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# **The 2003 Revisions to the Commentary to the OECD Model on Tax Treaties and GAARs: A Mistaken Starting Point<sup>1</sup>**

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## **1. Introduction: scope and structure of the article**

More frequently than is desirable, publications with arguable legal nature are taken by scholars, tax administrations and courts as real norms and therefore invested with ability to settle prior legal disputes. This attitude is based upon a mistaken understanding of binding rules and favours a gradual decrease in technical consistency of the publications, it being obvious that an organization invested with normative powers may find less incentive to properly justify its decisions than if it is merely stating an opinion. Finally, the growing trend towards an ambulatory effect of these publications in relation to the real binding rules to which they refer brings forward a whole array of constitutional issues regarding legal certainty.

These reflections might well be applied to the Commentaries on the articles of the OECD Model Tax Convention on Income and Capital (OECD Commentary, hereinafter) especially in relation to the improper use of tax treaties, as clearly as for the application of the general anti-abuse provisions of domestic law in a tax treaty context. It is well known that in January 2003, the OECD issued extensive revisions to the OECD Commentary in order to “clarify” this difficult task. If indeed the new version of the OECD Commentaries has been well received by certain scholars and practitioners, with regard to this issue,<sup>2</sup> it still fails to properly resolve the problem on a solid basis.<sup>3</sup> The inclusion in the Commentary of a starting point which might be contentious and the existence of an important number of contradictions in it, accompanied by more than a few gaps, might depreciate the “high

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1. This contribution is outlined in the research project SEJ2006-01159/JURI financed by the Spanish Ministry of Science and Technology and directed by Prof. Dr Juan Zornoza.

2. Sasseville, J., Tax Avoidance involving Tax Treaties, in Jirousek/Lang (eds.) *Praxis des Internationalen Steuerrechts, Festschrift für Helmut Loukota zum 65. Geburtstag* (Vienna: Linde, 2005), p. 451 (p. 459 et seq.); Sasseville, J., A Tax Treaty Perspective: Special Issues, in Maisto (ed.) *Tax Treaties and Domestic Law* (Amsterdam: IBFD Publications, 2006), p. 37 (p. 55 et seq).

3. This might be the reason several states formulated observations in relation to this issue: See OECD Commentaries on Art. 1 Paras. 27.4 to 27.9.

persuasive value” which has been conferred on the OECD Commentaries.<sup>4</sup> Its value may be even reduced if one takes into account the ambulatory application principle used by the Committee on Fiscal Affairs of the OECD which, as has been stated, might account for the decreasing role of the OECD Commentaries.<sup>5</sup>

As stated before, the 2003 OECD Commentary introduced important changes in relation to its Art. 1 on the improper use of tax treaties. Even though there are excellent descriptions of these changes – comparing the 2003 update with its former version<sup>6</sup> – we should briefly point them out as they represent a starting point for our contribution.

After decades spent defending the idea that states wishing to preserve the application of their domestic anti-avoidance provisions in situations governed by a tax treaty must insert a specific provision to that effect in their treaties, the 2003 OECD Commentary dramatically withdrew its former position by partially deleting Para. 7 of the Commentaries on Art. 1 in which this assertion was included.<sup>7</sup> In order to justify its new approach the Commentary distinguishes between those states for which an abuse of a tax treaty is also seen as an abuse of domestic law and those that consider these abuses as being abuses of the treaty itself.<sup>8</sup> The former will not encounter legal problems by applying domestic anti-abuse provisions in a treaty context as far as those are considered part of the basic rules for determining the facts that give rise to tax liability, and thus not addressed in tax treaties and not affected by them.<sup>9</sup> On the other hand, the latter states will be able to attack treaty abuses by means of a proper construction of the convention resulting from its object and purpose as well as the obligation of interpreting it in good faith.<sup>10</sup> In any case, in both cases the application of domestic anti-abuse provisions in a tax treaty context does not

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4. De Broe, L., *International Tax Planning and Prevention of Abuse*, Doctoral Series, Vol. 14 (Amsterdam: IBFD Publications BV, 2008), p. 323.

5. Martín Jiménez, A., “The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries?”, 58 *Bulletin for International Fiscal Documentation* 1 (2004), pp. 27-30.

6. Martín Jiménez, 58 *Bulletin for International Fiscal Documentation* 1 (2004), pp. 17-20. Arnold, B.J., “Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model”, 58 *Bulletin for International Taxation* 6 (2004), pp. 244-247. De Broe, *International Tax Planning and Prevention of Abuse* (2008), pp. 377-403.

7. This statement dated back to the 1977 OECD Model which contained the first reference in the Commentary to the improper use of tax treaties.

8. OECD Commentaries on Art. 1 Paras. 9.2. and 9.3.

9. OECD Commentaries on Art. 1 Para. 9.2. This statement is also repeated in OECD Commentaries Art. 1 Para. 22.1.

10. OECD Commentaries on Art. 1 Para. 9.3.

seem troublesome.<sup>11</sup> In relation to both approaches the OECD Commentaries clarify that it should be not lightly assumed that a taxpayer is entering into abusive transactions and therefore provides a – so-called *guiding principle*. According to this principle, the benefits of a 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 where obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.<sup>12</sup>

The improper use of tax treaties may be addressed from three different perspectives: the effect of the OECD Commentaries on this issue; the technical consistency of the Commentaries and, last but not least, the fiscal policy attitude in relation to the improper use of tax treaties especially with regard to developing countries. Needless to say, these three approaches are connected; but this mere fact does not justify a mixed consideration of the problem at stake, which might well lead to confusion and inconsistencies. As far as: (1) the power of persuasion of the Commentaries must be determined by its technical quality and (2) fiscal policy might not go beyond technical legal issues, we will merely focus on the second approach described above.

Therefore, this article tries to critically review the OECD position especially in relation to domestic general anti-avoidance rules and general anti-avoidance judicial doctrines (hereinafter GAARs<sup>13</sup>). For these purposes we will follow the very structure of the OECD reasoning, analysing, on the one hand, the possible application of GAARs in a treaty context and, on the other hand, the guiding principle referred to above. When it comes to analysing the first issue, we will first subject the OECD statement on the factual nature of GAARs – basic rules for determining the facts that give rise to tax liability – to scrutiny (section 2.) supporting the mere interpretative nature of these provisions and extracting consequences thereof (section 3.). After these reflections, we will focus on the guiding principle, analysing its

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11. OECD Commentaries on Art. 1 Para. 9.4. Nevertheless, as stated by De Broe, these distinctions might be artificial and unjustified whilst creating differences between those states that will always be faced with the constraints imposed by the interpretation rules of the Vienna Convention on the Law of Treaties, and those which may apply their domestic anti-abuse rules unrestrictedly (De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 388).

12. OECD Commentaries on Art. 1 Para. 9.5.

13. Even if the term “GAAR” should be reserved for domestic legal provisions, in order to achieve a certain terminological simplicity we will also use it when referring to anti-abuse judicial doctrines.

consistency and linkage with the case law of the European Court of Justice (ECJ) on income tax matters (section 4.).

## **2. The factual approach to GAARs: A technical mistake and a misleading starting point**

The OECD Commentaries repeatedly stress that anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to tax liability; they are not addressed in tax treaties and are therefore not affected by them.<sup>14</sup> This position, frequently labelled as the *factual approach*<sup>15</sup>, has also been used in different states for mere domestic purposes. As we will try to demonstrate, this approach does contain a bit of ambiguity, at least in its formulation by the OECD, is normally used to avoid the real nature of GAARs and might encourage wrong solutions in certain jurisdictions. These objections must be considered separately.

### **2.1. The factual approach is ambiguous**

The wording of the OECD Commentaries on this issue allows several interpretations. One could say that by this approach the OECD means that GAARs are rules that determine the taxable event.<sup>16</sup> But one could also say that, according to the above-mentioned words, the OECD considers GAARs to be rules establishing the facts to which domestic and treaty provisions are applied. Even if we reject a pure factual approach to GAARs,

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14. OECD Commentaries on Art. 1 Paras. 9.2 and 22.1.

15. Designated as *factual approach* in: Arnold, 58 *Bulletin for International Taxation* 6 (2004), p. 251. Zimmer, F., “Domestic Anti-Avoidance Rules and Tax Treaties – Comment on Brian Arnold’s Article”, 59 *Bulletin for International Fiscal Documentation* 1 (2005), pp. 25-26. Arnold, B.J. and van Waegele, S., The Relationship between Tax Treaties and Domestic Anti-abuse Measures, in Maisto (ed.) *Tax Treaties and Domestic Law* (2006), p. 91. It has also been labelled a *fact-finding approach* (De Broe, *International Tax Planning and Prevention of Abuse* (2008), pp. 390-391) or even *transactional approach* (Goyette, N., “Tax Treaty Abuse: A Second Look”, 51 *Canadian Tax Journal* 2 (2003), p. 780 et seq).

16. This interpretation matches in fact with the French version of the Commentary (...*dispositions déterminant les faits générateurs de l’impôt*) as stated by De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 389. This seems to be also the position of Martín Jiménez when stating: “According to Para. 9.2, as long as anti-abuse rules affect the taxable event...” (Martín Jiménez, 58 *Bulletin for International Fiscal Documentation* 1 (2004), p. 19).

only this second interpretation seems to be in line with the Commentaries' intentions.<sup>17</sup> In any case, the OECD's approach needs clarification.

## 2.2. The factual approach is a goal-oriented reasoning

The factual approach has not only been suggested in relation to this particular issue but also in different contexts. In any case, and as we will try to demonstrate, this approach has always been proposed in order to escape the unwelcome consequences of an interpretative approach. This attempt to avoid at all costs the interpretative approach implies supporting complicated theories on the relationship between facts and law that deserve critical review.

The application of a rule, whatever its nature may be, implies the determination of the facts to which that rule will be applied. These facts are what the taxpayer really did, without any legal labelling. Once these facts have been properly determined they call for the application of a rule, be it a domestic or treaty one.<sup>18</sup> The problem, in abusive transactions, is that the facts will be developed in a way that a rule either cannot be applied (*abuse through avoidance*) or is applied even if not intended for cases of the kind (*abuse through capture*).<sup>19</sup> In any case, the application of GAARs to these abuse strategies does not and cannot imply a mere determination of the facts but rather a sort of application of the avoided or captured rule.<sup>20</sup>

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17. In fact, this second interpretation is supported by a good number of scholars: Arnold, 58 *Bulletin for International Taxation* 6 (2004), p. 251; De Broe, *International Tax Planning and Prevention of Abuse* (2008), pp. 389-391.

18. It has been suggested that the application process implies two different steps: characterization of the facts and interpretation of the law. These considerations may be valid in a mere theoretical approach but in real application cases both characterization and interpretation take place simultaneously. In short, to paraphrase German scholars: *the eye of the judge wanders from the text of the law to the facts and from the facts to the law* (Kaufmann, A., *Analogie und Natur der Sache. Zugleich ein Beitrag zur Lehre vom Typus*, 2nd ed. (Heidelberg: Decker und Müller, 1982), p. 38).

19. These are the two main abuse strategies that have been described by German scholars (see the concepts of *Tatbestandsumgehung* v. *Tatbestandschleichung* in Kruse, H.W., *Steuerumgehung zwischen Steuervermeidung und Steuerhinterziehung, Steuerberater-Jahrbuch 1978-1979* (Köln: Dr. Otto Schmidt, 1979), pp. 454-455); Also in the Spanish literature: Báez, A. and López, H., "Nuevas perspectivas generales sobre la elusión fiscal y sus consecuencias en la derivación de responsabilidades penales. (Comentario a la Sentencia del TS de 30 de abril de 2003, rec. num. 3435/2001)", *Estudios Financieros Revista de Contabilidad y Tributación (legislación, consultas, jurisprudencia)* 251 (2004), p. 124; Báez, A., *Los negocios fiduciarios en la imposición sobre la Renta* (Pamplona: Thomson Aranzadi, 2009), p. 191.

20. This approach will be analysed in section 3.

There is little room for doubt that even for tax authorities invested with far-reaching powers, faking the existence of certain facts that did not really occur seems excessive. This would be equal to depriving rules of validity.

In order to overcome the inconsistencies of this version of the factual approach, a further meaning of the term “fact” has been developed so as to refer to the so-called “legal facts” (also referred to as “secondary facts”). They have been defined as “facts” established by the rules of private law or other non-tax fields of law, for instance, how a contract should be interpreted, whether an exchange of letters amounts to a contract, or whether a payment from a company to a shareholder should be considered as a salary, loan, dividend or capital gain.<sup>21</sup> This alternative *factual approach* is in our opinion a sort of conceptual *hocus-pocus*. If we say that “legal facts” are the legal acts actually performed<sup>22</sup>, it seems obvious that we are making reference to facts that have been characterized according to a specific previously interpreted applicable rule. In short, “legal facts” are not facts but actually the result of the application of a construed law. To give an example, if we consider that a *sale and lease-back* agreement does not amount to a sale this does not imply a simple assessment of the facts, but is really the result of a certain interpretation of the legal concept of sale. Definitely, this second variant of the “factual approach” is just a different version of a simple interpretative approach which will be analysed in following paragraphs.<sup>23</sup>

So, if all this is true, why then such an insistence on a factual approach? Hence, we come to the core of this position. It has been said that whether the factual or interpretative approach is used depends on a choice of perspective rather than on inherent differences in the rules as such and, therefore, it does not seem logical to attach serious legal consequences to the choice of approach.<sup>24</sup> One can share this opinion only by assuming, as a given, that internal GAARs might be applied in a tax treaty context. Nevertheless, such a reasoning may be circular precisely when it comes to

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21. Zimmer, 59 *Bulletin for International Fiscal Documentation* 1 (2005), p. 25; In the same direction but less clearly: Zimmer, F., General Report, in IFA (ed.) *Form and Substance in Tax Law, Cahiers de droit fiscal international*, Vol. 87a (The Hague: Kluwer, 2002), pp. 28-29.

22. As stated for example in: Zimmer, in IFA (ed.) *Form and Substance in Tax Law, Cahiers de droit fiscal international* (2002), p. 29.

23. We think this is exactly the conclusion of Prof. Zimmer when he states: “Thus, the factual approach embedded in the OECD Commentaries implies legal (including tax law) considerations, as does the interpretative approach” (Zimmer, 59 *Bulletin for International Fiscal Documentation* 1 (2005), pp. 25-26).

24. Zimmer, 59 *Bulletin for International Fiscal Documentation* 1 (2005), p. 25.



deciding whether or not GAARs conflict with double taxation conventions. This issue will be considered further ahead in the text. At this moment we just want to emphasize that the factual approach in either of its versions is just aimed at avoiding conflicts between GAARs and double taxation conventions. Indeed, if the tax authorities or the courts applying a GAAR merely determine the facts to which a treaty rule will be either applied or not applied, no conflicts will arise with double taxation conventions. The very statements of the OECD Commentary make its aim quite clear: "... to the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions".<sup>25</sup> In fact, one might say that factual approaches have been always, in this and other contexts, just a goal-oriented reasoning aimed at avoiding different problems that might result from a mere interpretative approach.

Nevertheless, the above inconsistencies are not the main problem to which a factual approach may lead in this context. As we will try to demonstrate in the following section, the OECD reasoning may give rise to a serious – and dangerous – misleading effect.

### 2.3. Factual approach and widening of the concept of sham: A risk in certain jurisdictions

Determining the borderline between sham and avoidance has never been an easy task.<sup>26</sup> In fact, the delicate distinction between both concepts seems to have been perceived for years<sup>27</sup> and has provoked, in certain jurisdictions, a gradual approximation (confusion) of both instruments.<sup>28</sup> This

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25. OECD Commentaries on Art. 1 Para. 9.2.

26. As Zimmer states: "...in countries which have anti-avoidance rules, the borderline between sham/simulation and avoidance may be blurred" (Zimmer, in IFA (ed.) *Form and Substance in Tax Law, Cahiers de droit fiscal international* (2002), p. 31).

27. Medieval scholars (Baldus) already stated that *tot modis committitur simulatio quot modis comittitur fraus* (sham is performed in the same way as avoidance). As quoted by: Coing, H., *Simulatio und Fraus in der Lehre des Bartolus und Baldus*, in *Festschrift für Paul Koschaker*, Vol. 3 (Weimar: Hermann Böhlhaus Nachfolger, 1939), p. 402.

28. This trend has been described by various scholars around the world. For Spain: Báez, *Los negocios fiduciarios en la imposición sobre la Renta* (2009), p. 204 et seq, in relation to fiduciary structures; Ruiz-Almendral, V., *El fraude a la ley tributaria a examen: El fraude a la ley tributaria a examen: los problemas de la aplicación práctica de*

rapprochement, for countries which have anti-avoidance rules, makes sense as a proposal *de lege ferenda*, but leaves the problem unresolved especially for those regulations in which sham transactions and GAARs have different procedural requirements and legal consequences. On the other hand, we think there is a possible criterion in order to make a distinction between sham and abusive transactions. In our opinion, the whole confusion is caused by the very classical criterion used in order to portray the concept of sham which requires that the transaction be conducted with an element of deceit, an element which in turn would be absent in abusive transactions. The fact is, and this has been frequently stressed by scholars, that abusive transactions incorporate a certain element of deceit as well,<sup>29</sup> which might be identified with the element of artificiality inherent in abusive transactions. In a nutshell, under this approach there is no way sham and avoidance can be distinguished. In our opinion, even if both simulation and avoidance share a fake element, this refers to different objects.<sup>30</sup> In sham transactions taxpayers lie about what has been labelled as “pure or real facts”<sup>31</sup> (Was the price actually paid? Did that person really take part in that meeting?). In contrast, in abusive transactions, taxpayers do not hide real facts – actually they attempt to achieve their legal consequences – but the purpose of the transactions they have conducted.<sup>32</sup>

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*la norma general anti-fraude del artículo 15 de la LGT a los ámbitos nacional y comunitario* (Pamplona: Aranzadi, 2006), p. 114 et seq. In the UK: Ballard, R.M. and Davison, P.E.M., United Kingdom, in IFA (ed.) *Form and Substance in Tax Law, Cahiers de droit fiscal international* (2002), p. 569 (p. 572), who describes the existence of certain clues in several cases that sham may have a wider meaning than that of simple factual deceit. In the United States: Streng, W.P. and Yoder, L.D., United States, in IFA (ed.) *Form and Substance in Tax Law, Cahiers de droit fiscal international* (2002), p. 595 (p. 596), who refers to the confusing “economic sham doctrine”.

29. This idea has been frequently stressed by Spanish scholars when dealing with the penalization of tax avoidance strategies: Palao Taboada, C., Los instrumentos normativos contra la elusión fiscal, in *La justicia en el diseño y aplicación de los tributos* (Madrid: Intituto de Estudios Fiscales, 2005), p. 111 (p. 120 et seq). Madrigal, F.J.A. and Gómez-Lanz, J., “Fraude a la ley tributaria, ilícito e infracción tributaria y delito de defraudación”, *Estudios Financieros. Revista de contabilidad y tributación* 281-282 (2006), p. 3 (p. 41). Ruiz-Almendral, *El fraude a la ley tributaria a examen* (2006), p. 115.

30. We therefore cannot share the opinion, as stated by Ruiz-Almendral, that sham and avoidance have the same nature, differing only in the degree of bluntness or sophistication that the avoidance transaction has been dressed up with (Ruiz-Almendral, “Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules”, 33 *Intertax* 12 (2005), p. 562 (p. 564).

31. Using the words of: Zimmer, in IFA (ed.) *Form and Substance in Tax Law, Cahiers de droit fiscal international* (2002), p. 19 (p. 28). Zimmer, 59 *Bulletin for International Fiscal Documentation* 1 (2005), p. 25.

32. This question really goes beyond the scope of this article. For an in-depth analysis see: Báez, *Los negocios fiduciarios en la imposición sobre la Renta* (2009), p. 205 et seq.

Once we have proved the existence of a real – and justifiable – borderline between sham and abusive transactions, we are in a position to analyse how the factual approach, as proposed by the OECD Commentaries, might cause confusion in relation to the above-mentioned distinction. As we saw before, the factual approach – or at least one of its versions – is based upon the assumption that, in certain circumstances, the “legal facts”, as assessed by taxpayers, might be correctly characterized by tax authorities (or courts) in order to take into account the “real legal facts”. This process can be illustrated by an easy dividend-stripping transaction. The legal facts as presented by the taxpayers (a capital gain) might be replaced by the tax authorities with the “real legal facts” they assume to have taken place (a dividend). As described by ZIMMER, according to the factual approach, even if the legal form is a gain “in fact” the payment is a dividend for tax purposes.<sup>33</sup> Even if it is evident that in this kind of transaction there is no deceit in relation to real or pure facts, certain countries might succumb to temptation and make use of sham transaction doctrines or rules in order to correct these situations.

This confusion has been reported in relation to states that lack GAARs.<sup>34</sup> But this mistake is also present even in those countries, like Spain, which have a GAAR (Art. 15 of the Spanish *Ley General Tributaria*).<sup>35</sup> In order to describe an example in line with the reflections of the 56th Congress of the IFA, let us describe the position of the Spanish Tax Administration in relation to international dividend-stripping cases in which a double

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33. Zimmer, 59 *Bulletin for International Fiscal Documentation* 1 (2005), p. 26.

34. This is the case in Colombia and Mexico. If we analyse the arguments put forward by Colombian and Mexican reporters at the 56th Congress of the IFA in order to consider a dividend-stripping as a case of sham, we will conclude that they are totally in line with the sort of factual approach defended by the OECD Commentaries. The Colombian Report states that: “...once the tax office is able to cut through this *apparent legal reality the truth surfaces*, that the transaction lacks real economic substance (and so is not a real economic tax event), *which takes us into the sphere of tax evasion*” (Paniagua-Lozano, J.E. and Mayorga-Arango, H.M., Colombia, in IFA (ed.) *Form and Substance in Tax Law, Cahiers de droit fiscal international* (2002), p. 213 (p. 220). The Mexican Report states: “If the judge decides that the act is simulated, it would probably be determined that *what the parties really agreed to was that C* (Company which pays the dividends) *would pay dividends to A* (original holder of shares) *and A would pay to B* (Company purchasing the shares according to the dividend-stripping transaction) *a certain amount of money*” (Moreno Gómez de Parada, F., Mexico, in IFA (ed.) *Form and Substance in Tax Law, Cahiers de droit fiscal international* (2002), p. 429 (p. 434).

35. This confusion has been recently mentioned and criticized in relation to the Spanish case law by: Zornoza, J., La simulación en Derecho Tributario, in *Tratado sobre la Ley General Tributaria. Homenaje a Álvaro Rodríguez Bereijo. (Tomo I)* (Pamplona: Aranzadi, 2010), p. 519 (p. 526-529).

taxation convention was applicable.<sup>36</sup> In a typical dividend-stripping set of transactions,<sup>37</sup> the Spanish *Tribunal Económico Administrativo Central*<sup>38</sup> stated that “... in fact we are in front of a set of purchase agreements which constitute the sham transactions that hide the real transaction really performed, a payment of dividends. [...] Therefore we should tax the real taxable event performed by the tax payer, regardless what legal form they have used. [...] If what we really have is a mere power of attorney the only income to be taxed would be the commission paid by the grantor to the grantee”.<sup>39</sup>

One might easily check whether all these comments are totally in line with a factual approach as advocated by the OECD Commentaries. Actually, the factual approach, even if not so intended, might encourage a total confusion between sham and abusive transactions even in those countries, like Spain, which have a GAAR. Therefore, in order to properly analyse the relationship between domestic GAARs and double taxation conventions, one should depart from a strict interpretative (applicative) approach, as will be shown in the following paragraphs.

### **3. Legal approach to GAARs: The need to add nuances**

The preceding reflections clearly show that GAARs must be considered to be instruments which embody a process of legal application as the very consequence of tax avoidance. As clear as this may be in theory, the question remains of exactly what can be considered application in the context of GAARs. The problem emerges due to the fact that there are different views regarding the very nature of legal application.

It is a widespread position among scholars that domestic anti-avoidance rules and judicial anti-avoidance doctrines are *interpretative principles* under which tax law applies only to transactions with economic or

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36. Nevertheless, there are further examples of this position, even assumed by both administrative and criminal courts, which cannot be reported in this article.

37. A company, resident in the UK, sells to another company, resident in Spain, shares which in turn have been issued by a third company also resident in Spain, days before the dividends are paid. After the payment of the dividend the UK company purchases the shares according to reciprocal call and put options previously agreed obtaining a gain equivalent to the dividend minus an amount which is actually the commission received by the second Spanish company.

38. TEAC 15 June 2006, (JT 2006, 1421).

39. There are also other rulings in this same line: TEAC 16 September 2005 (JT 2006, 85) and TEAC 2 February 2006 (JUR 2006, 157322).

commercial substance; therefore, tax legislation is *interpreted* not to apply to transactions that lack economic substance or business purpose. In keeping with this idea, there would be no conflict between tax treaties and domestic GAARs.<sup>40</sup>

This is also the position assumed by the OECD Commentaries when referring to states that label abuses as being abuses of the convention itself, and concluding that these states consider that a proper construction of tax conventions (resulting from their object and purpose) allows them to disregard abusive transactions.<sup>41</sup> This position closes the circle of the new OECD approach in relation to domestic GAARs and double taxation conventions: the factual approach is the solution for states which consider that an abuse of a tax treaty is also an abuse of domestic law; in turn, the interpretative approach saves the application of domestic GAARs in states that label abuse as being abuse of the convention itself.

Apart from the fact that the distinction upon which the OECD position is based has been reasonably considered artificial and unjustified,<sup>42</sup> the interpretive approach, as described above, merits criticism. These reflections manage a far-reaching and confusing concept of interpretation which is not unknown to the European legal tradition. In order to clarify this point we will first focus on the very concept of interpretation – especially by indicating its limits. After this, we will try to extract the consequences for the issue under scrutiny in this article.

### 3.1. Nature and limits of interpretation

The identification of GAARs with interpretative techniques departs from a wide-reaching concept of interpretation that makes it equal to the application of rules in general. This assimilation of GAARs and interpretative methods is evident among certain scholars dealing with the special problem addressed in this article.

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40. Martín Jiménez, 58 *Bulletin for International Fiscal Documentation* 1 (2004), p. 19; Sasseville, in Jirousek/Lang (eds.) *Praxis des Internationalen Steuerrechts* (2005), p. 459. Arnold, 58 *Bulletin for International Taxation* 6 (2004), p. 251. De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 387, implicitly when analysing the distinction between states that consider an abuse of a tax treaty as an abuse of domestic law and those that consider an abuse of a treaty as being independent.

41. OECD Commentaries on Art. 1 Para. 9.3.

42. De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 387.

Let us take the opinion of Martín Jiménez who, in an article previous to the 2003 version of the OECD Commentaries, stated: “The current situation of domestic anti-abuse measures in a tax treaty context may be affected by a misunderstanding on the part of the OECD. It has been shown that the rigid application of the *pacta sunt servanda* principle is not justified from the international law point of view. [...] Thus, it seems that the OECD’s starting point in 1977 generated a fake debate: from the point of view of international law, the obligations stemming from a treaty are not those derived from a literal wording of the treaty, but the obligations derived after a process in which the principle of good faith and a teleological interpretation are critical”.<sup>43</sup>

Nevertheless, this position is neither new nor especially focused on the relationship between GAARs and double taxation conventions. In fact, this particular understanding of GAARs is as old as GAARs themselves,<sup>44</sup> and is frequently used by German and Austrian scholars in order to deny these rules an own normative meaning being their nature a mere statement of the necessity of an interpretation according to the purpose of the avoided or caught provision.<sup>45</sup>

The mere assimilation of GAARs and interpretation techniques generates severe inconsistencies whose detailed analysis would considerably surpass the scope of this contribution. Notwithstanding we should emphasize that, on the one hand, the above described position might generate certain doubts as to when using mere interpretative techniques and when resorting

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43. Martín Jiménez, A., “Domestic Anti-Abuse Rules and Double Taxation Treaties: a Spanish Perspective – Part I.”, 56 *Bulletin for International Fiscal Documentation* 12 (2002), p. 542 (p. 550). This same idea is repeated in later articles with different words: “...general domestic anti-abuse rules do not extend the taxable event by adding to it certain conduct where an elusive element is presumed or conduct that is economically equivalent to that defined in the taxable event” (Martín Jiménez, 58 *Bulletin for International Fiscal Documentation* 1 (2004), p. 19).

44. As far as we know, in relation to tax matters, this debate started with the introduction of a GAAR in § 5 of the German *Reichsabgabenordnung* (1919). Many German authors in the 20s and 30s considered a GAAR unnecessary, for it was enough a simple interpretation of the provisions avoided: Ball, K., *Steuerrecht und Privatrecht* (Mannheim: Bensheimer, 1924), pp. 130-132; 142-147; Becker, E., *Die Reichsabgabenordnung*, 7th ed. (Berlin: Heymanns, 1930), pp. 109-113.

45. This idea has generated an important dispute in Germany between those who are in favour of the, so called, *Innentheorie* and those who advocate the *Außentheorie*. For Germany see: Tipke, K., *Die Steuerrechtsordnung. Band III: Föderative Steuerverteilung, Rechtsanwendung und Rechtsschutz, Gestalter der Steuerrechtsordnung* (Köln: Dr. Otto Schmidt, 1993), p. 1286 et seq. See, in relation to Austrian legal doctrine: Hohenwarther, D., Austria, in Maisto (ed.) *Tax Treaties and Domestic Law* (2006), p. 161 (pp. 195-196).

to GAARs.<sup>46</sup> On the other hand, and this is in our opinion the main point at stake, this simple assimilation creates serious doubts on the very limits of the interpretation process. This last reflection can be illustrated, for the purposes of this article, with the following statements of De Broe: “The result of the recharacterization or redetermination in which domestic anti-avoidance provisions often result can only be given effect for treaty purposes if that result is supported by the text of the tax treaty, construed in its context and light of its object and purpose”.<sup>47</sup> The question immediately arises: if the result of the recharacterization or redetermination is supported by the text of the treaty, why is it necessary the resort to GAARs? Why are the general interpretation techniques not enough for the purposes of combating tax avoidance? In our opinion, these questions might not be answered without a solid basis on the nature and limits of interpretation.

In our opinion the whole confusion on this issue is generated by the traditional interpretative criteria which have been accepted worldwide. The core of the problem is the distinction between literal and teleological interpretation in relation to the same provision and leading to different results.<sup>48</sup> The solution for this conceptual question might be found in the law theory.<sup>49</sup>

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46. And this might be a problem for those countries in which the legal consequences of the different applicative techniques may considerably diverge.

47. De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 387.

48. This distinction might be found when dealing with GAARs as a general issue. Especially in relation to GAARs and double taxation conventions in: Martín Jiménez, 56 *Bulletin for International Fiscal Documentation* 12 (2002), p. 550: “The rules of interpretation [...] in Arts. 31 to 33 of the Vienna Convention on the Law of Treaties [...] do not proclaim a literal interpretation as the main rule. Thus, a real interpretation of a treaty is needed which takes into account its purpose”; Vega Borrego, F.A., *Las medidas contra el treaty shopping* (Madrid: Ministerio de Hacienda, Instituto de Estudios Fiscales, 2003), p. 101: “...the goal of these rules – referring to GAARs – is to restrict a formalist interpretation which primes the text over the purpose favoring avoidance”. Goyette, 51 *Canadian Tax Journal* 2 (2003), p. 769: “Paragraphs 9.3 and 9.5 of the commentary evidence a desire to go beyond the mere letter of treaties and to consider their object and purpose”; following Advocate General Tesouro and Sasseville, in Maisto (ed.) *Tax Treaties and Domestic Law* (2006), p. 60: “Such a rule, conceived as a principle of interpretation, constitutes an indispensable safety-valve for protecting the aims of all provisions of Community law against a formalistic application of them based solely on their plain meaning”; De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 245: “Such interpretation may require that a purely literal interpretation is abandoned if such interpretation would do harm to the parties’ common intentions and expectations and/or the treaty’s object and purpose”.

49. In this contribution we depart from the classical view of Larenz (Larenz, K., *Methodenlehre der Rechtswissenschaft* (Berlin: Springer, 1969), p. 342) which has been assumed by German scholars and case law. See: Báez, *Los negocios fiduciarios en la imposición sobre la Renta* (2009), p. 31.

The wording of a legal provision might be polysemous in those cases in which it can be attributed different meanings. Interpreting a provision, or the term contained in a legal provision, implies the selection of one of its possible meanings according to several criteria among which the purpose of the interpreted rule might be considered crucial.<sup>50</sup> In this context, it is far from clear what “written law”, “wording” or “literal interpretation” means. The text of a provision is just the starting point for its interpretation and, at the same time, the limit for this process as the interpreter cannot go beyond the possible meaning(s) given to those words (*Wortsinn* in German legal theory<sup>51</sup>). Thus, every interpretation must be literal as it departs, when determining the possible sense of the words, from written law. At the same time every interpretation that pretends to be correct must be teleological if we take into account that the selection of the proper meaning must be guided and rational, and that rules must be considered to be instruments to achieve certain goals. If all this is true, it seems evident that considering GAARs as a means to go beyond the letter of a tax statute implies a logical contradiction.

In this context, the limits of interpretation must be defined according to the possibility of attributing different meanings to a single legal term. This may not be an easy task in those cases in which private law concepts are used in tax statutes, either by a simple or explicit remission. Even if legal theory states that the same term contained in different rules might be understood differently by following their respective legal purposes,<sup>52</sup> the practice in several countries shows a broad range of approaches in relation to this problem.<sup>53</sup> By contrast, as has been stated, even in jurisdictions with a strict adherence to private law concepts in tax law, there may be concepts in tax statutes that do not correspond to private law concepts or where the legislator has made it clear that the concept should have a different content

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50. As stated by Lang and Heidenbauer: “... the wording of a provision, if analysed carefully enough, usually leaves much room for heterogeneous results of interpretation. Taking into account the object and purpose of a provision, together with other means of interpretation, leads to a limitation of the number of possible different meanings” (Lang, M. and Heidenbauer, S., *Wholly Artificial Arrangements*, in Hinnekens/Hinneken (eds.) *A Vision of Taxes within and outside European Borders. Festschrift in honor of Prof. Dr. Frans Vanistendael* (Aalphen aan den Rijn: Kluwer Law International, 2008), p. 597 (p. 609).

51. As opposed to the words of a provision designated as *Wortlaut*.

52. This is in fact an old idea frequently named as “legal concept’s relativity”. See: Engisch, K., *Die Einheit der Rechtsordnung*, Unveränd. reprograf. Nachdr. d. 1935 (Darmstadt: Wiss. Buchges., 1987), p. 45.

53. In relation to this see: Zimmer, in IFA (ed.) *Form and Substance in Tax Law, Cahiers de droit fiscal international* (2002), p. 25 et seq.



from private law relations.<sup>54</sup> In these cases the private law meaning is not binding and the possibility of determining several possible meanings from a strict tax law perspective, is certainly easier.

In short, when tax statutes make use of private law concepts it seems difficult to fight tax avoidance by means of a simple interpretation of the provision avoided. In these cases it is necessary to go beyond the possible senses of the legal wording resorting to GAARs. Nevertheless, the problem might be different when tax laws contain autonomous concepts, as we will try to show in the next paragraph.

### 3.2. Combating intended avoidance: The case of attribution

The above-mentioned reasons justify that, in certain cases, taxpayers intend the avoidance or utilization of a tax statute (i.e. double taxation conventions) but this attempt may be faced with a simple construction of the avoided or illegally utilized provision. As has been said, real avoidance starts exactly there where the art of interpretation starts to fail.<sup>55</sup> For the same reason, not every intended avoidance requires the application of a GAAR. It is obvious that this way of fighting attempted tax avoidance cannot affect the *pacta sunt servanda* principle. As Lowe points out, although it is true that a treaty must be honoured, this does not say anything about the content of the agreement that must be respected. In short, for certain cases, a proper interpretation of domestic or treaty provisions, within the limits previously described, will be enough to counteract abusive transactions.

Scholars have pointed out several areas in relation to treaty shopping, in which this way of thinking might bear fruit.<sup>56</sup> Nevertheless, a comprehensive analysis of these areas surpasses the scope of this paper and therefore we

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54. Zimmer, in IFA (ed.) *Form and Substance in Tax Law, Cahiers de droit fiscal international* (2002), p. 27.

55. Hensel, A., Zur Dogmatik des Begriffs "Steuerumgehung", in Krüger (ed.) *Bonner Festgabe für Ernst Zitelmann zum fünfzigjährigen Doktorjubiläum* (München/Leipzig: Duncker und Humblot, 1923), p. 244. Also, in recent publications on the Netherlands: van Weeghel, S., *The Improper use of Tax Treaties. With Particular Reference to the Netherlands and the United States*, Series on International Taxation, Vol. 19. (London: Kluwer Law International, 1998), p. 165.

56. Hohenwarter, in Maisto (ed.) *Tax Treaties and Domestic Law* (2006), p. 206, making special references to the very concept of residence in relation to holding companies set up in low-tax jurisdictions. In a similar way, in relation to the corporate residence concept: Loomer, G.T., *Tax Treaty Abuse: is Canada responding effectively?*, Working Papers WP 09/05 (Oxford: Oxford University Centre for Business Taxation, 2009).

will merely focus on one of these issues, namely the attribution of income to taxpayers. An artificial use of the legal rules and principles that guide the attribution of income to taxpayers is behind an important number of abusive transactions in general and treaty-shopping structures in particular<sup>57</sup> and this justifies our intention to shed some light on it.<sup>58</sup>

Treaty shopping, in brief, is the situation in which a person resident in a given state who is not entitled to the benefits of a tax treaty sets up an entity in another state in order to obtain those treaty benefits that are not directly available to him,<sup>59</sup> it seems obvious that these kind of strategies are conducted through a particular configuration of the criteria normally used so as to attribute income to taxpayers. This assertion can be illustrated with a well-known example of the Spanish practice.

In the early 90s several sportsmen resident in Spain transferred their appearance rights to non-resident companies which in turn assigned these rights to the entity for which the sportsmen rendered their personal services (also resident in Spain). It goes without saying that this peculiar structure was designed in order to achieve several tax advantages (reduction of withholding taxes, tax deferral, avoidance of personal income tax...). Regardless of the decisions that the Spanish Tax Administration and Tax Courts have given on these transactions, one should bear in mind that this example clearly shows how ordinary attribution criteria are managed by the taxpayers in order to obtain tax savings. Income which would be normally attributed to a sportsman, performing personal services, is moved to a non-resident legal entity in order to obtain tax advantages.

In the presence of this kind of construction the resort to GAARs seems a temptation difficult to resist. Nevertheless, these kinds of transactions might be faced with different instruments that would be less problematic from the point of view of the rule of law and, summing up, of the *pacta sunt servanda* principle. This mechanism is nothing other than that of interpreting the rules under which the attribution of income is governed by in the

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57. On the importance of attribution criteria in the tax avoidance field: Báez, *Los negocios fiduciarios en la imposición sobre la Renta* (2009), p. 56 et seq. with an analysis of the German literature and case law on this particular issue.

58. This does not mean that the reflections and procedures described hereinafter might not be useful for other areas.

59. As described in: De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 5.

source state, given that, as a general rule, attribution issues are not dealt with in double taxation conventions.<sup>60</sup>

In this context one should depart from a particular analysis of attribution rules. It has been said that according to the prevailing opinion, income is attributable to the person that disposes of the source of income and the resulting benefits *inter partes*, i.e. the person that has the possibility of using market opportunities or managing performances.<sup>61</sup> These considerations may, but need not always, be valid. As mentioned above, a solution that relies upon attribution rules might depart from the very analysis of those rules, bearing in mind that attribution of income might be designed on the basis of legal or economic entitlement.<sup>62</sup> Accordingly, we should refuse “standardized solutions” and resolve the sportsmen case taking account of the Spanish general attribution rules.

When referring to attribution issues, Spain cannot be easily classified either as a legal or as an economic country.<sup>63</sup> The Spanish tax system contains different attribution criteria depending on the nature of the taxable person (natural or legal person) and the tax involved (personal income tax, corporate tax or withholding tax). Focusing on the sportsmen case one should consider the sportsman to be a taxable person subject to personal income tax according to either legal (for capital income) or economic attribution criteria (for income from employment) and the non-resident company subject to withholding taxes according to economic criteria (on the basis

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60. An exceptional position in relation to this issue is found in Henkel for whom attribution is effectively regulated in double taxation conventions because, otherwise, their rules would be incomplete. (Henkel, U.W., in Mössner (ed.) *Steuerrecht international tätiger Unternehmen*, 2nd ed. (Köln: Dr. Otto Schmidt, 1998), Rdn. E 491.) Nevertheless, it has been stated that in many countries treaties do not generally give any guidance on how the connection between income and a person is to be made for treaty purposes (Wheeler, J.C., General Report, in IFA (ed.) *Conflicts in the attribution of income to a person*, *Cahiers de droit fiscal international*, Vol. 92b (Amersfoort: Sdu Fiscale & Financiële Uitgevers, 2007), p. 17 (p. 22). In the same direction Lang states: “...tax treaties do not take any independent attribution decisions. [...] Tax treaties are hence based on the domestic attribution decision” (Lang, M., “CFC Regulations and Double Taxation Treaties”, *57 Bulletin for International Taxation* 2 (2003), p. 51 (p. 54)).

61. Hohenwarter, in Maisto (ed.) *Tax Treaties and Domestic Law* (2006), p. 207.

62. In relation to this issue: Wheeler, in IFA (ed.) *Conflicts in the attribution of income to a person*, *Cahiers de droit fiscal international* (2007), p. 20 et seq. In relation to Spain and considering fiduciary structures: Báez, *Los negocios fiduciarios en la imposición sobre la Renta* (2009), p. 66 et seq.

63. Even if we consider that this classification is rather simplistic as the so-called “economic criteria” are also “legal criteria” as they are reflected in legal (tax) rules.

of the autonomous concept of *obtaining*).<sup>64</sup> An attribution of income to the sportsman on the basis of pure economic criteria (it is the sportsman who disposes of the source of income and the resulting benefits) might on occasion prove demanding, especially if the income resulting from the transfer of appearance rights is classified as capital income. Nevertheless, even in that case, there are good grounds for attributing the income to the sportsman: (1) There is a rather general consensus on the very concept of obtaining.<sup>65</sup> (2) The attribution of the income to the non-resident company would be contrary to the economic criteria set up by the Withholding Tax Act.<sup>66</sup> (3) Last but not least, if the attribution criteria are aimed at the taxation of income in the hands of the taxpayer who actually shows ability to pay in relation to that income,<sup>67</sup> it seems logical to attribute the income to its “economic owner”, at least in those cases in which the interpretation of these criteria offers a wide range of possibilities (different meanings for a single legal wording).

To sum up, this attempt of avoidance might be faced with a simple construction of the avoided or unlawfully captured provision which, in this case, must be identified with the rules governing the attribution of income.

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64. For these rules in detail: Báez, *Los negocios fiduciarios en la imposición sobre la Renta* (2009), p. 66 et seq.

65. Started in Germany and Austria in the late 70s (Ruppe, H.G., *Möglichkeiten und Grenzen der Übertragung von Einkunftsquellen als Problem der Zurechnung von Einkünften*, in Tipke (ed.) *Übertragung von Einkunftsquellen im Steuerrecht* (Köln: Dr. Otto Schmidt, 1978), pp. 7-40), and recently used in Spain in relation to fiduciary structures (Báez, *Los negocios fiduciarios en la imposición sobre la Renta* (2009), p. 161 et seq.) or even to the transfer of appearance rights (Ortiz, E., “Las rentas derivadas de la cesión de derechos de imagen de los deportistas profesionales: su discutida calificación jurídico-tributaria”, *Revista jurídica de deporte y entretenimiento: deportes, juegos de azar, entretenimiento y música* 26 (2009), p. 113 (pp. 124 et seq.)). Even the US Tax Court has made use of a similar reasoning, holding that interest payments made from a US corporation to a related Honduras corporation, where an equivalent amount of interest was paid onward to a related Bahamas corporation were actually “paid” to the Honduran entity ((1971) 56 TC 925 (USTC)) as quoted by Loomer, *Tax Treaty Abuse: is Canada responding effectively?* (2009). It is of the most importance that the court considered that the Honduran entity did not have complete dominion and control over the funds, a similar reasoning to the concepts frequently used by European scholars and courts in relation to the concept of income obtaining.

66. Art. 12 of the *Texto Refundido de la Ley del Impuesto sobre la Renta de los no Residentes*.

67. This idea is to be found among European scholars with different legal traditions: Jarach, D., *El hecho imponible: teoría general del derecho tributario sustantivo*, 3rd ed. (Buenos Aires: Abeledo Perrot 2004), p. 168; Tipke, *Die Steuerrechtsordnung. Band III* (1993), p. 1353; Báez, *Los negocios fiduciarios en la imposición sobre la Renta* (2009), p. 135.

In order to offer a comprehensive picture of this issue, there are still two further questions which should be taken into account:

- As already mentioned, the OECD Commentaries clarify that it should be not lightly assumed that a taxpayer is entering into abusive transactions, and therefore it provides a so-called *guiding principle*. The technical elements of this guiding principle will be analysed in further paragraphs of this contribution. At this moment we will focus only on a very specific issue in relation to the interpretative solution previously described. The guiding principle is put forward and is designed as a limit to the application of domestic GAARs in a tax treaty context. What about cases, like the ones already discussed, in which an avoidance attempt is combatted by means of a proper interpretation of domestic rules? In our opinion, it is evident that these cases are beyond the scope of the guiding principle.<sup>68</sup> There are two reasons which might justify this statement: (1) The guiding principle, as formulated by the OECD Commentaries, is applicable to anti-avoidance rules. It seems evident that the mere interpretation of a domestic attribution rule cannot be included in this category. It must be taken into account that even the beneficial owner requirement in Arts. 10, 11 and 12 of the OECD Model – whose resemblance with income attribution criteria seems evident – has been viewed as being a fundamental rule of taxation rather than an anti-avoidance rule.<sup>69</sup> (2) Were the guiding principle also applicable to the interpretations followed in order to counteract avoidance attempts, it would not affect interpretations like those discussed above. It should be taken into account that corrections of attribution based upon the interpretation guidelines previously described exclude the very application of the double taxation convention possibly involved (i.e. the income is attributed to the resident sportsman as if paid directly by the resident corporation). Thus, it is evident that once the application of the double taxation convention has been excluded, the OECD Commentaries do not play a role at all, as the problem turns into a pure domestic situation.
  
- Nevertheless, this discussion may turn out to be insignificant in practice. As stated above, the application of the concept of obtaining

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68. A different opinion in a similar case (rather ambiguous): Garcia-Prats, F.A., “La interpretación jurisprudencial como mecanismo para hacer frente a la elusión tributaria”, *Tribunal Fiscal* 220 (2009), p. 22 (p. 35).

69. Arnold, 58 *Bulletin for International Fiscal Documentation* 6 (2004), p. 248. Recently on this issue: Martín Jiménez, A., “Beneficial Ownership: Current Trends”, 2 *World Tax Journal* 1, 2010.

income requires the identification of the person that has the possibility of using market opportunities or managing performances in relation to the income. If this person is correctly identified, and the treaty shopper is taken into consideration for tax purposes, this identification will be normally in line with the general criteria set by the guiding principle, an issue which will be considered in detail in subsequent paragraphs. The *Prévost Car* case may be an example of what has been previously discussed even though it involves the concept of beneficial ownership.<sup>70</sup> In this case the Canada Tax Court rejected a possible disregard of the treaty shopper (resident in the Netherlands) as there was no predetermined or automatic flow of funds to its shareholders (resident in UK and Sweden) and theoretical beneficial owners.<sup>71</sup> In short, the concept of obtaining income if properly applied excludes the possibility of disregarding a non-artificial transaction. The above-mentioned cases involved a correction of avoidance attempts in treaty shopping cases; as stated before, a proper construction of the concept of attribution excluded the very application of the double taxation convention. Nevertheless, this interpretative approach may run into further problems if applied to rule-shopping cases (i.e. improper use which affects objective rules of tax treaties as, for example, the conversion of dividends into capital gains). In these cases even if a proper understanding of the attribution criteria might correct the tax avoidance strategy, the tax treaty is still applicable but will make use of a different distributive rule (e.g. dividends instead of capital gains rules). The idea previously defended that certain avoidance attempts may be faced with a simple construction of the avoided or unlawfully captured provision seems too simple for these cases, taking into account that the double taxation convention is to be applied but using a different characterization of the income.<sup>72</sup> In short, this is not a mere interpretation of attribution rules but requires additionally an application of the treaty rules which may go beyond the possible meaning(s) of its wording. All this can be illustrated with a simple dividend-stripping example.

A, resident in State A, owns shares of Company B, resident in State B. A can sell the shares free of capital gains tax and it sells the shares to C,

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70. Nevertheless, the strong resemblance between the income-obtaining and the beneficial ownership concepts is worth noting: Hohenwarter, in Maisto (ed.) *Tax Treaties and Domestic Law* (2006), p. 207.

71. Loomer, *Tax Treaty Abuse: is Canada responding effectively?* (2009).

72. For that reason the general approach to improper use of tax treaties, valid both for treaty and rule shopping, demanded by Martín Jiménez (Martín Jiménez, 56 *Bulletin for International Fiscal Documentation* 1 (2002), pp. 549-550), need not always be valid.

resident in the State B, some days before the distribution of dividends. Just after the distribution of dividends, A buys the shares back for a price set in advance which takes into account the value of the dividend distributed.<sup>73</sup>

It has been argued that this kind of construction could be combated by means of a proper construction of attribution rules as it seems evident that the income is obtained, as far as market opportunities or managing performances are concerned, by the original owner of the shares. The dividends should therefore be attributed to A, resident in State A, and not to B.<sup>74</sup> Nevertheless, rule-shopping strategies require a further step if we take into account that the proper solution implies not only attributing the income to a person different from that originally reported by the taxpayers, but also a different characterization of the attributed income (capital gains characterized for tax purposes as dividends).

In our opinion, even in rule-shopping cases, like dividend stripping, a mere interpretation of attribution criteria would be enough to counteract avoidance attempts. In short, as in pure treaty shopping cases, there is no need to resort to GAARs. This statement requires an explanation.

Even if it seems that a characterization or recharacterization from capital gain to dividend requires going beyond the possible meaning(s) of the legal term “dividend” and “capital gain”, one should bear in mind the content of Art. 10(3) of the OECD Model Tax Convention: “The term ‘dividends’ as used in this Article means income from shares, ‘jouissance’ shares or ‘jouissance’ rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as *income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident*”. Even if the debate on the correct meaning of the text in bold is still open,<sup>75</sup> it is also true that the OECD Commentaries have stressed: “Article 10 deals not only with dividends as such but also with interest on loans insofar as the lender effectively shares the risks run by the company, i.e. when

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73. This is the basic dividend-stripping scheme which of course may be conducted by means of more complex structures, especially with regard to transactions used for (re) purchasing the shares.

74. In relation to a similar case with a (re)purchase making use of reciprocal put and call options: Báez, *Los negocios fiduciarios en la imposición sobre la Renta* (2009), p. 156 et seq.

75. Avery Jones, J., et al., “The Definitions of Dividends and Interests in the OECD Model: Something Lost in Translation?”, *British Tax Review* 4 (2009), p. 406 (p. 422 et seq).

repayment depends largely on the success or otherwise of the enterprise's business. Arts. 10 and 11 do not therefore prevent the treatment of this type of interest as dividends under the national rules on thin capitalisation applied in the borrower's country". Therefore, sharing the risk might also justify a characterization as dividend without going beyond possible meaning(s) of the legal terms of Art. 10 (3) of the OECD Model Tax Convention. In this context one should bear in mind the special circumstances of a dividend-stripping case as described above. Even if the original holder does not receive dividends in a formal sense, it seems evident that it shares (or at least has shared) the risk run by the company and, in fact, this might be the reason, under the attribution rules previously described, for attributing the income to the original holder and not to the formal recipient of the dividends. This means that Para. 3 of Art. 10 is not just a *renvoi* to domestic law that has its origins in the remaining dissimilarities between Member countries in the field of company law and tax law as regards the concept of dividend even a domestic treatment as dividends based upon a special anti avoidance rule, a GAAR or even a mere interpretation of attribution rules fits in with Art. 10(3) of the OECD Model Tax Convention.<sup>76</sup>

### 3.3. Real avoidance cases

When we face real avoidance cases – i.e. attempts which cannot be counteracted with a simple construing of the avoided or unlawfully captured

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76. As stated by De Broe (De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 486) Courts in Canada have included the result of similar recharacterizations under their domestic anti-avoidance rules within Art. 10 of the relevant treaties and the application of Dutch and US anti-avoidance doctrines in a domestic context also leads to a characterization as a dividend. Nevertheless, these cases merit further discussion since Canada frequently deviates from the OECD definition of dividends. In relation to this, Li and Sandler have indicated: "If the Canadian treaty definition of "dividends" is used in a particular treaty, a deemed dividend under Sec. 212.1 is clearly a "dividend" for treaty purposes even if the treaty was concluded before the introduction of Sec. 212.1. Therefore, there is no conflict between Sec. 212.1 and the dividend article of most of Canada's tax treaties. If, however, the OECD definition of "dividends" is included in a particular treaty, it is arguable that a deemed dividend under Sec. 212.1 is not a "dividend" for treaty purposes because it is not "income from other corporate rights." The definition of "dividends" in Art. 10(3) of the OECD Model is exhaustive. Except to the extent specifically provided in that provision, reference to Canada's domestic law is not permitted under either Art. 3(2) of the OECD model or Sec. 3 of the ITCIA. In this situation, unless Sec. 212.1 constitutes a treaty override, the provisions of the treaty are paramount and a provision based on Art. 13(4) of the OECD model, discussed below, would exclude the gain from the sale of shares from tax in Canada" (Li, J. and Sandler, D., "The Relationship Between Domestic Anti-Avoidance Legislation and Tax Treaties", 45 *Canadian Tax Journal* 5, p. 891 (p. 935)).



provision – the question arises whether or not the application of a domestic GAAR could be in breach of the *pacta sunt servanda* principle.

Apart from “*limitation of benefits provisions*” – which are not dealt with in this article – certain states have decided to expressly allow, in a tax treaty context, the application of domestic anti-avoidance rules. This is the case, for example, in several Canadian<sup>77</sup>, Belgian<sup>78</sup> and Spanish<sup>79</sup> tax treaties. With different nuances the wording of these treaty rules provides as follows: “*Nothing in the agreement shall be construed as preventing a Contracting State from denying benefits under the Agreement where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Agreement or of the domestic laws of that State*”.<sup>80</sup> Even if this kind of provision has been severely criticized by scholars,<sup>81</sup> it is obvious that they allow going beyond the possible sense(s) of the treaty wording and, therefore, prevent an eventual breach of the *pacta sunt servanda* principle.<sup>82</sup>

The situation turns problematic in those cases in which tax treaties are silent on the application of GAARs in the treaty context. But, even for these cases some jurisdictions, and a wide range of scholars,<sup>83</sup> take the view that a principle prohibiting treaty abuse is inherent in tax treaties. The existence of this principle is frequently linked to the general principles recognized by civilized nations according to Art. 38(1) of the Statute of the International Court of Justice. Moreover, this seems to be also in line with the recent birth of a general principle of abuse of law in general Community law,<sup>84</sup> and

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77. Art. 29(6) of the Canada–Germany tax treaty and Art. 29 A(7) of the Canada–US tax treaty (quoted by Loomer, *Tax Treaty Abuse: is Canada responding effectively?* (2009)).

78. Tax treaties with Germany, Luxembourg, Austria, Egypt and Hong-Kong (quoted by De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 461 et seq).

79. Tax treaty with Costa Rica.

80. For different models of this provision see: De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 462 et seq.

81. These provisions are considered to have been drafted less rigorously than special LOBs (Loomer, *Tax Treaty Abuse: is Canada responding effectively?* (2009)); These provisions have been also considered to promote legal uncertainty: Hortalà i Vallvè, J., *Comentarios a la Red Española de Convenios de Doble Imposición* (Pamplona: Aranzadi, 2007), p. 48.

82. García Prats, F.A., The “Abuse of Tax Law”: Prospects and Analysis, in Bizioli (ed.) *Essays in International and European Tax Law* (Napoli: Jovene, 2010), p. 49 (p. 86).

83. Ward, D.A., *Ward’s Tax Treaties 1996-1997* (Toronto: Carswell, 1996), p. 61. Vogel, K., *Klaus Vogel on Double Taxation Conventions*, 3rd ed. (London: Kluwer Law International, 1997), p. 125.

84. Even if that principle is a matter of discussion. Very critical about the existence of this principle: De Broe, *International Tax Planning and Prevention of Abuse* (2008), p.

at least in a bilateral dimension, the OECD Commentaries also flirt with that idea.<sup>85</sup> The existence of this principle is an enormous topic in its own right that would require an in-depth analysis of the legality principle and sources of international public law.<sup>86</sup> Based on the limited approach of this contribution we will focus, in any case, on the most practical issue at stake in relation to these cases.

Both treaty references to domestic GAARs and the implicit principle prohibiting treaty abuse pose similar problems. They may generate diverging and contradictory results taking into account the variety of anti-abuse rules worldwide. On the other hand, and this is especially applicable to the assumed existence of an implicit principle, the configuration and the conditions upon which the anti-avoidance rule may be applied remain totally open. This seems particularly worrying if the implicit international anti-abuse principle is merely identified with a substance-over-form principle,<sup>87</sup> substance over form being a mere description of the result of the application of a GAAR which does not provide a single clue on the conditions of its application.

In our opinion, the core goal of the guiding principle designed by the OECD is to combat the above-mentioned problems.<sup>88</sup> In short, the real question at stake is not the possibility, in abstract terms, of going beyond the possible sense(s) of the treaty wording, but the conditions under which this may be done.<sup>89</sup>

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828 et seq. As METTEOTI puts it “...it is far from clear whether a minimum tax abuse standard exists in the various domestic tax law systems” (Metteoti, R., “Interpretation of Tax Treaty and Domestic Anti-Avoidance Rules – A Sceptical Look at the 2003 Update to the OECD Commentary”, 33 *Intertax* 8/9 (2005), p. 100).

85. OECD Commentaries on Art. 1 Para. 7.1: “*Taxpayers may be tempted to abuse the tax laws of a State by exploiting the differences between various countries’ laws. Such attempts may be countered by provisions or jurisprudential rules that are part of the domestic law of the State concerned. Such a State is then unlikely to agree to provisions of bilateral double taxation conventions that would have the effect of allowing abusive transactions that would otherwise be prevented by the provisions and rules of this kind contained in its domestic law. Also, it will not wish to apply its bilateral conventions in a way that would have that effect*”.

86. A good overview of these problems in: Paschen, U., *Steuerumgehung in nationalen und internationalen Steuerrecht* (Wiesbaden: Deutscher Universitäts-Verlag, 2001), p. 125 et seq.

87. As in the standard formula of Vogel: Vogel, *Klaus Vogel on Double Taxation Conventions* (1997), p. 125.

88. Also suggested by De Broe: De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 317.

89. García Prats, in Bizioli (ed.) *Essays in International and European Tax Law* (2010), p. 83.

#### 4. The guiding principle: A critical analysis of its components according to legal theory and European Community Law

As stated before, the OECD Commentaries have construed a guiding principle which consists of two components.<sup>90</sup> One referred to the purpose of the transaction and another to the purpose of the avoided or caught treaty provision. Both components have to be analysed carefully as they embody the core of the OECD's position on the issue under scrutiny. The principle could also be of a great interest if we take into account that certain commentators have suggested that the two elements enshrined in the guiding principle can be also recognized in the emerging jurisprudence of the ECJ on the conditions under which a measure that hinders the basic freedoms of the Treaty could be justified on the basis of the prevention of tax avoidance.<sup>91</sup> If this is true, the guiding principle will provide Member States with a secure instrument to apply GAARs in a treaty context without compromising the basic European freedoms.

Both components must be analysed separately.

##### 4.1. Main purpose of the transaction

According to the first component of the guiding principle, the benefits of a convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position. This "main purpose requirement" has received much criticism among scholars who are especially focused on its wording (in particular the reference to the "main" instead of the "sole" or the "principal" purpose of the transaction<sup>92</sup>) and its connection with certain examples introduced in

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90. There is a conceptual issue in relation to the guiding principle that merits certain attention. The question is whether the guiding principle constitutes an anti-abuse rule in its own right or merely establishes limits in relation to domestic GAARs. This might be important for those states (like Spain) that require a special procedure in order to apply their domestic GAARs. Suggesting (not categorically) that the guiding principle is an anti-abuse rule: De Broe: De Broe, *International Tax Planning and Prevention of Abuse* (2008), pp. 317-318. Arnold is more emphatic, stating that the guiding principle may be tantamount to establishing a treaty anti-avoidance rule (Arnold, 58 *Bulletin for International Fiscal Documentation* 6 (2004), p. 247).

91. Sasseville, in Jirousek/Lang (eds.) *Praxis des Internationalen Steuerrechts*, p. 463.

92. De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 319 et seq.

the Commentaries in order to illustrate this component.<sup>93</sup> In our opinion, this first component is deeply rooted in the business purpose test doctrine which, notwithstanding its literal design (main/sole/principal purpose), has serious drawbacks as pre-requisite for deciding whether or not a transaction is to be considered abusive.

The resort to this particular anti-avoidance doctrine, whatever its formulation is, may well lead to the exclusion of lawful tax planning transactions from treaty protection.<sup>94</sup> This does not mean that the lack of commercial or business purpose test in a transaction is totally irrelevant in order to conclude its abusive character. This lack may well be a sign of artificiality. The problem of the guiding principle, as we will see in the next section, is that its second element has been designed without any reference to artifice and in a rather circular and self-referring manner.<sup>95</sup> This may lead to a transaction being characterized as abusive even in the absence of artifice.

This is also the key factor in order to decide whether or not the first component of the guiding principle is in line with the ECJ case law on tax avoidance. The existence of a wholly artificial arrangement has become a frequent requirement of the ECJ case law in tax avoidance cases. Apart from this requirement, which is not present in the guiding principle, we must take into account several nuances, especially the ones introduced in its ruling in *Cadbury Schweppes*, in which the ECJ explicitly questions the business purpose test as a valid guide: "...in this case CS decided to establish CSTS and CSTI in the IFSC for the avowed purpose of benefiting from the favourable tax regime which that establishment enjoys does

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93. Especially in relation to the case in which an individual who, essentially in order to sell the shares and escape taxation in that state on the capital gains from the alienation (by virtue of Para. 5 of Art. 13), transfers his permanent home to the other contracting state, where such gains are subject to little or no tax (OECD Commentaries on Art. 1 Para. 9). Critical of the first component in relation to this example: Martín Jiménez, 58 *Bulletin for International Fiscal Documentation* 1 (2004), p. 19. De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 321.

94. As rejected by: Martín Jiménez, 58 *Bulletin for International Fiscal Documentation* 1 (2004), p. 19. De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 321.

95. For this reason the use of the business purpose test as an element of anti-abuse rules is not problematic if the GAAR also enshrines artifice requirements as is the case for the Spanish GAAR (Art. 15 of the *Ley General Tributaria*). The real problem comes up in those cases in which business purpose test is explicitly the only parameter of abuse or, in those cases like the OECD guiding principle in which business purpose test is not formally but *de facto* the unique element in order to characterize a transaction as abusive.

not in itself constitute abuse”;<sup>96</sup> “...the fact that none of the exceptions provided for by the legislation on CFCs applies and that the intention to obtain tax relief prompted the incorporation of the CFC and the conclusion of the transactions between the latter and the resident company does not suffice to conclude that there is a wholly artificial arrangement intended solely to escape that tax”;<sup>97</sup> “In those circumstances, in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality”.<sup>98</sup> The conclusion is evident: an isolated<sup>99</sup> business purpose test is not acceptable from a Community law perspective.

#### 4.2. Tax treatment contrary to the object and purpose of the relevant provisions of the treaty

As stated above, the OECD guiding principle incorporates a second element that relies on the fact that the obtaining of favourable treatment, previously described, would be contrary to the object and purpose of the relevant treaty provisions.<sup>100</sup> This second element is accompanied by the addition of a new objective aside from the traditional purpose of double taxation conventions – to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons, – which is the prevention of tax avoidance and evasion.<sup>101</sup> This new drafting of the purposes of double taxation conventions seems logical, at least *prima facie*, if we take into account that its primary goal – eliminating international double taxation – might encourage tax avoidance strategies rather than help combat them.<sup>102</sup>

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96. ECJ 12 September 2006, C-196/04, *Cadbury Schweppes* [2006] ECR I-7995, Para 38.

97. ECJ 12 September 2006, C-196/04, *Cadbury Schweppes* [2006] ECR I-7995, Para. 63.

98. ECJ 12 September 2006, C-196/04, *Cadbury Schweppes* [2006] ECR I-7995, Para. 65.

99. As we will see in the next section the special design of the guiding principle turns the main-purpose element into the only abuse requirement in the OECD position.

100. OECD Commentaries on Art. 1 Para. 9.5.

101. OECD Commentaries on Art. 1 Para. 7.

102. It has been stated in fact that authors go on to say that, if one of the general objectives of tax treaties is to promote enhanced flows of international trade and investment, it is arguable that it does not matter if the desirable result is achieved by the direct use of tax treaties or by their indirect use (Loomer, *Tax Treaty Abuse: is Canada responding effectively?* (2009)).

But even this new purpose attributed to double taxation conventions, certainly created by the OECD out of thin air,<sup>103</sup> merits criticism. The main problem of this second element is that it is self-serving and circular.<sup>104</sup> Once it has been ascertained that the main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position (element one) it must be determined whether or not that tax treatment would be contrary to the object and purpose of the relevant treaty provisions (element two), which is identified with the prevention of tax avoidance. One should not forget that the aim of the guiding principle is to define what exactly constitutes tax avoidance. Therefore, in order to decide whether an arrangement could be considered abusive, one should previously ascertain that it is abusive! Apart from the logical inconsistency, the evident risk when it comes to the application of the guiding principle is that, once the main purpose of securing a more favourable tax position has been proven, the abusive character of the arrangement is automatically concluded. In fact the risk of the second element is its lack of practical relevance and it could therefore encourage the exclusion of lawful tax planning transactions from treaty protection.<sup>105</sup>

Taking into account that none of the above-mentioned purposes of tax treaties seem suitable for a purposive correction of tax avoidance under the second element of the guiding principle, we should reconsider the whole issue. Accordingly, one should consider separately:

- Treaty-shopping structures. Under a different approach, one should not forget that a tax treaty does not merely seek the elimination of international double taxation but pursues this objective based on the principle of reciprocity, which is one of the fundamental principles of tax treaty policy.<sup>106</sup> Even if reciprocity might not be a purpose of a double taxation convention it may well indicate how, or to what extent, the contracting states agree to correct double taxation. Treaty shopping breaches the principle of reciprocity and destroys the incentive

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103. Arnold, 58 *Bulletin for International Fiscal Documentation* 6 (2004), p. 249.

104. As stated by Arnold (Arnold, 58 *Bulletin for International Fiscal Documentation* 6 (2004), p. 249) but with different arguments as those discussed in this contribution.

105. As has been mentioned, according to the OECD's view, treaties are no longer instruments to distribute tax jurisdiction between two states, but instruments to ensure that income is taxed at least once in one of the states (Martín Jiménez, 58 *Bulletin for International Fiscal Documentation* 1 (2004), p. 27). A critical review of the prevention of double non-taxation as a treaty purpose in: Lang, M., General Report, in IFA (ed.) *Double Non Taxation, Cahiers de droit fiscal international*, Vol. 89a (Amersfoort: Sdu Fiscale & Financiële Uitgevers, 2004).

106. De Broe, *International Tax Planning and Prevention of Abuse* (2008), p. 350.

for countries to negotiate and conclude new treaties.<sup>107</sup> Under this approach, the reciprocity principle seems a valid purpose in order to counteract the improper use of tax treaties. Even if this reasoning seems less circular than that enshrined in the second element of the OECD guiding principle, the same problem remains as to the fact that this purpose does not indicate when a conduit company must be considered abusive and therefore be disregarded.<sup>108</sup>

- Rule-shopping structures. It is evident that the reciprocity principle is totally alien to a purposive correction of rule-shopping strategies. Moreover, unless we find a purposive logic for the distributive rules in a double taxation convention,<sup>109</sup> it seems a difficult task to correct this kind of strategy by taking into account the purpose of the avoided or caught treaty provisions.

And hence we come to the real core of the problem. Taking into account that (i) none of the purposes of tax treaties (correction of double taxation or prevention of tax avoidance and evasion) seem suitable for a purposive correction of the improper use of tax treaties; (ii) the principle of reciprocity may well be involved in treaty-shopping structures but it does not allow determination of what is really an abuse and (iii) it seems impossible to find a teleological design behind tax treaty distributive rules, is it possible to construct a guiding principle or, more generally, a standard to decide whether or not an arrangement is to be considered abusive in a tax treaty context? As far as the purposive approach of the OECD is maintained, the answer must be no.

The only way to properly resolve this problem is to design a standard that does not rely on the object and purpose of the treaty provisions but on the special characteristics of the arrangements.<sup>110</sup> In this context, and as we stated before, when dealing with the first component of the guiding principle, the key issue must be the concept of artificial arrangements.

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107. These are in fact the two main concerns put forward in the OECD Conduit Report against treaty Shopping. See: Loomer, *Tax Treaty Abuse: is Canada responding effectively?* (2009).

108. This explains the distinction between “treaty routing” and “treaty shopping” drawn by several authors. See: Loomer, *Tax Treaty Abuse: is Canada responding effectively?* (2009).

109. As pretended for example by Paschen, *Steuerumgehung in nationalen und internationalen Steuerrecht* (2001), p. 182 et seq.

110. We have come to the same conclusion in a case that is quite similar to the improper use of tax treaties: Báez, A., *Bad Laws Make Hard Cases: Halifax and the avoidance of inconsistent tax rules* (forthcoming).

This requirement is common to many GAARs and therefore conceptually well-developed in many states.<sup>111</sup> Moreover, the concept of wholly artificial arrangements has been repeatedly used in the case law of the ECJ on tax avoidance and recently explained in more detail.<sup>112</sup> Therefore, a guiding principle construed on this basis might fit better in the European legal context. Last but not least, this approach resolves many of the inconsistencies present in the OECD Commentaries on this particular issue.

Defining what is a “wholly artificial arrangement” is not an easy task. Suffice to say here that this is the proper way that should be followed in the coming years.

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111. Ruiz-Almendral, 33 *Intertax* 12 (2005), p. 565.

112. Lang, Heidenbauer, in Hinnekens/Hinneken (eds.) *A Vision of Taxes within and outside European Borders* (2008), pp. 597-615.