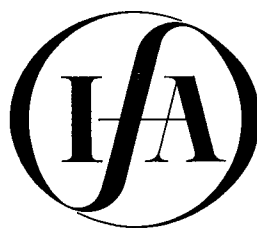


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Tax treaties and tax avoidance:
application of anti-avoidance provisions

Sdu

The Netherlands

1. Domestic anti-avoidance provisions with an international scope

1.1. General overview

This report describes US anti-avoidance doctrines and provisions and their relationship with tax treaties. The USA is a common law jurisdiction. It does not currently have a general statutory anti-avoidance rule,¹ but has several judicially developed anti-abuse² doctrines that may be used by the Internal Revenue Service (IRS) to challenge a transaction. These doctrines include the business purpose, economic substance, step transaction, substance over form and sham transaction doctrines. Although these doctrines are described herein as distinct for purposes of simplicity, they may overlap in certain circumstances and are not always applied consistently by courts.

These judicially developed anti-abuse doctrines may be applied in the international context, including when tax treaties are involved. In addition to these judicially developed anti-abuse doctrines, the US tax rules (the Internal Revenue Code)³ contain several specific international anti-avoidance rules, discussed in additional detail below.⁴

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¹ In the last decade, however, proposals to codify the “economic substance” doctrine have regularly been introduced in Congress. In the most recent House of Representatives version of economic substance codification, a new Code provision would provide: “In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction”: §562, Affordable Health Care for America Act, H.R. 3962 (2009). Under the recent proposals, codification would apply to transactions undertaken after the date of enactment.

² We may use the term “avoidance” or the term “abuse”. The term “abuse” arguably is a more accurate description of the scope of the doctrines used in the USA.

³ All references to the Code are to the Internal Revenue Code of 1986, as amended, and all references to “Treas. Reg. §” are to the Treasury regulations thereunder.

⁴ There are many specific non-international Code provisions and regulations with their own anti-abuse rules, such as the partnership anti-abuse rule of Treas. Reg. § 1.701-2(b) and the “clear reflection of income” requirement of Code s. 446, but these rules typically have not been used in the treaty context. Internationally related Code provisions have their own “clear reflection” rule in Code s. 482. See discussion below in section 1.3.5.

Anti-abuse doctrines in US tax law are generally considered to emanate from the US Supreme Court decision in *Gregory v. Helvering*.⁵ In *Gregory*, a taxpayer established a temporary subsidiary to convert ordinary income to capital gains. The taxpayer was the sole shareholder of a corporation that owned securities with a built-in gain. Rather than have the corporation sell the securities and then distribute the proceeds as an ordinary income dividend, the taxpayer had the corporation transfer the securities to a newly formed, temporary corporation, which was distributed by the first corporation to the taxpayer, and which then liquidated and distributed its assets (the securities) to its sole shareholder (the taxpayer). The taxpayer then sold the securities and claimed that the proceeds were capital gains.

The US Supreme Court, affirming a lower-court decision, disregarded the purported reorganization, stating that the transaction was:

“Simply an operation having no business or corporate purpose – a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. . . . The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction, upon its face, lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.”⁶

The business purpose doctrine generally requires that a taxpayer have a business reason, other than avoidance of taxes, for entering into a transaction. Certain tax rules, such as the rules according tax-free status to certain reorganizations, require a business purpose. In the absence of an explicit Code or regulatory business purpose requirement, the business purpose doctrine typically is used by courts via incorporation into other judicial anti-abuse doctrines, the most significant of which is probably the economic substance doctrine.⁷ The economic substance doctrine

⁵ *Gregory v. Helvering*, 293 US 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934).

⁶ *Ibid.* at 469–470.

⁷ The economic substance doctrine is a judicial doctrine intended “to prevent taxpayers from claiming tax benefits of transactions, which, although they may be within the language of the Code, are not the type of transaction Congress intended to favor”: *Horn v. Comm’r*, 968 F.2d 1229, 1236 (DC Cir. 1992). Courts typically evaluate whether (a) the transaction has objective economic substance (i.e. a change in the taxpayer’s economic position) and (b) the taxpayer has a subjective non-tax business purpose for entering into the transaction. Among the 13 Federal appellate courts (which are, in general, distinguished by geographical jurisdiction), the Federal, First, Seventh, and Eleventh Circuits apply a “conjunctive” test and require a transaction to have both objective economic substance and a subjective non-tax business purpose: *Coltec Industries, Inc. I. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert denied* 127 S. Ct. 1261 (2007); *Deweese v. Comm’r*, 870 F.2d 21 (1st Cir. 1989); *Yosha v. Comm’r*, 861 F.2d 494 (7th Cir. 1988); *United Parcel Service of Am., Inc. v. Comm’r*, 254 F.3d 1014 (11th Cir. 2001). The Second, Fourth, Eighth, and DC Circuits apply a “disjunctive” economic substance test so that the presence of either economic substance or business purpose is sufficient to satisfy the doctrine: *DeMartino v. Comm’r*, 862 F.2d 400 (2d Cir. 1988); *Rice’s Toyota World*, 752 F.2d 89 (4th Cir. 1985); *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); *Horn v. Comm’r*, 968 F.2d 1229, 1236 (DC Cir. 1992). The Third, Fifth, Sixth, Ninth, and Tenth Circuits view economic substance and business purpose as relevant factors

generally has not been used to invalidate the results of transactions involving the abuse of tax treaties.⁸

1.2. General anti-abuse provisions with international focus or effect

The US general anti-abuse judicial doctrines do not have a specific international focus but may have international effect.

1.2.1. Substance over form

In *Gregory v. Helvering*, the Supreme Court stated: “As a general rule, the incidence of taxation depends on the substance rather than the form of the transaction.” The “substance over form” doctrine is typically used to disallow tax benefits arising from transactions in which form differs from substance.

In the treaty context, the “substance over form” principle has been used to disregard intermediate entities as mere “conduits” or “shams” used to obtain tax treaty benefits.⁹

1.2.2. Sham entity

This “sham entity” test has its basis in several US Supreme Court cases. In *Higgins v. Smith*,¹⁰ the taxpayer formed a wholly owned corporation to which he sold securities in order to generate a loss.¹¹ The Supreme Court disregarded the corporation, stating that if “the *Gregory* case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration”. In *Moline Properties, Inc. v. Commissioner*,¹² however, the Supreme Court held that the corporate form should not be disregarded when there was a valid business purpose for forming the entity or when substantive business activity existed, stating:

cont.

to consider in determining whether a transaction satisfies the economic substance doctrine: *ACM Partnership v. Comm’r*, 157 F.3d 231 (3d Cir. 1998); *Merryman v. Comm’r*, 873 F.2d 879 (5th Cir. 1989); *Rose v. Comm’r*, 868 F.2d 851 (6th Cir. 1989); *Casebeer v. Comm’r*, 909 F.2d 1360 (9th Cir. 1990); *Keeler v. Comm’r*, 243 F.3d 1212 (10th Cir. 2001).

⁸ The economic substance doctrine has, however, increasingly been applied to cross-border transactions. See e.g. *Schering-Plough Corp. v. United States*, no. 05-2575 (D.N.J. 28 August 2009) (recharacterizing swap-and-assignment transactions between a US corporation and its foreign subsidiaries as loans from foreign subsidiaries to a US corporation to subject transactions to tax as a deemed repatriation under one of the US controlled foreign company (CFC) rules (Code s. 956)). See e.g. *Teong-Chan Gaw v. Commissioner*, T.C. Memo. 1995-531, 70 T.C.M. 1196.

⁹ See e.g. *Teong-Chan Gaw v. Commissioner*, T.C. Memo. 1995-531, 70 T.C.M. 1196.
¹⁰ *Higgins v. Smith*, 308 US 473 (1940).

¹¹ The case preceded the enactment of what is now Code s. 267(a)(1), which disallows deductions for such losses.

¹² *Moline Properties, Inc. v. Comm’r*, 319 US 436 (1936). In *Moline Properties*, a lender had requested that an individual form a corporation to hold the mortgage and title to certain property. The corporation carried out some activity, including refinancing and leasing portions of the property.

“Whether the purpose [of incorporating] be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator’s personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.”¹³

The Court concluded, “the corporate form may be disregarded where it is a sham or unreal”.¹⁴

In *Aiken Industries v. Commissioner*,¹⁵ the US Tax Court concluded that interest received by a Honduran corporation in a back-to-back loan arrangement was not actually “received”, as that term was used in the tax treaty, so that the interest was subject to withholding. A US subsidiary of Aiken Industries had borrowed funds from Aiken Industries’ Bahamian parent in exchange for a note. The Bahamian parent corporation then assigned the note to a Honduran affiliate, *Industrias Hondureanas, SA* in exchange for *Industrias’* own promissory notes. In the years at issue, there was a treaty in force between the USA and Honduras that provided for zero withholding on interest paid by a US corporation to a Honduran corporation. The treaty provided that:

“Interest on bonds, securities, notes or on any other form of indebtedness from sources within one of the contracting States received by a resident, corporation or other entity of the other contracting State not having a permanent establishment within the former State at any time during the taxable year in which such interest is received, shall be exempt from tax by such former State.”¹⁶

The Tax Court did not explicitly apply the “sham entity” principles of *Smith* and *Moline Properties*, but rather focused on the language of the treaty, first concluding that *Industrias* could not be disregarded as an entity because it qualified as a “corporation” under the definitions of the treaty. The court then determined, however, that the interest payments were not “received by” a corporation of a contracting state as required by the treaty. According to the court,

“As utilized in the context of article IX, we interpret the terms ‘received by’ to mean interest received by a corporation of either of the contracting States as its

¹³ See *Rogers v. Commissioner*, 34 T.C.M. 1254 (1975) (“*Moline* establishes a two-pronged test, the first part of which is business purpose, and the second, business activity. . . . Business purpose or business activity are alternative requirements”).

¹⁴ The Supreme Court has affirmed the *Moline Properties* principle in subsequent cases, holding that a corporation may act as an agent of its owner in certain narrow circumstances. *Commissioner v. Bollinger*, 485 US 340 (1988). In *Bollinger*, the Supreme Court cited a previous decision, *National Carbide Corp. v. Commissioner*, 336 US 422 (1949), for factors to be used in determining whether a corporation could be deemed an agent for its shareholders and concluded that the corporation was an agent where “the fact that the corporation is acting as its shareholders’ agent with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not the principal in all dealings with third parties relating to the asset”.

¹⁵ *Aiken Industries, Inc. v. Comm’r*, 56 T.C. 925 (1971).

¹⁶ Art. IX, 1957 USA–Honduras tax treaty.

own and not with the obligation to transmit it to another. The words ‘received by’ refer not merely to the obtaining of physical possession on a temporary basis of funds representing interest payments from a corporation of a contract State, but contemplate dominion and control over the funds.”

The court concluded that *Industrias* was “merely a conduit” and a “collection agent” and thus the interest payment did not qualify under the US-Honduran treaty.¹⁷

In *Teong-Chan Gaw v. Commissioner*,¹⁸ the Tax Court applied substance over form principles and determined that a US corporation’s interest payments to various intermediate entities were actually directed to non-treaty protected foreign corporations and thus subject to 30 per cent withholding. For example, in one of the transactions, the US corporation obtained a loan from a Dutch corporation that was a subsidiary of a Hong Kong corporation. The Tax Court determined that the interest payments on the loan were actually directed to the Hong Kong corporation and thus did not qualify for a zero withholding rate under the USA–Netherlands tax treaty. The Tax Court stated that, under the substance over form doctrine, “although the form of a transaction may literally comply with the provisions of the Code, that form will not be given effect where it has no business purpose and operates simply as a device to conceal the true character of that transaction”. The court concluded that the taxpayer did not carry his burden of showing that there were any non-tax business reasons for the transaction and thus the loan was treated as being made from the Hong Kong corporation.

The IRS attempted to use similar “conduit” principles to disregard a Netherlands Antilles company in *Northern Indiana Public Service Co. v. Commissioner (NIPSCO)*.¹⁹ Northern Indiana Public Service Co., a US corporation, had formed a Netherlands Antilles financing subsidiary (Finance) to borrow funds in the Eurobond market. Finance issued \$70 million of notes and then lent the proceeds to the US corporation, which had issued a \$70 million note to the Netherlands Antilles subsidiary. If the transaction was respected, there would be no withholding on either the interest payments from Finance to the investors or from Northern Indiana to Finance. If the transaction was treated as involving loans from Northern Indiana to the investors, the interest payments would be subject to 30 per cent withholding.²⁰

The court determined that, under *Gregory* and *Aiken Industries*, “[t]ransactions involving a foreign corporation are to be disregarded for lack of meaningful economic activity if the corporation is merely transitory, engaging in absolutely no business activity for profit – in other words, it is a ‘mere skeleton’”. The court noted that Finance made a profit on its borrowing and lending activities, Finance reinvested its proceeds and Northern Indiana had no control over the reinvestments, and Finance had borrowed from unrelated parties. Because “Finance carried on sufficient business activity”, the court concluded that the interest transactions should be respected.²¹

¹⁷ See section 2 for a discussion of the conduit provisions in the USA–UK tax treaty.

¹⁸ *Teong-Chan Gaw v. Commissioner*, T.C. Memo. 1995-531, 70 T.C.M. 1196.

¹⁹ *Northern Indiana Public Service Co. v. Comm’r*, 115 F.3d 506 (7th Cir. 1997).

²⁰ The “portfolio interest exemption” under current law would prevent the result of 30 per cent withholding on interest payments from the US corporation to foreign investors.

²¹ See *Indofood International Finance Ltd v. JP Morgan Chase Bank N.A. London Branch* [2006] EWCA Civ. 158 for an interesting UK back-to-back loan case.

In *SDI Netherlands BV v. Commissioner*,²² the IRS used a variation of the conduit concept, arguing that royalties paid from a Netherlands company to a Bermuda company for a worldwide license should be treated as US source to the extent that those royalties were attributable to the royalties that the Netherlands company received from a US company for a US license. The royalties paid from the USA to the Netherlands were exempt under the US–Netherlands tax treaty. Although the court noted that the IRS had not argued that the Netherlands company was a mere conduit of the US company, it viewed “the flow-through characterization concept [as] the conduit concept albeit in a somewhat different garb, i.e., whether the US source income is being received as such, because of the status of the paying entity in one case, and the status of the subject matter of the payment in the other”. The court, after reviewing *Aiken Industries* and *NIPSCO*, determined that the case was more similar to *NIPSCO*: “the two license agreements had separate and distinct terms and [the Netherlands company] had an independent role as the licensee from [the Bermuda company] and the licensor of the other entities, including but not limited to [the US company]”. The Tax Court’s decision in *SDI Netherlands* has been criticized as contrary to the plain language of section 861(a)(4), which provides that US source income includes royalties paid for the use of intellectual property in the USA.²³

1.2.3. Step transaction doctrine

Under the step transaction doctrine, formally separate steps of a transaction may be treated as a single transaction for tax purposes. The step transaction doctrine may be viewed as another variation of the “substance over form” principle. In determining whether steps should be integrated under the step transaction doctrine, courts and the IRS typically have applied three alternative tests. In the strictest test, the “binding commitment” test, a series of transactions will be “stepped together” only if, at the time the first step occurs, there is a binding commitment to undertake the subsequent steps.²⁴ In the “mutual interdependence” test, a series of transactions will be stepped together if the steps were “so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series”.²⁵ Under the “end result” test, a series of transactions will be stepped together if the parties’ intent at the commencement of the transactions was to achieve the particular result and the steps were all entered into to achieve that result.²⁶

²² *SDI Netherlands BV v. Comm’r*, 107 T.C. 161 (1996).

²³ See e.g. Michael J. McIntyre, “The Tax Court’s Indefensible Decision in *SDI Netherlands*”, *Tax Notes*, 98 TNT 2-73 (5 January 1998); Alice Welt Cunningham, “Sourcing Royalties Paid by Foreign Intermediaries,” *Tax Notes*, 97 TNT 159-40 (18 August 1997).

²⁴ See e.g. *Comm’r v. Gordon*, 391 US 83 (1968).

²⁵ *Estate of Christian v. Comm’r*, 57 T.C.M. 1231, 1243 (1989); see *Am. Bantam Car Co. v. Comm’r*, 11 T.C. 397 (1948), *aff’d pur curiam*, 177 F.2d 513 (3d Cir. 1949), *cert denied* 339 US 920 (1950).

²⁶ “Although there is no single set of factors that determines whether the step transaction doctrine should be applied, the courts generally look to the intent of the parties and the time interval between the transfers”: FSA 200122007 (13 February 2001); see e.g. *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

The step transaction doctrine has been used by courts to prevent a taxpayer from structuring a transaction in a certain way to gain treaty benefits. In *Del Commercial Properties Inc. v. Commissioner*,²⁷ the District of Columbia Court of Appeals held that Del Commercial Properties Inc. (Commercial), a US corporation, was liable for withholding tax in a back-to-back loan transaction. Delcom Financial Ltd (Financial), a Canadian corporation and an affiliate of Commercial, obtained a \$18 million loan from a third-party bank. Financial then loaned \$14 million of the loan to its wholly owned Canadian subsidiary, which then contributed \$14 million to its wholly owned Cayman subsidiary, which contributed the \$14 million to its wholly owned Antilles subsidiary, which contributed the \$14 million to its wholly owned Netherlands subsidiary (BV). BV then loaned the \$14 million to Commercial. Although the taxpayer had at first made its loan payments to BV (which then transferred the payments to Financial or Financial's Canadian subsidiary), it began making loan payments directly to Financial after a year and a half. The taxpayer claimed that the loan from BV to Commercial should be respected and that its interest payments to BV were not subject to withholding under the 1965 USA–Netherlands tax treaty, while the IRS argued that the loan was actually from Financial to Commercial and that interest payments were subject to 15 per cent withholding under the 1985 USA–Canada tax treaty.

The DC Circuit evaluated the transaction under the step transaction doctrine, stating that a step in a series of transactions would be ignored if the step does “not appreciably affect [the taxpayer’s] beneficial interest except to reduce his tax”.²⁸ The court found persuasive two revenue rulings from the IRS, stating that “if the sole purpose of the transaction with a foreign country is to dodge US taxes, the treaty cannot shield the taxpayer from the fatality of the step-transaction doctrine. For the taxpayer to enjoy the treaty’s tax benefits, the transaction must have a sufficient business or economic purpose.”²⁹ Although the court (like the lower court) described and purported to apply the step transaction doctrine, the court’s holding appears to be grounded more in substance over form and conduit principles, concluding that all of the payments from Commercial were subject to withholding because Commercial did not show that BV had “any business or economic purpose sufficient to overcome the conduit nature of the transaction”.

1.3. Specific anti-avoidance provisions with international focus or effect

1.3.1. Thin capitalization rules (section 163(j))³⁰

The USA has thin capitalization rules limiting the deductibility of interest (a) that is paid by a US person to a related party if the related party is not taxed on the interest, or (b) that is (i) paid by a US person on indebtedness that is guaranteed by a

²⁷ *Del Commercial Properties Inc. v. Commissioner*, 251 F.3d 210 (DC Cir. 2001).

²⁸ *Ibid.* (quoting *ASA Investering*, 201 F.3d 505, 512 (DC Cir. 2000)).

²⁹ *Ibid.*

³⁰ Courts typically analyze several factors in determining whether an instrument represents debt or equity. This debt–equity analysis may be applied in cross-border cases. See *Laidlaw Transportation Inc. v. Comm’r*, 1998-232.

related foreign person and (ii) not subject to gross basis taxation.³¹ Under these rules, an interest deduction is denied, at least in part, in the two situations described above if: (a) the US corporation has a debt-to-equity ratio of 1.5 to 1, or greater, and (b) the corporation's net interest expense (the amount the interest paid by the corporation exceeds the amount of the interest earned by the corporation) exceeds 50 per cent of its adjusted gross income.

1.3.2. Losses, expenses, and interest in transactions between related taxations (section 267)

Section 267 limits the deductibility of losses from the sale of property to foreign controlled affiliates of US persons. Section 267 also may limit the deductibility of interest deductions by US corporations for interest owed to non-US affiliates.

1.3.3. Stapled stock (section 269B)

Under section 269B, non-US corporations may be treated as US corporations for US tax purposes if a US corporation and a non-US corporation are "stapled entities" subject to an arrangement in which the stock of both must be transferred together.

1.3.4. Gain recognition on non-recognition transactions (section 367)

Section 367 contains a series of anti-abuse rules relating to transfers to and from non-US persons. For example, section 367(a) may require a US person to recognize gain on the "outbound" transfer of property to a foreign corporation in certain transactions that might otherwise qualify for non-recognition treatment.

1.3.5. Transfer pricing and use of the arms' length standard (section 482)

US transfer pricing rules incorporate the arms' length standard and may be used by the IRS to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more related corporations if the IRS determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or to clearly reflect income.³²

1.3.6. Interest expense allocation (section 864(e))

Section 864 provides that allocations and apportionments of interest expense shall be made on the basis of assets rather than gross income. This rule differs from the general allocation and apportionment rule for deductions, which generally allow for apportionment using gross income, gross sales, or expenses incurred.

³¹ S. 163(j).

³² S. 482.

1.3.7. Expatriation rules (sections 877, 877A, and 7874)

For any covered individual who expatriates after 17 June 2008, the Internal Revenue Code provides that all property of the individual shall be treated as sold on the day before expatriation for its fair market value.³³ The rules provide for a \$600,000 exemption and for an election to defer tax in certain circumstances if adequate security is provided. Covered individuals who expatriated before 17 June 2008 generally are subject to a tax for 10 years after expatriation.³⁴

Section 7874 subjects formerly US corporations that reorganize in non-US jurisdictions to tax on their “inversion gain”. In certain circumstances, formerly US corporations that reorganize as non-US corporations will continue to be treated as US corporations for US tax purposes.

1.3.8. Anti-conduit rules (section 881)

Regulations promulgated under section 881 of the Internal Revenue Code provide rules limiting the ability of taxpayers to reduce or eliminate withholding tax through the use of conduit entities established in jurisdictions with favorable treaty rates.³⁵ Under the regulations, intermediate entities may be disregarded for US tax purposes and the IRS may recharacterize ostensibly separate financing transactions as a direct financing arrangement. An entity may be treated as a conduit if (a) there are two or more “financing transactions”, which may involve debt and certain non-debt instruments, linked by an “intermediate entity” or group of entities (together, a “financing arrangement”), (b) the use of the intermediate entity reduces tax, and (c) the participation of the intermediate entity is pursuant to a tax avoidance plan.³⁶

1.3.9. Branch profits taxes (section 884)

The USA has “branch profits” tax rules that are designed to create tax parity between US business operations conducted in subsidiary form and those conducted in branch form.³⁷ The branch profits tax regime consists of three main components: (a) a tax on certain profits of a foreign corporation’s US business operations, (b) a branch-level interest tax on interest paid, or deemed paid, by a foreign corporation’s US trade or business, and (c) an anti-treaty shopping rule.³⁸ In general, a foreign

³³ S. 877A.

³⁴ S. 877.

³⁵ Treas. Reg. §1.881-3.

³⁶ Proposed regulations, issued on 22 December 2008, would treat “disregarded entities”, see Treas. Reg. §1.301.7701-2, as regarded “persons” for purposes of applying the anti-conduit regulations: 73 Fed. Reg. 246, REG-113462-08 (22 December 2008). Although a disregarded entity is generally disregarded for US federal income purposes, it may qualify as the beneficial owner of income under an income tax treaty because treaty residence (in the absence of specific treaty hybrid entity rules) turns on the entity’s non-US tax treatment. As a result, a disregarded entity may be used to reduce or eliminate withholding tax. Because certain taxpayers apparently took the position that a disregarded entity was not a separate “person” under the anti-conduit regulations and thus could not be an “intermediate entity”, the IRS issued the proposed regulations.

³⁷ S. 884; Treas. Reg. §1.884.

³⁸ Treas. Reg. §1.884-0(a).

corporation must be a “qualified resident”³⁹ of a treaty country in order to claim an exemption or rate reduction with respect to the branch profits tax, the branch level interest tax, and the tax on dividends paid by the foreign corporation. A foreign corporation is treated as a qualified resident if the foreign corporation is a resident of the country under the treaty and either meets certain ownership and base erosion requirements, meets certain publicly traded requirements, meets certain active trade or business requirements, or obtains a special ruling from the IRS that it is a qualified resident.⁴⁰

1.3.10. Hybrid entity rules (section 894(c))

The Code provides rules for when an item of income received by a fiscally transparent entity with respect to an item of income shall be eligible for reduction under a tax treaty. Section 894(c) of the Code provides that a foreign person shall not be entitled to a reduced rate of withholding tax under a tax treaty with a foreign country on an item of income derived through a fiscally transparent entity if (a) the item is not treated under the laws of the foreign country as an item of income of the person, (b) the treaty does not contain a provision addressing the applicability of the treaty in the case of income derived through a fiscally transparent entity, and (c) the foreign country does not impose tax on a distribution of the item of income from the entity to the person. Further rules applicable to hybrid entities and domestic reverse hybrid entities in the treaty context are provided in regulations.⁴¹

1.3.11. Disposition of Investment in US immovable property (section 897)

Under the Code, the sale of shares in a “United States Real Property Holding Corporation” is treated as effectively connected with a US trade or business and thus subject to US tax.⁴² This applies even when a treaty would prevent taxation of capital gains at source.

1.3.12. Foreign tax credit rules (sections 901 through 908)

The US foreign tax credit rules contain a variety of rules designed to prevent abuse of the foreign tax credit. For example, a foreign tax used to provide a “subsidy” is not creditable, nor is a non-compulsory tax. In addition, section 901(k) imposes minimum holding periods for certain taxes on dividends to qualify for the foreign tax credit.

1.3.13. CFC regime (sections 951 through 965)

The taxation of income earned by CFCs of US corporations is generally “deferred” until such income is repatriated by dividend to the USA. Certain exceptions are

³⁹ Note that the “qualified resident” requirement may be viewed as parallel to the LOB treaty rules.

⁴⁰ Treas. Reg. §1.884-5.

⁴¹ S. 894(c)(2). Some have questioned whether the hybrid entity provisions are relevant to the question of whether an entity is entitled to the protection of the treaty’s permanent establishment article.

⁴² S. 897.

continued in “Subpart F” of the Code. For example, certain passive income earned by CFCs may be currently taxed. Another component of Subpart F (section 956) may require US shareholders to be taxed currently on loans or other deemed repatriations from their foreign shareholders.

1.3.14. Gain from sales or exchanges in certain foreign corporations (section 1248)

Section 1248 may recharacterize a gain recognized by a US shareholder on the disposition of stock in a CFC as a dividend to the extent of earnings attributable to the US shareholder’s ownership interest in the CFC. Although now often used to harvest foreign tax credits, the provision was enacted and still may function as an anti-abuse rule.⁴³

1.3.15. Passive foreign investment companies (PFIC) (sections 1291 to 1298)

The PFIC rules generally apply to US persons owning shares of foreign corporations, at least 75 per cent of the income of which is passive or at least 50 per cent of the assets of which produce passive income. The PFIC rules may impose an interest charge on final dispositions, a current tax on undistributed income, or an annual mark-to-market tax on appreciation or depreciation in the stock’s value.

1.3.16. Dual consolidated losses (section 1503(d))

The dual consolidated loss rules of section 1503(d) prevent a US corporation from claiming a loss when the same loss has been claimed by the US corporation against foreign taxes.

1.3.17. Multi-party financing transactions (section 7701(l))

Section 7701(l) authorized regulations “recharacterizing any multi-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed”.

1.4. The relationship between the domestic anti-avoidance provisions and tax treaties

In general, US courts have not viewed domestic anti-abuse rules as inconsistent with treaties. Rather, they have applied domestic anti-abuse rules to questions involving the availability of treaty benefits as fully as they have applied those rules to other tax questions.

⁴³ See also Code s. 304, enacted as an anti-abuse rule but now often used by taxpayers affirmatively, particularly in the cross-border setting.

1.4.1. Domestic anti-avoidance provisions complementing treaties

Anti-abuse rules in US tax treaties are discussed in section 2. Briefly, these include, among other provisions, limitation on benefits (LOB) articles (qualified resident rules), beneficial owner requirements, related party rules allowing reclassification of interest and royalty payments, related party rules circumscribing allocation of expenses to permanent establishments, and provisions relating to fiscally transparent entities, conduits, and dual resident entities. Of these, we can find complementary domestic anti-avoidance provisions dealing with qualified resident rules (for branches), debt–equity authorities allowing reclassification of interest payments among related parties, related party (transfer pricing) rules circumscribing allocation of income and expenses, and provisions relating to fiscally transparent entities, conduits, and dual resident entities.

In addition, the US judicial anti-abuse doctrines are used to restrict treaty benefits in what are regarded as abusive situations. For example, in *Gaw and Del Commercial Properties*, discussed above, domestic anti-abuse doctrines were used to prevent taxpayers from gaining a treaty benefit in situations in which an intermediate entity appeared to be used solely to take advantage of a favorable tax treaty. Although the Tax Court purported to interpret the text treaty in reaching its result, *Aiken Industries* may also be viewed as the application of a judicial anti-abuse doctrine.

Although US courts typically do not explicitly state that they are evaluating claims of treaty benefits in the light of the “object and purpose” of the tax treaty, the cases generally are consistent with the statement in paragraph 9(5) of the OECD model tax convention commentary on article 1 that “the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions”. Domestic anti-abuse rules, however, do not always allow the IRS to attack successfully transactions designed to gain the advantage of treaty application, such as the back-to-back royalties through a Netherlands company in *SDI Netherlands BV v. Commissioner*.

Moreover, it is important to note that the “main purpose” language of the OECD model commentary was specifically rejected by the US Senate in its consideration of proposed treaties with Italy and Slovenia. The Senate placed reservations on those treaties when it approved them in 2000, which were based on concerns about a “main purpose” anti-abuse rule. The Slovenians promptly agreed to the treaty with the reservation but the Italian treaty entered into force only in late 2009, after almost 10 years of consideration by the Italians. The delay reportedly related to concerns over the US Senate reservation.

1.4.2. Domestic anti-avoidance provisions limiting the application of treaties (treaty overrides)

Under the US Constitution, federal domestic law and treaties are on equal footing.⁴⁴ Although a court will attempt to give effect to both when they relate to the

⁴⁴ US Const. art. VI, cl. 2.

same subject, if there is a clear conflict between a treaty and federal law, the later in time authority will prevail.⁴⁵

Several of the specific anti-avoidance provisions with international focus or effect limit the application of the US tax treaties (i.e. are treaty overrides). The US conduit financing regulations, the hybrid entity rules, the individual expatriation rules, the branch profits tax, and the tax on the disposition of investments in US immovable property, discussed above, may be viewed as treaty overrides.⁴⁶ In a number of these cases, the US treaties have been systematically amended to be harmonized with the domestic rules so no override has continued. Numerous other legislative proposals that have not been enacted also would raise override issues under our treaties, including limitations on treaty benefits when benefit claimants are owned by non-treaty based parents,⁴⁷ and foreign tax credit pooling proposals.⁴⁸

1.4.3. Domestic anti-avoidance provisions circumventing treaties

The application of judicial anti-avoidance doctrines by US courts in the tax treaty context generally is consistent with the OECD's observations in paragraph 22(1) of the commentary to article 1 that "as a general rule" there is no conflict between US tax law and the tax treaties. As described above, however, the US use of treaty overrides in its specific anti-avoidance provisions may be seen as in conflict with the US treaty obligations, although some have argued that the US use of treaty overrides may be viewed as consistent with the dual purpose of tax treaties to eliminate double taxation and double non-taxation.⁴⁹

1.5. Abuse of the tax treaty itself: domestic law principles or interpretation of the treaty?

Although the USA is not a party to the Vienna Convention on the Law of Treaties,⁵⁰ which requires countries to interpret the words of the treaty in its context and in light of the treaty's object and purpose,⁵¹ the US Department of State has stated that

⁴⁵ *Whitney v. Robertson*, 124 US 190 (1888); see s. 7852(d) ("For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law"); Sen. Rep. no. 100-445, 100th Cong. ("In adopting this rule, the committee intends to permanently codify (with respect to tax-related provisions) present law to the effect that canons of construction applied by the courts to the interaction of two statutes enacted at different times apply also in constructing the interactions of revenue statutes and treaties enacted and entered into at different times").

⁴⁶ The US thin capitalization rule also may be viewed as a treaty override, although the USA has argued that it does not violate non-discrimination rules because it applies to both domestic and foreign tax-exempt related parties.

⁴⁷ §561, America's Affordable Health Choices Act, H.R. 3200 (2009); §3203, Tax Reduction and Reform Act of 2007, H.R. 3970 (2007).

⁴⁸ §3201, Tax Reduction and Reform Act of 2007, H.R. 3970 (2007); US Treasury Department, General Explanations of the Administration's FY 2010 Revenue Proposals 41 (2010).

⁴⁹ Reuven S. Avi-Yonah, "Tax Treaty Overrides: A Qualified Defence of U.S. Practice" in *Tax Treaties and Domestic Law*, ed. G. Maisto, pp. 65-80 (2006).

⁵⁰ The USA has signed the treaty, but the US Senate has not given its advice and consent to the treaty.

⁵¹ Vienna Convention on the Law of Treaties, UN Doc. A/Conf. 39/27, art. 31.

“[t]he United States considers many of the provisions of the Vienna Convention on the Law of Treaties to constitute customary international law on the law of treaties”.⁵² Nevertheless, as described above, US court decisions involving transactions using a treaty to avoid taxes typically rely on judicially developed anti-abuse rules and do not explicitly invoke the object and purpose of the treaty. Therefore, we may consider that domestic law principles provide the predominant basis on which US courts evaluate claims of treaty abuse.

In some cases, the courts have purported to interpret the tax treaty in reaching their conclusions. For example, in *Aiken Industries*, the court interpreted the phrase “received by” in the USA–Honduras tax treaty to deny treaty benefits. Similarly, in *Johansson v. United States*,⁵³ the court interpreted the term “resident” in the US–Swiss tax treaty in light of the purpose of the treaty:

“The primary objective of our treaty with Switzerland, as well as of those with more than twenty other countries, is the elimination of impediments to international commerce resulting from the double taxation of international transactions while [the taxpayer] may have brought himself within the words of the Swiss treaty by his ‘residence’ in Switzerland and his ‘employment’ by a ‘Swiss corporation,’ he has failed to establish any substantial reasons for deviating from the treaty’s basic rule that income from services is taxable where the services were rendered. International trade will not be seriously encumbered by our refusal to grant special tax treatment to one only marginally, if at all, a Swiss resident and only technically, if at all, employed by a paper Swiss corporation.”

Although these, mostly older, cases suggest that some courts may be more comfortable approaching abuse questions by analyzing the four corners of the treaty without resort to domestic law principles, such an approach cannot be viewed as dominant in contemporary US jurisprudence.

2. General and specific anti-avoidance provisions in tax treaties

2.1. General overview

This section describes general and specific anti-avoidance provisions in the US tax treaties. These provisions reflect the US focus on ensuring that only those persons intended by the contracting states to be entitled to treaty benefits actually gain the benefits of the treaty.

The US Department of Treasury publishes a US model income tax convention, which generally is used as a starting point for US bilateral treaty negotiations. The most recent version of the US model income tax convention was issued in 2006 and

⁵² US Department of State, Vienna Convention on the Law of Treaties, available at <http://www.state.gov/s/l/treaty/faqs/70139.htm>.

⁵³ *Johansson v. United States*, 336 F.2d 809 (5th Cir. 1964).

contains both general and specific anti-abuse provisions, which are described below in parts 2.3 and 2.4.

2.2. Specific treaty provisions allowing application of domestic anti-avoidance provisions

As described above in part 1, the US general domestic anti-abuse doctrines are generally complementary to the goals of tax treaties and are not preempted by treaty provisions. As the technical explanation to the 2006 US model convention states with regard to the model's LOB provision (described in greater detail below):

“[The LOB provision] and the anti-abuse provisions of domestic law complement one another, as [the LOB provision] effectively determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (e.g., business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source Contracting State may be applied to identify the beneficial owner of an item of income, and [the LOB provision] then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.”⁵⁴

2.3. General anti-avoidance provisions in tax treaties

Several rules in the US tax treaties may be viewed as general anti-abuse rules, including residents requirements, beneficial ownership requirements, and the saving clause.

2.3.1. Residence

The residence rules of the US tax treaties may be viewed as the most basic general anti-abuse provision in US tax treaties. These rules generally provide that only residents of the USA or the other contracting state are entitled to the benefits of the treaty unless the treaty specifically provides otherwise. Under the 2006 US model convention, a person is generally treated as a resident of a contracting state if, under the laws of that state, the person is subject to tax by reason of certain criteria, generally including domicile, citizenship, or residence.

US treaties typically also contain “tie-breaker” rules to determine residence when an individual, corporation, or other person initially may be considered a resident of two contracting states. There is an anti-abuse element to the US corporate residence treaty tie-breaker rules. Specifically, the rules may deny all treaty benefits to dual resident corporations where the self-executing tie-breaker does not apply and the competent authorities cannot settle the question of corporate

⁵⁴ Note that, in contrast to the 2006 US model convention, the 1996 US model convention stated that the “beneficial owner” of an item of income would be determined by reference to the law of the residence state.

residence.⁵⁵ In a more specific instance of a US treaty's dual resident corporation rule operating as an anti-abuse rule, the corporate residence tie-breaker rule in the USA–Canada tax treaty is designed to prevent avoidance of taxes through “continuance” transactions.⁵⁶ Under this provision, if a corporation initially qualifies as a resident of both the USA and Canada but the competent authorities are unable to settle the question of residency by mutual agreement, the company will not be considered a resident of either state for purposes of claiming treaty benefits.⁵⁷

2.3.2. Beneficial ownership

US tax treaties typically require that the person claiming treaty benefits with respect to an item of income be the “beneficial owner” of such income. The term “beneficial owner” is not defined in the US tax treaties and therefore is defined by reference to the domestic law of the country imposing tax. Regulations promulgated under the Code define the term “beneficial owner”, but specifically only for purposes of payments of income other than a payment for which a reduced rate of withholding is claimed under a tax treaty. This definition, although circular, may be viewed as indicative of the US general conception of the beneficial owner concept:

“The term beneficial owner means the person who is the owner of the income for tax purposes and who beneficially owns that income. A person shall be treated as the owner of the income to the extent that it is required under US tax principles to include the amount paid in gross income. . . . Beneficial ownership of income is determined under the provisions of section 7701(l) and the regulations under that section and any other applicable general US tax principles, including principles governing the determination of whether a transaction is a conduit transaction. Thus, a person receiving income in a capacity as a nominee, agent, or custodian for another person is not the beneficial owner of the income.”⁵⁸

2.3.3. Arm's length rules

The arm's length rules in US tax treaties may also be viewed as general anti-abuse rules. US tax treaties require payments between related parties to be determined at

⁵⁵ See art. 4(4), 2006 US model convention.

⁵⁶ See US Department of Treasury, Press Release LS-883, “US, Canada Propose Tax Treaty Changes” (18 September 2000) (“[I]t has come to the attention of the Canadian and US tax authorities that some have asserted inconsistent positions with respect to a US corporation that has continued into Canada while retaining its status as a US corporation under US internal law. The argument put forward is that the corporation would, by virtue of the treaty, be a resident only of Canada, but that it would for other US tax purposes retain its status as a US corporation under US internal law. The negotiators agree that it was not contemplated that the continuance provision in the current treaty would be used to avoid taxes in this manner. Accordingly, the revised provision will clarify that a company incorporated in one country that continues into the other will still be treated as a resident of the first country unless that country's internal law no longer treats it as such. For example, a US corporation that continues into Canada but retains its status as a US corporation will, under the treaty, become a Canadian resident while remaining a US resident. Such a corporation will not be entitled to any benefits under the USA–Canada tax treaty except to the extent agreed upon by the competent authorities of the two countries.”)

⁵⁷ Art. 4(3)(b), 1997 USA–Canada tax treaty (as amended by 2007 protocol).

⁵⁸ Treas. Reg. §1.1441-1(c)(6).

arm's length.⁵⁹ For example, under the 2006 US model convention, profits attributable to a permanent establishment "shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment".⁶⁰ Similarly, under the 2006 US model convention interest and royalty rules, the favorable treaty rate is limited to the amount of interest or royalties that "would have been agreed upon by the payer and the beneficial owner in the absence of [a special relationship]".⁶¹

2.3.4. *Saving clause*

All of the US tax treaties contain a "saving clause" under which the contracting states reserve their rights, except as specifically provided in the treaty, to tax their residents and citizens as provided under their domestic laws. Under the saving clause of the 2006 US model convention, the contracting states also reserve their rights to tax former citizens and former long-term residents for 10 years following the loss of such status, a provision that allows the USA to tax its former citizens and long-term residents in accordance with section 877 of the Code, described above.

2.4. Specific anti-avoidance provisions in tax treaties

The USA has several specific anti-abuse provisions in its tax treaties. Several of these anti-abuse provisions are a central part of the US general treaty policy and are thus included in the 2006 US model convention and nearly all of the US tax treaties, while certain other anti-abuse provisions are included in a smaller number of treaties and reflect unique circumstances and/or were included at the request of the US treaty partner.

2.4.1. *Specific anti-avoidance provisions in the 2006 US model convention*

2.4.1.1. LOB

All but two of the US tax treaties currently in force contain an LOB article.⁶² This is intended to ensure that an entity purportedly resident in one state has a sufficient nexus with that state to justify the application of the treaty.

In general, an LOB article provides that only "qualified residents" are entitled to benefits under the treaty if such benefits are restricted to residents of the contracting states under the treaty. Under the 2006 US model convention, individuals, the contracting states, or political subdivisions thereof, and certain tax-exempt organizations are qualified residents. A company resident in a contracting state is

⁵⁹ See art. 9, 2006 US model convention.

⁶⁰ *Ibid.* at art. 7(2).

⁶¹ *Ibid.* at art. 11(5), art. 12(4).

⁶² As of February 2010, the USA–Hungary and USA–Poland tax treaties remain the only US tax treaties in force without an LOB article. The USA and Hungary initialed a new tax treaty with a comprehensive LOB provision on 3 June 2009. Treasury Department officials have stated publicly that negotiations with Poland are ongoing.

a qualified resident if the principal class of its shares, and any disproportionate class of shares, is regularly traded on one or more recognized stock exchanges and either (a) the company's principal class of shares is primarily traded on one or more specified recognized stock exchanges located in the contracting state of which the company is a resident or (b) the company's primary place of management and control is in its state of residence. Subsidiaries of publicly traded companies are qualified residents if five or fewer publicly traded companies that would be entitled to benefits are the direct or indirect owners of at least 50 per cent of the aggregate vote and value of the company's shares (and at least 50 per cent of any disproportionate class of shares). Entities also may qualify under an "ownership and base erosion test" if (a) 50 per cent of the aggregate voting power and value of the company is owned, directly or indirectly, by certain qualified residents and (b) less than 50 per cent of the entity's gross income is paid or accrued to certain persons not entitled to benefits under the treaty.

A company not otherwise eligible for treaty benefits generally under the tests described above may nevertheless qualify for treaty benefits with respect to certain items of income if the company meets an "active trade or business" test, obtains a discretionary determination of qualification from the competent authority, or, under several of the US tax treaties but not the 2006 US model convention, satisfies a "derivative benefits" test. In general, an entity may meet the active trade or business test if: (a) the entity is engaged in "the active conduct of a trade or business" in its residence state;⁶³ (b) the income derived from the source state is "derived in connection with, or is incidental to" that trade or business; and (c) the item is derived from a trade or business conducted in the source state or from a related person, the trade or business activity in the residence state is "substantial" compared to the trade or business activity in the source state.⁶⁴

Although not included in the 2006 US model convention, many US tax treaties contain a "derivative benefits" provision in the LOB article.⁶⁵ Under a derivative benefits provision, a company may be entitled to benefits if a specified percentage of its shares is owned (directly or indirectly) by persons (called "equivalent beneficiaries") who would have been entitled to equivalent or more favorable treaty benefits if they had directly derived the income in question.

⁶³ According to the 2006 US model convention technical explanation, "a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities".

⁶⁴ According to the 2006 US model convention technical explanation, "[t]he determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each Contracting State, the nature of the activities performed in each Contracting State, and the relative contributions made to that trade or business in each Contracting State. In any case, in making each determination or comparison, due regard will be given to the relative sizes of the economies in the two Contracting States".

⁶⁵ See e.g. art. 17(1)(g), 1992 USA–Mexico tax treaty (as amended by 2002 protocol); art. 29(4), 1980 USA–Canada tax treaty (as modified by 2007 protocol); art. 24(4), 1996 USA–Luxembourg tax treaty; art. 22(3), 1996 USA–Switzerland tax treaty; art. 23(3), 2001 USA–UK tax treaty; art. 26(3), 1992 USA–Netherlands tax treaty (as amended by 2004 protocol).

Several of the US tax treaties, but not the 2006 US model convention, have “triangular provisions” that add additional requirements to the LOB article.⁶⁶ Under a triangular provision, when an enterprise of a contracting state derives income from the other contracting state, and that income is attributable to a permanent establishment in a third jurisdiction, treaty benefits will be limited unless the combined tax that is paid with respect to such income in the residence state and the third jurisdiction is more than a specified percentage of the tax that would have been payable in the residence state if the income were earned in that state by the enterprise and were not attributable to the permanent establishment in the third jurisdiction.

2.4.1.2. Fiscally transparent entities

The 2006 US model convention addresses fiscally transparent entities by providing that: “An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident”. This provision is intended to (a) eliminate technical issues that might prevent investors in fiscally transparent entities from claiming treaty benefits and (b) prevent the use of fiscally transparent entities to claim treaty benefits when the investor is not subject to tax on the income in his residence state.⁶⁷ Identical or substantially similar provisions appear in several of the US tax treaties, including those with France,⁶⁸ Belgium,⁶⁹ and the UK.⁷⁰

The US tax treaties with Japan and Canada also contain rules addressing fiscally transparent entities.⁷¹ The US concern regarding the use of fiscally transparent entities to achieve double non-taxation for payments between US and Canadian entities led to the hybrid entities rules of section 894(c) (described above), which were enacted by the US Congress in 1997. The 2007 protocol to the USA–Canada tax treaty updated the USA–Canada tax treaty to address specifically the use of fiscally transparent entities.⁷²

2.4.1.3. Interest anti-abuse rules

Under the 2006 US model convention, “contingent interest” (i.e. interest determined by reference to the receipts, sales, income, profits or other cash flow or the debtor or a related person) may be taxed in the source state at a 15 per cent rate despite the model’s general rule that interest may be taxed only in the residence

⁶⁶ See e.g. art. 21(5), 2007 USA–Bulgaria tax treaty (as amended by 2008 protocol); art. 21(5), 2007 USA–Iceland tax treaty; art. 22(4), 1996 USA–Switzerland tax treaty; art. 24(5), 1996 USA–Luxembourg tax treaty; art. 12(8), 1992 USA–Netherlands tax treaty (as modified by the 1993 protocol).

⁶⁷ Art. 1, 2006 US model convention technical explanation.

⁶⁸ Art. 4(3), 1994 USA–France tax treaty (as modified by 2009 Protocol).

⁶⁹ Art. 1(6), 2006 USA–Belgium tax treaty.

⁷⁰ Art. 1(8), 2001 USA–UK tax treaty.

⁷¹ Art. 4(6), 2003 USA–Japan tax treaty.

⁷² Arts. 6 and 7, 1995 USA–Canada tax treaty (as amended by 2007 protocol).

state.⁷³ Similarly, interest that is an “excess inclusion” with respect to a residual interest in a real estate mortgage investment conduit (REMIC) may be taxed by each state according to its domestic laws.⁷⁴ Without this special rule for excess inclusions, “the US fisc would suffer a revenue loss with respect to mortgages held in a REMIC because of opportunities for tax avoidance created by differences in the timing of taxable and economic income produced by these interests”.⁷⁵

2.4.2. Other specific anti-avoidance provisions

2.4.2.1. Conduit provisions

The US tax treaties with the UK and Japan each contain an anti-conduit provision. These provisions were included in the treaty at the request of the UK and Japan because neither has domestic law rules addressing conduit arrangements.⁷⁶ Under the USA–UK conduit provision, treaty benefits are denied to income passed through a “conduit arrangement”, i.e. if it is paid under, or as a part of, a transaction or series of transactions that (a) has as one of its main purposes obtaining such increased benefits as are available under the treaty, and (b) is structured so that (i) a treaty beneficiary receives income from the other jurisdiction; (ii) but pays, directly or indirectly, (iii) all or substantially all of that income, (iv) at any time or in any form, (v) to a person who is not a beneficiary of the treaty and who would not be entitled to equivalent or better benefits under a treaty between that person’s jurisdiction and the jurisdiction in which the income arises.⁷⁷ The USA–Japan anti-conduit provision denies treaty benefits for certain back-to-back payments.⁷⁸

⁷³ Art. 11(2)(a), (b), 2006 US model convention.

⁷⁴ *Ibid.* art. 11(2)(c).

⁷⁵ Art. 11, 2006 US model convention technical explanation.

⁷⁶ See art. 3(n), 2001 USA–UK tax treaty technical explanation; art. 10, 2003 USA–Japan tax treaty technical explanation. At the request of the UK, the USA–UK tax treaty also contains anti-abuse rules regarding sale and repurchase transactions and remittances: art. 24, 2001 USA–UK tax treaty technical explanation (regarding sale and repurchase transactions: “The United Kingdom had seen a number of these transactions and was concerned about their potential impact.”); *ibid.* art. 1(7) (“Paragraph 7 is included in the Convention because the United Kingdom continues to maintain a remittance system of taxation for individuals who are resident but not domiciled in the United Kingdom. Such persons are subject to tax in the United Kingdom on non-UK source income only to the extent the income or gains are remitted to the United Kingdom. Under paragraph 7, such persons are entitled to the benefits of the Convention in order to reduce or eliminate tax only to the extent that the relevant income is remitted to or received in the United Kingdom”).

⁷⁷ Art. 3(1)(n), 2001 USA–UK tax treaty. Note that although the USA has rejected a general “main purpose” test, it has agreed to treaty provisions (such as this USA–UK conduit provision) with limited “main purpose” language.

⁷⁸ Arts. 10(1) (dividends), 11(11) (interest), 12(5) (royalties), 21(4) (other income), 2003 USA–Japan tax treaty.