International Tax Avoidance-The Tension between Protecting the Tax Base and Certainty of Law

1.0 Background and Introduction

In the context of cross border investment, the growing problem of tax avoidance and the use of double tax treaties deserves much greater examination. The problem is growing because business is increasingly international, while the need for tax revenue remains, after the recent financial crisis, essential to governments trying to deal with fragile economies and fiscal deficits. This paper evaluates the approach taken by selected countries to cross-border tax avoidance in an attempt to indentify the key principles behind a country's attempts to deal with international tax avoidance.

There is very little that is truly international in the assessment and collection of taxation because a country raises tax revenue for its own sovereign purposes. A country has a tax base and a need for the money it raises. That is the main point of taxation.

Almost all countries view as desirable, however, the attraction of foreign investment capital. This capital can boost production, employment, GDP and importantly, tax revenue.[1]

The principal reason for a country having a double tax treaty network is to attract investment by eliminating double taxation and by providing certainty in respect of the taxation of various categories of income.[2] Treaties do a lot more than reduce double taxation, as taxing rights are allocated, and in some cases limited, by treaties.[3] Taxpayers rely on these treaties to determine the tax outcome for their cross-border transactions.

While attracting foreign capital is an objective of a government, it cannot be at the expense of the fisc. Cross-border tax avoidance is hugely problematic when it reduces the flow of revenue into the Treasury coffers. This is particularly so cross-border, because it has been notoriously hard for tax administrators to gather information in foreign jurisdictions. In recent times tax treaties (including tax information exchange agreements) have played a positive part in improving this information flow.[4]

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[1] E. Borensztein, J. De Gregorio and J-W. Lee "How does foreign direct investment affect economic growth?" Journal of International Economics Volume 45, Issue 1, 1 June 1998, Pages 115-135 .

[2] Paragraph 7 of the OECD Commentary on Article 1 declares as follows: "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."

[3] In fact most countries provide unilateral relief for double taxation under the domestic law, either by a credit for foreign tax, exempting foreign income, or by a hybrid combination of the two. This has led some commentators to conclude that the main purpose of tax treaties is really the allocation and limitation of taxing powers: David A. Ward "Canada's Tax Treaties" (1995) Canadian Tax Journal, vol. 43, no. 5, 1719 at 1728.

[4] See for instance the initiatives of the OECD in the area of International Tax Cooperation and the project on improving the technical and practical aspects of information exchange discussed in the publication OECD's Current Tax Agenda (June 2010), OECD Publications, Paris.

Companies have become global in their business transactions whereas, as John F Avery Jones points out, "tax authorities have not".[5] Most large businesses are truly international. The objectives of a company may include maximising the return to shareholders, which could include paying lower amounts of tax in the different jurisdictions in which the multinational organisation operates. Cross-border tax planning has therefore been an important part of a multinational's annual business plan.

Such tax planning transactions may involve techniques where it is anticipated that one type of cross-border economic gain might be more favourably taxed than another, such as crystallising a capital profit through the sale of a company's shares rather than the payment of the dividend.[6] Or a capital gain may be made in one jurisdiction (where there is no taxation on the gain) through the sale of a share in a holding company, rather than the sale of the shares in the subsidiary (where the gain would be subject to tax).[7] Another transaction may utilise the features of sophisticated hybrid financing instruments, where the coupons paid are treated as deductible interest in the borrower's jurisdiction and exempt or non-assessable dividends in the lender's jurisdiction.[8] Yet another technique employed is the use of hybrid entities, regarded in one jurisdiction as a tax paying entity, and in another jurisdiction as a transparent or "look through" entity.[9]

These cross-border tax planning techniques necessarily involve the taxpayer relying on the provisions of a relevant double tax treaty to reduce taxation, either by limiting the rate of tax or by eliminating taxation completely. This article addresses the important issue of whether a taxpayer can rely on the outcome predicated by a tax treaty, when it conflicts with a domestic general anti-avoidance rule (GAAR).

The approach taken in this article is to examine first, whether there is a common broad overall theme amongst countries in the interaction between domestic GAARs and double tax treaties. For reasons outlined the relationship almost always varies from country to country although some common principles can be identified.

Secondly, the article looks at how countries are categorised in the Commentary to the OECD Model Treaty and enquires how helpful that dichotomy is. The suggestion made by the OECD Commentary

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[5] John F Avery Jones "The David R Tillinghast Lecture: Are Tax Treaties Necessary?" (1999) 53 Tax Law Review 1.

[6] A classic example of such a dividend stripping transaction is found in the Canadian case, *RMM Canadian Enterprises Inc v R* 97 DTC 302.

[7] *Vodafone International Holdings BV v Union of India and another* 13 ITLR 59. This was a decision of the Indian High Court in Bombay.

[8] Examples of these types of transactions are found in the New Zealand cases of *Westpac Banking Corporation v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834 at [5] where Harrison J described the international tax features of a structured finance transaction and concluded, "This process, known as tax arbitrage, is a settled feature of international financing arrangements". The "process" referred to was a "cross-border differential" creating tax asymmetry, where various "repo" transactions were treated as loans, with deductible interest coupons, by overseas jurisdictions in accordance with economic substance, whilst the New Zealand characterisation of a dividend (tax exempt in this situation) was based on legal form. The same features were present in *BNZ Investments Ltd v Commissioner of Inland Revenue* (2009) 24 NZTC 23,582 at [6] where Wild J described similar transactions as follows: "Cross-border tax arbitrage refers to the different tax treatment of the transaction in New Zealand and the foreign counterparty's jurisdiction. New Zealand tax law treated the transactions as equity investments, the counterparties' jurisdictions (the United States of America for the first three transactions; the United Kingdom for the later three) as secured loans. That enabled the counterparties to deduct, as interest, the distribution they made which the BNZ received free of tax in New Zealand."

[9] Examples of which are two decisions by tax courts of first instance, the United Kingdom First-Tier Tribunal and the Canadian Tax Court of Canada, namely, *Swift v Revenue and Customs Commissioners* 12 ITLR 658, and *TD Securities (USA) LLC v Her Majesty the Queen* 12 ITLR 783.

is that a country will fall into one of the two categories suggested by the Commentary as a result of the way in which the GAAR operates (the outcome of the operation of the GAAR). It will either reconstruct the facts of a transaction (the factual approach) or it will simply not allow the transaction to use the operative tax provisions because such an interpretation would be abusively offensive (the interpretative approach).

It is suggested, that a better, or perhaps more helpful, way to analyse these relationships is to look at three general categories of approach taken by countries on the question of whether the domestic GAAR overrides the treaty.

Having identified these three categories the article, finally, evaluates the strengths and weaknesses of the different approaches and suggests the best approach. It appears that two fundamental principles are at stake. The first is the certainty of the law and the inviolable nature of the agreement struck between two nations. The second is the purely domestic interests of the individual state not to have their treasury sacked by abusive taxpayers. 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.

A compromise, permitting the GAAR to override the treaty (unless there is a conflict, in which case the treaty will prevail) may be the best approach in most circumstances.[10]

2.0 Domestic GAAR's and Double Tax Treaties Concluded after 2003[11]

2.1 Looking for a Common Theme?

One of the Congress subjects of the 2010 Rome Congress of the International Fiscal Association discussed this issue of tax treaties and avoidance.[12] This is therefore a particularly apposite time to

[10] For an example of a country which applies this approach see the discussion in respective of the New Zealand rules by Craig Elliffe and John Prebble "General Anti-Avoidance Rules and Double Tax Agreements: A New Zealand Perspective" (2009) Revenue LJ volume 19, 48. In addition to these threshold tests, it is noted that many countries will also have another test, sometimes referred to as a type of "treaty avoidance rule" using the purposive interpretation of treaties suggested by paragraph 9.5 of the OECD Commentary to Article 1 (see paragraph 3.4 of this article for an explanation).

[11] Taxpayers may take the view that for treaties concluded prior to 2003, only the version of the Commentary which applied at the time the treaty was concluded should be considered in interpreting that treaty. There is considerable academic support for this view (Klaus Vogel, 'Double Tax Treaties and their Interpretation' (1986) 4(1*) International Tax and Business* 41 and the numerous academic writers referred to by Philip Baker in his book *Double Tax Conventions* Sweet & Maxwell, London, (2001) para E-16 footnote 1), it should be noted that is not the view of the Committee of Fiscal Affairs of the OECD, who take the view that taxpayers may find it useful to consult later versions of the Commentaries in interpreting earlier treaties. This raises the question of whether the changes that occurred to the Commentary in 2003 were so substantial that as a result treaties concluded after 2003 should be interpreted differently. This issue is beyond the scope of the enquiry in this article but it should be noted that changes in 2003 were described as "extensive revisions" which "significantly clarify" the position in respect of this relationship (see Brian J Arnold, "Tax Treaties and Tax Avoidance; The 2003 Revisions to the Commentary to the OECD Model" (2004) 58 (6) Bulletin for International Fiscal Documentation-Amsterdam). It is questionable as to whether the 2003 changes actually are a substantial change and this may be an area which would merit further examination.

[12] This was Subject 1 of the 64th Congress of the International Fiscal Association discussing "Tax treaties and tax avoidance: application of anti-avoidance provisions". The General and Branch reports are contained in the International Fiscal Association's Cahier De Droit Fiscal International (volume 95a, The Hague, the Netherlands 2010).

make this enquiry. The General Reporter, Stef van Weeghel,[13] concluded that in the vast majority of the branch reports countries reached the conclusion that the GAARs can be reconciled with their treaty obligations.[14] By this he meant that while most countries have statutory or judge-made anti-avoidance rules (although there are a considerable number of differences in their application),[15] they can and do apply to cross-border transactions. Van Weeghel concluded: "Without exception the GAARs can have international effect and there is no distinction in their application depending on the national or international effect."[16]

There may be agreement that the anti-avoidance rules can apply to international transactions, in situations where sham and substance over form doctrines are not applicable, there is considerable divergence of views on how this is achieved.[17]

Why is it that there is no uniform international approach to this issue? The first reason is that countries incorporate international tax treaties into their domestic law in different ways.[18] Secondly, further diversity arises from the fact that some countries do not have a GAAR at all, whilst others have either an express statutory provision, or alternatively judge-made anti-avoidance rules. A third reason for divergence is that some countries choose to expressly define the relationship between their treaties and domestic GAAR,[19]while the vast majority do not. This means that a discussion on the interrelationship between double tax treaties and the GAAR must be both conceptual (in the case of general principles and the guidance from various OECD publications) and specific (as it relates to a particular country).

Overall, as Stef van Weeghel indicated when discussing the overview of the countries represented by the International Fiscal Association, the predominant international consensus is that the GAAR applies to cross-border transactions.

2.2 The OECD Commentary-How Helpful is this Dichotomy?

The Commentary to the OECD Model Treaty says that countries fall into one of two categories.[20] The domestic anti-avoidance rules recharacterise the facts that give rise to a tax liability (the factual

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[13] Partner, PricewaterhouseCoopers and Professor of international tax law, University of Amsterdam.

[14] Above n12, at 21. From the 44 countries reports 42 countries' reporters concluded this outcome and only two notable exceptions arose. These were the positions reported from the Netherlands and Portugal.

[15] Above n12, at 22.

[16] Ibid.

[17] The General Reporter notes that "sham and substance over form doctrines" certainly can apply as an effective part of most countries' domestic anti-avoidance legislation, and be completely consistent with their treaty obligations, see above n12, at 26.

[18] Examples of the different ways jurisdictions adopt international treaties into the domestic law can be seen in the discussion by Philip Baker *Double Taxation Conventions* (Sweet and Maxwell, London, 2010) at F-1, where he categorises three groups of countries. First, those where the double taxation conventions automatically becomes part of the domestic law (examples are Austria, Japan and the United States). Secondly, those where approval, usually parliamentary (but in the case of New Zealand enters into force through the Governor-General by Order in Council-section BH 1 (3) of the Income Tax Act 2007), is required before the convention becomes part of the domestic law (other examples of this approach include Germany and Italy). Lastly those states where legislation is necessary to transform the convention into domestic law (these include Australia, Canada, Denmark, Ireland and the United Kingdom).

[19] Australia and Canada are examples.

[20] This categorisation is set out in paragraphs 9.2 and 9.3 of the OECD Model Tax Convention, *Commentary* on Article 1.

approach[21]) which is then followed in the application of the relevant double tax treaty.[22] For example a legal sale transaction is recharacterised by the domestic GAAR as a dividend. The avoidance rules are disregarding the legal form and substituting a dividend as the taxing event. The treaty is then applied upon the basis of this recharacterisation; that is, the dividend article of the treaty has application rather than the alienation of property article.

The other alternative category is that the GAAR is viewed as an abuse of the treaty itself (the interpretative approach) and not an abuse of the domestic law.[23] Here the treaty will not be allowed to be interpreted in a way which will facilitate the abusive transaction.

With the factual approach, as the OECD Commentary points out, as a general rule there will be no conflict between the domestic anti-avoidance legislation and the provisions of tax conventions.[24] If there is no conflict, then the treaty can apply to the transaction after the recharacterised factual analysis. Occasionally, however, the factual reconstruction by the domestic GAAR will be directly in conflict with the provisions of the double tax treaty. In the event of conflict a country should resolve whether the provisions of the treaty should prevail, or whether the GAAR prevails.

Countries that apply the interpretative approach will view the abuse as being an abuse of the treaty itself,[25] with the result that a proper interpretative construction of the treaty allows them to disregard the abusive transaction. No recharacterisation takes place but the treaty simply does not apply to the transactions as they were carried out.

The General Report suggests that this dichotomy (countries adopting either the factual or interpretative approaches) does not so clearly exist in the snapshot of those countries' reports that formed part of the 2010 Congress.[26] It is not clear why all the Country Reporters did not express a view on which approach their country takes to the OECD dichotomy. It may be that this diremption, while helping to understand a particular country's approach, gives no insight at all into the relationship of the two potentially competing legal provisions; namely, whether the treaty or the domestic GAAR prevails.

At the heart of the factual or interpretative approach is the *way* in which a country's domestic GAAR tax rules actually *operate* when invoked in circumstances of abuse. To assess which approach the country takes, ask "how does the GAAR work when is it is invoked?" Where the anti-avoidance rules void the actual legal transactions and instead recharacterise or reconstruct the transaction, then the country will apply a factual approach.[27] An example is the New Zealand Commissioner's power to adjust the taxable income of a taxpayer under the New Zealand Income Tax Act.[28] These powers

[21] The nomenclature used by Brian J Arnold, "Tax Treaties and Tax Avoidance; The 2003 Revisions to the Commentary to the OECD Model" (2004) 58 (6) Bulletin for International Fiscal Documentation-Amsterdam 244, 251.
[22] See paragraph 9.2, above n20.
[23] Ibid, paragraph 9.3.
[24] n20, paragraph 9.2.
[25] As set out in paragraph 9.3 of the OECD Model Commentary.
[26] Above n12, at 26. This may simply mean that the Country Reporters did not find it necessary to categorize their country's approach.
[27] See paragraph 22.1 of the OECD Model Tax Convention, *Commentary* on Article 1, where it states "Such rules are part of the basic domestic will set by domestic tax laws to determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them."
[28] Section GA 1 of the Income Tax Act 2007 (NZ). The approach in France is also similar (see the French Branch report, above n12, at 321 (Stephane Austry and Michel Collet).

enable an identification of a hypothetical situation,[29] and the adjustment of the taxable income of the taxpayer using reconstructed amounts.[30]

If however the domestic anti-avoidance rules apply canons of statutory interpretation, meaning that the relevant tax provisions cannot, in situations of abuse, be interpreted at face value, then the country is likely to take an interpretative approach to the abuse of their treaties. It is possible that examples of countries where this approach is adopted include the United Kingdom with its judge-made anti-avoidance rules, and also perhaps the United States with its general anti-abuse judicial doctrines (recently modified by codification).

The link between the factual or interpretative approach is therefore focused on the *effect* of the GAAR. The test is whether the GAAR voids the existing transaction and instead reconstructs a new non-abusive tax outcome (factual), or whether it simply disregards and voids as a nullity the transaction (interpretative).

Another, perhaps more helpful, way to categorise the response that countries take to the question of the relationship between treaties and avoidance, is to examine the extent to which a country will allow, and in some cases specifically provide for, their treaties to be *overridden* by the GAAR.

Examining whether the treaty overrides the domestic law or vice versa is more helpful because, first and most importantly, it is immediately useful, as it is a form of categorisation which identifies whether taxpayers and administrators can rely on the legal form of the transaction in their application of the treaty, or whether they need to consider the factors which could come into play with the application of the avoidance rules. In many jurisdictions these are factors such as economic substance, circularity, artificiality, associated parties, and non-commercial indicia.

The concept of override is a much clearer categorisation because of its focus on primacy between two competing law sources. The distinction between the factual and interpretative approach tells us little, if anything, about which law will prevail in the event of conflict. This is because it focuses on the *effect* of the application of the anti-avoidance rules and not the supremacy of the law.

3.0 Three General Categories of Approaches taken by Countries

From the complex matrix of the various types of GAARs that exist in different countries, the way that double tax treaties are integrated into law in different jurisdictions, and the way that the relationship between the GAAR and treaties is expressly defined, or otherwise, it is arguable that there are three general categories of approaches taken by countries.

3.1 Countries where the GAAR clearly overrides the Treaty

Examples of countries that arguably fit within this categorisation are Australia, Canada and the United States.[31] The first two of these countries have defined their position by quite explicit legislation which acknowledges that their GAAR is not subject to their double tax treaties.

Australia

In the case of Australia,[32] Professor Richard Vann summarises the position which is that "…treaties override the rest of domestic income tax legislation except the general anti-avoidance rule in Part

[29] Ibid, s GA 1 (4).
[30] Ibid, s GA 1 (2) and (5).
[31] It is surprising that there are not a significant number of other countries which have chosen, through express legislation, or by judicial developments to clearly elevate their GAARs above their treaties.

IVA".[33] This is also the view of the Australian Tax Office in a public ruling which deals with the interposition of a Dutch holding company between an entity resident in the Cayman Islands and an Australian holding company of the target assets.[34] The Tax Office conclude that where no sound commercial reasons for creating holding interests in the number of jurisdictions is apparent:[35]

> Where an arrangement is put in place merely to attract the operation of a particular tax treaty in the context of a broader structure an arrangement, this may be a scheme which otherwise satisfies the terms of Part IVA, and any tax benefit obtained in relation to such a scheme may be cancelled.

Canada

Canada has a similar legislative framework. The Income Tax Conventions Interpretation Act RSC 1985, was amended in 2005 to make it clear that the GAAR applies to any tax benefits obtained under a treaty.[36] As a result, the Canadian Reporters state that "...conflicts between tax treaties and the GAAR should no longer arise in Canada as the recent jurisprudence confirms".[37] The case law referred to in this quote are two recent cases involving the use of Barbados trusts and Canadian resident taxpayers seeking to shelter tax on capital gains. Both these decisions have been appealed to the Federal Court of Appeal.[38] In *Antle v R*,[39] Miller J concluded that the Barbados trust was not properly constituted and *obiter* he decided that the GAAR should apply notwithstanding that the Canada-Barbados treaty was concluded prior to the Income Tax Convention Interpretation Act:[40]

> It is a question of what trumps want. I conclude that specific reference in s 4.1 of the Income Tax Convention Interpretation Act to 'notwithstanding the provisions of a Convention or the Act giving the Convention the force of law in Canada' is more specific, later in time and crystal clear as to its intent and effect. It governs. GAAR can apply to the treaty.

The decision in *Antle* was unsuccessfully appealed to the Federal Court of Appeal without any comment being made on this *obiter* point.[41]

United States

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[32] In the case of Australia, since 1981 when Part IVA was introduced, the International Tax Agreements Act 1953, section 4 (2) provides:

> The provisions of this Act have effect notwithstanding anything inconsistent with those provisions contained in the Assessment Act (*other than Part IVA of that Act*) or in an Act imposing Australian tax. (Emphasis added).

A parallel statutory hierarchy exists in the Income Tax Assessment Act 1936, s 177B (1).

[33] See the Australian Branch Report n12, 79, at 85 (Richard J Vann).

[34] Taxation Determination TD 2010/20 Income tax: treaty shopping-can Part IVA of the *Income Tax Assessment Act 1936* apply to arrangements designed to alter the intended effect of Australia's International Tax Agreements network? (December 2010) http://law.ato.gov.au/atolaw/view.htm?docid=TXD/TD201020/ NAT/ ATO/00001.

[35] Ibid at 18.

[36] Income Tax Conventions Interpretation Act,s 4.1, SC 2005, c. 19, s. 60. This is also replicated in the Income Tax Act (Canada), s 245 (4).

[37] See the Canadian Branch Report n12, 171, at 182 (Nathalie Goyette and Phil D Halvorson).

[38] *Antle v Canada*, 2010 FCA 280 at [23] (Noel J.A., Sharlow J.A. and Layden-Stevenson J.A.), In *St Michael Trust Corp. v Canada*, 2010 FCA 309 the Federal Court of Appeal decided an appeal on the Tax Court of Canada decision of *Garron and another v R*, (2009) 12 ITLR 79 (Woods J). The taxpayer in *Garron* did not dispute that the GAAR could apply to the treaty [347] instead of electing to argue that in this case there had been no abuse of the treaty [367]. The argument, that there had been no abuse of the treaty, was accepted by both the Tax Court of Canada [395] and the Federal Court of Appeal [89].

[39] *Antle v R; Marquis-Antle Spousal Trust v R; Antle and another v R,* (2009) 12 ITLR 359 (TCC). Convention

[40] Ibid at [87].

[41] *Antle v Canada*, 2010 FCA 280.

Prior to the introduction of a general statutory anti-avoidance rule[42], the United States had several judicial anti-avoidance doctrines. These are described in concept in the United States General Report to the Rome Congress.[43] When the courts apply the domestic anti-abuse rules, "…they have applied domestic anti-abuse rules to questions involving the availability of treaty benefits as fully as they have applied those rules to other tax questions".[44]

Varma and West point to three significant United States decisions to support the above proposition,[45] and observe that, although there is no express reference to the "object and purpose" of the tax treaty in United States jurisprudence, the cases are consistent with the statement in paragraph 9 (5) of the OECD Commentary that "the benefits of double taxation Convention should not be available where a main purpose for entering into certain transactions…was to obtain a more favourable tax position…".[46]

3.2 Countries where the Treaty overrides the GAAR

The Netherlands

The Netherlands places great emphasis on the hierarchy of law established under the Dutch Constitution which does not permit the application of Dutch law where it is incompatible with the provisions.[47] The Dutch position is therefore summarised somewhat absolutely by Peters and Roelofsen as follows:[48]

> Since tax treaty provisions are binding upon everyone, they prevail over national law.

Dutch domestic law has for a long time had a case law developed abuse of law doctrine-the *fraus legis.* Dutch case law[49] and academic writing[50] indicates that the application of the *fraus legis* doctrine to Dutch tax treaties is possible but the weight of opinion is against this application,[51] primarily because it involves substitution of the facts and therefore is dependent on the shared

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[42] Section 7701 (o) of the Internal Revenue Code 1986 (US) introduced the United States's first GAAR, effective 30 March 2010. It applies to "any transactions to which the economic substance doctrine is relevant". At first blush it might appear that the legislation is simply a codification of judge-made law in the avoidance area. Professor John Prebble expresses the opinion that is a much more powerful weapon in the hands of the Commissioner than previous case law (see the note by John Prebble for Tax Prof Blog entitled "Prebble welcomes the US Treasury and IRS to the ranks of GAAR-empowered fiscs") http://taxprof.typepad.com/taxprof_blog/2010/05/prebble-.html. It is noted by the authors of the United States Branch Report n12, 827 (Amanda P Varma and Philip R West) that proposals to codify the "economic substance" doctrine have regularly been introduced in Congress. This time it was successful.

[43] See the United States Branch Report n12, 827, at 829-833.

[44] Ibid at 837. It is also noted that the United States made a Reservation to the OECD Commentary on Article 1 as follows:

> The United States reserves the right, certain exceptions, to tax citizens and residents, including certain former citizens and long-term residents, without regard to the Convention. (Paragraph 28, Article 1).

[45] *Teong-Chan Gaw v Commissioner,* T.C.Memo.1995-531, 70 T.C.M.1196, *Del Commercial Properties Inc v Commissioner*, 251 F.3d 210 (DC Cir 2001), and *Aiken Industries, Inc v Commissioner*, 56 T.C. 925 (1971).

[46] Paragraph 9.5 of the Commentary on Article 1, Commentary to the OECD Model, OECD (Paris).

[47] Article 94 of the Dutch Constitution referred to in the Dutch Branch Report n12, 551 at 561 (Faustina G. I. Peters and Aart Roelofsen).

[48] Ibid at 561, in fact this summary does not accurately reflect the final, more diffident, analysis.

[49] *Hoge Raad*, 18 May 1994, BNB 1994/252.

[50] B J Arnold and S van Weeghel, "The relationship between tax treaties and domestic anti-abuse measures", in *Tax Treaties and Domestic Law*, IBFD Publications 2006, at 110.

[51] See the conclusion on this point in the Dutch Report n12, 551 at 563, and B J Arnold and S van Weeghel, "The relationship between tax treaties and domestic anti-abuse measures", in *Tax Treaties and Domestic Law*, IBFD Publications 2006, at 112-113.

expectation of the treaty partners in the application of the treaty. The other state will not necessarily follow the recharacterisation in their treaty interpretation. The consequence of this is that "the predominant objective of tax treaties to prevent double taxation is then at risk."[52] Non application of the *fraus legis* doctrine to tax treaties is also consistent with the observation expressed by the Netherlands at paragraph 27.7 of the OECD Commentary which states: "The Netherlands does not adhere to the statements in the Commentaries that as a general rule domestic anti-avoidance rules and control foreign companies provisions do not conflict with the provisions of tax conventions".

The conclusion of the Dutch reporters to the Rome Congress was therefore "the jurisprudence of the Hoge Raad does not leave much room for the application of the *fraus legis* doctrine in treaty situations".[53]

Portugal

Portugal's position is very similar to the Netherlands and for similar reasons. Under the Portuguese constitutional system international rules binding the Portuguese state prevail over domestic provisions. Almeida Fernandes and de Sousa da Camara report that although the domestic anti-avoidance rules could be used to determine the tax liability of the taxpayer subject to Portuguese tax, they cannot be used in a way which would extend to a double tax treaty. They say:[54]

> 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 jeopardise 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.

The Portuguese, like the Dutch, cannot be accused of inconsistency. Paragraph 27.8 of the OECD Commentary on Article 1 rather directly states: "whenever the prevailing hierarchy of tax conventions regarding internal law is not respected, Portugal will not adhere to the conclusions on the clarification of domestic anti--abuse rules incorporated in the Commentary on Article 1."

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

Countries where the GAAR overrides a treaty, or alternatively, countries where a treaty overrides the GAAR have a comparatively clear position on the relationship between their treaties and their anti-avoidance provisions. But the position in most countries is not as clear because most countries attempt to reconcile these two potentially competing sources of law. Most countries know that the GAAR overrides the rest of the domestic tax legislation, and also that international tax treaties override the rest of the domestic tax legislation, but it is not clear whether the GAAR overrides treaties or vice versa.

Brian Arnold summarised this tension with the conclusion, "in most countries, generally speaking, tax treaties prevail over domestic tax laws in the *event of a conflict*" (emphasis added).[55]

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[52] n47, at 563.
[53] Ibid, at 561.
[54] See the Portuguese Branch Report n12, 651 at 659 (Jose Almeida Fernandes and Francisco de Sousa da Camara).
[55] BJ Arnold, "Tax Treaties and Tax Avoidance; The 2003 Revisions to the Commentary to the OECD Model" (2004) 58 (6) Bulletin for International Fiscal Documentation, Amsterdam, 244, 251.

New Zealand

Some countries apply a type of hybrid approach in order to reconcile the international public law obligations and the domestic law GAARs. New Zealand is such a country. Let us deal first with an example where there was no conflict between the tax treaty and the GAAR. It has been asserted[56] that in the vast majority of disputes there will be no conflict between the treaty and domestic law outcomes. This is because the recharacterisation of income under New Zealand's GAAR is then applied to the provisions of the double tax treaty.[57] When New Zealand applies the factual approach to interpretation,[58] the possibility of conflict between domestic anti-avoidance provisions and the treaty exists, but in practice, because the domestic law would ordinarily determine the facts which give rise to the tax liability, no such conflict occurs.[59] The result of this approach is that the GAAR will apply to cross-border transactions in the vast majority of transactions.

Sometimes there may be a conflict between the treaty and the domestic law reconstruction. In this situation it is asserted[60] that the treaty should prevail, reflecting the position summarised by the general observation of Brian Arnold above. An example may assist in the explanation.

Suppose a dividend is paid by a New Zealand resident company to a Canadian trustee shareholder.[61] Article 10 (2) of the Canada/New Zealand double tax treaty[62] provides that New Zealand is limited in its taxation to 15 per cent of the gross amount of the dividend. Assume that Canada regards the trustee shareholder as the beneficial owner of the dividends and imposes Canadian tax upon the trustee. Article 3 (2) of the Canada/New Zealand double tax treaty provides the following:[63]

> In determining, for the purposes of Articles 10, 11 or 12, whether dividends, interest or royalties are beneficially owned by a resident of a Contracting State, dividends, interest or royalties in respect of which a trustee is subject to tax in that Contracting State should be treated as being beneficially owned by that trustee.

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[56] Craig Elliffe and John Prebble "General Anti-Avoidance Rules and Double Tax Agreements: A New Zealand Perspective" (2009) Revenue LJ volume 19, 46, at 64. It is noted that the authors of that article differ in their views as to how comprehensively the domestic anti-avoidance rules interact with and complement New Zealand's treaties. John Prebble's view is that a New Zealand court faced with the issue will conclude that the GAAR will override the treaty in all cases.

[57] Consistent with paragraphs 9.2 and 22.1 OECD Model Commentary.

[58] n56, at 56.

[59] n56, at 55. See also the discussion in the case study at paragraph 4.2 of this article as it highlights the application of this type of factual recharacterisation by the New Zealand revenue authorities using the GAAR.

[60] n56, at 58. This treaty override is supported, first, by the terms of the domestic legislation in the way in which section BH1 (4) provides that a double tax agreement has effect in relation to income tax, *despite anything in this Act* (emphasis added). Secondly, provided the treaty is not being used in an abusive manner, the treaty should be interpreted in a way which does not frustrate its object and purpose and consistent with the public international obligations that it owes treaty partners. Thirdly, as a Commonwealth country New Zealand's inconsistency with Canada and Australia is marked. The implication from this difference is that the New Zealand Parliament is content to allow a situation where the GAAR is ineffective in limited circumstances where the clarity of the treaty outcome dictates otherwise.

[61] To simplify matters it is a dividend that carries no imputation credits (tax credits from corporate tax which is notionally imputed to the dividend and which can be used to reduce New Zealand resident and in some cases non-resident New Zealand taxation).

[62] Double Taxation Relief (Canada) Order 1981.

[63] This is not a particularly uncommon feature of New Zealand's tax treaty network, particularly amongst older treaties. Prior to April 29, 2000 New Zealand had an observation in respect of Article 3 of the OECD Model Convention which recorded the New Zealand position that it "would wish to treat dividends, interest and royalties in respect of which trustees are subject to tax on the state of which he is a resident as being beneficially owned by the trustee".

Now assume that New Zealand Inland Revenue decide that the beneficial owner of this dividend is the beneficiary resident in the Cayman Islands and not the Canadian trustee. As a consequence of this decision they decide to apply the GAAR and to reconstruct the dividend as having been derived by a resident of the Cayman Islands. Under this reconstruction they require the New Zealand company to withhold 30 per cent as withholding tax.[64]

In this case, it is suggested that, in the absence of an assertion that the treaty is being abused (discussed below in paragraph 3.4), the conflict between the application of the GAAR and the treaty must be resolved in favour of the treaty. This is because New Zealand has agreed with Canada that it will limit the tax imposed on New Zealand sourced dividend income to 15 per cent where the dividend is derived by a Canadian resident. For the purposes of the treaty, where a trustee is subject to tax in Canada, the dividend is treated as being beneficially owned by the Canadian trustee.

In other words, Canada and New Zealand have expressly agreed in the treaty, that if a trustee that derives a New Zealand sourced dividend is subject to tax in Canada, then New Zealand will treat that trustee as the beneficial owner of the dividend for the purposes of the treaty. Unless the treaty is itself being abused, the explicit definition in the treaty and the treaty itself should prevail over the GAAR.

United Kingdom

Under the law of the United Kingdom a double tax treaty is given force under the legislation, which incorporates the treaty into domestic law.[65] The provisions that give effect to double tax treaties say they are "notwithstanding anything in any enactment".[66] The statutory scheme, like New Zealand's, gives a primacy to tax treaties. This primacy does not mean that the treaty will always override domestic law. Rather, "it may be absolutely clear, expressly or by implication, that a provision of domestic law is intended to override a DTC in which case it will do so".[67] Although the United Kingdom does not have a GAAR, judges interpret the domestic law using principles of statutory interpretation which examine whether the taxpayers are applying the law in a way which is consistent with Parliamentary purpose and commercially realistic. The United Kingdom does have a number of "targeted anti-avoidance rules" (TAARs) as well.

It seems clear that specific provisions introduced into domestic law and intended to override a treaty outcome overtly will be given effect notwithstanding the primacy of the treaty. As an example, a recharacterisation under a TAAR will be effective in some instances under a treaty.[68] This is clearly not a universal rule, particularly if the treaty contains exhaustive definitions and these definitions conflict with the domestic TAAR. Morton and Sykes state:[69]

> Paragraph 22 (1) of the OECD commentary on article 1, states that DTCs will be applied after any recharacterisation of income or gain has taken effect. For the reasons given it is not clear that this can be stated with confidence as a general principle, in particular given that a DTC may contain some exhaustive definition (for instance of interest) which are unaffected by domestic law interpretations.

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[64] Income Tax Act 2007 (NZ),s RF 8 (2).
[65] See *IRC v Collco Dealings, Ltd* (1961) 39 T. C. 509 at 527-528.
[66] Section 788 (3) of the Income and Corporation Taxes Act 1988 (UK).
[67] See the United Kingdom Branch Report n12, 805, at 807 (Paul Morton and Laurent Sykes).
[68] See generally, Philip Baker, *Double Tax Conventions*, Sweet and Maxwell, London, (2001) part F-7.
[69] n67, at 813.

The position in the United Kingdom in respect of TAARs seems to reflect the principle that the domestic anti-avoidance rule will apply to the treaty unless there is a conflict, in which case the treaty will prevail.[70]

This is, however, subject to the caveat that if Parliament intends to override specifically a treaty and enacts subsequent legislation, then that subsequent legislation will prevail. Support for this proposition might be found in the decision *R (on the application of Huitson) v Revenue and Customs Commissioners.*[71] This was a judicial review case concerning Parliament enacting retrospective legislation to counter the operation of a tax avoidance scheme which took advantage of a double tax treaty. Kenneth Parker J held that it was a legitimate and important aim of United Kingdom public policy in fiscal affairs that double tax agreements should do no more than relieve taxpayers from double taxation; specifically that a double tax agreement should not be permitted to become an instrument by which persons residing in the United Kingdom avoid or substantially reduce the incidence of income tax.

Kenneth Parker J, in following the Court of Appeal decision of *Padmore*,[72] adopted a purposive interpretation of the treaty, finding that its fundamental purpose is to avoid double taxation. Its purpose was not to facilitate complete avoidance of income tax in any jurisdiction, or to allow residents of a particular state to reduce their tax to a level below that which they would ordinarily be exacted by the state of residence. The purpose of tax avoidance was particularly offensive when the means chosen to exploit the double tax treaty was artificial.

Given the public policy aspect, the United Kingdom legislature was entitled to enact legislation to ensure that the double tax treaty did not become an instrument of tax avoidance and furthermore had not been used in that way (the retrospective aspect). In describing the *Padmore* case Kenneth Parker J said;[73]

> Whatever the true meaning of the DTA, there was a wider rationale in terms of public policy: UK residents should pay UK income tax on the profits of any trade or profession; and a DTA, intended to relieve from double taxation, should not be used as an instrument either to avoid all taxation or to reduce it well below the level that would be applicable to the relevant income in the country of residence.

The position of the United Kingdom and New Zealand is similar when the United Kingdom applies its TAAR to a transaction and the New Zealand courts apply the GAAR. These are both situations where domestic statute law is being interpreted in the context of a potentially contrasting double tax treaty.

As to whether judge-made anti-avoidance principles (judge-made GAAR) flow into the treaty analysis in the same way as TAARs seems less clear, but there seems no reason why a judge interpreting domestic provisions should not be able to apply the *Ramsay* principles[74] to a cross-border transaction in the same way as above, or indeed, the same way as the United States judge would. The question then becomes, how do the *Ramsay* principles apply? A possible answer is that it may

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[70] n68, Philip Baker suggests that:

> …a Parliament *may* expressly and intentionally override a treaty by enacting domestic legislation which is to operate notwithstanding any arrangements made under section 788 of the Taxes Act. However, unless legislation expressly or by clear implication overrides section 788, a treaty *will* prevail over subsequent legislation by virtue of the wording of section 788 (3).

[71] *R (on the application of Huitson) v Revenue and Customs Commissioners* 12 ITLR 603.

[72] *Padmore v IRC* [1987] STC 36, 62 TC 352, ChD; *affd* [1989] STC 493, CA.

[73] N71, at 30.

[74] *IRC v Ramsay* [1981] STC 174.

be that the United Kingdom is an example of a country that applies the interpretative approach to reconciling the judicial GAAR to their treaty obligations.[75] If this is the case, then a proper construction of the treaty will facilitate the application of the judicial GAAR. If the treaty contains the exhaustive definition, then its proper interpretation would respect that construction. If the abuse is clear then a proper interpretation of the treaty would not allow the treaty to be used in that way.

3.4 *Abuse of treaty-A treaty anti-avoidance rule?*

The discussion above focuses on the use of the domestic GAAR (or judicial doctrines) to combat a transaction that complies with the treaty but offends the anti-avoidance domestic law. There is arguably another taxpayers' Waterloo in the tax administration armoury.[76]

Even where a tax outcome is clearly spelt out by the provisions of the treaty, a State does not have to grant the benefit of a double tax treaty when the arrangement constitutes an abuse of the provisions of the treaty. The test applied is whether "a main purpose" of entering into transactions is to secure a more favourable tax position contrary to the object and purpose of the relevant provisions. [77] Paragraph 9.5 of the Commentary records:

> ...a guiding principle was that the benefits of a double tax 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 the circumstances would be contrary to the object and purpose of the relevant provisions

This is tantamount to "establishing a treaty anti-avoidance rule",[78] however it is to be noted that the tax administrators should not "lightly assume"[79] a taxpayer is entering into an abusive transaction, and furthermore, that the test suggested under the Commentary is likely to be different and may have a higher threshold than domestic GAARs.[80]

Perhaps unsurprisingly, the approach taken by countries when examining the relationship between the domestic anti-avoidance rules and their treaties is mirrored by the way they approach the interpretation of a treaty using the "rule" of paragraph 9.5 of the OECD Model Commentary.

All of the three countries that clearly applied their GAAR to the treaties, Australia, Canada and the United States, reflect the sentiment that their own domestic rules are consistent with the

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[75] In contrast to the New Zealand position where New Zealand applies the GAAR using the factual approach. This would mean that the United Kingdom uses a mixture of factual approach (for TAARs) and interpretative approach (for judicial GAAR).

[76] For a fuller description of the application of this treaty abuse rule see Craig Elliffe and John Prebble "General Anti-Avoidance Rules and Double Tax Agreements: A New Zealand Perspective" (2009) Revenue LJ volume 19, 48 at 67.

[77] See the discussion n76, at 68 which reflects that the Commentary to Article 1 has a subheading "Improper use of the Convention".

[78] BJ Arnold, "Tax Treaties and Tax Avoidance; The 2003 Revisions to the Commentary to the OECD Model" (2004) 58 (6) Bulletin for International Fiscal Documentation, Amsterdam, 244, 251.

[79] Paragraph 9.5 of the OECD Model Commentary to Article 1.

[80] Contrast the New Zealand statutory test under section BG 1 of the Income Tax Act 2007 (NZ) which prescribes that a "not merely incidental" purpose or effect of tax avoidance is sufficient to avoid the transaction for tax purposes. For a comparative analysis of other domestic avoidance regimes see Zoe Prebble and John Prebble, "Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law" Bulletin for International Taxation April (2008), 151.

statements in paragraph 9 (5) of the OECD Commentary without the need to rely on the Commentary in the interpretation of their treaties. In contrast, but consistent with the approach referred to above in paragraph 3.2, namely that the treaty overrides anti-avoidance rules, the position in the Netherlands and Portugal reflects a reluctance to apply a treaty abuse doctrine.[81]

In the third category of countries, countries like the United Kingdom and New Zealand, it is likely an abusive use of the treaty will result in the benefits of the treaty being denied to the taxpayer.[82]

4.0 Evaluating the Approaches

In examining the different ways that countries deal with the relationship between the GAAR and providing certainty of law through the use of the provisions of a tax treaty, governments, and sometimes the judges or the judicial systems, have decided to support one guiding principle above another. One country may say that taxpayers and other revenue authorities must have certainty in dealing with the tax treatment on cross-border transactions involving their country. Another may say that the purpose of the tax treaty is to prevent double taxation and not to abuse the domestic tax base. For some countries it is best to think of this preference as part of a sliding scale in a continuum. A country, such as the Netherlands, which is a fierce defender of the primacy of the treaty, does not rule out completely the use of the *fraus legis* doctrine. Nevertheless, because of this preference for one principle over another, there can be inconsistency of treatment for a taxpayer with a cross-border transaction or business dealing.

4.1 A Case Study that illustrates the Inconsistency of Approach

An inconsistent application of the GAAR by different countries in respect of a cross-border transaction is illustrated by the following example:[83]

A Dutch shareholder sells shares in both a United States and a New Zealand company to another company that it owns, crystallising capital profits rather than receiving dividend distributions. Both the purpose and effect of this transaction was to obtain a more favourable capital gain tax treatment than the counterfactual dividend distribution. Both the United States and New Zealand revenue

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[81] n48, at 569 where the Dutch Branch Reporters state:

> Abuse of tax treaties is not, as such, countered by Dutch tax law. There are no provisions which explicitly deal with treaty abuse.

The Portuguese Reporters note that their authorities have not been invoking the abuse of treaties to justify tax adjustments that appear to concede that it is a possible course of action open to their authorities, but clearly one which would not be lightly entered into the net treaty obligations and the burden of proof, see n54, at 662.

[82] With respect to the United Kingdom the Branch Reporters n67, at 817, refer to the decision *Indofood International Finance Ltd v JPMorgan Chase Bank NA*, London branch 8 ITLR 1 as a possible example of an internationally coordinated approach to the construction of a double tax Convention. The New Zealand Branch Reporters point to the consistent reference to the Commentary by New Zealand courts in forming the view that a New Zealand court would have reference to paragraph 9.5 in situations where an abuse frustrate the object and purpose of the treaty, see the New Zealand Branch Report n12, 575 at 592 (Craig Elliffe and John Prebble).

[83] This example is discussed by the General Reporter (Stef van Weeghel), see above n12, at 27, and it is also used by the writer and John Prebble as a way to describe the factual approach in the article referred to in n10, at 54. This type of example is of the application of the GAAR in a "definitional" situation as opposed to the application of the GAAR in a situation that may constitute an abuse of the treaty such as treaty shopping. These are the two general situations analysed by Jinyan Li and Daniel Sandler in the article, "The Relationship Between Domestic Anti-Avoidance Legislation and Tax Treaties" (1997) Canadian Tax Journal, vol. 45, no 5, 891 at 948.

authorities may recharacterise this transaction under domestic anti-avoidance rules as a dividend disregarding the legal form of the sale transaction.[84] This domestic recharacterisation would then be applied for tax treaty purposes.[85] In the case of New Zealand it is suggested that the factual approach would be applied.[86] In the case of the United States it is suggested the interpretive approach is used.[87]

The approach to the sale in the Netherlands may be, and certainly has been,[88] to recharacterise the capital gain into a dividend under the *fraus legis* doctrine.[89] But in contrast to the United States and New Zealand treatment above, such a recharacterisation is unlikely to be applied by the Dutch for tax treaty purposes. The Netherlands would regard such a recharacterisation as being inconsistent with their tax treaty obligations.[90] The Dutch treatment for tax treaty purposes would be to regard the sale as a capital gain. Van Weeghel highlights this inconsistency in the General Report as follows:[91]

> 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, (the) for the Netherlands-USA tax treaty in the interpretation by the United States, and (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.

In the event of this nonalignment of treaty outcomes a taxpayer should have recourse to the mutual agreement procedures under the relevant article.[92]

The example above of dividend stripping is helpful because it illustrates how the approaches of the three countries operate in practice. It also enables the different countries' approaches to be examined from the perspective of which inherent principle is being upheld by the countries in taking the approach they have chosen. Let us now examine the reasons behind the approach taken by the three countries. It seems they fall into two groups, which either accentuate the desirability of certainty, or the desirability of preventing abuse.

4.2 Certainty and *Pacta Sunt Servanda*

The approach preferred by the Netherlands reflects the basic principle of international law of *pacta sunt servanda,*[93] and reinforces that the obligations made to a treaty partner ought to be inviolable, and not capable of a domestic law override. Inherent in this concept is that there was a consistent

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[84] New Zealand would apply the New Zealand dividend stripping rules under its domestic legislation (section GB 1 (1)-(3) which inter alia states "With the amount derived in substitution for a dividend is treated as a dividend derived by the person on the income year in which the disposal occurs". The US would use the general anti-abuse judicial doctrines that it has which it can apply to international transactions, see the United States Branch Report n12, 827, at 829 (Amanda P Varma and Philip R West).
[85] n12, at 55, in the case of New Zealand, and n12, 837, at paragraph 1.4, in the case the United States.
[86] n12, at 56.
[87] n12, at 27 in the General Report (Stef van Weeghel).
[88] *Hoge Raad*, 15 December 1993, BNB 1994/259.
[89] See the Netherlands Branch Report n13, 551, at 562 (Faustina G F Peters and Aart Roelofsen).
[90] Ibid, at 562, 563.
[91] n13 at 27.
[92] Under Article 25 of the OECD Model, the Mutual Agreement procedure is a special procedure outside of the domestic law, which has relevance where tax is imposed (or is about to be imposed) in disregard to the provisions of the treaty.
[93] Latin for "agreements must be kept", *Black's Law Dictionary* (8th ed, 2004).

tax treatment set out in the double tax agreement that will be followed by both countries therefore reducing the likelihood of double taxation (a significant stated reason for double tax treaties).[94]

There are two important principles here; principles that need to be separated. The first is that when a treaty says something, or prescribes an outcome, then a party should be able to rely on that outcome. This is the aspect of certainty. The second relates to the consistent application of the treaty by two countries in dealing with a cross-border transaction. This is the aspect of consistency.

The advantage of the Dutch approach is that a treaty can be interpreted on its face value and hence provide some certainty to taxpayers[95] seeking to use its provisions. The approach mirrors the first part of Article 31 (1) 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 terms of the treaty…".

Likewise, the Dutch approach supports a consistent application of the tax treatment for both jurisdictions.

In summary, in a perfect world, a taxpayer should be able to rely on the provisions of the double tax treaty that is certain and consistent. When domestic law overrides a clear outcome mandated by the terms of the treaty it clearly strikes at the usefulness and even fundamental integrity of the treaty.

4.3 Treaties are subject to domestic law

A contrary approach, taken by the United States and New Zealand in the example above, recognises that treaties are not to be abused and that sovereign countries do not give away their taxing rights in abusive situations. This approach may mean that a taxpayer does not achieve the outcome which they thought they were entitled to under a strict interpretation of the treaty.

The actual words of the treaty are clearly critical to its meaning but they must be interpreted within a framework. Article 31 (1) of the VCLT goes on to qualify the ordinary meaning concept referred to in section 4.2 above, with the instruction that the terms of a treaty are to be purposively interpreted "in their context and in the light of its object and purpose."

When a court is seeking to interpret a treaty in a manner that is likely to be acceptable and consistent with its treaty partner, it normally would have recourse to the OECD Model Commentary.

The OECD Commentary, particularly after 2003,[96] supports the approach that countries generally should be able to apply their GAARs to the treaties they have concluded.[97] A strong case can be made that to interpret the treaty with consistency, requires a court to consider that (as the

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[94] See n3 that most countries provide unilateral relief for double taxation under the domestic law, either by a credit for foreign tax, exempting foreign income, or by a hybrid combination of the two, leading some commentators to conclude that the main purpose of tax treaties is really the allocation and limitation of taxing powers: David A. Ward "Canada's Tax Treaties" (1995) Canadian Tax Journal, vol. 43, no. 5, 1719 at 1728.

[95] The common law doctrine of privity of contract, together with the fact that VCLT itself is concluded only by countries, would suggest that only the contracting states have legitimate expectations in respect of a concluded treaty, and the applicable rules of interpretation, but this is not the case. It is taxpayers who normally rely upon treaties, and they are the parties, together with one contracting state (usually) who are involved in the dispute and interpretation of the treaty. It is generally accepted that the treaty interpretation rules in the VCLT apply at a domestic level in a dispute between a country and taxpayer because of the long-standing rules of international law. See the discussion and authorities referred to in the article by Jinyan Li and Daniel Sandler, "The Relationship Between Domestic Anti-Avoidance Legislation and Tax Treaties" (1997) Canadian Tax Journal, vol. 45, no 5, 891 at 900, fn 13.

[96] When extensive revisions were made to the *Commentary* on Article 1.

[97] See paragraphs 9.2, 9.3 and 22 of the OECD Model Tax Convention, *Commentary* on Article 1.

Commentary reflects)"it is also a purpose of tax conventions to prevent tax avoidance and evasion".[98]

More generally, the application of domestic law into the treaty itself is no foreign concept to the OECD Model as there is often reference in it to the use of domestic law to define a concept or term not defined in the Model itself. As an example Article 3 (2) makes it clear that, unless the context suggests otherwise, in the absence of a definition in the Model reference must be made to domestic law. Article 10(3) provides a definition of "dividends", and defaults to domestic law in a similar way.[99] In one sense consistency is achieved if both contracting states apply their GAARs to the treaty.

In summary, treaties are entered into with the objective of reducing or eliminating double taxation but governments will not allow the artificial or cynical use of the treaty to erode their tax base. Even if there is a cost to taxpayer certainty, the abuse of the treaty is a worse evil.

4.4 Conclusion

There are three broad categories of approach that countries take to the relationship of general anti-avoidance provisions and double tax treaties. Some countries have taken the view that tax avoidance is such a serious threat that they will make it clear that the GAAR will apply to all transactions involving the double tax treaties.[100] This approach can be justified on the basis that the OECD Commentary, certainly since 2003 and possibly earlier, recognise this is the view of a significant majority of OECD members.

Other countries insist that the treaty stands for what it says. The answer to the problem of abuse lies in renegotiation of treaties and not the application of overriding domestic legislation.[101]

The view of the writer is that the OECD Commentary's classification offers limited insight into the true relationship of the question of whether the GAAR or the treaty should prevail. The better categorisation is simply identifying which overrides which. By analysing seven jurisdictions on this basis of overriding law, three categories of countries emerge. Those countries that place most importance on their domestic anti-avoidance provisions overriding the treaty, value most their ability to preserve the tax base and strike down abusive transactions. Those countries that place more importance on their treaties overriding the domestic GAAR, value most the certainty of law. The third category of countries has hybrid features, so that although the domestic GAAR will normally operate on cross-border transactions and override the treaty, in situations where the treaty conflicts with the GAAR, the treaty will prevail and override the domestic anti-avoidance provisions.

What is the best way to balance the two competing principles of respect towards treaty obligations whilst ensuring that treaties are not abused? The hybrid approach taken by the United Kingdom and New Zealand may achieve this result, because it ensures that clear treaty outcomes are respected if that is what is clearly stated in the treaty, whilst guarding against the abuse of treaties. The

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[98] See paragraphs 7 of the OECD Model Tax Convention, *Commentary* on Article 1.

[99] OECD Model Convention on Income and on Capital

[100] Another approach which is a variation on the Australian and Canadian amendment to domestic law making it clear that the anti-avoidance rules apply to treaties, is the German approach, whereby it has been a regular treaty policy of Germany since the year 2000 to include a provision in the treaty allowing the application of domestic anti-avoidance rules.

[101] Taxpayer certainty, rather than the protection of a foreign tax base, may be at the centre of these countries' concerns.

approach reflects that in certain circumstances, as appropriate, either one of the two principles might prevail.

This hybrid approach may be more widespread and recognised in other jurisdictions as well, because there is a difference for many countries (possibly most countries), between the relationship of domestic law and the GAAR, and treaties and the GAAR. This as Brian Arnold points out is that, generally speaking, where the treaty and the GAAR conflict, the treaty will prevail.[102] This does not necessarily apply to the relationship between domestic law and the GAAR because in some countries the GAAR works in tandem (the relationship is more equal) with the substantive provisions.[103]

The role of anti-avoidance legislation, in its desire to frustrate transactions that seek to avoid tax, means that it is necessarily pitted against the use by taxpayers of domestic substantive specific provisions in the rest of the legislation. The GAAR's relationship to tax treaties is somewhat similar. A GAAR is designed to frustrate transactions that seek to avoid tax and which would otherwise utilise the outcomes prescribed in a double tax treaty. The protection of the tax base should be paramount, unless Parliament has clearly said otherwise.[104] Taxpayer certainty may need to be sacrificed on that altar.[105]The hybrid approach allows a court, a tax administrator, and a taxpayer, to give emphasis to clear treaty intentions but does not allow unacceptable or unintended outcomes.

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[102] BJ Arnold, "Tax Treaties and Tax Avoidance; The 2003 Revisions to the Commentary to the OECD Model" (2004) 58 (6) Bulletin for International Fiscal Documentation, Amsterdam, 244.

[103] An example of this is the situation in New Zealand where it has been said "We consider Parliament's overall purpose is best served by construing specific tax provisions and the general anti-avoidance provision so as to give appropriate effect to each. They are meant to work in tandem. Each provides a context which assists in determining the meaning and, in particular, the scope of the other. Neither should be regarded as overriding." See *Ben Nevis Forestry Ventures Ltd & Ors v Commissioner of Inland Revenue; Accent Management Ltd & Ors v Commissioner of Inland Revenue* (2009) 24 NZTC 23,188 (SC) at [103] (per Tipping, McGrath and Gault JJ).

[104] It may have through the express terms of the treaty.

[105] In most circumstances, where there is no conflict, the GAAR will operate normally and have full application. This should be the default position because a GAAR has inherently different features to other legal tax rules in the sense that its purpose is to address tax avoidance: see the New Zealand Supreme Court decision *Ben Nevis Forestry Ventures Ltd & Ors v Commissioner of Inland Revenue; Accent Management Ltd & Ors v Commissioner of Inland Revenue* (2009) 24 NZTC 23,188 (SC) at [106] (per Tipping, McGrath and Gault JJ) :

> The general provision is designed to avoid the fiscal effect of tax avoidance arrangements having a more than merely incidental purpose or effect of tax avoidance. Its function is to prevent uses of the specific provisions which fall outside the intended scope in the overall scheme of the Act.

So while it has been said that certainty should be a key feature of taxation (Adam Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations* London(1776)) in the New Zealand cases Lord Templeman in *Challenge Corporation Ltd v CIR* [1986] 2 NZLR 513, and Richardson J in *CIR v BNZ Investments Ltd* [2002] 1 NZLR 450 (CA) at [40] remind us that in the context of tax avoidance, although certainty is important, it is not an "absolute value".