## Tax Treaty Shopping in Ethiopia: The Need to Integrate Anti-Treaty Shopping Rule into Double Taxation Avoidance Agreements and domestic income tax law.

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## Abstract

*Many countries of the world have signed bilateral tax treaties to avoid or mitigate double taxation and control tax evasion and planning in cross-border economic activities. However, such networks of bilateral tax treaties have in effect opened room for tax treaty shopping. As of September 2020, Ethiopia has signed more than 32 bilateral tax treaties. Yet, no study has been made on the issues of tax treaty shopping. Hence, this study examines whether the existing treaty provisions are sufficient to prevent the abuse of double taxation agreements by treaty shopping, and identifies its shortcomings. To this end, doctrinal legal research methodology is employed to investigate Ethiopia's pertinent income tax law and double taxation avoidance agreements. Accordingly, the findings show that tax treaty shopping is not sufficiently regulated under the Ethiopian bilateral tax treaties and domestic income tax system. Most of the Ethiopian bilateral tax treaties are devoid of anti-treaty shopping rules. Save for few bilateral tax treaties, most of the bilateral tax treaties have no anti-treaty shopping rules. Although the Federal Income Tax Proclamation has provided seemingly anti-avoidance rule, it may not serve its purposes since it cannot override treaties which may otherwise constitute a breach of the treaty under international law. In other words, the general anti-avoidance rule provided under the Federal Income Tax Proclamation may not extend to tackling treaty shopping as its scope is limited to domestic matters. Accordingly, Ethiopia should revisit its domestic anti-avoidance rules and incorporate anti-treaty shopping rules into bilateral tax treaties either by renegotiation or termination.*

**Keywords:** *Double taxation agreement, Treaty shopping, beneficial ownership, Limitation of benefits, principal purpose test.*

## Introduction

The international tax system as it stands today has its roots in the 1920s.[1] It was developed under a bilateral paradigm of extensive taxation in the residence state and a source state that fully uses its taxation rights by which the architecture of tax treaties

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[1] Moritz Scherleitner, The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting: An Analysis of the Principal Purpose Test from the Perspective of Finnish Tax Treaty Practice, *Journal of Financial Times*, Vol.2, (2018 ), P.126.

had been developed.[2] Over the last decades, bilateral tax agreements, concluded by nearly every jurisdiction globally, have prevented harmful double taxation and remove obstacles to cross-border trade in goods and services and movements of capital, technology, and persons across the borders.[3] Bilateral tax agreements or treaties are also called double taxation avoidance agreements.[4] Hence, the term bilateral tax agreement or tax treaties, or double taxation avoidance agreements (hereinafter called DTA) are interchangeably used throughout this article.

The primary objective of tax treaties is to avoid double taxation derived from the overlap of different tax jurisdictions.[5] The phenomenon may take economic or juridical manifestations. Economic double taxation arises in international taxation when the same economic transaction, item, or income is taxed in two or more states during the same period but in different taxpayers' hands.[6] On the other hand, in juridical double taxation, two or more states levy their respective taxes on the same entity or person on the same income and identical periods.[7] International double taxation can be eliminated using one of two forms: states may willingly enter into mutually binding double taxation treaties (DTTs), or the resident states may enact unilateral measures to prevent double taxation.[8] For instance, a capital-exporting country may allow for either a deduction of taxes paid in the host country, a credit of the amount which would have been incurred under domestic taxation, or a complete exemption from taxation.[9] While there are different methods employed to mitigate double taxation, a more detailed discussion of their respective uses and implications is beyond the scope of this paper.

Although avoiding double taxation is, in principle, possible through the terms of a tax treaty, individuals and business entities mostly tend to use the tax treaty network to avoid taxes through aggressive tax planning strategies.[10] In other words, the taxpayers may use the treaties' advantages to shift their incomes to lower jurisdictions, avoid domestic tax rules, or benefit from tax treaties that were not entitled to be used by them. The latter is known as the phenomenon of treaty shopping, a tax planning

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[2] *Id.*

[3] Michael Lang, Treaty Abuse in Introduction to the Law of Double Taxation Conventions, 7th edition, Amsterdam, International Bureau of Fiscal Documentation,(2013), p.30.

[4] Brian J.Arnold, Introduction Tax to Treaties, p.1.

[5] Lang, *supra note 3.*

[6] Roy Rohitagi, Basic International Taxation, 2nd edition, Richmond Law & Tax Ltd, Vol.1,(2005), P.2.

[7] *Id.*

[8] Janeba, E. Corporate Income Tax Competition, Double Taxation Treaties, and Foreign Direct Investment, Journal of Public Economics, Vol.56, No.2, (1995), p.320.

[9] *Id.*

[10] Lang, *supra* note3, p.30

strategy where a taxpayer shops the most appropriate tax treaty to achieve a lower tax burden or a double non-taxation.[11]

Treaty shopping is, therefore, a practice where multinational enterprises (MNE's), rather than investing directly in a host country, funnel the investment through a third country to take advantage of treaty provisions not found between the host and the home country of the investment.[12] As such, as treaty benefits should only be available to residents of the contracting states, the attainment of treaty benefits by non-residents is achieved by the imposition of a conduit legal entity in a treaty state.[13]

Turning to the effect of treaty shopping, one notices that it has various impacts on the international tax system. One of such effects is the loss of revenue by contracting parties to the bilateral double taxation avoidance agreements since the treaty shopper does not pay taxes which it would otherwise owe.[14] As a response to the potentially harmful effects of tax avoidance practices, the tax treaty system has focused on designing measures to counter avoidance practices.[15] To this end, the OECD has discussed the problem since 1961, which has resulted in quite a few proposals of how treaty shopping should be limited.[16] Accordingly, countries have employed domestic legislation that includes general or specific anti-avoidance rules to deny treaty benefits to prevent and attack treaty abuse.[17] Besides, governments have implemented specific anti-avoidance provisions from a tax treaty perspective, such as the Limitation on benefits provisions, beneficial ownership, and exclusion of tax-favored entities from treaty benefits, *bona fide* approach, and principal purpose test to limit the scope of the treaty.[18]

Turning to the Ethiopian context, one could observe that the country has been making considerable efforts to attract foreign direct investment as an instrument for growth and development. At the center of this move is signing bilateral investment treaties

[11] Christiana HJI Panayi, Double Taxation, Tax Treaties, Treaty-Shopping, and the European Community, Kluwer Law International, (2007), pp. 34-37.

[12] Ronald B. Davies, Tax Treaties and Foreign Direct Investment: Potential versus Performance, *International Tax, and Public Finance*, Vol.11, No.6,( 2004), pp. 775-802.

[13] *Id.*

[14] Stef van Weeghel, The Improper Use of Tax Treaties: with particular reference to the Netherlands and united states, Kluwer law international,(1998),p.105.

[15] José Domingo Palomino Pérez, Are the LOB Provisions Efficient Measures to Prevent Tax Treaty Shopping By Taxpayers?, Master's thesis, Tilburg University, (2017), p.5.

[16] Helmut Becker &Felix J Wurm, Treaty Shopping. An Emerging Tax Issue and its Present Status in Various Countries, Deventer, Kluwer Law, and Taxation Publishers, (1988), p. 2.

[17] Pérez, *supra* note 15, p.5.

[18] *Id.*

(BITs) and double tax avoidance treaties.[19] With the primary objective of minimizing the impacts of double taxation, the country has taken unilateral measures such as foreign tax crediting and tax exemption.[20] In addition, it has signed more than 32 bilateral tax treaties with other countries of the world.[21] A closer look into these bilateral tax treaties demonstrates that it has been signed based on the OECD Model Tax Treaty.[22] Signing bilateral tax treaties can play a pivotal role in attracting foreign direct investment as it increases multinational enterprises' involvement in the domestic industry. Yet, this would cause loss of revenue to the government through the strategy called treaty shopping. While such loss may pose a threat to the industry and the national economy at large, its magnitude and manifestations are not sufficiently explored. Further, no study has been made on tax treaty shopping issues under Ethiopia's income tax system.

Therefore, this study aims to examine whether the existing legal system is strong enough to prevent abuse of double taxation agreements by treaty shopping, identify its shortcomings, and explore opportunities for proper regulation. To this end, doctrinal legal research methodology is employed to investigate the pertinent provision of income tax law and double taxation avoidance agreements. Since most of the double taxation treaties are similar concerning treaty shopping, the researcher took representative treaties for examination instead of exploring every treaty. Accordingly, double taxation agreements with Cyprus, Singapore, and China were randomly selected. Besides, double taxation agreements with the Netherlands, South Korea, and Mozambique are also chosen as they have adopted anti-avoidance rules for tackling treaty shopping.

The article is organized into six sections. The first section highlights the general overview of tax treaties and tax treaty shopping. The second section presents common strategies for tax treaty shopping. The third section uncovers the impacts of treaty shopping, while the fourth section deals with the possible approaches to prevent tax treaty shopping. The fifth section explores Anti-treaty-shopping measures proposed by BEPS Action Plan 6 and 15. The sixth section analyses tax Treaty shopping under the Ethiopian tax system and Ethiopia's pressing need to integrate anti-treaty shopping

[19] Martha Belete Hailu and Tilahun Esmael Kassahun 'Rethinking Ethiopia's Bilateral Investment Treaties in light of Recent Developments in International Investment Arbitration', *Mizan Law Review*, Vol. 8, No.1, (2014).

[20] Federal Income Tax Proclamation of Ethiopia, Proclamation No. 979/2016, *Federal Negarit Gazetta*, year 22 No.104, (2016), (hereafter called Income Tax Proclamation No.979/2016), Art.45.

[21] Serkalem Eniyewu, Involving Constituent States in Negotiating Tax Treaties in Ethiopia, Master's thesis, Addis Ababa University,(2017),p.35.

[22] Aschalew Ashagre, A Note on Resolution of Tax Disputes Arising from DTTs and Implications for Developing Countries, *Mizan Law Review*, Vol. 13, No. 3,(2019), p.513.

rules into its double taxation agreements and domestic income tax law. Finally, the article ends with a brief conclusion and recommendation.

## 1. Tax Treaties and Tax Treaty Shopping: An overview

Double taxation agreements have been around for a long time. They first appeared in what is now Germany as an inter-state agreement entered among components of Prussia in 1899.[23] This treaty is largely regarded as the first modern DTA, serving as the major instrument of regulating business interaction among member states. A closer look into the historical literature on DTAs shows that only a few of such treaties were created until 1920. Yet, the wider inter-state interaction in the next half of the 20th century necessitated harmonizing taxation principles among other states in the rest of the world. This gave birth to modern international tax treaties.[24] These treaties, widely known as bilateral tax treaties, are international agreements in which their creation and consequences are determined according to the Vienna Convention rules on the Law of Treaties of May 23, 1969.[25] They are negotiated under international law as legally binding State-to-State agreements signed by two or more countries (called the *Contracting States* under the treaty).[26]

The double taxation treaty, one of the variants of such treaties, is set to pursue varying objectives. First, it seeks to avoid juridical double taxation, which mainly emanates from tax laws of countries that apply source–source or residence-residence or source-residence rule.[27] As such, the causes of international juridical double taxation take on three major forms. Dual residency conflict, the first of these forms, manifests when a person is taxed on worldwide income or capital in more than one country because they are deemed a resident for tax purposes in each of those countries.[28] The second is residence/source conflict, whereby a resident's income derived from the other state is subject to tax in both the resident state and the other state.[29] The third form is termed as source/source conflict. Under this situation, more than one country regards the same income as having a source in their territory under domestic law.[30] Finally, these

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[23] Arvid Age. Skaar, Permanent Establishment: Erosion of Tax Treaties Principle, Kluwer Law and Taxation,(1991), p.65.
[24] *Id.*
[25] Klaus Vogel, Double Tax Treaties and Their Interpretation, *Berkeley Journal of International Law*, Vol. 4,(1986), p.15.
[26] Rohitagi, *supra* note 6, p.3.
[27] Ariane Pickering, Why Negotiate Tax Treaties, 2014, p.9 available at https://www.un.org/esa/ffd/wp-content/uploads/2014/08/Papers_TTN.pdf&ved last accessed on June 18, 2020).
[28] *Id.*
[29] Eric Kemmeren, Principle of Origin in Tax Conventions: A Rethinking of Models, Dongen, Peijnenburg publishers,(2001), p.73.
[30] *Id.*

manifestations of taxation are so detrimental to inter-state trade activities, and it requires a double taxation treaty that particularly prunes these forms of taxation triggered by the juridical status of legal subjects.

Further, such treaties are vital to delimit the taxing rights between two contracting parties or the allocation of taxing rights. As such, the double taxation treaty grants taxing rights between parties to avoid double taxation for every single type of income and assets.[31] Still looking into another important role of such treaties, one could see their contribution to prevent fiscal evasion and avoidance. Evidencing this key role, a double taxation treaty characteristically tends to hinder evasion and avoidance of taxes on income and assets by exchanging taxpayer information and a legal framework for administrative co-operation and mutual assistance in tax matters between the two governments.[32] In doing so, the tax treaty goes far beyond merely addressing the problem of double taxation.

Apart from such roles, the tax treaty serves the purpose of establishing a unified procedure for dispute settlement. Through the terms of tax treaties, contracting states could reach an agreement on a dispute resolution mechanism arising from the observance of each related party's tax laws regarding cross-border transactions.[33] Such dispute resolution with the tax treaty is carried out based on a reciprocal agreement called Mutual Agreement Procedure (MAP) between the two parties' competent authorities.[34] Finally, a double taxation treaty could be employed as an instrumental means to harmonize tax definitions of contracting states. As states can levy taxes in their sovereign territory, they can describe the same term without a tax treaty.[35] For example, the concept of the *source according to service* may denote varying meanings. In one of the party states, "source" may mean where services are performed, while the other state may take *it* " as the place where services have their effects.[36] Such differing definitions would make double taxation too general and ambiguous. Yet, by standardizing such definitions, an inter-state tax treaty can eliminate the double

[31] Anh D. Pham, Ha Pham & Kim Cuong Ly, Double Taxation Treaties as a Catalyst for Trade Developments: A Comparative Study of Vietnam's Relations with ASEAN and EU Member States, *Journal of Risk and Financial Management*, Vol.12, No.4, (2019), p.177.
[32] *Id.*
[33] Pham et al, *supra* note 31, p.178
[34] *Id.*
[35] Xiaoye Xiong, The Effect of Tax Treaties on Foreign Direct Investment: A Study of China's Shifting Tax Treaty Policy, Master's thesis, Tilburg University, (2018), P.10.
[36] Dan Throop Smith, the Functions of Tax Treaties, *National Tax Journal*, vol.12, No.4, (1959), p.317.

taxation of foreign profits, strengthen legal certainty for individual taxpayers, and stimulate capital flows.[37]

While these varying roles of double taxation treaties are identified in the literature, the extent of their practical application is not yet clear. This is mainly because their application is inherently prone to the counter-effect of aggressive tax planning strategies in which individuals and business entities tend to use tax treaty network to avoid taxes.[38] Estimating such counter effects of aggressive tax planning requires assessing the magnitude of bilateral double taxation agreements (DTA) network in force today. Yet, it isn't easy to find a centralized, complete, and public database of such networks.[39] One can only find as many as 3,000 Double Taxation Agreements (DTAs) in the literature, which could be a fraction of potential bilateral tax relationships in force today.[40]

Despite the above-mentioned tax treaties' objectives, such bilateral tax treaties network may let individuals and business entities to employ aggressive tax planning strategies to avoid taxes.[41] Such moves of treaty abuse involve transactions or arrangements structured by persons who are not residents of a contracting state to obtain the benefits of a tax treaty whose benefits are only intended to be granted to the contracting states' residents. Such practices are widely known as *treaty shopping*. [42]

The concept is of American origin, and it is closely related to the term *'forum shopping,'* which has been commonly used in the U.S. civil procedure.[43] Its specific origin can be traced to Aiken *Industries Inc. v. Commissioner*, a case adjudicated by the U.S. Congress in April 1971.[44] In this case, a U.S. subsidiary borrowed funds from its parent company in Ecuador. To escape the interest payments under the U.S.-Honduras treaty, it paid the interest to a subsidiary in Honduras.[45] The U.S. Tax Court

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[37] Bruce A. Blonigen & Ronald B. Davies, Do Bilateral Tax Treaties Promote Foreign Direct Investment? *SSRN Electronic Journal*, 2002, p. 526, available at https://www.researchgate.net/deref/http%3A%2F%2Fdx.doi.org%2F10.2139%2Fssrn.445964 last accessed on July 28, 2020.

[38] Panayi, *supra* note 11.

[39] Martin Hearson, Measuring Tax Treaty Negotiation Outcomes: the Action Aid Treaties Data set. ,(2016a), ICTD Working Paper 47, Institute of Development Studies, p.13, available at http://eprints.lse.ac.uk/67869/1/Hearson_measuring_tax_treaty_negotiation.pdf (last accessed on May 20, 2020).

[40] *Id.*

[41] Lang*, supra* note3, p.30.

[42] Pérez, *supra* note 15, p.14.

[43] Andreas Nyberg, Treaty shopping, Master thesis, University of Lund, (2001), p.6.

[44] *Id.*

[45] Anna A. Kornikova, Solving the Problem of Tax Treaty Shopping using Limitation on Benefits Provisions, *Richmond journal of law and business,* Vol. 8, No. 2, (2008), P. 259.

disallowed treaty benefits in this back-to-back loan because, in the absence of a business purpose, the Honduran affiliate acted as a "conduit" to pass the interest payments to the parent in Ecuador.[46]

Although this is supposedly the time when the expression was created, the tax planning method dates even further back. As early as 1945, the tax treaty between the U.S. and the U.K. had an abuse clause trying to limit treaty abuse.[47] Therefore, in its historical essence and current use, treaty shopping is an artificial arrangement implemented by an economic operator to secure the benefits of a double tax treaty that were not intended by the contracting states in their negotiation. This activity may result in very sophisticated schemes mainly put in place by using conduit companies.[48]

Capturing its fundamental elements, Vogel describes it as "a situation where transactions are entered, or entities are established, in other States, solely to enjoy the benefit of particular treaty rules existing between the State involved and a third State which otherwise would not be applicable".[49] One of the major characterizing features implied in this definition is the fact that Treaty shopping involves at least three states. The first state is *the residence state*, where the law subject (like a physical person or a business) has its residence.[50] The company in the residence state then starts another business or invests in the second state. The second state is called the *base company state*, *conduit company state,* or *holding company state,* [51] *whereas the third state is a source state,* where the actual income or the appreciation of an investment is obtained.

Thus, the base/conduit/holding company state is an intermediary between the residence state and the source state.[52] As such, the residents of a third country may design their business structure to take advantage of the DTAs of a country with another country and avoid tax payment.[53]

## 2. Tax Treaty Shopping Strategies

Treaty shopping can be done in various ways. The most typical structure for a multinational group includes an intermediate holding company, acting as a link

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[46] *Id.*
[47] Nyberg, *supra* note *43*, p.6.
[48] Weeghel, *supra* note14, p. 119.
[49] *Id.*, p. 117.
[50] Nyberg, *supra* note *43*, p. 9.
[51] *Id.*
[52] *Id.*
[53] Sanjay Kumar Yadav, Abuse of Double Taxation Avoidance Agreement by Treaty Shopping in India, *Journal of Humanities and Social Science*, Vol.23: No. 10, (2018), p.68.

between the parent company located in a given country and the controlled companies operating in other countries.[54] An intermediate holding company is often a body through which treaty shopping is done and generally applicable in two forms: through *a direct conduit* and *stepping stone conduit*.[55] A direct conduit is achieved by interposing an entity in the state of residence. The entity then forwards the income, inbound from the source state, to an entity in a third state through a dividend distribution.[56] Direct conduits lead to no erosion of a company's taxable base as dividends are usually not deductible expenses.[57]

Further, in a direct conduit modality, an interposed corporation, taking advantage of a tax treaty, is used to shift income to another country whose residents cannot benefit directly from the treaty provisions.[58] In other words, whenever two countries, say A and B, have entered a tax treaty where a third country, say C, has signed a tax treaty with country B, the taxpayers in country C may take advantage of the tax treaty between A and B by incorporating a company in country B. Therefore, if the residents in country C want to invest in country A, by interposing a company resident in country B, they take advantage, firstly, of the tax treaty between countries A and B, avoiding the withholding tax on the income transferred from the country A to country B. Secondly, they benefit from the treaty provisions in force between countries B and C[59]concerning the withholding tax on the dividends distributed from the company in country B to the residents of country C.[60]

Alternatively, the income may be tax-exempted in country B because of the application of a parent-subsidiary regime. In other words, assets and rights giving rise to passive income are transferred to the company in country B to take advantage of the full or partial exemption from the withholding tax that country A would have levied in

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[54] Nyberg, *supra* note *43*, p.17.
[55] Federico G. Scarlata, Global Tax Planning and Offshore Opportunities, Helsingborg, Comtax AB publishing, (1995), p. 90.
[56] Benjamin Malek, The Concept of Beneficial Ownership in Tax Treaty Practice, Master's thesis, University of Lausanne, (2018), P.2.
[57] *Id*.
[58] Paolo Burattin, Anti-Avoidance Measures against Treaty Shopping and the Employment of Base Companies, Master's thesis, Ca' Foscari University,(2015), P.18.
[59]Simone M. Haug, The United States Policy of Stringent Anti-Treaty-Shopping Provisions: A Comparative
Analysis, *Vanderbilt Journal of Transnational Law*, No. 29, (1996), p. 205.
[60] Burattin, *supra* note 58, p.19.

case the investment had been made directly by using a company incorporated in country C.[61]

Turning to the stepping stone conduit modality, one can observe similar operations with limited differences. In this case, instead of dividend distribution, the payment takes the form of a deductible expense. More precisely, the company's tax base, interposed in the state of residence, is reduced with deductible expenses (e.g., interests, royalties, management fees) paid to the final beneficiary.[62] The stepping stone structure mainly relies on the erosion of the income produced through the investment in one country, say country A, by a company incorporated in country B, under the assumption that country B is a high tax jurisdiction.[63] In this case, the corporation in country B pays another company in country D, a low tax jurisdiction, deductible expenses, so that country B's net income is lower.[64]

Therefore, the income arrives at the residents of country C from the company in country D, which enjoys a privileged tax regime, and not directly from the company in country B.[65] In general terms, the essence of treaty shopping under the scenario of the modalities involves interposing a company entitled to claim the treaty benefit between the payer of the income and the recipient. As such, it occurs when a person, not a resident of a contracting state to a double taxation convention, attempts to obtain benefits granted to residents of that state.[66]

Still, treaty shopping is conducted through a third modality called a *base company* scheme.[67] In this case, the tax benefit arises in the residence state.[68] For example[69], if a company in state A owns all shares in a company situated in country X, based on state A's domestic tax legislation and the double taxation treaty between states A and X, the

[61] OECD, Double Taxation Conventions and the Use of Conduit Companies, R(6) in Model Tax Convention on Income and on Capital, 2014, paragraph 1( hereafter called OECD,2014) available at https://www.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2014-full-version/r-6-double-taxation-conventions-and-the-use-of-conduit-companies_9789264239081-99-en&ved (last accessed on July 28, 2020).

[62] Daniel Vries Reilingh, Manual of International Tax Law,2nd Edition, Zürich, 2014, p. 69.

[63] Burattin, *supra* note 58,p.19.

[64] Haug, *supra* note 59, p. 206.

[65] OECD,2014,paragraph 1.

[66] OECD, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report, OECD/G20 Base and Erosion Profit Shifting Project ( hereafter called OECD, Action 6 Final Report), p. 17. available at **https://www.oecd.org/tax/treaties/beps-action-6-preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstance-peer-review-documents.pdf&ved** last accessed on July 28, 2020.

[67] Nyberg, *supra* note 43, p.9.

[68] *Id*., p.20.

[69] *Id*.

disposition of the shares would trigger a tax effect. Accordingly, the company in state A transfers the shares to a wholly-owned company in state B. This internal transaction does not render any tax in state A.[70] The Company in state B then sells the shares of the company situated in country X, and such disposition of share is not taxed as the domestic laws may render capital gains to be tax-free.[71] The tax-free capital gain can then be transferred to the mother company in state A through dividends. It is assumed that the dividends are tax-free through the double taxation treaty between states A and B. In-state A, the company has, through this scheme, completely avoided a tax on the capital gains when selling the shares of the company in country X.[72] In sum, the tax benefit in this modality arises in the residence state.[73]

## 3. Major Impacts of Tax Treaty Shopping

Tax treaties play an important role in international tax planning.[74] To reduce tax liability, a taxpayer needs an incentive to undertake economic activities in a state that has a tax treaty with their state of residence. Suppose there is no applicable tax treaty between the state of their residence and the states in which the taxpayer wants to invest. In that case, the taxpayer will arrange their economic activities to utilize another state's tax treaty.[75] As treaty benefits should only be available to residents of the contracting states, the attainment of treaty benefits by non-residents is achieved by the imposition of a legal entity, a conduit, in a treaty state.[76] To this effect, treaty shopping has various impacts on the tax system.

The first impact of treaty shopping is the loss of revenue for contracting parties to bilateral double taxation avoidance agreements.[77] States expect that income is to be taxed in at least one of the states. If a state gives up its right to tax a particular income item, it expects the other state to tax it.[78] One situation in which income may not be subject to taxation is where a state has the exclusive right to tax that income and exempts that income from taxation.[79] Consequently, the taxpayer incurs no tax liability in one state yet still seeks the tax treaty's application against the other state. If the

[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] Louisa Boyd, Double Taxation Agreements: New Zealand's Approach to Treaty Shopping, *Auckland University Law Review*, Vol.4:No.13,(2007), P.65.
[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] Weeghel, *supra* note14, p.105.
[79] *Id.*

taxpayer were entitled to treaty protection, this would result in non-taxation, also known as tax avoidance.[80] Yet, there is no evidence of a general principle that a taxpayer must show that double taxation would arise as a pre-requisite to entitlement to treaty benefits. Consequently, a treaty becomes a convention for the avoidance of any taxation.[81] This, in effect means, treaty shopping opens a space for unintended use of tax treaties by third-country residents or individuals from non-contracting states. It makes bilateral treaties effectively "treaties with the world" and leads to a loss of tax revenues in the source State.[82]

Apart from such effects, treaty shopping also causes a loss of interest to enter tax treaties. If treaty shopping were permitted, the third state has a reduced incentive to enter into tax treaties as its residents can benefit from another state's tax treaty.[83] Furthermore, if the third state were to enter into treaty negotiations, its bargaining power would be increased.[84] As the residents of this state can utilize other treaties' benefits, the terms of a new treaty would be more beneficial than existing treaties.[85] Hence, treaty shopping creates a disincentive for countries to negotiate tax treaties.[86]

Finally, it is argued that treaty shopping is often linked to the breach of the reciprocity principle. As one of the forms of inter-state treaties, tax treaties are expected to be built on principles of reciprocity. Where such principle is not observed, a state will not enter a tax treaty[87], or it gives up or limits its rights to the treaty partner's tax residents and reciprocally would move to obtain the same benefits for its residents. Such effects are particularly associated with the involvement of a third state. When a third-country resident "shops" into a treaty, then the treaty concessions are extended to a resident whose state has not participated in this arrangement and may not reciprocate with corresponding benefits.[88] To this effect, the treaty's usual quid pro quo is therefore compromised and the process subverted.

[80] *Id.*
[81] Charles Kingson, The Coherence of International Taxation, *Columbia Law Review*, Vol. 81, (1981), p.1153.
[82] Rohitagi, *supra* note 6, P.6.
[83] Haug, *supra* note 59, p. 219.
[84] *Id.*,p.220.
[85] *Id.*
[86] H.David Rosenbloom &Stanley Langbein, United States Tax Treaty Policy: An Overview, *Columbia Journal of Transnational Law*, Vol.19, ( 1 98 1 ), p. 676.
[87] Weeghel, *supra* note14,p. 116.
[88] Reuven S. Avi-Yonah & Christiana HJI Panayi, Rethinking Treaty-Shopping: Lessons for the European Union, Michigan university, book chapters,2010, p.25, available at https://repository.law.umich.edu/book_chapters/78 (last accessed on May 28, 2020).

## 4. Global Responses to Tax Treaty Shopping

Treaty shopping is an integral part of global transactions and is, in principle, permitted as a general tax planning method. Yet, there are limits to such principles, the violations of which would lead to unacceptable transactions.[89] As such, the use of treaty shopping largely requires cautiously forecasting transaction consequences that may lead to undesirable outcomes.[90]

Accordingly, the tax treaty system has focused on designing mechanisms to counter specific practices that result in abuse of tax treaties by persons whom the treaties were not intended to benefit or persons who access benefits which the treaties were not designed to confer.[91] Through these moves, two major mechanisms have been devised as a way to contain such undue benefits. This can firstly be made by incorporating specific anti-treaty shopping provisions in the treaties. Alternately, countries may formulate domestic legislation prohibiting the use of a treaty for shopping.[92] Each of these two mechanisms involves several steps leading to the desired outcome. The following sections discuss these steps in greater depth.

### 4.1. Treaty Rules to Combat Treaty Shopping

Tax planning on the domestic or the international level is by no means objectionable, though extensive tax planning is an indication of imperfect legislation.[93] Nevertheless, tax planning may reach a point beyond which it cannot be tolerated within a legal system intended to conform to justice principles.[94] As a usual course of process, countries devise anti-abuse rules to prevent the residence principle's circumvention from allowing treaty benefits to taxpayers that are not residents of contracting states.[95]

As it has been pointed out earlier, one of such mechanisms is incorporating specific anti-treaty shopping provisions in a double taxation agreement.[96] This mechanism is widely in use in several countries such as the Netherlands, India, the USA, Switzerland, and the U.K. These countries incorporated specific provisions in their

[89] Klaus Vogel, Double Taxation Conventions, A Commentary to the OECD, UN, and US Model Convention for the Avoidance of Double Taxation of Income and Capital, With Particular Reference to German Treaty Practice, 3rd edition, London, Kluwer Law International, (1997), P.119.
[90] Nyberg, *supra* note 43, p.32.
[91] Pérez, *supra* note 15, p.5.
[92] Yadav, *supra* note 53, p.72.
[93] Nyberg, *supra* note 43, P.30.
[94] *Id.*
[95] Pérez, *supra* note 15, P.16.
[96] Yadav, *supra* note 53, p.72.

inter-state treaties mainly to prohibit misuse of a treaty by residents of a third state.[97] Looking into the contents of the terms in such treaties, one could observe that containing such adverse effects of treaty shopping requires incorporating important rules that effectively contain the adverse effects of treaty shopping. The next subsections identify these rules and characterize each of them with sufficient details.

#### 4.1.1. Limitation on Benefits Provision

*The limitation on benefits provision* is one of the containing terms in use against treaty shopping since the 1945 US-UK tax treaty.[98] The rule is largely referred to be the first foundation of what would later become the United States standard Limitation on Benefits Provision. The provision is included in almost all U.S. tax treaties today. Also, the historical literature shows that the 1962 U.S-Luxembourg treaty contained the first separate anti-treaty shopping provision. These terms specifically aimed at limiting benefits under the treaty to those who were citizens or residents of one of the contracting states by disallowing any treaty benefits to any holding company entitled to any special tax benefit under the specific treaty or any income derived from such companies by any shareholder thereof.[99]

The contents and intents of the limiting provision were refined in the next decades. In 1977, the United States published a Model Treaty to act as a coherent guide for future treaty negotiations.[100] This model treaty has included a Limitation of Benefits (LOB), which denies treaty benefits to a company resident in a contracting state if non-residents own more than 25% of the company's capital.[101] As an extension of this development, a more enriched LOB article was formulated in the 1989 U.S-Germany tax treaty. This article was the first provision representing all elements of a modern LOBs clause and was received by the tax community as a major innovation and has been used as a model for subsequent treaty negotiations.[102]

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[97] *Id.*

[98] I.K. Sugarman, "The U.S.-Netherlands Income Tax Treaty: Closing the Doors on the Treaty Shoppers", *Fordham International Law Journal*, Vol.17:No.3, pp. 776-824.

[99] Convention Between the United States of America and the Grand Duchy of Luxembourg concerning Taxes on Income and Property, signed on Dec. 18, 1962 (1962 U.S.-Luxembourg tax treaty) available athttps://www.irs.gov/pub/irstrty/luxem.pdf&ved (last accessed on May 28, 2020).

[100] Sugarman, *supra* note 98, pp. 776-824

[101] M.F. Huber and M.S. Blum, "Limitation on Benefits under Article 22 of the Switzerland-U.S. Tax Treaty", *Tax Notes International*, Vol.39, No.l 6, (2005), pp. 547-568.

[102] Sugarman, *supra* note 98, pp. 776-, see also P.T. Kaplan, "Treaty Shopping Under the New U.S.-Netherlands Treaty" *Bulletin for International Fiscal Documentation*, Vol.47: No. 4, (1993), pp.175-180.

The LOB provisions in the latter treaty limit the treaty's applicability only to the other state's residents by defining the term *resident* in the definition part of the tax treaty. For example, as a precondition to benefit from a tax treaty, it requires that state's residents to own half of a company's assets established in the third country.[103] Thus, the LOB clause denies the treaty benefits to taxpayers who would not pass its tests, thereby treating them more disadvantageously than others. Hence, from the perspective of fundamental freedom, the LOB clause treats the qualified resident from the non-qualified residents differently and creates a burden on cross-border activities.[104] This approach is well known in the international arena, and it is present in the U.S. tax treaty model and some Indian and Japanese treaties.[105]

### 4.1.2. Beneficial Ownership

The notion of beneficial ownership was originated in the equity law of England.[106] It is largely common in the trust practice, in which the English law uses it primarily to draw a difference in the ownership rights of trustees and ownership rights of beneficiaries in a trust.[107] As such, the concept of beneficial ownership manifests in two major forms: legal ownership in the head of the trustee and economic or beneficial ownership in the beneficiary's head[108] This distinctive use of the ownership forms has particular importance in identifying the rights and duties of respective subjects connected to tax benefits. For example, although the trustees as legal owners can administer the trust in themselves, they only can perform their duties and hold the ownership for the benefit of the beneficiaries.[109] Therefore, only the beneficiaries, as beneficial owners, will be entitled to appropriate the tax benefits of the trust.

The distinction between such rights can further open space to ensure that inter-state treaty benefits are limited to the contracting states' residents.[110] Accordingly, the concept of beneficial ownership provides that a resident invoking a withholding tax reduction should own the income. This requirement signifies that the purpose of treaty tax benefit, instead of merely allowing to pass income to a resident of a non-

[103] Rohitagi, *supra* note 6, P.6 .
[104] Filip Debelva, Dina Scornos, Jan Van den Berghen & Pieter Van Braband, LOB Clauses and EU-Law Compatibility: A debate Revived by BEPS, EC Tax Review, Kluwer Law International, (2015), pp. 134-135.
[105] OECD, Action 6 Final Report, Para. 19, p. 18.
[106] Pérez, *supra* note 15, P.17.
[107] *Id.*
[108] *Id.*
[109] *Id.*
[110] *Id.*,p.26.

contracting state,[111] is to reward legal subjects because of their involvement in transactions as residents of a contracting state, Therefore, according to this approach, treaty benefits on passive income can only be granted to residents of the contracting states that are ultimately the recipients of the economic benefits, irrespective of who the immediate recipient of the income is.[112] Thus, in the tax treaty system, the concept operates as an economic test applied to counter treaty-shopping strategies through conduit companies.[113]

Internationally, the concept of beneficial ownership was first introduced by the OECD in the Model Convention in 1977, and it has been serving as one of the anti-abuse rules directly provided for double taxation avoidance agreements.[114] Further, it is currently incorporated into more than 2400 Double Tax Treaties concluded by more than 170 countries worldwide.[115] Therefore, the idea is critical for determining a person's eligibility for the tax treaty benefits and allocating the taxing rights between two contracting states concerning the relevant category of income.[116]

#### 4.1.3. Third Country Articles or Bonafide Approach

It is pointed out earlier that moves of treaty shopping inherently involve the interaction of three states.[117] The major motive to include the third state, which could be a contracting state, is to reduce or avoid a tax.[118] In the absence of a treaty, the withholding tax rate may be substantial, and by routing the payment through a treaty country, the rate could be reduced. Yet, business entities or individuals may abusively move through these routes to escape taxes or other forms of payment. To prevent the treaty's abuse in this way, some articles (particularly interest and royalty articles) include a paragraph stipulating that the article shall not be applicable if payment was created or assigned mainly to take advantage of the treaty and not for *bonafide*

[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] *Id.see* OECD Model Convention of 1977, available at https://www.oecd-ilibrary.org/taxation/model-double-taxation-convention-on-income-and-capital_9789264055919-en&ved (last accessed on May 28, 2020. Articles 10, 11, and 12 of this Model Convention was applied the term beneficial owner as a provision to prevent the design of tax planning to allow residents of a third state to incorporate a conduit company in a contracting state to obtain a withholding tax reduction.
[115] Anna Vitko, Per Aspera ad Astra: Towards the International Fiscal Meaning of the Concept 'Beneficial Owner, Master's thesis, Lund University, (2011), p.3.
[116] *Id.*
[117] Lars Pelin, Internationell skatterätt Ur et svenskt perspektiv, 2nd edition, Lund, Student littérateurs,(2000), p.114.
[118] Nyberg, *supra* note 43, p.35.

commercial reasons.[119] To take a practical example, in a treaty between the U.K. and the Netherlands, a pertinent provision with this intent: provides;

> *This article's provision shall not apply if the debt-claim regarding which the interest is paid was created or assigned mainly to take advantage of this article and not for bona fide commercial reasons*.[120]

Looking into the contents of this provision, one can see that the *bona fide* approach is adopted to counter the treaty shopping concerning interest payment. Accordingly, if the debt claim in which the interest is paid were created or assigned to take the treaty's advantage and not for *bona fide* commercial reasons, the special privilege accorded by the concerned treaty would never be extended to such kinds of arrangements.

#### 4.1.4. Exclusion of Tax-Favored Entities from Treaty Benefits

Treaties could exclude particular tax-favored entities in treaty countries. These entities may be excluded from all forms of treaty benefits or benefits emanating from certain articles.[121] The U.K., for example, excluded certain holding companies in Luxembourg and Barbados from treaty benefits in their double taxation conventions.[122] Also, Sweden has used the same approach in its inter-state tax treaty with Barbados.[123]

At this point, it is important to note that often treaty shopping involves the interposition of companies in countries that enjoy a favorable tax regime. Thus, companies always tend to distance themselves from countries with such excluding treatments. Also, governments have been reluctant to sign treaties with so-called tax havens. Therefore, the abstinence approach means that countries will cautiously think to include or not include a treaty with states known for their low tax regime or as a place for conduit companies.[124]

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[119] Wenehed, L-E., A Guide to Effective Tax Planning Within a Global Group, Helsingborg, Comtax Publishing AB, P.31.

[120] The UK – Netherlands Double Taxation convention and protocol, signed on September 26, 2008, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/732461/netherlands-dtc-2008-2013.pdf&ved,Art.11(6) (last accessed on May 28, 2020).

[121] Nyberg, *supra* note 43, p.34.

[122] Wenehed, *supra* note 119, P. 30.

[123] Nyberg, *supra* note 43, p.35.

[124] Becker &Wurm, *supra* note 16, P.6.

### 4.2. Anti -Treaty Shopping Measures Proposed By BEPS Action Plan 6 and 15

Base Erosion and Profit Shifting (BEPS) refers to tax avoidance strategies whereby MNEs exploit the gaps or mismatches in tax rules to artificially shift profits to low or no-tax jurisdictions where there is little or no economic activity to minimize tax payment.[125] As one of the major developments in this area, In September 2013, the OECD and G-20 countries adopted a 15-point Action Plan with the primary purpose of managing BEPS by MNEs.[126] Out of the 15-points, Action Plan 6 was mandated to prevent granting treaty benefits in inappropriate circumstances.[127]

Further, in September 2015, the OECD released the final report on BEPS action plan 6, According to which treaty shopping is one of the most important sources of BEPS concern.[128] Accordingly, the OECD has presented three main recommendations.[129] First, it recommends the inclusion in the tax treaties of a special anti-abuse rule as the *Limitation on Benefits clause* (LOB), which would prevent the treaty's granting benefits to residents that do not fulfill its requirements. This approach is well known in the international arena, and it is largely in use in the U.S. tax treaty model and couple of Indian and Japanese treaties.[130]

The second recommendation justifies incorporating a general anti-abuse rule as the *principal purpose test* (PPT).[131] It is rationalized in the recommendation that the general anti-abuse rule would prevent the treaty benefits by testing the transactions or arrangements' principal purposes.[132] Capturing its essence in the final report of BEPS Action 6, the OECD has particularly proposed the following for the *principal purpose test*:

> *Notwithstanding with other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude that any arrangement or transaction is directly or*

[125] OECD, Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, ( hereafter called OECD BEPS action 7,2015 final reports) available at https://www.oecd.org/ctp/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htmlast (accessed on July 28, 2020).

[126] *Id.*

[127] OECD, Action 6 Final Report, p. 9.

[128] *Id*.

[129] Amela Juka, Is the BEPS Action Plan 6 " Preventing Treaty Abuse" Compatible With the EU Law Concept of Abuse?, Master's thesis, Lund University, 2015/16, p.3.

[130] OECD, Action 6 Final Report, p. 18.

[131] *Id.*

[132] *Id.*

> *indirectly for the principal purposes of obtaining benefit unless it is established that the granting of benefit is in light of the objective and purpose of this Convention.*[133]

Turning to the third recommendation, the institution directly refers to the amendment of the title and preamble, clearly stating that the tax treaties' purpose is not intended to generate treaty abuse opportunities of double non-taxation.[134] Accordingly, the OECD recommended an amendment of the title and preamble of the OECD Model Convention, which reads that "[c]onvention between State A and State B for eliminating double taxation concerning taxes on income and capital and prevention of tax evasion and avoidance."[135]

A closer look into the spirit of the convention shows that the OECD seeks to encourage states to enter into a tax treaty agreement that eliminates double taxation on income and capital taxes without creating opportunities for double non-taxation or reduced taxation through tax avoidance and evasion.[136] Yet, it is important to note that these actions are only proposals, and therefore they constitute soft laws. However, with their implementation in the tax treaties and domestic law, they will become hard laws.[137] Thus, the BEPS Action plan 6 recommendations will have legal consequences in the taxpayer's cross-border activities and the domestic legal system. Based on the BEPS Action Plan, the OECD Model Convention has integrated anti-treaty shopping rules, specifically, *principal purpose test* and *Limitation of benefits clause* as a part of the BEPS Action Plan.[138] Besides, a multilateral instrument (MLI) developed based on BEPS action plan 15 has also integrated the principal purpose test and Limitation of the benefits clause for fighting treaty shopping.[139] Hence, based on BEPS Action Plan 6 and 15, both the OECD Model Convention and MLI have brought these two instruments together as syndetic tools for fighting treaty shopping.

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[133] *Id*., p.55.
[134] *Id*., p. 9.
[135] OECD, Action 6 Final Report, p.91.
[136] Frans Vanistendael, Is Tax Avoidance the Same thing under the OECD Base Erosion and Profit Shifting Action Plan, National Tax Law and EU Law, Bulletin for International Taxation, IBFD, (2016), p. 169.
[137] Juka, *supra* note 129, p.3.
[138] OECD Model Convention, 2017 update, paragraph 9 to Art. 29 & paragraph 1 to Art.7,(hereafter called OECD Model Convention) available at https://www.oecd.org/ctp/treaties/2017-update-model-tax-convention.pdf (last accessed on June 03, 2020).
[139] Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base erosion and profit shifting, 24th November 2016, Art.6 &7(1), available at https://www.oecd.org/tax/beps/beps-actions/action7/ (last accessed on June 03, 2020).

### 4.3. **Domestic Anti-Avoidance Rules**

Treaty shopping can also be combated through domestic laws, using general anti-tax avoidance or anti-abusive provisions. Some countries have specific anti-treaty shopping provisions in their domestic law and sometimes contain Limitation on Benefits provision in their treaties to counter unintended treaty shopping.[140] Domestic anti-avoidance rules are domestic tax law rules intended to curb tax avoidance (including tax avoidance in cross-border situations).[141] The rules can be either established through judicial precedent[142] or introduced by the legislature in statutory law.[143] Accordingly, governments endeavor to combat abusive tax avoidance through specific anti-avoidance rules (SAARs) and general anti-avoidance rules (GAARs).[144]

According to Chris Evans, specific anti-avoidance rules constitute "smart bombs" in the war against specific abusive tax avoidance. They target individual subjects to contain their abusive moves in treaty shopping. On the other hand, general anti-avoidance rules act as “weapons of mass destruction,” curbing a mass of treaty shopping moves at a time[145]. In doing so, enactment of general anti-abuse provisions saves the tax system from "the far greater proliferation of detail that would be necessary if tax avoiders could succeed merely by bringing their scheme within the literal language of substantive provisions written to govern the everyday world."[146] Finally, it is important to note that specific anti-avoidance rule, unlike general anti-abusive rules, applies only to "stipulated or suspected" transactions and are rarely retroactive in an application. Therefore, they "cannot prevent avoidance transactions not previously detected." [147]

Another point worth considering under this subject is the varying moves of states in using the instruments. Some countries, as a supplement to specific statutory rules and

[140] Rohitagi, *supra* note 6, P.6.

[141] Larisa Gerzova &Oana Popa, Compatibility of Domestic Anti Avoidance Measures with Tax Treaties, *European Taxation*, Vol.53.No. 9, (2013), p. 421.

[142] Vikram Chand, The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties (with special references to the BEPS project), Tax Policy Series, Geneva/Zurich 2018, Schulthess,p.47.

[143] Bob Michel, Anti Avoidance And Tax Treaty Override: Pacta Sunt Servata, *European Taxation*, Vol.53.No.9, (2013), p. 414.

[144]David G. Duff, Tax Avoidance in the 21st Century, In Australian business reform in retrospect and prospect in Chris Evans & Rick Krever (eds), Thomson: Sydney, (2009), P. 492.

[145] Chris Evans, Containing Tax Avoidance: Anti-Avoidance Strategies, University of New South Wales Faculty of Law Research Series No. 40, (2008), P. 32.

[146] Surrey Stanley, Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail, *Law &Contemporary Problems*, Vol. 34, No. 32, (1969), P. 707.

[147]Finance Quebec, Aggressive Tax Planning, 2009, P.28 available at http://www.finances.gouv.qc.ca/documents/Autres/en/AUTEN_DocCons_PFA.pdf&ved (last accessed on May 28, 2020).

GAARs, would introduce statutory GAARs to discourage abusive tax avoidance. Also, others opt between SAARs and GAARs to discourage treaty shopping's harsh effects. In most cases, because of their advantages, governments continue to rely on SAARs to counteract abusive tax avoidance schemes.

It is argued that countries opt for the latter instruments due to the "boost to real-time intelligence" created by enacting disclosure regimes.[148] As such general anti-avoidance rules are amenable to domestic payments and could be difficult to apply to international payments.[149] Sometimes, they are not even applicable to the international arena. It isn't easy to prove that a global structure is not set up for *bona fide* commercial reasons but only for treaty benefits.[150] Currently, many states have SAARs instead of statutory GAARs[151], though this trend has changed in light of international developments, especially the OECD's BEPS project.[152]

Turning to another scenario of application for these tools, we could observe that domestic anti-avoidance rules may only be applied to double taxation treaties if justified by domestic and international laws.[153] At the domestic level, countries introduce anti-avoidance rules in their tax codes or treaties to combat the perceived abuse of their tax legislation and deny the granting of benefits of their bilateral tax treaties.[154] Such measures, in some circumstances, may override the existing treaty obligations. Thus, the determination of a tax treaty can be overridden by new domestic tax legislation depending on how the treaty is implemented into the domestic law.[155] Although some states permit specific domestic law to override treaty obligations, such override is considered as a breach of the treaty itself under international law.[156]

A final point worth noting is the relationship tax treaties have with international laws. As tax treaties are part of international law, their legal effects are also embodied in the Vienna Convention. Evidencing this fact, the principle of *pact sunt servanda,* adopted

[148] Evans, *supra* note 145, P. 15.
[149] Vogel, *supra* note 25, P.122.
[150] *Id*.
[151] Chand, *supra* note 142, p.8.
[152] *Id*., p.6.
[153] Nyberg, *supra* note 43, p.2.
[154] Luc De Broe, International Tax Planning and Prevention of Abuse: A Study Under Domestic Tax Law, Tax Treaties and EC Law Concerning Conduit and Base Companies, International Bureau of Fiscal Documentation, (2008), p.280.
[155] Craig Ellife, the Lesser of Two Evils: Double Tax Treaty Override or Treaty Abuse? *British Tax Review*, No.1,(2016), P.65.
[156] Nyberg, *supra* note 43, P.13.

under Article 26 of the Vienna Convention, does not allow states to invoke domestic laws to justify that they did not fulfill their obligation under tax treaties.[157]

## 5. The Need to Integrate Anti-Treaty Shopping rules into Ethiopian Income Tax System

Ethiopia's international business and investment activities involve global entities' interactions that inherently make sensible moves to gain the most out of their transactions. Further, the global business environment is so complex that it brings into contact varying business entities with multi-connections in terms of place of origin and residence. This, in effect, means that international business interactions are highly susceptible to abusive treaty shopping moves, requiring proactive responses on the part of trading states. Among others, this proactive move requires identifying areas of risk and devising protective measures against them. As part of the effort to achieve this in Ethiopia, the next sections of this article assess the legislative actions that the country has taken, identify the areas of vulnerability to abusive treaty shopping, and justify the need to incorporate containing mechanisms for such damaging moves.

### 5.1. The Need to Integrate Anti-Treaty Shopping Rules into Ethiopian Double Taxation Avoidance Agreements of Ethiopia

As pointed out in the explanatory sections of this article, the problem of double taxation is attributed to income tax jurisdiction whereby some countries adopt a source or a resident tax rule or a hybrid of both. Looking into the Ethiopian income tax jurisdiction, it sets out global jurisdiction concerning resident and source jurisdiction for a non-resident.[158] Accordingly, in the case of cross-border transactions, double taxation would inevitably occur. Double taxation tends to discourage international trade and investment. That is why the world communities have provided remedies for double taxation. This can be made either through unilateral acts of state via domestic laws or by multilateral and bilateral tax treaties.

To this end, Ethiopia has employed both unilateral actions and bilateral tax treaties as a remedy for double taxation. Unilaterally, Article 45 of the Income Tax Proclamation has integrated foreign tax credit into the Ethiopian income tax system.[159] Further, Article 48(1) of the Income Tax Proclamation has also allowed the tax authority to conclude bilateral tax treaties with the primary purpose of avoiding double taxation

[157] Ellife, *supra* note 155, p.66.
[158] Income Tax Proclamation No.979/2016, Art.7.
[159] Income Tax Proclamation No.979/2016, Art.45.

and fiscal evasion.[160] As such, Ethiopia has concluded several tax treaties with various countries to attract foreign direct investment and increase its participation in the international arena.[161]

Through all these moves, Ethiopia has signed more than 32 tax treaties to date.[162] However, the treaties' status differs in that some of them are ratified by the two governments, and the ratification document is exchanged between the parties, while in other instances only the Ethiopian government ratifies the documents. Yet the remaining category of treaties is just signed by the respective higher official of the two governments.[163] As such, only 11 tax treaties became effective after being approved by both governments, and ratification instruments were exchanged.[164] From a legal perspective, these are the only tax treaties binding on Ethiopia and its counterparts.[165]

The other set; (about 13 treaties) are ratified by the Ethiopian government.[166] These treaties are not binding on Ethiopia since the Ethiopian government does not have any information about the treaty's status on the other side.[167] The remaining set of treaties (8) are signed but not ratified.[168] Finally, it is important to note that Ethiopia's tax treaties' structure across the documents assessed is more or less the same since Ethiopia has her Tax Treaty Model presented to the other party when the need arises.[169]

The facts discovered through the documents' assessment suggest that such networks of bilateral tax treaties that Ethiopia has signed would inevitably open a room for tax treaty shopping unless a competent institution properly regulates it. Assessing the status and handling treaty shopping essentially requires examining the contents of Ethiopia's double taxation agreements in force. One of such agreements is the double

[160] Income Tax Proclamation No.979/2016, Art.48(1).
[161] Serkalem, *supra* note 21, p.34.
[162] *Id.*, p.35.
[163] *Id.*
[164] The tax treaty between the FDRE and Italy, Egypt, India, Sudan, China, French Republic, Turkey, United Kingdom of Great Britain and Northern Ireland, Kingdom of Netherlands, Kingdom of Saudi Arabia, and the Republic of Ireland is the one that is in force at this time.
[165] Serkalem, *supra* note 21, p.35.
[166] Tax Treaties between the FDRE government and Kuwait, Russian Federation, Yemen, Algeria, Tunisia, Romania, South Africa, Israel, Czech Republic, Seychelles, Portugal, Peoples Democratic Republic of Korea, and United Arab Emirates are ratified.
[167] Serkalem, *supra* note 21, p.35.
[168] Tax treaties between the FDRE government and Palestine, Poland, Cyprus, Qatar, South Korea, Slovakia, Morocco, and Singapore are signed but not ratified.
[169] Serkalem, *supra* note 21, p.36.

taxation and fiscal evasion agreement the country signed with China.[170] A closer look into this document shows that it has no anti-treaty shopping rules. The Ethio-Singapore double taxation treaty signed in 2016 is the second treaty that invites this examination.[171] Like the Ethio-China's double taxation agreement, no provision of this double taxation agreement set out the remedies for tackling treaty shopping. The same is true for Cyprus and Ethiopia's double taxation agreement signed on December 30, 2015, and came into force on October 18, 2017.[172] In sum, the scrutiny into Ethiopia's double taxation avoidance agreements reveals that bilateral tax treaties Ethiopia entered with potential trading states are devoid of anti-treaty shopping rules.

Though these bilateral tax treaties have not included anti-treaty shopping provisions, others, relatively the latest ones, have incorporated limitations of benefits provision as a remedy for fighting treaty shopping. For example, the double taxation agreement between the Federal Democratic Republic of Ethiopia and the Republic of Mozambique, signed on February 15, 2017,[173] provides a limitation of benefits provision to tackle treaty shopping. Evidencing this, Article 29 of this treaty provides that "a resident of a Contracting State will not be entitled to the benefits of the treaty if its affairs were arranged in such a manner as if the primary purpose or one of the primary purposes was to take the benefits of the treaty."

Looking into the intents of the provision, we notice a limit set by the treaty parties against moves of treaty shopping through conduit companies. As such, if the resident of the third states uses the conduit companies in one of the contracting states to the treaty with the primary purpose of taking treaty benefits between the contracting states, the resident of the third states cannot enjoy the benefits of the treaty as the contracting

[170] Agreement between the Federal democratic republic of Ethiopia and the government of the People's Republic of China for the avoidance of double taxation and prevention of fiscal evasion concerning taxes on income,(hereafter called double taxation agreement between Ethiopia and China) available at http://www.chinatax.gov.cn/n810341/n810770/c1152674/part/1152675.pdf (last accessed on June 03, 2020).

[171] Agreement between the Republic of Singapore and the Federal Democratic Republic of Ethiopia for the avoidance of Double Taxation and the Prevention of Fiscal Evasion concerning Taxes on Income, signed 24th August 2016,(hereafter called double taxation agreement between Singapore and Ethiopia) available at https://www.iras.gov.sg/irashome/Quick-Links/International-Tax/ (last accessed on June 03, 2030).

[172] Convention between the Republic of Cyprus and the Federal Democratic Republic of Ethiopia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion concerning taxes On Income, signed on 30th December 2015,(hereafter called double taxation convention between Cyprus and Ethiopia) available athttp://mof.gov.cy/assets/modules/wnp/articles/201610/45/editor/ethiopiaen.pdf (last accessed on June 03, 2020).

[173] Double taxation agreement between the Federal Democratic Republic of Ethiopia and the Republic of Mozambique, signed on 15 February 2017, but not ratified yet, available at https://www.orbitax.com/news/archive.php/Update-Tax-Treaty-between-Ethi-29984&ved (last accessed on June 03, 2020).

states itself denied the benefits of the treaty. Particularly, those legal entities without *bona fide* business activities are denied benefits of the treaty.

The other double taxation treaty that incorporated remedies for treaty shopping is a double taxation treaty between Ethiopia and the Netherlands. Accordingly, the Protocol amending the Convention between the Kingdom of the Netherlands and the Federal Democratic Republic of Ethiopia was signed on August 18, 2014. As of January 1, 2017, it has inserted a LOBs provision to curb treaty shopping.[174] Again, Article 28 of the double taxation agreement between the Federal Democratic Republic of Ethiopia and the Republic of Korea has included a limitation of benefits provision.[175]

As illustrated through the assessments outlined earlier, except the latest three bilateral tax treaties, others (more than 29) are devoid of anti-treaty shopping rules. This would inevitably open a room for multinational enterprises to resort to international tax planning treaty shopping. This abusive move inherently results in revenue loss since treaty shoppers do not pay the tax that otherwise owed. Besides, the possibility of treaty shopping also defeats an incentive for third states to negotiate a double taxation agreement with Ethiopia. Such third states do not need to concede their source taxation of Ethiopian residents as their residents already have an opportunity to take advantage of existing Ethiopia's double taxation agreements with other countries.

Currently, there is growing attention to the question of tax treaties signed by developing countries, and the costs of tax treaties to such countries have been highlighted in recent years by NGOs such as Action Aid and SOMO.[176] In one of such assessments, an influential IMF paper warned that developing countries "would be well-advised to sign treaties only with considerable caution." Further, the OECD, as part of its Base Erosion and Profit Shifting (BEPS) project, proposes to add text to the commentary of its model treaty to help countries decide "whether a treaty should be concluded with a State or whether a State should seek to modify or replace an existing

[174] Protocol amending the Convention between the Kingdom of Netherlands and the Federal Democratic Republic of Ethiopia signed on 18th of August 2014, and effective on January 1, 2017, available at https://zoek.officielebekendmakingen.nl/trb-2014-178.html?zoekcriteria (last accessed on June 03, 2020).

[175] Double taxation agreement between the Federal Democratic Republic of Ethiopia and the Republic of Korea that signed on May 26, 2016, available at https://www.orbitax.com/news/archive.php/Tax-Treaty-between-Ethiopia-an-28087&ved (last accessed on June 03, 2020).

[176] Mike Lewis, Sweet Nothings: The Human Cost of a British Sugar Giant Avoiding Taxes in Southern Africa, London: Action Aid UK, (2013); Katrin McGauran, "Should the Netherlands Sign Tax Treaties with Developing Countries?," SOMO, 2013, available at http://somo.nl/publications-en/Publication_3958/at_download/fullfile (last accessed on June 03, 2020).

treaty or even, as a last resort, to terminate a treaty."[177] Meanwhile, some developing countries seem recently to have been concerned with some of their treaties' negative impacts.[178] This evidence suggests that uncertainties pervade tax treaties in developing and developed economies alike.

Accordingly, there is a growing interest in counter mechanisms such as the Limitation of benefit. This instrument, widely taken as one of the prominent mechanisms for fighting treaty shopping, has its origin in the US.[179] The US had introduced a Limitation of benefits considerably a long time ago. Yet, most of the USA's bilateral tax treaties were devoid of LOBs provision.[180] The US then had to renegotiate her bilateral tax treaties and integrated LOB provision into all bilateral tax treaties with no anti-treaty shopping rules.[181]

What is interesting about the US moves is that it had terminated all of her bilateral tax treaties that were not successfully renegotiated.[182] The same is true for some African countries like the Republic of South Africa, Malawi, Zambia, and Rwanda.[183] They have successfully renegotiated their agreements with Mauritius to curb treaty shopping.[184] Accordingly, Ethiopia should renegotiate her bilateral tax treaties and integrate limitations of benefits to all of her bilateral tax treaties that are devoid of anti-treaty shopping rules. Renegotiation may not be easily realized as it needs the consent of states that are parties to the concerned bilateral tax treaties.Further,renegotiation of all bilateral tax treaties may need a long time and high costs. Where renegotiation is impossible, resorting to termination of a bilateral tax treaty is largely recommended.. Opportunities for such options could be readily available for countries as some double taxation agreements have a termination clause.

To this effect, the Ethiopian double taxation agreements include such clauses. For example, the double taxation agreement between China and Ethiopia provides for a

[177] OECD, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, 2014), available at https://www.oecd.org/ctp/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-9789264219120-en.htm&ved (last accessed on June 03, 2020).

[178] Martin Hearson, Tax Treaties In Sub-Saharan Africa: A Critical Review, Tax Justice Network- Africa, Nairobi, Kenya, Working Papers,(2015), p.6.

[179] Nyberg, *supra* note 43,p.33.

[180] *Id.*

[181] *Id.*

[182] *Id.*

[183] Martin Hearson, Tax Treaties In Sub-Saharan Africa: A Critical Review, Tax Justice Network- Africa, Nairobi, Kenya, Working Papers,(2015), p.6.

[184] *Id.*

termination clause.[185] The same holds for the double taxation agreement between Ethiopia and Singapore[186]and a double taxation agreement between Ethiopia and Cyprus.[187] Thus, Ethiopia would be in a strong bargaining position in negotiating the terms of treaties with other states. It can strongly work to convince the partner states to renegotiate the terms, or, failing to attain that, it can terminate the treaty as per the specific clause to that effect.

### 5.2. Tax Treaty Shopping and Anti-Avoidance Rules under Ethiopian Domestic Income Tax Law

As explained in the relevant section earlier, Treaty shopping could also be combated through domestic law by general anti-tax avoidance (GAARs) or specific anti-avoidance rules (SAARs). Accordingly, countries may introduce SAARs or GAARs to discourage the abusive effects of treaty shopping. Ethiopia's Federal Income Proclamation has both Specific Anti-Avoidance Rules (SAARs) and general anti-avoidance rules (GAARs). The specific anti-avoidance rules on income splitting, transfer pricing, and thin capitalization are among the rule aimed at tackling tax avoidance's abusive effects.[188] Likewise, Article 48 of the Federal Income Tax Proclamation has integrated the Limitations of Benefits for tackling treaty shopping.[189] Further, Article 48 (2) of the income proclamation sets a priority rule where a tax treaty prevails in cases where there is a conflict between the tax treaty and Federal Income Tax Proclamation. Providing a solution to this conflict, the proclamation stipulates that "if there is any conflict between the terms of a tax treaty having a legal effect in Ethiopia and this Proclamation, with the exception of sub-article (3) of this Article and Part eight of this Proclamation, the tax treaty shall prevail over the provisions of this Proclamation."

Yet, it is important to note that while a priority rule applies as a solution for such conflicts, it will be overridden to fight against treaty shopping as provided under Article 48 (3) and the anti-avoidance rules under part eight of the Federal income tax law. In this regard, Article 48(3) of the Federal Income Tax Proclamation provides that:

[185] Double taxation agreement between Ethiopia and China, Art.29.
[186] Double taxation agreement between Singapore and Ethiopia, Art .28.
[187] Double taxation convention between Cyprus and Ethiopia, Art .30 .
[188] Income Tax Proclamation No.979/2016, Art.47,78 &79.
[189] Income Tax Proclamation No.979/2016, Art.48(3).

> *When a tax treaty provides that Ethiopian source income is exempted or excluded from tax, or the application of the tax treaty results in a reduction in the rate of Ethiopian tax, the benefit of that exemption, exclusion, or reduction is not available to a resident of the other contracting state when fifty percent or more of the underlying ownership or control of that body is held by an individual or individuals who are not residents of that other contracting state.*[190]

From this provision, the Limitation of benefit could be adopted to tackle tax treaty shopping. Besides, from the cumulative reading of articles 48(2) and (3), it is clear that where there is a conflict between the terms of a tax treaty, having a legal effect in Ethiopia, and the Federal Income Tax Proclamation regarding tax treaty shopping, the provision of income tax proclamation will prevail. This would lead to the issues of treaty override.

Thus from the interplay of these rules, we could notice that, though providing a Limitation of benefits is an instrumental tool for tackling treaty shopping, the way it is provided under the Federal Income Tax Proclamation is not recommendable as treaty override is a breach of international law.[191] Besides, states cannot invoke the domestic laws to justify that they did not fulfil their tax treaty obligations.[192] Hence, specific anti-avoidance rule (Limitation of benefits) as provided under the Federal Income Tax Proclamation may not tackle treaty shopping as the implementation of the domestic law that overrides the treaty amounts to a breach of international law.

Turning to another legislative provision under Ethiopian law, the Ethiopian Income Tax Proclamation has general anti-avoidance rules (GAARs). This can be inferred from Article 80 of the new income tax proclamation, which states:

> *If a person has obtained a tax benefit (reduction in liability of tax or postponement of liability of tax or any other avoidance of liability of tax) from an agreement, arrangement, promise, or undertaking, whether express or implied, and whether enforceable by legal proceeding or not, or from any plan, proposal, course of action or course of conduct that was undertaken for the sole purpose of obtaining tax benefits, the tax authority can determine the*

[190] Income Tax Proclamation No.979/2016, Art.48.
[191] Nyberg, *supra* note 45,p.17.
[192] Ellife, *supra* note 159, p.66.

> *tax liability of the person who obtained the tax benefit or considers the appropriate measures for the prevention or reduction of tax benefits*.[193]

From this provision, it is clear that when a person undertakes a legally enforceable agreement, arrangement, or promise, with the sole purpose of obtaining tax benefits, the tax authority can consider the appropriate measures for the prevention or reduction of tax benefits. However, as pointed out under 4.3 of this paper, the general anti-avoidance rules are made for domestic payments and could be challenging to apply to international payments.[194] Sometimes, they are not even applicable in the international arena, and it isn't easy to prove that a global structure is not set up for *bona fide* commercial reasons but only for the use of treaty benefits.[195] Hence, the domestic anti-avoidance rules of Ethiopia may not be used for tackling treaty shopping.

## Concluding Remarks

The host of analyses made so far show that double taxation is a major barrier to international transactions. As a proactive move to this challenge, States of the world have generally agreed on the desirability of removing such barriers to increase global welfare. Moving a step forward, states have signed bilateral tax treaties to avoid or mitigate double taxation in cross-border economic activities. These treaties come under the umbrella of international agreements in which their creation and consequences are determined according to the Vienna Convention's rules on the Law of Treaties. They are negotiated under international law as legally binding State to State agreements signed by two or more countries. While these concerted moves of states would have a substantial role in avoiding or mitigating double taxation in cross-border economic activities, such networks of bilateral treaties would open room for treaty shopping.

Treaty shopping is a tax planning strategy where a taxpayer shops the most appropriate tax treaty to achieve a lower tax burden or a double non-taxation. It is an artificial arrangement implemented by an economic operator to secure the benefits of a double tax treaty, which were not intended by the contracting states in their negotiation. This activity is affected through sophisticated schemes that involve the use of direct conduit and stepping stone conduit companies. It can also be out through a base company scheme, where the benefit appears in the residence state. These abusive moves would entail varying adverse impacts such as loss of revenue, loss of incentive to enter

[193] Income Tax Proclamation No.979/2016, Art.80.
[194] Vogel, *supra* note 93, P.122.
[195] *Id*.

treaties, and breach of the principle of reciprocity which in turn cause substantial damage to national economies. Yet, global experience and practice show that tax treaty shopping can be tackled either through bilateral tax treaties themselves or domestic laws while it requires a substantial effort from different actors.

Looking into the Ethiopian situation in this light, one would see a considerable gap in attaining this goal. Ethiopia has signed more than 32 bilateral tax treaties with other countries. Yet, tax treaty shopping is not adequately regulated under domestic laws or bilateral tax treaties. As far as the domestic anti-avoidance rules are concerned, the Federal Income Tax Proclamation has provided specific ant- avoidance rules (Limitation of benefits) in a way that overrides treaty shopping. Hence, it may not serve its purposes as treaty override is a breach of the treaty itself under international law. The general anti-avoidance rule provided under the Federal Income Tax Proclamation may not be extended to treaty shopping as it is made for domestic payments. Besides, most of the Ethiopian bilateral tax treaties are devoid of anti-treaty shopping rules. Except for the double taxation agreement with Mozambique, the Netherlands, and South Korea, which constitute limitations of benefits provision as a remedy for tackling treaty shopping, Ethiopia's remaining double taxation agreements have no anti-treaty shopping rules.

Thus, these hosts of lacuna in the treaties and the country's domestic law would pose considerable economic damage, and it imperatively requires two important actions. First, Ethiopia should renegotiate and incorporate principal purpose tests and limitations of benefits provision into all of her bilateral tax treaties that are devoid of anti-treaty shopping rules. Where a renegotiation is impossible, it should terminate all of her bilateral tax treaties that are devoid of treaty shopping remedies. To achieve all the goals of these preventive moves, the researcher would recommend the inclusion of a provision widely recognized for its safeguarding potentialities. This provision, reflecting the safeguarding elements, reads as " a resident of a Contracting State would not be entitled to the benefits of the treaty if its affairs were arranged in such a manner as if the primary purpose or one of the primary purposes was to take the benefits of the treaty."

Finally, it should be noted that bilateral tax treaties may not fully tackle treaty shopping unless supplemented by domestic laws. Accordingly, it is recommendable for Ethiopia to revisit its domestic anti-avoidance rules and amend them to complement the tax treaty for tackling tax treaty shopping.