Double Taxation Conventions and the Use of Conduit Companies

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I. THE PROBLEM STATED

A. *General*

1. In its Commentary on Article 1 of the 1977 OECD Model Convention, the Committee on Fiscal Affairs expressed its concern about improper use of tax conventions (see paragraph 9) by a person (whether or not a resident of a Contracting State), acting through a legal entity created in a State with the main or sole purpose of obtaining treaty benefits which would not be available directly to such person.

2. This report deals with the most important situation of this kind, where a company situated in a treaty country is acting as a conduit for channeling income economically accruing to a person in another State who is thereby able to take advantage "improperly" of the benefits provided by a tax treaty. This situation is often referred to as "treaty shopping". The "conduit company" which is characteristic of such schemes is usually a corporation, but may also be a partnership, a trust or a similar entity. The tax advantages with which this report is primarily concerned occur to the detriment of the country of source of income. Whilst there is some brief consideration of taxation in the country of residence of the person to whom the income economically accrues, this is dealt with mainly in the foregoing report on "base companies".

3. Though not dealt with in this report, it is noted that a legal entity is sometimes created in an intermediary country for other than tax purposes (such as access to capital markets, currency regulations, political situations or the need to be present in the country of investment under the "flag" of the intermediary country), and that does, of course, have tax consequences.

B. *Conduit companies*

4. The treaty benefits referred to above may be obtained in two principle ways, either by the use of direct conduit companies or through a "stepping-stone" strategy. The essence of these manoeuvres is described below and represented diagrammatically in Annex I.

1. *Direct conduits*

   A company resident of State A receives dividends, interest or royalties from State B. Under the tax treaty between States A and B, the company claims that it is fully or partially exempted from the withholding taxes of State B. The company is wholly owned by a resident of a third State not entitled to the benefit of the treaty between States A and B. It has been created with a view to taking advantage of this treaty's benefits and for this purpose the assets and

rights giving rise to the dividends, interest or royalties were transferred to it. The income is tax-exempt in State A, *e.g.* in the case of dividends, by virtue of a parent-subsidiary regime provided for under the domestic laws of State A, or in the convention between States A and B.

2. *"Stepping stone" conduits*

The situation is the same as in example 1. However, the company resident of State A is fully subject to tax in that country. It pays high interest, commissions, service fees and similar expenses to a second related "conduit company" set up in State D. These payments are deductible in State A and tax-exempt in State D where the company enjoys a special tax regime.

In either case the use of the "conduit company" does not give rise to substantial taxation in the conduit States. This is normally essential for the scheme, as otherwise the advantage of using the tax treaty would mostly be compensated for by taxation in that State.

C. *Examples*

5. The following are some illustrative examples:

a) Example 1

A person X, resident of a State which has not concluded any tax treaties, derives interest from bonds of a number of States, which under the laws of these States is subject to withholding taxes therein. X sets up a company in State A, which has an extended network of tax treaties; he transfers the bonds to the company. The interest flowing now to that company is subject to no, or very low, taxation in State A due to specific tax exemptions provided for companies of that kind. On the basis of State A's treaty network, the company claims exemption from or reduction of withholding taxes in the States where the interest arises. The interest received by the company which is a resident of State A is then transferred to X as a loan.

b) Example 2

A company Y resident of State 0 has developed a patent and intends to enter into license agreements with licensees in a number of countries. Y transfers the patent to a company set up in State A. As in example 1, the royalties are subject in State A to no, or very low, taxation; and exemption from, or reduction of, withholding taxes is claimed in the States of source. The royalties may then be transferred

to Y as a dividend and may often be exempted by a participation exemption in the State of residence of Y.

c) Example 3

A company Z is a parent company with wholly-owned subsidiaries in States C_1, C_2, C_3. The State of residence of Z has no treaties with C_1, C_2 or C_3. Z transfers its participations to a company in State A. The dividends received are not subject to a tax because of a participation exemption or a system of indirect credit existing in that State. Exemption from withholding taxes in the States of residence of C_1, C_2, C_3 is claimed on the basis of the treaty network of State A. The dividends are reinvested by Z in new subsidiaries.

d) Example 4 (stepping-stone)

A tax haven company plans to invest funds as a loan in a high tax State A. The funds are channelled through a company set up for this purpose in a high tax State B. This company receives interest from State A at a rate of, say, 12 per cent and pays interest to the tax haven company at a rate of 11.5 per cent. State A levies a withholding tax on interest which is reduced to nil under the convention between States A and B. State B does not levy withholding tax on interest under domestic law. In such a case the tax haven company benefits from a treaty between the high tax States A and B though it is subject to tax in the latter State only to an insignificant degree (*i.e.* paying a normal tax only on the marginal 0.5 per cent of the interest).

D. Main characteristics of "conduit configurations"

6. Through the configurations described above, the conduit company takes advantage of the treaty provisions under its own name in the State of source; economically, however, the benefit goes to persons not entitled to use that treaty. A net tax advantage results because little or no taxation occurs in the State(s) of conduit. The advantage arises in the source country. As its tax laws deal adequately with the situation (it generally taxes all non-residents including the conduit company) the problem is created exclusively by the treaty itself and therefore can only be dealt with under the treaty.

7. This situation is unsatisfactory in several ways:

a) Treaty benefits negotiated between two States are economically extended to persons resident in a third State in a way unintended by the contracting States; thus the principle of reciprocity is breached and the balance of sacrifices incurred in tax treaties by the contracting parties altered;

b) Income flowing internationally may be exempted from taxation altogether or be subject to inadequate taxation in a way unintended by the Contracting States. This situation is unacceptable because the granting by a country of treaty benefits is based, except in specific circumstances, on the fact that the respective income is taxed in the other State or at least falls under the normal tax regime of that State;

c) The State of residence of the ultimate income beneficiary has little incentive to enter into a treaty with the State of source, because the residents of the State of residence can indirectly receive treaty benefits from the State of source without the need for the State of residence to provide reciprocal benefits.

These considerations endorse the Committee on Fiscal Affairs' general view that the use of treaties is improper where a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State primarily to obtain treaty benefits which would not be available directly to such person (*cf.* paragraph 1 above). They will be of relevance in deciding in which actual situations treaty benefits should be denied under existing treaties in order to cope with cases of "treaty shopping" and which new provisions should be included in bilateral treaties or in amendments to the OECD Model.

E. Other aspects of the problem

8. This report focuses on taxation in the State of source. There are also tax advantages in the State of residence of the taxpayer who economically benefits from the treaty benefits. In fact, in the examples set out in paragraph 5 above, that State cannot, or does not, tax the income, though in all cases the taxpayer has its full economic benefits (by receiving it as a loan or as a dividend or by using it for investment in other subsidiaries). However, these tax advantages raise quite different issues: they have their source in national law, and treaty aspects usually arise only as secondary problems. These issues are considered in the separate reports contained in this volume which deal with "tax havens" and "base companies". Similar considerations apply to problems arising from the issue of bonds through conduit companies set up in countries which have no withholding tax on interest.

F. Bona fide transactions

9. The configurations described above occur in many normal transactions of enterprises operating internationally. Thus a group's parent company in State X may have an operation subsidiary in State A which develops a patent in connection with its production activities and which licenses the patent to an enterprise in State B from which it receives royalties. It is clear that tax exemptions provided for such royalties in the treaty between State A and

State B should not be denied because there is no such treaty between the State of source of the royalties (B) and the State of the parent company (X). Such *bona fide* transactions do not fall within the scope of this report, for they clearly involve no improper use of tax treaties. This is, generally speaking, true in all cases in which the assets or rights giving rise to income for which treaty benefits are claimed are effectively connected to activities like producing, rendering of services or trading in the market of State A.

G. *Similar cases*

10. The foregoing discussion is based on the assumption that improper use was made by a person resident in a State which had no treaty with the State of source. Similar problems may arise where there is a treaty between the State of residence and the State of source, but:

a) This treaty offers less protection than the treaty between the State of source and the State of conduit;

b) The use of a conduit company can avoid the disclosure of information to the State of residence;

c) Both treaties offer equal protection but use is made of the conduit company in order to avoid taxation in the State of residence [*e.g.* because, by using the conduit company, income such as royalties is transformed into dividends to be exempted by a participation exemption (see example 2 of paragraph 5)].

The principles set forth in this report are applicable to such cases.

H. *Search for solutions*

11. The existence of "conduit companies" has long been perceived to be a problem in treaty negotiations. It may also become a problem in the application of existing treaties if the treaty partners were not aware of the existence of "conduit companies" when negotiating the treaty or if it only becomes a problem subsequently (*e.g.* by reason of changes in domestic laws or by the emergence of new tax avoidance schemes, as in the case of "stepping-stone strategies").

12. In seeking a response to this problem this report considers:

a) Certain provisions of existing OECD Model Convention and their implications for conduit companies (Part II);

b) Specific provisions currently found in bilateral treaties (Part III), and;

c) The problems of applying existing tax treaties (Part IV).

On the basis of these studies the report sets out suggestions for future action (Part V).

II. THE 1977 OECD MODEL CONVENTION: GENERAL APPROACH AND SPECIFIC PROVISIONS

A. *The general situation*

13. Normally under the OECD Model the conduit company is regarded as a person [Article 3, paragraph 1 *a)* and *b)*] resident in the State of conduit (Article 4). It is therefore entitled to claim the benefits of the treaty in its own name. There are of course situations where specific circumstances exclude the company from treaty benefits, but it is rarely possible to verify that such circumstances are present. This is the case, for example, where:

- The entity used as a conduit is not recognised as a juridical person (being, for example, a partnership, or a trust which may not be a "person" under the treaty provisions);
- The company is not liable to tax in the State of conduit on the basis of its domicile, place of management or other criterion of a similar nature (*e.g.* because its Board of Directors does not meet in that State);
- The assets and rights giving rise to the dividends, interest and royalties have not effectively been transferred to the company so that it acts as a mere nominee when receiving payments of such income.

In cases of doubt the conduit company should, at the request of the tax administration of the State of source, give the necessary information. It is, however, often found that these approaches are generally not sufficient to counteract the improper use of treaties in the conduit situation.

B. *Anti-avoidance provisions*

14. The OECD has incorporated in its revised 1977 Model provisions precluding in certain cases persons not entitled to a treaty from obtaining its benefits through a "conduit company".

a) Article 4, paragraph 1, second sentence 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 provision relates clearly to specific privileges granted by reason of the international relations of a person and giving such a person, in effect, the status of a non-resident rather than that of a resident. The commentaries on the 1977 OECD Model give as an example the case of certain diplomatic personnel. The provision would, however, apply according to its wording and spirit where, for example, foreign-held companies are exempted from tax on their foreign income (as viewed from their State of residence) by privileges tailored to attract conduit companies. It has, however, inherent difficulties and limitations. Thus it has to be interpreted

restrictively because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, so that there is an element of uncertainty concerning its application against conduit companies. Furthermore, to be effective, such provisions should also apply where the conduit company is fully exempt from tax under specific privileges, even though they cannot cover the stepping stone situation (see paragraph 4 *b)* above and paragraph 36 of the previous report on base companies) or cases where the special status is not based on an exemption of income.

b) Articles 10 to 12 of the OECD Model deny the limitation of tax in the State of source on dividends, interest and royalties if the conduit company is not its "beneficial owner". Thus the limitation is not available when, economically, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income (paragraphs 12, 8 and 4 of the Commentary to Articles 10, 11 and 12 respectively). The Commentaries mention the case of a nominee or agent. The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has a similar function to those of a nominee or an agent. Thus a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company). In practice, however, it will usually be difficult for the country of source to show that the conduit company is not the beneficial owner. The fact that its main function is to hold assets or rights is not itself sufficient to categorise it as a mere intermediary, although this may indicate that further examination is necessary. This examination will in any case be highly burdensome for the country of source and not even the country of residence of the conduit company may have the necessary information regarding the shareholders of the conduit company, the company's relationships to the shareholders or other interested parties or the decision-making process of the conduit company. So even an exchange of information between the country of source and the country of the conduit company may not solve the problem. It is apparently in view of these difficulties that the Commentaries on the 1977 OECD Model mentioned the possibility of defining more specifically during bilateral negotiations the treatment that should be applicable to such companies (*cf*. paragraph 22 of the Commentary on Article 10).

15. The new provisions of the 1977 OECD Model thus deal with the conduit situation in a rudimentary way, expressing only a general concern that improper use of treaties should be avoided. Although it is clear that all necessary information should be exchanged between the two Contracting States for the application of these clauses, this is not sufficient to preclude a person from acting through a legal entity created in a State in order to obtain treaty benefits which would not be available directly to them, and from obtaining unjustifiable tax advantages (paragraphs 8 and 9 of the Commentary on Article 1).

16. Opinions may differ as to whether the absence of an overall solution to the conduit problem was at the time a serious flaw in the 1977 OECD Model. It was understood, as pointed out in the OECD Commentaries, that member countries were free to insert adequate solutions in their bilateral treaties. However, the problem has become more acute over recent years and calls for further study. Improvements seem advisable in several respects:

a) OECD should set out policies regarding conduit companies in more detail in order to prevent improper use of tax treaties. Consequently the Commentaries should in some way (*e.g.* in a summarised form or by citing this report) take into account the conclusions reached by the Committee on Fiscal Affairs in Part III below;

b) Recently new strategies seem to have been developed for the use of conduit companies based in many countries. The OECD Model or its Commentaries should accordingly offer solutions to this problem taking into account the considerations under Part IV;

c) The provisions mentioned in paragraph 14 above and/or the Commentaries should be revised in order to solve any existing difficulties and doubts.

These problems will be considered in any revision of the OECD Model.

III. BILATERAL TREATIES: PROBLEMS FOR NEGOTIATIONS

A. General policy approaches

1. *Treaty policy* vis-à-vis *low-tax countries*

17. The conduit problem is normally generated by the fact that treaty benefits are not balanced by corresponding tax in the country where the conduit company has its residence, because under that country's system no tax (or no significant tax) arises. In such a situation, a radical solution would be not to conclude treaties with countries which are especially prone to

becoming a base for conduit companies (*e.g.* because they have no income tax or offer specific tax exemptions for such companies). Basically this policy in many cases is sound as the slight double taxation which may occur may be dealt with satisfactorily under provisions of domestic law.

2. *Specific provisions relating to low-tax countries*

18. Refraining from treaties with such countries is, however, not always feasible for other countries, for example, because important normal business relationships exist between the two countries concerned which should be protected against double taxation, or because of other overriding treaty objectives (*e.g.* improving the climate for private investment in developing countries). Furthermore, the conduit situation may even occur between countries whose taxation has no special features, especially in the case of stepping-stone strategies (see paragraph 4(2) above).

19. In such situations it would correspond to sound treaty policy to take special care that bilateral treaties form an instrument for avoiding international double taxation while counteracting improper use of its provisions. A treaty partner may, if it wishes to be protected against international tax avoidance schemes:

- Ask that the other State be prepared to co-operate by exchange of information and in any other way in order to prevent international tax avoidance;
- Take the necessary measures to be able in practice to give information [see Recommendation 833 (1978) of the Parliamentary Assembly of the Council of Europe, paragraph 11 *i)*].

Reference may also be made to that part [paragraph 11 *ii)*] of the Recommendation cited above according to which States should refrain from creating special tax laws which tend in practice to give undue tax favours to certain companies in respect to foreign-earned income.

20. Difficulties with conduit companies may occur between all OECD member countries, as specific tax avoidance schemes may use even a so-called “high tax country” as a basis for an improper use of tax treaties (*e.g.* by “stepping-stone companies” – *cf.* paragraph 4(2) above). Most OECD member countries are ready to co-operate in such situations in the way described in the foregoing paragraph. As bilateral treaties of an OECD country with other countries may be made use of by residents of other OECD countries there is a common interest among many OECD member countries that adequate policies are developed.

B. *Specific provisions relating to conduit companies*

21. An important method for finding adequate solutions to problems caused by conduit companies is the insertion of specific clauses dealing with this special situation. In this section, several specific approaches are discussed under the headings "general description", "scope and limitations" and "evaluation". These are:

1. The "look-through" approach (paragraphs 23-25);
2. The exclusion approach (paragraphs 26-28);
3. The subject-to-tax approach (paragraphs 29-36);
4. The channel approach (paragraphs 37-41);
5. *Bona fide* provisions (paragraph 42).

Examples of such provisions used in certain tax treaties between OECD members are set out in Annex II.

22. The Committee on Fiscal Affairs has refrained from drafting definitive texts, from making strict recommendations as to the circumstances in which they should be applied and from giving an exhaustive list of such possible counter-measures. The texts quoted below are merely intended as suggested benchmarks which treaty negotiators might consider when searching for a solution to specific cases. In referring to them there should be taken into account:

- The degree to which there may be actual tax advantages obtained by conduit companies;
- The legal context in both Contracting States, and;
- The scope of *bona fide* economic activities that might unintentionally be covered by such provisions.

1. *The "look-through" approach*

a) General description

23. The most radical solution to the problem of conduit companies would be to allow treaty benefits to a company only insofar as the company is owned by residents of the State of which the company is a resident. For example, such a provision might have the following wording:

> A company which is a resident of a Contracting State shall be entitled under this Convention to relief from taxation in the other Contracting State with respect to any item of income, gains or profits, only to the extent that it is not owned directly or through one or more companies, wherever resident, by persons who are not residents of the first-mentioned State.

b) Scope and limitations

24. The "look-through approach" ("piercing the veil of the company") is the most direct way of attacking the conduit problem. While it is relatively simple and straightforward, there are, however, evident disadvantages:

i) Such provisions are incompatible with the principle of the legal status of corporate bodies, as recognised in the legal systems of all OECD member countries, and except in cases of abuse, in the OECD Model;

ii) Such provisions would require extensive *bona fide* amplifications (*cf.* paragraph 4(2) below). This may lead to rules which are complicated and burdensome to administer;

iii) The provisions do not prevent "stepping-stone" strategies [*cf.* paragraphs 42 and 5 (d) above];

iv) There would have to be machinery to apply the clause in a simple and secure way. This may require the shift of the burden of proof;

v) Implementation of the provision would be very difficult in countries where companies' stock is mainly made up of bearer shares.

c) Evaluation

25. The "look-through approach" seems an adequate basis for treaties with countries which have no or very low taxation and where little substantive business activities would normally be carried on. Even in these cases it would be necessary to alter the provision or to substitute for it another one to safeguard *bona fide* business activities. What is said in paragraph 19 above would be relevant to such modifications.

2. The exclusion approach

a) General description

26. Often conduit situations can be created only by the use of tax-exempt (or nearly tax-exempt) companies which may be distinguished by special legal characteristics. The improper use of tax treaties may then be avoided by denying the tax treaty benefits to these companies. The main cases are specific types of companies enjoying tax privileges in their State of residence giving them in fact a status similar to that of a non-resident. As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would

be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause such as the following:

> No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under Section … of the … Act, or under any similar provision enacted by … after signature of the Convention.

The scope of this provision, as far as income paid by the company is concerned, could be limited by referring only to specific types of income, such as dividends, interest, capital gains, directors' fees, etc.

Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information),

b) Scope and limitations

27. An exclusion provision would cover companies which, under the tax law of the State of residence, have in practice the status of a non-resident, rather than that of a resident. Such a provision should, however, apply not only in cases of full exemption, but also in the case of a reduction of tax to levels lower than the expected overall treaty benefits. On the other hand, an exclusion provision would not exclude from treaty benefits charitable institutions enjoying tax exemption as a consequence of the specific purpose for which they are organised and operated. Such an exclusion provision, however, is of a very limited scope and cannot deal with more advanced techniques of improper use of tax treaties.

c) Evaluation

28. Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State which has created special privileges in its tax law may prevent these privileges from being used in connection with the improper use of tax treaties concluded by that State.

3. *The subject-to-tax approach*

a) General description

29. General subject-to-tax provisions provide that treaty benefits in the State of source are granted only if the respective income is subject to tax in the State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the OECD Model does not recommend such a general provision. While this seems

adequate with respect to normal international relationships a subject-to-tax approach might well be adopted in a typical conduit situation. A safeguarding provision of this kind could have the following wording:

> Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State:
>
> *i)* Have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and
>
> *ii)* Exercise directly or indirectly, alone or together, the management or control of such company, any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income which is subject to tax in the last-mentioned State under the ordinary rules of its tax law.

The concept of "substantial interest" may be further specified when drafting the Convention. Contracting States may express it, for instance, in terms of a certain percentage of the capital or of the voting rights of the company.

b) Scope and limitations

30. The subject-to-tax approach, although somewhat similar to the exclusion clauses, covers cases in which it is not possible to give a strict definition of the excluded situation. Thus, the "taxation under ordinary rules" test would exclude from treaty benefits companies enjoying:

- Specific privileges granted to "base companies", "domiciled companies", etc.;
- Waivers of tax under specific arrangements between the conduit company and the tax administration;
- Substantial reduction of tax as well as complete exemption.

31. On the other hand there are advanced techniques of improper use of tax treaties which could not be covered by the subject-to-tax approach. This is especially so with the "stepping-stone strategies", where the company incurs expenses it can offset against income in accordance with normal rules of tax laws.

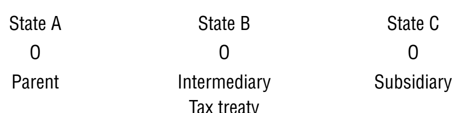
32. Moreover, the subject-to-tax approach would exclude from the benefit of tax treaties companies enjoying:

- Tax privileges granted to charitable organisations, pension funds or similar institutions;
- Tax privileges granted with a view to fostering the economic development of the country of the conduit company ("tax holidays").

In circumstances such as those derogations from such provisions may be envisaged.

c) Substantial participation

33. Special attention should be given in this context to the holding of a substantial participation in a company through an intermediary as illustrated by the following diagram:



In this case State B will grant dividends received by the intermediary from the subsidiary an exemption or an underlying tax credit tantamount to an exemption or near exemption.

34. As this exemption or credit is granted with a view to the tax borne by the subsidiary in its State of residence on the distributed profits (State C), many States will regard it as part of their normal rules for avoiding double taxation rather than a specific tax privilege. This approach would recommend that it be regarded as a tax under ordinary rules for the purposes of the foregoing paragraphs. Situations of this kind may, however, involve elements which would make it improper for the intermediary company to invoke the benefits of a tax treaty. This may, *inter alia,* be true if the intermediary company:

- Is not the beneficial owner of the dividends;
- Has to be regarded as a mere channeling company as referred to under paragraphs 37 to 41, or;
- Where such companies are used to shield off a low-taxed company against taxation in the country of the parent.

35. On the other hand, there is certainly no reason to regard the use of the treaty as improper, if the participation is effectively connected to a *bona fide* commercial activity carried on by the intermediary. Contracting States should consider cases of that kind with a view to their specific situation.

d) Evaluation

36. The subject-to-tax approach seems to have certain merits. It may be used in the case of States with a well-developed economic structure and a complex tax law. It will, however, be necessary to supplement this provision by inserting *bona fide* provisions in the treaty to provide for the necessary flexibility (*cf.* paragraph 42 below); moreover, such an approach does not offer adequate protection against advanced tax avoidance schemes such as "stepping-stone strategies".

4. *The channel approach*

a) General description

37. The approaches dealt with in the foregoing sections are in many ways unsatisfactory. They refer to the changing and complex tax laws of the Contracting States and not to the arrangements giving rise to the improper use. It has been suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision which would single out cases of improper use with reference to the conduit arrangements themselves. Such a provision might have the following wording:

> "Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State:
>
> *i)* Have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and
>
> *ii)* Exercise directly or indirectly, alone or together, the management or control of such company,
>
> any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, depreciation of any kind of business assets including those on immaterial goods, processes, etc.)."

b) Scope and limitations

38. This approach would be satisfactory in covering a broad spectrum of cases typically involving improper use of tax treaties like:

- Cases of mere administration of assets;
- The so-called "stepping-stone strategies";
- Other cases where income is merely transmitted through conduit companies with a view to minimising taxes.

39. On the other hand it could cover normal business activities or cases where the assets from which the income in question arises is effectively connected with a genuine activity like the carrying on of a trade or business or the exercise of independent personal services. Therefore, it would seem necessary to supplement such a provision by a *bona fide* clause (*cf.* paragraph 42 below).

40. Also this solution is of a very general nature, which might lead to administrative difficulties and doubts in its application such as the types of

expenses to be covered and the linkage, both in amount and in time, to be made between the income received and the expenses paid. This is evident in the case of substantial holding (*cf.* paragraph 33 above), as well as in cases where assets are held by a bank or an insurance business. The interpretation would certainly depend largely on standards the Contracting States have developed internally to counter unjustifiable tax advantages (like the principle of "substance-over-form", general anti-abuse clauses, etc.).

c) Evaluation

41. The solution proposed in paragraph 37 above appears the only one to be effective against "stepping-stone" devices. It is not found as such in bilateral treaties but its principle seems to underlie the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies. Contracting States which consider including a clause of this kind in their convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a *bona fide* clause. Moreover, because of the administrative difficulties referred to above, it seems advisable to include it only in specific cases, where the use of "stepping-stone devices" frequently occurs or is likely to occur.

5. *Bona fide provisions*

42. The solutions described above are of a general nature. In connection with them, it will be necessary to provide specific provisions to ensure that treaty benefits will be granted in *bona fide* cases. Such provisions could have the following wording:

i) General bona fide provision

> "The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and thus do not have as primary purpose the obtaining of any such benefits."

ii) Activity provision

> "The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income which is connected with such operations."

iii) *Amount of tax provision*

"The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident."

iv) *Stock exchange provision*

"The foregoing provisions shall not apply to a company resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned – directly or through one or more companies each of which is a resident of the first-mentioned State – by a company which is a resident of the first-mentioned State and the principal class of whose shares is so registered."

v) *Alternative relief provision*

In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that such expression "shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention."

The determination of those provisions which are regarded as necessary in a specific treaty depends on the general approach taken in that treaty.

IV. APPLICATION OF EXISTING TREATIES

A. General considerations

43. Existing conventions may have clauses with safeguards against the improper use of their provisions. Where no such provisions exist, treaty benefits will have to be granted under the principle of "*pacta sunt servanda*" even if considered to be improper. The Contracting States should, however, be prepared to grant all possible help by exchange of information (*cf.* paragraph 19 above) and to remedy the situation by adequately revising the treaty (*cf.* Part III above).

B. Handling of artificial tax avoidance

44. It may be asked, however, whether artificial tax avoidance schemes could not be countered by applying certain domestic measures available to

Contracting States to fight domestic tax avoidance. Two types of situations may be identified:

a) A State may wish to protect itself against "abuse of law" by applying the general provisions in its domestic laws: it will then deny the benefits of the convention to income paid by a resident of that State to a company situated in the other State when it has reasons to suspect an improper use of the convention. The question arises as to whether the denial of treaty benefits in such cases is compatible with treaty obligations. This relates to the issue of the priority accorded to international law in relation to domestic law, a matter on which opinions differ among States, some taking the view that where the beneficiary of the income fulfils the conditions set in the convention (beneficial ownership, residence), the provisions of the convention should apply, notwithstanding the domestic provisions of the State of source (see also paragraphs 43 to 48 in the foregoing report on "base companies") others taking the contrary view.

b) A State may be led to take steps to protect its partners from the result of the interaction of special characteristics of its domestic laws with the use of conduit companies situated in its territory. Switzerland is a case in point. The question of the impact of these unilateral measures in the State of source may arise in such situations. For instance, if Switzerland, as State of residence of the conduit company, finds that the company, while fulfilling the conditions set in the convention, does not meet the requirements of its domestic laws and, accordingly, refuses to certify and transmit to the tax authorities of the State of source a request for relieving tax withheld at source, it may be questioned whether the State of source has the right to refuse relief.

45. A special difficulty increasingly encountered by tax authorities under existing conventions is the use of highly artificial arrangements called "stepping-stone" devices [*cf.* paragraphs 4(2) and 5 *d)*]. Such arrangements make sense of the fact that two high taxing countries:

- Have differing tax laws (one levies a withholding tax on interest, the other does not);
- Respect the taxation rights of the tax haven country, and;
- Regard anti-abuse clauses in their treaties as unnecessary.

Improper use of tax conventions in such cases may be counteracted by changing one of these basic conditions. It is, however, evident that this may require a change of policies which could affect *bona fide* economic activities. This might also lead to complicated rules, highly burdensome to tax administrations. It may therefore be preferable to counteract such highly complex arrangements by recourse to the principle of "substance over form".

V. FINAL REMARKS

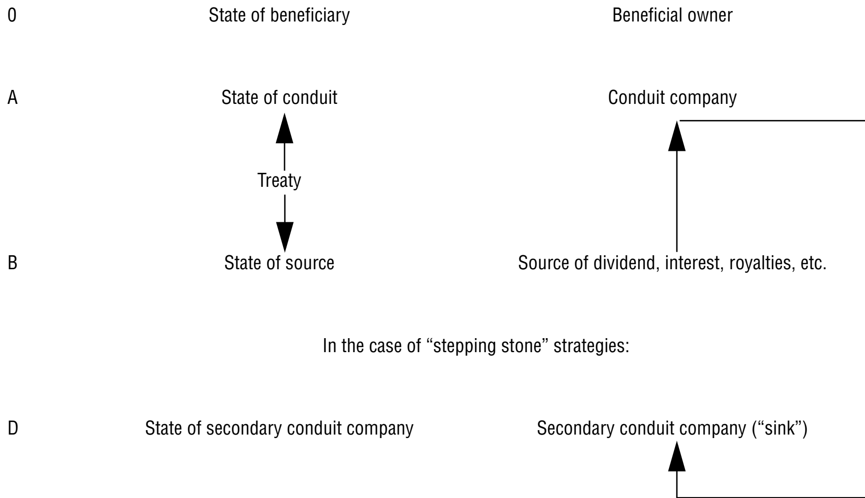
46. The Committee considers that competent authorities in charge of negotiating or revising conventions and of implementing existing ones:

i) Should pursue their efforts and foster co-operation against improper use of tax conventions through "conduit companies" and, for this purpose

ii) Take account of the considerations set out in Parts II to to IV of this report.

ANNEX I

DESCRIPTION OF "CONDUIT" SITUATIONS



ANNEX II

EXAMPLES OF BILATERAL CLAUSES

A. The "exclusion" approach

1. Type related exclusion (Germany-Luxembourg Agreement)

Article 1

1. The Agreement shall not apply to holding companies within the meaning of the special Luxembourg laws (currently the Acts of 31st July 1929 and 27th December 1937). Neither shall it apply to income derived from such holding companies by a person domiciled in the Federal Republic of Germany or to shares in such companies belonging to such person.

2. The Agreement shall not apply to non-recurrent taxes on fortune or on capital gains.

3. If any doubts arise with respect to the future taxes to which the Agreement shall apply, the competent authorities of the Contracting States shall come to an understanding with a view to interpreting or amending the Agreement as may be considered necessary.

2. Tax status related exclusion (German-Canadian Agreement)

Article 29 Miscellaneous rules

1. With respect to income taxable in a Contracting State, the provisions of this Agreement shall not be construed to restrict in any manner any exclusion, exemption, deduction credit, or other allowance accorded:

- *a)* By the laws of a Contracting State in the determination of the tax imposed by that State, or;
- *b)* By any other agreement entered into by a Contracting State.

2. It is understood that nothing in the Agreement shall be construed as preventing:

- *a)* Canada from imposing its tax on amounts included in the income of a resident of Canada according to Section 91 of the Canadian Income Tax Act;
- *b)* The Federal Republic of Germany from imposing its taxes on amounts included in the income of a resident of the Federal Republic of Germany according to Part IV of the German "*Aussensteuergesetz*".

Where such imposition of tax gives rise to a double taxation, the competent authorities shall consult for the elimination of such double taxation according to paragraph 3 of Article 25.

3. Articles 6 to 23 of this Agreement shall not apply to non-resident-owned investment corporations as defined under Section 133 of the Canadian Income Tax Act, or under any similar provision enacted by Canada after the signature of this Agreement, or to any income derived from such companies by any shareholders thereof.

B. The "subject to tax" approach

B1. (Germany-United Kingdom treaty)

Article V1

1. Dividends paid by a company resident in one of the territories to a resident of the other territory may also be taxed in the former territory. Tax shall not, however, be charged in that former territory at a rate in excess of 15 per cent on the gross amount of such dividends provided that those dividends either are subject to tax in the other territory or, being dividends paid by a company which is resident in the United Kingdom, are exempt from Federal Republic tax under the provisions of subparagraph *a)* of paragraph 2 of Article XVIII.

2. Notwithstanding the provisions of paragraph 1 of this Article Federal Republic tax on dividends paid to a company resident in the United Kingdom by a company resident in the Federal Republic at least 25 per cent of the voting shares of which are owned directly or indirectly by the former company may be charged at a rate exceeding 15 per cent but not exceeding 25 per cent if the rate of Federal Republic corporation tax on distributed profits is lower than that on undistributed profits, and the difference between those two rates is 28 per cent or more: where the difference between the two rates is 20 per cent or more but less than 28 per cent Federal Republic tax on such dividends may be charged at a rate exceeding 15 per cent but not exceeding 20 per cent.

3. Where a company which is a resident of one of the territories derives profits or income from sources within the other territory, there shall not be imposed in that other territory any form of taxation on dividends paid by the company to persons not resident in that other territory, or any tax in the nature of an undistributed profits tax on undistributed profits of the company, whether or not those profits represent, in whole or in part, profits or income so derived.

B2. (Germany-Switzerland treaty)

Article 23

2. Even though a company meets the conditions provided in paragraph 1, a company resident in Switzerland in which persons who are not residents of Switzerland have, directly or indirectly, a substantial interest in the form of a participation, may only claim the benefit of the reduction of taxes imposed by the Federal Republic of Germany on German source interest [Article 11, paragraph 1], royalties [Article 12, paragraph 1], and on capital gains [Article 13, paragraph 3], if these interests, royalties, or capital gains are subject, in the canton in which this company has its seat, to the cantonal tax on income under the same or similar provisions as are envisaged in regarding the federal defence tax.

3. A family foundation resident in Switzerland may not claim the benefit of the reductions of tax imposed by the Federal Republic of Germany on, German source dividends [Article 10, paragraph 2, through 4], interest [Article 11, paragraph 1], and royalties [Article 12, paragraph 1], and capital gains [Article 13, paragraph 3], if the founder, or the majority of the beneficiaries are non-residents of Switzerland and more than one-third of the relevant income is not, or will not benefit persons which are residents of Switzerland.

4. If the competent authority of the Contracting State, from which the items of income originate, has reasonable grounds to cast doubt on the declarations made by the recipient of the items of income in his effort to obtain a tax reduction, which are confirmed by the competent authorities of the other State, then the competent authority of the first-mentioned State shall communicate these grounds to the competent authority of the other State; this authority shall then undertake a new investigation and inform the competent authority of the first-mentioned State of the conclusions reached. In case of disagreement between the competent authorities of the two States, Article 25 shall apply.

C. The "channel" approach

German-Swiss tax treaty

Article 23

1. A company which is a resident of a Contracting State, and in which persons who are not residents of that State have, directly or indirectly, a substantial interest in the form of a participation, or otherwise, may only claim the tax reductions provided for in Articles 10 through 12 with respect to

dividends, interest, and royalties, derived from sources in the other State, as provided for in Articles 10 through 12, where:

a) The interest-bearing debts to persons who are not residents of the first-mentioned State are not higher than six times its equity capital and reserves; this restriction does not apply to banks and similar institutions;

b) The interest paid on loans agreed upon with non-resident lenders is not paid at a higher rate than the normal interest rate; the normal interest rate means:

   i) With respect to the Federal Republic of Germany: the rate of the current yield of interest-bearing securities from inland issuers plus two percentage points,

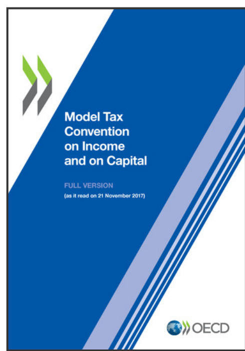
   ii) With respect to Switzerland: the average interest rate on debt obligations issued by the Swiss Confederation plus two percentage points;

c) Not more than 50 per cent of the relevant income derived from sources in the other Contracting State is used to satisfy claims (interest, royalties, development, advertising, initial and travel expenses, depreciation on any kind of business asset including on immaterial goods, processes, etc.) by non-residents of the first-mentioned State;

d) Expenses connected with the relevant income derived from sources in the other Contracting State are met exclusively from that income;

e) The corporation distributes at least 25 per cent of the relevant income derived from sources in the other Contracting State.

Additional measures already taken, or to be taken by one of the Contracting States, against abuse of the use of tax relief relating to withholding tax levied at source in the other Contracting State, are not prejudiced hereby.



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