GAAR and Tax Treaties

By

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Tax avoidance, a concept increasingly familiar to most developed countries, has assumed dominant presence in international taxation. The subject was the focus of the International Fiscal Association's (IFA) Seoul Congress in 2018, which focused on the use of the general anti-avoidance rule (GAAR) to combat avoidance. There is, however, no consensus between countries on what they mean by "tax avoidance" and the definitional challenges are substantial, which encourages conflicts that affect the movement of capital and services.

I. Structure of Tax Avoidance

Countries define tax avoidance in negative tones. Canada, for example, defines tax avoidance as transactions that are "abusive". Hence, GAAR does not apply unless the avoidance abuses the *Income Tax Act* ("*Act*"), *Regulations* or tax treaties read as a whole. Most countries define GAAR in broad terms that apply to transactions, arrangements, acts or course of conduct. Some countries attempt to refine the concept with adjectives such as, "unacceptable" (New Zealand, Israel), "unjustified" (Russia), "impermissible" (South Africa, India), "illegitimate" (Israel), or "aggressive" (EU, OECD).

Similarly, the OECD Study into the *Role of Tax Intermediaries*, which refers to "aggressive" tax avoidance, a tax position that is tenable but has unintended and unexpected revenue consequences or a tax position that is favourable without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law. This implies that the taxpayer should be obliged to red flag its own return to the tax authorities, which, coincidentally, Canada adopted in June 2023 [Bill C-47] for "reportable transactions" and "uncertain tax treatment rules".

Rather than assisting in interpretating GAAR, such terms add uncertainty, call for extensive jurisprudence and create conflicts between jurisdictions.

GAARs and anti-abuse rules can generally be broken down into several components:

- Definition of:
    - Tax benefits or advantage;
    - Series or step transactions;
    - Taxpayer's purpose or intent;
    - Form and substance;
    - Economic substance or fiscal nullity;
    - Abuse of law; and
    - Interaction with SAARs and TAARs.

Regardless of their structure, the DNA of most GAARs is found in the case law attempting to control unwarranted tax reduction that preceded their enactment [see, for example, *Stubart Investments Ltd.*, [1984] 1 SCR 536].

A. General Comment

Canada amended subsection 245(4) of the *Act* in 2005 together with the *Income Tax Conventions Interpretation Act*, R.S.C., 1985, c. I-4, section 4.1, which states:

> Notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada, it is hereby declared that the law of Canada is that section 245 of the *Income Tax Act* applies to any benefit provided under the convention.

The amendment, retroactive to 1988, makes it clear that GAAR applies to Canadian tax treaties.[1]

Tax treaties are bilateral agreements between countries, and we interpret them according to the principles of international law. Canada also enacts its tax treaties as domestic law. Thus, in one sense, Canada's treaties are international contractual agreements, and, in another sense, they represent domestic statutory legislation. This hybrid nature of treaties raises problems of interpretation.

Modern tax treaties serve dual purposes: (1) the prevention of double taxation and (2) the prevention of tax evasion and abusive tax avoidance.

The preamble to the *OECD Model Convention* (2017) commences by stating that the parties intend "to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States).

The first objective - prevention of double taxation - has historically dominated the development of treaties. With the expansion of international trade and electronic commerce, however, revenue authorities are increasingly focusing on the second purpose - the prevention of tax evasion and abusive tax avoidance through special purpose provisions, such as GAAR, anti-treaty shopping articles, and limitation of benefits rules in tax treaties.

Similarly, the *U.S. Model Convention* (2016):

> The Government of the United States of America and the Government of __________, intending to conclude a Convention for the elimination of double taxation with respect to taxes on income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third states), have agreed as follows:

[1] See section 4.1 of the *Income Tax Conventions Interpretation Act* ("ITCIA").

Similarly, the revised United Nations Model Convention (2017), which its title to "Convention between State A and State B for the elimination of double taxation with respect to taxes on income and capital and *the prevention of tax avoidance and evasion.*

A new preamble clarifies that tax conventions are not intended to create opportunities for tax avoidance or evasion including tax avoidance through treaty shopping arrangements.

B. Background

The League of Nations recognized the importance of the prevention of double taxation in 1921 when it began to develop a model treaty for use by its member states. The League completed its model convention in 1928, modified it in 1943 in Mexico, and modified it again in London in 1946. The Fiscal Committee of the Organization for Economic Cooperation and Development (OECD) revisited the study of the double taxation issue in 1956 and published four interim reports before finalizing its first model of the *Double Taxation Convention on Income and Capital* in 1963. The Model has been revised several times and most recently in 2017.

The *OECD Model Convention* is the commonly used base for the negotiation of international tax treaties between developed countries. The United States also has a model income tax convention that it uses for its treaty negotiations. The US model is substantially similar to the *OECD Model*.

Developing countries use the United Nations Model, which favours source taxation, for their treaties with developed countries.

C. Structure of Tax Treaties

Juridical double taxation arises when two countries impose comparable taxes on the same taxpayer in respect of the same subject matter and for identical periods. Juridical double taxation arises because most countries exercise jurisdiction to tax on at least two bases: Source of income and residence of the taxpayer.

The purpose of tax treaties is to prevent juridical double taxation. The *OECD Model Convention*, for example, seeks to curtail double taxation through a classification and assignment system. Thus, a treaty will typically classify income by type and then assign the right to tax the income to one or both contracting parties.

The "classify and assign" system avoids double taxation by assigning the right to tax each type of income to the country that has the primary connection with the income. Thus, economic allegiance determines classification. Concurrently, where the treaty assigns the right to tax income to the country where the income originates – the source country – it will also require the country of residence to relieve potential double taxation by providing an exemption for the income or credit for taxes payable.

Classification and assignment allows the country that has the closest economic ties with the income to tax it. For example, business income is usually taxable by the country of residence *unless* the

business has a permanent establishment in the source jurisdiction to which its income is attributable.[2] Similarly, investment income – for example, dividends, interest, and royalties - is generally taxable in the taxpayer's country of residence but the taxpayer is entitled to an exemption or a reduced rate of taxation in the country in which the income originates.[3]

The second objective of tax treaties - the prevention of tax evasion and abusive tax avoidance – has become increasingly important in recent years. Hence, treaties increasingly provide for exchange of information between the Contracting States. Article 26 of the *OECD Model Convention* (2017), for example, provides for the exchange of information between the tax administrators of the Contracting States and allows them to ascertain the acts underlying international transactions. By making the exchange of information more transparent in cross-border transactions, tax administrators can better curtail tax evasion.

Of course, bilateral tax treaties are effective only if both parties apply it in a consistent manner and in harmony with the purposes of its provisions. Thus, we need to understand the principles of interpretation and apply them uniformly to treaties if we want to prevent double taxation. The codification of the principles of customary international law in the *Vienna Convention on the Law of Treaties (Vienna Convention*) illustrates the importance that countries attach to treaty interpretation.

D. Implementation of Treaties

Canada implements its income tax treaties through its domestic legislative process, which requires Parliamentary ratification. Thus, Canadian bilateral tax treaties initially start out as negotiated international agreements but become domestic law through enabling legislation that Parliament enacts. Although it remains unclear as a matter of international law whether Parliament's approval of tax treaties is a necessary precondition for their implementation, the process has the advantage that it makes tax treaties part of domestic tax law, and, therefore, subject to the jurisdiction of Canadian courts.

E. Application of International Law

A treaty is a contract between two sovereign states and is to be interpreted as an international agreement. This dual character of treaties makes their interpretation unique and generates extensive doctrinal disputes. As McNair said: there is no part of the law of treaties which [he] approaches with more trepidation than the question of interpretation. [4]

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[2] See, for example, *OECD Model Convention*, Article 7.
[3] See, for example, *OECD Model Convention*, Articles 10 and 11.
[4] A.D. McNair, *The Law of Treaties*, 2nd ed. (Oxford: Oxford Univ. Press, 1961).

We interpret tax treaties according to the rules of international law and not according to the rules of statutory interpretation that apply to domestic fiscal legislation.[5] Hence, the doctrine of strict interpretation of fiscal legislation is inappropriate for treaty interpretation. For example:[6]

> [t]he accepted principle appears to be that a taxing Act must be construed against either the Crown or the person sought to be charged, with perfect strictness so far as the intention of Parliament is discoverable. Where a tax convention is involved, however, the situation is different and a liberal interpretation is usual, in the interests of the comity of nations. Tax conventions are negotiated primarily to remedy a subject's tax position by the avoidance of double taxation rather than to make it more burdensome. This fact is indicated in the preamble to the Convention.

Thus, we give treaties a "liberal and extended construction".[7] This approach might be as much a function of the process by which countries negotiate treaties, rather than any formalistic principle of international treaty interpretation. Countries negotiate treaties through the diplomatic process in which legal accuracy is not always the primary concern. In *Maltass,* for example:[8]

> We cannot expect to find the same necessity of strict definition as in modern documents, such as a deed, or Act of Parliament: it has never been the habit of those engaged in diplomacy to use legal accuracy, but rather to adopt more liberal terms.

Similarly, in *Maximov v. United States*,[9] the U.S. Supreme Court said that the basic approach to treaty interpretation is "to give the specific words ... a meaning consistent with the genuine shared expectation of the contracting parties". And in *Air France v. Saks*:[10]

> Treaties are construed more liberally than private agreements, and to ascertain their meaning we may look beyond the written words to the history of the treaty, the negotiations, and the practical construction adopted by the parties.... The analysis must begin, however, with the text of the treaty and the context in which the words are used.

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[5] See generally A.D. McNair, *The Law of Treaties*, 2nd ed. (Oxford: Oxford Univ. Press, 1961); D.P. O'Connell, *International Law*, 2nd ed. (London: Stevens, 1970); McDougall, Lasswell & Miller, *The Interpretation of Agreements and World Public Order* (New Haven, CT: Yale Univ. Press, 1967); G.C. Fitzmaurice, "*Vae victis*, or, Woe to the Negotiators" (1971), 65 *Am. J. Intl. L.* 358; J.G. Castel, *International Law*, 3rd ed. (Toronto: Butterworths, 1976); J. Van Houtte, *Principles of Interpretation in Internal and International Tax Law* (Int. Bur. of Fisc. Doc., 1968); S.K. Agrawla (Ed.), *Essays on the Law of Treaties* (Essex: Orient Longman Ltd., 1972); T.O. Elias, *The Modern Law of Treaties* (Dobbs Ferry, N.Y.: Oceana Publications, 1974); G.C. Fitzmaurice, "The Law and Procedure in the International Court of Justice; Treaty Interpretation and Certain Other Treaty Points" (1951), 28 *Br. Yr. Bk. of Int'l. L.* 1; I.M. Sinclair, "Treaty Interpretation in the English Courts" (1963), 12 *Intl and Comp. L.Q.* 508; C.H. Schreuer, "The Interpretation of Treaties by Domestic Courts" (1971), 45 *Br. Yr. Bk. of Intl. L.* 255; J.L. Brierly, *Law of Nations* (4th ed., Oxford, 1949) at 234 *et seq.*; *Oppenheim's International Law* (8th ed. by H. Lauterpract, London, 1955) vol. 1, at 950 *et seq.*

[6] *Saunders v. M.N.R.*, 54 D.T.C. 524 at 526 (T.A.B.) cited with approval in *C.P. Ltd. v. The Queen*, [1976] C.T.C. 221, 76 D.T.C. 6120 (F.C.T.D.), *per* Walsh, J.: The parties are in agreement that the terms of a treaty will over-ride an Act and that it should be construed more liberally.

[7] *The Sante Cruz* (1798), 1 Ch. Rob. 50.

[8] *Maltass* v. *Maltass* (1844), Rob. Eccl. 67 at p. 73 and 76.

[9] *Maximov v. United States*, 299 F. to 565, 568, to d Cir. 1962) affd, 373 U.S. 49 (1963).

[10] 470 U.S. 392, 396-97 (1985).

The difficulties of treaty interpretation, however, go beyond the different traditions of the use of language in domestic legislative and diplomatic assemblies. Tax treaties are *bilateral* agreements between sovereign Contracting States that may have different legal systems, legislative processes, political traditions, and judicial structures. Thus, the parties to a treaty may not necessarily share the same community of legislative, administrative, or judicial values.

Contracting States left to their own domestic traditions may not interpret bilateral tax treaties in a manner that implements their underlying objectives. Further, each Contracting State has its own economic interests to advance, and their interests may influence the judicial approach to treaty interpretation. These issues can be particularly important in the interpretation of tax avoidance, abuse of law, and GAAR.

The interpretation of bilateral tax treaties raises issues that are not present in interpreting domestic fiscal legislation. For example:

- Should we interpret treaties according to the intention of the parties, the meaning of the words used or the object and spirit of the provisions?
- What is the interrelationship between the principles of interpretation that we use in domestic legislation and bilateral tax treaties?
- What is the role of legislative history in treaty interpretation?
- What is the role of Model Conventions?
- What is the relevance of domestic anti-avoidance and broad tax abuse principles?
- What is the role of anti-treaty shopping and limitation of benefits provisions?

F. Interpretation

Tax treaty interpretation differs from the interpretation of domestic fiscal statutes because of the underlying differences in which treaties and statutes come into existence. Bilateral tax treaties are concluded between sovereign states after extensive negotiations and, therefore, reflect an element of contractual consensus that is not present in domestic fiscal legislation.

Further, the interpretation of tax treaties by two Contracting States with completely different legal systems, traditions, and governmental structures requires consistency and coherence on the part of both States. The principles of tax treaty interpretation are also complicated by the necessity of interpreting them in a consistent manner to avoid or prevent double taxation and tax evasion.

There are at least two distinct differences between the interpretation of international tax treaties and domestic tax legislation. First, countries do not write international tax treaties with the same legislative precision as the *Income Tax Act*. Hence, it is unreliable to place as great an emphasis on the literal meaning of the words in a treaty. As Addy, J. said in *Gladden Estate*:[11]

> Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or

[11] *J.N. Gladden Estate v. The Queen,* [1985] 1 C.T.C. 163 at 166 (F.C.T.D.) (exemption of tax on capital gains of non-residents under the *Canada-U.S. Tax Convention* applies to deemed dispositions upon death).

> legalistic interpretation must be avoided where the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned.

A second difference is in the use of extrinsic evidence, such as, preparatory work in the form of committee reports, working papers and government documents. Traditionally, Canadian courts have not readily admitted much extrinsic evidence in the interpretation of the *Income Tax Act*.

Although Canadian courts have lowered some barriers towards the admission of extrinsic evidence, their approach to supplementary materials is cautious and one-sided. They generally restrict the admission of extrinsic evidence to official statements by the responsible Minister, government documents, such as the Minister's Technical Notes that she tables when she introduces finance legislation in the House, and the Canada Revenue Agency's administrative bulletins and interpretations.

In contrast, extrinsic evidence is readily admissible in the interpretation of international tax treaties. In the context of the English rules of statutory interpretation, the House of Lords said:[12]

> [s]o far as purely domestic legislation is concerned it is well established as a principle of interpretation that, even where the words of a statute are ambiguous or obscure, the proceedings in Parliament during the course of the passage of the Bill may not be resorted to for the purpose of ascertaining what ambiguities or obscure provisions mean…So, Hansard can never form part of the "travaux préparatoires" of any Act of Parliament whether it deals with purely domestic legislation or not…
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> It is, however, otherwise with that growing body of written law in force in the United Kingdom which, although it owes its enforceability within the United Kingdom to its embodiment in or authorization by an Act of Parliament, nevertheless owes its origin and its actual wording to some prior law-making process in which Parliament has not participated, such as the negotiation and preparation of a multinational international convention…which Her Majesty's Government wants to ratify on behalf of the United Kingdom but can only do when the provisions of the Convention have been incorporated in our domestic law…
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> My Lords, it would seem that courts charged with the duty of interpreting legislation in all the major countries of the world have recourse in greater or less degree to "travaux préparatoires" or "legislative history" (as it is called in the United States) in order to resolve ambiguities or obscurities in the enacting words…
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> Accordingly, in exercising its interpretative function of ascertaining what it was that the delegates to an international conference agreed upon by their majority vote in favour of the text or an international convention where the text itself is ambiguous or obscure, an English court should have regard to any material which those delegates themselves had thought would be available to clear up any possible ambiguities or obscurities.

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[12] *Fothergill v. Monarch Airlines Ltd.*, [1981] A.C. 251 at 281-3 (H.L.), *per* Lord Diplock. See also Art. 32, *Vienna Convention, ante*.

O'Connell explains the use of legislative history as follows:[13]

> From a policy point of view resort to travaux preparatoires is unavoidable. A municipal judge operates within an accepted context of social patterns, and is not open to the criticism of favoring a political position represented by one or other party. An international judge, however, is very vulnerable in this respect, and it is a guarantee both to him and to the litigant States of judicial impartiality if his area of discretion is delimited. Instead of devising a construction to a treaty which is open to alternative interpretations, he has the remedy of discovering exactly what the parties meant by examining their minutes of conferences, their correspondence and their rejected drafts. If objectivity is the aim of judicial construction, it is best achieved by this means. Furthermore, a treaty, unlike a municipal contract, often represents a compromise of vital political interests. To interpret it without reference to the struggle for compromise is gravely to over-simplify the problem of treaty application.

The OECD recommends that Member States adopt specific provisions that address abusive transactions. Further, Member States can also recognize domestic anti-avoidance provisions − such as, The General Anti-Avoidance Rule − in their bilateral tax treaties.[14]

Paragraphs 68-70 of the Commentary (2017) state as follows:

> Tax authorities seeking to address the improper use of a tax treaty may first consider the application of specific anti-abuse rules included in their domestic tax law.
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> Many specific anti-abuse rules found in domestic law apply primarily in cross- border situations and may be relevant for the application of tax treaties. For instance, thin capitalisation rules may apply to restrict the deduction of base-eroding interest payments to residents of treaty countries; transfer pricing rules (even if not designed primarily as anti-abuse rules) may prevent the artificial shifting of income from a resident enterprise to an enterprise that is resident of a treaty country; exit or departure tax rules may prevent the avoidance of capital gains tax through a change of residence before the realisation of a treaty-exempt capital gain; dividend stripping rules may prevent the avoidance of domestic dividend withholding taxes through transactions designed to transform dividends into treaty-exempt capital gains; and anti-conduit rules may prevent certain avoidance transactions involving the use of conduit arrangements.
>
> Generally, where the application of provisions of domestic law and of those of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of "pacta sunt servanda" which is incorporated in Article 26 of the Vienna Convention on the Law of Treaties. Thus, if the application of specific anti-abuse rules found in domestic law were to result in a tax treatment that is not in accordance with the provisions of a tax treaty, this would conflict with the provisions of that treaty and the provisions of the treaty should prevail under public international law.

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[13] D.P. O'Connell, *International Law*, 2nd ed. (London: Stevens, 1970), at 262.
[14] See, for example, Article XXIXA, *Canada-US Treaty* at paragraph 7.

Countries can use broad concepts – such as, anti-treaty shopping[15], anti-abuse, substance over form, and the general anti-avoidance rule (GAAR) – to prevent abusive tax avoidance. Some of these concepts are judge made, others are embodied in domestic tax legislation and others in bilateral double tax treaties.

A. Specific legislative Anti-abuse Rules (SAARs)

The OECD recognizes the use of specific anti-abuse rules as a mechanism for controlling tax avoidance and the problems that arise when such legislation conflicts with treaty provisions.

Paragraphs 70-75 of the OECD Commentary provides as follows:

> Many specific anti-abuse rules found in domestic law apply primarily in cross- border situations and may be relevant for the application of tax treaties. For instance, thin capitalisation rules may apply to restrict the deduction of base-eroding interest payments to residents of treaty countries; transfer pricing rules (even if not designed primarily as anti-abuse rules) may prevent the artificial shifting of income from a resident enterprise to an enterprise that is resident of a treaty country; exit or departure tax rules may prevent the avoidance of capital gains tax through a change of residence before the realisation of a treaty-exempt capital gain; dividend stripping rules may prevent the avoidance of domestic dividend withholding taxes through transactions designed to transform dividends into treaty-exempt capital gains; and anti-conduit rules may prevent certain avoidance transactions involving the use of conduit arrangements.

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[15] *Aiken Industries, Inc. v. Commissioner*, (1971) 56 T.C. 925.