Summary

This thesis makes a radical proposal for a redraft of the OECD Model Income Tax Convention, in order to correct a fundamental structural flaw in the current version of the Model which causes a large number of difficulties in determining which persons are entitled to treaty benefits.

The difficulty of making that determination in the current treaty structure is visible in many ways. The growth of treaty provisions such as limitation on benefit provisions and anti-conduit clauses evidences the need felt by states to protect their treaties against treaty shopping. The continuing discussion about the beneficial ownership requirement concerns, not only the meaning of the term, but also its very role in the treaty. It is still not clear what the "liable to tax" requirement in the residence definition entails. Difficulties sometimes arise because the Model starts by stating that it applies to persons, whereas the distributive articles are written as though they apply to income, regardless of the person who derives the income. It is not always self-evident which person is the correct person to claim benefits in respect of a given item of income. And even the reference to persons in the opening article is not always appropriate, because one person can have multiple taxable capacities.

The solutions that have been found or proposed for these problems generally consist of adding further treaty provisions or adopting a specific interpretation of the current provisions; these solutions, in other words, take the current wording of the OECD Model as their starting point. But solutions based on the current OECD Model will never be entirely satisfactory, because the problems stem from a fundamental structural flaw in the current Model, namely that two basic conditions for claiming entitlement to treaty benefits do not connect properly. Only by dealing with that structural flaw can a coherent path be defined for claiming entitlement to treaty benefits.

The fundamental disconnection in the current OECD Model is that the residence definition looks for a general liability to tax on a person, whereas the distributive rules are based on some form of ownership of income of the person. The problem is that ownership of an item of income and tax liability in respect of that item of income do not necessarily go hand in hand; they can be separated, for example, in a regime which taxes the profit of group companies in the hands of the top company in the group, or by anti-

avoidance regimes which tax income in the hands of a person who has only a remote connection to the income.

In the current OECD Model these two conditions, of bearing a general liability to tax and having ownership of the income, come together in the person who is entitled to treaty benefits; that person is the fulcrum on which the application of the treaty balances. There is, therefore, a great deal of pressure on a correct identification of the person and the interpretation of the treaty becomes strained when there is a disconnection between the person's liability to tax and the ownership of the income.

The main argument of this thesis is that this focus on the person is misplaced. The essential element leading to treaty entitlement should be, rather, liability to tax in respect of a specific item of income. This element is what is described as the missing keystone in the title of this thesis, as the current OECD Model pays no attention to it.

If all states agreed on the attribution of income to a person for treaty purposes, a less drastic solution could probably be found than the redrafting of the Model suggested here. It is, however, manifestly not the case that there is agreement in this respect. That much is evident from the study reproduced in Appendix II, which comprises an extensive analysis and comparison of the domestic law of the Netherlands and the United Kingdom in this respect.

Even this study limited to two countries reveals a wide range of differences in the way in which they attribute income to a person and the philosophies behind those differing attributions. The very broad principles in both countries are similar and predictable: legal entitlement to income generally provides an initial indication of the person to whom income should be attributed; and the person carrying on an income-producing activity is a strong indicator for the attribution of the income derived from the activity. But the countries start to diverge as soon as one starts to look at a more detailed level. Those divergences have various causes, such as the differing property law of the two countries, the differing basic attribution principles expressed in their tax legislation, the differing reaches of their anti-avoidance legislation and the differing imperfections in their tax legislation. It is hardly conceivable that a comparison of any other pair of countries would reveal differences that are substantially fewer in number or of a lesser importance, and indeed the case law discussed in the main body of this thesis does reveal similar differences among other countries.

The aim of this study was to investigate whether it was possible to identify substantive factors that could be used in shaping a treaty principle to deal with attribution conflicts between these two countries, but the study concludes that this is not a fruitful path to take. The basic factors used by domestic law in the attribution of income require a considerable degree of fleshing-out in order to be of any practical use, as is evident from the sheer size of the study. This issue is, in other words, far too complex to be captured in principles of a sufficient level of abstraction for inclusion in a treaty.

A better solution is to leave the attribution of income to a person to states to determine as part of their domestic system and to restructure treaties in the knowledge that states may have very different ideas in this respect. This philosophy is the basis of the new approach suggested by this thesis.

In contrast with the current treaty structure, the new approach takes the imposition of tax liability by a state in respect of a specific item of income as its starting point – a starting point which reflects the reason for including the distributive articles in treaties, namely to prevent double taxation. This starting point also gives the treaty a more objective nature, as it focuses in the first instance on the income. Nevertheless, it remains necessary to retain a subjective element and to look at the person too; given that states can have such different views on why a specific item of income is taxed in the hands of a specific person, the treaty should not oblige states to accept without question the attribution of another state as a basis for treaty entitlement. Therefore the treaty would allow states to test this tax liability in a number of ways.

In the majority of cases in which treaty benefits are claimed, it is the source state that is required to limit or forgo its taxing claim. In this situation, the first test applied by the source state would focus on the tax liability in the residence state and would allow the source state to refuse treaty benefits if that liability is not sufficient. The residence-state liability may be considered insufficient if, for example, the rate is extremely low or if the treaty claimant benefits from a very favourable incentive regime. Obviously the treaty would have to provide guidelines in this respect, and might also name specific tax regimes as imposing a sufficient or an insufficient liability.

The insufficiency of the tax liability in the residence state could also arise if base erosion in the residence state makes the formal tax liability on the income for which treaty protection is sought meaningless. The base erosion could affect the specific item of income for which treaty protection is sought; this is the classic case of a conduit structure. Alternatively, the base erosion could affect the entire taxable base of the company seeking treaty protection; this is the main situation targeted by most limitation on benefits provisions. In the current treaty framework, claims to treaty benefits in conduit structures are generally combated on the basis of the company's ownership of the income, even though the problem arises precisely because the residence state taxation is founded on the company's legal ownership of the income. Limitation on benefit provisions, on the other hand, combat their target structures by looking primarily for substantive connections to back up the company's residence claim.

Neither response is entirely appropriate. Although both structures rely on artificial arrangements which place the ownership of income where it is needed for treaty shopping purposes, the true issue in both cases is that the residence state taxes the net income whereas the source state faces a claim for treaty benefits in respect of the gross payment. There is, in other words, a mismatch between the tax liabilities of the two states. The new approach allows source states to combat both phenomena by focussing on the true problem and determining that the tax liability in the residence state is not sufficient as a basis for granting treaty benefits.

The second test to be applied by the source state looks at the connection between the income and the person claiming treaty benefits, in order to determine whether it finds it acceptable to grant treaty benefits to that specific person in respect of that specific item of income. The treaty would probably include a list of connecting factors which are agreed between the two states to be acceptable for this purpose, such as the income being paid in respect of an activity carried on by the person, the person having the enjoyment of the income or the person having control over the application of the income. In making this determination states would be expected to allow a reasonable margin of discretion to their treaty partners; the issue here is not whether the law of the residence state is identical to the law of the source state, but only whether the source state finds the connection between the income and the person acceptable as a basis for imposing tax.

It is in connection with this test that source states would have to consider, in particular, situations in the residence state in which liability to tax in respect of an item of income is imposed on a person other than the legal owner of the income. Anti-avoidance law may be an issue in this respect; the comparative study in Annex II describes some examples in both the Netherlands and the United Kingdom of anti-avoidance law which attributes income to a person on the basis of a rather remote connection between the person and the income. If treaty partner states find these connections unacceptably remote as a basis for imposing a tax liability, there is no reason to oblige them to grant treaty benefits on the basis of that liability.

On the other hand, the more objective character of the new approach offers the possibility of aggregating the attributes of two persons in order to form one complete entitlement to treaty benefits. So if, for example, domestic law taxes the income of a subsidiary in the hands of the parent company, the tax liability of the parent may be aggregated with the ownership of the subsidiary in order to claim treaty protection for the income. This possibility works best if both companies are resident in the same state, but the thesis also considers how it might work if they are resident in different states.

The third test applied by the source state looks at the connection between the person claiming treaty benefits and the state in which residence is claimed. As liability to tax in respect of the income is the starting point of the new approach this test, unlike the current treaty structure, would go straight to material tests of residence such as an individual having a permanent home in a state or a company having its management and control in a state. As with the second test, states would be expected to allow each other a reasonable margin of discretion in this respect.

By going directly to the material connection between the person claiming treaty benefits and the residence state, the new approach avoids the problems that arise in respect of the "liable to tax" criterion in the current residence definition. Many of those problems arise because, when applied to a person, the "liable to tax" test is not a binary test; there are many shades of grey between a person that is fully liable to tax and a person that is not liable. When applied to a single item of income, however, the test does have a binary quality; either the income is included in the taxable base or it is not.

The basic principles of the new approach would not grant treaty benefits in respect of either tax-exempt persons, such as pension funds and charitable organisations, or income that is exempt from tax in the residence state, such as dividends subject to a participation exemption. States would, however, remain free to include provisions in their treaties extending treaty benefits to these persons and income. This aspect of the new approach has the advantage of bringing some clarity to this issue, especially by comparison with the current situation in which the treaty entitlement of such persons sometimes relies on a rather strained interpretation of the treaty.

In respect of the residence state, the new approach follows a comparable route to the granting of double tax relief under the treaty. The issues for the residence state are whether there is an acceptable connection between the income and the state imposing tax on a source basis and, in some cases, on whether there is an acceptable connection between the income and the person on whom the tax is imposed. If the residence state uses the exemption method for active income, it would also be able to determine whether or not the source-state tax is sufficient to give entitlement to the exemption or whether it would switch to the credit method instead.

As the new approach sets out a logical and consistent path to claiming entitlement to treaty benefits, it is also capable of resolving a number of further current problems. One of those problems is that of identifying a "person" for treaty purposes. Although the thesis generally discusses treaty entitlement in terms of "persons", it also considers the difficulties caused by persons who have multiple taxable capacities, such as trustees, and the imposition of a tax liability on something that is not a legal person, such as a partnership and certain types of collective investment fund. The new approach resolves these problems by granting treaty benefits to a taxable capacity, rather than to something that is strictly a person in legal terms. This aspect of the new approach follows logically from its starting point, namely the imposition of a tax liability in respect of a given item of income. The tax liability indicates which taxable capacity is implicated, and that is the taxable capacity that may be entitled to treaty benefits.

Although not a major part of the discussion, this element of the new approach is also capable of resolving the problem that permanent establishments are not treaty-entitled persons, whereas in certain situations the application of treaties would be much more logical if they were. By regarding a permanent establishment as a separate taxable capacity of the enterprise of which it is a part, the more logical application of treaties can be achieved.

A further issue that is solved by the new approach is whether the distributive rules of a treaty apply on a subjective basis or an objective basis. In other words, do they apply to the income, regardless of which person derives the income, or do they apply to a specific person in respect of the income? The starting point of the new approach is clearly an objective one; it is liability to tax on the specific item of income that forms the entry threshold into the treaty. A subjective element is introduced in order to substantiate the claim to treaty benefits by looking at the connections between the income and the person and between the person and the claimed residence state. In other words, the new approach has a mix of objective and subjective elements but, unlike the current treaty structure it is clear which element plays a role at which point.

As the new approach, unlike the current treaty framework, pays specific attention to the reasons for which income is attributed to a person, it is capable of dealing with situations in which states disagree about the attribution of income. The solution suggested is to include a tiebreaker provision in the treaty which sets out a hierarchy of connections between the income and a person in order to determine which attribution takes priority. The thesis includes a substantial discussion as to how this tiebreaker provision would work in a number of two-state and three-state constellations.

Finally, the new approach also offers the possibility to resolve overlapping claims to source-state taxation in a treaty. As the entry threshold for claiming treaty benefits is the imposition of a tax liability on a specific item of income, the treaty could also incorporate a provision dealing with situations in which both states impose tax on a source basis. This possibility is, however, not explored extensively as it would extend the scope of thesis too far.

A substantial part of the thesis is devoted to testing the new approach in a variety of situations taken from decided cases. It is also tested in respect of the application of treaties to trusts, as the taxation of trusts under the domestic law of various countries raises almost every conceivable challenge for a theory on entitlement to treaty benefits. This part of the discussion focuses on the major common-law countries, as the taxation of trusts in civil-law countries is further complicated by the difficulties experienced in those countries in accommodating trusts in their civil law.

What emerges from this testing process is that the new approach is capable of providing solutions in all these situations. Whereas the courts in the cases discussed have usually arrived at the most appropriate answer from a policy point of view, they have often had to adopt a rather forced interpretation of the treaty in order to do so. The new approach avoids these problems, because the steps that it sets out for the determination of entitlement to treaty benefits all follow each other logically. The new approach also leaves room for states to determine their own policy on treaty entitlement. And because it deals with the elements of treaty entitlement one at a time, it raises each policy issue at the most appropriate stage in this process.

Two issues remain which cannot be resolved by the new approach. One is the perennial problem of drawing dividing lines. In the context of the new approach, the most problematic dividing line is likely to be the distinction between on the one hand a person who receives an item of income and pays that same income to another person, and on the other hand a person who receives income and uses it to fund the payment of a different item of income to another person. This distinction is particularly important in deciding whether a person who is legally entitled to an item of income has a sufficient connection with the income to be granted treaty benefits in respect of it.

The second issue which cannot be resolved by the new approach is that treaties are generally bilateral instruments, whereas treaty questions also arise in triangular situations. Triangular situations are considered throughout the thesis and some suggestions are made as to how to apply the new approach, but the risk remains that differences among the applicable treaties will lead to inconsistencies and mismatches. Neither of these problems, however, is a particular feature of the new approach; they are both, rather, inherent to the nature of treaties as rather abstract documents which are generally concluded in bilateral relationships.

The discussion of the new approach concludes in Appendix I with a suggested text for a redrafted OECD Model. This text contains the basic provisions which would be necessary to introduce the new approach, with a brief commentary highlighting the differences from the current OECD Model and the most important policy choices that would have to be made. It follows the current OECD Model to the extent possible, but nevertheless contains a number of provisions which have no equivalent in the current model.

If the redrafted text were to be adopted in practice, it would be necessary to develop a large body of case law and practice to flesh out the details. But it is not the intention of this thesis to provide a solution for immediate adoption in practice. By proposing such an experimental solution, this thesis aims only to highlight the true problems with the current OECD Model and in that way to contribute to the discussion on entitlement to treaty benefits. The redrafted text of the OECD Model is offered in the knowledge that it can do no more than provide a focus for further discussion.