TREATY SHOPPING and TAX AVOIDANCE

By

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General Comment

Agreements for the avoidance of double taxation are bilateral Conventions (herein, sometimes referred to as “treaties”) between sovereign States. The personal scope article of the Convention usually restricts treaty benefits to persons who are residents of the Contracting States (“treaty partners”). For example, Article I of the *OECD Model Convention (2017)*[1]:

> This Convention shall apply to persons who are residents of one or both of the Contracting States.
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> and the United Nations Model Double Taxation Convention between Developed and Developing Countries (1980) (2017 Update) (“*UN Model Convention*”).

and Article 1 of the *United States Model Income Tax Convention* (2016): [2]

> This Convention shall apply only to persons who are residents of one or both of the Contracting States, except as otherwise provided in this Convention.
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> Hence, “persons” and “residence” determine the initial parameters or scope of treaties.

Persons

Article 3(1)(a) defines "person" to include an individual, a company and any other body of persons.

Thus, the term "person" includes unincorporated entities that are treated as a body corporate for tax purposes and entities that, it follows that, although not incorporated, are treated as a body corporate for tax purposes. Hence, partnerships are also “persons” either because they fall within the definition of “company” or because they constitute other bodies of
persons. [3]

However, the *U.S. Model Treaty* has a longer list of inclusions in its definition of “person”. Article 3(1)(a) states that “person” includes an individual, an estate, a trust, a partnership, a company, and any other body of persons.

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[1] Convention between (State A) and (State B) for the Elimination of Double Taxation with respect to Taxes on Income and on Capital and the Prevention of Tax Evasion and Avoidance, adopted by the Organization for Economic Co-operation and Development (“OECD”) (the “OECD Model Tax Convention on Income and on Capital 2017”) (Paris: OECD Publishing, 2019), online: <http://dx.doi.org/10.1787/g2g972ee-en> (“*OECD Model Convention*”).
[2] Article 1 of the United States Model Income Tax Convention of February 17, 2016 (“*U.S. Model Treaty*”).
[3] See Commentary to Article 3 of the *OECD Model Convention*.

Article III(1)(e) of the *Canada-U.S. Treaty* is an exception.[4] Although it does not specifically mention partnerships, it does refer to "any other body of persons". For the purposes of treaty interpretation of undefined terms, one refers to the law of the taxing State.[5] The domestic rules of the other OECD member countries differ substantially in respect of the treatment of partnerships. Some countries treat partnerships as taxable units (sometimes even as companies), whereas other countries disregard the partnership entity. and treat it is a pure conduit for the partners.

Deemed Residence

Article 4 of the *OECD and UN Model Conventions* define the term "resident of a Contracting State" to mean "any person who under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of management or any other criterion of a similar nature …". Many countries *deem* a company to be resident in the country if it is incorporated therein. Canada, for example, deems a company incorporated in Canada to be a domestic corporation.[6] Hence, a foreign person may be eligible for tax treaty benefits merely by forming a corporation in Canada in order to bring itself within the personal scope of a Canadian bilateral tax treaty.

What is Treaty Shopping?

"Treaty shopping" refers to circumstances where a person who is not entitled to the benefits of a tax treaty makes use — in the widest sense of the word — of an individual or a legal person in order to obtain treaty benefits that are not available directly.[7] Treaty shopping refers to the use of a treaty by persons who might not ordinarily come within the personal scope article of the particular treaty.

Thus, treaty shopping allows one to do indirectly what a particular treaty may not permit directly. Treaty shopping can reduce withholding taxes, recharacterize income to exempt otherwise taxable income, and can result in double non-taxation of income.

Canada restricts treaty benefits to persons who are resident in the country. A corporation resides in Canada if it is incorporated in, or managed and controlled, in Canada. Hence, a foreign person could become eligible for tax treaty benefits merely by forming a corporation in Canada to bring itself within the Personal Scope of a Canadian bilateral tax treaty.

For example, §7701(a)(1) of the *Internal Revenue Code* defines "persons" to include an individual, a trust, estate, partnership, association, company, or corporation.[8] The phrase "body of persons" is broad enough to include partnerships to the extent that partnerships are not wholly treated as conduits.

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[4] Article III(1)(e) of the Convention between Canada and the United States of America with respect to Taxes on Income and on Capital, C.T.S. 1984 No. 15, entry into force August 16, 1984 ("*Canada-U.S. Treaty*").
[5] See, *Maximov v. United States*, 299 F.2d 565 (2nd Cir. 1962), affd 373 U.S. 49 (1963).
[6] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 250(4).
[7] Barry Larking, ed., *International Tax Glossary*, 4th ed. (Amsterdam: International Bureau of Fiscal Documentation, 2001).
[8] The United Kingdom courts have held that a "person" includes a partnership for the purposes of the *U.K.-Jersey Treaty*. *Padmore v. I.R.C.*, [1987] STC 36 and [1989] STC 493.

Nature of Treaty Shopping

Treaty shopping is the use of a treaty by persons who do not ordinarily come within its scope. Generally, treaty shopping occurs where residents of a State that is not party to a particular Treaty use it to obtain benefits under it that are otherwise not available to the resident. For example, a resident of State X creates a conduit company in State A to derive benefits under a Treaty between States A and B. The OECD is concerned about the "improper use of tax conventions" through the use of conduit legal entities ["*Double Tax Conventions and the Use of Conduit Companies*", November 27, 1986, "*Conduit Company Report*".

Canada's tax treaties typically have anti-avoidance provisions pertaining to withholding taxes on, for example, dividends, interest, royalties, and business income not connected to a permanent establishment in the country. The objective of treaty shopping is to reduce source taxation typically on such payments. This may occur where the treaty shopper's country of residence does not have a tax treaty with the source State or, if it does have a treaty, the treaty has less favourable terms than another more advantageous treaty. The treaty shopper then shops for a treaty with a third State and sets up residence in the country through an entity (usually a corporation) to exploit the Treaty.

Hence, the essence of treaty shopping is to bring the taxpayer within the personal scope of a treaty to derive its benefits that would not otherwise be available to it as a non-resident person. Thus, in the absence of controls, a foreign person could reduce an entity's income and avoid source taxation by having it pay interest, royalties, compensation, or other deductible amounts through a conduit.

The principal impetus for treaty shopping is withholding taxes (sometimes as high as 30 percent) on passive income, such as dividends, interest, and royalties. The withholding tax on dividend payments can be particularly onerous because dividends are often subject to double taxation, once at the corporate level and again in the hands of the recipient shareholder. Although bilateral tax treaties generally reduce withholding taxes, rates of reduction are uneven and the spread between a high rate and a low-rate treaty country can substantially affect the after-tax rate of return on international financing.

Essential Characteristics

Treaty shopping typically involves three features:

1. The beneficial owner of the treaty shopping conduit does not reside in the country where the entity is created;

2. The conduit has minimal economic activity in the jurisdiction in which it is located; and

3. The income is subject to minimal (if any) tax in the country of residence.

There are two common variations on these features. A taxpayer may use a conduit to shift income from the source country to the ultimate recipient and beneficial owner of the income. This requires a corporation (or other entity) to act as a conduit in a country with a favourable treaty that has a special or preferential exemption under the domestic laws of the country where it is created. Thus, the

structure must satisfy both conditions for the arrangement to be successful: (l) The conduit itself must be tax exempt in the country where it is organized and (2) The income should pass through the conduit to the beneficial owner with minimum withholding taxes.

In the absence of any controls, a foreign person in the above circumstances can reduce its income and avoid source taxation by having the payer pay interest, royalties, compensation, or other deductible amounts through a conduit.

We shall discuss beneficial ownership and treaty shopping in a follow up article.