

Alexandra Cooper

**Defining the Relationship
between Domestic General Anti-Avoidance Rules
and Double Tax Agreements**

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ABSTRACT

- Double taxation agreements pose a particular analytical problem. While they provide a coherent structure that encourages cross-border investment, the agreements also provide opportunities for taxpayers to avoid their domestic tax obligations. To prevent tax avoidance, some countries enact domestic general anti-avoidance rules to protect their domestic interests. These rules raise questions as to what the relationship between the domestic law and the double tax agreement is. The Organisation for Economic Cooperation and Development's Committee on Fiscal Affairs provides Commentary on the Organisation for Cooperation and Economic Development Model Double Tax Agreement. This Commentary sets out an analytical framework from which this relationship is to be evaluated. This paper argues that the framework is of little practical significance. The paper concludes that the weight and usefulness of the Commentary lies in a guiding principle set out in the Commentary. Consequently, the wider interpretative approaches do not practically add to the analysis and should be given little weight.*
- [Double tax agreements; international tax; Committee of Fiscal Affairs; domestic general anti-avoidance rules]

**IT'S TIME TO TALK: DEFINING THE RELATIONSHIP BETWEEN
GENERAL ANTI-AVOIDANCE RULES AND DOUBLE TAX
AGREEMENTS**

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Submitted for LLB (hons) degree

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I The Conceptual Problem

Tax avoidance in cross-border transactions is a growing problem for countries worldwide. With business becoming increasingly international, there is a greater need for coherent structures that facilitate cross-border transactions and help protect economies that are increasingly fragile and reliant on one another. An example of such a structure is double tax treaty networks. These networks are designed to prevent international double taxation. International double taxation is generally defined as “the imposition of comparable taxes in two or more States on the *same* taxpayer in respect of the *same* subject matter and for identical periods”.¹ By eliminating double taxation, the treaties encourage economic investment; promote the movement of capital and exchange of goods and services; and provide certainty as to the taxation that the investments will attract.²

However, double taxation agreements pose a particular analytical problem. This is because they provide opportunities for taxpayers to avoid domestic tax obligations and receive undue benefits under the treaty. This would be the case where someone acts through a company created in another State to obtain benefits that would not be available directly to the individual alone.³ While cross-border investment and transactions are attractive to national governments, international tax avoidance poses a threat to the integrity of domestic tax systems and the flow of revenue governments receive from them.

To counter-act undesirable avoidance, countries enact general and specific anti-avoidance rules to protect their domestic interests. This creates a direct tension between the domestic law and the international treaty and raises questions as to the relationship between them.

There are two fundamental principles to consider when evaluating approaches to the relationship between tax treaties and domestic anti-avoidance rules. First, the application of domestic anti-avoidance rules

¹ OECD Model Tax Convention, *Commentary* Introduction, at [1] (emphasis added).

² OECD Model Tax Convention, *Commentary* on Article 1, at [7].

³ *Commentary* on Article 1, above n 2, at [9].

may undermine the certainty of law and the inviolability of agreements struck between nations. This is balanced against the domestic interests of a state in maintaining the integrity of their tax system and not having their tax revenue exploited by abusive taxpayers.⁴

The relationship between domestic anti-avoidance rules and double tax treaties varies from country to country.⁵ Often commentators evaluate this relationship by looking to the explanation laid out in the Organisation for Economic Cooperation and Development (“OECD”) Model Commentary. This paper critically evaluates the approaches laid down by the Commentary and argues that the interpretative framework is unhelpful. The paper then evaluates alternative approaches commentators have used to characterise the differing relationships between domestic general anti-avoidance rules and double tax agreements. The paper concludes that these are also directed by a factual enquiry and rely on the OECD Model.

The paper also discusses concerns around whether the approach taken by the Commentary reflects potential agency capture or undue influence from sophisticated taxpayers on the Committee on Fiscal Affairs. The paper argues that despite the analytical framework contained in the Commentary, the guiding principle found in paragraph 9.5 of the Commentary should be the key and true framework for analysis. Finally, the paper evaluates the application of the guiding principle. The paper concludes that the principle would allow for domestic anti-avoidance rules to be used successfully and in line with international obligations. Further, the use of domestic anti-avoidance rules within this framework would be justified even considering concerns around unjustifiable uncertainty and inviolability of international agreements. Consequently, the paper argues that while

⁴ Craig Macfarlane Elliffe “International Tax Avoidance – The Tension between Protecting the Tax Base and Certainty of Law” (2011) *Journal of Business Law* 7 at [1.0].

⁵ *Commentary* on Article 1, above n 2, at [27]. See also: Craig Macfarlane Elliffe “International Tax Avoidance – The Tension between Protecting the Tax Base and Certainty of Law” (2011) *Journal of Business Law* 7 at [1.0].

the Commentary is central to OECD member's approaches to double tax agreements, the guiding principle should be the only principle given weight when evaluating the relationship between domestic anti-avoidance rules and double tax agreements.

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II OECD Model Commentary

The OECD Model Convention on Income and on Capital ("Model Convention") and associated commentary ("Commentary") was developed in recognition of the need to clarify and standardise the "fiscal situation of taxpayers who engage in activities in other countries".⁶ The Council of the OECD recommended that member countries should conform to the Convention when concluding double taxation agreements.⁷ Since its inception, the Model Convention has received worldwide recognition and has influenced negotiations involving non-member countries.⁸ The Committee on Fiscal Affairs developed the Commentary to help interpretation of the provisions and aid application of them.⁹ One area that the Commentary aims to clarify is how countries are able to protect themselves against improper use of the Convention by taxpayers.¹⁰

20

One way in which countries try to protect against avoidance of domestic tax liability is through general anti-avoidance rules within their domestic law. General anti-avoidance rules have operated in a number of common law jurisdictions including Canada,¹¹ New Zealand,¹² South Africa,¹³ and Australia.¹⁴ The International Fiscal Association has noted that without exception, domestic general anti-avoidance rules can have international effect and there is "no

⁶ OECD Model Tax Convention, *Commentary* Introduction, at [1].

⁷ OECD Model Tax Convention, *Commentary* Introduction, at [3].

⁸ OECD Model Tax Convention, *Commentary* Historical Background, at [14].

⁹ OECD Model Tax Convention, *Commentary* Introduction, at [3].

¹⁰ *Commentary* on Article 1, above n 2, at [7 – 12].

¹¹ Income Tax Act RSC 1985 c 1 (Canada), s 245.

¹² Income Tax Act 2007, s BG1 and GB1.

¹³ Income Tax Act 1962 (South Africa), s103.

¹⁴ There are a variety of general anti-avoidance rules in Australian legislation. These include the Income Tax Assessment Act 1936 (Cth), Part IVA and Fringe Benefits Tax Assessment Act 1968 (Cth), s 67.

distinction in their application depending on the national or international effect”.¹⁵ However, in the light of double tax agreements, the effect of a domestic general anti-avoidance rule is a subject of much debate.

5

The Commentary on Article 1 of the Model Convention sets out an interpretative framework to help analyse the relationship between domestic general anti-avoidance rules and double tax agreements. The Commentary acknowledges that domestic general anti-avoidance rules
10 raise two questions for consideration.¹⁶ First, whether the benefits of the treaty must be granted even if they do constitute an abuse of the treaty provisions.¹⁷ Secondly, whether the domestic anti-avoidance rules *themselves* conflict with treaties.¹⁸

15 For the majority of countries, the second issue will be the only question at stake. This is because any domestic implementation of the treaty would require any abuse of it to be treated as an abuse of the domestic law provisions themselves.¹⁹ Consequently, this paper focuses on the second question.

20 *A The two approaches*

The OECD Commentary outlines two approaches to help evaluate the compatibility of domestic anti-avoidance rules.²⁰ The Commentary suggests that the countries will assess the relationship between tax treaties and domestic anti-avoidance rules on the basis of how the
25 general anti-avoidance rule operates. According to Elliffe, if a general anti-avoidance rule provides the ability for the reconstruction of an abusive transaction (which would result in the original transaction being void) the country will fall under the factual approach.²¹

¹⁵ International Fiscal Association “Cahier De Droit Fiscal International” (2010) vol 95a at 22.

¹⁶ *Commentary* on Article 1, above n 2, at [9].

¹⁷ *Commentary* on Article 1, above n 2, at [9.1].

¹⁸ *Commentary* on Article 1, above n 2, at [9.1].

¹⁹ *Commentary* on Article 1, above n 2, at [9.2].

²⁰ *Commentary* on Article 1, above n 2, at [9.2] and [9.3].

²¹ Elliffe “International Tax Avoidance” above n 4 at [2.2].

Alternatively, if a general anti-avoidance rule results in the nullification of the abusive transaction, the general anti-avoidance rule will fall under the interpretative approach.²²

1 *Factual Approach*

- 5 The first approach outlined is the factual approach. The factual approach is where the domestic general anti-avoidance rule forms part of the domestic tax laws that determine which facts of the transaction give rise to tax liability.²³ The approach is found in paragraph 9.2 of the Commentary, which states:²⁴

10

[t]o the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them...

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- As a result, there is likely to be no conflict between the domestic rules and the double taxation agreement. This is because the anti-avoidance rule itself is being used to identify the factual basis on which tax liability is based. Once the factual basis is established, the treaty will be applied. Consequently, these rules are not addressed in tax treaties and are therefore not affected by them.²⁵
- 20

- Commentators have argued that New Zealand courts would take a factual approach for the following reasons.²⁶ First, the overriding nature of double tax agreements in New Zealand legislation suggests that there will be situations where the domestic anti-avoidance rule will conflict with the treaty (that is, the definition in the treaty clearly
- 25

²² Elliffe above n 4 at [2.2].

²³ *Commentary* on Article 1, above n 2, at [22.1].

²⁴ *Commentary* on Article 1, above n 2, at [9.2].

²⁵ Brian Arnold and Stef Van Weeghal "Chapter 5: Relationship between Tax Treaties and Domestic Anti-Abuse Measures" in Guglielmo Maisto (ed) *Tax Treaties and Domestic Law* (IBFD, Netherlands, 2006) at [5.3].

²⁶ Craig Elliffe and John Prebble "General Anti-Avoidance Rules and Double Tax Agreements: a New Zealand Perspective" (2009) *Revenue Law Journal* 19 at 7.

- indicates an outcome that is at variance to New Zealand law).²⁷ Secondly, New Zealand has a history of paying regard to the Commentary of the OECD Model, which has the factual approach as its fundamental basis.²⁸ Thirdly, New Zealand's domestic general anti-avoidance rule provides the Commissioner of Inland Revenue with the power to adjust the taxable income of the taxpayer and recharacterise transactions to "counteract any tax advantage obtained by that person from or under that arrangement".²⁹
- 10 The ability to reconstruct transactions is central to the distinction of the approaches. Another example of a reconstruction power is the application of a domestic general anti-avoidance rule that would result in a redetermination of the taxpayer who found to be receiving the income.³⁰ In these situations, the double taxation agreement would
- 15 apply, but would take into account the factual changes in the basis of liability.³¹

2 *Interpretative Approach*

- The second approach is the interpretative approach where the abuse is treated as abuse of the treaty itself and not of domestic law.³² There is no provision under domestic law to recharacterise the income. Instead, the abusive transaction will be disregarded.³³ The second approach is qualified by the view that tax legislation, in its domestic and treaty forms will not be interpreted to apply to transactions that lack economic substance or a bona fide business purpose.³⁴ In this situation, the general anti-avoidance rule operates to assume no

²⁷ Craig Elliffe and John Prebble "General Anti-Avoidance Rules and Double Tax Agreements: a New Zealand Perspective", above n 29, at 7.

²⁸ Craig Elliffe and John Prebble, above n 29, at 7.

²⁹ Income Tax Act 2007, s GA1.

³⁰ *Commentary* on Article 1, above n 2, at [22.1].

³¹ *Commentary* on Article 1, above n 2, at [22.1].

³² *Commentary* on Article 1, above n 2, at [9.3].

³³ Craig Elliffe and John Prebble, above n 29, at 6. Examples of countries that may follow this approach are the United Kingdom and the United States.

³⁴ *Commentary* on Article 1, above n 2, at [9.5]; see also Craig Elliffe and John Prebble, above n 29, at 7.

transaction occurred.³⁵ The likely result is that the court will substitute the transaction with one that does not result in tax avoidance.³⁶ However, as defeating extra taxation could fall within the scope of a bona fide business purpose, a clear understanding of what the test requires is important.

B Problems with these approaches

There are two problems with this framework. First, the test of the transaction requiring a bona fide business purpose or economic substance imports a factual analysis into the interpretative approach anyway. The test mirrors the guiding principle found within the Commentary. The guiding principle applies to both approaches. Consequently, transactions under the factual approach will also be subject to the requirements of a bona fide business purpose or economic substance. Any consideration of the test would require analysis of the factual basis of the transaction. This suggests that the distinction between the approaches may not be a true distinction at all. The fact the same factual enquiry applies to either approach highlights the artificiality in the distinction.

Secondly, neither approach constructs a clear relationship or hierarchy between the domestic general anti-avoidance rule and the treaty. In fact, central to the application of both approaches is the “way in which a country’s domestic general anti-avoidance rule actually operates when invoked in circumstances of abuse”.³⁷ The only difference between the two approaches appears to be whether a jurisdiction grants reconstruction powers to its Commissioner. It is artificial in a treaty interpretation context to have this power as the pinnacle point of difference. This is because the power only partially describes the operation of the general anti-avoidance rule. The operation of the rule domestically is only an element of the wider context of the treaty itself. As a result, focus on the power of reconstruction fails to consider the wider relationship of the rules and raises questions as to the necessity or usefulness of the approaches.

³⁵ Craig Elliffe and John Prebble, above n 29, at 6.

³⁶ Craig Elliffe and John Prebble, above n 29, at 7.

³⁷ Elliffe “International Tax Avoidance” above n 4 at [2.2].

III An alternative approach

The approaches set out in the Commentary are abstract and general. To understand the result of the Commentary's commentators look to individual transactions occurring with specific and differing domestic contexts and the corresponding treaty framework.

In the 2010 International Fiscal Association Rome Congress, 42 out of 44 countries reached the conclusion that the domestic general anti-avoidance rules can be reconciled with their treaty obligations.³⁸ While there seems to be agreement as to the ability of general anti-avoidance rules to apply to international transactions, there is divergence as to the extent of their application. This divergence arises from the fact that countries incorporate international treaties differently. Countries provide for domestic general anti-avoidance rules through statutory enactment or judicial decisions, while other countries do not have a domestic general anti-avoidance rules at all. Further, some countries have expressly defined the relationship between general anti-avoidance rules and tax treaties, while others are silent on the issue. Consequently, commentators have looked to consolidate the operation of domestic anti-avoidance rules in the context of double taxation agreements by looking to how domestic jurisdictions have expressed the relationship.

A Express legislative override

The first category is where the country's legislation provides an express legislative override. In this case, the general anti-avoidance rule prevails. An example is Australia's legislation, which provides:³⁹

The provisions of this Act have effect notwithstanding anything inconsistent with those provisions contained in the Assessment Act (*other than Part IVA of that Act*) or in an Act imposing Australian tax (emphasis added).

³⁸ International Fiscal Association "Cahier De Droit Fiscal International" (2010) vol 95a at 21. The two countries that reported differing positions were the Netherlands and Portugal.

³⁹ International Tax Agreements Act 1953 (Cth), s 4(2) as amended in 1995.

In other words, treaties will override Australia's domestic income tax legislation unless the transaction triggers the general anti-avoidance rule contained in Part IVA of the International Tax Agreements Act 1953.

Similarly, following amendments made in 2005, Canada's general anti-avoidance rule applies to any tax benefits obtained under a treaty.⁴⁰ As a result, Canadian jurisprudence suggests that no conflict between tax treaties and the general anti-avoidance rule will arise. Interestingly, *Antle v R* held that the general anti-avoidance rule would apply notwithstanding the fact that the treaty in question was concluded prior to the amendments.⁴¹

Express legislative overrides are inconsistent with the position taken in the 1989 OECD Report of the Committee on Fiscal Affairs. The Committee declared its strong opposition to domestic legislative overrides, even where such legislation will counteract abuse of the treaty.⁴² The reluctance of the Committee on Fiscal Affairs to support express overrides suggests that while there is a place for domestic general anti-avoidance rules to operate in the double tax treaty context, there still needs to be consideration and balance with the wider international law considerations.

B Where the treaty overrides the domestic general anti-avoidance rule

The second category is where the treaty automatically overrides the general anti-avoidance rule in cross-border transactions. An example of this category is the Netherlands, where the prevailing rule is

⁴⁰ Income Tax Act RSC 1985 c 1 (Canada), s245 (4).

⁴¹ *Antle v R*; *Marquis-Antle Spousal Trust v R*; *Antle and another v R*, (2009) 12 ITLR 359 (TCC) at [87].

⁴² OECD *Recommendation of the Council concerning Tax Treaty Override* C(89)146/FINAL (1989). See also: Brian Arnold and Stef Van Weeghel "Chapter 5: Relationship between Tax Treaties and Domestic Anti-Abuse Measures" in Guglielmo Maisto *Tax Treaties and Domestic Law* (IBFD, Netherlands, 2006) at 5.3 pg 103.

“[because tax treaty provisions are] binding upon everyone, they prevail over national law”.⁴³

5 Similarly, Portugal has taken the constitutional view that international law prevails over domestic provisions.⁴⁴ Thus, while the domestic rules determine the factual tax liability of a taxpayer domestically, they do not extend to the double tax treaty context without specific provision in the treaty.⁴⁵

10 There is some merit in this position. States should not be able to avoid their treaty obligations by enacting domestic general anti-avoidance rules.⁴⁶ However, the guiding principle in Paragraph 9.5 of the Commentary seems to undermine this approach. This is because the
15 avoidance rule could aid countries in maintaining their international obligations. Paragraph 9.5 states that:⁴⁷

20 The benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

25 Consequently, this suggests that a rule that prevents tax avoidance from falling within the scope of the guiding principle should become an obligation of states. The complete override of domestic law may be inconsistent with this as it would prevent any application of a domestic general anti-avoidance rule and would render the guiding principle

⁴³ Faustina G. I. Peters and Aart Roelofsen “Dutch Branch Report” n12, 551 at 561.

⁴⁴ *Commentary* on Article 1, above n 2, at [27.3].

⁴⁵ Note, *Commentary* on Article 1 at [27.8] directly states, “whenever the prevailing hierarchy of tax conventions regarding internal law is not respected, Portugal will not adhere to the conclusions on the clarification of domestic anti-abuse rules incorporated in the Commentary on Article 1”.

⁴⁶ Brian Arnold and Stef Van Weeghal “Chapter 5”, above n 25, at [5.3].

⁴⁷ *Commentary* on Article 1, above n 2, at [9.5].

inoperable without the required anti-avoidance rule being included in the treaty.

C Cases of conflict

The remaining countries fall within a category where the relationship
5 between the general anti-avoidance rule and the treaty is unclear. Brian
Arnold has described the approach of these countries as creating a
position where treaties will prevail over the domestic general anti-
avoidance rule in the event of a conflict.⁴⁸ The merit of this type of
analysis is that it looks directly to how the rules are utilised in preventing
10 the abuse of unintended benefits of tax treaties.

An example of a case of conflict is in relation to the Canada/New
Zealand double tax treaty.⁴⁹ Article 3(2) of the treaty provides:⁵⁰

15 In determining, for the purposes of Articles 10, 11, or 12,
whether dividends, interest or royalties are beneficially owned
by a resident of the Contracting State, dividends, interest or
royalties in respect of which a trustee is subject to tax in that
Contracting State should be treated as being beneficially owned
20 by that trustee...

Here, in absence of an assertion that the treaty is being abused, the
conflict between the treaty and the general anti-avoidance rule must be
resolved in favour of the treaty. This is because Canada and New
25 Zealand have expressly agreed in Article 3(2) that if a Canadian
trustee derives a New Zealand sourced dividend which is subject to
tax liability in Canada, then New Zealand will treat the trustee as the
beneficial owner of the dividend for the purpose of the treaty. This
could preclude application of New Zealand's general anti-avoidance
30 rule to recharacterise the dividend as derived by a third party, which
may result in New Zealand tax liability to that third party. Thus,
unless the treaty is itself abused, the explicit definition in the treaty

⁴⁸ BJ Arnold, "Tax Treaties and Tax Avoidance; the 2003 Revisions to the
Commentary to the OECD Model" (2004) 58 (6) Bulletin for International Fiscal
Documentation, Amsterdam 224, 251.

⁴⁹ Elliffe "International Tax Avoidance" above n 4 at [2.2].

⁵⁰ Double Taxation Relief (Canada) Order 1981.

and the treaty itself should prevail over the general anti-avoidance rule. This will be a case-by-case analysis.

However, this approach also looks to how the general anti-avoidance rules operate. An example where a domestic general anti-avoidance rule denied treaty benefits is the Canadian case of *RMM Canadian Enterprises v The Queen*.⁵¹ As the decision was before Canada's legislative amendments,⁵² the case continues to offer insight into the relationship between tax treaties and domestic anti-avoidance rules in the absence of an express legislative override. In this case, the taxpayer, a US company, sold the shares of its Canadian subsidiary as a means of stripping the surplus the subsidiary accrued. This was done in an attempt to avoid Canadian withholding tax. The tax authorities applied the Canadian general anti-avoidance rule to treat the gain on the sale of the shares as a dividend to the extent the sales proceeds exceeded the paid up capital of the shares. Accordingly, Article X of the Canada – US treaty applied to reduce the rate of Canadian withholding tax on the deemed dividend from the statutory rate of 25% to the treaty rate of 10%. The Canadian Tax Court's analysis was in accordance with the new Commentary.⁵³ Application of the domestic anti-avoidance rule established that the gain was a dividend for Canadian tax purposes and the treaty applied as if the amount were a dividend (subject to 10% withholding tax) and not a gain (which would not have been subject to tax).

In the case, the Canadian general anti-avoidance rule uses a primary-purpose test, whereas the treaty uses a “one of the main purposes” test.⁵⁴ It was open to the Court to find that the general anti-avoidance rule did

⁵¹ *RMM Canadian Enterprises v The Queen* 97 DTC 302 (TCC); Elliffe “International Tax Avoidance” above n 4 at [4].

⁵² Canadian Charter on Rights and Freedoms, s 33. The section contains the power to enact an express legislative override in certain situations. For consideration of how the general anti-avoidance rule operates post-amendment, see *Evans v The Queen* (2005) TCC 684 per Bowman J.

⁵³ Elliffe “International Tax Avoidance” above n 4 at [4].

⁵⁴ Brian Arnold and Stef Van Weeghal “Chapter 5”, above n 25, at [5.3].

not apply because there was no misuse or abuse of the Income Tax Act.⁵⁵ Nonetheless, the Court denied the treaty benefits. However, as the decision was in the Court of first instance and was not appealed, it is unclear whether the higher Canadian Courts would confirm the decision
5 and reasoning behind the application of the general anti-avoidance rule.⁵⁶

The application of the general anti-avoidance rule despite no abuse of the Income Tax Act can also arguably be justified with reference to article 3(2) of the Treaty that provides that undefined terms in the treaty have
10 the meaning that they have under domestic law unless the context requires otherwise.⁵⁷ The issue would then become whether the recharacterisation of an amount under the domestic general anti-avoidance rule establishes the meaning of the general anti-avoidance rule for the purposes of the treaty.⁵⁸ If so, there would be no conflict between
15 domestic law and the treaty and the taxpayer's argument would be ineffective. In the alternative, the context of the treaty could leave open an argument that the treaty requires the use of a different meaning from any meaning determined pursuant to the general anti-avoidance rule.⁵⁹ Due to the factual enquiry that both the guiding principle and the OECD
20 Commentary require, it seems such an argument is unlikely to be successful. If domestic law establishes the factual basis of liability, and this is to remain consistent with the Convention, then any other meaning would undermine both the domestic law and the factual enquiry of the Commentary. Thus, the domestic general anti-avoidance rule is likely to
25 apply regardless.

IV Propaganda and capture: a concern to be considered

It is important to consider the potential taxpayer influence on the Committee of Fiscal Affairs in creating the analytical framework. The
30 effectiveness of the Commentary's guidance in establishing a practical understanding of the relationship remains questionable. This raises concerns about undue influence from taxpayers, or agency capture, of the

⁵⁵ Brian Arnold and Stef Van Weeghal "Chapter 5", above n 25, at [5.3].

⁵⁶ Brian Arnold and Stef Van Weeghal "Chapter 5", above n 25, at [5.3].

⁵⁷ Double Taxation Relief (Canada) Order 1981.

⁵⁸ Brian Arnold and Stef Van Weeghal "Chapter 5", above n 25, at [5.3].

⁵⁹ Brian Arnold and Stef Van Weeghal "Chapter 5", above n 25, at [5.3].

Committee of Fiscal Affairs. The reason is that the lack of clear direction can increase the ability to use the tax treaties to receive undue benefits.

A Defining agency capture

A captured agency is a regulatory body unduly influenced by the interest groups directly affected by its decisions.⁶⁰ In the Model Commentary context, this would mean that taxpayers have unduly influenced the Committee on Fiscal Affairs. This would be difficult to prove definitively, but one can look to the Commentary and the effect of the interpretative framework to address whether this should be a concern.

B Does the Commentary raise this concern?

The interpretative framework alone is what raises these concerns. However, this paper argues that the guiding principle mitigates these concerns. This is because it is still key to the analysis and can add much to the enquiry. Thus, the interpretative framework may be practically unhelpful, but the Commentary as a whole may still be of use.

V The importance of a guiding principle

As noted earlier, the guiding principle found in paragraph 9.5 of the Commentary states:⁶¹

that the benefits of a double tax Convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in the circumstances would be contrary to the object and purpose of the relevant provisions.

⁶⁰ Mark Bradford “Superfund Contractors and Agency Capture” (1993) Faculty Articles and Other Publications 115.

⁶¹ *Commentary* on Article 1, above n 2, at [9.5].

A A treaty anti-avoidance rule

A State does not have to grant the benefit of a double tax treaty when the arrangement constitutes an abuse of the provisions of the treaty.⁶² The test to apply is whether “a main purpose” of the transaction is to secure a more favourable tax position contrary to the object and purpose of the relevant provisions.⁶³

It is arguable that the guiding principle establishes a treaty anti-avoidance rule.⁶⁴ A literal reading of the principle would suggest that a taxpayer could not rely on the treaty where the main purpose of the transaction is to secure a more favourable tax position than that intended by the provisions of the treaty.

This paragraph is prefaced with a caveat that it will not be lightly assumed that the taxpayer is entering into abusive transactions. The principle requires tax administrators and the courts to exercise caution and prudence before exercising their powers to categorise a transaction as being abusive of the object and purpose of the treaty.⁶⁵ Examination of whether the favourable tax position is contrary to the object and purpose of the relevant provisions will involve considering the reasons for those provisions and whether the transactions frustrate or abuse the treaty.⁶⁶

Another way of interpreting the paragraph is that the principle establishes a test transactions should meet before a domestic general anti-avoidance rule will apply. This would provide a balanced and testable standard to which transactions would need to meet before a domestic anti-avoidance rule would apply.⁶⁷ This test is that domestic anti-avoidance rules should apply to a transaction in the context of a tax treaty only if the main purpose of the transaction is to secure treaty benefits that will result in

⁶² Elliffe “International Tax Avoidance” above n 4 at [3.4].

⁶³ Elliffe “International Tax Avoidance” above n 4 at [3.4].

⁶⁴ Elliffe “International Tax Avoidance” above n 4 at [3.4].

⁶⁵ Craig Elliffe and John Prebble “General Anti-Avoidance Rules and Double Tax Agreements: a New Zealand Perspective”, above n 29, at 15.

⁶⁶ Craig Elliffe and John Prebble, above n 29, at 16.

⁶⁷ Subject to any contrary explicit agreement/clarification contained in a double tax treaty.

defeating the object and purpose of the relevant provisions of the treaty. Thus, a domestic anti-avoidance rule that does not meet the test of 9.5 would conflict with the provisions of tax treaties and should be precluded from being applied.⁶⁸ This argument is attractive because it contains a

5 standard for countries to adhere to in maintaining their international obligations and domestic protections. Countries should not design or apply their domestic anti-avoidance rules so broadly that treaty benefits are denied where they should not be. The guiding principle demonstrates that a limitation on the use of domestic anti-avoidance rules in the

10 context of tax treaties is necessary. A country should not be able to avoid its treaty obligations by taking the position that virtually all transactions are abusive and all of its domestic tax rules are anti-avoidance rules. The guiding principle provides the ambit of general anti-avoidance rule application and is helpful in analysing the approach to be taken.

15

There are potential areas of concern with reliance on the guiding principle. At the very least, application of the principle requires a balance in analysis. This is because tax authorities and courts cannot be too quick to deny treaty benefits with respect to transactions.⁶⁹ It is important to

20 remember that tax planning is a legitimate behaviour and taxpayers can (and should) be expected to arrange their affairs to pay the minimum amount of tax. The Privy Council noted that the law does not require people to arrange transactions in order to incur the greatest possible tax liability available.⁷⁰ Further concerns as to the guiding principles

25 operation need to be addressed in detail.

1 Lower threshold

First, what if there is a lower threshold from a domestic general anti-avoidance rule than that found in the treaty?

⁶⁸ Brian Arnold and Stef Van Weeghal “Chapter 5”, above n 25, at [5.3].

⁶⁹ Brian Arnold and Stef Van Weeghal, above n 25, at [5.3].

⁷⁰ *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591, 568 (PC); see also Rebecca Prebble and John Prebble “Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law?” (2010) Saint Louis University Law Journal; Victoria University of Wellington Legal Research Paper No 8/2012 at 23.

The differences between New Zealand's approach and that of Canada and Australia are somewhat marked. The New Zealand domestic test of "more than a merely incidental purpose" of tax avoidance is lower than the focus in the Commentary. The focus in the Commentary is whether a main purpose of the transaction was to secure a more favourable tax treatment inconsistent with the object and purpose of the treaty provisions. The domestic law test has a lower threshold so that if tax avoidance is one of the purpose or effects of a transaction it can be voided, if the tax avoidance purpose or effect present is not merely incidental. It is thus possible to have a situation where the test under the domestic anti-avoidance provisions would be met, but where the threshold under the treaty Commentary at 9.5 is not reached.⁷¹ In practice however, one would have to come to the conclusion that the thresholds are the same. Arguably, the inference is that having taken no steps comparable to those in Canada and Australia, the New Zealand Parliament is content to allow New Zealand taxpayers to use structures that employ the provisions of tax treaties to avoid New Zealand income tax.⁷² This is an inference taken from New Zealand not including an express legislative override.

This argument seems odd. This is because it does not make sense to have a different threshold. A Government will not be content to allow structures to help taxpayers avoid a domestic tax liability. A key focus of governments is reducing any barrier to trade by increasing the network of double tax treaties and protection that flows from them. For New Zealand, this focus was identified in a recent press release on the signing of the Australia/New Zealand double tax agreement. The media statement said that:⁷³

The new DTA will help to reduce barrier so trade and investment even further and improve certainty for trans-Tasman business. It will help to accelerate progress towards the full realisation of the goal of the 'Single Economic market' to which the New Zealand and Australian

⁷¹ Craig Elliffe and John Prebble, above n 29, at 16.

⁷² Craig Elliffe and John Prebble, above n 29, at 8.

⁷³ Hon Peter Dunne, Minister of Revenue and Hon Tim Grosser Minister of Trade (Media Statement, 29 June 2009).

Prime Ministers have committed. One of the main features of the new double tax agreement will be lower withholding taxes on dividend and royalty payments between Australia and New Zealand.

- 5 Thus, there is a focus from the Government to utilize double tax agreements. Certainty for trans-Tasman business will include certainty for governments in realising their internal revenue.

2 When there is no direction from the treaty

- 10 Consider a treaty between two countries that is silent about domestic general anti-avoidance rules. One country might have domestic general anti-avoidance rules and would apply those rules to a particular transaction while the other country may not have a general anti-avoidance rule or would not apply the rule to the transaction in question.⁷⁴

- 15 According to Arnold, the effect of the current Commentary is that the onus is on the country without the anti-avoidance provisions (or disagreeing to their application) to put provisions in the treaty preventing the application of the first country's anti-avoidance rules.⁷⁵ However, it is questionable whether the provisions preventing the application would be a successful approach. Countries are unlikely to agree to provisions of double taxation agreements that would result in allowing abusive transactions that they could otherwise prevent through rules contained in their domestic law.⁷⁶ Further, countries are unlikely to apply their international agreements in a way that would have this effect.⁷⁷ This would mean that the guiding principle could create a standard to which a transaction would have to meet before a domestic anti-avoidance rule applies.⁷⁸

- 30 Similarly, if the treaty and domestic law contain similar anti-avoidance rules but the treaty is silent on their application, one argument is that it

⁷⁴ Brian Arnold and Stef Van Weeghal "Chapter 5", above n 25, at [5.3].

⁷⁵ Brian Arnold and Stef Van Weeghal "Chapter 5", above n 25, at [5.3].

⁷⁶ *Commentary* on Article 1, above n 2, at [7.1].

⁷⁷ *Commentary* on Article 1, above n 2, at [7.1].

⁷⁸ In a situation where the treaty is silent about general anti-avoidance rules and the countries differ in their application and/or existence.

would seem inappropriate to apply the broader domestic rules in the context of the agreement.⁷⁹ The basis for this proposition is that there is a reasonable inference between the contracting States that they agreed on a narrower rule (i.e. the one contained in the treaty) than the broader domestic anti-avoidance rules. This argument has some merit. However, it does not void the application of the guiding principle completely. If the Commentary reflects the shared expectations and common understanding of the contracting States,⁸⁰ then the guiding principle may still apply. This is because the treaty itself is silent to the application of the rules and thus remains open to some analysis and interpretation from the wider context of the treaty (of which the Commentary forms part of).

It is worth noting that absent a tax treaty, there are no legal restraints on a country to counter tax-avoidance. This would mean that we could not read the guiding principle as establishing a general treaty anti-avoidance rule. This is because the guiding principle would need to be explicitly included within the particular treaty to create a definite obligation on States. However, we can consider the guiding principle as outlining the approach to take when evaluating the relationship between domestic general anti-avoidance rules and tax treaties.⁸¹

B Applying the principle

From a practical point of view, the dichotomy presented by the Commentary is not effective in creating any certainty of the law for taxpayers. One benefit of the guiding principle is that it establishes a consistent test to apply when looking to the application of domestic general anti-avoidance rules. Understanding the relationship will assist with predicting potential tax outcomes of transactions.

However, what the guiding principle requires us to analyse is whether there is a bona fide business purpose or economic substance. Even with the restriction of “main purpose” in the guiding principle of the Commentary, it is difficult to define what a main purpose is, or what it

⁷⁹ Brian Arnold and Stef Van Weeghal “Chapter 5”, above n 25, at [5.3].

⁸⁰ In that they are both OECD member States.

⁸¹ That is, instead of defining the relationship between any treaty and a domestic general anti-avoidance rule.

looks like. Logically, targeted avoidance is evasion,⁸² but whether structural avoidance is included, or what the other purposes necessary for consideration are, would be difficult to articulate.

- 5 Uncertainty as to what transactions fall into unacceptable tax avoidance (and therefore under the scope of the general anti-avoidance rule) could raise concerns as to the justifiability of the guiding principle and the use of general anti-avoidance rules generally.⁸³

10

VI Retrospect and certainty: Rule of Law Considerations

A Justified uncertainty

- The ability to rely on a treaty and the outcome it prescribes is important.⁸⁴ However, tax law is inherently uncertain. Further, one of
15 the purposes of the general anti-avoidance rules is to stop avoidance. This strengthens the coherent structure in place to facilitate international business and protect domestic interests.

- Further, concerns as to the justifiability of general anti-avoidance rules
20 because of the uncertainty they may create assume that tax planning deserves the same respect as planning to make legitimate tax profits. It is one thing to say certainty and respect of commercial and tax consequences were intended by Parliament. It is another thing to say that that certainty and respect should extend to transactions designed
25 to avoid liability. For example, if savings through Kiwisaver, as a compulsory scheme, were taxed at the maximum rate taxpayers would have a legitimate grievance. The incentive of the scheme is that it is cheaper than the normal tax rate. However, the predominant incentive of double taxation treaties is not to allow taxpayers to avoid domestic

⁸² *Cridland v Federal Commissioner of Taxation* 140 CLR 330.

⁸³ Rebecca Prebble and John Prebble “Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law?” (2010) Saint Louis University Law Journal; Victoria University of Wellington Legal Research Paper No 8/2012 at 28.

⁸⁴ Vienna Convention on the Law of Treaties 1155 UNTS 331 (opened for signature 23 May 1969, entered into force 27 January 1980).

liability by exploiting differences between two countries' tax laws.⁸⁵
Consequently, taxpayers cannot have the same expectation of absolute
certainty as to what liability a transaction will attract if they are
planning to secure benefits from the treaty that were unintended by
5 Parliament.

One of the main criticisms of domestic general anti-avoidance rules is
that their inherent vagueness fails to provide guidance to taxpayers.⁸⁶
This would breach one of the requirements of the rule of law.⁸⁷
10 Despite this, the rules are effective in allowing governments to
recover revenue they would otherwise lose from the transaction.⁸⁸
Without a general anti-avoidance rule, there is likely to be a great
extent of tax avoidance and revenue loss that governments cannot
prevent.⁸⁹

15 As a result, while domestic general anti-avoidance rules may lack rule
of law certainty, the practicality required in maintaining the integrity
of a domestic system remains important. The general anti-avoidance
rule is designed to frustrate tax avoidance. This can include situations
20 where a taxpayer is taking advantage of double taxation agreements to
utilise the benefit in a way that undermines the ability of a country to
tax the transaction properly. The protection of a domestic tax base
needs to be the single most important factor in the consideration of the
relationship between general anti-avoidance rule and treaties. This is
25 because unlike other areas of law, the international component of
income taxation has an ability to completely undermine the revenue

⁸⁵ *Commentary* on Article 1, above n 2, at [7.1]

⁸⁶ Rebecca Prebble and John Prebble "Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law?" (2010) Saint Louis University Law Journal; Victoria University of Wellington Legal Research Paper No 8/2012 at 30.

⁸⁷ Rebecca Prebble and John Prebble "Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law?" above n 75, at 30.

⁸⁸ Rebecca Prebble and John Prebble "Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law?" above n 75, at 34.

⁸⁹ Rebecca Prebble and John Prebble, above n 75, at 38.

stream of a state. Taxpayer certainty in cross-border transactions will fall secondary to these considerations. This is because losses to State revenue have the potential to affect taxpayers as well. Among other effects, tax avoidance has the ability to “reduce the effectiveness of welfare systems”.⁹⁰ As a consequence, the oft-quoted dictum from Lord Tomlin in *Duke of Westminster* that “every man is entitled if he can to order his affairs so that tax attaching under the appropriate Act is less than it otherwise would be”⁹¹ is now subject to the qualification that taxpayers cannot participate in impermissible international tax avoidance.

It is worth noting that income tax law may be one of those circumstances where “certainty should not be the overriding aim and where, in any event it may be elusive or even undesirable”.⁹²

15 ***B Pacta Sunt Servanda***

Further, the principle of *pacta sunt servanda* would suggest that the use of the guiding principle and domestic anti-avoidance rules should not undermine or violate the agreement as made. The approach taken by the Netherlands and Portugal reflects the basic public international law idea of *pacta sunt servanda* – or the idea that “agreements must be kept”.⁹³ The primacy of the treaty arrangements reflects the idea that agreements between treaty parties are inviolable. The ability to rely on the treaty and the outcome prescribed by it is an important consideration of certainty and consistency in cross-border investment operations.

25 Absent a tax treaty, there are no legal restraints on a country other than those generally under its domestic law or international law to counter tax avoidance. The question then becomes how the prevention of tax avoidance can be a specific goal of a tax treaty if the only potential effect

⁹⁰ Rebecca Prebble and John Prebble “Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law?” (2010) Saint Louis University Law Journal; Victoria University of Wellington Legal Research Paper No 8/2012 at 40.

⁹¹ *IRC v Duke of Westminster* [1936] AC 1 at 19.

⁹² T. Endicott “Vagueness in Law” (OUP, Oxford, 2000).

⁹³ Black’s Law Dictionary (8th ed, 2004).

is to limit anti-avoidance measures that may be available.⁹⁴ Potentially it cannot. As a result, there could be an argument to interpret the guiding principle differently (that is, not implicitly creating a framework for the operation of anti-avoidance rules). This could mean that the guiding principle needs to be explicitly included in the agreement in order to inform analysis of the effect of the domestic general anti-avoidance rule on a particular treaty. Another potential solution could be for a provision allowing the application of domestic anti-avoidance rules to be included in the treaty.⁹⁵

Alternatively, the wider context of treaty interpretation suggests this may not be required. While the Commentary provides for a purpose of tax conventions to prevent tax avoidance, it is not the sole or most important purpose. The most important purpose of tax conventions is to facilitate international trade and investment through the elimination of double taxation.⁹⁶ However, it is also a purpose of tax conventions to prevent tax avoidance and evasion.⁹⁷ Thus, tax avoidance is only one consideration to take into account when evaluating the context of the Convention. Consequently, the wider context and purpose of the treaty is likely to carry more weight than the vague purpose highlighted in the Commentary.⁹⁸

In some ways, this wider context mirrors the Vienna Convention on the Law of Treaties.⁹⁹ According to paragraph 9.3 of the Commentary on Article 1, the ability to disregard a transaction entered into with the intention of obtaining unintended benefits arises partially from the application of the obligation to interpret tax treaties in good faith.¹⁰⁰

⁹⁴ Brian Arnold and Stef Van Weeghal “Chapter 5”, above n 25, at [5.3].

⁹⁵ This would reflect Germany’s approach post 2000.

⁹⁶ *Commentary* on Article 1, above n 2, at [7].

⁹⁷ *Commentary* on Article 1, above n 2, at [7].

⁹⁸ Brian Arnold and Stef Van Weeghal “Chapter 5”, above n 25, at [5.3].

⁹⁹ Vienna Convention on the Law of Treaties 1155 UNTS 331 (opened for signature 23 May 1969, entered into force 27 January 1980).

¹⁰⁰ Vienna Convention on the Law of Treaties 1155 UNTS 331 (opened for signature 23 May 1969, entered into force 27 January 1980), art 31(1).

Consequently, the approach is more purposive and looks to wider context, object and purpose of the treaty itself.

- 5 A supporting argument is that the Commentary on Article 1 reflects the shared expectations and common understanding of the contracting States with respect to the relationship between tax treaties and domestic anti-avoidance rules, unless there is something explicit in the treaty to indicate otherwise. However, this does not necessarily exclude the legitimate use of domestic anti-avoidance rules to prevent
10 tax avoidance and the receipt of undue benefits from double tax agreements. This argument would apply to any treaty based upon the model commentary but has more merit for treaties concluded between OECD Member countries.¹⁰¹
- 15 Craig Elliffe essentially argues that those countries that place more importance on their treaties overriding the domestic general anti-avoidance rule value most the certainty of law whereas those countries that place most importance on their domestic anti-avoidance provisions overriding the treaty, value most their ability to preserve the tax base and
20 strike down abusive transactions.¹⁰² Consequently, a hybrid approach which allows the override of the treaty by the domestic general anti-avoidance rule save in conflicting situations may achieve a compromise by creating clear treaty outcomes and guarding against the abuse of treaties.¹⁰³ The guiding principle could inform this inquiry by creating a
25 framework and obvious tests for transactions. From a practical point of view, this is considerably stronger than the misguided approaches of the wider interpretation framework the Commentary sets down.

VII Conclusions

- 30 Whether taxpayers can rely on the outcome predicated by a tax treaty in the case of a conflict with a domestic general anti-avoidance rule is a matter of much debate and interpretation. The growth in avoidance activity is a matter of concern due to the negative impact on the

¹⁰¹ Brian Arnold and Stef Van Weeghal “Chapter 5”, above n 25, at [5.3].

¹⁰² Elliffe “International Tax Avoidance” above n 4 at [4.4].

¹⁰³ Elliffe “International Tax Avoidance” above n 4 at [4.4].

capacity of national tax jurisdictions to collect the revenue they require.¹⁰⁴

- 5 Cross-border transactions, especially those involving tax havens and conduit companies pose a serious and significant threat to domestic tax bases. In an increasingly international business climate, the operation of protective domestic anti-avoidance rules and their relationship with double tax agreements is an important question to consider in international tax planning.
- 10 The guidance principle is an aspiration of the Committee on Fiscal Affairs and is a strong statement of the circumstances where treaty benefits arising from transactions should be denied. This paper argues that the weight and usefulness of the Commentary lies in the guiding principle alone and not in the interpretation provisions. The wider approaches, while not clearly subject to the accusation of agency capture, are confusing and add little to the analysis. Commentators should treat the two approaches with less weight and more focus should rest upon understanding what an internationally accepted bona fide business purpose or economic substance of a transaction would be.
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Word count

The text of this paper (excluding abstract, table of contents, footnotes, and bibliography) comprises approximately 6,620 words.

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¹⁰⁴ Chris Evans “*Barriers to Avoidance: recent legislative and judicial development in common law jurisdictions*” (1 November 2006)
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