From the Avoidance of Double Taxation to the Avoidance of Double Non-Taxation: The Changing Objectives of Tax Treaties

The OECD/G20 Base Erosion and Profit Shifting Project has clarified that relief from double taxation under tax treaties does not extend to double non-taxation. This (new) objective of tax treaties is analysed from the perspective of the preamble and the amendments to the OECD Model (2017) and the related case law.

1. Tracing the History of the Objectives of Tax Treaties

Throughout the 100 years or so of the existence of the international tax regime, the right to collect and levy income taxes has been allocated either to the country of residence or of source. The right to tax in source and residence states is sovereign rights. When these rights are exercised, simultaneously on the same income, this situation gives rise to double taxation. Avoiding the double taxation of the same income was the main objective and the principle on which tax treaties were based. The allocation to the residence country is reduced to the extent that income taxes (such as business profits, as referred to presently) are levied in the country of source. Tax treaties provide for relief to be granted by the residence state and the right to tax by the source state.

The League of Nations 1928 Draft Bilateral Convention (the “1928 Convention”), where these principles were first discussed, is very similar to the current situation. The 1928 Convention considered attribution on the basis of “income produced”, a phrase which has now become “profits attributable”, and which has the same connotations. Further, the draft treaty produced by the Committee on Double Taxation and Tax Evasion in 1927 contained space for the “competent authorities” (i.e. financial administrations, as referred to in the draft) to confer and determine the appropriate taxing rights with regard to an entity and, if not, to refer to a dispute resolution mechanism, as is the position today.

Given the limited changes from the 1928 Convention, the prime object of the OECD Draft (1963), as stated previously in this section, was to prevent double taxation. Due to the sovereign right of the source and residence state to tax the income, it was not anticipated that a consequence of the prevention of double taxation would be to foster double non-taxation. However, this situation soon became apparent, and amendments were introduced into the Commentary on Article 1 of the OECD Model (1977) that expressly provided that tax treaties were not intended to encourage tax avoidance or evasion. The relevant part of the OECD Commentary on Article 1 (1977) read as follows:

The purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons; they should not, however, help tax avoidance or evasion.

Again, this did not address expressly double non-taxation. The OECD Commentary on Article 1 (1977) restricted itself to stating that only in cases of tax avoidance or evasion, would the benefit of a tax treaty be available. The OECD Commentary on Article 1 (1977) was further refined in the Commentary on Article 1 of the OECD Model (2003) to make it clear that one of the purposes of tax treaties was to assist in the prevention of tax avoidance and evasion. This change meant that a tax treaty would take an active role in such prevention, rather than merely not “helping” in that respect. In this context, OECD Commentary on Article 1 (2003) read as follows:

The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion.

However, as noted previously in this section, the principal purpose of a tax treaty remained the same, i.e. to prevent double taxation. As a result, before the OECD Commentary on Article 1 (2003), there was no reference of the role of tax treaties in preventing double non-taxation. Accordingly, it would be amiss to state that tax avoidance or evasion are synonymous with double non-taxation.

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Various court decisions, such as MIL Investments (2006 and 2007)\textsuperscript{11} in Canada, Azadi Bachao Andolan (2003)\textsuperscript{12} in India and Lamesa Holdings (1997)\textsuperscript{13} in Australia, among others worldwide, have interpreted tax treaties as not preventing double non-taxation.

In Azadi Bachao Andolan\textsuperscript{14}, the Supreme Court of India (SCI) held that:

According to Klaus Vogel, “Double Taxation Convention establishes an independent mechanism to avoid double taxation through restriction of tax claims in areas where overlapping tax claims are expected, or at least theoretically possible. In other words, Contracting States mutually bind themselves not to levy taxes or to tax only to a limited extent in cases when the treaty reserves taxation for the other Contracting State either entirely or in part. Contracting States are said to ‘waive’ tax claims or more illustratively, to divide ‘tax sources’, taxable objects, amongst themselves.” Double taxation avoidance treaties were in vogue even from the time of the League of Nations. The experts appointed in the early 1920s by the League of Nations describe this method of classification of items and their assignments to the Contracting States. While the English lawyers called it “classification and assignment rules”, the German jurists called it “the distributive rules” (Verteilungsnormen). To the extent that an exemption is agreed to, its effect is in principle independent of whether the other Contracting State imposes a tax in the situation to which the exemption applies, and irrespective of whether the State actually levies the tax.

Commenting particularly on the German Double Taxation Convention with the United States, Vogel comments: “Thus, it is said that the treaty prevents not only ‘current’ but also merely ‘potential’ double taxation.” Further, according to Vogel, “only in exceptional cases, and only when expressly agreed to by the parties, is exemption in one of the Contracting States dependent upon whether the income or capital is taxable in the other Contracting State, or upon whether it is actually taxed there.

It is, therefore, not possible for us to accept the contentions so strenuously urged by the respondents that the avoidance of double taxation can arise only when tax is actually paid in one of the Contracting States."\textsuperscript{15}

The SCI, therefore, held that the purpose of tax treaties was not levy tax but to “attribute” taxing rights to states, where each state binds itself to not levy taxes to the extent agreed. This situation arose independent of whether the other contracting state “imposes a tax in the situation to which the exemption applies, and irrespective of whether the State actually levies the tax.”\textsuperscript{16}

In MIL Investments, the Tax Court of Canada (TCC)\textsuperscript{17} found on the basis of the facts in the case that the transaction was for the purposes of tax avoidance. On appeal to the Canadian Federal Court of Appeal (CFCA),\textsuperscript{18} the taxpayer admitted that the transaction in question was for avoidance of tax. However, the CFCA held that:

\begin{quote}
If it is clear that the Act intends to exempt non-residents from taxation on the gains from the disposition of [sic] exempt property. It is also clear that under the terms of the Tax Treaty, the respondent’s stake in DFR was treaty exempt property. The appellant urged us to look behind this textual compliance with the relevant provisions to find an object or purpose whose abuse would justify our departure from the plain words of the disposition. We are unable to find such an object or purpose.
\end{quote}

The residence of a taxpayer with regard to the application of a tax treaty stems from the taxpayer being “liable to tax” in the resident state. Liability to tax is distinct from the payment of taxes.\textsuperscript{19} As the Commentary on Article 4 of the OECD Model (2010) acknowledged, “[i]n many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax.”\textsuperscript{20} This position has remained unchanged in the Commentary on Article 4 of the OECD Model (2017).\textsuperscript{21} As expressed in MIL Investments and Azadi Bachao Andolan, treaty shopping resulting in double non-taxation was not frowned upon. The source state, having concluded a tax treaty, cannot deny its application merely because of a unilateral measure to exempt taxation in the residence state.

As the global treaty network has expanded, the opportunities for entities with global reach to exploit the treaty network grew significantly. Competition among states to attract investment through tax exemptions and lower rates also increased to an alarming extent, whereby major multinational enterprises (MNEs) could arbitrage tax treaties and countries into achieving nil tax rates. Anger slowly arose among the public, who felt that the international tax system was unfair for those taxpayers who could not arbitrage the treaty networks in their favour. This concern was evident when the global financial crises of 2008 hit the financial markets, and, therefore, had a major effect on the revenues of many large countries worldwide. This anger against tax havens and the financial slippages suffered resulted in the birth of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project.

The OECD/G20 BEPS initiative was aimed at alleviating concerns regarding double non-taxation. The work undertaken in respect of Action 6 of the OECD/G20 BEPS initiative was directed at clarifying that tax treaties are not intended to create opportunities for double non-taxation.

\begin{thebibliography}{9}
\bibitem{12} See the decision of the Supreme Court of India (SCI) in IN: SCI, 7 Oct. 2003, Union of India and another v. Azadi Bachao Andolan and another, 2003-(263)-ITR-706-SC, 263 ITR 706, Case Law IBFD.
\bibitem{13} See the decision of the Federal Court of Australia (FCA) in AU: FCA (Full Court), 20 Aug 1997, Lamesa Holdings BV v. Commissioner of Taxation, NG 225 of 1997, Case Law IBFD.
\bibitem{14} Azadi Bachao Andolan (2003), supra n. 12.
\bibitem{15} Id., at p. 744.
\bibitem{16} Id., at p. 744.
\bibitem{17} TCC, MIL Investments (2006), supra n. 11.
\bibitem{18} CFCA, MIL Investments (2007), supra n. 11.
\bibitem{19} Id., at pp. 6-8.
\bibitem{20} See OECD Model Tax Convention on Income and on Capital art. 4 (22 July 2010), Treaties & Models IBFD.
\bibitem{21} OECD Model Tax Convention on Income and on Capital Commentary on Article 4 para. 8.6 (22 July 2010), Treaties & Models IBFD.
\bibitem{22} Para. 8.11 OECD Model: Commentary Article 4(2017).
\end{thebibliography}
by way of tax avoidance structures. In order to provide clarification, it was decided to state in the title to the OECD Model (2017) that the prevention of tax evasion and avoidance is a purpose of tax treaties. It was also decided that the OECD Model (2017) should include a preamble that expressly provides that states enter into a tax treaty with the intention of eliminating double taxation without creating opportunities for double non-taxation or reduced taxation through tax evasion and avoidance. Given the particular concerns about treaty shopping, it was decided to refer expressly to such arrangements (which was aimed at obtaining reliefs provided in the OECD Model (2017) for the indirect benefit of residents of third states) as one example of tax avoidance that should not result from the conclusion of tax treaties. This action is a seminal shift in the purpose of tax treaties based on the OECD Model, which previously, before the Commentary on Article 1 of the OECD Model (2003) had stated that their principal purpose was the avoidance of double taxation, and that only an ancillary purpose was to avoid tax evasion and avoidance.

The shift in policy is intended to be achieved by the amendment and/or insertion of the following three measures into the OECD Model (2017):

1. the amendment of the Preamble;
2. the addition of the principal purpose test (PPT); 22 and
3. a limitation on benefits (LOB) clause. 28

Prior to the OECD/G20 BEPS Project, the title to the OECD Model (2010) read “Convention between (State A) and (State B) with respect to taxes on income and on capital”. After the OECD/G20 BEPS initiative, the title was amended in the OECD Model (2017) to read “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” [emphasis added].

With regard to the preamble, there was none in the OECD Model (2010). However, the OECD Model (2017) inserted the following Preamble:

(State A) and (State B),

Desiring to further develop their economic relationship and to enhance their co-operation in tax matters,

Intending 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),

Have agreed as follows:... [Emphasis added.]

The qualification in the Preamble to the OECD Model (2017) makes it clear that, only where there is a causal link between tax evasion or avoidance and non-taxation or reduced taxation, would it be contrary to the objective of a tax treaty. Any other action that could result in double non-taxation is not prevented by the Preamble to the OECD Model (2017).

In this context, the CFCA in Alta Energy (2020) dealt with a transfer of shares in a Canadian company with US shareholders. A restructuring had been carried out as a result of which the Canadian company was first owned by a Luxembourg entity and then ultimately owned by US shareholders. The sale transaction was disputed as article 13(5) of the Canada-Luxembourg Income and Capital Tax Treaty (1999) prevented Canada from taxing the gain that was derived from the transfer. The gain was not taxable in Luxembourg. The Canada Revenue Agency (CRA) disputed the transaction and applied Canada’s general anti-avoidance rule (GAAR), stating that the entire purpose of the transaction was tax avoidance. The CFCA, in refusing to apply the GAAR and referring to an earlier judgment, stated that:

[73] Just as this Court was unable to find any rationale behind Article 13(4) and the related provisions of the Luxembourg Convention, other than as reflected in the words chosen for these provisions [in MHL], I am also unable to find any object, spirit, or purpose other than as reflected in these words. The object, spirit and purpose of Articles 1, 4 and 13(4) is that a person will qualify for the exemption in issue in this appeal, which is applicable to gains arising on the disposition of certain shares, if:
(a) that person is a resident of Luxembourg for the purposes of the Luxembourg Convention, and
(b) the value of the shares is principally derived from immovable property (other than rental property) situated in Canada in which the business of that corporation is carried on. [Emphasis added.]

As a result, the CFCA refused to apply the provisions of GAAR, as there was no tax avoidance or evasion. There was certainly double non-taxation, which the taxpayer conceded. However, this was interpreted as being permissible by the CFCA, in the same was as was decided by the SCI in Azadi Bachao Andolan. This position of the CFCA was arrived at, as any contrary purpose to prevent double non-taxation could not be deciphered. Accordingly, if the reduced taxation or non-taxation was not due to tax avoidance or evasion but, rather, arose for other reasons, including that of state policy, as in the case of Luxembourg in Alta Energy, double non-taxation would not be prevented by a simple amendment of only the preamble, without specific backing in the text of the tax treaty in question.

Even in India, in order to encourage investment and the importation of foreign exchange, the infamous "Mauritius
route” was promoted actively at a federal level, and was undermined at the assessing officer level. In most cases, the courts ignored the resulting double non-taxation.

It is also safe to say that double non-taxation requires the combination of an exemption provision in a tax treaty and an absence of taxation in the resident state. At the first instance, both are government policy, which then leaves a loophole to be exploited. A reduction in the payment of tax by the exploitation of government plans and initiatives without there being the taint of tax avoidance is perhaps permitted even today.

2. Changing Objectives and Concerns

Action 6 of the OECD/G20 BEPS Project seeks to “clarify that tax treaties are not intended to be used to generate double non-taxation” 33. This situation leads to a fundamental rethinking of the purpose of the OECD Models and those tax treaties that follow the OECD Models. Under the current wording, the OECD Model (2017) only allocates taxing rights. It does not interfere with the sovereign taxing rights that states preserve under domestic law and, therefore, does not oblige the states to exercise their allocated taxing rights. Consequently, it can be construed that preventing double non-taxation was not the objective of the OECD Model. Even after Action 6 of the OECD/ G20 BEPS initiative, merely amending the Preamble may not be sufficient to alter the objective of the OECD Model and include prevention of double non-taxation.

The source state is not required to give relief from its tax on the condition that the income is actually taxed in the state of residence. Rather, relief in the source state is conditional on the beneficiary of the income being a “resident” of the other state. Such a construction implies that this person is “liable to tax” in that state. This expression also requires that that person is subject to the most comprehensive tax liability in that state by reason of a personal nexus with that state, but not that the person actually pays tax in the state of residence on the relevant (foreign-source) income. Article 23A of the OECD Model (2017) requires the taxpayer’s residence state to exempt income that “may be taxed in the other State”. Such a provision entails double non-taxation each time that the source state of the income does not effectively exercise the taxing rights conferred to it under the provisions of the OECD Model.

As a result, ideals (and hopes) in the title of and/or preamble to a bilateral tax treaty that the treaty’s objective is the prevention of double non-taxation, other than those occasioned by avoidance strategies, may be unjustified. This position will also offer little practical guidance to courts as how to construe the terms of the tax treaty to prevent double non-taxation. This situation was exactly the result in Alta Energy (see section 1).

The Commentary on the OECD Model (2017) emphasizes that the Preamble and Title, according to the Vienna Convention on the Law of Treaties (the “Vienna Convention” (1969)), 34 would provide an important tool for the interpretation of a tax treaty:

16.2 Since the title and preamble form part of the context of the Convention and constitute a general statement of the object and purpose of the Convention, they should play an important role in the interpretation of the provisions of the Convention. According to the general rule of treaty interpretation contained in Article 31(1) of the Vienna Convention on the Law of Treaties, “[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.” 35

Preambulatory clauses certainly ensure that the objectives of a tax treaty are well enumerated. However, general statements in the preamble to include the non-creation of “opportunities for non-taxation or reduced taxation through tax evasion or avoidance” 36 without any consequential amendment to the substantive articles of the OECD Model would result in conflict. This position is especially so, as preambulatory clauses do not have a hierarchy compared to other substantive provisions of a tax treaty. Accordingly, in the case of conflict between the articles of a tax treaty and the preamble, it is not necessary that the preamble should be interpreted in a manner that goes against the text of the conflicting article. Article 31(2) of the Vienna Convention (1969), as quoted in the Commentaries in the OECD Model (2017), states that the Preamble provides for the “context, background and the object of the treaty”.7 However, it does not clearly require that a perambulatory clause would override the substantive provisions of a tax treaty in the case of conflict.

Though not falling within the context of taxation, investment tribunals, when considering bilateral investment treaties (BITs) have interpreted preambulatory clauses. The tribunals have not been quick to rely on the preamble to understand the object and purpose of a BIT. As noted by the tribunal in Philip Morris v. Republic of Uruguay (2016) 38 to the effect that:

the reference in the Preamble... appears too general to permit the drawing of definitive conclusions regarding the need for the investment to contribute to the host state’s economic development. 39

Commentators too have frowned on general and vague preamble clauses and their ability to steer the interpretation of a substantive clause towards the envisaged objects. 40

The other side of the argument is that the OECD Model, and tax treaties in general, were intended only to avoid double taxation. As stated in the Commentary to the 1928


39. Id., at p. 201.

40. See, for example, J.R. Weeramantry, Treaty Interpretation in Investment Arbitration 2nd edn., para. 3.80 (Oxford U. Press 2012).
Convention to the Draft Bilateral Convention as submitted by the League of Nations Committee of Technical Experts:

From the very outset, the Meeting of Government experts realised the necessity of dealing with the questions of tax evasion and double taxation in co-ordination with each other. It is highly desirable that States should come to an agreement with a view to ensuring that a taxpayer shall not be taxed on the same income by a number of different countries, and it seems equally desirable that such international co-operation should prevent certain incomes from escaping taxation altogether. The most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once, and once only.41 [Emphasis added.]

This position has been the fundamental principle of international taxation, i.e. “all incomes would be taxed once and only once”.42 In other words, the international tax norms should not only avoid double taxation, but also prevent double non-taxation.

Though there is an underlying assumption of there being at least one state that exercises the right to tax the income in question, many times the exemption and/or allocation rules under tax treaties together with the absence of the exercise of the right to tax by the allocated and/or residence state result in double non-taxation. Accordingly, the non-taxability of income by one state would still not permit the other state to levy tax on that income.

3. Conclusions

There are several policy reasons why the purpose to tax “once” failed. First, the assumption that the ability to use a multilateral process to defeat the tax “once” process. It was not envisaged that bilateral tax treaties would give rise to a multilateral web of tax treaties, whereby the taxpayers could take advantage of several tax treaties and create situations of double non-taxation.

Second, the international tax regime concentrated on the bilateral treaty process on what would eventually become a multilateral problem of evasion and double non-taxation. The inertia of the tax regime to respond quickly and forcefully to the changing circumstances has caused the issue to explode. The “Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting” (the “Multilateral Instrument”, or MLI)43 has served as a huge step towards a multilateral consensus on the purpose of tax treaties to prevent double non-taxation or tax “once”. Not to sound sceptical, but, the MLI, though multilateral, is too little too late, and is more like an angry person stomping in the rain trying to get rid of the puddles that surround him.

Third, another pertinent reason why the tax once purpose failed was that the regime ignored the competitive attitude of states to forgo taxation to attract investors and investments. The ability of global corporations to exploit the loopholes in the system was also overlooked. This situation led to a global “tax sieve” where revenue was not taxed.

The solution envisaged by major countries is a new minimum Global Tax under Pillar Two.44 The difficulty will be in arriving at global consensus. With countries like the United Kingdom seeking exemptions in respect of its financial service sector (its major industry), the possibility for a global consensus appears to be difficult. Other countries may seek similar exemptions, leading to no agreement. But perhaps a simpler system in reducing the complexity of international taxation rather than what Pillar Two envisages would be to shift reliance on the avoidance of double taxation in tax treaties away from the exemption method towards the credit method. This action would be an easy step to alleviate the concerns of double non-taxation. This is a necessary step in order to alleviate the concerns of double non-taxation. Accordingly, a remedy, through amendments in the preambles and other changes without treaty specific clauses, may not be the best solution.

42. Id.
43. OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (6 June 2017), Treaties & Models IBFD (hereinafter the Multilateral Instrument, or MLI).