

General Anti-Avoidance Regulations: An Acceptable Alternative to Limitation on Benefits Provisions?

By Chris Davis¹

I. INTRODUCTION

In the early 1980s, the U.S. introduced a strict residence test into its tax treaties, the limitation on benefits (LOB) provision, to prevent companies incorporating in treaty partner countries solely to obtain treaty benefits (known as “tax treaty shopping”). This LOB provision is incompatible with European Union (EU) law, poorly constructed, and an overreaction to the problem of tax treaty shopping. The U.S. should consider using a general anti-avoidance regulation (GAAR) instead of an LOB provision, because a GAAR would provide more flexibility to domestic courts, and still prevent genuine instances of tax treaty shopping.

Tax treaties are bilateral agreements between nations, designed to facilitate commerce and minimize the double taxation of income and gains. Without tax treaties, taxpayers would be subject to double taxation on income and that could prove a significant obstacle to conducting global business. Tax treaties alleviate or reduce most instances of double taxation and never increase, or impose, a tax.

Tax treaties reduce tax liabilities, so it is therefore perhaps inevitable that they are subject to abuse. A common form of abuse is when a taxpayer resident in a country not party to the treaty attempts to gain access to the treaty benefits agreed upon by other nations. This is known as “tax treaty shopping.” The U.S. attempted to block treaty shopping by adopting LOB provisions in its tax treaties.

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LOB provisions block some tax treaty abuse by adding an additional test after the company has satisfied an initial, more basic, test of residence. An LOB provision denies treaty benefits to entities not controlled by residents of the contracting state under which it is claiming the benefits. LOB provisions consist of a set of objective criteria that determines which taxpayers can claim treaty benefits.

This paper suggests that LOB provisions are flawed and recommends they be replaced with GAARs. Part II of this paper provides background on the nature of tax treaties and examines how U.S. courts dealt with tax treaty abuse through the development of the common law “economic substance” doctrine. Part III looks at the development and use of LOB provisions. It examines three criticisms of LOB provisions: (1) they are in conflict with European Union (EU) law; (2) they are based on objective criteria which makes them subject to abuse; and (3) they are overly complicated and an overreaction to the problem of treaty shopping. The paper then proposes that a GAAR should replace the LOB provision, because a GAAR will result in a less objective, and more flexible, doctrine that will block a wide range of tax abuse for the foreseeable future. Part IV is the conclusion that recommends the U.S. replaces LOB provisions with GAARs its future treaties.

II. BACKGROUND

The U.S. adopted LOB provisions in its tax treaties because it had limited success in blocking treaty abuse in the courts. U.S. courts used the economic substance doctrine to block some tax treaty abuse, however the courts refused to extend the doctrine to all forms of abuse.

A. Tax Treaties

“A tax treaty is an agreement between two countries to modify their generally-applicable rules of taxation for transactions and relationships between persons resident in the [signatory] countries.”² Whereas treaties generally are either multilateral or bilateral, tax treaties are always bilateral. States enter into tax treaties for two main reasons: (1) to prevent double taxation in respect of transactions involving the two countries; and (2) to allocate the right to tax income.³ Tax treaties now also include extensive “exchange of information” provisions that give states the right to request information on its citizens income in the other treaty country.⁴

B. The Partial Success of U.S. Courts in Preventing Tax Treaty Abuse

Tax treaties are designed to reduce tax, so it was perhaps inevitable that taxpayers would attempt to abuse tax treaties.⁵ Before adopting LOB provisions, U.S. courts, with mixed success, attempted to prevent tax treaty shopping through the common law economic substance doctrine. The economic substance doctrine allows U.S. courts to look through conduit companies and ignore step transactions, however courts will not invalidate a transaction if the company claiming the treaty benefit performs minimal functions or generates a profit.

1. Unacceptable Forms of Treaty Shopping

U.S. courts have expressly denied treaty benefits where the transaction includes conduit companies or step transactions to obtain treaty benefits.

² Richard L. Reinhold, *What is Tax Treaty Abuse? (Is Treaty Shopping an Outdated Concept?)*, 53 TAX LAW. 663, 673 (2000).

³ Reinhold, *supra* note 2, at 673.

⁴ *See e.g.* UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, Art. 26.

⁵ John A. Townsend, *Tax Treaty Interpretation*, 55 TAX LAW. 219, 307 (2001) (“A [tax] treaty is . . . a compilation of words that can be abused”).

U.S. courts will not allow a company to claim treaty benefits if the company is a conduit company. In *Aiken Industries, Inc.*,⁶ the court refused to provide treaty benefits to a company that did not truly “receive” money. In this case, a company was incorporated in Honduras to benefit from a treaty Honduras had with the U.S.⁷ The Honduran company had equal inter-company debt and liabilities, so it would receive interest and then immediately pass it on to another group company.⁸

The court first held that the treaty prevented the court from just ignoring the Honduran corporation.⁹ The court looked not just the language of the treaty, but the entire context, to determine whether the treaty protects the taxpayer.¹⁰ The Honduras-U.S. treaty applied to interest payments “received by” the Honduras corporation.¹¹ There was no definition of “received by” in the treaty. The court held that specific words in a treaty should be defined to give a “meaning consistent with the shared expectations of the contracting parties.”¹² Applying this principle, the court held “received by” to mean “received by a corporation of either of the contracting States as its own and not with the obligation to transmit it to another.”¹³ The court further stated that to receive interest the corporation should have “complete dominion and control over the funds.”¹⁴ The Honduran company was a conduit company because it was obligated to pass the money

⁶ *Aiken Ind., Inc. v. Comm’r*, 56 TC 925 (1971).

⁷ *Aiken* at 930.

⁸ *Aiken* at 930.

⁹ *Aiken* at 932-33.

¹⁰ *Aiken* at 933 (“To say that we should give a broad and efficacious scope to a treaty does not mean that we must sweep within the Convention what are legally and traditionally recognized to be taxpayers not clearly within its protections.” “It is necessary to examine not only the language, but the entire context of the agreement.”) (quoting *Maximov v. United States*, 299 F.2d 565, 568).

¹¹ *Aiken* at 933.

¹² *Aiken* at 933 (quoting *Maximov v. United States*, 299 F.2d 565, 568 (C.A.2 1963) *aff’d* by 373 U.S. 49 (1963)).

¹³ *Aiken* at 933.

¹⁴ *Aiken* at 933.

on to another company and it did not have complete control over the funds. The court therefore denied the treaty benefits.

U.S. courts have also blocked companies using “step transactions” to benefit from a treaty. The step transactions doctrine applies if the “taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes.”¹⁵ In *Del Commercial Properties, Inc.*,¹⁶ a Canadian company obtained a loan from a Canadian bank and moved it between group companies based in the Cayman Islands, Netherlands Antilles, and the Netherlands, before the money ended up with a U.S. company.¹⁷ The court stated that a transaction must have a sufficient business or economic purpose to benefit from a tax treaty.¹⁸ If the sole reason for undertaking a series of transactions was to avoid U.S. taxes, then the treaty will not protect a taxpayer from the application of the economic substance doctrine.¹⁹ The series of transactions entered into here did not affect the taxpayer’s beneficial interest, so the court applied the step transactions doctrine to deny treaty benefits.²⁰

2. Acceptable Forms of Treaty Shopping

U.S. courts will not prevent a company claiming treaty benefits if the company performs minimal business functions or generates income.

¹⁵ *Del Comm. Prop., Inc. v. Comm’r*, 251 F.3d 210, 213 (D.D.C. 2001).

¹⁶ *Del Comm. Prop., Inc. v. Comm’r*, 251 F.3d 210 (D.D.C. 2001).

¹⁷ *Del Comm. Prop* at 211-12.

¹⁸ *Del Comm. Prop* at 214.

¹⁹ *Del Comm. Prop* at 214.

²⁰ Interestingly, the court may have allowed the transaction if the taxpayer had been trying to mitigate Canadian taxes and not U.S. taxes. *Del Comm. Prop* at 216.

U.S. courts allow a company to claim treaty benefits where the company performed minimal business functions such as signing contracts and performing other relatively low-key activities. In *Bass v. Commissioner*,²¹ a U.S. taxpayer incorporated a company in Switzerland and then sold an interest in oil and gas leases to that company.²² The court recognized that a taxpayer may choose a business form that results in tax savings and then held that “a taxpayer may adopt any form he desires for the conduct of his business” as long as the chosen entity actually engages in substantive business activity.²³ The Court held that the company did engage in substantive business activity,²⁴ because it conducted activities such as: signing contracts; collecting income; paying expenses; and investing income.²⁵ For some businesses, the cost of maintaining an overseas base with a small number of employees, may be a small cost when compared to possible tax savings available under a treaty.

U.S. courts have also allowed treaty benefits where the overseas company can prove a profit motive. In *Northern Indiana Public Service Co.*,²⁶ the parent company (NIPSC) incorporated a subsidiary (Finance) in the Netherlands Antilles to obtain funds from the Eurobond market.²⁷ Finance issued notes on the Eurobond market for \$70 million, at an interest rate of 17.25%²⁸ and NIPSC guaranteed these notes.²⁹ On the same day, NIPSC issued a loan note to Finance for \$70 million at an interest rate of 18.25%.³⁰ The interest payments under the loan note between NIPSC and Finance were the subject of the case.

²¹ *Bass v. Comm’r*, 50 TC 595 (1968).

²² *Bass* at 599.

²³ *Bass* at 600.

²⁴ *Bass* at 602.

²⁵ *Bass* at 600.

²⁶ *N. Ind. Pub. Serv. Co. v. Comm’r*, 105 TC 341, *aff’d*, 115 F.3d 506 (7th Cir. 1997).

²⁷ *N. Ind. Pub. Serv. Co.* at 342.

²⁸ *N. Ind. Pub. Serv. Co.* at 344.

²⁹ *N. Ind. Pub. Serv. Co.* at 344.

³⁰ *N. Ind. Pub. Serv. Co.* at 344.

The court, following the holding in *Bass*, recognized the need for substantive business activity. The court held that the borrowing and lending of money for profit was sufficient to meet this requirement and therefore concluded that Finance was not a mere conduit company.³¹ The court distinguished *Aiken Industries* on two grounds: (1) Finance made a profit on its lending, whereas the Honduran company in *Aiken Industries* did not; and (2) Finance dealt with a third party, whereas the transactions in *Aiken Industries* were entirely between related parties.³² This not only allows companies to claim treaty benefits, it also encourages them to generate profits in that overseas jurisdiction.

III. ANALYSIS

Tax treaty abuse was a big problem for the U.S., so the U.S. Treasury introduced an LOB provision into the U.S. Model Tax Treaty (U.S. Model Treaty) and began including an LOB provision in all of the U.S.'s future tax treaties. LOB provisions do block some treaty abuse, however they are not ideal. The provisions are inconsistent the EU law, subject to abuse due to their reliance on objective criteria, and an overreaction to the problem of treaty shopping. A GAAR in tax treaties would be preferable to an LOB provision, because it would give the courts more power to prevent treaty abuse, while allowing transactions with no abusive intent to go unpunished.

A. The Development and Use of LOB Provisions

An LOB provision has been in every version of the U.S. Model Treaty since 1981.³³ LOB provisions are “anti-treaty shopping provisions that are intended to prevent residents of third countries from benefiting from what is supposed to be a reciprocal

³¹ *N. Ind. Pub. Serv. Co.* at 355. The profit being the 1% difference between the interest rate at which the money was borrowed on the Eurobond market, and the rate at which it earned interest from NIPSC.

³² *N. Ind. Pub. Serv. Co.* at 354-55.

³³ Paul R. McDaniel et al., INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION, 183 (2005).

agreement between two countries.”³⁴ LOB provisions do not look at the subjective intent of the taxpayer, instead they focus on objective criteria.³⁵ The LOB provision in the U.S. Model Treaty is used by the U.S. as a starting point in treaty negotiations, however it may be changed to suit the needs of the treaty partner. There are a number of variations of the LOB provision in use, however they are all subject to similar criticisms.

1. LOB provision in the U.S. Model Treaty

The U.S. Model Treaty forms the basis of all of the U.S.’s tax treaty negotiations.³⁶ The LOB provision in the U.S. Model Treaty shows how the provision relies on objective criteria to prevent tax treaty abuse. To qualify for treaty benefits under the U.S. Model Treaty, an entity must first qualify as a “resident” and then as a “qualified person.” The U.S. Model Treaty has a relatively straightforward test to determine a resident—an entity is a resident in the contracting state if it is liable to tax in that jurisdiction.³⁷ The entity must then ensure it is a “qualified person” under the LOB provisions. To be a “qualified person” the resident must be one of the following: (1) an individual; (2) a contracting state; (3) a corporation that is either publicly listed in the contracting state, managed and controlled in the contracting state, or more than 50% owned by companies that are publically listed or managed and controlled in the contracting state; (4) a charitable entity; (5) a pension fund that is 50% controlled by members of the contracting states; or (6) an entity owned by qualifying persons and one that does not pay more than 50% of its income to entities who are not residents of either contracting state.³⁸

³⁴ UNITED STATES MODEL TECHNICAL EXPLANATION ACCOMPANYING THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, at 63.

³⁵ U.S. MODEL TECHNICAL EXPLANATION, at 63.

³⁶ UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006.

³⁷ UNITED STATES MODEL INCOME TAX CONVENTION, Art. 1.

³⁸ UNITED STATES MODEL INCOME TAX CONVENTION, Art. 22.

Corporations are used in most instances of tax treaty shopping, so the third test is most relevant to prevent tax abuse. The third test prevents a company claiming treaty benefits if it is not managed and controlled in the contracting state or trading its shares on a recognized stock exchange. The test will also be satisfied if the company is controlled by five or fewer companies that are publically listed or managed and controlled in the contracting state. A company is managed and controlled in the contracting state if day-to-day responsibility for management of the company is exercised from the contracting state.³⁹ To satisfy this condition, the executive officers and senior management employees must exercise day-to-day responsibility for strategic, financial, and operational strategy from that contracting state, more often than they do from another state.⁴⁰ The company's headquarters should also be located in the contracting state.⁴¹

2. The LOB Provision in Practice—U.S.-U.K. Tax Treaty

As stated, the U.S. Model Treaty is only the starting point for negotiations. Actual tax treaties may contain different clauses due to compromises with other states or just to reflect the different trading environment relating to that state.

The U.S.-U.K. tax treaty⁴² is one of the most commercially significant tax treaties in the world, and it contains a variation on the LOB provision in the U.S. Model Treaty.⁴³

The U.S.-U.K. treaty provides for an initial test of “resident” status that is similar to the

³⁹ U.S. MODEL TECHNICAL EXPLANATION, 66-67.

⁴⁰ U.S. MODEL TECHNICAL EXPLANATION, 67.

⁴¹ U.S. MODEL TECHNICAL EXPLANATION, 67.

⁴² CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL GAINS, (U.S.-U.K. TREATY).

⁴³ Kimberly Blanchard, *New Tax Treaty Between U.S. and U.K.*, available at <http://www.weil.com/news/pubdetail.aspx?pub=8575>.

one in the U.S. Model Treaty.⁴⁴ Under the U.S.-U.K. treaty, a company is a “qualified person” if it meets one of three tests. First, the company is listed on a registered stock exchange, or more than 50% owned by five or fewer companies that are listed on a registered stock exchange.⁴⁵ Second, the company satisfies a two-part ownership/base erosion test. The company will satisfy this test if: (1) more than 50% of the shares are owned by qualifying persons, including individuals; and (2) less than 50% of the company’s gross income is paid to persons who are not residents of the contracting states (not including arm’s length payments for services or tangible property) in the form of payments that are tax deductible in payor’s state of residence.⁴⁶ Third, the company’s income is related to the business of the resident of the first contracting state.⁴⁷

The U.S.-U.K. treaty also provides treaty benefits to “equivalent beneficiaries” in an attempt to take account of the contracting states’ obligations under EU law and the North American Free Trade Agreement.⁴⁸ The equivalent beneficiaries clause only applies to dividend, royalty, and interest payments.⁴⁹ If a company is at least 95% owned by seven or fewer persons who are equivalent beneficiaries then the treaty benefits can apply.⁵⁰ The treaty defines an equivalent beneficiary as a resident of an EU Member State or the European Economic Area, or a party to the North American Free Trade Agreement.⁵¹ The rule above is subject to an important restriction. The treaty benefit will only be

⁴⁴ Compare U.S.-U.K. TREATY, Art. 4, with UNITED STATES MODEL INCOME TAX CONVENTION, Art. 4.

⁴⁵ U.S.-U.K. TREATY, Art. 23(2)(c).

⁴⁶ U.S.-U.K. TREATY, Art. 23(2)(f).

⁴⁷ U.S.-U.K. TREATY, Art. 23(4).

⁴⁸ U.S.-U.K. TREATY, Art. 23(3).

⁴⁹ U.S.-U.K. TREATY, Art. 23(7)(d)(i)(B).

⁵⁰ U.S.-U.K. TREATY, Art. 23(3).

⁵¹ U.S.-U.K. TREATY, Art. 23(7)(d).

available if the equivalent beneficiary could claim the same treaty benefit if it were the recipient.⁵²

The restriction to the equivalent beneficiaries rule can be illustrated through a straightforward example. A U.K. subsidiary with a Spanish parent company can claim the benefits of the U.S.-U.K. treaty if the Spanish company could claim the same benefits under the U.S.-Spain treaty. The U.S.-U.K. treaty provides for a 0% withholding tax on dividends,⁵³ however the U.S.-Spain treaty provides for a 10% withholding tax.⁵⁴ The Spanish parent company would not be eligible to claim a 0% withholding rate on dividends paid from the U.S. to Spain, so the U.K. subsidiary will not be able to take advantage of the 0% withholding rate in the U.S.-U.K. treaty. As shown in the next section, this different treatment based on the location of the parent does create a problem in treaties with EU Member States.

3. Concerns with LOB Provisions

Although LOB provisions are a fundamental part of most U.S. tax treaties, they suffer from three key drawbacks. First, the provisions are inconsistent with E.U. law, because EU Member States are permitting “passive discrimination” against other Member States when they sign a treaty including an LOB provision. Second, LOB provisions are based on objective criteria and can therefore be over- and under-inclusive, resulting in the denial of treaty benefits to legitimate transactions, while permitting the provision of treaty benefits to abusive transactions. Third, LOB provisions are complicated and an overreaction to the problem of tax treaty shopping.

⁵² U.S.-U.K. TREATY, Art. 23(7)(d).

⁵³ U.S.-U.K. TREATY, Art. 10(3).

⁵⁴ CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE KINGDOM OF SPAIN FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, Art. 10(2)(a).

i. Inconsistency with E.U. Law

Perhaps the biggest problem with LOB provisions is that they are inconsistent with EU law, because they force Member States to engage in passive discrimination. The European Court of Justice (ECJ) has issued two decisions on the use of LOB provisions, however the decisions are inconsistent and the legality of LOB provisions is still unclear. As a result, it seems likely that the ECJ will hear the issue again.

The invalidation of a provision that is in all U.S. tax treaties with EU Member States would be a significant problem. The U.S. has tax treaties with all 27 EU Member States, representing more than a third of its tax treaty network.⁵⁵ In addition, “nearly one-half of U.S. foreign portfolio investment is in EU securities, totaling approximately \$1,400 billion” and “EU portfolio investment in the United States is approximately \$1600 billion. . . .”⁵⁶ If the ECJ ruled against LOB provisions, the U.S. may have to renegotiate all of its treaties with EU Member States.

a. LOB Provisions are Inconsistent with EU Law

LOB provisions are inconsistent with EU law, because when an EU Member State signs a treaty including an LOB provision it is engaging in passive discrimination against other EU Member States. The EC Treaty, to which all Member States are signatories, provides four freedoms to Member States, one of which is the freedom of establishment.⁵⁷ The freedom of establishment prohibits nationality discrimination

⁵⁵ See <http://www.irs.gov/businesses/international/article/0,,id=96739,00.html>.

⁵⁶ Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice*, 59 TAX L. R. 65, 66 (2005).

⁵⁷ E.C. Treaty, Art. 43.

between Member States,⁵⁸ by requiring Member States to allow companies to operate “under the conditions laid down for its own nationals.”⁵⁹

LOB provisions appear to breach the freedom of establishment because the entire purpose of LOB provisions “is to exclude nonresidents from treaty benefits.”⁶⁰ The U.S. has attempted to mitigate this problem by providing benefits to equivalent beneficiaries, however the example of a U.K. company with a Spanish parent company⁶¹ has already shown that the equivalent beneficiaries exemption does not prevent different treatment between EU Member States.

The problem with LOB provisions in the EU context can be illustrated through the use of three short examples. In the first example, a U.S. company pays a dividend to its U.K. parent company that is in turn owned by another U.K. company. In this situation, the full benefit of the U.S.-U.K. treaty will be available because the U.K. recipient of the dividend is owned by a company managed and controlled in the U.K. No tax will be withheld on the dividend.

In the second example, the facts are the same as above except the ultimate parent company is resident in Belgium. Under both the U.S.-U.K. treaty and U.S.-Belgium treaty, there is no withholding tax on dividends.⁶² The Belgium parent company is therefore an equivalent beneficiary and the U.K. company receiving the dividends will be able to benefit from the reduced withholding rate provided by the treaty. No tax will be withheld on the dividend.

⁵⁸ E.C. Treaty, Art. 12, Note 7.

⁵⁹ E.C. Treaty, Art. 43.

⁶⁰ Mason, *supra* note 56, at 83.

⁶¹ See Part III.A.2. *supra*.

⁶² CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE KINGDOM OF BELGIUM FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, Art. 10(3).

In the third example, the facts are the same as the first example except the parent company is resident in France. Under the U.S.-France treaty, the dividend withholding rate is only reduced to 5%.⁶³ Therefore a company resident in France cannot obtain the same benefits under the U.S.-France treaty. Under this scenario, the U.K. company will not be able to claim the treaty benefit. The U.S. company must withhold tax at the standard rate of 30%.

b. EU Court Decisions

The ECJ has heard two cases involving LOB provisions, however its conflicting decisions have left a cloud of uncertainty over this important legal issue.

A. *Open Skies*

In *Open Skies*,⁶⁴ the ECJ held that EU Member States could not enter into treaties that contained LOB provisions that discriminated against other EU Member States. The U.S. entered into a treaty with the U.K. that contained a clause restricting the benefits to airlines owned by nationals of the U.K. The U.K. argued that the decision “to refuse traffic rights to airlines not controlled or owned by the United Kingdom is a sovereign choice of the United States of America.”⁶⁵ Effectively the U.K. was trying to argue that it was not the one discriminating against other Member States—instead it was the U.S. engaging in the discrimination. The EU rejected this argument holding that it was the

⁶³ CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE FRENCH REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL, Art. 10(2).

⁶⁴ Case C-446/98, *Comm'n v. U.K.*, 2002 E.C.R. I-9427; Case C-467/98, *Comm'n v. Denmark*, 2002 E.C.R. I-9519; Case C-468/98, *Comm'n v. Sweden*, 2002 E.C.R. I-9575; Case C-469/98, *Comm'n v. Finland*, 2002 E.C.R. I-9627; Case C-471/98, *Comm'n v. Belgium*, 2002 E.C.R. I-9681; Case C-472/98, *Comm'n Luxembourg*, 2002 E.C.R. I-9741; Case C-475/98; *Comm'n v. Austria*, 2002 E.C.R. I-9797; Case C-476/98, *Comm'n v. Germany*, 2002 E.C.R. I-9855.

⁶⁵ Case C-446/98, *Comm'n v. U.K.*, 2002 E.C.R. I-9427, at 35.

agreement itself, which the U.K. signed, that was discriminatory.⁶⁶ This case shows that states may not engage in “passive discrimination against EU nationals.”⁶⁷

The analogy to LOB provisions in tax treaties is clear. In tax treaties, as in the treaty in the *Open Skies*, the discriminating party is the U.S., however the treaty facilitates the discrimination. Therefore in tax treaties the signatory is engaging in passive discrimination by agreeing to LOB provisions.

B. U.K. Tax Credit Case

The decision in *Open Skies* suggested that the ECJ would rule against the use of LOB provisions in tax treaties. That was not the case. In *ACT IV*,⁶⁸ the ECJ held that an LOB clause was valid even though it restricted a tax credit to companies whose shareholders were also resident in the recipient country.

This case involved the U.K.’s use of a tax credit that it made available to its treaty partners, but only if the ultimate shareholders of the overseas company were also resident in the treaty country.⁶⁹ This provision is similar to the LOB provisions in U.S. tax treaties. The ECJ dealt with the issue in just two paragraphs, holding that granting a tax credit is an integral part of a treaty and the credit does not need to be available to non-residents who are not within the scope of the treaty.⁷⁰ This decision appears to show ECJ acceptance of LOB provisions in tax treaties.

c. Criticism of the ECJ Approach

⁶⁶ Case C-446/98, *Comm'n v. U.K.*, 2002 E.C.R. I-9427, at 51.

⁶⁷ Mason, *supra* note 56, at 82.

⁶⁸ Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Comm'r of the Inland Revenue*, 2006 E.C.R. I-11673.

⁶⁹ 2006 E.C.R. I-11673, ¶ 72.

⁷⁰ 2006 E.C.R. I-11673, ¶ 72-73.

The ECJ's decision in *ACT IV* arguably gives LOB provisions legitimacy in EU law, however the decision is flawed for two reasons. First, the ECJ's decision was incorrect and inconsistent with the freedom of establishment.⁷¹ The ECJ's mere two paragraph analysis of LOB provisions shows that the court did not adequately distinguish between the use of an LOB provision from the more basic question of whether the U.K. is entitled to provide treaty benefits to some countries and not others.⁷² Second, the decision in *ACT IV* is not consistent with other recent case law from the ECJ on broader issues of corporate taxation and the freedom of establishment.⁷³ In allowing a treaty to discriminate between Member States, the ECJ has created an "above the law" status for tax treaties that is unsustainable in the long run.⁷⁴

Despite the *ACT IV* decision, it is fair to say that the "effect of ECJ decisions on the sustainability of double taxation treaties between EU member states and non-member states is uncertain."⁷⁵

ii. Objective Nature

LOB provisions consist of objective criteria that allow a taxpayer and the competent authorities to determine whether treaty benefits will be available for any given transaction. There have long been concerns about the specialized nature of LOB

⁷¹ Pasquale Pistone, *Test Claimants in Class IV of the ACT Group Litigation: Limitation-of-Benefits Clauses are Clearly Different from Most-Favoured-Nation-Clauses*, BRITISH TAX R. 2007, 4, 363-65; Servaas van Thiel, *The Direct Income Tax Case Law of the European Court of Justice: Past Trends and Future Developments*, 62 TAX L. REV. 143, 153 (2008) ("the court confuses the right of Member States to shape the balance in rights and obligations as regards the allocation of jurisdiction and the avoidance of double taxation . . . , with the prohibition on using tax treaties to vary the substantive rights and duties of taxpayers . . .").

⁷² It has even been suggested that the U.K. judge to whom the decision is addressed should ignore the opinion of the ECJ in *ACT IV* because it was based on a "wrong understanding of the relevant facts." Pistone, *supra* note 71, at 365.

⁷³ Timothy Lyons, *Class IV ACT: Limited Benefits for All*, BRITISH TAX R. 2007, 2, 112-121, at 119; Pistone, *supra* note 71, at 364.

⁷⁴ Thiel, *supra* note 71, at 153.

⁷⁵ C John Taylor, *Twilight of the Neanderthals, or are Bilateral Double Taxation Treaty Networks Sustainable?*, 34 MELB. U. L. R. 268, 302 (2010).

provisions.⁷⁶ Attempts to strengthen LOB provisions to combat new forms of tax abuse, just result in new tax plans that avoid the new criteria.⁷⁷

The objective nature of LOB provisions causes the provision to apply to taxpayers who are not involved in treaty shopping. The following problem illustrates this example.⁷⁸ Person A is an individual resident in Nigeria. A wishes to acquire Target Co., a resident in Country X, however she needs to use a corporate vehicle from an industrialized country to gain credibility. A chooses a U.S. company. The tax treaty between the U.S. and X provides for a reduced dividend withholding tax rate of 5%, and it contains an LOB provision similar to that in the U.S. Model Treaty. The corporate structure outlined above will not satisfy the LOB provision, however there does not appear to be any tax abuse. The structure does not erode the U.S. tax base and any gain on the disposal of Target Co. will be chargeable to U.S. tax.

iii. Complicated and an Overreaction

LOB provisions are complicated and an overreaction to the problem of treaty shopping. LOB provisions “have become increasingly complex and detailed.”⁷⁹ This was probably inevitable given the objective nature of the provisions. The attempt to close off one loophole “inevitably gives rise to multiple subsidiary issues that must then be addressed via further rules and interpretations. . . .”⁸⁰ This is best evidenced in the U.S.-Netherlands tax treaty that contains an LOB provision that is longer than some tax

⁷⁶ Rosenbloom, *Toward a New Tax Treaty Policy for a New Decade*, 9 AM. J. TAX POL'Y 77, 92

⁷⁷ Rosenbloom, *supra* note 76, at 92 (the U.S. has “fallen into a pattern of legislating increasingly detailed and complicated rules aimed at particular transactions deemed to be abusive, which legislation is followed—like the night by day—by a new and more complex range of potentially abusive tax plans.”)

⁷⁸ Richard L. Reinhold, *What is Tax Treaty Abuse? (Is Treaty Shopping an Outdated Concept?)*, 53 TAX LAW. 663, 692 (2000).

⁷⁹ Reinhold, *supra* note 78, at 664.

⁸⁰ Reinhold, *supra* note 78, at 701. Reinhold illustrates the problem by looking at an example of domestic legislation that required the adoption of numerous sub-rules and concluded that “highly articulated rules cannot work in the treaty context.”

treaties.⁸¹ Applying LOB provisions requires the interaction of multiple treaties. This adds to the complexity of the provision and provides opportunities for tax arbitrage.⁸²

LOB provisions are also an overreaction to the tax treaty problem, especially in the context of industrialized nations. Following “the general elimination of tax treaties between the United States and tax-haven jurisdictions, it seems unnecessary to restrict treaty benefits in the case of companies formed in industrialized jurisdictions that are the main trading partners of the United States.”⁸³ One commentator has been more direct in criticizing LOB provisions, stating that “on the usual U.S. principle that anything worth doing is worth overdoing, recent formulations [of LOB] provisions have [gone] to new heights, or depths, of detail and complication”⁸⁴

B. The Proposal for a GAAR

LOB provisions are an inefficient way of combating tax abuse, and the U.S. should consider an alternative. A GAAR should be adopted in the U.S. Model Treaty and included in all U.S. treaties going forward. The GAAR should replace, not supplement, the LOB provision in tax treaties. A GAAR is preferable to specific anti-abuse provisions, because targeted legislation “is followed—like the night by day—by a new and more complex range of potentially abusive tax plans.”⁸⁵ A GAAR is favorable to the current anti-abuse provisions that “have been rendered virtually obsolete by technical readings and the creative genius of generations of tax planners.”⁸⁶

⁸¹ Paul H. Sleurink & Richard E. Andersen, *Benefits Under New U.S.-Dutch Treaty Are Limited by Complicated Tests*, 4 J. INT'L TAX'N 212, 212 (1993).

⁸² Reinhold, *supra* note 78, at 696.

⁸³ Reinhold, *supra* note 78, at 664.

⁸⁴ Rosenbloom, *supra* note 76, at 92.

⁸⁵ Rosenbloom, *supra* note 76, at 92.

⁸⁶ Rosenbloom, *supra* note 76, at 92.

GAARs already play an important role in many jurisdictions' domestic tax legislation. In addition there are also similar rules in some tax treaties. A GAAR in tax treaties will prevent tax abuse if it is well written, supported by adequate guidance for courts, and contains a formal arbitration procedure for when the contracting states disagree on its interpretation.

1. Current Use of GAARs in the Tax Treaty Context

GAARs outside of the tax treaty context are common and not a new concept. Countries all over the world now include GAARs in their domestic tax codes.⁸⁷ Countries that do not have a statutory GAAR, like the U.K. and, until recently, the U.S., may have a common law doctrine instead.⁸⁸ Some tax treaties include anti-abuse provisions that are similar to GAARs.

i. Main purpose clause

Some of Italy's tax treaties contain a "main purpose" clause that is similar to a GAAR, although it is far broader in application. Italy seeks to include a main purpose clause in its tax treaties because it doubts whether its domestic anti-abuse laws can block abusive transactions.⁸⁹ This provides an interesting comparison to the U.S.'s adoption of LOB provisions after a failure to block treaty abuse in its domestic courts.

The main purpose clause denies treaty benefits if "the *main purpose* or one of the main purposes of the creation or existence of such resident or any person connected with

⁸⁷ Countries with a GAAR include Australia, China, France, Germany, Netherlands, South Africa, and the U.S.

⁸⁸ The U.K. has a doctrine similar to the economic substance doctrine discussed in Part II, *supra*.

⁸⁹ TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE ITALIAN REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND THE PREVENTION OF FRAUD OR FISCAL EVASION, at 37.

such resident was to obtain the benefits under this [treaty] that would not otherwise be available”⁹⁰

Italy attempted to include this provision in the U.S.-Italy tax treaty, however the U.S. Senate rejected it. The Senate and the Joint Committee on Taxation both criticized the provision for being subjective and vague.⁹¹ The provision did receive support from Phil West, the Treasury International Tax Counsel, who defended the clause on the grounds that even though taxpayers would be required to make some judgment decisions, the “standard creates no more uncertainty than other U.S. doctrines that may also apply . . . such as the business purpose or step transaction doctrines.”⁹² The U.S. rejection of the main purpose clause provides an important lesson for any GAAR—it must not be too vague or subjective.

ii. Other Rules Similar to GAARs

The U.S.-Canada tax treaty contains a clause that could constitute a broad anti-abuse provision. In that treaty, there is an addition to the LOB provision that allows the parties to “deny benefits under [the treaty] where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of this Convention.”⁹³ The Treasury

⁹⁰ PROTOCOL TO THE CONVENTION BETWEEN THE REPUBLIC OF ICELAND AND THE ITALIAN REPUBLIC FOR THE AVOIDANCE ON DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND CAPITAL AND THE PREVENTION OF FISCAL EVASION, Art. 8(a) (emphasis added). Some provisions are even broader. The Italy-Israel treaty has a main purpose clause that allows the parties to deny benefits to any person if the “receipt of those benefits, under the circumstances, would constitute an abuse of the Convention according to its purpose.” CONVENTION BETWEEN THE GOVERNMENT OF THE STATE OF ISRAEL AND THE GOVERNMENT OF THE REPUBLIC OF ITALY FOR THE AVOIDANCE ON DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND CAPITAL AND THE PREVENTION OF FISCAL EVASION, Art. 30.

⁹¹ JCT Chief of Staff Addresses Tax Treaties at Senate Hearing, TAX NOTES TODAY (Nov. 12, 1999); Senate Foreign Relations Committee Holds Tax Treaty Hearings, TAX NOTES TODAY, (Oct. 29, 1999).

⁹² Dept. of the Treasury, Treasury Int’l Tax Counsel Philip R. West Testimony Before the Senate Comm. On Foreign Relations, TREASURY NEWS, at 9 (Oct. 27, 1999). Reinhold supports this opinion stating that even though advisors will consider economic substance without a reminder in the treaty, it wouldn’t hurt to have one in there anyway. Reinhold, *supra* note 78, at 702.

⁹³ CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND CANADA WITH RESPECT TO TAXES ON INCOME AND CAPITAL, Art. 29A(7).

explanation to this provision states that Canada wanted to ensure it could still rely on its domestic GAAR to prevent tax abuse.⁹⁴ However, the language appears to apply to any instance of abuse, and could be relied upon by either the U.S. or Canada.⁹⁵

2. How Would the GAAR Work?

For the GAAR to successfully prevent tax abuse, it is important that the provision is sufficiently clear, that it gives appropriate guidance to courts, and that it includes a procedure for dealing with differences in interpretation between contracting states.

i. Language of the GAAR

There are many statutory GAARs in existence, but perhaps the most relevant one, and also the most recent, is the U.S. GAAR, enacted in 2010.⁹⁶ The U.S. GAAR is a good model, because it has already been approved by the U.S. Congress, albeit in a domestic context. Including the GAAR in tax treaties is preferable to just relying on the domestic GAAR, because a bilateral solution would be more effective than the U.S. acting on its own.⁹⁷

The U.S. GAAR specifies how courts should apply the economic substance doctrine. The GAAR states that in order to treat a transaction as having economic substance, the transaction must: (1) change, in a meaningful way (apart from tax benefits), the taxpayer's economic position, and (2) the taxpayer must have a substantial non-tax

⁹⁴ TECHNICAL EXPLANATION OF THE PROTOCOL DONE AT CHELSEA ON SEPTEMBER 21, 2007 AMENDING THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND CANADA WITH RESPECT TO TAXES ON INCOME AND CAPITAL, 51-52.

⁹⁵ Reinhold, *supra* note 78, at 700.

⁹⁶ 26 U.S.C. § 7701(o).

⁹⁷ Anna A. Kornikova, *Solving the Problem of Tax-Treaty Shopping Through the Use of Limitation on Benefits Provisions*, 8 RICH. J. GLOBAL L. & BUS. 249, 272 (2008) (“Unilateral measures in one country alone may not effectively discourage treaty shopping as a global problem. . . . A long-term solution of the treaty shopping problem should take into consideration other jurisdictions’ practices.”).

purpose for entering into such a transaction.⁹⁸ If the taxpayer intends to show the transaction has profit potential, then the transaction will need to satisfy the profit test.⁹⁹ The profit test is satisfied if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits.¹⁰⁰

This GAAR gives some flexibility to domestic courts while also requiring that any profit is not inconsequential in relation to the tax savings. In other words, the GAAR should allow transactions that have a motive more important, or as important as, the tax saving achieved.

This GAAR would not conflict with EU law. The ECJ has already indicated that discriminatory treatment is acceptable in clear instances of tax abuse.¹⁰¹ The transactions blocked by the GAAR should only represent genuine tax treaty abuse, and will therefore be consistent with EU law.

ii. Use of Examples in the GAAR

Because a GAAR does not use objective criteria, it can block abusive transactions, while allowing similar transactions that a legitimate purpose. However, it is important that both contracting states have similar expectations as to how the GAAR will be applied. This paper proposes the use of examples included within the text of the treaty itself to guide the courts in interpretation of the GAAR.

The use of examples to guide courts is not a novel idea; examples are already common in explanatory materials accompanying tax treaties. The technical explanation

⁹⁸ § 7701(o)(1).

⁹⁹ § 7701(o)(2)(A).

¹⁰⁰ § 7701(o)(2)(A).

¹⁰¹ Case C-196/04, *Cadbury Schweppes Plc v. Comm'rs of Inland Revenue*, 2006 E.C.R. I-7995, at ¶ 75 (holding that a nationality-based discrimination is acceptable on in instances relating to the use of “wholly artificial arrangements intended to escape the national tax normally payable.”)

to the U.S. Model Treaty contains examples that explain when treaty benefits should and should not be denied under the LOB provision.¹⁰² The use of examples should not be confined to unilateral explanatory materials such as the U.S. technical explanation. Although U.S. courts may give deference to the U.S. technical explanation, it is unlikely that foreign courts will. Examples within the treaty will be binding forms of interpretive guidance on both parties.

iii. Dealing with Disputes – Arbitration

There are few “mechanisms for enforcement of international law”¹⁰³ and this has led to the criticism that countries like the U.S. can “releas[e] themselves from treaty obligations when they [deem] it fit.”¹⁰⁴

A GAAR in tax treaties would give a lot of power to domestic courts. Each contracting state will have concerns about how the other state will interpret certain transactions. While that problem should be mitigated significantly by the use of examples as discussed above, an agreed upon method of arbitration is also essential to the success of a GAAR in tax treaties. One scholar suggests that “denial of treaty benefits be conditioned on prior consultation with the competent authority. . . .”¹⁰⁵ This solution is not practical, because it would require states to discuss every instance of tax abuse before any transaction can take place.

Instead the GAAR should include a formal arbitration process that will apply when the contracting states disagree about the tax treatment of a transaction. Specifically the GAAR should provide for a “baseball-style” arbitration process. This mandatory

¹⁰² TECHNICAL EXPLANATION TO THE U.S. MODEL, at 65-66, 70-71.

¹⁰³ Kornikova, *supra* note 97, at 277.

¹⁰⁴ Kornikova, *supra* note 97, at 277 quoting Antonio Cassese, INTERNATIONAL LAW, 153-54 (2 ed. 2005).

¹⁰⁵ Reinhold, *supra* note 78, at 701.

baseball-style arbitration will apply when the competent authorities cannot resolve a difference of opinion concerning the tax treatment of a transaction. Under baseball-style arbitration, both sides would submit a proposal and the arbitrator would choose one.¹⁰⁶ There is no opportunity to modify the proposal. This should ensure that both parties put forward reasonable proposals at the first time of asking. The U.S. included this type of arbitration clause in the recent U.S.-Germany treaty.¹⁰⁷

3. Criticisms of a GAAR in Tax Treaties

The proposal to add a GAAR into future tax treaties will be criticized for three main reasons. The biggest obstacle will probably be the uncertainty inherent in GAARs. There will also be concerns about how foreign courts will interpret such a clause. Finally, the time and effort it will take to implement this proposal will be significant. Ultimately, although the points are valid, this paper concludes that the possible negative implications do not outweigh the potential benefits of a GAAR in tax treaties.

i. GAARs and Uncertainty

GAARs are, by definition, general and subjective, and this can lead lawmakers to believe that a GAAR will create uncertainty for taxpayers and tax authorities. The U.S.'s response to Italy's main purpose provision shows that the subjective nature of GAARs is a concern.¹⁰⁸ This criticism should not prevent the use of a GAAR in tax treaties for three reasons. First, the successful use of GAARs in domestic legislation shows that subjectivity can be handled by courts. Second, tax treaties take a long time to negotiate

¹⁰⁶ Kornicova, *supra* note 97, at 278.

¹⁰⁷ PROTOCOL TO THE CONVENTION BETWEEN THE UNITED STATES OF AMERICAN AND THE FEDERAL REPUBLIC OF GERMANY FOR THE AVOIDANCE ON DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL AND TO CERTAIN OTHER TAXES, Art. 13.

¹⁰⁸ See Part III.B.1.i. *supra*.

and therefore need a subjective and flexible anti-avoidance provision. Finally, the use of examples within the treaty can guide courts in interpretation.

GAARs are included in the domestic legislation of many large industrialized countries, including the U.S. Countries that do not have a codified GAAR may have a strong anti-avoidance principle in common law that can apply to block abusive transactions.¹⁰⁹ The proposal in this paper is based on the U.S. statutory GAAR, that contains specific guidance to aid courts in its interpretation. It is worth noting that the U.S. GAAR was passed as recently as 2010. This suggests there may have been a shift in the U.S. attitude to GAARs since the U.S. rejection of Italy's main purpose provision.

Tax treaties cannot be amended quickly and therefore lawmakers cannot instantly block new tax avoidance schemes by amending treaties. This contrasts with domestic law which can be updated relatively quickly to block new forms of tax abuse.

This paper has also shown how the uncertainty in a GAAR could be minimized through the use of examples that are actually incorporated into the treaty. Domestic courts, and in turn taxpayers and tax authorities, would be guided by these examples when deciding cases involving possible tax avoidance. The interpretation of GAARs by domestic courts leads into the next possible criticism of GAARs in tax treaties.

ii. Interpretation of GAARs by Foreign Courts

Some countries will not want to rely on the interpretation of the treaty by foreign courts. For example, the U.S. may not want to rely on a Chinese court for judgment on a transaction that affects a U.S. company. This criticism can be addressed in two ways. First, as stated, the use of examples is intended to give guidance to courts and reduce uncertainty. A foreign state court that does not follow the guidance in the examples, puts

¹⁰⁹ See *e.g.* the U.K.'s substance-over-form common law doctrine.

the state in breach of the treaty in the same way as if the state had broken any of the other provisions. Second, the proposal in this paper includes a mandatory arbitration procedure to deal with differences of opinion between the parties.

All treaties rely, at least in part, on the interpretation of treaty provisions by the other party. Sometimes treaty interpretation by foreign jurisdictions negatively affects U.S. companies. For example, in India the local tax authorities took an inconsistent approach in defining whether someone is a resident of a contracting state.¹¹⁰ This resulted in the denial of treaty benefits to a U.S. pension fund. The U.S. pension fund was held not to be “subject to tax” in the U.S. because it was a tax exempt pension fund.¹¹¹ This is despite an earlier ruling that defined the similar term “liable to tax” as covering any company subject to the jurisdiction’s tax laws.¹¹² If the earlier definition had been applied, the U.S. pension fund could have claimed treaty benefits.

It is inevitable that the GAAR will be interpreted slightly differently by overseas courts, however a clearly written rule, and the use of examples for guidance, should keep disagreements to a minimum. Including a GAAR in tax treaties may actually provide for more certainty in treaty interpretation, because courts will not need to consider domestic GAARs when confronted with potentially abusive transactions.

¹¹⁰ See Kornicova, *supra* note 97, at 268-70 for a more detailed discussion of India’s recent tax decisions on residence status.

¹¹¹ Gen. Elec. Pension Trust, A.A.R. No. 659 of 2005 (Dec. 14, 2005), available at <http://www.indiankanoon.org/doc/1334991/> (last visited Nov. 13, 2011) (holding that “liable to taxation” and “subject to tax” are not the same. The trust is liable to U.S. taxation, but not subject to U.S. tax on the income in question).

¹¹² Union of India v. Azadi Bachao Andolan, [2003] 263 I.T.R. 706 (India), available at <http://judis.nic.in/supremecourt/chejudis.asp> (search for “azadi” between “Jan. 1, 2003” and “Dec. 31, 2003.” (“Merely because, at a given time there may be an exemption from income-tax in respect of any particular head of income, it cannot be contended that the taxable entity is not liable to taxation.”)).

iii. Time Required to Amend Tax Treaties

Tax treaties are time consuming to agree. They require the agreement of two nation states, so any change to a tax treaty, or tax treaty policy, needs to consider the time and costs involved. If the U.S. amended its Model Treaty to replace the LOB provision with a GAAR, the U.S. would need to eventually replace or amend every one of its tax treaties. This may seem like enough of a reason to maintain the status quo, however it is not.

Tax treaties take a lot of time to agree, however they also last for a long time. A GAAR in tax treaties is intended to cover a wide range of tax avoidance transactions, some of which have not yet been conceived. The effort extended to include a GAAR in tax treaties will be offset by the long-term benefits achieved.

This paper is not suggesting that every existing treaty be amended within a set time frame. LOB provisions were first included in tax treaties in 1981, however the U.S. is still amending existing treaties and signing new ones. The GAAR could be included in new treaties and existing ones could gradually be replaced. The time and effort required to amend treaties did not stop the U.S. adopting LOB provisions, and it should not stop the U.S. replacing those provisions with GAARs.

IV. CONCLUSION

It is easy to see why the U.S. began including LOB provisions in its tax treaties. U.S. courts did not fully prevent tax treaty abuse, and this led to concerns that the U.S. tax base could be eroded. LOB provisions prevent some forms of tax abuse, however the provisions rely on objective criteria and that creates the potential for further abuse. In addition, LOB provisions face an uncertain future in the EU. The U.S. should therefore

consider replacing LOB provision with GAARs. A GAAR can block a wider range of abusive transactions and is not as susceptible to abuse as an LOB provision. The U.S. should amend its Model Treaty to include a GAAR and then begin incorporating the GAAR into all future treaty negotiations. Over time, existing treaties should be amended to replace the LOB provision with a GAAR. The effort required to do this should not be underestimated, however the time and energy expended will be rewarded by an anti-avoidance provision that will prevent a wide range of tax abuse for many years to come.