Double Taxation Conventions and the Use of Base Companies

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I. THE PROBLEM STATED

A. *Base companies*

1. For a number of years taxpayers have made increasing use of so-called "base companies". Such companies, which are predominantly situated in low tax countries, are used for the purposes of sheltering income there and thus reducing taxes in the home country of the taxpayer. This report examines how these tax advantages operate, the measures taken by various countries to combat such devices and safeguard the equity and neutrality of their tax systems and the international implications of these measures, especially with reference to double taxation conventions. It is clear that the problem of "base companies" should be seen against the background of the overall tax system in the country concerned. Thus, as discussed in paragraph 13 et seq. of the Introduction to this volume, the concept of neutrality may have a different meaning when applied to income in respect of which the country of residence operates a credit mechanism than when applied to income in respect of which an exemption mechanism is operated by the residence country.

2. Possibilities for international tax avoidance may be opened up by certain features of domestic tax laws. Double taxation conventions – the positive aspects of which are recognised – may, as a side effect, increase these possibilities. The same tax effects may, under certain circumstances, be the result of features in domestic laws, while, under other circumstances, they will result from tax treaties. Similarly, counteracting measures may be taken either under domestic law or under a tax treaty.

B. *Relevant considerations*

3. With regard to the frame of reference of this report three points should be kept in mind.

1. Relationship to other issues

4. The main issue dealt with in this report is the compatibility of domestic anti-abuse measures with, and their consequences for, the existing system of international tax relations. The OECD Model Convention which sets internationally-accepted standards in this field is used as a yard-stick. The report should also be considered in connection with the general framework of OECD activities on the improper use of tax treaties and in particular the work on "conduit" companies, which constitutes the next report in this volume. The "conduit company" concept is focused on tax advantages to be secured in the country of source of the sheltered income, whereas the "base company" is concerned with minimisation of tax in the country of residence of its controllers. Often the same corporate structure is designed to achieve both of

these results and in those cases the problems can be regarded as different sides of the same coin.

5. The subject of this report is also related to the problem of international tax avoidance and evasion through the use of tax havens, a matter dealt with separately in the previous report in this volume. The emphasis of the present report, however, is on the implications for double taxation conventions.

2. *Economic aspects*

6. This report does not deal with the economic merits or demerits of base companies. Although there may be in some cases valid economic reasons or personal motives for making use of base companies, in practice, they are often used primarily for the purpose of reducing taxes chargeable to the person using the device. There are even instances where the wish to facilitate or to veil criminal activities is one of the motives behind the tax-saving arrangement. Whatever the main motive, where a tax advantage is obtained by using base companies the question arises whether, and to what extent, that advantage should be eliminated to ensure equity and neutrality of taxation in a country whose taxpayers make use of such companies.

3. *Territorial aspects ("tax havens")*

7. As noted above, the concept of base companies is often related to so-called "tax-haven countries". Even though a territorial clustering of base companies in such countries evidently occurs, base companies may also be found in so-called high-tax countries, either because the taxation there is acceptable for the taxpayers concerned due to the respective effective rates of tax in the country of the base company and in the country of their residence, or to advantages taken of special regimes or to the unintended consequences of domestic tax laws. This point is illustrated by the use of so-called "stepping-stone strategies", where income is sheltered in a low tax country and then channelled through a high-tax country to its final destination, the real origin of the income being concealed from the tax authorities of the latter.

C. *Terminology*

8. Terms such as "base company", "passive income" and "low taxation" are used throughout this report and typically encountered in discussions on this topic. However, no definitions of these terms are put forward in the report because they are flexible and relative notions depending upon the facts of particular cases and the policy attitudes in the taxing jurisdiction. The schematic presentation of typical situations given in Annex I and the description of legislation in six countries and the examples in the text should

be sufficient to provide an understanding of the concepts involved. The following abbreviations are used in this report:

Country of	Referred to as:	Abbreviation
Residence of a base company's shareholder	Residence country	R
Residence of the base company itself	Base country	B
Source of the base company's income	Source country	S

II. ANALYSIS OF FUNCTIONS AND USES OF A "BASE COMPANY"

A. *Sheltering of income*

9. For tax purposes, the most important function of a base company is to collect income which otherwise would flow directly to the taxpayer. The taxpayer, therefore, does not normally become liable to tax on the income received by the base company, though economically he is entitled to such income and may well be able to direct its disposition. Thus, in the absence of counteracting measures, the base company would be able to shelter in a low tax jurisdiction such income from taxation in the taxpayer's residence country.

1. *Primary sheltering*

10. Initially, the income is sheltered from taxation in the taxpayer's country of residence by the mere fact that the base company is an entity of its own and is recognised as such in the residence country. By shifting the respective income from the taxpayer to the base company it is no longer covered by the normal taxation of world income to which the taxpayer is subject in most countries. This advantage is not offset by taxation in the country of the base company, since by carefully choosing the place of incorporation and arranging the affairs of the base company, the latter is subject to no tax or a very modest tax there. It is true that income may be taxed in the country of source (which may well be the same as the taxpayer's country of residence) under a "limited tax liability" criterion. But for a number of reasons this taxation is often non-existent or very low with respect to the type of income which is selected by taxpayers for sheltering in base companies as noted in the next report in this volume "on conduit" companies. Important net savings of taxes may accordingly result.

11. The tax advantage exists only as long as the sheltered income is not distributed. Taxpayers, therefore, often claim that this is merely a tax deferral. As the taxpayer may avoid such distributions by deferring them indefinitely

and as strategies against their taxation can often be successfully deployed (*cf.* paragraph 12 below), the tax advantage may, in practice, be frequently equivalent to a permanent one.

2. *Secondary sheltering*

12. When income sheltered in a base company is distributed or otherwise transferred to the taxpayer it becomes taxable, usually as a dividend. Thus, the initial tax advantage of the sheltering would normally be eliminated. However, this taxation which offsets the original tax advantage may also be avoided or reduced by "secondary sheltering". The main strategies are:

- Distribution as income of a type which is tax-exempt, the exemption being granted under tax treaties or specific domestic rules (director fees, salaries, dividends distributed by a subsidiary to its parent where an affiliation exemption applies in the latter's country);
- Reinvestment abroad of income sheltered in the base company or ploughing back as a loan to the shareholder company;
- Alienation of the capital holding in the base company, with the shareholder thereby realising a gain which is tax exempt or taxable at reduced tax rates.

Secondary sheltering is dealt with specifically in Part VI of this report.

B. Types of base companies

13. Base companies may be classified under different criteria. The following represents one possible classification.

1. *Asset administration*

14. This is the most common type of base company: the taxpayer transfers an income-generating assets to the company, thus sheltering from tax in the country of residence the income arising from those assets.

Example 1:

T, resident in country R, owns shares and debentures which he transfers to a base company in country B. The base company uses the sheltered income to buy other assets of the same kind.

Example 2:

T has developed a new product. It is patented in favour of a base company in country B which gives licences to third parties in countries S1, S2, S3 and shelters the income arising from them (or lends it to T against the payment of interest which is deducted from T's taxable profits).

2. *Financial pivots*

15. Some base companies are used to form financial pivots for broad international activities. This usually concerns holding companies, *e.g.* the regional centres for multinational enterprises, and companies formed to issue loans or to centralise similar activities. Companies of this kind may also centralise banking or insurance activities and it may then be doubtful whether one can still regard them as "base companies" receiving passive income.

Example 3:

A multinational enterprise based in country R holds its participation in South America through a holding company set up in country B which is also the pivot for the whole intra-group financial relationships with respect to the area. A second base company in the Bahamas issues international loans and pays interest on them free of withholding tax.

Example 4:

A multinational enterprise centralises its insurance contracts in an "off-shore" captive corporation, which insures the risks within the group and covers them by reinsurance contracts.

3. *Operational base companies*

16. Base companies of this kind are used in connection with business or professional activities some of which are carried on outside the country where they have been set up. Thus, the base company "feeds" on the profits derived from these activities exercised elsewhere, so that the income derived can at least partly be sheltered in the base company.

Example 5:

T carries on an enterprise producing cars in country R and selling them in countries S1, S2, S3. The cars are sold to wholesalers in these countries or in others via a base company set up in country B which acts as a sales company and shelters part of the income.

Example 6:

An artiste acts as an employee of a base company owned by himself ("rent-a-star"). The base company thus "feeds" on his professional income (the artiste receives only a relatively small salary) and shelters it.

Where operational base companies are used, the consequences of the avoidance devices are frequently aggravated by the manipulation of transfer prices.

4. *Other types of base companies*

17. Other types of base companies may be used for the purpose of channelling income only, for hiding activities or for other purposes (*cf.* for example the following report on the use of conduit companies).

III. COUNTERACTING MEASURES IN NATIONAL TAX LAWS

Preliminary remarks

18. There are two different approaches that national tax laws may take with respect to base companies. Adequate taxation may be sought:

- In the context of taxation of world-wide income in the State where the taxpayer is resident ("taxation from the top"), or;
- In the context of territorial taxation in the country of origin of the base company's income ("taxation from below"),

Annex I gives a schematic presentation of the situation.

19. It has often been claimed that "taxation from below" is the appropriate response to the base company problem. Experience of the major States concerned has shown, however, that while adequate "taxation from below" is indispensable, legislative measures "from the top" are also necessary. This report deals only with the "measures from the top" of the taxpayer's country of residence. The problems of "taxation from below" are dealt with in the following report on conduit companies.

A. *General surveillance measures*

20. Under this heading two main groups of rules may be mentioned.

a) Transfer pricing

Transfer pricing is the subject of special provisions in most domestic tax laws. It is also covered by Article 9 of the OECD Model, and thoroughly treated in the 1979 and 1984 OECD reports on the topic. Transfer pricing rules are necessary to prevent income from being shifted artificially to base companies, especially in the case of operational companies. However, the arm's-length rules may not always be sufficient to prevent income shifting, as for instance, in the case of asset administration. Furthermore, problems which are difficult to solve may arise where the activities of the base company cannot clearly be ascertained or evaluated. This may be because there is a complex and intricate relationship between that company and an enterprise of the taxpayer or because the company is allegedly carrying on a real economic activity which it cannot effectively sustain given the

limited scope of its actual activities or resources (*cf.* paragraphs 47-49 and 92-98 of the preceding report on tax havens);

b) Special procedural rules

Tax laws may impose special information requirements on taxpayers operating in foreign countries. More far-reaching requirements may be applied to taxpayers relationships with companies having the characteristics of a base company. In some States the burden of proof is shifted to the taxpayer in such cases (see paragraphs 86-91 of the preceding report on tax havens).

B. "Substance-over-form" provisions

21. Substance-over-form provisions and courts' attitudes to them are discussed in paragraphs 52-54 and 81-85 of the preceding report on tax havens. In the context of this report it is noted that they are generally – but not exclusively – applied in the context of "taxation from the top" and reflect one of the following approaches:

a) The legal personality of the base company may be disregarded;

b) The base company may be regarded as a resident in the taxpayer's country, *e.g.* because its place of effective or central management is situated there;

c) The base company may be deemed to have a permanent establishment in the taxpayer's country of residence, *e.g.* because it has a place of management there;

d) The sheltering of the income may be disregarded, *i.e.* the activity of the base company or the income derived from it may be regarded as an activity or as income of the taxpayer himself.

22. These approaches presuppose that the economic reality of the base company and its economic motives can be fully evaluated. In the view of some countries this is very difficult, especially in the absence of any exchange of information with the country where the base company is situated. Other countries, however, (e.g, the Netherlands) which have quite general legal provisions and/or case law which permit the application of substance over form, are of the opinion that they are able to effectively combat tax avoidance through base companies. Even in cases where there is no exchange of information with the base country, it may be possible for the tax authorities of the residence country to determine the reality of the base company's operations when, under the residence country's rules, the taxpayer has the burden of proving that the base company carries on real economic activities. One advantage of this approach may be that overreaction can be better

avoided by applying substance over form on a case by case basis than by introducing generally-applicable and complicated counteracting measures.

C. *Subpart-F type counteracting legislation*

1. *General*

23. As outlined in paragraphs 62-64 of the report on tax havens, several countries have adopted specific legislation against the sheltering of income in low-taxed base companies situated abroad. Such legislation provides that, under certain conditions, a resident shareholder (*e.g.* a parent company) may be taxed on the profits of a foreign-controlled company which are not distributed to the shareholder (the term "subpart-F type" defence legislation, as used in this report, refers to provisions of that type). Such legislation is not normally applicable where base companies are made use of for non-tax reasons, *i.e.* where their use is fully justified on purely economic grounds.

2. *Taxation of sheltered income in the hands of the resident taxpayer*

24. Counteracting legislation provides for the taxation of the resident shareholder on the income sheltered in the base company which he controls. The base company itself seems in no case to be subjected to tax or obligations connected therewith. The shareholder's taxation rests on the assumption that the sheltered income is deemed:

- *i)* To be distributed ("fictive dividend" approach); or
- *ii)* To have arisen in the hands of the shareholder, *i.e.* that the company's activities are to be attributed to him ("piercing the veil" approach); or
- *iii)* To have improved the ability of the shareholder to pay taxes because economically it is at his disposal, thus constituting a capital yield of a special nature.

In practice counteracting legislation seems to have proceeded in a pragmatic way rather than by following rigidly any one of these theoretical approaches.

3. *Relevant technical aspects*

25. Only a few characteristics of the extremely technical provisions can be mentioned here:

- *i)* Generally counteracting legislation aims at a level of taxation which is no more burdensome than if the sheltered income had arisen directly to the taxable shareholder;
- *ii)* Specific problems arise with respect to dividends distributed by the base company to its shareholders; in these cases counteracting

legislation prevents an internal double taxation (namely as income sheltered and as a dividend);

iii) Taxes levied on the sheltered income, whether in the country of source or in the country of the base company, are usually credited;

iv) All such legislation aims at covering base companies held indirectly (*e.g.* through a chain of base companies), though these often highly-technical provisions have to vary widely between countries;

v) Further problems concern the treatment of pure holding companies, and of companies with both active and passive income.

4. *International implications*

26. States with a counteracting legislation evidently regard the effects of base companies as unbalancing the equity and neutrality of their tax systems. Tax advantages obtained through such companies seem improper to them, even if they are used for valid reasons or understandable motives. Opinions about what is improper or not may differ. Counteracting measures nevertheless have to respect the general principles underlying the OECD Model Convention, as discussed further in paragraphs 47 and 48.

IV. IMPLICATIONS OF A CONVENTION BETWEEN THE STATE OF THE TAXPAYER AND THE STATE OF THE BASE COMPANY

A. *Treaty implications of general surveillance measures*

1. *Transfer pricing*

27. Article 9 of the OECD Model Convention applies to relationships between the taxpayer and the base company. Therefore, transfer prices which differ from those which would be agreed upon between unrelated parties may be adjusted under that provision.

28. The considerations to be taken into account in this examination do not differ basically from those to be taken into account in other cases, so that the principles set out in the 1979 OECD report "Transfer Pricing and Multinational Enterprises" are valid in these cases. The actual economic function of the base company has to be carefully analysed (paragraph 17 of the 1979 report). The mere fact that the base company is able to shelter its profits under a low tax systems would, in any case, not lead independent parties to concede price advantages to it. Thus, its actual activities, risks and responsibilities have to be ascertained. Where the base company has no economic functions of its own but serves exclusively to channel assets to, or income through, a low tax

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area, it would normally not be able to realise profits in acting between independent parties and this would be the guideline in examining its transfer prices. No, or only a minimal, profit might thus be expected to arise to a base company in a low-tax country formally acting as a seller of merchandise produced by the taxpayer to customers outside that country, if the company actually does not carry out the delivery or other substantial commercial activities (paragraph 59 of the 1979 report). A base company with limited functions, responsibilities or risks corresponding to that of a broker, standby or subcontractor could, if acting between independent parties, obtain a profit only for its actual economic contribution and its transfer prices would normally be examined on a cost-oriented basis (*e.g.* based on a fee or on the cost-plus method). This basis would normally apply where mere marginal or auxiliary activities are exercised by the base company; where such arrangements do not correspond to normal business practice, no additional profit could be attributed to the base company by reference to what, under normal circumstances, would be the exercise of sound commercial judgement, or by reference to a specific allocation mechanism, *e.g.* the centering of cost-sharing arrangements in the base company.

2. *Special procedural rules*

29. The question arises whether special procedural rules are consistent with Article 9 (Associated enterprises) and Article 24 (Non-discrimination) of the OECD Model Convention:

a) **Procedural rules and transfer pricing**

30. As noted in paragraph 25 of the 1979 OECD report, transactions between related parties should be supported by relevant documentation. It is clear from the report that this applies in a specific way to arrangements aiming at minimising taxes in low tax areas. In this context it may be asked whether the reversal of the burden of proof or presumptions of any kind which are sometimes to be found in the context of national laws on base companies are contrary to the arm's-length principle. These questions are not confined to base company situations, and have to be considered in a wider context. It should be noted, however, that a number of countries interpret Article 9 in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of that Article and that it has the function of raising the arm's-length principle at treaty level, thus enabling the Contracting States to deal with it under mutual agreement procedures and to give rise to corresponding adjustments. This is a topic dealt with in the 1984 OECD report on transfer pricing (see bibliography to this volume) and which might be reconsidered again by the Committee on Fiscal Affairs at some later date.

b) Procedural rules and non-discrimination

31. Even if the country of residence of the taxpayer imposes information requirements on him in respect of his relationship with the base company which are more stringent than the normal requirements, or even if the burden of proof is reversed in this respect, member countries, subject to one dissenting view, consider that there is no discrimination within the meaning of Article 24 of the OECD Model. First of all, the different treatment is not based on nationality (*cf.* paragraphs 1 and 3 of Article 24). Secondly, the different treatment does not depend on whether or not the taxpayer is controlled by a non-resident (*cf.* paragraphs 4 to 6 of Article 24). In addition the circumstances under which the information requirements are imposed are not "the same" within the meaning of Article 24, because it follows from the very nature of foreign relationships which cannot be explored effectively by the national tax authorities that information requirements have to be more burdensome than for the purely domestic context. However, if applied indiscriminately to all situations (including non-tax havens), these requirements could constitute an obstacle to international investment.

3. Conclusions

32. It appears then that general surveillance measures are not curtailed by a tax treaty between the country of residence of the taxpayer and the country of the base company. The internationally agreed principles of the 1979 OECD report on "Transfer Pricing and Multinational Enterprises" provide valid guidelines for an effective application of the arm's-length principle in the case of base companies. In any future revision of the OECD Model Convention this aspect might however be stressed in the Commentaries on Article 9.

33. On the other hand, general surveillance measures may lead to differences in applying the Convention. Any such difficulties should be solved in accordance with the mutual agreement procedure as set out in Article 25 of the Model Convention.

B. Treaty implications of "substance-over-form" provisions

1. The concept of person

34. Normally the base company will be regarded as a person (*cf.* Article 3 of the OECD Model) if it has been set up according to the laws of a given country. There may be specific situations in which a base company has to be treated as non-existent, *e.g.* because:

- The treaty exceptionally does not treat it as a company; or
- It has to be denied legal personality under the rules of international private law; or

– The act of setting-up the base company is invalidated in itself under the laws of the country where it is established.

Leaving aside these very special situations, the base company cannot be treated as non-existent under the Convention. The question however arises of whether or not the company is a resident of the low-tax country where it has been set up.

2. *Definition of residence*

35. For treaty purposes a company is a resident of the Contracting State in which its place of effective management is found, and this is so irrespective of where its place of incorporation is situated (*cf.* paragraphs 1 and 3 of Article 4 of the OECD Model). The country of residence of the taxpayer could therefore tax the income of the base company if the place of effective management were situated there. This will sometimes be the case in practice. On the other hand, deeming under national law that the place of effective management is situated in the taxpayer's country would not overrule the provisions of the Convention.

36. Article 4, paragraph 1, second sentence of the OECD Model, excludes from the term "resident of a Contracting State" any person who is "liable to tax in a Contracting State in respect only of income from sources in that State or capital situated therein". This exclusion relates clearly to specific privileges granted by reason of the international relations of a person and gives such a person in effect the status of a non-resident rather than that of a resident. The Commentaries on the OECD Model give as an example the case of certain diplomatic personnel. The exclusion would, nevertheless, apply according to its wording and spirit where, for example, foreign-held companies are exempted from tax on their foreign income by privileges tailored to attract base companies. There are, however, difficulties inherent in this approach which are discussed in paragraph 14 of the following report on conduit companies.

3. *Permanent establishment of the base company*

37. While the place of effective management is normally situated in the country where the base company has been set up, it could be questioned whether or not a permanent establishment of the base company is situated in the taxpayer's country of residence, thus enabling that country to tax the income attributable to the permanent establishment, for example, because it has a place of management there [*cf.* Article 5, paragraph 2 *a)* of the OECD Model]. This is a question of fact but it also involves difficult problems of interpreting these provisions. Here again, the use of a deeming provision under the national law of that country would not suffice if there is no factual

basis for recognising a permanent establishment. Even if a permanent establishment in the form of a place of management were present, it has to be kept in mind that the tax regime of a permanent establishment differs to a large extent from that of a company having its place of effective management in the country. Only profits attributable to the permanent establishment are taxed. Sometimes, there are different tax rates, taxation of distribution is differently effected, etc.

4. *Attribution of activities and/or income*

38. While recognising that the base company as a legal entity has its place of effective management in the country where it has been set up and does not have a permanent establishment in the country of residence of the taxpayer, the latter country could at least, under its national tax law, attribute to the taxpayers the activities and/or the income of the base company. This approach would clearly not be contrary to the OECD Model if the base company acted as a mere intermediary, an agent, a fiduciary or nominee of the taxpayer (*cf.* for example, the notion of beneficial owner in Articles 10 to 12 of the OECD Model). However the question arises as to whether, quite generally, domestic rules as to who is regarded as the recipient of specific income for tax purposes are compatible with treaties. This question especially arises in the case of "anti-abuse" or "substance-over-form" rules according to which it is not the base company itself but its shareholder, who is regarded as the true recipient of the income shifted to the base company.

39. The large majority of OECD member countries consider that rules of this kind are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. These rules are not addressed in tax treaties and are therefore not affected by them. One could invoke the spirit of the Convention, which would be violated only if a company, which is a person within the meaning of the Convention, ended up with no or almost no activity and/or income being attributed to it, and the Contracting States took divergent views on the subject, with economic double taxation resulting therefrom, the same income being taxed twice in the hands of two different taxpayers (*cf.* Article 9, paragraph 2). A dissenting view, on the other hand, holds that such rules are subject to the general provisions of tax treaties against double taxation, especially where the treaty itself contains provisions aimed at counteracting its improper use.

40. It is not easy to reconcile these divergent opinions in theory, nor in mutual agreement procedures on specific cases. The main problem seems to be whether or not general principles such as "substance-over-form" are inherent in treaty provisions, *i.e.* whether they can be applied in any case, or only to the extent they are expressly mentioned in bilateral conventions. On

the dissenting view, to give domestic rules precedence over treaty rules as to whom, for tax purposes, is regarded as the recipient would erode the protection of taxpayers against double taxation (*e.g.* where by applying these rules, base company income is taxed in the country of the shareholders even though there is no permanent establishment of the base company there). However, it is the view of the wide majority that such rules, and the underlying principles, do not have to be confirmed in the text of the convention to be applicable. The problems arising here are very similar to those arising in the case of specific counteracting measures (see paragraph 47 below).

5. *Conclusions*

41. Tax treaties set limitations to technical rules though these limits are not very well defined. Furthermore, there are certain doubts as to their implications for the "substance-over-form" provisions. This adds to the well-known practical difficulties of implementing national provisions of this type. Further clarification therefore seems to be necessary. In any case, where States feel that difficulties might arise in this area, they would try to settle them by inserting specific safeguards in their bilateral treaties.

42. A certain danger remains that technical and "substance-over-form" provisions could lead to double taxation even where a convention exists. Therefore, States applying provisions of this type should endeavour to alleviate any such double taxation in accordance with the letter and if possible with the spirit of their double taxation treaties.

C. *Treaty implications of counteracting measures*

1. *General outline of the problem*

43. Under existing counteracting measures, the country imposes a tax on residents who are shareholders in the foreign base company. The foreign company as such is not taxed; generally the income which gives rise to the taxation does not originate in the country of the base company but in the taxing country itself or in a third country. A tax treaty between the country using the counteracting legislation and the country of the base company usually protects, however, income flows only between these two countries. The first-mentioned country may therefore claim that the tax imposed under the counteracting legislation does not come under the scope of the said tax treaty.

44. This attitude has sometimes been challenged as being contrary to the general structure and the spirit of tax treaties, except where a specific saving clause acknowledges the counteracting measures. It is said that counteracting

measures implicitly disregard the company as a person, which is contrary to the treaty (*cf.* paragraph 34 above).

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45. There seems to be several answers to that contention:

a) On the technical level, counteracting measures can attribute activities – and thus income – to a shareholder, which is not contrary to tax treaties (*cf.* paragraph 40 above). If the counteracting measures have the effect of taxing a deemed dividend of the base company, this is well within the taxing rights conferred on the taxpayer's country of residence under the rules of tax treaties regarding taxation of dividends (*cf.* Articles 10, 23 A and 23 B of the OECD Model);

b) On the tax policy level, counteracting measures pierce only the "umbrella effect" of the taxpayers' arrangements. This effect and the consequent possibilities for an indefinite deferral are not guaranteed by tax treaties which were never intended to prohibit national safeguards for the equity and neutrality of a country's tax law;

c) On the international level, as long as some countries regard it as a sovereign right to shape their fiscal system in a way which might negatively affect other countries, tax authorities in these other countries must safeguard their sovereign right to preserve the equity and neutrality of their tax systems. It has never been intended that tax treaties would replace national sovereign rights with international co-operation to safeguard the integrity of tax systems.

46. It is evident that these are the views of States adopting counteracting measures and a very large majority of OECD member countries have supported them. However, while counteracting measures as described above are not inconsistent with the spirit of tax treaties, there is agreement that member countries should carefully observe the specific obligations clearly evidenced in tax treaties, as long as there is no clear evidence that the treaties are being improperly used. Furthermore, it seems desirable that counteracting measures comply with the spirit of tax treaties with a view to avoiding double taxation. Where the taxpayer complies with such counteracting measures, it might furthermore be adequate to grant him the protection which the treaty network would have provided if the taxpayer had not used the base company.

47. Whilst the majority of OECD member countries thus accepts counteracting measures as a necessary means of maintaining equity and neutrality of national tax laws in an international environment characterised by very different tax burdens, it firmly adds that such measures should be used only for this purpose. It would be contrary to the general principles underlying the OECD Model Convention and to the spirit of tax treaties in general if counteracting measures were to be extended to activities such as production, normal rendering of services or trading of companies engaged in

real industrial or commercial activity, when they are clearly related to the economic environment of the country where they are resident in a situation where these activities are carried out in such a way that no tax avoidance could be suspected. Counteracting measures should not be applied to countries in which taxation is comparable to that of the country of residence of the taxpayer. It is also of relevance that a country's willingness to co-operate effectively with other tax administrations will normally be a strong deterrent to use base companies in that country.

48. However, there is no easy way of drawing clear-cut rules from these guidelines. An international consensus should be established, to which States newly introducing counteracting measures might refer. In this respect, the OECD Committee on Fiscal Affairs has played and could continue to play a role which would be helpful, *vis-à-vis* both member countries which already apply counteracting measures or are considering adopting measures of this kind, and those member countries which view such measures taken in other countries as infringing their own tax sovereignty, or going against their tax policy or being contrary to international commitments. The Committee would accordingly appear to constitute the appropriate forum for discussion of such policy issues.

2. *Paragraph 5 of Article 10 of the OECD Model*

49. It might be argued that where the taxpayer's country of residence, pursuant to its counteracting measures, seeks to tax profits which have not been distributed it is acting contrary to the provisions of paragraph 5 of Article 10. However, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under a counteracting legislation. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.

3. *Treatment of the taxable amount*

50. The appropriate treatment of the taxable amount under a tax convention between the country of the base company and the country of the taxpayer depends on how the relevant counteracting legislation is regarded. If it attributes the activities or the income of the base company to the taxpayer, one has to look to the composition of the income; it may be composed of different items of income (business profits, interest and royalties) derived from the country of the base company or from any other country and the provisions that are relevant for these items have then to be applied. If the taxable amount is, however, a deemed dividend or a particular capital yield, it is clearly derived from the base company thus constituting income from that company's country. Even then, it is by no means clear whether the taxable

amount is to be regarded as a dividend within the meaning of Article 10 of the OECD Model or as other income within the meaning of Article 21 of the OECD Model. At least under some counteracting measures the taxable amount is treated as a dividend with the result that an exemption, provided for by a tax convention, *e.g.* an affiliation exemption, is also extended to it (for instance, in Germany). It is doubtful whether the treaty requires this to be done. If the country of residence considers that this is not the case – and consequently refuses the affiliation exemption for "deemed dividends" – it may face the allegation that it is obstructing the normal operation of the affiliation exemption, by taxing the dividend (in the form of "deemed dividend") in advance.

4. *Treatment of dividend distributions of the base company*

51. Where dividends are actually distributed by the base company the provisions of a bilateral Convention regarding dividends have to be applied in the normal way because there is dividend income within the meaning of the Convention. Thus, the country of the base company may subject the dividend to a withholding tax. The country of residence of the shareholder will apply the normal methods for the elimination of double taxation (*i.e.* tax credit or tax exemption is granted). This implies that the withholding tax on the dividend should be credited in the shareholder's country of residence, even if the distributed profit (the dividend) has been taxed years before under counteracting legislation. However, the obligation to give credit in that case remains doubtful. Generally the dividend as such is exempted from tax (as it was already taxed under the counteracting legislation and one might argue that there is no basis for a tax credit. On the other hand, the purpose of the treaty would be frustrated if the crediting of taxes could be avoided by simply anticipating the dividend taxation under a counteracting legislation. The general principle set out above would suggest that the credit should be granted, though the details may depend on the technicalities of the counteracting measures and the system for crediting foreign taxes against domestic tax, as well as on the particularities of the case (*e.g.* time lapsed since the taxation of the "deemed dividend").

V. IMPLICATIONS OF CONVENTIONS WITH THIRD STATES

52. Base companies often shelter third country income. There exists no apparent tax-relevant relationship between the country of source (S) and the home country (R) of the taxpayer as long as the latter does not take protective measures. Only when that country recoups its taxation in ways described in Chapter III, does its system have an effect on taxation in country S. By doing

so, country R may in specific situations even produce effects of tax significance for other countries (*cf.* subchapter C below). The present chapter deals with the relevance and implications of such relationships for taxation.

A. *Third country income: basic approaches*

53. In the case of third country income, the following problems may arise.

a) In the absence of a treaty between country R and country S, should country R allow a credit for the taxes which are imposed by country S?

b) Where a tax treaty exists between these two countries:

i) Should country S limit its taxation under the treaty provision?

ii) Should country R credit the taxes of country S and, if so, should it credit the full amount or only the amount due under treaty limitations?

iii) Should country R exempt income if the treaty provides for such an exemption in case of direct flows of income from country S?

54. It seems clear that the answer in each case should normally be negative as, from a legal point of view, it is assumed that two separate relationships exist between countries S and B on the one hand, and between countries B and R on the other hand, and the base company's own separate entity prevents any direct tax relationship between country S and country R. The answer would be positive only if a tax-relevant direct relationship existed between those two countries.

55. Whether a tax-relevant relationship exists between country S and country R depends on how the legislative measures in country R are legally construed. Basic situations may be illustrated, by three examples.

Example A:

Country R regards the base company as a resident because, under its domestic law, that company has a place of central management there. Country R thus treats the base company as any other resident. Consistently, the companies' dealings with country S should be treated as any other direct relationship, so that double taxation reliefs available in R domestically or under the treaty between S and R have to be granted. Treaty protection should also be given by country S since it depends (under Article 4 of the OECD Model) only on the law of country R whether the base company is a resident thereof for the purposes of the treaty and falls, consequently, under its personal scope (Article 1 of the OECD Model).

Example B:

Country R regards the base company as a foreign resident. However, it considers, under its national tax law, income sheltered in the base company to be income arising directly to its resident shareholder (*e.g.* by a substance-over-form approach). Again, viewed from country R, there is a direct relationship because one of its residents receives income from country S. Country R will, therefore, grant relief against double taxation which is available domestically or under its treaty with country S. The situation may, however, be viewed quite differently by country S which may maintain that, according to its law, the income was received by the base company and that seizure of that income by country R cannot change this. In fact, if country R allocates, under its domestic law, income to the resident shareholder, it does not, under the OECD Model, automatically follow that the income is covered by the treaty as country S may allocate the income, independently, on the basis of its own domestic law (with the exception mentioned in paragraph 58 below).

Example C:

Country R has a counteracting legislation under which the income of the base company is deemed to be distributed to the shareholder resident in country R at the time when it accrues to that company. From a legal point of view, there then exists no tax-relevant relationship between country S and country R. The base company is recognised by both countries as a resident of country B and as recipient of the income, land this bars any direct relationship between countries S and R. Neither country would, therefore, grant domestic or treaty protection against double taxation.

56. Even though the situation may be very similar in all three cases from an economic point of view, *i.e.* income sheltered in a tax haven has been recouped by country R, the relationship between country R and country S depends on the specific kind of counteracting measures in country R and varies, therefore, from one example to another. It may seem adequate to take into account in some way the taxation in country S and treaty relationships with that country. This is suggested, *inter alia*, by the fact that the tax administration of country R will frequently be dependent, for the implementation of its counteracting measures on co-operation with the tax administration of country S on the basis of the treaty between these countries. This may be a reason why even countries with legislation of the kind referred to in Example C above often on their own account grant their taxpayers the benefits of treaties with source countries, though they would not formally be obliged to do so.

B. *Third country income: conclusions and recommendations*

1. *Credit in the country of residence for foreign taxes paid at source*

57. Tax authorities – and especially, subject to one dissenting view, those of countries which apply "subpart F" type defensive provisions – concur with the view that country R should credit in all cases the taxes of country S where this is provided for generally by its domestic law or by its treaties in case of direct flows of income from country S. This is evidently based less on technical or legal considerations than on the acceptance of a general principle. As set out in paragraphs 46-48 of this report, counteracting measures should comply with the spirit of international tax law by seeking to avoid double taxation. To follow this in the relationship between country R and country S should be generally encouraged.

2. *Limitation of source taxation under double taxation treaties*

58. As a general principle, it cannot be accepted that the source country is obliged to waive or reduce its tax under a treaty with the country of residence. Such an obligation would result clearly from the OECD Model only where the base company is resident in country R by the criteria of Article 4. Whether this is the case will often be difficult to ascertain, and Contracting States will normally need a mutual agreement procedure to make the necessary findings. It would not be acceptable, for instance, that the base company itself asks for some reduction of S's tax under the convention between S and R without showing that it is treated as a resident of country R.

59. In all other cases, the country of source will normally treat the income in question as income of the base company itself. There is, then, no basis in the treaty between country R and country S for the base company to claim a limitation of source taxation. It may, of course, happen that pursuant to country S's domestic law it is possible to allocate income under a "substance-over-form" approach to a person other than the one formally receiving it. Country S, however, may well argue that such approaches are designed to combat the avoidance of taxes of its own country. In the present context, however, treaty application would not serve to counteract tax avoidance in the country of source but to protect country R's revenue or the interests of its taxpayers.

3. *Amount of credit to be granted in the country of residence*

60. It has been argued above that country R should, according to its domestic law, credit the taxes of country S in the same way as it would credit taxes levied at source on direct flows of income (*cf.* paragraph 57); there are even more reasons for doing so where a treaty exists between country S and

country R. It may, however, occur that taxation at source levied by country S is relieved or reduced under such convention in the case of income arising directly to a resident of country R. Would country R then be entitled to deny its credit or limit its amount of tax to treaty levels? The answer, in principle, should be in the negative as the source country is normally not obliged to relieve or reduce its tax (*cf.* paragraph 58 above). Where, in specific cases, country R and country S agree that source taxation on the base company income should be limited under the treaty between them, this would of course affect the credit granted in country R. The tax authorities of country R may also reasonably expect the taxpayer to take advantage of any tax treaty which might exist between country B and country S. In order to find a general guideline and to simplify an already complex situation, it is suggested that residence countries, as a general rule, should give full credit for taxes effectively levied at source.

4. *Application of the exemption method by the country of residence*

61. Country R may, in its treaty with country S, have adopted the exemption method for relieving double taxation. This will not affect passive income like dividends, interest and royalties which normally give rise only to credit for tax at source. However, exemption may be applicable to income arising to the base company from immovable property or permanent establishments in State S, where the treaty between R and S would provide for exemption in the case of similar income derived directly from S by residents of R.

62. It seems clear from the text of the convention that the exemption method has to be applied in the Examples A and B (see paragraph 55 above). In Example C, no such obligation exists but some States seem to be inclined to grant the application of the exemption method for special reasons under their domestic law (*e.g.* because it simplifies matters and prevents more tax being levied in cases of tax avoidance than in other cases). The application of treaties in such cases requires international co-operation in order to prevent the income being exempted twice, but otherwise no general recommendation can be given.

5. *Holding companies*

63. A characteristic situation is the one where a base company receives income from an active subsidiary. This is often the case when base companies are used by internationally-operating enterprises as a regional centre or as a financial pivot.

64. In a situation where a participation in a company of S were held directly by a resident of R, the dividends would mostly be relieved from recurrent corporate taxation by an indirect tax credit, or by an exemption (affiliation

exemption) in country R, either under domestic law or under the treaty with country S. The question whether these reliefs should be granted where a counteracting measure applies has to be answered in principle in the same way as the question whether an exemption under a treaty between countries R and S should be applied for direct income flows originating in S (*cf.* paragraph 62).

C. *Relationships with non-source countries*

1. *Implications of tax conventions on second-tier base companies*

65. Since counteracting measures also include second-tier base companies, situations may arise where two different measures of this kind are imposed simultaneously on the same income. Thus a German parent holding a Bahamas base company (sub-subsidiary) via a Canadian base company (subsidiary) may be taxed on the undistributed income of the Bahamas base company while the same amount may be taxable under the Canadian defence legislation in the Canadian company. Though the second-tier base company (sub-subsidiary) is outside the personal scope of the convention between the country of the parent and the country of the first-tier base company (subsidiary), member countries having adopted subpart F type legislation agree that both the country of the parent and the country of the first-tier subsidiary may apply their counteracting measures in this situation, unless there is a saving clause on this in the convention between the country of the parent and that of the subsidiary.

66. From a legal point of view, situations may, once more, vary according to what kinds of measures are used by both States applying counteracting measures. It may well be that there is a direct tax relationship between them, *e.g.* if both consider the base company as resident. In this case, treaties or domestic laws generally would avoid double taxation. Where no such direct relationship exists (*e.g.* when both countries use the mechanism of Example C), fully-fledged double taxation might result, thus creating an overreaction by measures designed to counter international tax avoidance. While this may not be in conflict with the Model Convention, States in which this problem arises should endeavour, in appropriate circumstances, to solve it either by domestic law or in their treaties. Germany and Canada have resolved it in the Protocol to their tax treaty by inserting the following provision: "... in cases where the same income is subject to the special tax referred to in ... and the special tax referred to in..., the contracting State of which the controlling shareholder is a resident shall give credit for the special tax of the other Contracting State."

2. *Shareholders (of base companies) with double residence*

67. Where the taxpayer who is subject to counteracting measures in country R, (of which he is a resident under that country's domestic laws), is at the same time a resident of X (under the latter's domestic laws), and his personal and economic relations are closer to country X (*cf.* paragraph 2 of Article 4 of the OECD Model), the application of the counteracting legislation may be barred on the grounds that income derived from a third country is taxable only in the country of residence within the meaning of the Convention (*i.e.* country X), unless there is a permanent establishment in the other country (R) with which the participation in the base company is effectively connected. This seems to be justified because the taxable amount, though possibly not considered as income in country X constitutes income within the meaning of the Convention (*cf.* Article 21 and Article 3, paragraph 2, of the OECD Model) and thus has to be treated accordingly. This becomes even more evident if both country R and country X impose counteracting legislation of a "subpart-F" type.

3. *Participation in a base company held in a permanent establishment*

68. Where the participation in the base company is effectively connected with a permanent establishment situated in a third country, a similar question arises if the Convention with that country provides for exemption of the permanent establishment's income (*cf.* Article 23 A of the OECD Model). There can hardly be any doubt that the country of residence has in this case to exempt the income. However, it will be rather exceptional in practice that the participation is in fact effectively connected with the permanent establishment, *i.e.* that the base company has relations exclusively with the permanent establishment and not with the enterprise as a whole.

VI. QUESTIONS OF SECONDARY SHELTERING

69. As indicated in paragraph 12 of this report, when income sheltered in a base company is distributed or otherwise transferred to the taxpayer, it becomes subject to tax, normally as a dividend. Thus, the initial tax advantage of the sheltering would normally be eliminated. However, this taxation which offsets the original tax advantage may also be avoided by "secondary sheltering", the main strategies of which have already been described. In the following paragraphs, the main issues arising in an international context are briefly discussed, with respect to countries who do not have counteracting measures as described in the foregoing chapters.

70. The cases of secondary sheltering may be summarised by saying that income is disposed of by the taxpayer in such a way that it is either:

a) Not taxable under the domestic law of his country of residence, which will be the case, for instance, when it is accumulated and reinvested in the base country or in a third country; or

b) Ploughed back in the taxpayers' enterprise in country R, as a loan giving rise to interest payments which are normally deductible from taxable profits of that enterprise; or

c) Exempted from normal taxation in country R under special rules of domestic law or of a double taxation treaty, the most frequent cases being the following:

i) Base company income is distributed to the parent company resident in country R, where an affiliation exemption applies to relieve recurrent corporate taxation either under domestic rules or under a treaty;

ii) The taxpayer (an individual) receives income from the base company as salaries or directors' fees, which are exempt in R under a treaty; or

d) Enjoying a special tax treatment in country R, *e.g.* where, at the liquidation of the base company, income accumulated there is distributed to the parent-company in country R as profits from liquidation and subject there to a lower rate of tax applicable to capital gains.

1. Reinvestment in a country other than the country of residence

71. In this case, it will be difficult for the country of residence to combat secondary sheltering. Countries wanting to counteract this type of strategy should rather have recourse to counteracting measures described in the foregoing chapters.

2. Reploughing by loans to the shareholder company

72. Though a naive and rather straightforward form of tax avoidance, reploughing by loans is not easy to counter once a tax administration has accepted the use of base companies as a *bona fide* arrangement. The authorities in the country of residence may endeavour to show that the loan operation is an artificial one. They may want to argue that, on the facts, no interest deduction is to be allowed to the taxpayer's enterprise (if any "interest" is paid) because the funds are in reality not those of the base company but belong to the taxpayer. Demonstration of this will be easier if the domestic laws of country R contains "substance-over-form" provisions.

73. However, proving that the loan is effectively a distribution under a substance-over-form standard will often be difficult if the argument is restricted to the "loan arrangement" itself (because the background arrangement has been accepted). Even in the case of a highly artificial arrangement, it will often be difficult to ascertain facts and intentions (such as, when it is part of the arrangement, the lack of intent to repay the "loan"). It may be easier if the "loan arrangement" is regarded as part of a series of interdependent stages in a scheme which, looked at as a whole, can be regarded as a single composite transaction. The loan might be disregarded if the transaction as a whole, or a single part of it, does not meet "substance-over-form" criteria. It is, however, clear that such arguments might imply that not only the "loan" and the secondary sheltering but the use of the base company and the primary sheltering are abusive.

74. United States law contains a provision which includes as income of United States shareholders of base companies certain loans by the base company to United States persons. However, when the income of the base company has already been included in the United States shareholder's income under subpart F, these rules would not operate to impute additional income to the shareholders. No other specific domestic measures are known against reploughing through loans. They would probably have to take into account the whole series of transactions rather than only the "loan". Once more efforts against secondary sheltering would require similar legislation and administrative machinery to those against primary sheltering.

3. *"Repatriation" as dividends or other tax-exempt income*

a) *Repatriation as tax exempt dividends*

75. Where the income sheltered in the base company is "repatriated" as dividends paid to the parent company, such income will frequently be exempted under an affiliation exemption. The country of residence (of the parent company) should examine closely whether the dividends received would unconditionally qualify for the affiliation exemption, if there is no, or very low, corporate taxation in the country of the base company. Clearly, the exemption creates a void in tax terms and, as it were, transfers the low tax level of the tax haven country into the tax system of the country of residence. Countries which wanted to avoid such secondary sheltering have limited their exemptions in their domestic law, or in their treaties, to cases where recurrent corporate taxation really occurs. This may be done, among other things, by:

- Providing for an "activity clause" which prevents dividends from "non-active" companies from being exempted;
- Excluding from the exemption, dividends distributed by companies subject to low taxation;

– Switching from the exemption system to a system of indirect tax credit.

A further solution may be to adopt a more severe "substance-over-form" approach.

76. The measures described above may be difficult to apply and add to the complexity of a country's tax system, as it might be necessary to draw a dividing line between active and passive income and/or to define low taxation. In order to remain flexible, a special regime countering secondary sheltering may have to combine both elements in some way. Similar technical difficulties to those which exist under more comprehensive counteracting measures (especially those of the subpart-F type) would then have to be solved. It may, therefore, be better to adopt counteracting measures described in the foregoing chapters (*i.e.* one already designed to counter primary sheltering) rather than to set up a complicated system for the sole purpose of countering secondary sheltering.

b) Other tax-exempt payments

77. Where there is a convention between the base country and the country of residence and the latter applies the exemption method to avoid double taxation, "repatriation" of sheltered income sometimes takes forms such as wages or directors' fees. In these cases, the authorities of country R may endeavour to show, as the case may be, that such income does not have the character of wages, or of directors' fees, within the meaning of the relevant articles of the convention between country B and country R, (corresponding to Articles 15 and 16 of the OECD Model) but rather constitutes "dividends" or "other income" (under Article 21) thus being fully taxable in the taxpayer's country of residence.

78. For example, if dependent services were not carried out on behalf of the base company but on behalf of the taxpayer himself or of his enterprise, exemption might be denied. Likewise, amounts paid as directors' fees would be treated as dividends insofar as they exceed the amount which would have been paid in the absence of the taxpayer's own interest in the base company. No tax exemption would be due where, according to Article 4 of the 1977 OECD Model, the base company is to be regarded as a resident in country R. The exemption should also be denied if the taxpayer has claimed tax exemption or reduction in the country of the base company by pretending that the payment had not the character of a salary of director's fees. For doing so, the tax authorities of country R may obtain information from the tax authorities of country B (*cf.* Article 26 of the Convention) in order to show that the taxpayer did not exercise in country B, an activity sufficient to justify the payment of

the income; country R may also wish to enter a mutual agreement procedure with country B.

79. There may remain artificial arrangements which cannot be solved in this way. The problem then arises as to whether the exemption can be denied in another way, *e.g.* by showing that the payment is a part of a series of interdependent transactions in a prearranged scheme which, as a whole, has no other purpose than securing a tax advantage.

80. Where it seems necessary, tax treaties should take into account situations of the kind discussed in paragraphs 75 to 79 above. This may best be done by excluding certain companies from their scope or by adopting the credit method for eliminating double taxation, either generally or for certain items of income.

4. *Extraction of income as capital gain*

81. In a number of countries capital gains are subject to lower taxation than ordinary income. There are therefore substantial tax benefits to be obtained by arranging to convert income into a capital gain through a base company. This can be done by accumulating the income, and then extracting it by either disposing of part or all of the holding in the base company or liquidating the company altogether.

82. This is a common tax avoidance route. One area in which it has been exploited is that of collective investment institutions such as offshore mutual funds (referred to in paragraph 108 of the foregoing report on tax havens). A number or countries have specific counteracting measures to ensure that a proper tax charge is levied on the investor's share of the base company's income.

83. In such cases, the country of residence will have to make use of any safeguards, provided under domestic law, for not granting the special tax regime applicable to capital gains where the circumstances in which the company has been liquidated suggest that artificial arrangements have been made for the purpose of enjoying the benefit of the special regime. If no such safeguards exist in its law, country R could introduce provisions under which capital gains from the disposal of a participation in a base company would be taxable as ordinary income.

5. *Final remarks*

84. Amending domestic laws with adequate provisions for dealing with secondary sheltering may be difficult in practice, and the efficacy of such counteracting measures cannot be guaranteed. These considerations may therefore lead the country of residence to consider introducing counteracting

measures as described in the foregoing sections which may be directed both at primary and secondary sheltering.

VII. COMBATING TAX AVOIDANCE AND TAXPAYER PROTECTION

85. When a taxpayer tries to avoid taxation by sheltering income in a base company, he enters a "tax triangle" formed by his home country, the base country (the tax haven) and the country of source. While this may give rise to considerable tax advantages, the taxpayer risks running unexpectedly into tax charges he would not otherwise have borne. Thus, the taxes in the country of source may be unexpectedly high, especially if a treaty between the base country and the country of source cannot be invoked because one or both Contracting States regard its use as improper by reason of the artificiality of the arrangement. It is possible that unexpected changes in taxation procedures and domestic laws of the base country may cause difficulties for the taxpayer. Counteracting measures deployed by the home country may definitely aggravate the situation. It is clear that the taxpayer using a base company has to bear the risks inherent in the situation which he has created.

86. Another danger is that of double taxation (especially economic double taxation). A number of such situations have been described in the foregoing chapters and still others may occur. This results from three risks inherent in the "tax triangle":

- Counteracting measures are by their nature unilateral measures of a State which finds that its tax has been avoided; those countries in the "triangle" whose tax has not been avoided (or avoided in a specific way) and which deploy no such measures, have no reason to recognise them, because to do so might even have undesirable tax effects for them;
- International tax relations are based on the assumption of *bona fide* situations and not adapted to specific measures such as counteracting measures, especially in a triangular situation;
- The tax authorities concerned may be reluctant to rectify a situation created by the taxpayer for his own advantage.

Taxpayers should therefore always be aware of such risks and realise that tax authorities cannot be expected to be as anxious to avoid the consequences of the situation as they might be in normal cases.

87. There is even doubt whether, in the base company situation, double taxation should be avoided in a systematic way. Two lines of thinking have been expressed:

- It is argued, on the one hand, that the taxpayer has to bear the full risks of an arrangement which he has voluntarily entered into with a view to obtaining a tax advantage. Tax authorities could not safeguard him in any way from the unexpected consequences that such arrangements may have. In addition, such protection may not be desirable, as the residual risk of double taxation could act as a certain deterrent against artificial arrangements;
- On the other hand, it is argued that the taxpayer may ask for fair treatment, once tax administrations have successfully deployed their counteracting measures. Letting him incur double taxation in cases where this could be avoided would clearly lead to an additional tax burden which has the character of a penalty. However, this cannot be justified, as penalties would normally be imposed by the domestic laws of the countries concerned and should be under the safeguard of their normal courts.

These diverging views cannot readily be reconciled. They are not based on well-defined legal principles but rather reflect different general attitudes towards tax avoidance. These divergences and the fact that they will often be difficult to reconcile are matters that taxpayers should be aware of.

88. The nearest one can come to a conclusion is that, while tax administrations cannot offer any guarantee against the risks inherent in base company arrangements, they should certainly try to avoid over-reacting. For this, it is advisable that:

- Residence countries should observe the general principles set out in paragraphs 46-48 when shaping and deploying their counteracting measures;
- Countries which have co-operated through an exchange of information in order to combat tax avoidance should be willing to co-operate in appropriate circumstances for the avoidance of double taxation in the same case.

89. There are, however, limits to this. Co-operation will presuppose that the taxpayer has given full information and that tax authorities are sufficiently convinced that they have under view the full scope of the taxpayer's tax avoidance strategies, so that no other income of considerable amount has been sheltered from their taxation. In practice such a presupposition may often be ill-founded. Furthermore, the taxpayer cannot justifiably expect to have the taxation imposed in the base country reduced, when he voluntarily

used this country as a means of sheltering his income from taxation in his country of residence.

90. Finally, in the context of taxpayers' protection, mention should be made of the mutual agreement procedure provided for by Article 25 of the OECD Model. As a principle, OECD States generally agree that Article 25 applies to double taxation resulting from the application of defensive measures described above. This was made explicit when the OECD Model was completed, in 1977, to cover cases of economic double taxation, with the scope of the mutual agreement procedure being extended accordingly (see paragraph 8 of the Commentary on Article 9 and paragraphs 8 and 9 of the Commentary on Article 25). In practice, and except in one State where the courts have taken an opposite view, tax authorities do consider that taxation under counteracting measures is within the scope of the mutual agreement procedure.

91. However, the mutual agreement procedure does not guarantee to the taxpayer that double taxation will be fully avoided. A taxpayer whose attempts to avoid tax have been successfully frustrated by counteracting measures cannot expect his tax authorities to be anxious to enter into a mutual agreement procedure. More generally, Article 25 lays on tax administrations a mere duty to negotiate but in no way an obligation to reach agreement, as no procedure, for arbitration or otherwise, is available to the taxpayer in cases where tax administrations still disagree on the way double taxation should be remedied.

VIII. FINAL REMARKS

92. After consideration of the problems arising from tax avoidance and evasion through the use of base companies, it does not seem possible to formulate recommendations which would be applicable in all cases and acceptable to all member countries. However, a number of tentative conclusions have emerged:

a) Counteracting measures against the use of tax havens are a relatively novel feature in both domestic laws and in international tax relations, which are sensitive to the extent that such counteracting measures deal with situations where conflicts arise between the legal form and economic realities;

b) In the view of the States which have introduced them, counteracting measures constitute an essential instrument against tax avoidance practices, which in their absence would probably have become more widespread. Subject to one dissenting view, these measures are regarded as generally consistent with the principles underlying the

OECD Model Convention and the spirit of international tax treaties. Solutions to possible difficulties should be found either in the text or by observing the spirit of the Model. However, taxpayers who have recourse to artificial arrangements are taking risks against which they cannot be fully safeguarded by tax authorities;

c) The use of base companies exploits national legal systems for the diversion of income out of the reach of national taxation. It is therefore inevitable that counteracting measures go against the general structure of legal systems in member countries, such as territoriality of taxation and the recognition of juridical persons. By doing so, counteracting measures may create uncertainties as far as legal positions and business environments are concerned. States should avoid as far as possible bringing inconveniences to *bona fide* economic activities and should not infringe upon the tax sovereignty of other States;

d) Counteracting measures should therefore focus on clearly-identified fields of abuse. They should not be extended to activities such as production, or normal rendering of services or trading, of companies engaged in real industrial or commercial activity when they are clearly related to the economic environment of the country where they are resident and these activities are carried out in such a way that no tax avoidance can be suspected. Technical aspects of such legislation also should be consistent with the spirit of tax treaties. It is desirable that States which have introduced, or will introduce, measures of that type be ready to discuss any problems created in a bilateral or, where appropriate, a multilateral context;

e) Matters dealt with in this report tend to evolve over time. The Committee on Fiscal Affairs, which is the appropriate body for discussions on such measures, will therefore be closely following developments in this area, and will be prepared to take the matter up again as required, with the possibility that amendments to the 1977 Model Convention may result.

93. In conclusion, the Committee has expressed the wish that:

a) member countries which introduce measures to counteract the use of base companies, should design such measures in accordance with both the principles of international taxation generally agreed upon among OECD member countries and the spirit of double taxation conventions and take account of the undesirable consequences that such measures might have for other countries;

b) member countries, when applying any such measures, should, to the maximum extent possible keep this application consistent with their obligations arising from their double taxation conventions;

c) Those member countries which consider that counteracting measures taken in other countries infringe their tax sovereignty, or are contrary to international commitments and their tax policy, or create other problems, should take up the matter in the Committee with a view to finding appropriate solutions.

94. The Committee also intends:

i) To continue to explore problems so raised and recommend solutions to them;

ii) To discuss new developments in this field; and

iii) To take up the topic again when next considering possible amendments to the 1977 Model Convention.

Observations by Switzerland:

95. The counteracting measures described in this report, notably in paragraphs 29 to 38 and 39 to 40, are contrary to the spirit of bilateral double taxation conventions signed between OECD member countries as they result, in effect, in an extra-territorial application of domestic tax legislation.

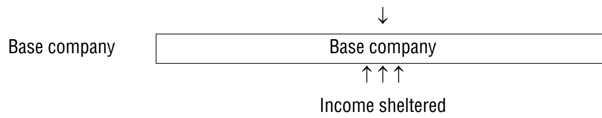
96. These measures hamper international economic relations and result in an additional administrative burden for both taxpayers and tax authorities. As divergences of view exist as to what extent some provisions (*cf.* paragraphs 30, 38 and 39 above) are contrary to the 1977 OECD Model Convention (Article 7, paragraph 1 and Article 24 especially), legal provisions of that kind should not be implemented without prior consultation of partner countries; the latter's interests should then be taken into consideration.

97. Finally, Switzerland considers that the interpretation given in paragraph 36 of the report, concerning paragraph 1 of Article 4 is not in conformity with the meaning and purpose of that provision.

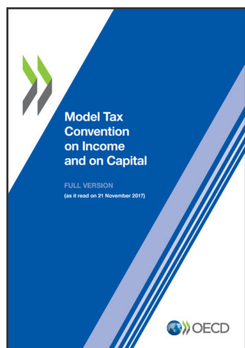
ANNEX I

INTERNATIONAL COUNTERACTING MEASURES: AN OVERVIEW

Country of: Residence of shareholder	General surveillance measures – Arm's-length rules – Procedural rules	Substance-over-form provisions	Defence legislation	Measures "from the top"



Source of income	General measures – Arm's-length rules – Procedural rules	Specific approaches: – Look-through approach – Exclusion approach – Subject-to-tax approach – Channel approach – Bona fide provisions	Taxation at source (e.g. withholding tax)	Measures "from below"



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