This could be used to approve any type of interpretation: literal or textual, purposive or intentional. Furthermore, as mentioned before in this thesis, in the case of interpreting the convention on the basis of its purpose to prevent tax avoidance, it could be said that preventing tax avoidance is not the sole or principal purpose of tax convention. Thus, Arnold comes to conclusion that using the interpretive approach would result in more confusion rather than clarity on the OECD discussions and impede reaching further consensus among the states.⁶²

4.2. The role of the OECD Commentary in treaty interpretation

The OECD Model and the Commentaries do not, however, have as much weight as the wording of the convention itself because they are not part of the agreement.⁶³ According to Arnold, it is difficult to reach consensus with regard to Commentaries status since VCLT does not mention it and eventually there is no equivalent to the Commentaries in treaties.⁶⁴

Some scholars consider that the OECD Commentaries put together part of the context mentioned in Article 31 VCLT⁶⁵, others of the opinion that the OECD Model Convention and the Commentary thereto are ‘supplementary means of interpretation’ by reference to Article 32 VCLT, provided that tax treaty negotiations were based of the OECD Model and its Commentaries⁶⁶. This position can be proved by the fact that during the drafting procedure member states always have opportunity to submit their observations to interpretations offering their opinion on the matter and that the absence of such an observation can be construed as an expressed agreement with the Commentaries position.⁶⁷

The process of interpreting a tax treaty triggers plenty of issues worth addressing. These are: static vs. ambulatory interpretation of tax treaties, changes of the OECD Model and the Commentaries under static and ambulatory interpretation and relation between the Commentary

⁶¹ Para.9.3 of the Commentary on Art.1 to the OECD Model (Condensed Version), 2010.

⁶² B.J. Arnold, Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model, Bulletin – Tax Treaty Monitor, June 2004, p. 249.

⁶³ M. Lang, Introduction to the Law of Double Taxation Conventions, June 2010, Ch. IV, para.2.3.

⁶⁴ B.J. Arnold, The Interpretation of Tax Treaties: Myth and Reality, Bulletin for International Taxation, January 2010, pp.8-9.

⁶⁵ A. Jones, The Effect of Changes in the OECD Commentaries after a Treaty is Concluded, Bulletin – Tax Treaty Monitor, March 2002, p.102.

⁶⁶ M. Lang, F. Brugger, The Role of the OECD Commentary in tax treaty interpretation, Australian Tax Forum, 2008, vol.23, p.98.

⁶⁷ R. R. Young, The Use of Extrinsic Aids in the Interpretation of Tax Treaties, Tax Management International Journal, Vol. 28, #12, 1999, p.811.

and Articles 31 and 32 VCLT. Legal certainty and *pacta sunt servanda* are the crucial arguments in favour of static interpretation meaning that later developments are irrelevant and should not be taken into consideration.⁶⁸ In some cases, however, a more recent version of the OECD Commentary can be helpful in the interpretation of an older DTT because that version reflects practice already common in some areas. The first OECD Model and Commentary from 1963 were not created overnight but followed existing bilateral treaty practice. Provided that a version of the OECD Model or the Commentary actually reflects bilateral practice, these materials can also be useful for the interpretation of later DTT(s).⁶⁹ Thus, an ambulatory interpretation stresses that an interpretation based on obsolete references and assumptions is inefficient and can lead to unsatisfactory outcomes.⁷⁰

Alongside with the debate on the legal status of the OECD Commentary, another issue arises – with regard to post-treaty amendments in the Commentaries, which version of the Commentary should prevail?

The approach of applying later versions has been convincingly criticized by some commentators, as these later versions of the Commentary have not been considered by the parliament who approved the DTT. Later versions of the Commentary are not ‘context’ for the purpose of Art.31(1) of the VCLT because only those Commentaries that are made in connection with the conclusion of the treaty can be considered as context. They cannot be considered ‘subsequent agreements’ either for the purposes of Art. 31(3) of the VCLT since that would require further ratification. In order to be considered ‘subsequent practice’ within the meaning of Art. 31(3) VCLT, evidence would be required to show that the Commentary reflected actual subsequent practice of both contracting states; relying on the words of the OECD Commentary only would not suffice for this purpose.⁷¹ Finally, later changes to the Commentary cannot be considered ‘special meaning’ within the meaning of Art. 31(4) of the VCLT since the parties could not have intended an interpretation that did not exist at the time the DTT was concluded.⁷²

It has, however, been pointed out that refusing to take later Commentaries into account can result in the Commentaries being frozen in time and therefore failing to adapt to changes in business or technology. If later Commentaries are not used, the result could be a different interpretation of

⁶⁸ P. J. Wattel, O. Marres, *The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties*, *European Taxation*, July/August 2003, Vol.43.#7, pp.222-223.

⁶⁹ M. Lang, *Introduction to the Law of Double Taxation Conventions*, June 2010, Ch. IV, para.2.4.

⁷⁰ P. J. Wattel, O. Marres, *The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties*, *European Taxation*, July/August 2003, Vol.43.#7, pp.222-223.

⁷¹ M. Lang, *Introduction to the Law of Double Taxation Conventions*, June 2010, Ch. IV, para.2.4.

⁷² K. Vogel, *The Influence of the OECD Commentaries on Treaty Interpretation*, *BFIT*, December 2000, p.612-616.

identical wording in treaties entered into at different times. This goes against the goal of uniform interpretation of DTTs.⁷³

The OECD attitude towards the status of the Commentaries, is expressed in Para.35 of the Introduction to the Commentary as follows: “[c]hanges or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD member countries as to the proper interpretation of existing provisions and their application to specific situations” and in Para.36: “Many amendments are intended to simply clarify, not change, the meaning of the Articles or the Commentaries...”.⁷⁴

Though, scholars agree that even the revised Commentary falls within the scope of ‘supplementary means of interpretation’ mentioned in Art.32 VCLT, while the Commentary at the time of entering into the agreement can set up ‘the context’ according to Art. 31. It should be noticed that the Commentary itself has a great authority on account of the OECD’s outstanding expertise and solid support of the member states⁷⁵.

4.3. Summary

Thus, the general rules of interpretation are presented in Art.31, 32 VCLT. Art.31 embodies the main rule to interpret in a good faith and according to the purpose of the treaty, whilst Art.32 describes the supplementary means of interpretation that is weaker rather than the main rule expressed in Art.31.

Two principal methods of interpretation can be followed to determine how OECD Model and Commentaries thereto refer to the VCLT.

Under the static interpretation the OECD Model and Commentaries can be considered to form the context referred in Art.31 and therefore have crucial value in case if some convention provision need to be clarified. At the same time the ambulatory means of interpretation reflects both political and economical changes that take place after the treaty was signed.

Some scholars argue that Commentaries refer to the supplementary means of interpretation. However, others cast doubts whether the revised Commentaries can depict the intentions of the parties at the moment when the agreement was reached and more importantly later Commentaries were not ratified by the parliaments of the contracting states. Such reasoning is extremely legitimate and persuading but not less important is the fact that the vast variety of tax

⁷³ A. Jones, The Effect of Changes in the OECD Commentaries after a Treaty is Concluded, Bulletin – Tax Treaty Monitor, March 2002, p.102.

⁷⁴ Commentaries on Articles of the Model Tax Convention, 2010, Condensed version, Paras.35, 36.

⁷⁵ P. Wattel, O. Marres, The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties, European Taxation, July/August 2003, p.228.

conventions was signed several decades ago and the economic situation has changed radically since then.

Although the OECD Model Convention and Commentaries thereto have a crucial value for the double tax conventions interpretation and are broadly used by non OECD member states, they don't have unfortunately legally binding authority.

5. WHAT SHOULD PREVAIL IN CASE OF CONFLICT: TAX TREATY OR GAAR?

Reporters from 44 countries submitted their contributions to the IFA regarding consistency between GAAR and tax treaties during the 2010 Rome Congress. As stated in the General Report the vast majority of branch reports countries do admit that the GAARs can be reconciled with their treaty obligations that is fully in line with the 2003 Revisions to the OECD Commentary.

As indicated previously, the Commentary says that countries usually follow two distinct approaches distinguished in Para.9.2 and 9.3. The factual one, when the domestic anti-avoidance rules recharacterize the facts that give rise to a tax liability. The abuse of the treaty means the abuse of domestic provisions either. In such a situation the treaty is applied after the so-called recharacterization. The second approach has got the title of interpretative one due to the vast academic discussion around this controversial issue or simply because it relies on the interpretation of DTT. The underlying category is that an abuse of the treaty does not coincides with an abuse of domestic rules, that results in interpretation of the treaty itself in order to disregard the abusive transaction. Interestingly, only a few states clearly expressed in their branch reports which approach is followed by the present state. However, some reports, *e.g.* New Zealand, do mention that their countries stick to the factual approach and, consequently, that the determination of the facts under domestic law is then followed for tax treaty purposes⁷⁶. To make the question sharp, namely, whether treaty prevails or domestic GAAR?

C. Elliffe considers that the very underpinning in differentiation between the factual and interpretative approaches is the way in which domestic GAAR operate when applied to an abusive transaction. Apparently, the type of choosing between these two approaches can be determined if answered on "How do GAAR operate after being invoked?" Where the anti-avoidance rules void the actual legal transactions and recharacterise it on the spot, then obviously the country will apply a factual approach. If, however, a country applies canons of statutory interpretation, meaning that the relevant tax provisions cannot, in case of abuse, be interpreted at face value, then an interpretative approach to the abuse of treaties at stake should be applied. Thus, the link between the factual and the interpretative approaches depends on the GAAR's effect on the abuse of the treaty. In the first case a GAAR voids the existing transaction and

⁷⁶ S v. Weeghel, IFA General Report, 2010, p. 26.

reconstructs a new non-abusive outcome (factual), and in the other case it simply disregards the abusive transaction (interpretative)⁷⁷.

It is worth mentioning that an approach taken by the country tells very little about the source of law that will be the primary source to apply in the case of any conflict. It is more concentrated on the effect of anti-avoidance rules' application but not the supremacy of law. As Elliffe stresses in his article it is crucial to decide whether treaty overrides the domestic law or the other way round. What is more important in such a situation, to protect the tax base or stick at the certainty of law?⁷⁸

Conditionally, the branches states' reports assume that three general categories of approaches exist (throughout world-wide diversity of GAARs):

5.1. Countries where the GAAR clearly overrides the Treaty

As Richard Vann summarizes the position of Australia in its Branch Report, since “*Australia has many deviations from the OECD model in its treaties that guidance is often not available or very helpful. In such cases the courts are mainly guided by the text of the treaty (being the outcome of detailed negotiations) and less influenced by broad generalities such as the avoidance of double taxation*”. In respect to priority of tax conventions or anti-abuse rules “[t]reaties override the rest of domestic income tax legislation except the general anti-avoidance rule”⁷⁹.

Canadian taxpayers are not entitled to any rights before the treaties are implemented in statutes. According to the general rule the treaty overrides any conflicting national provision except for ITCIA. The Canadian government clearly proclaimed that the GAAR applies to any benefit provided by a treaty⁸⁰.

The USA reporters inform that domestic anti-abuse rules are equally applied to questions involving the availability of tax treaty benefits as well as to other tax questions. The American courts consider that domestic anti-avoidance rules are consistent with tax treaties⁸¹.

5.2. Countries where the Treaty overrides the GAAR

Being a vocal advocate of strict hierarchy of sources of law set under art.94 of the Dutch Constitution, the Netherlands do not allow the supremacy of anti-abuse legislation over the tax conventions in case of conflict “*Since tax treaty provisions are binding upon everyone, they*

⁷⁷ C. Elliffe, International Tax Avoidance – the tension between protecting the tax base and certainty of law, Journal of Business Law, 2011, 7, p. 649.

⁷⁸ C. Elliffe, International Tax Avoidance – the tension between protecting the tax base and certainty of law, Journal of Business Law, 2011, 7, p. 649.

⁷⁹ R. J. Vann, Australian Branch Report, IFA, Cahier de Droit Fiscal International, 2010, p.84-85.

⁸⁰ N. Goyette, P. Halvorson, Canadian Branch Report, IFA, Cahier de Droit Fiscal International, 2010, p.181-182.

⁸¹ A. Varma, P. West, the USA's Branch Report, IFA, Cahier de Droit Fiscal International, 2010, p.837.

prevail over national law”⁸². Despite the fact that *fraus legis* doctrine was developed for a long time in the Netherlands, its application along with tax conventions casts doubt on the treaty partners shared views and justified expectations as well as threatens the predominant purpose of tax conventions to prevent double taxation⁸³. At least, such position is totally consistent with the declared observation under Para.27.7 of the Commentaries.

After careful examination of the Dutch and Portuguese Reports one may find their standpoints analogous with each other. Under the Portuguese constitutional system international rules binding the Portuguese state prevail over domestic provisions, regardless of the time when such rules had been enacted. This means that DAAR can not be applied if this result in the tax treaty provisions being overridden. *“In spite of the OECD MC Commentary on article 1, the reporters believe that DAARs may be used to determine the tax liability of a specific taxpayer, but not to change the fact pattern in a way that first would jeopardize the agreement signed between two contracting states and, secondly, would undermine the confidence and certainty of taxpayers' legitimate expectations that are protected by the Portuguese Constitution.”*⁸⁴

5.3. Countries where the GAAR will override the Treaty unless there is a clear conflict, in which case the Treaty prevails

It is comparatively easy to accept two first categories of approaches due to their explicit position at issue what prevails in substance the treaty provisions or GAAR. In various countries the attitude on the matter is not that clear due to attempts to reconcile these competing sources of law. As B. Arnold summarized in his article *“[i]n most countries, generally speaking, tax treaties prevail over domestic tax laws in the event of a conflict”*⁸⁵. New Zealand is a very bright example of such a country. It has elaborated a kind of hybrid approach aiming to reconcile the international public law with the domestic GAARs. The academics analyze the New Zealand legislation and refer to the Income Tax Act that admits precedence of both tax avoidance arrangements and double tax arrangements with regard to the rest of legislation, but without any primacy as against each other⁸⁶. Therefore, the scholars' standpoints have split and J. Prebble takes the view that the GAAR application is totally unfettered. Otherwise, C. Elliffe does

⁸² F. Peters, A. Roelofsen, Dutch Branch Report, IFA, Cahier de Droit Fiscal International, 2010, p.561.

⁸³ F. Peters, A. Roelofsen, Dutch Branch Report, IFA, Cahier de Droit Fiscal International, 2010, p.561-563.

⁸⁴ A. Fernandes, F.Sousa da Camara, Portuguese Branch Report, IFA, Cahier de Droit Fiscal International, 2010, pp.656-659.

⁸⁵ B.J. Arnold, Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model, Bulletin – Tax Treaty Monitor, June 2004, p. 244.

⁸⁶ C. Elliffe, J. Prebble, General Anti-Avoidance Rules and Double Tax Arrangements: A New Zealand Perspective, Revenue Law Journal, Vol.19: Iss.1, Art.4, p.10.

Available at: <http://epublications.bond.edu.au/rlj/vol19/iss1/4>

consider that unless the treaty is itself being abused, the explicit definition in the treaty and the treaty itself should prevail over the GAAR. Anyway, both authors agree that under the factual approach, the GAAR will recharacterize the transaction that way so there will be no conflict between tax treaty and the GAAR⁸⁷. The same position is depicted in the New Zealand Branch Report. “*However, in circumstances where there is conflict between the treaty and domestic law, the treaty will prevail, unless the transaction is an abusive one, in which case the test under the commentary will be whether “a main purpose” is to obtain a favorable tax position that is contrary to the object and purpose of the relevant provisions*”⁸⁸.

5.4. Abuse of the tax treaty itself: domestic law principles or interpretation of the treaties?

Interpretation of the DTT itself is not the application of domestic anti-abuse rules. Usually treaties are construed based on the domestic interpretation methods and such domestic interpretation methods often are in a form of anti-abuse legislations. Hence, abuse of the tax treaty itself approach is basically the application of a domestic law.

Interestingly, it could be construed from the General IFA Report that the consolidated approach in respect to interpretation of tax convention being abused itself does not exist. In slight deviation from Paras.9.2 and 9.3 of the Commentary the branch reporters were asked to comment on their country’s approach to abuse of a tax treaty itself: would it be addressed under domestic law principles or by means of interpretation of tax convention? Whilst some countries, like Ukraine⁸⁹, have no precedent on the matter and therefore are not able to provide any guidance, other states’ replies very significantly. Traditionally, some states hold an opinion that the abuse of the treaty must be addressed through interpretation of the treaty itself referring to Art.31 of the VCLT, New Zealand, for instance. But considerable number of states clearly expressed that such an abuse is addressed by applying domestic anti-abuse principles⁹⁰. France indicated that “*The abuse of a tax treaty is legally granted in the statutory general anti-avoidance abus de droit. Abuse of tax treaties may be sanctioned only based on the statute and not on the DDT itself*”. “*Unless an abus de droit is characterized under domestic law, there can be no situation of abuse of a tax treaty*”⁹¹. The South Africa explicitly states that “[o]nce a treaty is enacted it has the same standing as other domestic law provisions”. “[p]rovisions of the

⁸⁷ C. Elliffe, J. Prebble, General Anti-Avoidance Rules and Double Tax Arrangements: A New Zealand Perspective, Revenue Law Journal, Vol.19: Iss.1, Art.4, pp.1-23 available at: <http://epublications.bond.edu.au./rlj/vol19/iss1/4>

⁸⁸ C. Elliffe, J. Prebble, New Zealand Branch Report, IFA, Cahier de Droit Fiscal International, 2010, pp.575-593.

⁸⁹ P. Evdokimov, O. Marchenko, Ukrainian Branch Report, IFA, Cahier de Droit Fiscal International, 2010, p.793.

⁹⁰ S v. Weeghel, IFA General Report, 2010, p. 26.

⁹¹ S. Austray, M. Collet, French Branch Report, IFA, Cahier de Droit Fiscal International, 2010, p.324.

treaty will rank equally with South African domestic statutory provisions...” “Consequently, they need to be interpreted in terms of the normal rules”⁹².

While analyzing these three approaches that states undertake with regard to relationship between the GAAR and tax treaties, governments, judges or even judicial systems give precedence to one guiding principle above another. Some countries consider that having certainty in dealing with cross-boarder activities is of great importance both for tax payers and revenue authorities. Others stick to opinion that the main purpose of tax convention is to prevent double taxation along with not to abuse the domestic tax base. Netherlands, for instance, being the votary of the primacy of the treaty does not however totally exclude *fraus legis* doctrine application. Hence, there can be inconsistency of treatment of a tax payer due to the diverse preference of one principle over another by different states.

Such an inconsistent approach of various states with regard to cross-boarder transactions can be illustrated by the following example⁹³.

This ‘definitional’ situation was discussed by the general reporter Stef van Weeghel, as well as by C. Elliffe, J. Prebble in their article “*General Anti-Avoidance Rules and Double Tax Arrangements*”. A Dutch shareholder receives capital gains by selling shares in both a US and a New Zealand company to another company that it owns. The purpose of this transaction is to obtain more favorable tax treatment in the capacity of capital gains rather than receiving dividend distributions. Under domestic anti-abuse rules both the US and New Zealand tax authorities may recharacterise this transaction as a dividend disregarding the legal form of the sale transaction and further such domestic recharacterisation would then be applied for tax treaty purposes. From the New Zealand perspective it is considered as the factual approach that would be applied. From the United States perspective it is considered as the interpretive approach that was used.

As for the Netherlands, the capital gain should be recharacterised into a dividend under the *fraus legis* doctrine. But contrary to the US and New Zealand treatment, such a recharacterisation under the Dutch legislation for tax treaty purposes conflicts with their tax treaty obligations. So the Dutch treatment would be in line with its tax treaty provisions to regard the sale as a capital gain.

“A capital gain derived by a resident of the United States in respect of shares in the company resident in the Netherlands could thus be regarded as a dividend (a) for US domestic law purposes, (b) for the Netherlands-USA tax treaty in the interpretation by the United States, and

⁹² L. Oliver, the South African Branch Report, IFA, Cahier de Droit Fiscal International, 2010, p. 724.

⁹³ C. Elliffe, International Tax Avoidance – the tension between protecting the tax base and certainty of law, Journal of Business Law, 2011, 7, p. 661.

(c) for Dutch domestic law purposes (and prior law), but as a capital gain for the Netherlands-USA tax treaty in the interpretation by the Netherlands.”⁹⁴

In case of discrepancies of treaty outcomes a taxpayer should refer to the mutual agreement procedures under the relevant article.

Such example, presented in the IFA General report according to C.Elliffe brightly illustrates how the approaches of three countries regarding dividend stripping do function in practice. Each country has its own arguments in favour of either prevalence of certainty approach or prevalence of abuse approach. Certainty and *pacta sunt servanda*, the approach preferred by the Netherlands reflects the basic principle of international law of *pacta sunt servanda*. It not only highlights the inviolable nature of double tax treaties but also refrains the treaty partners from infringement of their obligations under the convention. Tax treaties override the domestic legislation and in case of uniform application by both states reduce possibilities of double taxation (that historically used to be the core purpose of double tax conventions). Two aspects are combined by *pacta sunt servanda*: the certainty itself, when a taxpayer can rely on the outcome prescribed by a treaty; and the aspect of consistency – the consistent application by both states while dealing with cross-boarder transaction⁹⁵.

The approach taken by the US and New Zealand in the aforementioned example, pursue the states’ sovereign taxing rights in abusive situations. This arguably can result in the situation that a taxpayer will not receive the outcome prescribed by the treaty under its strict interpretation. The previous statement is clearly critical to its meaning since as explained in other sections of this thesis the treaties should be interpreted in accordance with VCLT that could be with reference to OECD Commentaries. The OECD Commentary in its turn starting from 2003 approved the prevention of tax avoidance as one of the treaty’s direct purposes and held the view that countries should be generally able to apply their GAARs to the treaties that they concluded (even without directly specifying this in the treaty itself). In a nutshell, governments will not allow the artificial use of the treaty to erode their tax base⁹⁶.

5.5. Summary

The OECD Commentary position does not suggest the comprehensive classification of the relationship that in practice exists between anti-avoidance legislation and double tax conventions

⁹⁴ S v. Weeghel, IFA General Report, 2010, p. 26.

⁹⁵ C. Elliffe, International Tax Avoidance – the tension between protecting the tax base and certainty of law, Journal of Business Law, 2011, 7, pp. 661-664.

⁹⁶ C. Elliffe, International Tax Avoidance – the tension between protecting the tax base and certainty of law, Journal of Business Law, 2011, 7, pp. 661-664.

in various countries. The author totally supports the C. Elliffe standpoint that the best criteria to follow is indentifying which overrules which.

In general countries could be grouped in three categories. Those that consider avoidance as extremely serious problem have clearly proclaimed that GAARs apply to abusive transactions involving the double tax treaties and overrule treaties. This approach is based on the OECD Commentary position. The other approach stands for the application of the treaty that overrides domestic legislation. Certainty is of crucial value for such countries. In such a situation to solve a problem of abuse requires renegotiation of treaties.

The third category of countries has hybrid features. Basically the domestic GAAR operate on cross-border transactions and override the treaty, but in case of a conflict between tax treaty and GAARs, the treaty will prevail and override the domestic anti-abusive rules.

In attempt to reconcile two competing principles towards treaty obligations to be observed while ensuring that treaties are not abused it is not easy to determine the most appropriate approach. The hybrid approach may be more common and therefore accepted by various countries because it ensures clear treaty outcomes along with protection against treaty abuse. One more argument in favour of this approach is difference in relationship between domestic law and the GAAR, and treaties and the GAAR undertaken by many states⁹⁷.

6. CASE LAW: RUSSIA

6.1. Examination of cases

Case A56-19578/2006 of 9 April 2007

Interregional Tax Inspectorate No. 6 of Leningrad region (hereinafter, the tax authority) has recharacterized the interest paid by a Swedwood Tikhvin LLC (hereinafter, the taxpayer), a Russian subsidiary to its parent company resident in the Netherlands. Under Russian thin capitalization rules, the payment could not be qualified as a deduction since the net assets of the taxpayer were negative during time at issue. As a result, the interest that was considered by a taxpayer as a deductible expense was recharacterized into dividend and tax authorities charged additional withholding tax at source with regard to such payments.

The Court in its decision relies on Art.7 of the Russia's Tax Code that clearly states as follows: *"If the international agreement of the Russian Federation, including provisions, regarding taxation and fees, set rules and provisions contrary to the present Code and regulatory legal acts on taxes and (or) fees, adopted thereto, the rules and provisions of such international*

⁹⁷ C. Elliffe, International Tax Avoidance – the tension between protecting the tax base and certainty of law, Journal of Business Law, 2011, 7, pp. 664-665.

*agreements of Russian Federation shall be applied then*⁹⁸. This position is also approved in Para.12 of the Highest Arbitration Court's Information Note #58 of 18.01.2001 and Para.10 Information Note of the Presidium of the Highest Arbitration Court of 25.12.1996.

Art. 11 and 25 of the Netherlands-Russia Income and Capital Tax Treaty of 16.12.1996 (hereinafter, the DTT) were carefully analyzed by the court. Based on deduction non-discrimination clause and ownership non-discrimination clause enshrined accordingly into Art.25(3) and 25(4) of DTT the taxpayer claimed that domestic thin cap rules were not compatible due to the fact that the thin cap rules do not apply to interest on loans between resident companies. Also, the court noted that according to Art.IV and VII of the Protocol to DTT that provides for the definitions of both interests and dividends accordingly, and the tax authorities erroneously, contrary to the definitions of terms indicated in the DTT recharacterized the interest into dividends⁹⁹.

Art.15(4) of the Constitution of Russia applied jointly with Art.7 of the Tax Code of RF constitutes the precedence of international agreements over domestic legislation¹⁰⁰.

The Federal Arbitration Court of the North-West Region has confirmed the decisions taken by the first level court and the appellate court in favour of the taxpayer. Since with regard to expenses on interest under the loans, the DTT constitutes other rules than provided by other regulatory legislation of RF, and in substance such expenses on interest are not restricted by the Convention, and there are no any reservations on application of national legislation herein the courts of previous instances soundly approved the precedence of DTT over domestic legislation and in substance applied Art.11(2) of the DTT¹⁰¹.

Case A26-6967/2008 of 23 September 2009

A Russian resident AEK LLC (hereinafter, the taxpayer) paid interest on a loan to its parent Karkhatek JSC in Finland. The Russian tax authorities took the position that the domestic thin-capitalization rules prescribed by Art.269(2) of the Tax Code allowed them to re-characterize the interest payments into dividends, if a debt-equity ratio between the foreign lender and the Russian interest payer exceeds 3:1 and as a result to charge additionally tax at source.

As in previous case, the Court carefully examined the definitions of terms provided in Art.10 and 11 in the Finland-Russia Income Tax Treaty and 'Ownership non-discrimination clause' under Art. 23(4). According to Art.312 of the Tax Code the foreign resident shall not be charged tax at

⁹⁸ Tax Code of the Russian Federation (Part1 of 31.07.1998)#146-FZ, and (Part2 of 05.08.2000)#117-FZ available at http://base.garant.ru/10900200/1/#block_20001.

⁹⁹ Art.IV and VII of the Protocol to Netherlands-Russia Income and Capital Tax Treaty of 16.12.1996.

¹⁰⁰ Art.15(4) of the Constitution of the Russian Federation available at <http://www.constitution.ru>.

¹⁰¹ Case A56-19578/2006 of 9 April 2007 available at www.garant.ru.

source in case if he acts according to provisions of the effective DTT and has provided the tax residence certificate from its Residence country¹⁰².

Since the Finnish company provided for all documentation required under Art.312 of the Tax Code, and based on the Art. 11(2) applied in conjunction with Art.23(4) of DDT, the Federal Arbitration Court of North-West Region came to conclusion that DTT has a precedence over thin cap rules in order to guarantee the non-discriminatory treatment of Russian companies owned by Finnish ones¹⁰³.

Case KA40/9453-09-2 of 23 September 2009 is very similar to the previous case and therefore is not presented in a detail. The non-discrimination clause in Para.24(4) of the Cyprus-Russia Income and Capital Tax Treaty also precludes the application of domestic thin cap rules because DTT has a primary powers¹⁰⁴.

Case 8654/11 of 15 November 2011

The taxpayer, “Ugolnaya kompania “Severniiy Kuzbass” JSC (hereinafter, the taxpayer), was company resident in Russia (previously, a subsidiary to a Cypriot parent). In 2007, the taxpayer borrowed money from another Russian company, “Severstal Resurs”, under the loan agreement. Hereafter, the lender yielded the right of claim to Mittal Steel Holding AG, registered in Switzerland, and subsequently this right of claim was also transferred to ArcelorMittal Finance (Luxemburg). The Steel Holding AG was also the shareholder of more than 20% of shares in “Severstal Resurs”. The taxpayer had also loans from other affiliated companies.

According to Art.269(2) of the Tax Code of the RF, the thin capitalization rules (debt-equity 3:1) apply, if a non-resident company which directly or indirectly holds or controls more than 20% of a Russian company’s share capital, or if a Russian company has a debt to another Russian company which is an affiliate of a non-resident company. The thin capitalization rules do not apply if a Russian company is wholly owned by other Russian entities or individuals¹⁰⁵. Taking into account the fact, that loans were provided by affiliated companies, the tax authorities argued that thin cap rules should be applied with regard to the interests paid under the loan agreements of a shareholder and that such interest payments should not be included in a taxpayer’s expenses. During the case examination the Supreme Arbitration Court took into consideration the following facts:

¹⁰² Art. 312 of the Tax Code of the Russian Federation (Part1 of 31.07.1998)#146-FZ, and (Part2 of 05.08.2000)#117-FZ available at http://base.garant.ru/10900200/1/#block_20001.

¹⁰³ Case A26-6967/2008 of 23 September 2009 available at www.garant.ru.

¹⁰⁴ Case KA40/9453-09-2 available at www.garant.ru.

¹⁰⁵ Art. 269(2) of the Tax Code of the Russian Federation (Part1 of 31.07.1998)#146-FZ, and (Part2 of 05.08.2000)#117-FZ available at http://base.garant.ru/10900200/1/#block_20001.

- significant amounts of the loans were granted without guarantees or pledges while the taxpayer’s net assets were negative (this argument casts doubts that the loans were made between unrelated parties);
- when the taxpayer’s shares were transferred from the Cyprus to the Swiss holding, the debt was transferred simultaneously;
- interest on the loan was accrued but was not paid for significant periods of the loans’ terms.

The Russia’s Supreme Arbitration Court held that previous decisions (in the first and appellate instances) were made erroneously due to reference to Art.24 (4) of DTTs with Switzerland and Cyprus accordingly that states as follows: “*Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected*”.¹⁰⁶ The Court states that aforementioned Art.24(4) was construed too broadly that in substance denied application of the domestic thin cap rules under Art.269(2) of the Tax Code.

Instead, the Court made a link between the affiliated persons in question under Art.269(2) and transfer pricing rules provided under Art.9 of OECD Model and arm’s length principle thereto. The Court directly refers in its decision to Para1.3(b) of Commentaries on Art.9 to the OECD Model which explicitly states that “[t]he article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm’s length rate, but also whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital”¹⁰⁷.

Thus, the Court came to conclusion that Art.9 calls upon for application of national legislation to deny benefits enshrined in Art.24(4) especially in such a situation when a taxpayer has not liquidated its debt before non-residents lenders.

The Supreme Arbitration Court held in favour of the tax authorities. The taxpayer was precluded from including the interest payments into its deductible expenses. The Court observed that in general tax treaties do not preclude the application of domestic anti-avoidance rules, in particular, in respect of the re-characterization of loan into equity contributions. Ultimately, Supreme Arbitration Court concluded that the anti-avoidance provisions in Russian domestic law

¹⁰⁶ Art. 24(4) of both Russia - Switzerland Income and Capital Tax Treaty of 15.11.1995 and Cyprus-Russia Income and Capital Tax Treaty of 15.12.1998.

¹⁰⁷ Para.1.3(b) of Commentaries on Art.9 to the OECD Model(Condensed Version), 2010

in respect of thin capitalization rules are neither discriminatory nor in conflict with Russia's obligations under its tax treaties¹⁰⁸.

A40-1164/11-99-7 of 27 February 2012

Under Art.269(2) of the Tax Code, the thin capitalization rules apply in cases where a Russian company has an outstanding debt to a foreign company which possesses directly or indirectly more than 20% of its shareholder capital¹⁰⁹. Naryanmarneftegas LLC (hereinafter as the taxpayer "NMNG") was financed by its sisters companies - members of the same international group of companies. Interestingly, the one of the lenders Philips Petroleum International Investment Company ("PPIIC") did not own any shares in taxpayers' share capital, either directly or indirectly. In 2004 the USA Company ConocoPhillips established a joint venture with the Russian company, Lukoil, in order to obtain a 30% stake in "NMNG" through indirect participation and also to acquire some entitlements to gas-oil activities in Russia. The US Company ConocoPhillips indirectly owns 30% in the share capital of the taxpayer ("NMNG"). At the same time, the taxpayer "NMNG" has a debt exceeding 3:1 debt/equity ratio before "PPIIC" company that is totally owned by the US ConocoPhillips Company.

The courts of previous instances ascertained the fact that the total debt of a taxpayer before the whole international group exceeded more than 3 times the debt/equity ratio prescribed by Art.269. Besides, such settlements were not objected by the taxpayer. There were no any loan agreements between the taxpayer and the US Company ConocoPhillips. In the taxpayers' opinion the thin cap rules can be applied only in case if a lender itself possesses directly or indirectly more than 20 % in its share capital. Therefore, there are no any features of the controlled debt and in observation of the taxpayer Art.269(2) can not be applicable in this situation. The strongest arguments of a taxpayer "NMNG" among others were as follows:

- PPIIC was not the shareholder of NMNG and owned NMNG neither directly nor indirectly.
- NMNG did not conclude any loan agreements with ConocoPhillips.
- PPIIC is a resident of the United States; therefore the treaty applies.
- The treaty does not provide a basis for re-characterization of interest payments into dividends.
- Under Art.807 of the Civil Code of the RF, a relationship in a loan agreement only exists between lender and borrower.

¹⁰⁸ Case 8654/11 of 15 November 2011 of Supreme Arbitration Court available at <http://ras.arbitr.ru/>.

¹⁰⁹ Art. 269(2) of the Tax Code of Russian Federation (Part1 of 31.07.1998)#146-FZ, and (Part2 of 05.08.2000)#117-FZ available at http://base.garant.ru/10900200/1/#block_20001.

After the careful consideration of the framework agreements between the Company ConocoPhillips and Russian Company Lukoil, loan agreements and the financial statements of all companies involved in this case, the Federal Arbitration Court of Moscow Region (hereinafter, the Court) came to conclusion that in substance it was the US Company ConocoPhillips who financed the taxpayer by using its daughter company PPIIC as a technical vehicle. Following an analysis of the agreement, Lukoil and ConocoPhillips agreed that funding of the joint venture was performed through debt financing instead of capital financing.

The financing was performed by Lukoil and ConocoPhillips on a pro rata basis according to their stakes in the taxpayer NMNG share capital through indirect participation. Thus, it held in favour of the tax authorities. The Court observed that this financing scheme used by an integrated group of companies should be considered altogether since it is embodied by the sole purpose and the common obligation aiming at financing the taxpayer “NMNG”¹¹⁰.

6.2. Conclusion

The Russian domestic legislation does not contain the statutory GAAR. Instead it has specific rules that aim at preventing certain types of abuse, transfer pricing, thin capitalization and the limitation on participation exemption among others. ‘Unjustified tax benefit’ doctrine is currently being developed by national courts¹¹¹.

Based on the careful examination of cases presented in this thesis, as well as analysis of the domestic Russian legislation the following outcomes can be reached with regard to relationship between the domestic anti-avoidance provisions and tax treaties:

- According to Art.15(4) of the Constitution of the RF in conjunction with Art. 7 of the Tax Code, the tax treaties shall take precedence over national legislation in case of conflict between domestic provisions and those in tax treaties.
- Russia signed the VCLT in 1969, which became effective for Russia as of 29th of May 1986 that constitutes the international public law principle *pacta sunt servanda* to be observed by the RF under its treaty obligations.
- The RF is not a member of the OECD, and therefore Commentaries to the OECD Model have no any binding effect for Russia while interpreting tax treaties by national courts.

The first three cases obviously highlight the incompatibility of Russian thin cap rules with the applicable provisions of DTTs. The courts interpret the term interest autonomously under tax treaties and deny the recharacterization of interest into dividend under domestic tax law. Russia clearly follows the approach when the tax treaty overrides domestic anti-avoidance rules. To

¹¹⁰ A40-1164/11-99-7 of 27 February 2012 available at http://ras.arbitr.ru/PdfDocument/fac08b3d-7aff-46a1-aece-d3f530d78202/%D0%9040-1164-2011_20120227.pdf

¹¹¹ B. Bruk, R. Vakhitov, Russian Branch Report, IFA, *Cahier de Droit Fiscal International*, 2010, p.685-687.

protect its tax base in such a situation Russia initiated amendments to the effective conventions by signing the Protocol thereto. The Cyprus-Russia Protocol to the 1998 Treaty is a bright example of this effort with regard to interest-dividend matter that may arise in case of reclassification. *“However, the term “interest” shall not include for the purpose of this Article penalty charges for late payment or interest regarded as dividends under paragraph 3 of Article 10”*¹¹². Thus, Art.10(3) of the Cyprus-Russia Tax Treaty (as amended through 2010) gives the new definition of dividend that also encompasses *“income even paid in the form of interest”*¹¹³ that serves as a great evidence of Russia’s will to reconcile its DTTs with domestic anti-abuse rules.

But the last two cases envisaged in this thesis explicitly demonstrate the harsh changes in the chosen trend. The domestic thin cap rules provided under Art.269 of the Tax Code of the RF were applied to deny benefits provided by the range of Russian DTTs with the USA, Switzerland and Cyprus as well. Interestingly, the aforementioned changes enacted by Cyprus-Russia Protocol has entered into force as of 2nd of April 2012, but last two decisions were held by courts before that date, that is a heavy evidence of treaty’s misinterpretation. The taxpayers arguments based on non-discrimination clauses were disregarded then. The fresh approach was explained with a glance to the following aspects:

- The DTT’s provisions on dividends and interests were interpreted in such a way that domestic thin cap rules were not considered discriminatory as against rules provided by conventions.
- Domestic thin cap rules are considered as specific provisions that are in line with the purpose of DTTs to prevent tax avoidance.
- Art.31 of the VCLT allows reference to supplementary means of interpretation that in substance means to the OECD Model and Commentaries thereto.
- Even though the RF is not a member of the OECD, but the official interpretation of DTTs enshrined in Commentaries to the OECD Model takes the obligatory character for Russia aiming to reach reciprocity in interpretation and application of a DTT entered with the OECD member state¹¹⁴.

Thus, the position of the Russian courts taken in the last decisions follows the official OECD position with regard to possibility of recharacterization of interest into dividend and results in the

¹¹² Art. VI of Cyprus-Russia Protocol to the 1998 Treaty, of 7 October 2010.

¹¹³ Art.10(3) of Cyprus-Russia Income and Capital Tax Treaty (as amended through 2010), of 5 December 1998.

¹¹⁴ A40-1164/11-99-7 of 27 February 2012, p.26 available at http://ras.arbitr.ru/PdfDocument/fac08b3d-7aff-46a1-aece-d3f530d78202/%D0%9040-1164-2011__20120227.pdf

interpretation of non-discrimination clause as general rule compared to the specific thin cap rule enshrined in the Tax Code of the RF.

The author, however, considers last precedents as flagrantly violating both the international public law (*pacta sunt servanda*) and domestic Constitutional legal order in Russia. In the author's opinion, in a general course of things, the RF should have firmly stick to approach when the treaty overrides GAAR (due to *pacta sunt servanda principle* and constitutionally settled precedence of the ratified conventions over national legislation), but recent precedents give evidence to the contrary. The national courts have chosen to rest upon Commentaries to the OECD Model despite the fact that the RF is not an OECD member state and its obligations under conventions. Thereby, even though under the general rule in Russia treaties prevail over national legislation, in case of a conflict between a DTT and domestic anti-avoidance rules, the Russian courts have applied the domestic anti-abuse legislation to deny tax treaty benefits.

7. CONCLUSIONS

This paper has investigated a very controversial and complicated question: whether domestic anti-abuse legislation applies to deny tax treaty benefits. The four main themes were analyzed and compared in order to clearly understand the assigned task: the OECD position on the matter, the methods of interpretation under the VCLT, the approaches undertaken by various countries based on their reports 2010, and ultimately the case law of the RF to contribute in issue from the national perspective. While it is still difficult to detect precisely the commonality and differences of approach to tax treaties and anti-abuse rules, a number of outcomes can be drawn from the materials analyzed.

First, it can be construed that many states make an attempt to reconcile their anti-avoidance legislation with tax treaty obligations. The OECD position clarified due to changes in the Commentary made in 2003 is supported by great number of states that in substance means that domestic anti-avoidance rules are consistent with double tax conventions; therefore states may use them in order to determine facts that give rise to a tax liability with further recharacterization of abusing transactions.

Second, after the careful examination of the General Report 2010 and Reports of some states, the author comes to conclusion that despite the OECD position is very useful and aims to providing certainty on the matter, it is not fully reflective of the practical situation from the states national perspective. Among three approaches considered in this paper, the hybrid one seems the most effective and compromise. It seeks to reconcile both fulfillment of tax treaty obligations with counteracting abusive transactions.

Third, abuse of the treaty itself section of this thesis shows that there is no essential outcome for the question raised herein whether states interpret the treaty based on the domestic law principles

or pure interpretation of the treaty. Whichever method of interpretation is chosen by a certain state, ultimately it will be funneled to the underlying principal matter, whether the present state appreciates the *pacta sunt servanda* (the certainty at stake) or protection of its tax base the most. Based on the Russian case law study, it is worth mentioning that in a perfect world, a taxpayer should be able to rely on the provisions of the double tax treaty that are certain and consistent. While deciding in complicated cases the courts should take into consideration not only the official position of the OECD, but also the domestic Constitutional legal order in the country, and the transaction itself that is supposed to be abusive. When domestic law overrides a clear outcome granted by the provisions of the treaty it flagrantly violates the usefulness and even fundamental integrity of the treaty.

The last but not least argument to be told by this thesis, is that the question posed whether domestic anti-abuse legislation applies to deny tax treaty benefits can be answered differently depending on the country chosen. Among those, considered in substance, it definitely can from the Russian perspective, but for the Netherlands, for instance, in spite of well-developed *fraus legis* doctrine, the question will meet the negative reply.

In the author's opinion, it is impossible to reach certainty in this question due to significant diversity of states legal systems, tax avoidance schemes and anti-avoidance rules. Neither strict definition of tax avoidance nor of anti-abuse rules can be formulated because otherwise plenty of sophisticated counter schemes will be elaborated by tax practitioners aiming to illegally receive benefits granted by double tax treaties.

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9. Appendix #1.

