**METHODS OF TAX AVOIDANCE**

In the past, two basic strategies (which can be combined) have been mainly used

to achieve these ends: increasing the prices of payments and changing the type of

payments. To take some simple examples, a local subsidiary operating an assembly plant

can pay inflated prices for the components and the technical and management services it

purchases from related companies; or a nonresident parent company can invest in the

subsidiary by way of loan capital rather than share capital and receive interest payments

(deductible to the subsidiary) instead of dividends (usually not deductible to the

subsidiary). Similar results can be produced by reducing the amount of payments for

goods or services to the local branch or subsidiary for goods or services it provides to

other (nonresident) members of the group. Recently, international tax planning has

become more sophisticated along with the financial markets. The following discussion

will start with the simpler methods of tax avoidance and then move to more recent

techniques.

***1. Transfer Pricing***

“Transfer pricing” is the general term used to refer to the problem of allocating

profits among the parts of a corporate group. For the group as a whole, all that matters at

the end of the day is the after-tax profit of the group rather than of its individual

members. The prices charged within the group for goods or services provided and the

financing methods used between the members of the group simply serve as means of

moving funds around the group and do not in a commercial sense create profits for the

group. Hence, there is often no obstacle to charging any price or structuring a transaction

in any way within the group, and the fair or proper distribution of the overall group

profits among the companies in the group is often a secondary consideration to tax

consequences. In financial accounting, which seeks to determine profits for reporting to

shareholders and others with financial interests in the group, the response is to require

accounts for the enterprise (group) as a whole and to eliminate transactions within the

group, as well as (in most countries) accounts for each company in the group.

In taxation, it is necessary to allocate profits among the companies in the group

because under international tax norms a country will tax a nonresident only on the profits

sourced in that country. While the country can tax a local (resident) subsidiary on its

profits worldwide, affairs within a multinational group will usually be arranged so that

the subsidiary only has profits sourced in that country. In theory, this allocation of profits

can be effected in one of two main ways. A country can take the worldwide profits of the

group and allocate some portion of those profits to a source in that country, thus

bypassing the need to consider the pricing and nature of transactions within the group.

Alternatively, the country can seek to determine the profits of a local branch or subsidiary

separately from the rest of the group on the basis of the pricing and nature of the

transactions engaged in by the branch or subsidiary with the rest of the group. In the

former case, it is necessary to have allocation rules based on formulary criteria like

relative assets, revenues, or salaries (and so this method is often referred to as formulary

apportionment), while in the latter case rules are needed to deal with the problems arising

from the special nature of transactions within the group.

While arguments range back and forth as to which method is preferable, in

practical terms countries pursuing a policy of negotiating tax treaties are automatically

tied into the separate accounting method because articles 7 and 9 of the OECD and UN

Model treaties operate on the basis of taxing each company within the group separately

and dealing with problems of pricing and the nature of transactions on the basis of the

arm’s-length principle. Under this principle, adjustments are made to transactions within

the group to reflect the terms and nature of transactions that would have been entered into

if the transaction had been made with an independent third party rather than with another

part of the group.

A drafting issue for the domestic law is that the arm’s-length principle should be

provided for both branches and subsidiaries. This is most easily done by using language

similar to that found in tax treaties. Such an approach ensures that there is a basis in

domestic law for making transfer pricing adjustments. In many countries, it is not clear

whether tax treaties on their own would provide a sufficient basis for such adjustments,

and, in any event, it is necessary to have the rules in the case of residents of countries

with which there is no tax treaty in force. Using statutory language based on treaties has

the added advantage of giving a clear signal that the country intends to follow

international norms.

Article 7(4) of the OECD and UN Models provides that a country can maintain a

customary method of calculating the profits of branches, so long as the result is in accord

with the arm’s-length principle (a further provision in each case provides for the

application of the same method from year to year unless there is good reason to the

contrary). Some countries use simplified profit calculation methods for branch cases

(such as a specific percentage of turnover of the branch). These methods can be retained

in the legislation insofar as they reasonably reflect actual profits and can be used in cases

where tax treaties are involved. The application of the arm’s-length principle to branches

is more complex in one way than in the case of subsidiaries, because the branch and the

head office are part of the same legal person, and transactions cannot be sensibly

reconstructed in some cases. For example, it is often difficult to allocate notional

ownership of property between head office and branch.

Simplified methods in domestic legislation are not generally regarded as

consistent with article 9 of the OECD and UN Models in the case of related companies,

but this does not mean that countries are confined to making tax adjustments between

related companies only in international transactions and on arm’s-length principles. Some

countries apply their transfer pricing rules in purely domestic cases; where there are

different tax rates for different kinds of income or business, taxpayers can use transfer

pricing to move profits to categories of income or business with lower tax rates. There are

also a number of reasons why countries may wish to have special pricing rules for

specific transactions. For example, some countries treat all disposals of property without

consideration as having been made for market value— whether between related parties or

not—while others treat gifts of property to charities as having been made for the higher

of cost or market value. These rules do not directly deal with transfer pricing issues. To

the extent that they can apply to international transactions between related parties, they

will not generally be contrary to tax treaty arm’s-length pricing rules. How all these rules

are coordinated within the tax legislation depends on the specific rules adopted and

should be reviewed carefully in each country.

To achieve the application of the international arm’s-length principle in practice,

the tax administration starts with the accounts of the local branch or subsidiary, makes

the usual adjustments to reflect differences between financial accounting and tax rules,

and then makes such further adjustments in accordance with the arm’s-length principle as

necessary. Nontax considerations may lead to the group preparing its branch or

subsidiary accounts on this basis in any event. For management purposes, the group will

wish to know the real profitability of its separate parts, local employees may be

remunerated in part on the basis of the local contribution to group profit, and local

accounting rules will likely require that the financial accounts give a proper view of the

profits of the branch or subsidiary. In practice, the tax administration may use simplified

methods and various financial ratios that are similar to formulary apportionment in order

to test whether the profits reported by a local branch or subsidiary fall within acceptable

boundaries. These methods frequently operate as a means of selecting taxpayers for

further checking (audit). The use of such administrative methods will not be contrary to

tax treaty rules so long as they are being used as a means to the end of establishing the

arm’s-length price.

The increasing integration of the activities of corporate groups, the growing

importance of unique intragroup intangibles and services, and the sophistication of their

financing operations mean, however, that application of the arm’s-length standard is

becoming more difficult, both conceptually and practically. The problems have been

addressed in part by the OECD, which has updated and expanded its guidance on this

issue.125 The OECD standards represent the internationally accepted norms giving

content to the arm’s-length principle.

Transfer pricing adjustments on the arm’s-length principle have traditionally been

viewed as involving price only (as the name suggests) and not the reconstruction of

transactions in the sense of disregarding the nominal transaction between the related

parties and substituting another arrangement for tax purposes. The transfer pricing

guidelines,126 while recognizing that adjusting prices of actual transactions is the norm,

do permit tax administrations to recharacterize transactions in two exceptional

circumstances, first, “where the economic substance of a transaction differs from the

form” and secondly, where the “arrangements made in relation to the transaction, viewed

in their totality, differ from those which would have been adopted by independent

enterprises behaving in a commercially rational manner and the actual structure

practically impedes the tax administration from determining an appropriate transfer

price.”127 The example of thin capitalization is given for the first category (see next

heading) and, for the second, the outright transfer of intangible property before its value

is fully known when independent parties could have been expected to enter instead into a

continuing research agreement (under which payments would not be irrevocably fixed in

advance).

Increasingly, countries are enacting general provisions in their tax laws directed

against tax avoidance, which give powers to reconstruct transactions.128 It seems to be increasingly accepted by the OECD that such rules are not in conflict with tax treaty

obligations and can be applied to international transactions.

125OECD, Attribution of Income to Permanent Establishments (1994); OECD, Transfer Pricing Guidelines

for Multinational Enterprises and Tax Administrations (1995, updated 1996, 1997). The problem that

transfer pricing currently represents for developing and transition countries is one of administrative

capacity. The development of advance pricing arrangements with the encouragement of the OECD (*see*

*infra* note 160) may simplify the administrative task of transition and developing countries in the future by

supplying readily applicable formulas for various economic sectors.

129 While such rules in

conjunction with transfer pricing rules expressed in the general terms suggested above

can deal with many problem situations, they can leave taxpayers uncertain as to their

position. Accordingly, countries are increasingly enacting more specific provisions to

deal with particular cases and to spell out the rules in more detail, as, shown for example,

under the next heading.

***2. Thin Capitalization***

Thin capitalization is the practice of excessively funding a branch or subsidiary

with interest-bearing loans from related parties rather than with share capital.130 The fact

that interest is usually deductible for the borrower and taxed to the nonresident lender at a

low rate of withholding tax (or not at all in some cases) while in most cases company

profits funding dividends are fully taxed makes the practice attractive taxwise to a

nonresident investor. Although it is possible to deal with these problems under the arm’slength

principle, taxpayers and tax administrators often want more guidance on the level

of permissible loan funding for a subsidiary than to be told that related party loans can be

made up to the point and on the terms that an independent third-party lender would allow,

having regard to the other liabilities of the subsidiary. Thin capitalization rules seek to

deal with this problem by denying deductions for interest in defined cases (and possibly

recharacterizing the payments of interest as dividends).

Tax law provisions in this area can be drafted in a large variety of ways. One

important constraint is the nondiscrimination article in tax treaties. In its typical OECD

and UN form, this article overrides thin capitalization rules that apply only to payments

of interest to related nonresidents by resident enterprises or by branches of nonresidents

unless the rules are applied in accordance with arm’s-length principles. Another

constraint arises from tax administration concerns. If loans by certain lenders only, such

as related nonresidents, are affected by the rules, it is possible to get around this

limitation through back-to-back loans.131 Rules can be drafted to deem such loans to have

been made by the parent company—and so subject to the thin capitalization limits—but it

is very difficult for the tax administration in the country of the subsidiary to detect such

transactions, especially if the bank is located in a country with strict bank secrecy laws.

One possible solution to problems of this kind is to make the rules generally applicable to

all loans for which interest deductions are claimed. Hence, although the specific problem

arises in the context of foreign direct investment, the solution for practical reasons may

be across the board for all investment.

129*See* OECD, Taxation of New Financial Instruments (1994) and the resulting change to the Commentary

on art. 11 of the OECD Model in 1995 para. 21.1; David Ward, *Abuse of Tax Treaties*, *in* Essays on

International Taxation in Honor of Sidney Roberts 397 (Herbert Alpert & Kees van Raad eds. 1993).

130*See generally* International Fiscal Association, International Aspects of Thin Capitalization, 81b Cahiers

de droit fiscal international (1996).

131*See supra* text accompanying notes 92–93.

Further issues relate to the way in which the denial of interest deductions is

calculated. One common approach is to provide express ratios of loan capital to share

capital beyond which interest deductions are denied (debt to equity rules).132 Another is

to limit interest deductions by reference to a proportion of the income of the taxpayer

(earnings-stripping rules).133 What the appropriate financial ratios are in each case is also

an issue (anywhere between 1.5:1 and 3:1 being common for debt-equity rules) as is the

application of the rules to financial institutions whose business consists in borrowing and

lending and which typically operate at much higher debt levels than other businesses. The

following draft suggests a possible approach to these issues.

1. A taxpayer, other than a bank or a financial institution, is denied a deduction

for interest in excess of the product of three times the net income-producing assets

of the taxpayer and

(a) in the case of a loan denominated in the currency of *X*, 110 percent of

the interest rate charged on loans by the Central Bank of *X* to commercial

banks on the last day of the preceding tax year; or

(b) in the case of a loan denominated in a foreign currency, 110 percent of

the interest rate charged by the U.S. Federal Reserve on U.S. dollar loans

to U.S. banks on the last day of the preceding tax year.

2. The net income-producing assets of a taxpayer are assets giving rise to income

that is included in the gross income of the taxpayer less liabilities relating to those

assets, each averaged between the beginning and end of the tax year.

3. With the prior written permission of the tax administration, a taxpayer may

(a) calculate net income-producing assets on an alternative basis; or

(b) in the case of a loan denominated in a foreign currency other than U.S.

dollars, use a different interest rate based on the interbank rate of the

central bank responsible for that currency.

4. Any excess interest that is not allowed as a deduction in a tax year solely as a

result of the application of this provision is treated as interest expense of the

taxpayer in the following tax year.

Paragraph (1) limits the interest deduction to an amount obtained by multiplying a

specified interest rate and three times the net income-producing assets (equity) of the

taxpayer. This draft thus provides effectively a 3:1 debt-equity ratio. No limitation in

terms of related parties or nonresidents is contained in the provision for reasons already

given. Banks and other financial institutions are excluded from the provision altogether,

but it would be possible to specify an alternative ratio for this case based on the

prudential rules of the central bank for commercial banks. Rather than specifying the

amount of loans on which interest is deductible, which is the approach many countries

take, the provision directly calculates the amount of interest. This method has two effects.

It eliminates the need to calculate the amount of loans, which can be complicated in

certain cases, and deals with the problem of excessive interest rates being charged on

loans between related parties rather than leaving this as a separate issue for the transfer

pricing rules. If an explicit rule is to be provided for thin capitalization, it may as well

spell out all the elements.

The interest rate is specified in paragraph 1 using the base rate charged by the

central bank at the end of the previous tax year. The provision deals with loans in foreign

currency by setting an interest rate based on the international reserve currency, the U.S.

dollar, but also permits in paragraph 4 the use of other (major) currencies with the

permission of the tax administration. Whether a reference to foreign currency is

necessary depends on the rules adopted for dealing with foreign currency in the tax

legislation, which are discussed in chapter 16. If, for example, foreign currency

conversions are dealt with by recalculating foreign currency assets and obligations at the

end of each tax year, giving rise to income or expense accordingly, then no rule for

foreign currency is necessary in this provision. The interest rate is set by reference to the

end of the previous tax year so that taxpayers know the operative rate at the beginning of

the relevant tax year. The central bank rate is marked up by one-tenth on the assumption

that most borrowers will not be able to obtain funding at central bank rates.

The net-income producing assets of the taxpayer are defined to include only

assets that give rise to income that enters the calculation of taxable income. It is assumed

in this draft that interest will be deductible only to the extent that it relates to the

production of income included in the calculation of taxable income, which is not the

position in all countries. Generally, the calculation is effectively the total assets less

liabilities averaged between the beginning and end of the year. For resident companies,

the capital and retained profits in the tax balance sheet are effectively equivalent to assets

less liabilities (assuming there are no major categories of exempt income for such

companies, such as foreign business income). Individuals will often not have a balance

sheet as such, and so the calculations of assets less liabilities needs to be made

specifically for each case. For nonresidents, only assets giving rise to income sourced in

the country and taxed on a net basis after deductions enter the calculation along with their

accompanying liabilities. Given that many countries employ final gross withholding taxes

on the income of nonresidents, except for income from real property and business (see

above), the loans to which the rules apply for nonresidents are likely to be limited.

Where the income-producing assets are shares, the appropriate treatment can be

more complicated. Although dividend income is taxed in some countries at a final rate of

tax on a gross basis for resident and nonresident shareholders, shares should be included

for the purpose of this draft if interest expenses relating to such income will be allowed as

a deduction. It is possible, for example, for intercorporate dividends to be exempted so as

to eliminate the cascade of company taxation through chains of companies, but for

interest expenses relating to the dividend income to be deductible. The rules here need to

be coordinated with the interrelationship of the taxation of dividends and the allowance

of interest deductions relating to dividend income, but beyond this general caution it is

not possible to be specific.

The tax administration may give permission under this draft to vary the

calculation of net income-producing assets where the calculations required above are

difficult to apply in the particular circumstances of the taxpayer. Interest disallowed as a

deduction under this draft is not permanently disallowed but is carried forward and

treated as an interest deduction of the succeeding year. The same calculation is then done

for that succeeding year under this draft, and it may turn out that the interest deduction is

allowed in that year. The disallowed interest is not treated as a dividend or some other

form of payment. Country practices vary widely on this aspect of thin capitalization.

Where countries also have general rules relating to characterization of investments as

share capital or loans, it will be necessary to consider how those rules should be

coordinated with the thin capitalization area. Tax treaties also have standard definitions

of interest and dividends that do not provide clear guidance in the thin capitalization area.

The OECD Commentaries seem to indicate that it is permitted but not obligatory to

recharacterize interest that is disallowed under thin capitalization rules as dividends.134

The carryover of interest deductions in the draft will need to be coordinated with

the general carryover of losses in the tax legislation, although coordination is likely to be

automatic. The general rule for loss carryover is likely to apply only to deductions that

are allowed in a particular tax year and that exceed income; because interest in excess of

the permitted amount under this draft for a particular tax year is not allowed as a

deduction in that year, it cannot enter such a carryover loss.

While a number of detailed issues would require elaboration in the practical

application of the draft (e.g., the identification and valuation of assets and liabilities that

are used in the calculation of net income-producing assets), what the draft conspicuously

fails to do is to define “interest.” The reason is that, with the advent of modern financial

instruments, interest is an increasingly difficult concept. We turn now to these

instruments.

***3. Modern Financial Instruments***135

The previous heading left open the definition of interest, that is, the

characterization of payments as interest or something else. Other issues that have to be

considered in the international domain are the source rules, nonresident withholding

taxes, and deductions available to the payer for payments under modern financial

instruments. The specific focus of the discussion for the moment is direct investment

involving related parties.

Because of the complexity of these issues, OECD countries are still searching for

solutions. Hence, it is impossible to provide widely accepted methods that may be of use

to developing and transition countries, but it is possible to suggest some partial solutions

and note the problems that remain. The solutions that are adopted will need to be closely

related to the more general question of how modern financial instruments are dealt with

in purely domestic cases to ensure that the domestic and international regimes are

consistent.

If a narrow definition of interest is adopted in domestic tax law (which is the

typical case where new financial instruments have not been specifically addressed in the

tax system), then it will be a simple matter for the taxpayer to use some financial

instrument that does not generate interest but that is a functional equivalent so as to avoid

rules that refer to interest. For example, an interest swap arrangement can be structured to

be the equivalent of a loan, but swap payments are not regarded as interest in many

countries. (An interest rate swap is a financial transaction in which two parties agree to

make streams of payments to each other calculated by reference to an underlying or

notional principal amount; in its simplest form, it involves an agreement between two

parties to make each other’s interest payments on their respective loans.) In this case, any

attempt to deal with thin capitalization will be aborted unless some general antiavoidance

rule is applied to recharacterize the payment as interest in the particular circumstances.

If a broad definition of interest is adopted to deal with this and similar problems (such as

any payment or accrual under a financial arrangement widely defined), then it is

necessary to adapt the source, withholding, deduction, and related party rules to the

broader scope. One particular problem arises from the fact that tax consequences—

inclusions in income or deductions—under regimes dealing with modern financial

instruments often occur on an accrual basis (i.e., on an internal-rate-of-return calculation

or a mark-to-market rule) without any actual payment. Lack of a payment poses problems

for withholding taxes, for example.

Take the relatively straightforward case of a zero coupon bond where the issuer

receives $100,000 on issue and undertakes to pay $161,051 on redemption of the bond in

five years. This transaction is the equivalent of a five-year loan of $100,000 at 10 percent

135For a general discussion of domestic and international issues, see OECD, Taxation of New Financial

Instruments (1994), International Fiscal Association, Tax Aspects of Derivative Financial Instruments 836,

Cahiers de droit fiscal international (1995); and Australian Treasury and Australian Taxation Office,

Taxation of Financial Arrangements, An Issues Paper (1996).

annual compound interest with interest payment only on redemption. In a number of

countries, this transaction would be treated as giving rise to interest income and

deductions in a purely domestic case for the five tax years of $10,000, $11,000, $12,100,

$13,310, and $14,641, respectively. If the holder of the bond is a nonresident, it is

difficult to collect tax annually because there is no payment to subject to withholding tax,

although it is possible to require the issuer to pay tax annually as if a payment had been

made. If nonresident withholding tax is postponed until the end of the five-year period,

the nonresident may sell the bond to a resident before redemption and avoid the tax

(assuming that there is no final interest withholding tax on payments to residents). If tax

is collected from the issuer annually and the nonresident sells the bond to another

nonresident, the buyer and seller will have to be aware that the issuer has been paying tax

and take account of the tax in the pricing of the bond; if the buyer and seller are resident

in different countries, the issuer may have to adjust the amount of tax withheld after the

sale because of different tax rate limits in the tax treaties involved.

Mechanical solutions can be devised to deal with the problems of withholding and

timing of deductions, for example, levying the nonresident withholding tax only on

payment and postponing deduction for the issuer until that time. These solutions usually

bring with them practical enforcement problems and borderline issues where different

regimes are being applied in different cases. What, for example, is the effect on accrued

deductions and inclusions in income in this case where the nonresident transfers the bond

to a resident and an accrual system is in place between residents? Not surprisingly, even

in the relatively simple case of a zero coupon bond, there is little agreement as to the

appropriate international tax regime and a large amount of diversity in practice. Some

countries do not even assimilate such a payment to interest, let alone deal with timing and

withholding issues.

For more sophisticated instruments, such as interest rate swaps and currency

hedges, withholding tax can make legitimate transactions uncommercial for reasons

similar to those discussed above in relation to interest withholding taxes on ordinary

loans. Many countries have therefore not extended their interest withholding tax to these

cases. This limitation creates a relatively simple way to avoid withholding tax, especially

between related parties. If, in response to this problem, withholding taxes on new

financial instruments are directed to transactions between related parties, problems arise

with back-to-back transactions.136

As to source of income, it is possible to create special rules for payments under

new financial instruments, even if the payments are not characterized as interest. Without

special source rules or recharacterization as interest so that the interest rule applies, the

source rules for whatever category the payments are placed in will govern (e.g., business

income or capital gains), which may allow nonresident parties to avoid source tax on

what is equivalent to interest by manipulating the source rules.

Modern financial instruments may also allow parties, especially by combining

different instruments, to make an equity position look like debt and vice versa. In the

international context, this could lead to substantial erosion of the corporate tax base in

relation to subsidiaries in developing and transition countries for what is essentially

equity investment. The thin capitalization discussion above dealt with this problem in the

case of related parties, where, what is pure debt in a formal sense can be viewed in effect

as share capital because no independent third party would have made a loan in the

situation. Modern financial instruments open this position up more generally even for

portfolio investors (see below) and allow related parties in many cases to escape thin

capitalization rules.

Tax treaties further complicate the international situation because they were

framed before the era of financial innovation and use traditional categories. The OECD

Commentary on the interest article was recently changed to clarify the issue as follows:137

The definition of interest in the first sentence of para. 3 does not normally apply to payments made

under certain kinds of nontraditional financial instruments where there is no underlying debt (for

example, interest rate swaps). However, the definition will apply to the extent that a loan is

considered to exist under a “substance over form” rule, an “abuse of rights” principle, or any

similar doctrine.

The import of this para. seems to be that hedges and swaps will not be regarded as

giving rise to interest, except when a transaction has been deliberately manipulated to

substitute a future or a swap for what would otherwise have been a normal borrowing

operation and when domestic law has recharacterized the transaction to give rise to

interest under an antiavoidance measure. Although the Commentary does not say so,

payments of discounts under zero-coupon bonds seem to be accepted as interest for the

purposes of tax treaties. The result is that many payments under modern financial

instruments to nonresidents will be characterized as business profits, capital gains, or

other income, and, for treaties in OECD Model form, the result is that the source country

will not be able to levy tax unless the payments are connected with a permanent

establishment of the nonresident in the country. To partially address concerns in the

related-party area, the OECD Commentary on article 21 has also been revised to include

a suggested treaty provision that will allow recharacterization of payments in this kind of

case.138

Against this complex backgound, what action can a developing or transition

country take to protect itself against the sophistication of modern financial markets and

multinational enterprises? A number of factors suggest a focus on the deduction area in

the form of a general thin capitalization rule, combined with a comprehensive definition

of interest for the purposes of the rule to catch all payments under modern financial

instruments to the extent they would otherwise be deductible. First, this approach is not

contrary to tax treaties, whereas the scope for action in the withholding area is clearly

limited by treaties; second, back-to-back problems with related parties can be avoided;

and third, the problem of chacterization between debt and equity in relation to direct

investors is addressed. How the definition of interest is framed for this purpose will

depend on whether the country has comprehensive rules dealing with modern financial

instruments for general domestic purposes, in which case definitions from that regime

can be adopted. Experience to date suggests that a definition framed in general terms is

preferable to a list of the kinds of instruments that are covered, given that the number of

available instruments increases daily.

As regards withholding tax and source rules, the tax treaty position means that all

that can be done directly is to maintain the traditional withholding tax on interest and

consider extending it to zero-coupon bonds and similar instruments, although a number

of technical problems will arise in doing so, as discussed above. The extract quoted from

the OECD Commentary above strengthens the case for including a general antiavoidance

provision in domestic law so that it can be applied (especially in the case of related

parties) to recharacterize payments under modern financial instruments as interest and

can subject them to the interest withholding tax accordingly. Back-to-back transactions

may make the involvement of related parties difficult to detect, but the possibility of

applying the antiavoidance provision and any resulting penalties may provide an

incentive for related parties to fund local branches and subsidiaries by ordinary loans up

to the limit permitted by the thin capitalization rules and to pay withholding tax on the

resulting interest, thus limiting the problems.

***4. Payments to Tax Havens***

Where an industrial country resident makes a direct investment in a subsidiary in

a developing or transition country, the residence country of the parent will be operating

either an exemption system or a foreign tax credit system to relieve double taxation. At

first sight it seems, in an exemption system, that there is no residence country concern if

income is shifted out of the source country to the residence country because the income

will be exempt. This, however, is not the outcome. If the profit shifting involves transfer

pricing, whereby the parent charges inflated prices for the goods or services that it

provides to the subsidiary, the increase in the parent’s profits will be taxable in the

residence country. This result follows because the profits will not usually be regarded as

income sourced in the source country that attracts the exemption but rather as an increase

of income sourced in the residence country (e.g., increased manufacturing profit) and so

taxed there.

Similarly, if thin capitalization of the subsidiary by the parent is used to shift

profits out of the source country, the interest received will probably not be exempt to the

parent because the exemption usually extends only to business profits of a branch and

dividends on direct investments in subsidiaries, and not to interest taxed by low-rate gross

withholding in the source country (especially where the tax rate has been limited by a tax

treaty). While there may be reasons why a parent company would find it advantageous to

shift profits from the source country to the residence country (such as an imputation

system in that country that bases tax credits to shareholders on residence country tax

paid), often this form of profit shifting will effect little tax saving. In a residence country

operating a foreign tax credit system, shifting profits out of the source country to the

residence country as a means of lowering tax in the source country will usually lead to a

corresponding increase in residence country taxation.

Accordingly, tax planning by multinational company groups is likely to be

directed simultaneously to reducing source country and residence country taxation, which

means in many cases that a third country needs to be found to which the profits can be

shifted. Tax havens will be used for this end. In the transfer pricing case, one possibility

would be for the parent company to sell the goods to a related company in a tax haven for

cost plus an artificially small profit (thus shifting part of the profit out of the residence

country). The tax haven company then on-sells the goods to the subsidiary in the source

country at an inflated price that leaves little profit to that subsidiary and most of the profit

with the tax haven company. Similarly, in the thin capitalization case, the parent

company may invest in a tax haven company by way of share capital (equity), and that

company then lends to the subsidiary. Interest paid to the tax haven company will not be

taxed in the tax haven. In each case where the country of the parent company is an

exemption country, the tax haven subsidiary may be able to pay a dividend tax free to the

parent so that the profits end up with the parent company having suffered very little tax.

If the residence country of the parent company is a foreign tax credit country, the profits

can often be retained in the tax haven company and used for group operations in other

countries without attracting tax in the parent’s residence. Again, the overall result is

payment of little or no tax in the source or residence country.

Given that both the residence and source countries are suffering from this tax

haven activity, action can be expected from both. The source country may deny

deductions for payments by resident companies or by branches of nonresident companies

to tax havens or may permit deductions subject to special conditions.139 A rule of this

kind has a number of problems. It is necessary to have a list of countries that are treated

as tax havens, and, although such lists are readily available, they need frequent updating.

The rule reintroduces the problem of the back-to-back transaction, in that the tax-havenrelated

company in the thin capitalization case above can, for example, route the loan

through a bank in a country that is not a tax haven. Such a rule may also affect quite

legitimate payments to tax havens (which in a number of cases are major financial and

trading centers in their own right). Finally, if a tax treaty is in force with the tax haven,

the rule may fall foul of the nondiscrimination provision in the treaty (obviously, great

care is needed in negotiating a tax treaty with a tax haven).

Nevertheless, a rule focusing on payments to tax havens should be considered in

some form, for example, a tax clearance system for payments that, to the knowledge of

the payer, are made directly or indirectly to tax haven entities. Another possibility is to

require all companies and branches in the country to report selected information on

transactions with tax havens or more broadly on international transactions.140

***5. Double-Dipping***

Alternative techniques for reducing source and residence taxation that have been

used in recent times seek to double up on favorable tax rules in both source and residence

countries (generally referred to as double-dipping). A variety of methods are used.

One method is to exploit differences in the tax law treatments of the same

transaction in the source and residence countries. A common example has been the

financial lease of equipment. Some countries recharacterize finance leases for tax

purposes as purchases and loans, while other countries treat them in the same way as

operating leases (i.e., the lessee is treated as paying rent and the lessor as being the owner

of the equipment).141 The result is that two countries can end up treating two separate

taxpayers (one country the lessor and the other country the lessee) as the owner of

equipment and entitled to depreciation and interest deductions. Given that rent in

economic terms is equivalent to depreciation and interest, the difference in treatment

should not produce a substantial tax variance, but many countries have tax incentives for

investment in capital equipment in the form of accelerated depreciation, investment

credits, or allowances. Where two different taxpayers are treated as the owner of the

equipment in different countries and each is entitled to these incentives in one of the

countries, the taxpayers effectively double up on the incentives in a way not intended by

either country.

It is not clear, however, which country is being disadvantaged in tax terms and

which might therefore be expected to take remedial action. One of the affected countries

could enact a rule that investment incentives will not be available under its law when

similar incentives are being obtained in respect of the equipment under the law of another

country, but the rule will lead to circularity if both countries adopt it. Alternatively, a

country may limit investment incentives to equipment used in the country, which will

work in most cases, although not for mobile equipment like airplanes. Another solution is

for each country to do away with or reduce the investment incentives, as in fact happened

in many industrial countries during the 1980s (for more general policy reasons having

little to do with the problems of international tax avoidance). Where a developing or

transition country adopts this kind of investment incentive, a rule limiting the benefit of

the incentive to equipment used in the country is probably the easiest way to ensure that it

does not suffer unduly from double-dipping of this form.

140For example, sched. 25A to the Company Income Tax Return in Australia requires extensive reporting of

information on international transactions, and a number of countries have special powers for collecting

information from foreign persons, AUS ITAA § 264A; USA IRC § 982.

Another form of double-dipping that has been much exploited involves dualresidence

companies. Some countries permit grouping of the income and losses of

commonly owned resident companies (often achieved by permitting the transfer of tax

losses to related companies). If the same company is resident in two such countries and

has borrowed to finance group operations (whether in those countries or elsewhere), it

may be able to deduct the interest in each country. If it has little or no current income, a

loss will arise from the interest deductions that may be able to offset the income of two

related companies, one in each country where the loss company is resident. Again, it is

not clear which country is the loser from this transaction. Nevertheless, a number of

countries have enacted rules that prevent the losses of dual-residence companies arising

from financing transactions being used to offset the income of any other related company

in the country; that is, the losses can be used only to offset future income of the dualresidence

company.142 If a developing or transition country does not permit the transfer of

losses within a group of companies, it is unlikely to suffer from this particular doubledipping

problem. It follows that care should be exercised in permitting transfer or

consolidation of losses for tax purposes among commonly owned resident companies.

The deduction of the same expense in two countries is not of itself a cause for

concern. Where a resident of a foreign tax credit country has a branch in another country,

it will typically get deductions for the same expenses in the source and residence

countries. These deductions will generally be offset, however, against the same income

that each country is taxing, with the residence country giving double tax relief. The

double-dipping problem usually involves the offsetting of the same deductions against

different income of different taxpayers. As there are probably as many ways for taxpayers

to exploit differences in tax systems of different countries as there are differences, and as

the outcome is often ambiguous in terms of whether tax avoidance is involved and which

country is suffering an unfair reduction in tax, it is likely that double-dipping will

continue to be a difficult international tax problem without a clear solution.

***6. Treaty Shopping***

Tax treaties themselves may become the object of tax avoidance activities, even

though they often express the purpose of preventing tax avoidance. This possibility was

of course never intended by the original framers of model tax treaties and is not in itself

sufficient reason for a country to reject the negotiation of tax treaties as their benefits

usually outweigh the detriments. The possibility of abuse arises from two features of the

tax treaty network—its incomplete coverage of the world and its bilateral structure. The

former feature flows from the latter because it is not possible to negotiate with virtually

all of the countries of the world at once (as contrasted, say, to the Uruguay Round of

multilateral trade negotiations of the General Agreement on Tariffs and Trade); the latter

is regarded as flowing from the wide variations in tax systems around the world, so that it

is felt necessary for each country to handcraft a tax treaty accommodation with other

countries one by one.

A resident of a country that does not have a tax treaty with a particular developing

or transition country can simply incorporate a subsidiary in another country that does

(usually one with which the investor’s country also has a treaty) and route its investment

through that subsidiary, which will be entitled to the reduced tax rates and other

protections available under the treaty. Alternatively, a resident of a country with which

the developing or transition country does have a treaty may seek what it regards as better

tax treatment under another tax treaty by the same route.

For example, the treaty between the investor’s country and country *X* may have a

10 percent rate limit on royalty payments. If that investor can find another country that

has a tax treaty with country *X* that contains a zero tax rate on royalties, then it will be

possible to route a licensing transaction through a subsidiary in that country and eliminate

the source country royalty tax; if that third country in turn has a treaty with the investor’s

country containing a zero tax rate on royalties, it will be possible in turn to pay the

royalty on to the investor without tax in that country. These examples assume that the

royalties are deductible in each country by the person who is paying them. The

nondiscrimination article of tax treaties will normally ensure that they are deductible on

the same basis as royalties paid domestically, so that the assumption will be correct in

most cases.

This kind of practice is known as “treaty shopping.” A country can prevent treaty

shopping by seeking to ensure that its treaties with other countries are uniform in their

main elements, especially the tax rate limits on interest and royalties and the definition of

permanent establishment. If all treaties to which country *X* is a party have a 10 percent

tax limit on royalties, for example, the planning in the second example in the previous

para. would not be possible. Many countries have been able to achieve this consistency in

their treaty negotiations and have thereby reduced the problems of treaty shopping.

Nonetheless, the possibility remains that residents of nontreaty countries will get treaty

benefits through related companies in treaty countries.

One way to deal with the problem is to insert a general provision in tax treaties

denying treaty benefits in such cases. The United States is the only country to practice

this approach in a comprehensive way143 although some other countries routinely insert

more limited treaty abuse provisions in specific articles of treaties.144 The Commentary

on article 1 of the OECD Model contains a number of possible provisions for this

purpose.145 Developing and transition countries may instead prefer to rely on general

143See U.S. Model Income Tax Convention of Sept. 20, 1996, art. 22, Limitation of Benefits.

144The United Kingdom includes special rules in the interest and royalty articles; the beneficial owner rule

in arts. 10–12 of the OECD Model also limits treaty shopping.

antiavoidance provisions in domestic legislation to deal with treaty abuse. While a view

is developing that such provisions are not inconsistent with tax treaties, it is probably

safer to spell out in the negotiations that the general antiavoidance provision of domestic

law will be applied to treaty abuses and to ensure that the general priority rule for tax

treaties in domestic law makes this relationship clear.146

***7. Combinations of Tax Avoidance Techniques***

International tax avoidance in many cases will utilize a combination of the

techniques outlined above. Thus, treaty shopping activities will often go hand in hand

with the use of tax havens and the interaction of tax treaties and domestic law. For

example, and by way of extension of the case of treaty shopping in the royalties area

discussed above, some countries do not in their domestic law charge withholding tax on

payments of royalties by residents to nonresidents for reasons that have been discussed

earlier. If such a country has a treaty with a developing or transition country containing a

zero royalty rate, a nonresident investor can incorporate a company there to receive

royalties from the developing or transition country and then arrange to have the royalties

paid to a tax haven company. If the royalties paid to this company equal the royalties

received by the company in the tax treaty country, no tax will be collected in that country

because the deduction for the royalties paid will wipe out the royalty income received and

no withholding tax will be levied on the outgoing royalties. Hence, the result will be

achieved of no tax at all being levied on the royalties (unless the residence country of the

ultimate owner of the tax haven company has a controlled foreign company regime of the

kind discussed below).

The financing of company groups often involves variations on double-dipping,

treaty shopping, and tax haven use. For example, a parent company may borrow to

finance investment by way of share capital in a tax haven finance subsidiary, which in

turn lends to an operating subsidiary in a developing or transition country through a backto-

back transaction with a bank in a country that has a tax treaty with the developing or

transition country, lowering the rate of withholding tax on outgoing interest. If the

residence country of the parent is an exemption country but nonetheless permits

deduction of the interest paid on the loan taken out to finance the investment in the tax

haven subsidiary, it is likely that the dividends received from the tax haven subsidiary

(representing the interest received by that subsidiary) will be exempt in the parent’s

residence country, and yet interest deductions may have been obtained in two countries

(that of the parent and the operating subsidiary) for offset against different income of

different taxpayers.

Because of the sophistication of international tax planning and its frequent

combination of domestic law, tax havens, and tax treaties, the taxation of nonresident

direct investors by developing and transition countries is not an easy task. An array of

provisions in domestic legislation (such as provisions on transfer pricing, thin

146*See supra* note 95; Australia makes this relationship clear in International Tax Agreements Act 1953

s 4(2). *See also* GEO TC § 4(8), (9).

capitalization and tax haven payments, and a general antiavoidance rule) and great care in

the negotiation of tax treaties will assist in dealing with the differing kinds of tax

planning.

A developing or transition country should make clear through explanatory or

administrative material that it does not intend to use (the threat of) multiple taxation to

penalize taxpayers. If it is felt that the problems of international tax avoidance justify

severer penalties than normal, then the tax penalty regime should provide for this

directly. Similarly, if higher levels of disclosure of information are required in the

international area, the legislation should provide for such disclosure explicitly. Care in

drafting such provisions is necessary to ensure that they are not in breach of

nondiscrimination provisions in tax treaties. For this reason as well as the considerations

raised in relation to residents below, the provisions should apply to both inward and

outward investment cases.

Stricter enforcement regimes may be viewed adversely by foreign investors and

temper their willingness to invest in the country in question. Each developing and

transition country has to judge this issue for itself. The same reluctance may also be

triggered by legislation directed at international tax avoidance practices. One possible

response (effectively giving in to the difficulties of enforcing international tax rules) is to

not include antiavoidance provisions of the kinds outlined above in domestic tax

legislation and so to allow nonresident direct investors to determine their tax level for

themselves. Alternatively, such provisions can be coupled with special tax regimes for

foreign investors conferring tax holidays and other tax privileges on them in specified

cases. The alternative approach nominally gives control over the targeting of the tax

benefits for foreign investors to the developing or transition country, although in practice,

as noted in chapter 23, it generally leads to other forms of tax avoidance.

***8. Nonresident Portfolio Investors***

The position of nonresident portfolio investors differs substantially from that of

direct investors. Because direct investors have control over the transactions undertaken

within the company group, they can engage in transfer pricing, thin capitalization, and the

like in ways not generally available to the portfolio investor. It is possible for portfolio

investors to employ tax havens and treaty shopping in some of their activities (e.g., using

tax treaties to obtain lower withholding tax rates on interest), but generally the scale of

the investment in a particular company by a particular investor is unlikely to justify

elaborate tax avoidance of the kind that may be practiced by direct investors.

The tax planning of the portfolio investor is likely to consist of portfolio choice.

For example, purchasing shares in a company resident in a developing or transition

country exposes the investor to the corporate tax and the withholding tax on portfolio

dividends, which is probably higher than the tax on dividends paid on direct investment.

Some portfolio investors (e.g., tax-exempt pension funds) will be tax privileged in their

residence countries and so may not benefit greatly from double tax relief in this case.

Failing special provisions in the law of the source or residence country (or both, possibly

through a tax treaty) to deal with the international implications of its special tax position,

the portfolio investor may adopt a different investment strategy, such as investing in

(profit-related) debt of the company resident in the source country and options over the

unissued capital of the company. In this way, it benefits from increases in the value of the

company’s shares and a share in its income stream without being exposed to much if any

tax in the source country (interest withholding tax probably being the only tax applicable)

while enjoying its tax privileges in the residence country. With the advent of modern

financial instruments, more sophisticated strategies are available to the portfolio investor

who wishes to be exposed to a particular market or company without the accompanying

source tax liabilities.

Often, the influence of the portfolio investor will be felt not directly but indirectly

in the source country through the foreign direct investor responding to the needs of the

portfolio investor. Since portfolio investment opportunities are often limited in

developing and transition countries (because of the lack of a stock exchange or very thin

trading in whatever stock market exists), portfolio investors more often than not will

invest in the multinational direct investors operating in the countries (and many other

countries) as a way of exposing themselves to investment in many countries and at the

same time minimizing risk by having multicountry coverage in the investment. As the

totality of investment in many multinational companies will be dominated by institutional

portfolio investors, such as pension schemes, banks, and insurers, the companies are

likely to adapt their tax profile to suit the institutional investors. If the preference of the

institutional investors is to have low taxed returns because of their privileged tax position

in their residence countries, the optimal tax strategy for the multinational company may

be to reduce its tax liabilities in all countries, which takes us back to the beginning of the

discussion in this section of the chapter.

Increasingly in recent times, international investment has developed many tax

niches, with offshore funds offering specialized investment products designed to appeal

to particular kinds of investors. The discussion of capital flight above dealt with one kind

of such fund in the case of resident portfolio investors. Here, the discussion concerns

similar funds designed for nonresident portfolio investors. To the extent that the

multinationals do not respond to the tax situations of their different classes of portfolio

investor, it is often possible to find a fund that consolidates portfolio investors with a

similar tax and investment profile and develops investment products that suit that profile.

While it often may not be worthwhile for a single portfolio investor to use treaty

shopping and tax havens for its operations, it is for such offshore funds. Hence, the other

major effect of portfolio investors in developing and transition countries is being felt

through the operations of such funds (with many specializing in investment in (particular)

developing or transition countries). To the extent that this investment is highly tax

sensitive, there is little that a developing or transition country can do to prevent offshore

fund tax planning in which the nonresident portfolio investor decides to invest in a

particular fund or to withdraw from the fund.

The major problem that the nonresident portfolio investor poses is the potentially

deleterious incentives that the investor’s tax position creates for direct investors to reduce

source country taxation. Hence, additional antiavoidance provisions are not necessary in

the law to deal with the tax position of the portfolio investor beyond what has been

canvassed in earlier discussion. If the source country specifically wants to cater for the

tax problems faced by foreign pension funds and the like, some suggestions have already

been made.

***9. Resident Investors***

Although developing and transition countries will most often encounter the forms

of tax avoidance outlined above in the case of nonresident direct investors, many of them

are equally available to residents of the developing or transition country (resident in the

sense that the ultimate investor is a resident of the country and is not foreign owned). It is

necessary in this case to distinguish two investment situations, first, where the ultimate

investment is made by the resident overseas and, second, where the ultimate investment

is made in the developing or transition country itself.

The first case is the more obvious but less frequent in practice from the point of

view of the developing or transition country. A resident engaging in direct investment

overseas can engage in transfer pricing and the other kinds of activities outlined above for

the dual purpose of reducing the tax in the country of source (where the investment is

made) and in the country of residence. Avoidance of resident country tax will often

involve the diversion of income from the country of residence to tax havens, combined

with manipulation of the system of double taxation relief. Avoidance of source country

tax in these kinds of cases is not directly the concern of the residence country, its main

concern being to protect its own taxing rights. The mechanism to control tax haven use

by residents that is increasingly being used in advanced market economies is to tax

residents on their share of low-taxed foreign income derived by nonresident companies

controlled by the residents. These “controlled foreign company” regimes are usually very

complex in operation.147

As regards the second case, initially it seems unlikely that a resident of a

developing or transition country would get involved in international tax avoidance for

investment in that country. In fact, however, a resident direct investor can easily appear

as a nonresident direct investor by channeling investment into the country through a

nonresident company that the resident owns. By this means, the possibilities of reducing

tax in the country by transfer pricing, thin capitalization, tax havens, and treaty shopping

become possible in a similar way as for true nonresident direct investors. In addition, the

resident can also by this route seek to enjoy any tax concessions given specifically to

nonresident investors.

This possibility of residents assuming the guise of nonresidents is closely linked

to the capital flight issue canvassed earlier, at least in transition countries. Capital flight

147The seminal comparative work on these regimes is Brian Arnold, The Taxation of Controlled Foreign

Corporations: An International Comparison (1986); for a more recent summary of current practice, see

OECD, Controlled Foreign Company Legislation (1996).

was the first reaction of many wealthy people there to the uncertainty and instability

created by the transition. As the situation has clarified to the extent that it is possible to

conduct profitable business operations in the countries, it seems likely that a number of

these people have reintroduced their capital into businesses as disguised foreign direct

investment. While the capital is thus reexposed to the risks that it was originally fleeing,

the ownership of the capital is usually hidden (as it often originates in tax havens), tax

concessions may be available, and further flight remains possible to the extent that the

capital remains mobile. There is some evidence that much of this capital is invested in

import-export and similar activities that do not anchor the capital in the same way as

investing in large-scale plant and equipment would.148

For both kinds of tax avoidance by residents, the provisions discussed above—

such as rules on transfer pricing, thin capitalization, tax havens, and general

antiavoidance—are available to deal with some of the problems. It was partly because of

the need to control circular transactions of residents taking capital offshore and

reintroducing it into the country that it has been suggested that many of the rules should

not be directed to nonresidents. Eventually, controlled foreign company regimes will be

needed, despite the difficulties that they entail. For the time being, the embryonic

measure that has been outlined above for the capital flight case can at least be adopted to

signal that a developing or transition country is aware of the international tax avoidance

techniques that residents may use and proposes to combat them.