

What is "treaty shopping"? Is treaty shopping still a problem? How is treaty shopping dealt with in Australia's DTA's?

Treaty Shopping

INTRODUCTION

The topic of treaty shopping is a highly emotive one for the simple reason that it touches on so many areas affecting government policy, including national sovereignty, the impact of European Union ("EU") Directives, the significance of bilateral agreements between countries and trade liberalization.

It is submitted that the questions posed above are (within the field of international tax law) among the most significant questions that can be posed today.¹

That treaty shopping is of major importance in global taxation is without doubt. It has been perceived as a problem as early as 1962 when the first preventative measure was enacted in Switzerland.² Treaty shopping was always viewed by the OECD as a major problem and a practice which must be eliminated as abusive.³

This article will focus on the above questions with the aim of providing the reader with the answers based on the "current" state of play in Australia and internationally.

What is "treaty shopping"?

The first part of the article will provide the author's view of the generally accepted

"answer". An example will be provided to illustrate the concept.⁴

Is "treaty shopping" still a problem?

From the perspective of a revenue authority I would submit (based on the evidence that lies herein) the answer is an unequivocal "yes". From the perspective of the taxpayer (and their tax advisor) the answer is "sometimes".

This is because ample opportunities exist to practice treaty shopping and a number of international examples will be highlighted below.

It will also be seen that a number of countries adopt a "liberal" interpretation of a tax treaty when in fact their domestic law would prevent a particular transaction or arrangement from succeeding.

This section will consider the operation of S 3A of the International Agreements Act 1953 ("the IAA"), a unilateral provision introduced, to prevent treaty shopping in relation to the sale of Australian real property interests.

The paper will then examine Part IVA of the Income Tax Assessment Act 1936 ("the 1936 Act") to consider its application to treaty shopping.⁵

Assess how if at all treaty shopping is addressed in Australia's DTA's?

It is submitted that Australia's past and current treaty policy is unclear and currently inconsistent. Respected commentators have stated that "working out Australia's treaty policy and its evolution...is a form of divination that few people have the desire to practice".⁶

The paper will focus on measures that Australia has adopted in particular agreements to counter "treaty shopping" including:

- the Australian/US DTA⁷ ("the US DTA");
- the Australian/Russian DTA⁸ ("the Russian DTA");
- the Australian/Chinese DTA⁹ ("the Chinese DTA"); and
- the Australian/Vietnam DTA¹⁰ ("the Vietnamese DTA");

My view is that currently treaty shopping appears to be alive and well and able to be practiced depending upon the particular treaty used as an access point to Australia and the type of gain or benefit sought to be achieved.

WHAT IS "TREATY SHOPPING"?

Treaty shopping is a technique followed by persons or entities that "shop" for a favourable DTA in order that they can structure their business and investment transactions to obtain treaty benefits in ways that were originally unintended by the bilateral treaty partners.

Edwardes-Ker states:¹¹

"Because tax treaty benefits cannot be denied to those proving their entitlement to such benefits, 'treaty-shopping' may be advantageous. Treaty shopping typically arises because no (or only an unattractive) tax treaty exists between an investor's residence State and a source State.

The treaty-shopping investor will then typically decide to establish a (base or conduit) company or other entity allegedly resident in a third State.

This entity will then seek to claim the benefits of an attractive tax treaty between this third State and the source State".

The actual practice of "treaty shopping" can be appreciated by way of an example.

Let us assume an example involving three countries, *Taxalot*, *Fairalot* & *Notazot*.

Taxalot. It levies a 40 per cent corporate tax rate and a 30 per cent withholding tax on dividend, interest and royalty payments made to non-residents. The withholding tax rate is reduced to 10 per cent under *Taxalot's* DTA's. *Taxalot* has a DTA with *Fairalot*, but not with *Notazot*.

Fairalot. It levies a 15 per cent corporate tax rate and provides a credit (on a "gross up" basis) for foreign taxes paid. It does not require withholding taxes on dividends, interest and royalty payments to be withheld on payments to non-residents.

Notazot. It avoids double taxation by using the exemption method, that is, it does not tax its residents on income earned outside its territory.

Robber Hood Inc is a resident of *Notazot*.

It owns a patent and is interested in licensing it to *Maid Marion Co* in *Taxalot*.

Since there is no tax treaty between *Taxalot* and *Notazot*, *Taxalot* would impose a 30 per cent withholding tax rate to any royalty payments made to *Robber Hood Inc* by *Maid Marion Co*.

Let us assume that royalty payments are expected to be \$200,000 from *Maid Marion Co* to *Robber Hood Inc*.

The net after-tax cash receipt would be \$140,000 as illustrated in Table A.

Table A

Licensing the patent directly	
Taxable Income (Royalty)	\$200,000
Taxalot withholding tax at 30%	\$ 60,000
Notazot income tax	Exempt
Net after-tax income	\$140,000

However *Robber Hood Inc* may be able to take advantage of the reduced 10 per cent withholding tax rate available under the *Taxalot-Fairalot* DTA.

Robber Hood Inc establishes a

subsidiary, *Robber Sub* in *Fairalot* which will be a resident of that country. *Robber Hood Inc* sells the patent to *Robber Sub* for its "market value".¹³

Robber Sub licenses the patent to *Maid Marion Co* for a licence fee of \$200,000.

As a result of *Robber Sub's* residence in *Fairalot* the royalty payments from *Taxalot* qualify for the reduced 10 per cent withholding tax rate available under the *Taxalot/Fairalot* tax treaty.

Hence *Robber Sub* receives \$180,000 net after *Taxalot's* tax.

The \$20,000 withholding tax paid in *Taxalot* is credited by *Fairalot* against *Robber Sub's* corporate tax liability. *Robber Sub's* net after tax income is \$170,000 in *Fairalot*.

Robber Sub distributes its profits to its parent, *Robber Hood Inc*, by way of dividend payments.

Under *Fairalot's* tax laws, the \$170,000 dividend payments to *Robber Hood Inc* are exempt from withholding tax.

Therefore for *Robber Hood Inc* the dividends would represent the final net after tax income as calculated in Table B.

Table B

Licensing the patent indirectly through Fairalot	
Taxable income (royalty)	\$200,000
Taxalot reduced withholding tax at 10%	(\$20,000)
Net after Taxalot tax	\$180,000
Fairalot corporate tax at 15%	(\$30,000)
Fairalot tax credit	\$20,000
Net profit available for distribution	\$170,000
Fairalot withholding tax at 0%	Exempt
Notazot income tax	Exempt
Net after tax income	\$170,000

Thus it can be seen that the benefit of treaty shopping in the above example is \$30,000.

IS "TREATY SHOPPING" STILL A PROBLEM?

Before commencing a detailed answer to this question it is worth recalling a recent comment by Second Commissioner of the

Australian Taxation Office, Jim Killaly on the work of the OECD against harmful tax practices.

Mr. Killaly states that “the OECD work is not about harmonising tax systems, or even expecting havens to have tax systems remotely like those of developed countries. It is about competing fairly!”¹⁴

One would respectfully suggest that the word “fairly” depends entirely on one’s perspective.

As we will see my view is that treaty shopping is alive and well. This view is supported by opportunities that exist in many current DTA’s between countries as well as due to the recent initiatives in the EU.

It is submitted that the opportunities for treaty shopping will continue to flourish despite the general policy thrust of the OECD.

It is also submitted that the current Part IVA¹⁵ of the 1936 Act is due to its design flaws not an adequate weapon to deal with the myriad of treaty shopping possibilities affecting Australia.

Vienna Convention on the Law of Treaties (“VCLT”)

A useful point to start in considering the context from which treaty shopping arose in international tax is the VCLT.

The VCLT was enacted in 1969 and it entered into force in 1980.¹⁶

Article 26 of the VCLT contains the doctrine of “pacta sunt servanda” which means that every treaty in force is binding upon the parties to it and must be performed by them in good faith.

Article 27 of the VCLT states that a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.

These two articles are very important in public international law. If domestic law overrides a tax treaty, the State would violate its international obligations.

Thus the above principles “seem” to permit treaty shopping if a taxpayer is able to find a circumstance where the taxpayer can benefit from a DTA.

It must be noted that many countries frown on treaty shopping as they believe that it reduces the bilateral treaty function to a “treaty with the world”.¹⁷

The OECD¹⁸ has concluded that treaty shopping is undesirable since it frustrated the spirit of the DTA if not the legal provisions in the DTA.

Despite this the report concluded that anti-treaty shopping provisions under domestic law should *not* override treaty provisions.

This is because every DTA is binding on the parties and under the VCLT should be performed in “good faith” even if benefits were conferred on an improper basis.

The suggested remedy is to renegotiate the treaty rather than override the treaty.

When a country unilaterally commences overriding a tax treaty this can lead to retaliatory action by the other contracting state to the detriment of its own nationals.

See the discussion below on Australia’s attempt at treaty override in the context of S 3A of the IAA.

Examples of Treaty Shopping Opportunities Currently Available

Set out below are three examples of treaty shopping which are able to be implemented at the present time.

*Hong Kong Investor in UK Property*¹⁹

In this example Mr Lee, a Hong Kong resident, had the opportunity to buy some property in the United Kingdom at a price which he believed would provide him a profit on re-sale.

Mr Lee could not do the deal directly as he would be liable to UK tax on the profit.

However his tax advisor suggested that he form a Jersey resident company which did the deal instead.

Mr Lee had to make sure that the Jersey

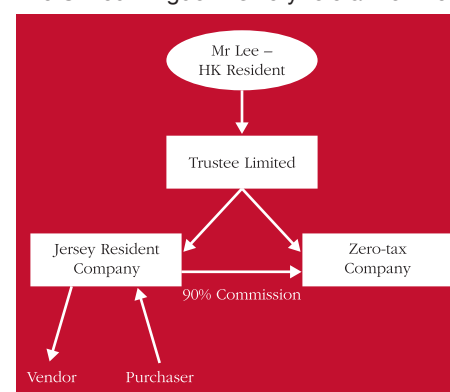
company was “managed and controlled” in Jersey.²⁰

A final addition to the strategy was to establish a zero-tax company – typically a Jersey exempt company so that when the “profit” was made on the sale by the Jersey company a 90 per cent commission was paid to the zero tax company.

The Jersey tax collector was happy to treat this commission as tax deductible. Mr Lee therefore would only pay 2 per cent tax in Jersey.

The transaction is shown in the diagram below:

The United Kingdom is very tolerant of the



use of its treaties with the Channel Islands.

Another area in which treaty shopping is available involves trusts as can be seen from the following example.

Hong Kong Investor in Spanish Company

In this example a Mr Lee wishes to invest in a Spanish Company to make a capital gain.

If he invests directly he is advised that he will be subject to tax on any gain that he makes.

Therefore Mr Lee decides to use a UK Trust established some years earlier which holds an international share portfolio.

As Mr Lee is not resident in the UK his UK trust is free from tax in respect of foreign income and free of tax also on capital gains.

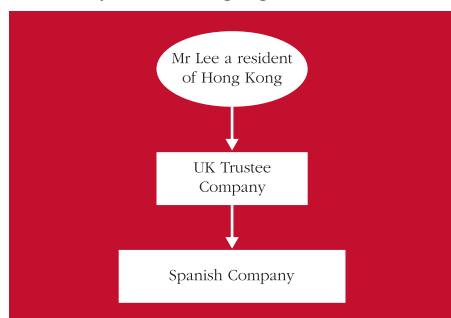
The trust may be largely for the benefit of Mr Lee and his family however the UK treaty with Spain exempts the trust from

tax on such capital gain.

This is classic treaty shopping because the benefit of the UK/Spain DTA does not go to a UK taxpayer, but to someone resident in Hong Kong!

The transaction is shown in the diagram below:

An example which highlights the use



of treaty shopping involving Australia concern's Mr Lee's cousin, Mr Sang, a resident of Luxembourg.

Luxembourg Investor Acquiring Shares in Australia

Mr Sang is the director of a company that specialises in investing in mining companies around the world.

Mr Sang is examining the question of whether he should establish an entity either in Hong Kong or Singapore to acquire the Australian mining company shares.

Mr Lee suggests that the subsidiary be established in Hong Kong.

However Mr Sang favours Singapore for a number of reasons – including the existence of a DTA between Australia and Singapore.

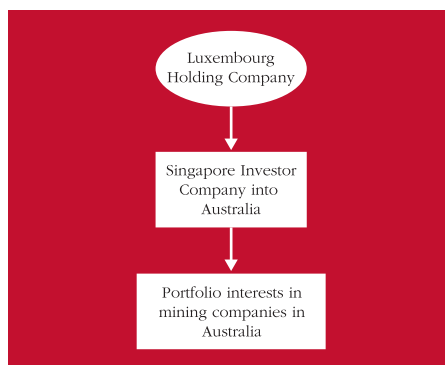
An advantage of utilizing Singapore to establish his company is that as unfranked dividends will predominantly be paid to SingCo they will be subject to a maximum rate of withholding tax of only 15 per cent.

If the dividend was paid directly to Hong Kong Co or Luxembourg Co the withholding tax rate would be 30 per cent under Australia's domestic tax law.

Mr Sang was concerned about Australia's general anti-avoidance provision Part IVA of the 1936 Act.

However Mr Sang was advised by Senior Counsel in Australia that S 177CA of the 1936 Act deems a tax benefit to arise under the anti-avoidance provisions of Part IVA of the 1936 Act if a complete defeasance (but not merely a reduction) of withholding tax is achieved.²¹

The example of this structure would be as follows:



Support for Treaty Shopping Opportunities Internationally

European Developments

European tax law is developing a new legal environment, which will cause a gradual elimination of Member States' national tax sovereignty and will offer taxpayers a serious protection of their individual rights under the jurisdiction of the European Court of Justice ("ECJ")²².

ECJ – Case D (C-376/03)

D-case (c-376/03) has resulted in the taxpayer's protection in the field of direct taxation in respect of cross border transactions being significantly increased.

That case concerned a German taxpayer, holding property in the Netherlands, who sought to avoid the imposition of the Dutch wealth tax.

Dutch law would have allowed Mr D to avoid the tax if he was Belgian (under the tax treaty between the Netherlands and Belgium) – but as Mr D was a German resident, the treaty between the Netherlands and Germany provided no

such relief.

Mr D's tax advisors brought the case before the Dutch court which then referred two major questions to the ECJ for preliminary ruling.

These questions were:

1. Whether the situation in which a domestic taxpayer is entitled to the deduction of a tax allowance from wealth tax liabilities whereas a non-resident taxpayer has no such right is discriminatory in accordance with existing Community law (prohibition of nationality discrimination – Article 56 in conjunction with Article 12 of the European Community Treaty); and
2. If not whether it makes a difference that the Netherlands has granted such entitlement to residents of Belgium in the double taxation agreement (Most Favoured National Treatment);

In the opinion of Advocate General Colomer the answer to the first question was "Yes" and the answer to the second question was "No". The significance of these answers cannot be understated.

In answering "Yes" to the first question, Advocate Colomer stated:

"I propose that the Court of Justice should rule that the free movement of capital within the EU precludes national legislation which, in relation to wealth tax, grants resident taxpayers entitlement to an allowance which it denies to non-resident taxpayers..."(emphasis added).

In answering "No" to the second question, Advocate Colomer stated:

"The fact must not be overlooked that national provisions, which include validly concluded and ratified international treaties, must not infringe the fundamental freedoms of the European legal system. I am aware of the danger, which the foregoing considerations imply for the equilibrium and reciprocity, which prevail in the system of double taxation treaties, but those difficulties must not become obstacles to the establishment of the single market" (emphasis added).

Thus is it clear from Case D that national legislation to prevent treaty shopping must not be viewed as effective in the face of EU law and the “fundamental freedoms of the European legal system”

There is little doubt that tax treaties of Member States are in open conflict with European Community Law.

The primacy of EU law is evident whereas Member State’s sovereignty is relative and depends on recognition.

EU Directives

It is interesting to note that the Directives themselves have no “anti-shopping” provisions.²³

Therefore there is increased scope internationally to continue to exploit differences in the tax regimes of Europe.

The EU Council Directive 2003/49/EC provides for no tax on interest and royalty payments.²⁴

From the perspective of the tax advisor these developments are extremely promising because the EU now includes jurisdictions which are effectively zero-tax jurisdictions.

That means that businesses can operate in and through the EU, using its entire web of tax treaties and Directives, to bring money into the EU on a tax favoured basis; take it out to an EU jurisdiction where there is no tax; and then finally pass it along to an international offshore financial services centre at no cost.

An example of such an international offshore financial services centre is the low tax regime of Cyprus.²⁵

Cyprus has adopted, in its law all the EU Directives²⁶ and it has fully complied with the OECD criteria.

It has provided in its tax system, a tax rate of 10 per cent which is the lowest in Europe.

It has a DTA network with 33 countries and by virtue of its place in the EU it offers via its Cyprus Holding Company the following:

- The ability to extract dividends at low or zero tax;
- The ability to receive dividends at low or zero tax; and
- The ability to dispose of international holdings without any capital gains tax;

The door to the EU therefore appears wide open.

From a taxpayer perspective the most encouraging aspect of the new landscape is that the European Commission is prepared to accept “low-tax offshore centres”.²⁷

The key feature which distinguishes the Directives from DTA’s is that the Directives have no “limitation of benefits” provisions, so that it makes no difference whether the shareholders of the company which is invoking the Directive are resident in the treaty jurisdiction, or whether a proper amount of tax is paid.

From the perspective of the taxpayer this is a highly important and desirable result.

EU Council Directive 2003/49/EC on interest and royalties provide clear support for the use of conduit companies.²⁸

It is difficult to speculate how long this combination of new EU jurisdictions sporting very interesting and low-tax regimes with the Directives is going to last and whether at some point the EU will introduce limitation of benefit clauses to its Directives.

However as the law stands treaty shopping into and out of the EU is fundamentally easier and more flexible even for residents of countries that have no DTA with EU countries.

For the sake of completeness is it worth mentioning that some countries have tried to have their domestic policies block the implementation of the benefit of the EU Directives.²⁹

How successful these unilateral measures will be remains to be seen. Unlike the Vienna Convention on the law of interpreting treaties – EU directives have force of law.

For example France recently had its “exit tax” struck down by the ECJ.³⁰

Other Country Support for Treaty Shopping

Austria³¹ considers treaty shopping as acceptable under its domestic law. The tax authorities cannot challenge it even if the sole purpose is tax avoidance provided it is lawful.

Netherlands does not support comprehensive anti-treaty shopping provisions as it supports the free flow of capital. The concept of “fraus legis” applies to all Netherlands tax laws.³²

However the tax authorities in the Netherlands refuse to apply this principle when it comes to Netherlands tax treaties.³³

Case Law Example of Treaty Shopping Problems

Perhaps the best known Australian case involving treaty shopping is Lamesa.³⁴

Lamesa’s case³⁵

The Lamesa case concerned the taxation of a non-resident investor on the sale of shares in Australian companies and the interpretation of the Australian/Netherlands DTA³⁶ (“the Dutch DTA”).

The Court in that case was primarily concerned with whether the DTA provided “protection” from Australian tax on the sale of shares.

Lamesa agreed that the profit was included in its assessable income under the 1936 Act. It however sought protection of the profit under the “Business Profit” Article 7 of the Dutch DTA.

“

the door to the EU... appears wide open

”

The Commissioner sought to tax the profit under Article 13 of the Dutch DTA³⁷ but the Commissioner failed in his attempt to do so.³⁸

Interestingly though the Australian Taxation Office did not argue Part IVA.

As noted by Ian Gzell QC³⁸:

"The Commissioner did not rely on Part IVA in Lamesa.

Had he argued that the interposition of the Dutch Company between GELP in the US and ARL in Australia could be ignored under Part IVA... the profits were still beyond Australia's taxing power because of the business profits article in the Australia/US treaty.

Like the Australia/Netherlands treaty the capital gains article in the Australia/US treaty is limited to real property and land rich companies (as it then was!)"(emphasis added)

Clearly then Part IVA would have been an ineffective tool in this situation.

Treaty Override

Following the decision in Lamesa, S 3A of the IAA was introduced in an attempt to ensure that the ATO would not "fail" again in similar circumstances.

There was a delay between the Federal Court decision on 20 August 1997 and the introduction of legislation on 9 December 1999.³⁹

With respect to the ATO it is not certain that a provision of this type would be effective if challenged by a treaty partner for a number of reasons, including:

- Applying this provision to transactions commenced before April 1998 is far too severe;
- The unilateral abrogation of Australia's treaty obligations by amending domestic law is not effective because a change such as the one made actually requires the acceptance of a bilateral agreement between treaty parties;
- There is a lack of certainty arising from leaving the term "alienation or disposition" undefined.

That Australia has "practiced" treaty override is clear.⁴⁰ This may provoke a

number of responses by an affected treaty partner.⁴¹

It is submitted that treaty override is a "clumsy" solution to address a perceived problem which is better dealt with by pressing for renegotiation of the offending article.

Applying Part IVA to "Treaty Shopping"

It is clear that Part IVA of the 1936 Act is able to be used against "treaty shopping" due to the operation of S 4(2) of the IAA.⁴²

Unlike other jurisdictions Australia does not have specific treaty shopping legislation in its domestic law.

Currently – Part IVA of the 1936 Tax Act only operates if there is a "tax benefit" as defined.

A treaty will normally provide a benefit by "excluding" the right of Australia to tax. That was the type of benefit which arose in Lamesa.

It is considered that the benefit available to Lamesa under the Dutch DTA did not amount to an exclusion from assessable income for the purposes of Part IVA of the 1936 Act.⁴³

The profit on sale of the shares was included in Lamesa's assessable income. The effect of the treaty was that Australia's right to tax that assessable income was forgone.

Therefore this point of distinction highlights another opportunity for the treaty shopper to structure their circumstances so that no "tax benefit" can be said to have arisen in Australia.

Part IVA Developments

It is worth noting that the current Part IVA was addressed by the Review of Business Taxation Committee in which recommendations were suggested.⁴⁴

The Federal Government in the second stage response to the Ralph Report⁴⁵ has accepted that the definition of a "tax benefit" should be expanded and that it should include treaty shopping.⁴⁶

Recommendation 6.3⁴⁷ is particularly relevant to the concept of treaty shopping. The commentary to this recommendation in the Ralph Report notes that this revised "tax benefit" definition would apply to treaty shopping by for example the re-routing of royalty payments through a series of countries having tax treaties with Australia so as to minimise a withholding tax liability.

As this would be a "tax benefit" it would be subject to Part IVA⁴⁸ of the 1936 Act.

At present, the Government has not tabled any draft legislation or Bill in regard to the expanded definition of tax benefit so it is difficult to know how it may actually operate in practice.

It has been noted that "significant legislative pressures associated with tax reform have meant that these proposed amendments have not yet been introduced".⁴⁹

The Government has announced via a press release (Treasurer Press Release No 16 of 22 March 2001) that any amendments to Part IVA will have effect from the date of introduction into Parliament of the relevant legislation.

It will be interesting to see what final form the proposed amendments take and how they enhance the application of Part IVA to prevent treaty shopping.

HOW IS TREATY SHOPPING ADDRESSED IN AUSTRALIA'S DTA'S?

Before considering this part of the question it is useful to consider two preliminary matters, namely:

1. The role of Australian courts in interpreting DTA's; and
2. How international models deal with "treaty shopping"

The Role of Courts

While there are specific rules for the interpretation of DTA's, judges draw on their domestic "conditioning" to apply a mindset to the task of interpretation.⁵⁰

In the early days of Australian judicial interpretation a “literal approach” was taken.⁵¹

Australian courts have in recent times moved away from adopting a literal approach to a “purposive approach” to construction.

This is to say that “the construction will be accepted which gives effect to the legislative purpose and emphasis”⁵² of a particular provision of a DTA.

How this is done when a term in a DTA is undefined and applied in a foreign language is vitally important.

I discuss below the Chinese DTA and in particular, the term “principal purpose”.⁵³

As this term is not defined in the Chinese DTA it would be interpreted according to the current Australian judicial approach to interpreting words using their common law meaning in Australia.

However should the term be of significance to an Australian company seeking to obtain benefits in China, there may be two problems, namely:

1. The general interpretation of the term in a foreign language (ie Mandarin); and
2. The unique legal concepts employed in China.⁵⁴

This example highlights an inherent problem that faces taxpayers when considering the impact of relatively new DTA “anti-treaty shopping” provisions.

How International Model Agreements deal with Treaty Shopping

A. The United States Model Income Tax Convention⁵⁵

This convention contains an extensive Limitation on Benefits (“LOB”) Article which will be discussed below.

It is sufficient here to say that during the negotiations between the United States and Australia – Australia accepted by and large the LOB clause (though not identical) of the Convention.⁵⁶

This represented a significant departure from past treaty practices.⁵⁷

At this stage it is also worth noting that only three of Australia’s DTA’s contain LOB provisions but the trend towards including them seems to be gathering momentum.

B. The UN Model Convention⁵⁸

The Convention was written more from the viewpoint of the developing nations than the first world countries. There is thus no LOB Article in this convention.

It is also worth noting that the definition of resident allows for the possibility of a conduit entity being established as a resident of a developing country.

C. The OECD Model Convention⁵⁹

Whilst there is no LOB Article in the model convention, the Commentaries to Article 1 do contain substantial discussion approving the application of provisions in bilateral DTA’s in order to limit the ability of third state residents to obtain DTA benefits.⁶⁰

Australia for its part has in a number of agreements implemented such bilateral provisions.

Australia’s approach

The provisions discussed below are “treaty shopping” provisions mentioned in certain DTA’s that Australia has entered into.⁶¹

The following clauses are designed to limit and counter treaty shopping:

1. The LOB clause;
2. “Beneficial Ownership” limitation in Interest, Dividend & Royalty Articles;
3. Principal purpose “residence clause” as mentioned in the Chinese DTA;
4. Article 16(7) of the US DTA;
5. Article 23(7)(c) of the Vietnamese DTA;

>> 1. Limitation on Benefits

This type of provision is not a usual feature of Australia’s DTA’s. It was insisted upon by the US and a provision of its type also exists in the Russian DTA.

Nonetheless it is a weapon available to Australia to deal with treaty shopping. That it came about as a result of US insistence⁶² is not the presently relevant.

The LOB article in the US DTA is far more extensive than the previous version.

It incorporates many of the features in the 1996 US Model Convention.

Under the new US LOB article there are essentially three tests employed:

- The “qualified persons test” – generally benefits of the DTA are only available to qualified persons;⁶³
- The “active trade or business test”⁶⁴ – if a person is not a “qualified person” that person will nevertheless be entitled to DTA benefits if they are engaged in the conduct of an active trade or business in the country of residence;
- The “competent authority determination”.⁶⁵

By contrast the Russian DTA LOB provision is far more specific and confined in its operation when compared to the US DTA.

Article 23 of the Russian DTA provides that benefits shall not flow to income or profits arising from specific activities where under the law or administrative practices of a contracting state, those income or profits are taxed concessionally and in relation to that treatment the information is dealt with in a manner which is beyond the usual or general protection of information provided for tax purposes.⁶⁶

This has led commentators to speculate whether this relates to some particular suspicion on Australia’s part regarding Australia’s dealing with Russia.⁶⁷ This seems plausible given that there is no such concept covered in other recent protocols such as Canada and the US.

>> 2. “Beneficial Ownership” Limitation

It is worth noting that only the “beneficial owner” is able to benefit from articles in many of Australia’s DTA’s relating to interest, dividends and royalties.

“ limiting the attractiveness of Australia as a place to invest for the 'third country residents' has potential to harm our economic growth ”

Thus a conduit company which is acting as a nominee or in an agent capacity would not receive the benefit of the treaty protection.

This is clear based on the OECD Model Commentary. In fact the 1987 OECD⁶⁸ report stated that a conduit company acting as an administrator for its shareholders with very narrow powers was similar to an agent or a nominee.

Consider the case where third country shareholders form an overseas company in a country with which Australia has a DTA eg Singapore. Often these shareholders will utilize nominee directors with the sole aim being to access Australian sourced dividends or interest and benefit from low rates of withholding tax.

It is submitted that the “beneficial ownership” limitation could be applied to prevent such a company claiming treaty protection for Australian sourced dividends, interest and or royalties.

>> 3. “Principal Purpose” Residence Clause

A very interesting and recent development is Article 4(5) of the Chinese DTA.⁶⁹

This article is clearly aimed at preventing treaty shopping.

Article 4(5) states that:

“If a company has become a resident of a Contracting State for the principal purpose of enjoying benefits under this Agreement, that company shall not be entitled to any of the benefits of Articles 10, 11 and 12”.

As stated above there is no definition of “principal purpose” in the agreement.

Thus the provision appears quite far reaching in its application.

Its effect on “treaty shopping” seems thus to turn on how a particular Contracting

State views the activities of a company attempting to benefit from the treaty.

Let us assume that a Seychelles resident has say, three purposes, in establishing a company in Australia to do business wholly in China. These purposes are as follows:

1. To obtain entry to a growing market place – 30 per cent of the purpose;
2. To diversify business risk away from its reliance on its home market – 34 per cent of the purpose;
3. To obtain a favourable benefit under the China DTA – 36 per cent of the purpose.

On these facts it would seem open for a Chinese court to interpret the third purpose to be a “principal purpose”. That is even though other purposes add to 64 per cent of the total purpose – a 36 per cent purpose may be “principal purpose”.

This opens the possibility for considerable ambiguity affecting genuine business transactions.⁷⁰

>> 4. Article 16(7) of the US DTA

Within the US DTA LOB provision there is a clause that has potentially far reaching effects.

Article 16(7) provides that:

“nothing in this Article shall be construed as restricting, in any manner, the right of a Contracting State to apply any anti-avoidance provisions of its tax law”.

This on its face seems directed at allowing the application of Part IVA of the 1936 Act to apply.

However as S 4(2) of the IAA already does this one consequence of this may be aimed at preserving the application of Part IVA of the 1936 Act and other domestic anti-avoidance rules and negating any argument based on John’s case.⁷¹

Importantly the above article does also seem to allow for the application of any yet to be introduced Australian “anti-avoidance provisions” to operate to strike down DTA benefits.

This has the effect of allowing Australian domestic law application other than that law envisaged in S 4(2) of the IAA.

It remains to be seen if a provision of this nature becomes part of Australia’s new DTA policy.

>> 5. Article 23(7)(c) of the Australia-Vietnam DTA⁷²

This restriction on DTA benefits is significantly narrower than the US DTA but nonetheless is important in its own right.

Article 23(7)(c) states that:

“any scheme entered into by an Australian resident with the purpose of using Vietnam as a conduit for income or as a location of property in order to evade or avoid Australian tax through the exploitation of the Australian foreign tax credit provisions or to confer a benefit on a person who is neither a resident of Australia, nor of Vietnam”.

The above quote merely uses the words “with the purpose” – without additional words such as “dominant” or “principal” or “main”.

This provision is aimed at treaty shoppers and limits the availability of “tax sparing” credits if there was the requisite avoidance purpose.

Therefore if the purpose (even a 0.1 per cent purpose!) of entering the scheme was to confer a benefit on a person who was not an Australian or Vietnamese resident this clause could have application to deny treaty benefits.

CONCLUSION

The Future for “Treaty Shoppers”

Whilst Australia’s DTA policy is far from consistent it is undoubtedly the case that Australia has taken a proactive anti-treaty shopping approach (albeit on a piecemeal basis) in those DTA’s where Treasury has cause for concern.⁷³

Also Australia has submitted when required to ensure that bilateral DTA parties' own policy objectives are met.

From a practitioner's perspective it will be interesting to see the following forces at work:

1. A pro-treaty shopping policy (tacit or express) within EU Directives;
2. Considerable opportunities to "treaty shop" into and out of the EU under Community law;
3. A relaxation of source taxation rules in Australia as they apply to non residents;
4. Proposed changes to Part IVA of the 1936 Act; and
5. The direction in which Australia's treaty policy develops having regard to the LOB type provisions in three of Australia's recent DTAs.

Australia's economic growth depends largely on the flow of investment capital both into and out of Australia.

As such it is submitted that "tax planning" opportunities available in jurisdictions which compete with Australia for investment capital should also be available in Australia.

At a time when Europe is moving to become a very attractive place to invest from a tax perspective – Australia should recognise that investors from countries "outside" those with which it has concluded bilateral tax treaties – have substantial capital which can benefit our economy.

Limiting the attractiveness of Australia as a place to invest for "third country residents" has potential to harm our economic growth.

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(Footnotes)

- 1 No client or their taxation advisor can consider embarking on any form of cross-border transaction without an appreciation of the above questions and a thorough understanding of the "answers" to these questions, or failing there being an answer to some of the questions, the main issues involved.
- 2 Refer to The Abuse Decree and the Circular issued on 31 December 1962 by the Federal Tax Administration.

- 3 Kubala, Krzysztof, "The new playing field: treaty shopping and D-Case" International Tax Planning Association website www.itpa.org.
- 4 At the outset I note that this article will not address the concept of "basket shopping" which focuses on a taxpayer attempting to argue that the taxpayer ought to be covered by one article in a tax treaty eg business profits as compared to another article eg royalties.
- 5 It will discuss the current structure of Part IVA of the 1936 Act and also briefly examine the recommendations of the Ralph Report and the Treasurers' Press Release dated 11 November 1999.
- 6 Vann, Richard "International Master Class Australia's New Treaty Policy: Noise or Music?" Paper Presented at Radisson Plaza Hotel, Sydney, NSW Division 22 July 2003
- 7 Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Sydney on 6 August 1982 and the Protocol Amending the Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Canberra on 27 September 2001.
- 8 Agreement between the Government of Australia and the Government of the Russian Federation for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Canberra on 7 September 2000.
- 9 Agreement between the Government of Australia and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Canberra on 17 November 1988.
- 10 Agreement between the Government of Australia and the Government of the Socialist Republic of Vietnam for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Hanoi on 13 April 1992, as amended by an Exchange of Notes dated 22 November 1996.
- 11 Edwardes-Ker, Michael, "Tax Treaty Interpretation, The International Tax Treaties Service, para 58.02
- 12 In order to ensure that transfer pricing provisions are not contravened.
- 13 Killaly, Jim "Opening Remarks and Double Tax Treaties" Financial Services Conference 2002 Hyatt Regency Sanctuary Cove.
- 14 See comments below as to the likelihood of further amendment to Part IVA of the 1936 Act.
- 15 Australia has signed and accepted the Vienna Convention.
- 16 Rohatgi R, "Basic International Taxation" (UK: Kluwer International, 2001) page 363.
- 17 Committee on Fiscal Affairs: Double Taxation Conventions and the Use of Base and Conduit Companies (OECD 1987).
- 18 Grundy, Milton "The Offshore World and the UK Taxpayer", Journal of the International Tax Planning Association Vol. V No.1 June 2005 page 71.
- 19 That involved some visits to Jersey by him or his representative. The shares in the Jersey resident company were vested in Jersey trustees rather than Mr Lee personally.
- 20 Shaddick, Richard & Edmonds, Gabrielle, "New Developments in Cross Border Anti-Avoidance" Paper presented at the International Tax Seminar, Victorian Division 22 August 2000. Additionally Senior Counsel notes that although changes were recommended to Part IVA and originally envisaged to have a commencement date of 11 November 1999 – the Government subsequently announced via Press Release dated 22 March 2001 that any amendments to Part IVA will take effect from the date of introduction into Parliament of relevant legislation rather than 11 November 1999 as originally intended.
- 21 Kubala, Krzysztof, "The new playing field: treaty shopping and D-Case" International Tax Planning Association website www.itpa.org.
- 22 "The European Commission has no intention of making any proposals on the corporate tax rate, because EU governments have the right to tax companies at any rate they choose. Any suggestion that there was going to be uniformity is a load of hot air". Gray, Stephen "Low Tax Jurisdictions in Europe: An Update" Journal of International Tax Planning Association Vol V No 1 page 43.
- 23 See para 4 which states – "The abolition of taxation on interest and royalty payments in the Member State where they arise, whether collected by deduction at source or by assessment is the most appropriate means of eliminating (double taxation and administrative formalities) and of ensuring equality of tax treatment as between national and cross border transactions; it is particularly necessary to abolish such taxes in respect of such payments made between associated companies of different Member States as well as between permanent establishments of such companies"
- 24 Economides, Peter "Cyprus: The New Regime" Journal of International Tax Planning Association Vol V No 1 p25.
- 25 The main EU directives being the Mutual Assistance Directive (which provides for exchange of information), the Merger Directive, the Parent-Subsidiary Directive, the Interest & Royalties Directive and the Savings Directive.
- 26 Estonia is another new EU member and it has a very flexible tax regime. There is no corporate tax due until the Estonian company makes what is known as a "distribution" to its shareholders. There is no local income taxation on retained profits. Interest paid out of an Estonian company is not considered a distribution to a shareholder. So a parent lender can strip all the money out of its Estonian subsidiary simply by way of a loan. Estonia has no withholding tax on interest or dividends paid to a non-resident and no withholding tax on royalties paid to an EU resident.
- 27 See in Article 1(1) which states that – "Interest or royalty arising in a Member State shall be exempt from any taxes imposed on those payments in that State whether by deduction at source or by assessment provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State" Further it mentions in Article 1(4) that – "A company of a Member State shall be treated as the beneficial owner of interest and royalties only if it receives that payment for its own benefit and not as an intermediary and such as an agent, trustee or authorised signatory". This is a relatively easy test to satisfy.
- 28 These countries include Austria, France, Germany, Gibraltar, Ireland, Italy & Spain.
- 29 See Judgment of the Court on 11 March 2004 – Hughes de Lasteyrie du Saillant v Ministere de l'Economie. Des Finance et de l'Industries Case C – 9/02
- 30 Rohatgi R, "Basic International Taxation" (UK: Kluwer International, 2001) page 368
- 31 Essentially this is a domestic anti avoidance law when a transaction does not have a relevant business purpose.
- 32 Gzell, Ian "Treaty Shopping" Australian Tax Review Volume 27 June 1998 page 75.
- 33 FCT v Lamesa Holdings BV (1997) 36 ATR 589.
- 34 Essentially the facts of the case were that a limited partnership formed in the United States acquired Lamesa a company incorporated in the Netherlands. Lamesa acquired an Australian company, Australian Resources Limited ("ARL") and it acquired another company Australian Resources Mining Pty Limited ("ARM"). ARM made a successful on market takeover of Arimco NL ("Arimco") which had as one of its wholly-owned a company which held gold mining leases Arimco Mining Pty Limited ("Arimco Mining"). In November 1993, within 2 years of the takeover, the group was reflagged by ARL issuing new capital which was quoted on the stock exchange. Lamesa made a profit in excess of A\$ 200 million by selling out of its stake in ARL.
- 35 Agreement between Australia and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income signed at Canberra on 17th of March 1976.
- 36 This article is an exception to the general business profits article. Article 13(1) states that "Income from the alienation of real property may be taxed in the State in which that property is situated". The Commissioner argued that indirect rights to exploit or explore natural resources fell within the capital gains article. The Commissioner further submitted that a controlling shareholder's interest (as Lamesa's was) was

- a "comparable interest in a company" under Article 13(2)(iii). This "in substance" approach was rejected by the Full Court.
- 37 This is despite the fact that Evidence was provided in that case by an expert witness that the only obvious reason why the transaction was structured in such a manner was to obtain treaty benefits.
- 38 Gzell, Ian "Treaty Shopping" Australian Tax Review Volume 27 June 1998 page 65.
- 39 The Seventh Report of 2000, Senate Standing Committee for the Scrutiny of Bills, 7 June 2000 disclosed that the Commissioner had written to those treaty partners on 28 April 1998 but their response is unknown. This one can assume was the reason for the delay in introducing S 3A.
- 40 See the definition of "treaty override in the OECD Treaty Override Report (1989) ie "a situation where he domestic legislation of a State overrules treaty provisions either of a single treaty or all treaties hitherto having had effect in that State"
- 41 This may lead to a Treaty Partner to undertake the following courses of action (i) Make an official protest by invoking mutual agreement procedures (under OECD MC Article 25) or (ii) Retaliate with a similar domestic override; or (iii) appeal to the International Court of Justice as provided for in VCLT Article 66; or (iv) Terminate or suspend the treaty as a material breach under customary international law (note there is no right to sue) This last point would potentially have an adverse impact on Australia and her citizens depending upon investment flows.
- 42 Section 4(2) of the IAA provides that "The provisions of this Act have effect notwithstanding anything inconsistent with those provisions contained in the Assessment Act (other than s 160AO or Part IVA of that Act) or in an Act imposing Australian tax". It is also noted the new US DTA provides for other anti-avoidance legislation to be used by Australia and the United States.
- 43 Gzell, Ian "Treaty Shopping" Australian Tax Review Volume 27 June 1998 page 72.
- 44 Essentially these are contained in Recommendation 6.3 which suggested the expansion of the definition of "tax benefit" to cover any reduction or deferral of tax payable, including through tax rebates and credits or losses, Recommendation 6.4, the operation of the existing reasonable hypothesis test is to be improved by ensuring the counterfactual to a tax avoidance scheme reflects the commercial substance of the arrangement and Recommendation 6.5, the Commissioner should be given a new power to issue a single determination in respect of a scheme where more than one person can obtain a tax benefit through participation in the scheme.
- 45 "A Tax System Redesigned" Report of the Review of Business Taxation chaired by John Ralph, 30 July 1999.
- 46 The new measure is said to apply to schemes entered into or carried out after 1.00pm on 11 November 1999.
- 47 "A Tax System Redesigned" Report of the Review of Business Taxation chaired by John Ralph, 30 July 1999.
- 48 Bevan, Christopher "Proposal to Amend Anti-Avoidance Rule: Part IVA" Taxation Specialist Volume 4 No 1 August 2000 page 27.
- 49 D'Ascenzo, Michael "Anti-Avoidance and the Tax Office" page 10 of a paper presented at the National Convention 2001 of the Taxation Institute 22-24 March 2001 at the Sheraton on the Park, Sydney
- 50 Hill, Graham "Role of Courts in Interpreting Double Taxation Agreements" page 5 of a paper presented at the 4th World Tax Conference 2004, Sheraton on the Park, Sydney Australia
- 51 Heward v the King (1905) 3 CLR 117 at 127-8 "the taxpayer has a right to stand upon the literal construction of the words used, whatever might be the consequence".
- 52 Hill, Graham "Role of Courts in Interpreting Double Taxation Agreements" page 7 of a paper presented at the 4th World Tax Conference 2004, Sheraton on the Park, Sydney Australia.
- 53 Article 4(5) of the Chinese DTA.
- 54 "The reality of applying the treaty articles to China's income tax laws leads to quite different tax consequences . These affect both the taxing rights of the countries involved and the overall international position of (the taxpayer)..." Sharkey, N "China's Income Tax Concept of "Enterprise" and the Concept of "Company" – Interaction with the Australia-China Tax Treaty" page 157 Asia-Pacific Tax Bulletin, 2005 International Bureau of Fiscal Documentation, April 2005
- 55 Dated September 20, 1996 contains an extensive provision in relation to the Limitation on Benefits namely Article 22 of the convention.
- 56 Statements made by the U.S. Department of Treasury on the same day that the US/Australia Protocol was ratified are consistent with the new LOB Article being more a product of the United States insistence on standardized LOB language to address general concerns than of specific Australian concerns.
- 57 Vann, Richard "International Masterclass: Australia's New Treaty Policy Noise or Music?" page 11 of a paper presented at the International Masterclass at the Radisson Plaza Hotel, Sydney.
- 58 Articles of the United Nations Model Double Tax Convention Between Developed and Developing Countries (2001) Model
- 59 OECD Model Convention on Income & Capital Update 2000
- 60 See Commentary on Article 1, para 19 and 20): "Except as otherwise provided in this Article, a resident of a Contracting State who derives income from the other Contracting State shall be entitled to all the benefits of this Convention otherwise accorded to residents of a Contracting State only if such resident is a "qualified person"(...)"
- 61 I will not comment on anti-avoidance Articles that are contained in certain interest and royalty articles because these are not strictly speaking "treaty shopping" provisions. For example Article 12 (7) of the Irish Agreement states that (in the context of the Interest Article) "the provisions of this Article shall not apply of the indebtedness in respect of which the interest is paid was created or assigned mainly for the purpose of taking advantage of this Article and not for bona fide commercial reasons". This is an avoidance provision directed at "basket shopping" rather than treaty shopping per se.
- 62 Fulton, John "The Limitation on Benefits Article of the Australia-United States Income Tax Treaty" Australian Tax Forum Volume 18 2003 page 469.
- 63 For example – a resident of Australia or the United States that is a natural person.
- 64 The term trade or business is not specifically defined in the Article 16(3)(a) other than it cannot consist of a business of making or managing investments for the resident's own account. There is a further exception if these activities are banking, insurance or a securities dealer.
- 65 If a person is not otherwise a "qualified person" they will nevertheless be entitled to receive DTA benefits if the competent authority of the source country considers that the principal purpose of the establishment, acquisition or maintenance of such person was to gain treaty benefits.
- 66 The reason for this provision according to the Government is that Australia is concerned that a tax privileged area might be established by its treaty partners which could operate to deny access to information by Australia relating to highly mobile incomes.
- 67 Norman, Peter, "Recent Developments in Australian Tax Treaties", Tax Specialist, Volume 6 No 1, August 2002
- 68 Committee on Fiscal Affairs: Double Tax Conventions and the Use of Base and Conduit Companies.
- 69 Agreement between the Government of Australia and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Canberra on 17 November 1988.
- 70 As stated by Sharkey, N "...treaties based on the OECD Model do not allow for the uniqueness of China's tax laws. This can result in international tax outcomes that are incongruent and belie expectations..." page 157 "China's Income Tax Concept of "Enterprise" and the Concept of "Company" – Interaction with the Australia-China Tax Treaty" Asia-Pacific Tax Bulletin, 2005 International Bureau of Fiscal Documentation, April 2005
- 71 John v FCT (1989) 20 ATR 1, para 39 which stated that where there is specific statutory provision on a topic there is no room for implication of any further matter on that same topic.
- 72 Agreement between the Government of Australia and the Government of the Socialist Republic of Vietnam for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Hanoi on 13 April 1992, as amended by an Exchange of Notes dated 22 November 1996.
- 73 See the Press Release from the office of The Hon Peter Costello MP, Treasurer of the Commonwealth of Australia, dated 16 January 2004 "In the case of the Australia-Russia treaty, Australian revenue will be protected under treaty from inappropriate claims for treaty benefits under Article 23 (Limitation of Benefits)".