



Treaty shopping: tax planning in the international field or form of abuse of rights (?)

Rayneider Brunelli Oliveira Fernandes¹
Rafhael Frattari Bonito²

ABSTRACT

The International Tax Law appears as area of law destined to determine the legal effects of international operations, because is too much relevance to the corporations that exploit economic activity in many jurisdictions the impact of the exaction of taxes on their income, which may even derail a satisfactory profit margin, and thus decrease the market competitiveness. This study aims to measure the effects that the anti-treaty shopping rules have regarding this phenomenon, widely used as a form of tax planning designed to mitigate taxes. We seek to verify the real effectiveness of these measures, but also to discuss the foundation upon which is alleged its illegality. It's defended that the treaty shopping, in our view, is largely responsible for a greater movement of capital between countries, consolidating it into a way by which the need to implement investment be effective regardless of preexisting international agreements by which they coveted would grant tax benefits.

KEY WORDS: treaty shopping; tax planning; treaty; double taxation.

**Treaty shopping:
planejamento tributário no plano internacional ou forma de abuso de direito
(?)**

RESUMO

O Direito Tributário Internacional surge como ramo jurídico destinado a determinar os efeitos jurídicos das operações internacionais, porquanto é de suma relevância para as corporações que exploram atividade econômica em diversas jurisdições o impacto que a exação de tributos causa em suas receitas, podendo a imposição fiscal até mesmo inviabilizar uma

¹ Graduated in Law from the Federal University of Ouro Preto. Masters in Public Law from the Federal University of Uberlândia. Federal University of Uberlândia. E-mail: rayneider@yahoo.com.br. This article was translated by Marcus de Almeida Lima and authorized for publication by the author in 30/06/2013. Version in portuguese received in 29/10/2011, accepted in 04/03/2013.

² Doctor and Master Law School of the Federal University of Minas Gerais, in the concentration area of law Tributário.Universidade WSCF. E-mail: @ rafhael.frattari vlf.com.br



margem de lucro satisfatória, e assim prejudicar a competitividade no mercado. O presente trabalho tem como finalidade mensurar os efeitos que as regras *anti-treaty shopping* apresentam com relação a esse fenômeno, muito utilizado como forma de planejamento tributário destinado a mitigar a tributação. Busca-se verificar a real efetividade dessas medidas, mas também discutir o fundamento sobre o qual é alegada a sua ilicitude. Defende-se que o *treaty shopping* é um dos grandes responsáveis para a maior circulação de capitais entre os países, consubstanciando-se verdadeiro meio pelo qual a necessidade de aplicar investimentos se efetiva independentemente da preexistência de acordos internacionais.

PALAVRAS-CHAVE: treaty shopping; planejamento; tratado; tributação.

1 INTRODUCTION: Unfolding the Problem - The Work Thesis-

The present study³ seeks to investigate the broadness of anti-treaty-shopping rules in the international context, through the analysis of their measures, such as, the need for contract oriented and economic motivation of the transactions.

The illegality of treaty-shopping remains controversial, as its characterization as legally abusive is not certain. Hence, one must seek to identify the objectives of countries (e.g.: United States, United Kingdom, Canada, Germany and France) that adopt anti-treaty-shopping rules, that being defined as the attempt from residents of third countries to benefit from what is intended to

³ This study is of legal-comprehensive nature, with special attention to the comparative method (by that it is understood the kind that serves to "[...] identify the resemblances and differences of norms and institutions between two or more legal systems"; and its great advantage would be the possibility to uncover and solve its possible faults. [WITKER, Jorge. *Como elaborar un tesis en derecho: pautas metodológicas técnicas para el estudiante investigador del derecho*. Madrid: Civitas, 1985. 148p.]), in relation to foreign legal systems and position of international bodies. The research, which started in August 2010, and was concluded in mid 2011, was elaborated from the inventory and analysis of Brazilian, as well as foreign doctrinaire texts (comparative Law). In this sense, the comparison between legal systems was the main activity. Considering the nature of the legal researches (as applied social science) it was not possible to ignore the assertive objective of this study. Hence, triggered by the questioning of the institutes evaluated, it is sought to propose an adequate legal orientation for the Brazilian legal system. For such, it was used as theoretical benchmark, Habermas Theory of Discourse in which "arguments are reasons that recover, under conditions of the speech, an expectation of validity raised through acts of speech that may be either acknowledgeable or regulatory, moving the participants of the debate, rationally, to accept the descriptive or regulatory norms as valid" (HABERMAS, Jürgen, 1929- *Direito e democracia: entre facticidade e validade*, volume I/Jürgen Habermas; tradução: Flávio Beno Siebeneichler. – Rio de Janeiro: Tempo Brasileiro, 1997, p.280 e ss). It is necessary to emphasize that, by means of argumentation; the norms and statements must be constantly justified and legitimized, in order to verify the maintenance of consensus, which would be the only reason for its legitimacy and efficacy, against the risk of causing the stagnation of communication dynamics. Hence, it becomes evident that, in this scenario, the truth is not previously constituted and thus capable of being unveiled, but susceptible of construction, by argumentation.



be a reciprocal agreement between two other countries, avoiding double taxation⁴, as a way to reduce the amount of taxes to be withheld.

This paper, therefore, intends to demonstrate the possible uses of this procedure as well as the rules which allow for the disregard of private acts performed by the taxpayers, by part of the tax administration, applying to that act the taxation which it intended to reduce or mitigate. Moreover, by debating about the arguments that lead to the curbing of *treaty-shopping*, the present study focuses on the exposition of the diversity of treatments applied to *treaty-shopping*.

As its main concern, the study must analyze both the Brazilian and international doctrine related to *treaty-shopping*. The hypothesis which tries to dismantle the arguments used to characterize as form of right abuse, is brought up, since in short, the following conclusions were identified:

- Not all treaty-shopping structures can be characterized as artificial and deprived of economic substance
- As for the argument that treaty-shopping subverts the trade balance between the contracting countries, there is no evidence of that. Treaties are not always fair for their participants.
- In view of the multiplicity of arrangements that could characterize treaty-shopping, it can not be presumed that this type of fiscal arrangement may violate the principle of economic allegiance;
- There is no consensus over the definition of the principle of economic allegiance, and the alleged disincentive of treaty agreements can not ignore the market's forces of self-correction and international economic pressure towards fiscal conversion.

⁴In order to find a way to solve the undesirable problems caused by international multi-taxation, which greatly concerns the international market's economic agents, the States which adopt the principle of universality (world-wide income taxation) in their tax regimes, must simultaneously elect, unilaterally, internal mechanisms (compatible with the fiscal policies objectives) that may seem more adequate" (TÔRRES, Heleno. *Pluritributação Internacional sobre as Rendas de Empresas*. São Paulo: Revista dos Tribunais, 1997, p. 285).



It has finally been understood that the arguments which attribute a sense of illegality to treaty-shopping are weak, speculative and bearing a protectionist trend.

According to the vision hereby constructed, treaty-shopping is a legitimate instrument for cutting down tax withholding, provided that the prerequisites established by law or treaty, placing limits on the fruition of benefits established by international agreements, are complied with⁵.

Even though the above mentioned prerequisites are also viewed as inhibiting norms, their existence guarantee legal assurance to the investor who plans to benefit from the treaties' privileges in the transactions between contracting countries.

Initially, we shall analyze the meaning of the term and the concept of *treaty-shopping*. Later, the various aspects around the subject will be debated. As an example, the judicial procedures originated by treaty-shopping in Canada and France, and the related discussion regarding the acceptance of the beneficial owner in the U.K.⁶.

2 A PORTRAY OF THE SUBJECT MATTER

2.1 The Term *Treaty-shopping*

Although *treaty-shopping* is not a new phenomenon it remains controversial. It seems that the more jurisdictions try to deal with it, the broader become the ambiguities as to what is treaty-shopping and what is just legitimate tax planning.

⁵“International Tax Law has as its object *cross-border situations*, or, real-life situations which have contact, by any of its elements, with more than one jurisdiction capable of taxation; the international nature of the situation arises from its connection with more than one legal system, as opposed to a purely internal or to an internal affairs situation in a foreign country, occurring in the realm of one single State” (XAVIER, Alberto Pinheiro, *Direito Tributário Internacional do Brasil*, 4ª Ed. Rio de Janeiro: Forense, 1998 1997, p.3).

⁶One may find grounds from Habermas when using the present argument to sustain that “interpretation of singular cases, issued under the perspective of a coherent system of norms, depend on the communicative aspect of a speech constituted this way, from a social-ontological standpoint”; and that coherence points out to pragmatic argumentation presupposition. (HABERMAS, Jürgen, 1929- *Direito e democracia: entre facticidade e validade*, volume I/Jürgen Habermas; tradução: Flávio Beno Siebeneichler. – Rio de Janeiro: Tempo Brasileiro, 1997, p.285). In effect, this theory bears the epistemic origin of the hermeneutical root to be configured by communicative rationale, often called upon when dealing with constitutional interpretation issues, once what is really the matter is the insertion of ethical-discursive principles, while normative criteria that seek for the foundations of constitutional applicable norms, in a theoretical-pragmatic proposition for the methodology of Law (DUARTE, Écio Oto Ramos. *Teoria do discurso e correção normativa do direito: Aproximação à Metodologia Discursiva do Direito*. São Paulo: Landy. 2003, p. 24).

It is believed that the term ‘treaty-shopping’ was originated in the US. The analogy was drawn from the term ‘forum shopping’, which described the situation in US civil court case where a litigant tried to ‘shop’ between jurisdictions trying to find a decision that was more favorable to his needs⁷.

David Rosenbloom, who served as International Fiscal Counsel of the American Treasure Department between 1977 and 1981, described the phenomenon of *treaty-shopping* as “[...] the practice of some investors ‘borrowing’ a tax treaty by forming an entity (usually a corporation) in a country having a favorable tax treaty with the country of source – that is, the country where the investment is to be made and the income in question is to be earned”⁸. In other words, the person selects a treaty which otherwise would not be available, through complex structures; hence, the term *treaty-shopping*⁹.

The term *treaty-shopping* has never featured in any version of the OECD Model, nor has it been properly defined or explained in the OECD Commentaries. On the contrary, the emphasis is always on eliminating *treaty-shopping* and the measures that can be adopted against it.

In this respect, Luís Eduardo Schoueri explains that David Rosenbloom:

[...] criticizes those who treat the issue as *treaty abuse*, because he judges it as a “heavy loaded term”. He also rejects the term *tax havens*, when studying the subject, since *treaty-shopping* doesn’t require the interposition of tax havens, made possible in certain situations by the interposition of companies resident in States with high tax rates. Finally, the author rejects the term *treaty-shopping*, for considering it deceiving, as it implies a premeditated effort by the taxpayer to benefit from international treaties¹⁰.

Most references to *treaty-shopping* are standard when discussing *anti-treaty-shopping* dispositions. As an example, references to the problem commonly defined as *treaty-*

⁷BECKER, Helmut & Würm, Felix J., *Treaty-shopping: An Emerging Tax Issue and its Present Status in Various Countries*, Kluwer: Deventer, 1988, in AVI-YONAH, Reuven S. PANAYI, Christiana HJI. *Rethinking Treaty-Shopping: Lessons for the European Union*, Michigan: Public Law and Legal Theory working paper series, Work paper n° 182, Empirical Legal Studies Center, 2010, p. 2. Available at: <<http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx>>. Downloaded in Feb. 2011.)

⁸(ROSENBLOOM, David, *Derivative Benefits: Emerging US Treaty Policy* 22 Intertax 83, 1994.

⁹AVI-YONAH, Reuven S. PANAYI, Christiana HJI. *Rethinking Treaty-Shopping: Lessons for the European Union*, Michigan: Public Law and Legal Theory working paper series, Work paper n° 182, Empirical Legal Studies Center, 2010, p. 2. Available at: <<http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx>>. Downloaded in Feb. 2011.

¹⁰SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 22-23.



shopping were first made in the OECD¹¹ commentary in its 1st article which dealt with limitation of benefits (LOB) provisions and how such dispositions are aimed at solving the *treaty-shopping* issue in a comprehensive way.

"A description of treaty-shopping is given indirectly and in very general terms. It is stated that Limitation-of-Benefits provisions are there to address treaty-shopping. Then it is stated that LOB provisions are aimed at preventing persons who are not residents of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of these States¹².

According to the new US Technical Explanation accompanying the United States model, *treaty-shopping* may be characterized as a form of elusion¹³, when describing the function of anti-treaty-shopping provisions. The clause of the above mentioned Technical Explanation regarding limitation of benefits found in article 22 states that this article contains "anti-treaty-shopping provisions that are intended to prevent residents of a third country from benefiting from what is intended to be a reciprocal agreement between two countries".

"Nonetheless, the criticism against the expressions "*treaty-shopping*" and "treaty abuse" is also made by Guttentag (1984/3), to whom these are "obviously demeaning terms". In this sense, the author argues that the issue can not be examined under the premise that they consist of a fraud, or abuse. For that reason, he understands that a better defining (longer) although more neutral term must be used. We would thus, have that: "*the extent to which non-residents of a treaty country can and should benefit from the tax treaty of that country*". According to this author, it is exactly to avoid such a derogative approach that the US Treasury Dept. does not refer, in its publications to "treaty abuse" but to "*limitation of treaty benefits*"¹⁴.

When observing the near definition of treaty-shopping, one may note that the treatment given to the term may reflect upon a far reaching spectrum of structures, ranging from the more purely abusive and artificial to others with more economic substance. However, are all these

¹¹ Available in: <http://www.oecd.org/home/0,2987,en_2649_201185_1_1_1_1_1,00.html>. Downloaded on April 23rd 2011.

¹² AVI-YONAH, Reuven S. PANAYI, Christiana HJI. *Rethinking Treaty-Shopping: Lessons for the European Union*, Michigan: Public Law and Legal Theory working paper series, Work paper nº 182, Empirical Legal Studies Center, 2010, p. 4, free translation. Available in: <<http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx>>. Downloaded in Feb. 2011.

¹³ Available in: <http://www.irs.gov/pub/irs-trty/temod006.pdf>. Downloaded on 23 April 2011.

¹⁴ SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 22-23



instances of improper use of international conventions? The OECD commentary seems to perpetuate this confusion.

The descriptions given in paragraphs 9th and 20th of the OECD commentary to article 1st seemed to involve general forms of treaty-shopping, i.e., treaty-shopping without connotations about tax havens or interposition schemes. Nonetheless, the examples given on paragraph 11th of the commentary seemed to relate to treaty-shopping from a more specific and abusive standpoint, in special treaty-shopping by conduit and/or base companies. Therefore, there are two obvious extremes to this spectrum: treaty-shopping through conduits and *buonafide* commercial enterprises.

Therefore, treaty-shopping of a clearly improper nature would entail the following:

- (1) the beneficial owner¹⁵ (Company P) of the treaty-shopping entity (Company S) does not reside in the country where the entity is created;
- (2) the interposed company (Company R) has minimal economic activity in the jurisdiction in which it is located; and
- (3) the income is subject to minimal (if any) tax in the interposed company's country of residence.

From this explanation, the following anti-*treaty-shopping* dispositions can be derived:

- In (1), the State requires that the company constituted in its territory shows one of its elected subjective criteria (domicile, residence or nationality);
- In (2), the State requires that the company develop economic activity relevant enough to justify its eligibility to the income it may benefit from the treaty;
- In (3), the State taxes without considering the treaty's dispositions, based on the fact that the company's residence is a tax haven.

¹⁵The meaning of the term "beneficial owner", according to the OCDE's glossary is: "A person who enjoys the real benefits of ownership, even though the title to the property is in another name. Often important in tax treaties, as a resident of a tax treaty partner may be denied the benefits of certain reduced withholding tax rates if the beneficial owner of the dividends etc is resident of a third country" (OCDE, *Glossary of Tax Terms*. Available in: <<http://www.oecd.org/ctp/glossaryoftaxterms.htm#>>. Downloaded on 23 mar. 2011).



There could be many variations of this scheme. For example, it may be possible to use more than one tax treaty and move the funds around through several countries, in the process of which, these funds may change their characteristics (e.g.: dividends turned into loans).

However, as already mentioned, this is only one end of the spectrum. A treaty-shopping scheme could be made up of different degrees of artificiality. The intermediary company could be fake or have minimal economic substance or could be *abuona fide* commercial contract. Clearly, not all levels of third country residents benefitting from international tax treaties to which their own countries are not part, are examples of misuse.

While one may more readily distinguish a complete sham from a *buona fide* commercial arrangement -not always easy, as it depends on the jurisdictional perspectives on tax planning- the disputes (and litigation) usually relates to borderline cases. Successive Models and Commentaries have done little to clarify the confusion. In fact, they seem to perpetuate it. This may be deliberate. It is certainly to the advantage of the tax authorities to have discretion to determine on an *ad hoc* basis what is to be considered improper treaty-shopping and what is legitimate tax planning¹⁶.

As it will be clearly seen, the above mentioned authors, understand that none of the people making traditional theoretical objections to treaty-shopping are capable of presenting a very convincing argument. And not all of such objections are addressed to entirely artificial structures. This has important implications as to how treaty-shopping is dealt with in various jurisdictions.

2.2 The concept of treaty-shopping

International treaties are legal mechanisms incorporated into internal jurisdiction and by which the States¹⁷ agree upon the relief from double taxation¹⁸ and the concession of fiscal

¹⁶ AVI-YONAH, Reuven S. PANAYI, Christiana HJI. *Rethinking Treaty-Shopping: Lessons for the European Union*, Michigan: Public Law and Legal Theory working paper series, Work paper nº 182, Empirical Legal Studies Center, 2010, p. 6, Free translation. Available at: <<http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx>>. Downloaded in Feb. 2011.

¹⁶ Available at: <http://www.irs.gov/pub/irs-trty/temod006.pdf>. Downloaded in 23 Apr. 2011.

¹⁷ "Legal public persons of international Law are the sovereign States (to which are leveled, for singular reasons, the Santa Sé) and the international bodies in strict sense" (REZEK, Francisco. *Direito Internacional Público: curso elementar*. São Paulo: Saraiva, p. 153)



benefits, as a means to increase capital flow between them. When referring to international treaties this is how Luís Eduardo Schoueri states:

The concessions which are subject of double taxation treaties have, according to Victor Uckmar (1983/4,5), a "personal character", in other words, they are destined to benefit the residents of another contracting State, as a measure of reciprocity (KRAFT, 1991/3)¹⁹, not including, therefore, its extension to residents of third States²⁰.

This impossibility of the State which may not have participated in the negotiation from adhering to a bilateral treaty, is based on the fact that this is a treaty of a closed nature. Such situation results from the *pacta tertiis nec nocent nec prosunt* (an agreement does not help nor harms a third party) which announces the "fundamental principle by which the treaty is applied between its parties", which stands as a corollary of the principle of consent, sovereignty²¹ and independence of the States²².

¹⁸ In this sense, Van Hoorn Jr argues that: "[...] whatever form of double taxation - legal or economic in the narrow sense, or economic in the case of two coexisting kinds of taxes - the issue is to know if there is any legal principle according to which a State may be obliged to abide by it. Each State is sovereign in taxation issues and there is no principle or general rule that limit the sovereign power to tax, in addition to those few principles that can limit the sovereignty of a State, in general. Therefore, the position of a country with regards to double taxation - as well as with regards to international tax law, in general - depends in a great deal, if not entirely, on its domestic economic objectives, and on the structure of its international position with respect to other countries. This applies to any unilateral rulings. The taxation of world (or global) income, as well as that of strictly territorial level, is a result of the international status of a country as an exporter or importer of technology or capital. This is what happens to unilateral measures that aim to avoid double taxation (legal), as well as, with fiscal incentives legislation which aim to the creation of a more favorable tax environment for foreign investment and transfer of technology." (JR HOORN, J. O papel dos tratados no comércio internacional. In: TAVOLARO, Agostinho Toffoli; MACHADO, Brandão; MARTINS, Ives Gandra da Silva (Coords.) *Princípios tributários no direito brasileiro e comparado: estudos em homenagem a Gilberto de Ulhôa Canto*. Rio de Janeiro: Forense, 1988. p. 420-421).

¹⁹ KRAFT, Gerhard, 1991, *Die Mißbräuchliche Inanspruchnahme von Doppelbesteuerungsabkommen: zur Problematik des Treaty-shopping unter Berücksichtigung der Rechtslage in der Bundesrepublik Deutschland*, in der Schweiz und in der Vereinigten Staaten, Mannheimer rechtswissenschaftliche Abhandlungen – Band 10, Heidelberg, Müller, p. 149. *Apud* SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 20.

²⁰ SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 20.

²¹ According to Heleno Torres, fiscal sovereignty is " (...) the institutionalized power which places the State as a subject in the world order, providing it with autonomy and independence in the definition of taxable events and procedures for tax collection, in terms of the self limitation of sources originally internal and constitutional, as well as international sources" (TORRES, Heleno Taveira. *Pluritributação Internacional sobre as Rendas de Empresas*. 2 ed. Rev., ampl. e atualizada. São Paulo: Revista dos Tribunais, 2001, p. 67). Luigi Ferrajoli states that "the external sovereignty of a State has always had as its main justification the need to defend itself against external threats. Nowadays, with the reduction of such need for defense, this system of unequal sovereignties and the relations ever more asymmetric between rich and poor countries which the international community has turned itself into: a system which does not seem to be tolerable, in the long run, by the very political systems of the more developed countries, which base their democratic legitimacy exactly over those same promises and their universalism" (FERRAJOLI,

Article 34 of the Vienna Convention states that “a treaty does not create obligations or rights for a third State without its consent”²³. However, Schoueri points out to the following fact:

Failures in the elaboration of the referred agreements, or limitations imposed by the domestic law of the contracting States, or even, by International Law, allow the taxpayers who, at first, would not be benefit from the derived norms, to actually benefit from them (Kraft). This kind of fiscal planning, the international doctrine is referring to as treaty-shopping (Vogel, 1983/59; Kraft 1991/6)²⁴.

At a first glance, one can derive, with Becker, the identification of “(...) treaty-shopping, when, at the interposition of a person, the protection from a convention of double taxation, can be obtained, when otherwise, it would not be possible”²⁵.

Schoueri acknowledges that a doctrinaire examination reveals, on the other hand, that the concept above mentioned does not satisfy, entirely, the understanding of the issue, since, “Becker's concept does not refer to the intention of the taxpayer” and that “[...] *treaty-shopping* does not apply to situations where the taxpayer is motivated by extra fiscal reasons”²⁶.

In this case the hypothesis of a given corporation benefit from the favourable fiscal provision of its controlled company's country of residence (by means of eventual interposition) would be mere causality. However, one can not ignore the fact that when trying to interpose a third person into a certain jurisdiction, the concurrence of fiscal and extra-fiscal motives may occur.

Schoueri argues that treaty-shopping requires that there must not be another reason for the interposition of a third beneficiary of the treaty, other than the actual treaty benefit. Krabbe

Luigi. *A soberania no mundo moderno – nascimento e crise do Estado nacional*; trad. Carlo Coccioli, Márcio Lauria Filho; rev. da trad. Karina Jannini. São Paulo: Martins Fontes, 2002, p. 47-48).

²² BROWNLIE, Ian. *Princípios de Direito Internacional Público*. Trad. Maria Manuela Ferrajota et al. Lisboa: Calouste Gulbenkian, 1997, p. 646.

²³ Available in: <<http://www2.mre.gov.br/dai/dtrat.htm>>. Downloaded on July 15th, 2011.

²⁴ SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 20.

²⁵ SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 20.

²⁶ SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 21.



points out that the interposition of the third party was due to the intention, of the taxpayer, to obtain a reduction of its tax load.²⁷

Nonetheless “[...] Krabbe includes in its concept the interposition of a company located in a State that is part of a double taxation treaty”, “[...] *treaty-shopping* does not require that the interposed person be a society, although this is most often found”²⁸.

The same author explains that, initially, it is possible to conceive *treaty-shopping* by the interposition of a third natural person²⁹, contractually obliged to convey the resources obtained by that scheme, to the company at the end of the link. This way, the third party may be related to the investor, even as a subsidiary. The major point is, according to the author:

“[...] *treaty-shopping* occurs when, with the purpose of obtaining benefits from a double taxation treaty, a taxpayer who, initially, would not be included among its beneficiaries, arranges its businesses, in a way that a person, or permanent establishment, who is entitled to such benefits is interposed between itself and the source of its income”³⁰.

Schouer stresses the fact that fiscal benefit must necessarily derive from a double taxation treaty, excluding the cases of simulation, in which the advantage does not originate from the treaty itself, but from the mere “legal umbrella” created by the taxpayer, which produces exact same effect, if the planning did not involve a double taxation treaty country member.³¹

²⁷ KRABBE, Helmut, 1985, “Abeitendês OEC-Steueranschlusses zur Inanspruchnahme von DBA-Vergünstigungen und Abkommensmißbrauch”, in J.W. Gaddum, Heinz Hofmann *et al* *Zinzen in internationalen Steuerrecht*, pp. 45-50, *apud* SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 21.

²⁸ SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 20.

²⁹ Individuals and private companies have no legal personality in the international law. “There is a generous and progressive idea, which is persistent nowadays, that this kind of personality can also be assigned to the natural person - from whose creation, at last, results all the legal science, and whose asset is the primary object of law. But if we derive from it that the natural person, in addition to legal personality is also assigned national right of its home country as well as all other States, still maintains - to a certain extent, as some will say - legal personality of international law, we will face in our humanist argument the discomfort of having to recognize that the company, the mercantile society, the judicially created profit-oriented being, in the light of the private law of any given country is also - in a larger scale and for longer - a personality of the people's law. (REZEK, Francisco. *Direito Internacional Público: curso elementar*. São Paulo: Saraiva, 2010, p. 154).

³⁰ SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 21.

³¹ SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 22.

2.3 Basic examples of treaty-shopping

The structures that are most often referred to, by the doctrine, as examples of interposition schemes, are known as "conduit companies" and "stepping stone companies".

The typical scenario of treaty shopping by conduit companies, as also described in the OECD Conduit Companies Report, is the following:

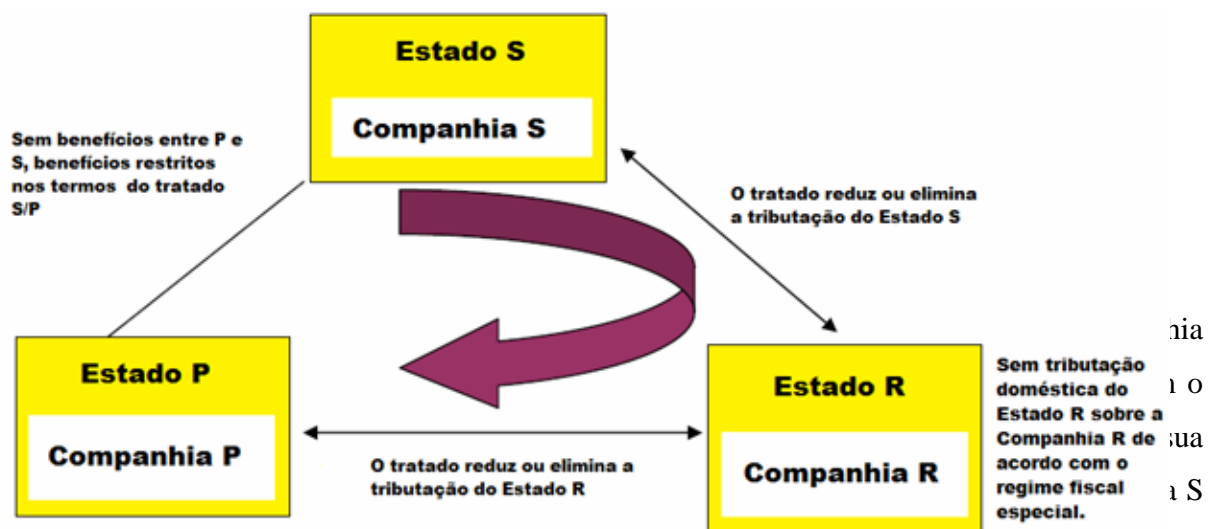


Figura 1: Esquema básico de *treaty shopping* (tradução livre).

Fonte: Berkeley Electronic Press, Empirical Legal Studies Center, Work paper n° 182, Paper n. 7, 2010.

A holding Company R would be established in State R. This State has privileged tax provisions both with a State S where a subsidiary Company S is located and with a State P where its parent Company P is located. Company R would be controlled by Company P and Company S would be controlled by Company R.

³²AVI-YONAH, Reuven S. PANAYI, Christiana HJI. *Rethinking Treaty-Shopping: Lessons for the European Union*, Michigan: Public Law and Legal Theory working paper series, Work paper n° 182, Empirical Legal Studies Center, 2010, p.4, Free translation. Available at: <<http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx>>. Downloaded in 12 feb. 2011.



If Company S's income is paid directly to Company P, it is subject to State S's withholding tax with very little (if any) treaty benefits. Company P's income, on the other hand, is tax-exempt (or entitled to beneficial tax treatment) if channeled through Company R. This may be, if the income is in the form of dividends, by virtue of a parent-subsidary regime under the domestic law of State R or a participation exemption or due to a convention between States S and R. This would be the case where there is minimal, or no relevant activity at all being conducted by the interposed company. This way there would be no extrafiscal purpose.

As for "stepping-stone companies", these are created by a resident of a State which has no international treaty signed allowing for tax benefits with any of the States in which it intends to maintain economic activities and interpose resources. In this case, the investor finds itself in an "island", since it can not reduce taxation in view of international treaties in a linked manner.

In order to solve this, the controlling company (a) creates a subsidiary company (b) in a State with reduced taxation and lends a certain amount to it, which, in its turn, will redirect the same value by through another loan, to a company (established in a country which may have signed a treaty with the country in which the referred subsidiary is located) located in a State where the controlling company may wish to invest that capital (c).

The subsidiary company (b), hence, will not be taxed because the interests owed to its controller (a) will be deducted, not showing up as profit. This way, the subsidiary works as a bridge, allowing for the application of these resources with reduced, or zero taxation, in other businesses, according to the wishes of its controller.

In order to demonstrate how treaty-shopping may be accomplished, a rather peculiar method will be used: treaty-shopping through life insurance policies.

Among the various possibilities available to reduce withholding tax on dividends, Milton Grundy comes up with a peculiar one. In this situation, insurance companies, through policies, redistribute their income to their investors. Grundy brings such an example as a case of treaty-shopping, since, according to his view, the contract between the insurance company and the investor has no purpose other than the reduction of withholding tax.³³

³³GRUNDY, Milton. Treaty-shopping Through Life Assurance, *GITC Review* Vol V No.2, p. 69, 2005. Available in: <http://www.taxbar.com/documents/treaty-shopping_mg_000.pdf>. Downloaded in 22 Feb. 2011.



This is the example: Mr. H. is a resident of Hong Kong. He plans to make a substantial investment in a Silicone Valley company listed on the NASDAQ Exchange. In the first scenario, he takes up 40% of the shares, the company does well and he receives substantial dividends for a number of years. He is taxed by the US at 30% on these dividends.

Now let us look at the alternative scenario. Mr. H. takes out a policy with a UK insurance company. He pays a premium to the insurance company and the insurance company subscribes for the shares in the American company. The American company prospers and pays dividends, but this time to the UK insurance company. Under the terms of the tax treaty between the United Kingdom and the United States, dividends paid by a US corporation to a UK resident carry a much lower rate of withholding tax, or even, zero.

After describing the facts, Grundy alerts us for the fact that there is a great difference between Mr. H.'s position as a direct investor of the American company and as a policyholder with an insurance company which makes that investment, and that is, if the insurance company goes bankrupt, he has no right to the US investment, but must join the queue of creditors of the insurance company to get a share of whatever may be available to general creditors³⁴³⁵.

As described in the doctrine, conduit and stepping stone companies are the most typical examples of treaty-shopping; but it can also be observed, such as in the case involving insurance policies, that many other possibilities exist and may still be created.

³⁴GRUNDY, Milton. Treaty-shopping Trough Life Assurance, *GITC Review* Vol V No.2, p. 69, 2005. Available at: <http://www.taxbar.com/documents/treaty-shopping_mg_000.pdf>. Downloaded in 22 Feb. 2011.

³⁵When studying the rules about Irish and Luxembourg companies, Milton Grundy calls attention for the peculiarities of the case: it was found that the local rulings require the companies to maintain what in Ireland is known as "technical reserves", referring to the total value of all the obligations with the holders of insurance policies, so that in case of insolvency, all actives representing technical reserves become autonomous for the absolute benefit of the policy holders, subject to expenses. This seems to provide policy holders with some kind of security, but it is not known to what extent these regulations apply to other countries. It may also be observed that there may be duplicity of residencies: one related to the norms over the policies, and other related to taxation. These rules are limited to the benefits applied by international treaties, but in the case of solvency of the insurance companies do not obstruct fiscal planning. (GRUNDY, Milton. Treaty-shopping Trough Life Assurance, *GITC Review* Vol V No.2, p. 74, 2005. Available in: <http://www.taxbar.com/documents/treaty-shopping_mg_000.pdf>. Downloaded in 22 Feb. 2011).



3 ANALYSIS OF THE THEORETICAL DEBATES AROUND *TREATY-SHOPPING*

As already mentioned, treaty-shopping is repressed by various States. In order to understand this struggle, professors Reuven Avi-Yonah and HJI Panayi undertake a thorough examination of the current trends of anti-treaty-shopping dispositions and evaluate the theoretical arguments justifying such approach.

According to these researchers treaty-shopping is, indisputably, an instrument of tax planning in the international arena. So, it remains to be learned: what is there in this model of tax planning that makes it questionable? Several arguments have been developed in the international tax law community.

First, it has been argued that treaty-shopping is a method of tax avoidance and, as such, improper and contrary to the purposes of tax treaties. It has also been raised that treaty-shopping breaches a treaty's reciprocity and also alters the balance of concessions attained between the two contracting States. When a third country resident benefits from 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 (e.g. exchange of information). The usual *quid pro quo* of the treaty is therefore compromised and the process subverted.

Another argument is based on the principle of economic allegiance. Pursuant to economic allegiance, a taxable base may be attributed to the jurisdiction where it is thought to have started its economic existence. Tax treaties are premised on the allocation of taxing rights according to this principle. Treaty concessions are of a personal nature and are not to be extended to third country residents. As a result of treaty-shopping, the third country gains revenue power, free of any (substantial) claim to economic allegiance.

As a matter of fact, it is frequently argued that treaty-shopping discourages the negotiation of tax treaties. If third-party countries could benefit from reduced taxation for their residents without conferring reciprocal benefits to non-resident investors, then there would be no need to join a tax treaty, especially if there are concerns that the treaty could be imbalanced. Furthermore, lack of fiscal co-operation increases opportunities for international tax evasion.

Finally, it is argued that treaty-shopping is often linked with (undesirable) revenue loss. Tax treaties are based on an optimized balance level between actual and potential income and



capitalflow between one country and another.

When the benefits of the given treaty are abused, the balance level of these flows are distorted, as a result of the distorted sharing of relevant chargeable income that is channeled to each State. Treaty-shopping expands the ordinary bilateral relationship of the treaty. A generous treaty contracted with a trading partner becomes a treaty with the world. This *de facto* multiple side of the tax treaty is known to result in a huge and immeasurable cost to the source country.

With regards to the first argument, it is never an easy task to distinguish fiscal evasion (international) from legitimate tax planning. What makes treaty-shopping a case of evasion more than a case of tax planning? Why are all forms of treaty-shopping considered as tax evasion, regardless of their degree of artificiality?

As already mentioned, not all forms of treaty-shopping may be characterized as artificial and lacking of economic substance. The term treaty-shopping, when generically applied, could absorb a variety of structures: it could involve structures in which the intermediary interposed company is a pure conduit company without any economic substance (entirely owned and controlled by the parent company and located in a channel-country or fiscal heaven), or not.

However, this is only one extreme of this spectrum. There is another end, in which the intermediary company has some substance, conducting its own deals, not controlled by the parent company and susceptible to some tax withholding in its country of residence.

As for the reciprocity argument, although persuasive, it is based on the assumption that for every treaty benefit there is always reciprocity. This may not be the case. Some treaty concessions may be unilateral if the other contracting State already provides for them in its domestic legislation. Also, while there might be reciprocity in a treaty, it is not granted that the underlying balance of the treaty is a fair one. A tax treaty may be biased in favor of the economically more powerful country. Therefore, breaching reciprocity may not necessarily mean that a 'fair' balance has become 'unfair'. It is the negotiated balance that is being subverted; whatever the fairness credentials of this balance.

As for the economic allegiance argument, this seems to be tautological. Opinions vary as to the defining characteristics of economic allegiance. In other words, what kind of relation is necessary in order to generate the duty of economic allegiance in favor of a jurisdiction? Even if the principle of economic allegiance is agreed upon, there are no guarantees that countries



negotiating tax treaties would abide by them.

In any case, it is understood that not all instances of treaty-shopping are in conflict with the principle of economic allegiance. Some cases of treaty-shopping might be more abusive than others, for example, those in which the conduit country is a fiscal haven or when the conduit company has no activity other than channeling payments to their parent companies. In such cases, the principle is flagrantly violated as there is no economic activity taking place in the conduit country, that could justify their claim of economic allegiance.

As for the disincentive to negotiate argument, when assessing this argument's strength, competition's self-correcting forces and international economic pressure for fiscal convergence should not be ignored. It must also be pointed out that their own countries can still maintain foreign investors' competitiveness if double taxation is relieved through unilateral measures.

As a matter of fact, it is often said that treaty-shopping discourages the third country from entering into tax treaties and that the source country wants tax treaties. In some cases the source country might not want a tax treaty with the third country, for example, if that country is a tax haven or a notorious conduit location.

This is, on the other hand, a valid argument. Even if double taxation can be softened by unilateral means, there are some reciprocal advantages which can only or more easily be achieved through tax treaties (e.g. provisions dealing with pensions, students, artists, etc).

With respect to the revenue loss argument, there is no concrete evidence that treaty-shopping can cause revenue loss and economic distortions. First, it's not easy to calculate the benefits and costs of a tax treaty to a State. A Contracting State could simultaneously be a country of residence and a country of source; enjoy the benefits and bear the costs of both positions. In view of that it would be hard to assess the costs and benefits of a tax treaty. Some of the benefits - mutual assistance, for example - cannot even be translated into monetary terms.

Furthermore, why does a loss have to be assumed? It could be argued that when treaty-shopping increases economic activity, the overall economic gain might exceed the source country's loss. This brings the following question: When does treaty-shopping increase economic activity and when doesn't it? Does it depend on the source country being a developing one?



In the example set forth by Reuven Avi-Yonah and Christiana Panayi, the case of *Union of India v. Azadi Bachao Andolan*³⁶ is analyzed. In it, India's Supreme Court rejected the interpretation of an anti-treaty-shopping clause in the India-Mauritius³⁷ treaty.

In this trial, the Supreme Court emphasized that in developing countries, treaty-shopping was often regarded as tax incentive to attract scarce foreign capital or technology.³⁸ "Developing countries need foreign investments, and the treaty-shopping opportunities can be an additional factor to attract them".³⁹

A holistic vision has been taken: "Developing countries need foreign investments and allow treaty-shopping as an additional factor to attract them"⁴⁰.

Up to the point of not identifying (if this acknowledgment is even possible) any significant revenue loss, treaty-shopping may be a necessary evil for the guarantee of economic progress. This way, the argument against treaty-shopping grounded upon the assumption that such phenomenon ends up resulting in tax revenue loss, does not hold ground.

Actually, what has not yet been proved is the cause-effect relation between the use of treaty-shopping structures and the loss of tax revenue by the States, as the values that are not collected may end up being reinvested and eventually taxed again.

³⁶ INDIA, Supreme Court of India. [2003] 263 ITR 706 (SC), Appeal (civil) 8161-8162/2003. Juiz Relator: B.N. Srikrishna. Judged in: 10/07/2003. Available in: <[http://law.incometaxindia.gov.in/DitTaxmann/incometaxacts/2007itact/%5B2003%5D263ITR0706\(SC\).htm](http://law.incometaxindia.gov.in/DitTaxmann/incometaxacts/2007itact/%5B2003%5D263ITR0706(SC).htm)>. <http://www.merriam-webster.com/>.

³⁷ AVI-YONAH, Reuven S. PANAYI, Christiana HJI. *Rethinking Treaty-Shopping*: Lessons for the European Union, Michigan: Public Law and Legal Theory working paper series, Work paper nº 182, Empirical Legal Studies Center, 2010, p. 10, Free translation. Available in: <<http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx>>. Downloaded in Feb. 25th, 2011.

³⁸ As Jürgen Habermas mentions, the international economic system has turned into a transnational economy and "[...] the most relevant issue consists today in the acceleration of the international capital flow and the imperious valorization of the investment sites (*Standorte*) of a nation through the finance markets interconnected in global level". Hence, for Habermas "[...] in the current scenario, the States are inserted in the markets, and not the contrary" (HABERMAS, Jürgen. *Era das Transições*; tradução e introdução de Flávio Siebeneichler. Rio de Janeiro: Tempo Brasileiro, 2003, p. 103-104).

³⁹ AVI-YONAH, Reuven S. PANAYI, Christiana HJI. *Rethinking Treaty-Shopping*: Lessons for the European Union, Michigan: Public Law and Legal Theory working paper series, Work paper nº 182, Empirical Legal Studies Center, 2010, p. 10, Free translation. Available in: <<http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx>>. Downloaded in Feb. 21st, 2011.

⁴⁰ AVI-YONAH, Reuven S. PANAYI, Christiana HJI. *Rethinking Treaty-Shopping*: Lessons for the European Union, Michigan: Public Law and Legal Theory working paper series, Work paper nº 182, Empirical Legal Studies Center, 2010, p. 10, free translation. Available in: <<http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx>> Downloaded on Feb. 21st, 2011.



In addition, it has been observed that developing countries have placed as a goal, when contracting treaties, the leading of capital investment by ways of fiscal incentives, as the concept of fiscal neutrality invoked by the developed nations gets shifted.

Thirdly, there isn't such a thing as a truly neutral tax system. It could be argued that the inherent non-neutralities typical of the referred tax systems create an incentive to treaty-shopping. In other words, it may be fair to say that treaties create treaty-shopping. As stated by Reuven Avi-Yonah and Christiana HJI Panayi, treaty-shopping is perhaps a self-help way of lessening or removing fiscal impediments to international business imposed by inadequate dispositions against double taxation and the lack of treaties⁴¹.

4 The Term "BENEFICIAL OWNERSHIP"

It becomes necessary to underline the importance gained by the term beneficial ownership in the hermeneutical aspect of international tax law, and the very little that is known about it.

Philip Baker explains that the term "beneficial owner" has been used in international treaties that deal with tax law since the 1940's and is part of the OECD models, of the U.N., and the U.S. and practically in every treaty that the U.K. has signed⁴².

Curiously, there was little orientation about its meaning until the British Court of Appeal decision in the case of *Indofood Int'l Finance v. JP Morgan Chase Bank NA*⁴³.

The term "beneficial owner" is usually found in articles dealing with the dividend, interest and, sometimes, the royalties of a tax treaty. These articles generally provide for a reduced level of withholding tax over a relevant category of income: although such benefit is

⁴¹ AVI-YONAH, Reuven S. PANAYI, Christiana HJI. *Rethinking Treaty-Shopping: Lessons for the European Union*, Michigan: Public Law and Legal Theory working paper series, Work paper nº 182, Empirical Legal Studies Center, 2010, p. 10, free translation. Available in:

<<http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx>>. Downloaded on Feb. 21st, 2011.

⁴² BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 15, Free translation. Available at: <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>. Downloaded on Sep. 12th 2010.

⁴³ REINO UNIDO, Court of Appeal, Civil Division. *Indofood International Finance Ltd v. JP Morgan Chase Bank N.A. London Branch*, processo n. A3/2005/2497. Judged on 02/03/2006. Available in: <<http://court-appeal.vlex.co.uk/vid/-52568119>>. Downloaded on Jan. 29th, 2013.



only available if the beneficial owner of the dividends, interest or royalties is a resident of the state, which is a party to the treaty. Thus, the need for a resident to be a beneficial owner represents a limitation (BO limitation) as well as a restriction on the availability of a reduced tax rate.

It is pretty clear that the *beneficial ownership limitation* was introduced to combat treaty-shopping by conduit companies. The issue has been, however, for some time, exactly as broad as is the scope of the BO limitation. Or putting it in another way, how artificial must be this channeling structure in order for the benefit of the treaty to be denied?

As argued by Philip Baker, at one extreme, one can imagine situations where simply by registering shares or loan notes in the name of a nominee who was resident in a treaty state, one might claim benefits from a treaty⁴⁴. At the other end, all companies distribute the income they receive to shareholders or other stakeholders: if a company was not entitled to benefit from a treaty because the income received might ultimately be paid to a third party, then when could any company or collective investment vehicle ever be entitled to the benefit of the three central provisions of most tax treaties?

There is an OECD commentary regarding the meaning of *beneficial ownership*. This has been developed over the years. The original Commentary to Articles 10 and 11 of the OECD referred to the exclusion of nominees (designated or "fake" companies), which were interposed as an attempt to obtain treaty benefits⁴⁵. Following the Conduit Companies Report the Commentary was extended to include conduits, which had such narrow powers over the income they received that they were in the position of mere fiduciaries of that income.

This seemed to be as far as the OECD could get to achieve consensus upon the meaning of beneficial ownership. Another very sensitive point was that it meant that the BO limitation excluded very obvious cases of treaty-shopping, but went no further than that. States that wished to go further to deter treaty-shopping could – and did – include more anti-treaty-shopping

⁴⁴ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 16, Free translation. Available in: <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>. Downloaded on Jan.30th, 2013.

⁴⁵ In the referred commentary it is stated that the term 'beneficial ownership' is not employed in a strictly technical sense, thus, a treaty must be interpreted at the light of its scope (its purposes) in order to suppress double taxation and avoid fiscal evasion. (OCDE, *Clarification of the meaning of "Beneficial Owner" in the OECD model tax convention*. Paris: Centre for Tax Policy and Administration [TPA], 2011, 10p. Available at <<http://www.oecd.org/tax/taxtreaties/47643872.pdf>>. Downloaded on Jan.30th, 2013).



provisions in specific treaties as, for example, the treaty between the U.S. and the U.K. (*UK/US TaxTreaty*)⁴⁶.

The OECD Commentary, with its emphasis on conduit companies acting as mere fiduciaries, provided a reasonably useful rule of thumb for determining beneficial ownership. If the recipient entity had gone into a liquidation process, and it was a mere fiduciary, then no dividends received by it could be transferred to the “actual beneficial owner” and would not be available for general creditors.

If, on the other hand, the dividends actually belonged to the liquidating company, then it would be considered the actual beneficial owner and that income would be made available for its general creditors.

In the meantime, it has been established that limitations to beneficial ownership aim to exclude mere fiduciaries, who are not considered the owners of the income in their countries of residence; as well as any other conduit having power over that income when acting under the command of the beneficial owner.

Actually, the term “beneficial owner” must have an international meaning; not limited by the application of a certain aspect to specific cases. This way, it can be concluded that a more clarifying orientation of the term is still lacking, since so far, only the situations where beneficial ownership cannot be established, are known.

5 INTERNAL LEGAL MEASURES TO CURB *TREATY-SHOPPING*

As it will be seen further when analyzing judicial leading cases, *treaty-shopping* is usually referred to as a kind of abuse, either of method or of the law.

These two pathologies, as it is emphasized, do not have a uniform conception in the doctrine. Hence, one must have in mind that the characterization of *treaty-shopping* as an illegal activity, derives from the lack of criteria to establish the legitimacy of fiscal planning methods.

⁴⁶ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 17, Free translation. Available in: <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>. Downloaded in Sep. 20th. 2010.



As for the implications of the economic interpretation, the theory of the abuse of method consists, basically, in curbing, or prohibiting, the use of an "unusual" method to a given transaction, imposing the use of the "typical" procedure, for the very same operation, which would entail a higher tax withhold.⁴⁷

The theory of law abuse is a consequence of the economic interpretation. It is noted for considering as illegal, the conduct of the taxpayers who intend to benefit solely from tax reduction, based on a, so-called, immoral use of the Law. The interpreter would apply his own moral standard, turning it into a legal rule to be applied in each specific case. Each situation would demand its own specific moral standard. Its field of application is the moral realm, which goes against the principle of legality and the value of legal assurance⁴⁸.

Considering those approaches, it becomes evident that such theories do not find full acceptance in Brazil. Even with the sole paragraph of article 116 of the National Tax Law Code, introduced in the legal system by the LC 104/2001, in addition to the application of the principle of legal assurance, the prohibition of taxing by analogy as well as that of the strict legality in the fiscal order are already enough to limit considerably the scope of this disposition⁴⁹.

As it is well put by Luís Eduardo Schoueri, treaty-shopping does not characterize simulation, once there is no lack of will by the parties involved. It is certain that they are motivated by reasons of fiscal righteousness, which does not characterize it as a case of simulation⁵⁰.

Switzerland, in the 1960's, was the first country to try to avoid treaty-shopping based on the *status* (element of connection) of the beneficiary. Nonetheless, those first measures, founded on the legal qualification of the investor, failed either because they did not present practical efficiency or because they conflicted with other norms (domestic or from Conventions).

⁴⁷ ESTRELLA, André Luiz Carvalho. A norma antielisão e seus efeitos – artigo 116, parágrafo único, do CTN. *Revista Jus*. Available in: <http://www.planalto.gov.br/ccivil_03/revista/Rev_30/artigos/Art_andre.htm>. Downloaded on April 20th, 2012.

⁴⁸ ESTRELLA, André Luiz Carvalho. A norma antielisão e seus efeitos – artigo 116, parágrafo único, do CTN. *Revista Jus*. Available in: <http://www.planalto.gov.br/ccivil_03/revista/Rev_30/artigos/Art_andre.htm>. Downloaded on April 20th, 2012.

⁴⁹ Para compreender melhor o tema, cf.: MARTINS, Ives Gandra da Silva (Coord.). *Caderno de Pesquisas Tributárias n.º 13*. In ROCHA, Valdir de Oliveira (Coord.). *O Planejamento Tributário e a Lei Complementar 104*. 1ª ed. São Paulo, Dialética, 2002, p. 117-128.

⁵⁰ SCHOUERI, Luís Eduardo. *Planejamento fiscal através de acordos de bitributação: treaty-shopping*. São Paulo: Revista dos Tribunais, 1995, p. 86.



The study of the limitation of benefits clause finds a clear example in Germany. In that country the companies are not eligible to benefit from international treaties when the following elements are present:

- ▶ There is no economic, or any other relevant reason for the company to establish itself as non-resident;
- ▶ The non-resident company does not receive more than 10% of its gross income through its own economic activity;
- ▶ The non-resident company has no adequate establishment to conduct its activities.⁵¹

As it can be noticed, there is no explicit reference to the concept of treaty-shopping. What remains are prerequisites for the concession of fiscal benefits (which could or could not be a waiver, a presumed credit or reduced tariff).

Therefore, the combat against treaty-shopping constitutes more of a political or economic decision than a legal one, as it is up to each specific State to impose limitations on the use of beneficial provisions originated from treaties.

6 JURISPRUDENCE

Considering that there is no general agreement about treaty-shopping, the problem rests on how to deal with it. If there are varying approaches towards the same phenomenon, a good strategy would be to analyze it through court rulings.

Fiscal planning or fiscal avoidance contours the taxpayers' right to anticipate the burdens established by the legislator. In Tax Law, the non-retroactivity rule of the norms, as well as the 90-day's notice and anteriority, attempts to protect the reliability of the legal system.

Niklas Luhmann stated "(...) trust builds a more effective way to reduce complexity". Taking up from that concept, it can be established that "trust must reduce the future in a way that it equals the present (...)"⁵².

⁵¹ AVI-YONAH, Reuven S. PANAYI, Christiana HJI. *Rethinking Treaty-Shopping: Lessons for the European Union*, Michigan: Public Law and Legal Theory working paper series, Work paper n° 182, Empirical Legal Studies Center, 2010, p. 22, free translation. Available at: <<http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx>> Download on Feb. 11th, 2011.



Further on, Luhmann argues that trust is not mere hope. It constitutes, in fact, expectation, representing interference in the decision made by the trusted person. It must be stressed that in relations of supremacy over the events, trust is not necessary, not even its protection.

Picking up from that idea, Misabel Abreu Machado Derzi states that in fiscal relations “[...] the State does not occupy the position of that person who trusts, and for that, deserves protection, but it may be held responsible for the trust generated”⁵³.

Hence, when in good faith, there is trust to be protected, being that trust and good faith are “[...] constitutional principles derived from judicial security, as a value and as a principle [...]”⁵⁴.

Therefore, just as the Law, a court decision will also be a source of trust. Professor Misabel Abreu Machado Derzi teaches that the judging authority must soften the effects of any change, with the purpose of protecting trust and good faith of those who had behaved in agreement with outdated judicial decisions (jurisprudence)⁵⁵.

6.1 Canada: *Prevost Car Inc. v. The Queen*

The case of the *Prevost Car v. The Queen* deserves attention in the present study due to the repercussion and the innovations that it brought to the Canadian legal system⁵⁶. *Prevost Car* was established in 1924, located at Sainte-Claire, Quebec. They have offices in the United States and their market extends to the North America region. Their main activities range from

⁵² LUHMANN, Niklas. *Confiança*. Trad. Amada Flores. Anthropos. Santiago: Universidad Ibero Americana, 1996, p. 14, in DERZI, Misabel Abreu Machado. *Modificações da Jurisprudência no Direito Tributário*: proteção da confiança, boa-fé objetiva e irretroatividade com limitações constitucionais ao poder de tributar. São Paulo: Noeses, 2009, 647 p.

⁵³ DERZI, Misabel Abreu Machado. *Modificações da Jurisprudência no Direito Tributário*: proteção da confiança, boa-fé objetiva e irretroatividade com limitações constitucionais ao poder de tributar. São Paulo: Noeses, 2009, p. 337.

⁵⁴ DERZI, Misabel Abreu Machado. *Modificações da Jurisprudência no Direito Tributário*: proteção da confiança, boa-fé objetiva e irretroatividade com limitações constitucionais ao poder de tributar. São Paulo: Noeses, 2009, p. 381.

⁵⁵ DERZI, Misabel Abreu Machado. *Modificações da Jurisprudência no Direito Tributário*: proteção da confiança, boa-fé objetiva e irretroatividade com limitações constitucionais ao poder de tributar. São Paulo: Noeses, 2009, p. XXVI.

⁵⁶ The term “*treaty-shopping*” was first used in Canada in 1995, at the Supreme Court decision regarding the case “*Crown Forest v. Canada*” (9 [1995] 2 SCR 802, 95 DTC 5389) in which, however, the occurrence of *treaty-shopping* was not identified (in KANDEV, Michael, *Treaty-shopping After Prevost Car: What Does The Future Hold?*, *International Tax Seminar*, Kingston, Ont.: International Fiscal Association, 2009, 1-25. Available at: <http://www.dwpv.com/~media/Files/PDF/Treaty_Shopping_After_Prevost_Car_-_What_Does_The_Future_Hold.ashx>. Downloaded on Feb.10th, 2013.



manufacturing buses, sale of parts, and maintenance services. Its web site informs that it has 979 employees and is part of the Volvo Corporation.⁵⁷

In May, 1995, Prevost Car stockholders decided to sell their shares to Sweden based, Volvo Bus Corporation, and U.K. based Henlys Group PLC. Those two, in their turn, contracted a deal in which a Dutch holding (Dutchco) was to be incorporated, and all the Prevost shares to be transferred to it. Fifty-one percent of the holding's shares would belong to Volvo and 49% to Henlys. It was established that not less than 80% of the holding's and its subsidiaries' profits combined, would be distributed among its shareholders in the form of dividends, capital return or loans. The distribution corresponding to a fiscal year would have to be declared and would be done, as soon as possible, within that fiscal year⁵⁸.

Some documents showed inconsistency regarding ownership of Prevost's shares by the Dutch holding. For instance, the shareholders minute books established that only the representative's of Volvo and Henlys would participate in the meeting. Not Dutchco's. Finally, in the documentation provided to its banker, Dutchco had declared that Volvo and Henlys beneficially owned Prevost's shares⁵⁹.

Under the provisions of the treaty (Canada-Netherlands) the tax rate over the dividends paid by a resident of Canada to a resident of the Netherlands would be reduced to 5% if the beneficial owner were the direct or indirect holder of at least 25% of the capital, and had, at least, 10% of the voting rights⁶⁰.

PrevostCar, then, paid 5% taxes over the value corresponding to the dividends paid to Dutchco, in agreement with the treaty signed by the Netherlands and Canada, which establishes a reduced rate in certain cases when the beneficial owner of the dividends is a company resident in the Netherlands. The Canadian tax authority (CRA – *Canada Revenue Agency*) fined Prevost Car for the difference between the total amount taxed and what would have been paid if the dividends were paid directly to the former shareholders (Volvo and Henlys), considering that

⁵⁷ Available in: <www.prevostcar.com>. Downloaded on: Feb.15th, 2011.

⁵⁸ BAAS, Nicolas, *Prevost Car Inc. v. The Queen*, Calgary: Moody's Tax Advisors, 2009. Available at: <<http://moodystax.com/blog/22-corporatetax/70-prevost-car-inc-v-the-queen.html>>Downloaded in 12 Apr. 2010.

⁵⁹ BAAS, Nicolas, *Prevost Car Inc. v. The Queen*, Calgary: Moody's Tax Advisors, 2009. Available at: <<http://moodystax.com/blog/22-corporatetax/70-prevost-car-inc-v-the-queen.html>>Downloaded in 12 Apr. 2010.

⁶⁰ BAAS, Nicolas, *Prevost Car Inc. v. The Queen*, Calgary: Moody's Tax Advisors, 2009. Available at: <<http://moodystax.com/blog/22-corporatetax/70-prevost-car-inc-v-the-queen.html>>Downloaded in 12 Apr. 2010.



they would be the beneficiary owners of dividends paid to Dutchco. With Sweden, the tax rate is 15%, and with the UK it is 10%. Prevost appealed⁶¹.

In May, 2008, the Canadian *Tax Court* issued the expected decision regarding this case involving PrevostCar, being the first case where the meaning of "beneficial owner" was ever discussed for fiscal purposes. The Court ruled that the Dutch holding, which received dividends from the Canadian subsidiary, was in fact the beneficial owner of the dividends and therefore, applied the lower rate, defined by the treaty signed between Canada and the Netherlands.⁶²

It became clear in the process that the PrevostCar's shares belonged to Dutchco. The Dutch company's shares were in the hands of a Swedish entity (51%) and another British entity (49%). Dutchco had no office, staff, activities or any significant asset other than Prevost Car's shares.

In his decision, the judge appraised the material extension of the meaning of "beneficial owner", considering domestic and international cases, dictionary translations of the expression in French, English and Dutch, as well as OECD commentaries (*Organization for Economic Cooperation and Development*) about their model-treaty. Nevertheless, it is hard to determine which authorities the judge determined to be more relevant and persuasive.

After consulting the authorities, the judge simply concluded that beneficial owner of the dividends is the person who receives the dividends for its own use, and who accepts the risk and controls the dividends received⁶³. In other words, the dividends are for the benefit of its owner, who is not obliged to explain to anyone what it does with the revenue from this dividend⁶⁴.

The judge indicated insofar as corporations are concerned, that the corporate veil should not be pierced, except if the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other

⁶¹BAAS, Nicolas, *Prevost Car Inc. v. The Queen*, Calgary: Moody's Tax Advisors, 2009. Available at: <http://moodystax.com/blog/22-corporatetax/70-prevost-car-inc-v-the-queen.html>. Downloaded in: 12 Apr. 2010.

⁶²BAAS, Nicolas, *Prevost Car Inc. v. The Queen*, Calgary: Moody's Tax Advisors, 2009, trad. livre. Available at: <http://moodystax.com/blog/22-corporatetax/70-prevost-car-inc-v-the-queen.html>. Downloaded in: 12 Apr. 2010.

⁶³CANADA, Tax Court of Canada. 2008 TCC 231, [2008] 5 C.T.C. 2306, 2008 DTC 3080. Available at: <http://reports.fja.gc.ca/eng/2010/2009fca57.html>. Downloaded in: 15 fev 2012.

⁶⁴BAAS, Nicolas, *Prevost Car Inc. v. The Queen*, Calgary: Moody's Tax Advisors, 2009, trad. livre. Available at: <http://moodystax.com/blog/22-corporatetax/70-prevost-car-inc-v-the-queen.html>. Downloaded in: 12 Apr. 2010.



than what that person instructs (for instance, a stock broker who is registered as owner of the shares it controls for his clients)⁶⁵.

Even though there was an agreement between the last stockholders - Henlys and Volvo - establishing a policy for dividend payments, the judge indicated that this agreement could not be imposed against Dutchco, as the latter was not part of it. Dutchco was free to determine dividend payment to its shareholders and even chose to exercise this right: some dividends received were their own and made available to its creditors. There was no predetermined or automatic transference of funds to its shareholders.

Considering the above mentioned reasons, the judge understood that Dutchco was the beneficial owner of the dividends. He did not pay attention to the fact that Dutchco had no office or staff located in the Netherlands. Besides, administrative errors of lesser importance such as the reference to the last stockholders as being stockholders of Prevost shares in this company's minute books were not decisive to conclude who was the beneficiary owner.

In a private note, the Court positioned itself in the sense that the OECD commentaries in its Conventions must be considered in the interpretation of terms present in treaties, even if such documents ended up producing effects only after the signing of that particular treaty⁶⁶.

On February 26th, the Federal Court of Appeal (FCA) released the decision on the appeal placed by the Canadian tax authority. The FCA maintained what the *Tax Court* had originally decided, in its whole.⁶⁷

⁶⁵ CANADÁ, Tax Court of Canada. 2008 TCC 231, [2008] 5 C.T.C. 2306, 2008 DTC 3080, trad. livre. Available at: <<http://reports.fja.gc.ca/eng/2010/2009fca57.html>>. Downloaded in: 15 fev 2012.

⁶⁶ BAAS, Nicolas, *Prevost Car Inc. v. The Queen*, Calgary: Moody's Tax Advisors, 2009, trad. livre. Available at: <<http://moodystax.com/blog/22-corporatetax/70-prevost-car-inc-v-the-queen.html>>. Downloaded in: 12 Apr. 2010.

⁶⁷ A decisão da FCA foi assimementada: "*Income Tax — International tax treaties — Convention between Canada and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income — Appeal from Tax Court of Canada (T.C.C.) decision finding beneficial owner of dividends paid by respondent Dutch corporation, shareholder of respondent — Dutch corporation receiving dividends from respondent, then paying similar amount of dividends to corporate shareholders, residents of Sweden, U.K. — Respondent's rate of withholding under Convention 5%, but higher if beneficial owner Swedish, British shareholders — T.C.C. correctly interpreting term "beneficial owner" — Appeal dismissed.*"

Construction of Statutes — Interpretation of term "beneficial owner" in Convention between Canada and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Art. 10, para. 2 — Judge examining ordinary, technical, legal meanings of "beneficial owner", relying on Organization for Economic Cooperation and Development (OECD) Commentaries — OECD Commentaries acceptable guides in interpreting, applying bilateral conventions — Judge capturing essence of term "beneficial owner"" (CANADÁ, Federal Court of Appeal. *Prevost Car Inc. v. Canada*, 2009 FCA 57, [2010] 2

The FCA did not investigate deeply enough the workings of the treaty and the largest part of the decision is dedicated to the principles that rule over the interpretation of international tax treaties, more specifically the value assigned to the OECD documentation about this matter. The Court made comments about the hermeneutics of international treaties which are obviously in favor of the agents involved in international taxation.⁶⁸

The FCA, on the other hand, did not present the case with a point of view contrary to the fiscal authority's allegation that one could "look through" (disregard) the holdings in order to get to the dividend's last beneficiary.

The CRA tried to convince the court that beneficial owner (*bénéficiaire effectif*) means "the person who may, in fact, benefit from the dividend". This proposed definition does not appear anywhere in the OECD documents and the use of the term "may" opens room for a variety of possibilities that would put at risk the relative degree of certainty and stability that an international treaty attempts to create.⁶⁹

Considering the importance of the FCA's decision over the OECD's Model Treaty, it is relevant to transcribe the part concerning the discussion about the meaning of "beneficial owner".

The requirement to declare the identity of the beneficial owner was introduced in the second paragraph of article 10 in order to clarify the meaning of the words "paid... to a resident" since they are used in the first paragraph of the same article. This clarifies that the source-State does not have to refrain from taxing the dividends only because a resident of the State with which the source-State may have signed a treaty immediately received the income. The term "beneficial owner" is not used in a strict sense, or rather; it must be read in its context and under the light of the object and purpose of the treaty, including the denial to double-tax and prevention of fiscal evasion⁷⁰.

F.C.R. 65. Juiz Relator Robert Décary. Julgado em: 17/02/2009. Available at: <http://reports.fja.gc.ca/eng/2010/2009fca57.html>. Downloaded in: 15 Feb. 2012).

⁶⁸CANADÁ, Federal Court of Appeal. *Prevost Car Inc. v. Canada*, 2009 FCA 57, [2010] 2 F.C.R. 65. Juiz Relator Robert Décary. Julgado em: 17/02/2009. Downloaded in: <http://reports.fja.gc.ca/eng/2010/2009fca57.html>. Downloaded in: 15 Feb. 2012

⁶⁹BAAS, Nicolas, *Prevost Car Inc. v. The Queen*, Calgary: Moody's Tax Advisors, 2009. Available at: <http://moodystax.com/blog/22-corporatetax/70-prevost-car-inc-v-the-queen.html>>Downloaded in 12 Apr. 2010.

⁷⁰BAAS, Nicolas, *Prevost Car Inc. v. The Queen*, Calgary: Moody's Tax Advisors, 2009, trad. livre. Available at: <http://moodystax.com/blog/22-corporatetax/70-prevost-car-inc-v-the-queen.html>>Downloaded 12 Apr. 2010.



In short, this decision clearly relates to the theory that dividends paid to holdings (that are not conduits) will be eligible to benefit from the treaties that seek to decline double taxation⁷¹.

6.2 Canadá: *MIL Investments S.A. v. The Queen*

This case involved the disposition of shares of a Canadian public company, Diamond Fields Resources Ltd. ("DFR") by MIL Investments S.A. ("MIL"), a company incorporated in Cayman Islands and owned by Mr. Boulle, a Monaco resident. In 1993, MIL acquired a stake in DFR large enough to qualify the shares as "taxable Canadian property" by paragraph (f) of the definition of that term in subsection 248(1) of the Income Tax Act (the "Act")⁷².

In 1994, DFR discovered a major mineral deposit increasing the value of MIL shareholding in DFR by more than \$500 million, the disposition of which would trigger taxation in Canada⁷³.

In 1995, MIL hired the services of tax lawyers to furnish a tax planning. Their report indicated that MIL could be moved to a jurisdiction where an international treaty would be applied, and specifically identifies Luxembourg as one of a few suitable countries, but also noted that the exemption in the treaty was available only if MIL did not own 10% or more of the shares of any class in the Canadian company.

The fully developed tax plan recommended the exchange, in the terms of disposition 85.1 of the Act⁷⁴, of DFR shares for Inco's shares (the future buyer) as a means to reduce MIL and Mr. Boulle's aggregate shareholding in DFR below the 10% threshold and recommended the

⁷¹ "In the event of double taxation there is no logic contradiction between effective norms, when it comes to reciprocal exclusion. What happens is an independent application from which results in a collective production of legal consequences from both. It is therefore found the figure of actual cumulative concurrence, of norms of or pretensions (Anspruchshäufung), according to GEORGIADIS' terminology. It's the softening or the elimination of such cumulation which constitutes the object of dispositions aiming to avoid double taxation" (XAVIER, Alberto Pinheiro. *Direito Tributário Internacional do Brasil*, 4ª ed. Rio de Janeiro: Forense, 1998, p. 41).

⁷² Available at: <<http://laws-lois.justice.gc.ca/eng/acts/I-3.3/>>. Downloaded in 22 Apr. 2011.

⁷³ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

⁷⁴ Available at: <<http://laws-lois.justice.gc.ca/eng/acts/I-3.3/>>. Downloaded in 22 Apr. 2011.

continuation of MIL into a Luxembourg company, which would enable the application of the Canada-Luxembourg Convention⁷⁵⁶.

Teck Corporation paid US\$ 108 million for 10% of DFR and signed a deal with DFR in which it was committed not to buy any more shares without DFR's permission (*stand still agreement*). Inco Limited bought 25% of the shares from *Voisey's Bay Nickel Company Limited*, one of DFR's subsidiaries and signed a *stand still agreement* with DFR as well⁷⁷.

Acting according to such purposes, MIL sold Inco's shares, acquired under the terms of disposition 85.1 (*share-for-share exchange*)⁷⁸, by which MIL's participation was reduced to 9,817%, resulting in a capital gain of approximately US\$65 million, and, finally sold 50,000 shares from DFR, gaining around US\$4.5 million. In those 2 operations MIL did not collect taxes because it was considered exempt (declared itself eligible for the benefit and CRA acknowledged it)⁷⁹.

In 1996, after negotiating with two different corporations (Falcon Bridge Limited and Inco), MIL sold its remaining DFR shares to Inco, in an operation that was accepted by DFR, realizing a capital gain close to US\$426 million, over which it claimed the exemption under the treaty. Shortly thereafter, the major part of that gain was transferred to a new company from the Cayman Islands owned by Mr. Boule⁸⁰.

Canada Revenue Agency ordered MIL to deny the exemption established by the treaty over the gain from the final sale in 1996, under the terms of subsection 245(2) of the *Income Tax Act*⁸¹. CRA, in one of its old directives about the general anti-evasive clause (subsection 245 [4]), explained that the rule does not apply to an evasive operation when it can be reasonably

⁷⁵ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

⁷⁶ Cf. *Íntegra do tratado internacional firmado entre Canadá e Luxemburgo destinado a suprimir a dupla tributação e combater a evasão fiscal*. Available at: <http://www.collectionscanada.gc.ca/webarchives/20071126040811/http://www.fin.gc.ca/news99/data/99-075_1e.html>. Acesso 11 mar. 2011.

⁷⁷ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

⁷⁸ Available at: <<http://laws-lois.justice.gc.ca/eng/acts/I-3.3/>>. Downloaded in 22 Apr. 2011.

⁷⁹ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

⁸⁰ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

⁸¹ Available at: <<http://laws-lois.justice.gc.ca/eng/acts/I-3.3/>>. Downloaded in 22 Apr. 2011.



considered that the transaction would not result in a misuse or abuse of the Law or the provisions⁸², considering the Act's disposition as a whole⁸³.

The argument used by the Fiscal authority was the following: operations that are based over specific dispositions (incentive provision, for example) or in the Law's general rules may be over ruled if its consequences are so inconsistent with the general provision of the Law that they may not be within the Parliament's expectations (the will of the legislator). On the other hand, a transaction that is coherent with the object and the spirit of the Law will not be affected⁸⁴.

The Canadian Tax Court decided that subsection 245(2) of the Income Tax Act was not applicable since there was no avoidance⁸⁵ according to the terms of subsection 245(3), and that not even the request for the exemption placed by MIL constituted an abuse of the treaty for the purposes of subsection 245 (4)⁸⁶.

The Court also decided that there was no ambiguity in the treaty which could accommodate an interpretation regarding the presence of an anti-abuse clause. It also arrived at the conclusion that even if the preamble referred to the combat of fiscal evasion⁸⁷, that would not constitute an anti-treaty-shopping rule.

According to the judge, the *pacta sunt servanda* principle (parts in the contract must abide by what is agreed) from the Vienna Convention, combined with the treaty's disposition imply that MIL had no right to benefit from the exemption. As a matter of fact, OECD's position in 1977,

⁸² A OCDE define "abuse of law" como: "The doctrine which allows the tax authorities to disregard a civil law form used by the taxpayer which has no commercial basis" (OCDE, *Glossary of Tax Terms*. Available at: <<http://www.oecd.org/ctp/glossaryoftaxterms.htm#>>. Downloaded in 23 mar 2011).

⁸³ CANADÁ, Canada Revenue Agency. *Using Tax Havens to Avoid Paying Taxes*: Worth the risk? Available at: <<http://www.cra-arc.gc.ca/E/pub/tg/rc4507/rc4507-09e.pdf>>. Downloaded in 21 mar. 2011.

⁸⁴ CANADÁ, Canada Revenue Agency. *Using Tax Havens to Avoid Paying Taxes*: Worth the risk? Available at: <<http://www.cra-arc.gc.ca/E/pub/tg/rc4507/rc4507-09e.pdf>>. Downloaded in 21 mar. 2011.

⁸⁵ A elusão fiscal se aproxima da definição de "tax avoidance", conceituado pela OCDE como: "A term that is difficult to define but which is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow" (OCDE, *Glossary of Tax Terms*. Available at: <<http://www.oecd.org/ctp/glossaryoftaxterms.htm#>>. Downloaded in 23 mar 2011).

⁸⁶ CANADÁ, Tax Court of Canada. *MIL (investments) S.A. v. The Queen*. 2004-3354(IT)G. Juiz Relator R.D. Bell. Julgado em 30/03/2006. Available at: <<http://decision.tcc-cci.gc.ca/en/2006/2006tcc208/2006tcc208.html>>. Downloaded in 25 Feb. 2011.

⁸⁷ This is what the preamble of the treaty states: "The Government of Canada and the Government of the Grand Duchy of Luxembourg desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital, have agreed as follow" (Available at: <http://www.collectionscanada.gc.ca/webarchives/20071126040811/http://www.fin.gc.ca/news99/data/99-075_1e.html>. Downloaded in 21 mar 2011).

established that taxpayers could explore the differences between the tax base and the advantages offered by the States, but that only the States could adopt provisions in its internal legislation to combat possible abuse⁸⁸.

In order to arrive at the conclusion that none of the operations resulted in tax evasion, the Court considered that the global objective of a series of transactions would be the purpose of all joint operations, and that the final sale in 1996 was not part of a series of transactions because, in the course of the operations, that was only a mere possibility.

With regards to subsection 245(4), the Court declared that the contents of MIL's conduct did not result in the treaty's abuse because the selection of a treaty to minimize the tax load, by itself, cannot be interpreted as abusive. The use of the selected treaty is what must be analyzed. It was also understood by the Tax Court that article 13(4) of the Convention⁸⁹ may not be interpreted as abusive by MIL, because it must be presumed that Canada, in its provisions of exemption have valid motivation to allow Luxembourg the right to withhold taxes on the gains in such specific situations as, for example, the intention to stimulate foreign investment in the Canadian market⁹⁰.

The Tax Court ruled that OECD supervening commentaries may not be consulted for the purpose of interpreting pre-existent treaties. This conclusion seems to be inconsistent with other decisions already taken by the Tax Court, such as in the case of *Cudd Pressure v. The Queen* (FCA 98 DTC 6630)⁹¹, in which it was stated that OECD commentaries should always be

⁸⁸ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

⁸⁹ This is what the art. 13 (4) of the international treaty under study declares: "*Gains derived by a resident of a Contracting State from the alienation of: (a) shares (other than shares listed on an approved stock exchange in the other Contracting State) forming part of a substantial interest in the capital stock of a company the value of which shares is derived principally from immovable property situated in that other State; or (b) an interest in a partnership, trust or estate, the value of which is derived principally from immovable property situated in that other State, may be taxed in that other State. For the purposes of this paragraph, the term "immovable property" does not include property (other than rental property) in which the business of the company, partnership, trust or estate was carried on; and a substantial interest exists when the resident and persons related thereto own 10 per cent or more of the shares of any class or the capital stock of a company*" (Available at: <http://www.collectionscanada.gc.ca/webarchives/20071126040811/http://www.fin.gc.ca/news99/data/99-075_1e.html>. Downloaded in 21 mar 2011).

⁹⁰ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

⁹¹ CANADÁ, Federal Court of Appeal. *Cudd Pressure Control Inc. v. The Queen*, 98 DTC 6630. Juiz Relator J.A. Robertson. Julgado em: 19/10/1998. Available at: <http://decisions.fca-caf.gc.ca/en/1998/a-369-95_6778/a-369-95.html>. Downloaded in 21 mar. 2011.

invoked as part of the treaties context, even when they do not reveal the parties' intention at the time the treaty was signed.

The CRA, by its turn, appealed to the FCA. The Federal Court of Appeal ruled against changing the interpretation of the Tax Court about “serial transactions” and decided that even if the final sale is part of a series of transactions, there was no misuse of any provisions established by the Income Tax Act or the treaty between Canada and Luxembourg⁹².

⁹²The decision is so phrased: “[1] In order to succeed in this appeal, the appellant Her Majesty the Queen must persuade us that one transaction in the series of transactions in issue is an avoidance transaction, and that the tax benefit achieved by the respondent MIL (Investments) S.A. is an abuse or misuse of the object and purpose of article 13(4) of the Convention between Canada and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of fiscal Evasion with respect to Taxes on Income and on Capital (the Tax Treaty).

[2] The Tax Court judge found that the series of transactions consisted of the respondent's sale of 703,000 shares of Diamond Fields Resources Ltd. (DFR), the payment of the Final Dividend (as described in the Tax Court judge's reasons) and the continuance of the respondent as a Luxembourg corporation. The Tax Court judge found that the respondent's August 1996 sale of its remaining shares in DFR was not part of the series because “at the end of the series of transactions, DFR management, including co-chairman Boule (the directing mind of the respondent) and therefore the appellant [respondent in the appeal] had no intention of selling”: Reasons for Decision, at para. 67.

[3] The appellant's task has been made easier by the respondent's admission that its continuance as a Luxembourg corporation was an avoidance transaction. As a result, and even though the Tax Court judge found that the respondent's August 1996 sale of its shares in DFR was not, in and of itself, an avoidance transaction, the tax benefit which the respondent ultimately obtained following that sale may be subject to the General Anti-Avoidance Rule (GAAR) if the sale was part of the series of transactions or was undertaken in contemplation of the series of transactions.

[4] Counsel for the appellant and counsel for the respondent, each in their turn, took us to the evidence in support of their position. The fact that there is evidence in support of each side's position makes it unlikely that the Tax Court judge's conclusion was the result of a palpable and overriding error.

[5] We do not have to answer that question as we are of the view that the appeal would fail in any event as we are unable to see in the specific provisions of the Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.) (the Act) and the Tax Treaty to which we were referred, interpreted purposively and contextually, any support for the argument that the tax benefit obtained by the respondent was an abuse or misuse of the object and purpose of any of those dispositions.

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

[7] If the object of the exempting provision was to be limited to portfolio investments, or to non-controlling interests in immovable property (as defined in the Tax Treaty), as the appellant argues, it would have been easy enough to say so. Beyond that, and more importantly, the appellant was unable to explain how the fact that the respondent or Mr. Boule had or retained influence of control over DFR, if indeed they did, was in itself a reason to subject the gain from the sale of the shares to Canadian taxation rather than taxation in Luxembourg.

[8] To the extent that the appellant argues that the Tax Treaty should not be interpreted so as to permit double non-taxation, the issue raised by GAAR is the incidence of Canadian taxation, not the foregoing of revenues by the Luxembourg fiscal authorities.

[9] As a result, the appeal will be dismissed with costs” (CANADÁ, Federal Court of Appeal. MIL (Investments) S.A. v. Her Majesty the Queen, [2007] 4 C.T.C. 253, 2007 FCA 236. Juiz Relator J.D. Denis Pelletier. Julgado em

In their analysis of the treaty between the two countries, the FCA only considered article 13(4) and decided that if the object of the exempting provision was to be limited to portfolio investments, or to non-controlling interests in immovable property (as defined in the Tax Treaty), the treaty should have specified that. Under this rationale, among the arguments presented in the appeal, CRA, refusing to interpret the norm literally, had sustained that the exempt should have been limited to the portfolio investments⁹³.

It is noticeable that in their decision, FCA remained silent regarding the Tax Court's argument that the choosing of a treaty as a means to reduce taxation in itself can not be considered abusive.

The Judiciary's view caused great repercussion in Canadian doctrine. Many jurists did not conform to the decision, which, for them, made it look like a clear case of treaty-shopping being accepted. The fact that Mr. Boulle had detoured his income by way of Luxembourg in order to benefit from the treaty, made it seem like an evasion operation, since MIL was only resident of Luxembourg out of mere convenience⁹⁴, and the treaty was explicitly limited to the residents of both contracting countries⁹⁵ (Canada and Luxembourg), instead of being taxed as a Cayman Islands resident (or Monaco).

Critics of the Court's decisions were issued in the sense that while the *Tax Court* simply accepted *treaty-shopping* as a legitimate practice, the *Federal Court of Appeal* (FCA) limited its analysis of the case as an alleged abuse, or misuse, of article 13 (4), which deals with taxation over capital gain of the treaty, while ignoring the most fundamental issue: the application of the treaty itself with respect to its own objectives. In the view of those critics, according to subsection 245(4) of the *Tax Income Act*, FCA should have at least tried to offer some standards

13/06/2007. Available at: <<http://decisions.fca-caf.gc.ca/en/2007/2007fca236/2007fca236.html>>. Downloaded in: 21 Feb. 2011).

⁹³ CANADÁ, Federal Court of Appeal. *MIL (Investments) S.A. v. Her Majesty the Queen*, [2007] 4 C.T.C. 253, 2007 FCA 236. Juiz Relator J.D. Denis Pelletier. Julgado em 13/06/2007. Available at: <<http://decisions.fca-caf.gc.ca/en/2007/2007fca236/2007fca236.html>>. Downloaded in: 21 Feb. 2011

⁹⁴ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

⁹⁵ O Art. 1º do tratado explicita sua natureza e fecha: “*This Convention shall apply to persons who are residents of one or both of the Contracting States*” (Available at: <http://www.collectionscanada.gc.ca/webarchives/20071126040811/http://www.fin.gc.ca/news99/data/99-075_1e.html>. Downloaded in 21 mar 2011).



to establish when a tax reduction transaction would be considered as abusive to the treaty and its dispositions, specially with regards to articles 1 and 2⁹⁶, which define the scope of the treaty.

Article 4 deals with the prerequisites for a person to be considered resident⁹⁷. Since, in the case, there was no violation of that norm, critics argued that the mere fulfilling of such requirements were of no consequence, if the purpose of the treaty were violated, incurring, thus, in a case of abuse⁹⁸.

However, it is understood that in view of the legal assurance principle, it would not be advisable to recognize the existence of other prerequisites or exceptions to those conditions for the use of the resident status, other than those established by law⁹⁹.

⁹⁶ Art 2º do tratado Canadá-Luxemburgo: “*Taxes Covered. 1. The existing taxes to which the Convention shall apply are, in particular: (a) in the case of Canada: the taxes imposed by the Government of Canada under the Income Tax Act, (hereinafter referred to as "Canadian Tax"); (b) in the case of Luxembourg: (i) the income tax on individuals; (ii) the corporation tax; (iii) the special tax on directors' fees; (iv) the capital tax; and (v) the communal trade tax; (hereinafter referred to as "Luxembourg tax"). 2. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws*” (Available at: <http://www.collectionscanada.gc.ca/webarchives/20071126040811/http://www.fin.gc.ca/news99/data/99-075_1e.html>. Downloaded in 21 mar 2011).

⁹⁷ Art. 4º do tratado: “*Resident. 1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, place of management or any other criterion of a similar nature. This term also includes a Contracting State or a political subdivision or local authority thereof or any agency or instrumentality of any such State, subdivision or authority. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State. 2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then the individual's status shall be determined as follows: (a) the individual shall be deemed to be a resident only of the State in which the individual has a permanent home available; if the individual has a permanent home available in both States, the individual shall be deemed to be a resident only of the State with which the individual's personal and economic relations are closer (centre of vital interests); (b) if the State in which the individual's centre of vital interests is situated cannot be determined, or if there is not a permanent home available to the individual in either State, the individual shall be deemed to be a resident only of the State in which the individual has an habitual abode; (c) if the individual has an habitual abode in both States or in neither of them, the individual shall be deemed to be a resident only of the State of which the individual is a national; (d) if the individual is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement. 3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall by mutual agreement endeavour to settle the question. In the absence of such agreement, such person shall not be entitled to claim any relief or exemption from tax provided by the Convention*” (Available at:

<http://www.collectionscanada.gc.ca/webarchives/20071126040811/http://www.fin.gc.ca/news99/data/99-075_1e.html>. Downloaded in 21 mar 2011).

⁹⁸ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

⁹⁹ According to Misabel Derzi, “[...] the trustworthiness of the legal system and the predictability of State interventions lead to the protection of the trust in the law or norm (DERZI, Misabel Abreu Machado. *Modificações*

Furthermore, nowadays, the interpretation of the law is more often based on the *mens legis* than on the *mens legislatoris*¹⁰⁰¹⁰¹. Based on that, it is understood that one should not ignore the context in which norms are applied and even the original objective of the legislators (in this case, *negotiators*) alter constantly, in the light of new social realities.

With regards to the *General Anti-Avoidance Rule* (GAAR), subsection 245[2] of the Income Tax Act¹⁰², invoked by the CRA as a disposition capable of legally justifying the disregarding of a transaction, there seemed to have some difficulties, similar to those established by article 116th of the Brazilian Tax Law (Código Tributário Nacional)¹⁰³.

Most likely, the CRA's argument to defend the idea that the tax authorities of Luxembourg didn't tax Mr. Boule's capital gain, as it was exempt by Canada, was due to the CRA's intent to demonstrate that Mr. Boule had no intention of paying taxes. The FCA, on the other hand, didn't have any difficulties disputing this argument by pronouncing that "[...]the issue raised by GAAR is the incidence of Canadian taxation, not the foregoing of revenues by the Luxembourg fiscal authorities"¹⁰⁴.

As it turned out, Canadian ruled in favor of legal assurance, denying the broader interpretation of legal dispositions, which could have led to the inconsideration of legal

da Jurisprudência no Direito Tributário: proteção da confiança, boa-fé objetiva e irretroatividade com limitações constitucionais ao poder de tributar. São Paulo: Noeses, 2009, p. 11 e 49).

¹⁰⁰ Starting in the 18th Century, the necessity to interpret the legislator's mind was removed; since then the interpretative and the enforcing functions of the legislation were assigned to the courts. Luhmann, in view of that, argues that "only this can allow that courts decide every case presented to them. The connection to the law becomes, thus, object of the judge's interpretation" (LUHMANN, Niklas, *A posição dos tribunais no sistema jurídico*, traduzido por Peter Naumann e revisado por Vera Jacob de Fradera, Revista *Ajuris*: Porto Alegre, n. 49, ano XII, jul., 1990, p. 153).

¹⁰¹ Nestesentido: BOWLER, Tracie. *Countering tax avoidance in the UK: Which way forward?* – Tax Law Review Committee Discussion Paper No. 7 London: The Institute for Fiscal Studies, 2009, p. 11.

¹⁰² Subseção 245 (2) do *Income Tax Act*: "Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction" (Available at: <<http://laws-lois.justice.gc.ca/eng/acts/I-3.3/page-398.html#h-151>>. Downloaded in 21 mar. 2011).

¹⁰³ As it is generally assumed, it will be considered evasive the transaction or contract formed before (almost always) the taxable event, and without the use of simulation, dissimulation, sonegation, abuse, misuse or other forms of law fraud (illegalities). If such faults are not identified, it is understood that the non-consideration of the treaty is what is against the legal system.

¹⁰⁴ CANADÁ, Federal Court of Appeal. *MIL (Investments) S.A. v. Her Majesty the Queen*, [2007] 4 C.T.C. 253, 2007 FCA 236. Juiz Relator J.D. Denis Pelletier, Free translation. Julgado em 13/06/2007. Available at: <<http://decisions.fca-cf.ca/en/2007/2007fca236/2007fca236.html>>. Downloaded in: 21 Feb. 2011.



contracts. In this aspect, the courts' positions in favor of the trust in the legal system and the predictability of state interventions, must be complimented.

6.3U.K.: *Indofood International Finance Ltd v. JP Morgan Chase Bank N.A. London Branch*

The analysis of this legal case revolves around the definition of the term "beneficial ownership". Surprisingly enough, in the U.K., there was practically no jurisprudence regarding the meaning of *beneficial ownership* until the *Indofood case*. There was a Dutch case a few years back in which a company from the U.K. acquired the right of use to the dividends of Dutch shares: The *Amsterdam Court* decided that the person who had the right of use was not the beneficial owner, but the Supreme Court (*Hoge Raad*) correctly reverted that decision, stating that the mere fact that the company had the rights to dividends and not to the ownership of the shares did not prevent it from being the beneficial owner¹⁰⁵.

In March 2006, the Court of Appeal's decision about the meaning of beneficial ownership is published, however, since then, it has been questioned whether or not it helped in the understanding of this term's meaning. Considering that this was a case where a definition for such a key-expression in the international law was expected, it is surprising that it did not, technically, involve a tax situation directly¹⁰⁶.

It was a case of civil law brought by both parties in view of a loan contract. It was a rather complex case, but which can be summarized. An Indonesian company wished to raise a loan for business purposes: had it done so directly, there would have been a 20% withholding tax on the interest it paid¹⁰⁷. Instead, the Indonesian company established a subsidiary in Mauritius and borrowed money from JP Morgan, who acted as trustee for the bondholders. Interest paid from Indonesia to Mauritius benefited from the Indonesia-Mauritius Tax Treaty, with a reduced withholding tax of 10%. Interest paid from Mauritius to the bondholders was not

¹⁰⁵ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 18, Free translation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf> Downloaded in 12 set. 2010.

¹⁰⁶ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 18, Free translation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>. Downloaded 12 set. 2010.

¹⁰⁷ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 18, Free translation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf> Downloaded in: 12 set. 2010.



subject to any withholding tax¹⁰⁸.

Some of the terms of the arrangement with the Mauritius finance subsidiary were relevant: the identical amount of money that was borrowed by the Mauritian company was then lent on to the Indonesian counterpart, with identical rate of interest to the loan to and from Mauritius. The dispositions in the contract regarding the interest to be paid by the Indonesian parent to the Mauritian subsidiary were due on day 1, and from the Mauritian subsidiary to the trustee for the bondholders on the following day. Based on that it was derived that the interest was paid directly from the Indonesian parent to the trustee for the bondholders, leaving the Mauritian subsidiary out.

The Court of Appeal ruled that the terms of the loan documentation precluded the Mauritian subsidiary from meeting its interest obligations to the bondholders from any source other than interest paid by its Indonesia parent, thus the Court of Appeal seems to have considered that both in practice and according to the documentation, the Mauritian subsidiary was in fact forced to pay on every dollar received from its Indonesian parent to the bondholders: none of the interest received could be retained by the Mauritian subsidiary¹⁰⁹.

With this understanding the Indonesia-Mauritius Tax Treaty was terminated.

This procedure would have implied that the value of the tax to be withheld over the Indonesian parent company would be reverted to the domestic rate of 20%. Nevertheless, the loan documentation contained a provision establishing that if the tax rate on the interest was increased, the payer would have to support the amount paid so that, net of the higher tax, the bondholders received the same return as previously. Because this placed a heavier burden on the borrower, it had an option to, if there was no alternative to revert the situation (reducing the withholding tax), anticipate the payment of the loan.¹¹⁰

Now, we must get to the core of the Indofood case: the Indonesian borrower claimed that

¹⁰⁸BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 18, Freetranslation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf> Downloaded 12 set. 2010.

¹⁰⁹REINO UNIDO, Court of Appeal, Civil Division. *Indofood International Finance Ltd v. JP Morgan Chase Bank N.A. London Branch*, processo n. A3/2005/2497. Julgado em: 02/03/2006. Available at: <<http://court-appeal.vlex.co.uk/vid/-52568119>>. Downloaded in 29 jan. 2013.

¹¹⁰BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 19, Freetranslation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf> Downloaded 12 set. 2010.



there was nothing it could do to benefit from the reduced tax fate, so it should be allowed to anticipate the loan's payment. JP Morgan, acting for the bondholders, counter argued that there was, in fact, a very reasonable alternative and there was no reason to anticipate the loan's payment. It became obvious that the interest rates available had changed so that it was attractive to the borrower to repay early and refinance, while JP Morgan, wished to maintain the loan contract as it were¹¹¹.

The solution proposed by JP Morgan was to interpose a Dutch company between the Indonesian and the Mauritius companies in a way that they could benefit from the treaty between their countries, which had also established a tax rate of 10%(or even a possibility of a 0% withholding tax)¹¹².

Two arguments were raised to show that the proposed interposition of a Dutch company would not work: 1) it would not be the beneficial owner of the interest; and 2) it would not be considered a resident of the Netherlands for fiscal purposes.

In such circumstances the suggested Dutch company would fail to alleviate the tax rates, and a measure that is considered doomed to fail is not a reasonable one¹¹³.

Technically, the question was whether or not the Dutch company would be entitled to the reduced withholding tax under the Indonesia-Netherlands Tax Treaty. This was essentially a matter of how the Indonesian Revenue would respond to the Dutch company – would they consider it the beneficial owner – and, if they rejected a treaty application, how would the Indonesian Courts respond? Therefore, the issue was one of Indonesian law practice. The litigation came to London, however, because the loan agreements had a choice of jurisdiction clause assigning it to the English High Court.¹¹⁴

At first instance, Judge Evan-Lombes sustained that, if the Mauritian company had been

¹¹¹ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 20, Freetranslation. Available<www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>. Downloaded 12 set. 2010.

¹¹² BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 20, Freetranslation. Available<www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>Downloaded 12 set. 2010.

¹¹³ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 20, Freetranslation. Available<www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>Downloaded 12 set. 2010.

¹¹⁴ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 21, Freetranslation. Available<www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>. Downloaded 12 set. 2010.



the beneficial owner of the interest, so would the Dutch company. Of course, there is a simple answer to this: maybe the Mauritian company had not been considered as the beneficial owner to begin with.¹¹⁵

The Court of Appeal reversed the first instance judgment. Unanimously, they considered that the interposed Dutch company would not be the beneficial owner of the interest. This trial was relevant because, for the first time, an English court had to come up with a definition of the term "beneficial owner" in a tax treaty over international tax law. Unfortunately, the way they did it provided very little light to the meaning of the legal term¹¹⁶.

Two relevant aspects must be highlighted regarding the Court of Appeal's ruling. First, none of the judges (and none of the counsel) was an expert in tax law, let alone in international tax law; and, as a technical issue, the Court of Appeal had only to decide if the interposition of the Dutch company was the reasonable measure for the borrower to assume¹¹⁷.

Hence, the Court should decide whether or not the Indonesian fiscal authorities had gone on record to declare that they would not regard the interposed company as the beneficial owner, and thus positioning itself with respect to the reasonability of that conduct (the interposition). However, this was not the Court of Appeal's position. Fortunately, the court chose to face the issue of the meaning of the term "beneficial ownership"¹¹⁸.

One of the great fears of the U.K. tax lawyers was that the judges would recognise the term "beneficial ownership" from their knowledge of equity and the law of trusts, assuming that the term had meaning only under the common law system with which they were familiar: that is, that there was a distinction between legal ownership and beneficial ownership. The meaning of the term would then be muddled up with the distinction between these separate ownership interests of

¹¹⁵ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 21, Free translation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf> Downloaded 12 set. 2010.

¹¹⁶ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 21, Free translation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>. Downloaded 12 set. 2010.

¹¹⁷ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 22, Free translation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf> Downloaded 12 set. 2010.

¹¹⁸ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 22, Free translation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf> Downloaded 12 set. 2010.



the trustee and its beneficiary under a trust¹¹⁹.

The term "beneficial ownership" is used in many treaties contracted between common law, civil law countries, as well as in others with distinct legal systems whose historical origins are totally diverse. Following this rationale, Philip Baker emphasizes that the term needed an "international fiscal meaning"¹²⁰.

The Court of Appeal decided, correctly, that the term "beneficial ownership" should not have a definition established within the U.K.'s domestic laws, instead it needed a uniform international meaning. The challenge was where to find such international fiscal meaning. There are some good and bad aspects regarding the referred decision. The good aspects are that the Court of Appeal submitted its investigation to the OECD Commentary and seemed to agree to endorse the international fiscal meaning¹²¹. The bad ones are some unfortunate references to statements from the Director General of Income Tax in Indonesia to whom it meant "the full privilege to directly benefit from the income"¹²².

In the end, and settling back to the facts of the court case (and it's important to emphasize that this one was decided incidentally), the proposed Dutch company would not have been the beneficial owner of the interests. In this sense, the proposed solution would not work and it would not be reasonable to expect that the borrower would follow a path that was doomed to failure¹²³.

At the time of writing this short note, discussions between City law firms, the Law Society and HM Revenue & Customs (the British tax authority) has led to the publication of the draft of a guide manual by HMRC over the impact of the *Indofood* case. That guide seems to have been designed by a desire to reassure the City Law firms that many existing structures

¹¹⁹ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GIRC Review 1, 2007, p. 22-23, Free translation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf> Downloaded 12 set. 2010.

¹²⁰ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GIRC Review 1, 2007, p. 23, Free translation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf> Downloaded 12 set. 2010.

¹²¹ REINO UNIDO, Court of Appeal, Civil Division. *Indofood International Finance Ltd v. JP Morgan Chase Bank N.A. London Branch*, processo n. A3/2005/2497. Julgado em: 02/03/2006. Available at: <<http://court-appeal.vlex.co.uk/vid/-52568119>>. Downloaded in 29 jan. 2013.

¹²² BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GIRC Review 1, 2007, p. 24, Free translation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf> Downloaded in: 12 set. 2010.

¹²³ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GIRC Review 1, 2007, p. 24, Free translation. Available <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf> Downloaded in 12 set. 2010.



would not be subject to any adverse scrutiny as a result of the *Indofood* case. However, Philip Baker states that "the approach adopted by HMRC to reach this comforting result is not particularly appealing from an intellectual point of view". Many law firms wanted to "bury" the result of the *Indofood* case, under the arguments that its jurisprudence did not relate to the U.K.'s fiscal norms¹²⁴.

Nevertheless, Phillip Baker admits that as a practical matter, the decision is clearly of broader significance. Once the Court of Appeal accepted that the term "beneficial ownership" should have an international fiscal meaning, there was no reason why it should not be equally applied if similar facts arose in the United Kingdom. To the very least, it must be recognized that the Court of Appeal, as a strongly persuasive authority, produces jurisprudence of undisputed relevance¹²⁵.

HMRC, in its guide manual, corroborates that the Court of Appeal has provided an orientation for the meaning of the term "beneficial ownership" for the UK's legal system (and not just in Indonesia). Nonetheless, they emphasized that this meaning should be interpreted in the context of the object and purpose of a treaty: the object and purpose includes combating international tax avoidance through treaty-shopping.

The guide suggests, therefore, that the phrase only has its international fiscal meaning when treaty-shopping is intended, but that does not happen when the intention to treaty shop is not present. Philip Baker claims that "intellectually, this is a very unattractive position to take, and it is hard to see any legal support for this approach"¹²⁶.

At last, the HMRC intended, with this reasoning, to identify commercial agreements that would not have denied their established benefits, but only if they did not intend to treaty shop.

6.4 France: *Societe Bank of Scotland v. Ministre de l'Economie, des Finances et de l'Industrie*

¹²⁴ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 25-26, Freetranslation. Available: <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>Downloaded 12 set. 2010.

¹²⁵ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 26, Freetranslation. Available: <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>Downloaded 12 set. 2010.

¹²⁶ BAKER, Philip. *Beneficial ownership after Indofood case*. Londres: 6 GITC Review 1, 2007, p. 26-27, Freetranslation. Available: <www.taxbar.com/documents/Beneficial_Ownership_PB.pdf>.Downloaded 12 set. 2010.



In 2006, the case involving *Bank of Scotland*, the French State Counsel (*Conseil d'État*) applied the concept of law fraud (*fraude à la loi*) in the context of *treaty-shopping*. The term "law fraud" hereby refers to any action taken with the sole purpose of tax evasion, in a way not established by Law¹²⁷.

The peculiarities of this case are worth analyzing, since they expose the reality over which the decision was taken. In that context, an American corporation named *Merrel Dow Inc*, contracted with a resident company of the U.K., *Bank of Scotland*, with the objective of gaining advantages granted by a treaty signed between the U.K. and France (*France-UK treaty*). In order to achieve that, the American corporation transferred to the bank, at no charge, non-voting preferred shares of its French subsidiary under a usufruct agreement, for a period of three years. *Bank of Scotland* received predetermined shares from the French subsidiary and, in return, paid the interests on equivalent amount, corresponding to a loan contract to the American corporation. Several clauses from the *back-to-back*¹²⁸ contract safeguarded *Bank of Scotland* against any risk associated to this settlement¹²⁹.

¹²⁷ Sobre a "fraude à la loi", cf.: SAUVÉ, Jean-Marc; BÉNARD, Yohann. *L'abus de droit en matière fiscale*. Paris: Conseil d'État, 2007, 8p. Available at

<http://www.conseil-etat.fr/media/document/abus_de_droit_070307.pdf>. Downloaded in 20 Feb. 2012.

¹²⁸ A *back-to-back* operation may be defined as that of "[...] currency exchange nature aimed at backing a purchase and sale of foreign product, contracted abroad by a company established in Brazil, without the product ever entering the Brazilian territory, does not characterize an export" (BRASIL, Ministério da Fazenda, Secretaria da Receita Federal, Superintendência Regional da Receita Federal/8ª Região Fiscal, solução de consulta nº 202, de 16 de outubro de 2003. Available at: <[http://decisoes.fazenda.gov.br/netacgi/nph-brs?s10=&s9=NAO+DRJ/\\$.SIGL.&n=DTPE&d=DECW&p=1&u=/netahtml/decisoes/decw/pesquisaSOL.htm&r=18&f=G&l=20&s1=SRRF/8%AA+RF+OU+Disit+08+OU+Diana+08&s6=SC+OU+DE&s3=202&s4=&s5=&s8=&s7=>](http://decisoes.fazenda.gov.br/netacgi/nph-brs?s10=&s9=NAO+DRJ/$.SIGL.&n=DTPE&d=DECW&p=1&u=/netahtml/decisoes/decw/pesquisaSOL.htm&r=18&f=G&l=20&s1=SRRF/8%AA+RF+OU+Disit+08+OU+Diana+08&s6=SC+OU+DE&s3=202&s4=&s5=&s8=&s7=>)> Downloaded 15 feb. 2011.

¹²⁹ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

This procedure was specifically drawn to the benefit of article 24¹³⁰, combined with article 9, from the above mentioned treaty, in which the *TrésorFrançais* (French Treasury) assumes the obligation to return, in the form of tax credit to the residents of the U.K.,

¹³⁰This is what article 24 of the UK-France treaty establishes: “*ELIMINATION OF DOUBLE TAXATION* 1. Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (which shall not affect the general principle hereof): (a) French tax payable under the laws of France and in accordance with this Convention, whether directly or by deduction, on profits, income or chargeable gains from sources within France (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which French tax is computed; (b) in the case of a dividend paid by a company which is a resident of France to a company which is a resident of the United Kingdom and which controls directly or indirectly at least 10 per cent of the voting power in the company paying the dividend, the credit shall take into account (in addition to any French tax for which credit may be allowed under the provisions of sub-paragraph (a)) the French tax payable by the company in respect of the profits out of which such dividend is paid. 2. For the purposes of paragraph 1: (a) profits, income and capital gains owned by a resident of the United Kingdom which may be taxed in France in accordance with the other Articles of this Convention (except capital gains which may be taxed in accordance with paragraph 6 of Article 14) shall be deemed to arise from sources in France; (b) capital gains from sources neither in France nor the United Kingdom which may be taxed in the United Kingdom in accordance with paragraph 6 of Article 14 shall be deemed to arise from sources in France; (c) the taxes referred to in clauses (i) to (iv) of subparagraph (b) of paragraph 1 of Article 2 and, in respect of the taxes mentioned in those clauses, in paragraph 2 of Article 2, shall be considered French tax. 3. In the case of France, double taxation shall be avoided in the following manner: (a) notwithstanding any other provision of this Convention, income which may be taxed or shall be taxable only in the United Kingdom in accordance with the provisions of this Convention shall be taken into account for the computation of the French tax where such income is not exempted from corporation tax according to French domestic law. In that case, the United Kingdom tax shall not be deductible from such income, but the resident of France shall, subject to the conditions and limits provided for in sub-paragraphs (i), (ii) and paragraph 4, be entitled to a tax credit against French tax. Such tax credit shall be equal: (i) in the case of income other than that mentioned in sub-paragraph (ii), to the amount of French tax attributable to such income provided that the resident of France is subject to United Kingdom tax in respect of such income; (ii) in the case of income referred to in Article 7 and paragraph 3 of Article 14 when that income is subject to French corporation tax, and in the case of income referred to in Article 11, paragraphs 1, 2 and 6 of Article 14, paragraph 3 of Article 15, Article 16, paragraphs 1 and 2 of Article 17 and paragraph 3 of Article 23, to the amount of tax paid in the United Kingdom in accordance with the provisions of those Articles; however, such credit shall not exceed the amount of French tax attributable to such income; (b) for the purposes of sub-paragraph (a) of this paragraph the term “amount of French tax attributable to such income” means: (i) where the tax on such income is computed by applying a proportional rate, the amount of the net income concerned multiplied by the rate which actually applies to that income; (ii) where the tax on such income is computed by applying a progressive scale, the amount of the net income concerned multiplied by the rate resulting from the ratio of the tax actually payable on the total net income taxable in accordance with French law to the amount of that total net income; (c) for the purposes of sub-paragraph (a) of this paragraph, the term “amount of tax paid in the United Kingdom” means the amount of United Kingdom tax effectively and definitively borne in respect of the income concerned, in accordance with the provisions of this Convention. 4. (a) Where gains may be taxed by a Contracting State by reason only of paragraph 6 of Article 14, that Contracting State, and not the other Contracting State, shall eliminate double taxation in accordance with the methods set out in this Article as if the gains arose from sources in the other Contracting State. (b) Where gains may be taxed by a Contracting State by reason of paragraphs 1, 2, or 3 of Article 14, the other Contracting State, and not the first-mentioned Contracting State, shall eliminate double taxation in accordance with the methods set out in this Article. 5. In paragraph 3 the term “income” means income or capital gains as the context requires (Available at: <<http://www.hmrc.gov.uk/taxtreaties/in-force/france.pdf>>. Downloaded in 16 jan. 2013).



the taxes withheld over the dividends from the French companies, distributed among the British residents. The treaty signed between the U.S. and France (*France-US Convention*) does not grant similar advantages to Americans. By using the *France-UK treaty*, the fiscal benefits gained by the American company *Merrell Dow* were quite substantial. By channeling dividends payment through the U.K., Merrell Dow, was able to repatriate immediately the dividends of its French subsidiary, withholding, effectively, only 1% tax over the value of the dividend¹³¹.

Bank of Scotland was the other beneficiary in this transaction, since, by receiving a dividend in which a domestic withholding tax of 25% was applied, Bank of Scotland filed an application claiming the reduced withholding tax rate and a refund from the French fiscal authorities (*avoir fiscal français*) based on the provisions outlined in the France-UK treaty.

When alerted by the IRS (*Internal Revenue Service*) about the procedure, the *Conseil d'État* ruled in favor of the tax administration, based on the agreement between the two parties being aimed solely to the fiscal credit from the treaty, which in no other manner would be available or perceived. The analysis of this arrangement revealed that the beneficial owner of the dividend was the American company, and not the Bank of Scotland¹³².

In view of the purpose and object of the treaty provision, the *Conseil d'État* concluded that the intent of the negotiator was that all benefits under Article 9 of the France-UK treaty could only be claimed by the beneficial owner of the dividend, even if the particular provision did not specifically refer to the “beneficial ownership” concept. To reach such a conclusion, the *Conseil d'État* applied the notion of beneficial ownership within the framework of the concept of *fraude à la loi*¹³³.

As far as the *Conseil d'État* was concerned, the beneficial owner of the dividend was not the *Bank of Scotland*, but *Merrell Dow*. It did not become clear, however, under what premises the

¹³¹ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

¹³² CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

¹³³ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.



Conseil d'État based its analysis of the beneficial ownership concept. Instead, it chose to enfold its decision on the concept of the *fraude à la loi*¹³⁴.

Two conditions must be met in order to identify the *fraude à la loi*: 1) The transaction must be objectively contrary to the intention of the legislator; and 2) the transaction must be undertaken only for tax reasons¹³⁵.

The *Conseil d'État* concluded that the first condition was fulfilled since article 9th of the treaty clearly states that the fiscal benefits are destined only to U.K. residents which, by consequence, should be the beneficial owners of the dividends. Since that was not the case, the *Conseil d'État* derived that the agreement between the two companies went against the will of the two contracting countries - France and the UK.

The second condition, related to the fiscal motivation, is more subjective. Even if there was a commercial purpose to the scheme, the American company gained immediate access to the capital, which allowed the *Conseil d'État* to arrive at the conclusion that the sole object of the contract was to have access to the benefits established by the treaty. The *Conseil d'État*, therefore, considered as present all the necessary conditions to identify the *fraude à la loi*. Consequently, the tax reduction was denied.

¹³⁴ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.

¹³⁵ The decision of the *Conseil d'État* was transcribed as such: “*ABUS DE DROIT | CONVENTION FISCALE INTERNATIONALE | FRANCE | ROYAUME UNI | DIVIDENDE | FRAUDE FISCALE. Le Conseil d'Etat a considéré que le litige opposant la société Bank of Scotland et l'administration fiscale concerne le refus de celle-ci de lui accorder le remboursement de l'excédent de retenue à la source et la restitution de l'impôt fiscal ; qu'il est constant que la société n'a pas fait l'objet d'une procédure de redressement et que les pénalités attachées à la répression des abus de droit ne lui ont pas été appliquées ; que dès lors, l'administration fiscale pouvait, sous le contrôle du juge, requalifier le contrat de cession litigieux comme dissimulant la réalité d'un contrat de prêt concluant l'unique but d'obtenir abusivement le bénéfice des clauses favorables de la convention fiscale franco-britannique, afin de déterminer le bénéficiaire effectif des dividendes versés par la société française, sans mettre en œuvre la procédure prévue par l'article L. 64 précité, inapplicable en l'espèce; Considérant qu'il résulte de tout ce qui précède que la société Bank of Scotland n'est pas fondée à soutenir que c'est à tort que, par jugement du 4 juillet 2001, le tribunal administratif de Paris a rejeté sa demande tendant au remboursement de l'excédent de retenue à la source versé à raison de la distribution de dividendes par la société Marion Merrell Dow SA résultant du plafonnement de cette retenue par la convention franco-britannique et la restitution de l'impôt fiscal attaché à ses dividendes ; qu'il y a lieu, par voie de conséquence, de rejeter les conclusions présentées par la société au titre des dispositions de l'article L. 761-1 du code de justice administrative*” (FRANÇA, *Conseil d'État. Societe Bank of Scotland v. Ministre de l'Economie, des Finances et de l'Industrie*. Litígio n. 283314. Relatora Anne Egerszegi. Julgado em 29/12/2006. Available at: <http://www.bibliobaseonline.com/ouvrir_fichier_fenetre.php?NOM_FICHIER=89502_1.PDF&NUMERO=89502>. Downloaded in: 12 jan. 2013).



The theory behind the concept of *fraude à la loi* is not different than the theory behind Canada's General Anti-Avoidance Rule (GAAR). According to subsection 245(3) of the Canadian Income Tax Law an evasive operation is adopted mostly with the objective of gaining a law benefit. In France, based on the concept of law fraud, the transaction must be exclusively intended to access those advantages. In Canada, however, it was harder to prove that such a transaction was evasive, than in France¹³⁶.

7 CONCLUSIONS

Since it depends on political decisions, it is quite a challenge to indicate the most adequate approach to the problem of treaty-shopping. In Brazil, one may already notice that in some of the treaties signed LOB (limitation of benefits) dispositions were included.

It is understood that the best policy would be to evaluate to what extent the use of treaty-shopping brings benefits to the economy without causing relevant impact to fiscal revenue.

In view of that, it may be concluded that measures that limit those benefits excessively, as a way to restrict the use of such methods, and destined to combat treaty-shopping, could end up restricting or even making it impossible to apply private capital in a given State. Thus, the free capital flow and the suppression of double taxation as principles of international law, must be defended.

As hereby studied, no argument seems to challenge the practice of *treaty-shopping* strongly enough to convince the authorities, unanimously, to restrain it. Such as in the Indian case, it appears that the major benefit to the economy provided by treaty-shopping - the increase of capital flow - outweighs the eventual, debatable and not yet completely proven disadvantages.

In view of that, it is also possible to conclude that only LOB provisions, inserted in the treaties or domestic regulation, may be able to curb *treaty-shopping*, effectively, since, in this case, the taxpayer is required to prove not only his nationality or residency, but, most of all, the prerequisites related to his economic activity and accounts.

¹³⁶ CHATEL, Sophie. *Treaty-shopping: A Canadian Case Study and the International Scene*. Available at: <www.ceff.univ-cezanne.fr/documents/chatel.doc>. Downloaded in 11 mar. 2011.



Furthermore, if it was previously risky to propose any anti-treaty-shopping measure; it may rest assured that only the States who guarantee the full right to fiscal planning, will experience sustainable economic growth. The controversy remains and there is still a lot of ground to cover.

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