LIUC – Università Carlo Cattaneo

International Tax Law

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Abuse of law and tax treaty abuse

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TAX AVOIDANCE vs. TAX EVASION

Abuse of law

Tax avoidance and tax evasion

- International transactions provide many opportunities for the avoidance of tax
- In this context, **tax avoidance** must be distinguished from **tax evasion**

Abuse of law

Tax evasion

- The concept of **tax evasion** is usually used to appoint **illegal and intential behaviors**
- OECD definition (1987 report International tax Avoidance and Evasion): "*taxpayer avoids the payment of tax without avoiding the tax liability, so that he escapes the payment of taxes that is unquestionably due according to the law of the tax jurisdiction and even breaks the letter of the law*".

Abuse of law

Tax evasion

- Main features of tax evasion:
  - Illegal
  - Avoid the payment of taxes without avoiding tax liabilities
  - Administrative penalties applicable
  - Criminal penalties usually applicable
- In an international context what is illegal in one country could be perfectly legal in an other country

Abuse of law

Tax avoidance

- Tax avoidance is difficult to define precisely
- It generally involves transactions or arrangements entered into by a taxpayer in order to <u>minimize the amount of tax payable in a lawful manner</u>
- The ways of avoiding tax through international transactions are far too numerous to itemize

Abuse of law

Tax avoidance

- Examples:
  - A taxpayer can shift his or her residence from one country to another country that levies lower or no taxes;
  - A taxpayer can divert domestic source income to a controlled foreign entity, such as a trust or a corporation, established in a tax haven;
  - A taxpayer can establish a tax haven subsidiary to earn foreign source income or to receive dividends from subsidiaries in other foreign countries;
  - If advantageous treaties exist, a taxpayer can route dividends, interest, royalties and other amounts through subsidiaries established in foreign countries in order to reduce the amount of withholding tax on such amount.

Abuse of law

Tax avoidance

- Main features of tax avoidance:
  - It is intentional
  - It is aimed at the reduction of taxes
  - Element of artificiality and the various arrangement do not have an economic aims
  - It takes advantages of loopholes of the law or of applying legal provision intended for other purposes

Abuse of law

Tax avoidance

- The concept of tax avoidance has to be distinguished also from the concept of <u>tax planning</u>
- OECD Report on international Tax Avoidance and Evasion: "*It is possible to reduce or remove tax liability by* ***perfectly acceptable tax planning*** *(e.g. choosing among tax reliefs and incentives the most advantageous route consistent with normal business transaction) or even by refraining consuming a taxed product…*"
- "*…it is clearly not the intention of governments to combat activities of this kind… In this view tax planning is perfectly acceptable… while tax avoidance is not, the latter covering only those form of tax minimization unacceptable to governments*"

Abuse of law

Tax avoidance

- Main features of tax planning:
  - It is legally allowed as opposed to tax evasion
  - It is intentional
  - It is aimed at the reduction of taxes

  [e.g. choosing a low tax jurisdiction to start a genuine business or applying for a tax relieves or incentives]

Abuse of law

Tax avoidance

- Most countries have specific anti-avoidance rules to deal with certain types of international tax avoidance, and some countries still have exchange controls to regulate foreign investments and transactions by residents
- States that do not use exchange controls employ a wide variety of tax measures to combat international tax avoidance

ANTI-AVOIDANCE RULES

Anti-avoidance rules

Overview

- General anti-avoidance rules
- Anti-avoidance rules in tax treaties
- Specific anti-avoidance rules

General anti-avoidance rules

Italy

- Tax authorities can disregard the tax effects arising from transactions which
  - are devoid of sound business purposes
  - are entered into in order to circumvent obligations/prohibitions set forth by tax law
  - are entered into in order to obtain a tax benefit otherwise undue
- Applicable only to certain transactions
- e.g. capital contributions, mergers/divisions, distributions of capital reserves

General anti-avoidance rules

Germany

- An abuse of law is deemed to exist if the transactions is unusual and it was chosen exclusively for tax reasons

- If there is an abuse of law, the structure is disregarded for tax purposes, and the tax arises in the same way as if a normal structure had been used

General anti-avoidance rules

France

- Abnormal acts: Possibility to reassess companies with respect to management decision contrary to the interest of the business

- Abuse of law: possibility to reassess company with respect to legal acts which are artificial or which have no other purposes than the tax saving

General anti-avoidance rules

Belgium

- Tax authorities may recharacterize for tax purposes any transaction or series of transactions entered into by the taxpayer if the transaction was chosen to avoid tax
  - unless the taxpayer gives evidence that the transaction was also entered into because of legitimate financial or economic reasons.

- An administrative ruling may be requested on the question of whether or not the transaction meets the standard of legitimate financial or economic needs

General anti-avoidance rules

Spain

- Article 16 of the General Tax Law (*Ley General Tributaria*) provides that tax can be levied by reference to the substance and not the legal form of a transaction

Anti-avoidance rules in tax treaties

Italy-UK Income Tax Treaty – Art. 10(5)

"*The provisions of neither sub-paragraph (b) nor (c) of paragraph 3 and neither sub-paragraph (a) nor (b) of paragraph 4 of this Article shall apply unless the recipient of a dividend shows ... that the shareholding in respect of which the dividend was paid was acquired by the recipient for bona fide commercial reasons or in the ordinary course of making or managing investments and it was not the main object nor one of the main objects of that acquisition to obtain entitlement to the tax credit referred to in sub-paragraph (b) or sub-paragraph (c) of paragraph 3 or in sub-paragraph (a) or sub-paragraph (b) of paragraph 4 of this Article, as the case may be*"

Anti-avoidance rules in tax treaties

Italy-France Income Tax Treaty – Art. 10(8)

“*Where the beneficial owner of the dividends is a company resident in a State, and more than half of its capital is owned by one or more persons who are not resident in that State, the provisions of paragraphs 3 and 4 shall apply only on condition that such company furnishes the competent authority of the other State, if so requested by that competent authority, information permitting the authority to determine if the company has acquired the holding in good faith for business reasons or in the normal framework of investment operations and not primarily to benefit from the "avoir fiscal" or the "credito d'imposta*”

Specific anti-avoidance rules

Thin-capitalization and CFC

- Measures to combat tax avoidance may be introduced in order to prevent specific behaviours
- e.g. Thin-capitalization rules
- e.g. CFC rules

Specific anti-avoidance rules

Thin-capitalization rules

- When a resident corporation pays interest to nonresidents, the interest is usually deductible by the payer in computing income unless there are special rules to the contrary
- The interest payment may be subject to withholding tax, but the rate of withholding tax may be substantially reduced or completely eliminated pursuant to an applicable tax treaty.
- The nonresident lender may or may not be subject to tax in the interest in its country of residence
- If the nonresident lender is also the controlling shareholder of the resident corporation, the nonresident lender/shareholder will usually have a choice of financing its subsidiary with debt or equity and extract the profits of the subsidiary by receiving either dividend or interest

Specific anti-avoidance rules

Thin-capitalization rules

- The advantage of paying interest to nonresident shareholders compared to paying dividends constitutes an inherent bias in favor of debt financing of resident corporations by nonresident investors
- In fact, financing a resident corporation with debt might be considerably more effective in reducing the source country tax than financing with equity, because interest is deductible whereas dividends are noty deductible
- In response of the bias in favor of debt compared with equity, several countries have adopted restrictions on the deduction of interest paid to nonresidents, or on the deduction of interest more generally

Specific anti-avoidance rules

Thin-capitalization rules

- Under «**thin-capitalization**» rules, the deduction for interest paid by a resident corporation to a nonresident controlling shareholder is denied to the extent that interest deduction claimed by the corporation are considered to be excessive
- Under these rules, interest is considered to be excessive to the extent that the corporation’s debt relative to its equity exceeds a fixed debt
- The term «thin capitalization» refers to the fact that the rules apply only when a corporation’s equity capital is small in relation to its debt

Specific anti-avoidance rules

Thin-capitalization rules

- Typically, thin-capitalization rules have the following structural features:
  - **Nonresident lenders:** these rules generally apply only to interest paid to nonresident who own a significant percentage of the shares of a resident corporation
  - **Domestic entities:** these rules usually apply only to resident corporations
  - **Determination of excessive interest:** countries use a variety of different approaches to determine what constitutes excessive interest (there is no international consensus on this issue)

Specific anti-avoidance rules

CFC rules

- One of the most effective ways for resident to avoid tax on their worldwide income is the use of CFCs and other legal entities to earn foreign source income
- Domestic tax on foreign source income can easily be deferred or avoided completely by establishing a **foreign corporation** or other legal entity, such as a trust, to earn the income
- The problem of tax avoidance and deferral through the use of CFCs is most pronounced with respect to investment carried out through offshore entities in tax havens

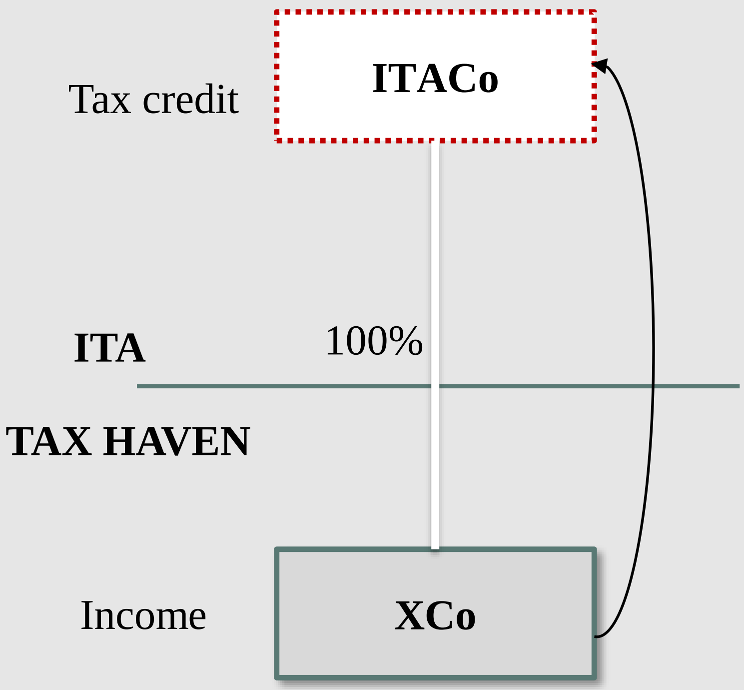
Specific anti-avoidance rules

CFC rules

- «**CFC**» stands for Controlled Foreign Companies and refers to entities:
  - that are nonresident
  - that are corporations or similar entities taxed separately from their owners
  - that are controlled by domestic shareholders or in which domestic shareholders have a substantial interest
- Some countries applies CFC rules also to foreign branches or PEs

Specific anti-avoidance rules

CFC rules



- Several countries have adopted detailed statutory rules to **prevent or restrict the use of CFCs to defer or avoid domestic tax.**
- e.g. Italy: Art. 167 CITA

Specific anti-avoidance rules

CFC rules

- The basic pattern of CFC legislation is similar in all countries: resident shareholder that control – or have a substantial interest in – a foreign company established in a no-tax or low-tax jurisdiction are subject to residence country tax on their proportionate share of all or some of the income of the foreign corporation, whether or not the income is actually distributed to them
- If a foreign company is engaged in legitimate commercial activities offshore, however, the CFC rules do not generally apply to the income generated by those activities

TAX TREATY ABUSE AND TREATY SHOPPING

Tax treaty abuse

Scope of Tax Treaty

- Purpose of Double Tax Treaty (DTT) (OECD Commentary of art. 1 para. 60):
  - *"The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. As confirmed in the preamble of the Convention,* ***it is also a part of the purposes of tax conventions to prevent tax avoidance and evasion****"*
- Conventional tax treaty abuse concept is in line with art. 31 of the Vienna Convention on the Law of Treaties («*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*»).

Tax treaty abuse

Scope of Tax Treaty

- Eligibility for DTT' benefits (MC OECD Commentary of art. 1 para. 60):
  - *"...States do not have to grant the benefits of a double taxation convention where arrangements that constitute an* ***abuse of the provisions of the convention*** *have been entered into"*

- Guiding principle (MC OECD Commentary of art. 1 para. 61):
  - *"A guiding principle is that the benefits of a double taxation convention should not be available where a* ***main purpose*** *for entering into certain transactions or arrangements was to secure a* ***more favourable tax position*** *and obtaining that* ***more favourable treatment*** *in these circumstances would be contrary to the object and purpose of the relevant provisions"*

Tax treaty shopping

Improper use of Tax Treaty

- Commentary to OECD Model Convention does not include a specific definition about the concept of «**Treaty shopping**»
- The Commentary gives some principles useful in order to identify the two illegitimate behaviours.
- Treaty shopping may be defined as a situation for which «*transactions are entered, or entities are established, in other States, solely for the purpose of enjoying the benefit of particular treaty rules existing between the State involved and a third state otherwise would not be applicable*» (Source: Vogel K., On Double Tax Conventions, Kluwer, 1991).

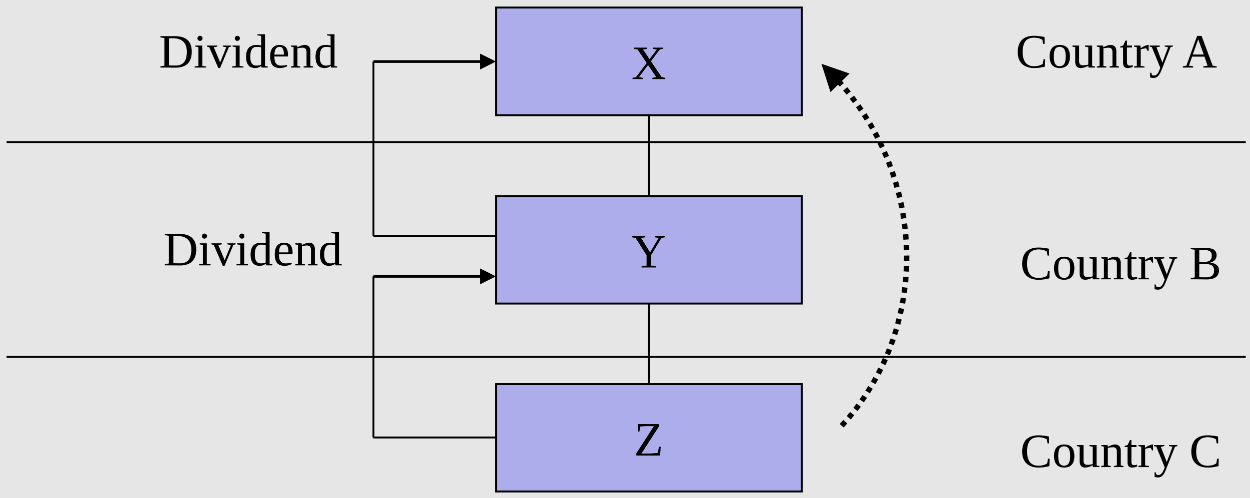
Tax treaty shopping

Conduit arrangements

- The concept of Treaty shopping is strictly connected to the use of artificial legal constructions in order to benefit from DTC provisions
- OECD issued in 1986 a specific Report, dealing with the matter connected to the use of «**conduit**» companies in order to benefit from DTC provisions, giving some guidelines and propose solutions to be negotiated in bilateral agreements about such improper use of DTC benefits («Double Taxation Conventions and the Use of Conduit Companies» adopted by OECD Council on 27 November 1986).
- Such conclusions have been transposed into the OECD Commentary.

Tax treaty shopping

Example of "conduit arrangement"



- Scenario:
  - Dividend distribution from the subsidiary Z to the parent X
  - No treaty between A–C (i.e. the Z domestic WHT of 25% shall apply)
  - The A-B Treaty provides for a 5% WHT
  - X interposes Y to benefit from the B–C treaty which provides for a WHT of 5%
  - Y (no actual activities) turns the dividends to X

Tax treaty override

Domestic tax law vs. Conventional legislation

- Possible conflict between international treaty provisions and national law provisions
- A situation where the domestic legislation of a State overrules provisions of either a single treaty or all treaties having effect in that State
- Domestic legislation may take the form of a provision that treaty provisions are to be disregarded in certain circumstances (e.g. in cases of treaty shopping or other forms of abuse)
- Breach of Art. 26 and Art. 27 of Vienna Convention on the Law of Treaties (*pacta sunt servanda*). State cannot justify breach of treaty on the basis of national law
- Tax treaty override may occur, for example, in those States in which international law becomes a law of the State and it ranks equal to national law. Such States may consider international legislation as amended because of subsequent national provisions (*lex posterior abrogat priori*)

Tax treaty override

Domestic tax law vs. Conventional legislation

- Commentary on Art. 1 of OECD Model Convention includes comments on the relationship between domestic and conventional anti abuse rules:
  - The OECD Commentary allows States to qualify Treaty Abuse according to their domestic legislation. This is based on the alleged absence of conflicts between domestic and Conventional tax avoidance rules;
  - In case of conflict, the provisions of tax treaties are intended to prevail (*pacta sunt servanda*).

Tax treaty override

Domestic tax law vs. Conventional legislation

Example: Italy

- No tax treaty override should occur in Italy due to Constitutional/Legislative framework:
- Art. 117(1) of the Italian Constitution: legislative is limited by international treaty obligations;
- Art. 75 of Presidential Decree N. 600 of 29 September 1973: tax treaty provisions prevail over domestic tax legislation;
- Art. 169 CITA: domestic tax rules prevail over tax treaty provisions <u>if more favorable to taxpayers</u>.

BEPS and MLI

Addressing *Base Erosion and Profit Shifting*

Instrument to prevent tax treaty abuse

- Base erosion and profit shifting (BEPS) refers to tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying taxes
- Developing countries' higher reliance on corporate income tax means they suffer from BEPS disproportionately
- BEPS practices cost countries USD 100-240 billion in lost revenue annually
- Working together since 2013 within OECD/G20 Inclusive Framework on BEPS, over 130 countries and jurisdictions are collaborating on the implementation of 15 measures to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment

Addressing *Base Erosion and Profit Shifting*

Instrument to prevent tax treaty abuse

- The 2015 final BEPS Reports recommend changes to domestic laws, the OECD Model and the OECD Transfer Pricing Guidelines, along three key pillars:
  1. Introducing coherence in the domestic rules that effect cross-border activities **(COHERENCE);**
  2. Reinforcing substance requirements in the existing international standards **(SUBSTANCE);**
  3. Improving transparency as well as certainty **(TRANSPARENCY & CERTAINTY).**

Addressing *Base Erosion and Profit Shifting*

Instrument to prevent tax treaty abuse

- The 15 Actions of the BEPS project equip governments with domestic and international rules and instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created
- The 15 Actions may be divided into the three key pillars mentioned in the previous slides, except for Action 1 and Action 15 which can be referred to each key pillar

Addressing *Base Erosion and Profit Shifting*

Instrument to prevent tax treaty abuse

COHERENCE

- Action 2: Hybrid Mismatch Arrangements
- Action 3: CFC Rules
- Action 4: Interest Deductions
- Action 5: Harmful Tax Practices

SUBSTANCE

- Action 6: Preventing Tax Treaty Abuse
- Action 7: Avoidance of PE Status
- Action 8: TP - Intangibles
- Action 9: TP – Risk and Capital
- Action 10: TP – High Risk Transactions

TRANSPARENCY & CERTAINTY

- Action 11: Measuring and monitoring BEPS
- Action 12: Disclosure Rules
- Action 13: TP Documentation
- Action 14: Dispute Resolution

Action 1: Digital Economy

Action 15: Multilateral Instrument

BEPS Action 6

Prevent Tax Treaty Abuse

- BEPS Action 6 addresses treaty shopping through new treaty provisions whose adoption forms part of a **minimum standard** that members of the BEPS Inclusive Framework have agreed to implement
- It also includes specific rules and recommendations to address other forms of treaty abuse
- Action 6 identifies tax policy considerations that jurisdictions should address before deciding to enter into a tax agreement

BEPS Action 6

Prevent Tax Treaty Abuse

Action 6 recommends the following approach to deal with treaty shopping:

1. a clear statement that the States that enter into a tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance
2. a specific anti-abuse rule, the limitation-on-benefits (**LOB**) rule, that limits the availability of treaty benefits to entities that meet certain conditions will be included in the OECD Model. These conditions seek to ensure that there is a sufficient link between the entity and its State of residence
3. in order to address other forms of treaty abuse, a more general anti-abuse rule based on the principal purposes of transactions or arrangements (the **principal purposes test** or "**PPT**" rule) will be included in the OECD Model

Multilateral Instrument («MLI»)

Action 15 BEPS

- **24 novembre 2016**: publication of **MLI** following a negotiation between more than 100 States
- **7 June 2017**: 68 States, including Italy, sign the MLI
- Purpose: Simultaneous amendment of double tax treaties in order to implement BEPS measures
- MLI is applicable only to «**Covered Tax Agreements**», i.e. the double tax treaties notified by both Contracting States

Multilateral Instrument («MLI»)

Action 15 BEPS

- Some Articles of the MLI constitute a «**minimum standard**» that the signatory States cannot refuse to adopt (i.e. Action 6)
- States are free to make reservations to exclude some of the MLI's provisions in their Covered Tax Agreements

STATE A	STATE B	RESULT
Reservation	No Reservation	No amendment to the Treaty
No Reservation	Reservation	No amendment to the Treaty
Reservation	Reservation	No amendment to the Treaty
No Reservation	No Reservation	Amendment to the Treaty

Multilateral Instrument («MLI»)

Tax Treaty Abuse

BEPS Action 6 costitute a minimum standard of the MLI. In particular:

- MLI – Part III: Treaty Abuse
  - **Article 6**. Purpose of a Covered Tax Agreement
  - **Article 7**. Prevention of Treaty Abuse

Multilateral Instrument («MLI»)

Tax Treaty Abuse

Art. 6(1) MLI: «Purpose of a Covered Tax Agreement»

new preamble to double tax treaties

- A Covered Tax Agreement shall be modified to include the following preamble text: "*Intending to eliminate double taxation with respect to the taxes covered by this agreement* ***without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance*** *(including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions),*"

Multilateral Instrument («MLI»)

Tax Treaty Abuse

Art. 7 MLI: «Prevention of treaty abuse»

- Minimum standard but three options
  - a) Principle Purpose Test (PPT) only
  - b) Simplified Limitation on Benefit (LOB) + PPT
  - c) Detailed Limitation on Benefit (LOB) (No text in Convention, but commitment to bilateral negotiation)
- Possible Asymmetry
- **Matching exercise (examples)**:

The Netherlands	UK
PTT only	PTT only

Outcome: **PTT**

Russia	Cyprus
PTT only	PTT only

Outcome: **PTT**