



Improper use of tax treaties and source taxation: policy, practice and beyond

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The Mischief

“Global” in nature:

- Taxpayer’s activities are global
- Taxpayer’s desire to avoid tax is universal



Source: IFA subject 2 presentation slides



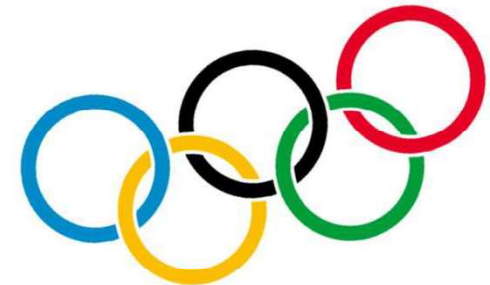
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Legal Instruments

- National law
- Bilateral tax treaties

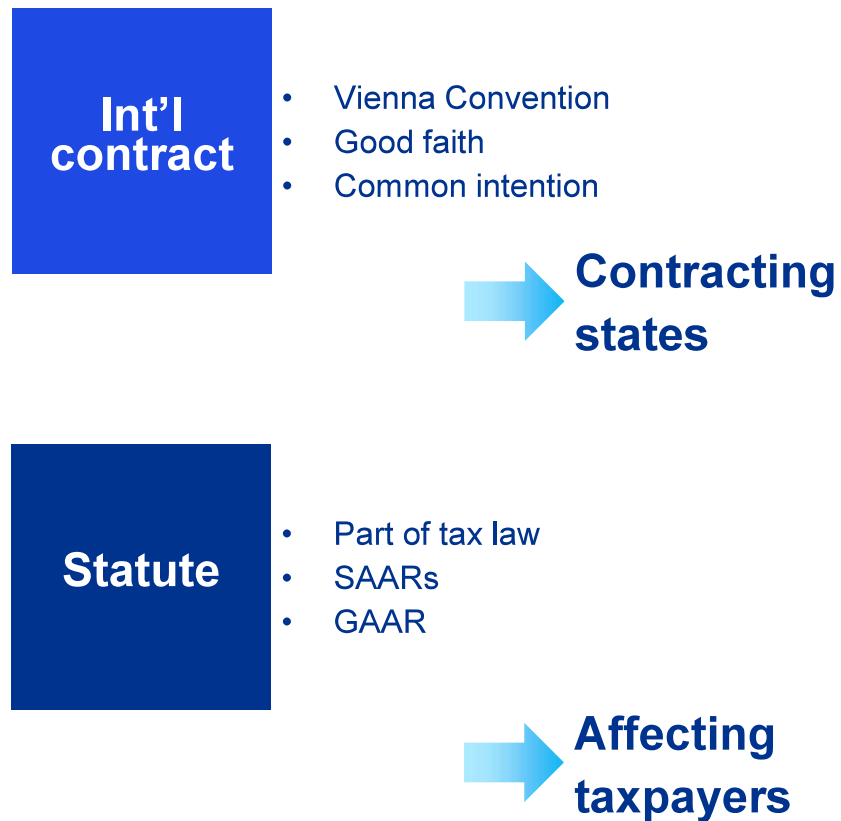


- PPT or OECD Guiding Principle One
Ring that binds them all”



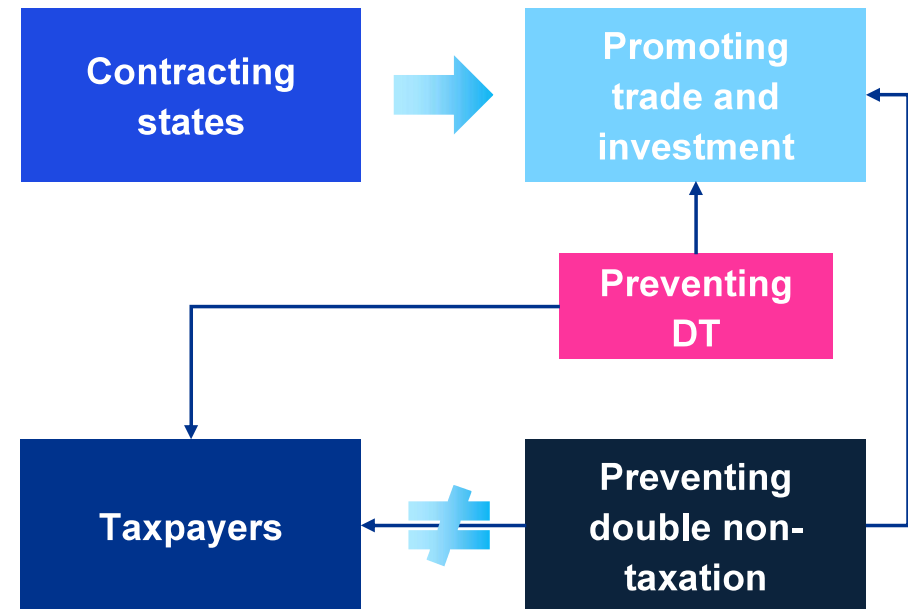
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Duality

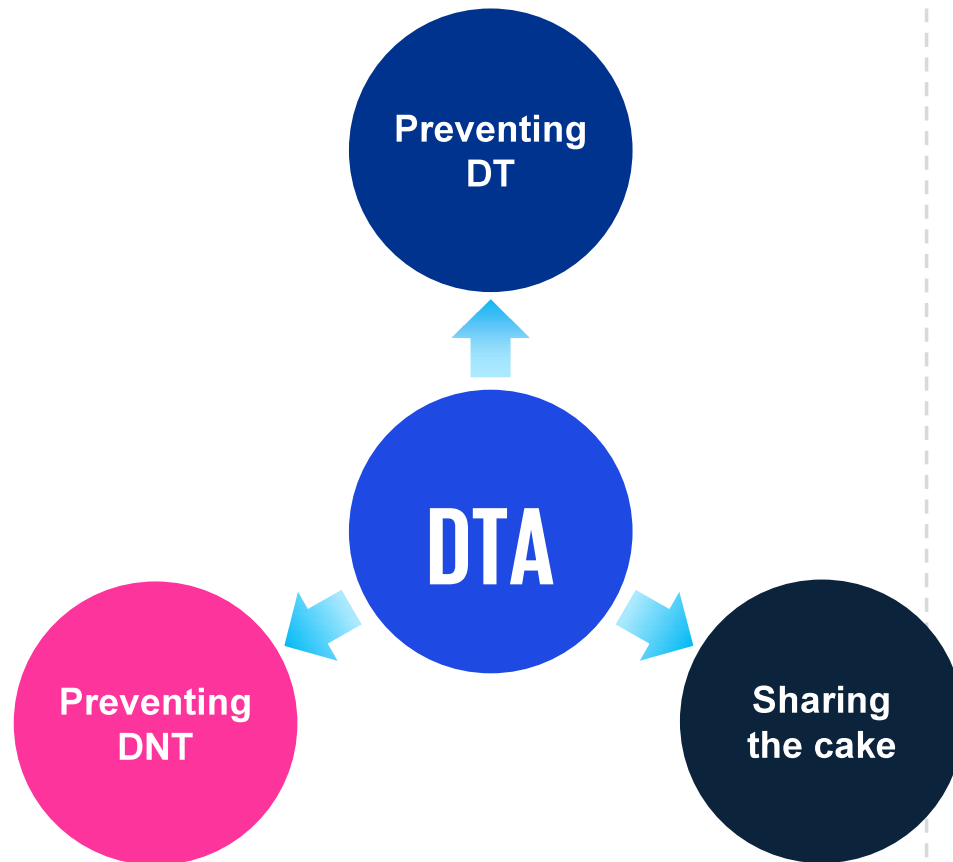


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“Use”

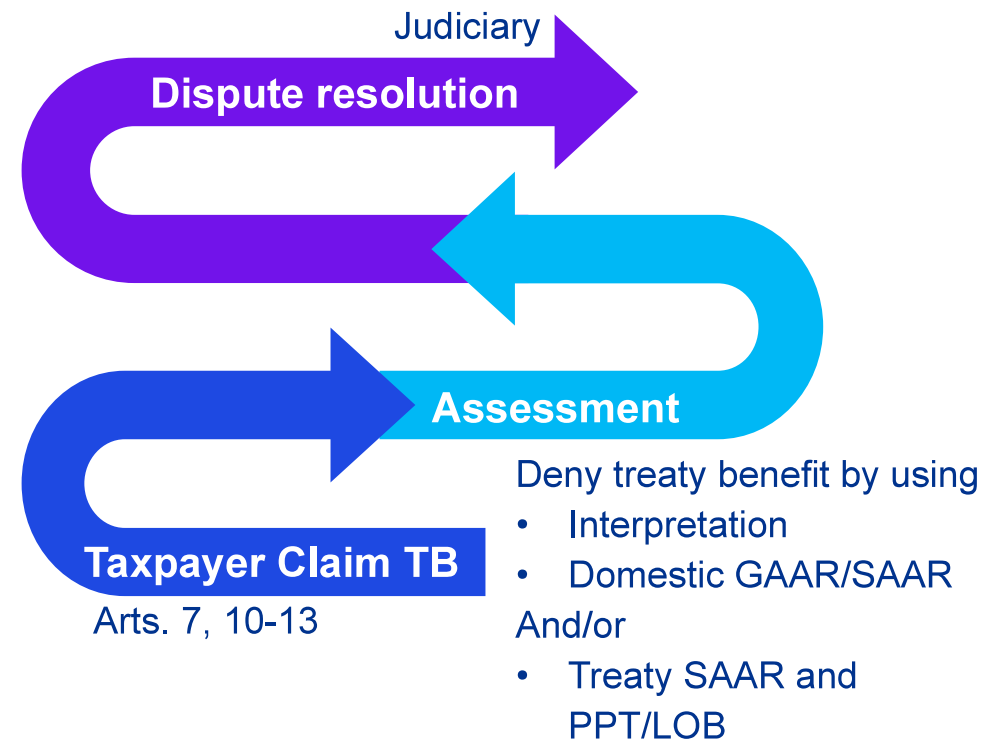


Confusion



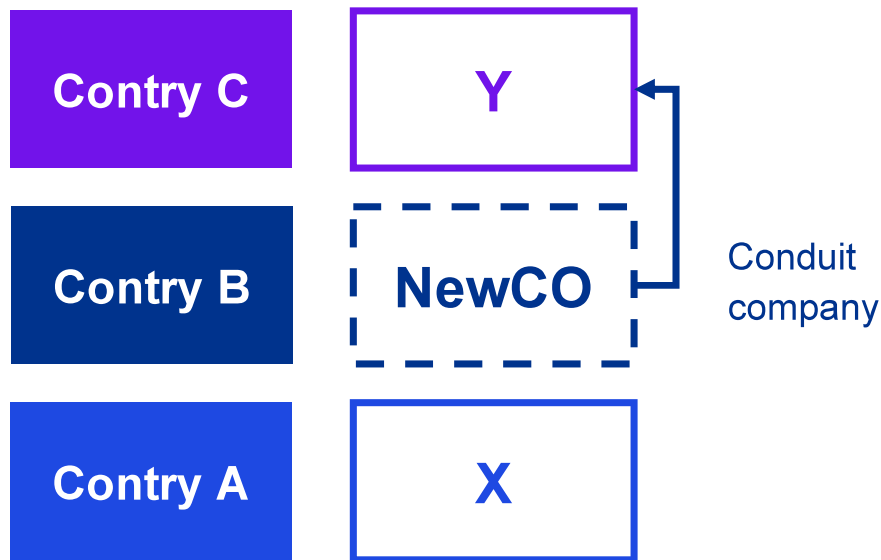
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The Process of Use



IFA On-site Voting Survey

- A and B have a tax treaty
- B and C have a tax treaty
- A and C **do not** have a tax treaty



Q: Considering the A-B and B-C DTAs, Company X, a resident of A, set up a company in B(treaty shopping). If there is abuse, which treaty is abused?

- a) The A-B DTA has been abused
- b) The B-C DTA has been abused
- c) None of the DTAs has been abused
- d) Both treaties have been abused

Source: IFA subject 2 presentation slides

Divergence in treaty interpretation

A

Textual

**Treaty bargain
(common intention)**

B

**Purposive
(broader context)**

**Adding implicit
qualifications to treaty
articles**

Source: IFA subject 2 presentation slides

Divergence in application (construction of facts)

A

Legal

**Tax planning is legitimate
purpose**

B

Economic commercial

**“artificial”
Transactions deemed
abusive**

Source: IFA subject 2 presentation slides

Divergence in the effect of domestic GAAR

A

**Cannot alter the original
treaty bargain**

Good faith

B

**“Neutralize” the effect of
the other state’s domestic
law**

Good faith

Source: IFA subject 2 presentation slides

Family Matters

- **Common law** jurisdictions:
 - The legal analysis of the transaction and
 - Textual or contractual interpretation of the treaty provisions
- **Civil law** jurisdictions:
 - Economic substance
 - Reading in “conditions” through GAAR or PPT

Source: IFA subject 2 presentation slides



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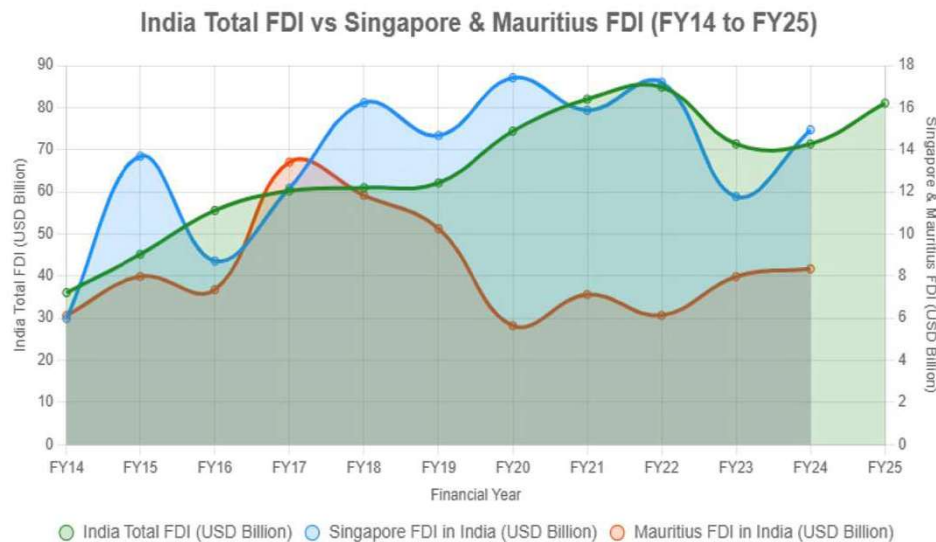
Source Country's Perspective Protecting Source Taxation

Balancing anti-abuse measures with preservation of investment attractiveness

- Why countries remain committed to source taxation
- How countries determine their tax and economic priorities – a false dichotomy between “developed” and “developing” countries?
- Domestic law and treaty measures to protect source taxation
- Tension between desire for inbound capital investment and rigorous enforcement of source taxation principles
- Case study: How can Australia realise its ambition for a faster “energy transition” whilst simultaneously ensuring that it collects its “fair share” of tax from the exploitation of natural resources?

Source: IFA subject 2 presentation slides

Balancing anti-abuse measures with preservation of investment attractiveness



- CAGR: Ind-16% (in 25 yrs); Sing-11% (in 10 yrs)
- \$ 81.04 bn FDI (FY 25), 14% up from FY 24

Source: IFA subject 2 presentation slides

Journey of eco-drive to fiscal fears!!

Cap on source tax ignite foreign funds flow

Boards are eco-driven; not tax lured

Treaty shopping –necessary evil?

Where is the abuse?

BEPS Action 6

DTC between Brazil and the Netherlands



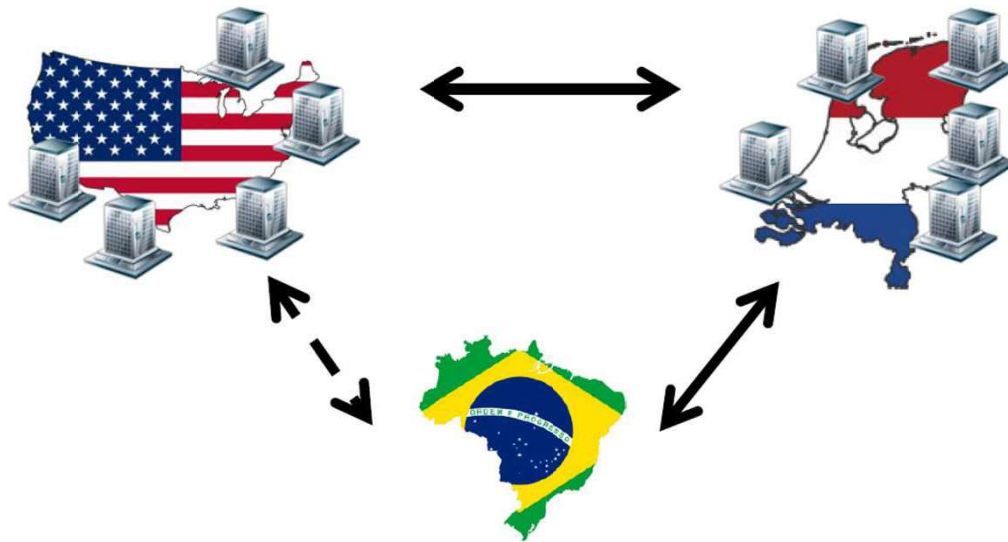
- High number of DTCs
- High number of holdings

- The purpose of the DTC is to promote Investments
- If treaty shopping were to be restricted, an LOB or PPT clause in the treaty between Brazil and the Netherlands should not have been included

Source: IFA subject 2 presentation slides

BEPS Action 6

DTC between Brazil and the Netherlands



The US investor can profit from the treaty between the United States and the Netherlands that makes the tax planning possible

Source: IFA subject 2 presentation slides

If the treaty shopping should be avoided, **the first step should be to ask where the abuse is.**

The **treaty between the residence state and the state of the intermediary person** should be considered rather than **the one between the latter and the source state.**

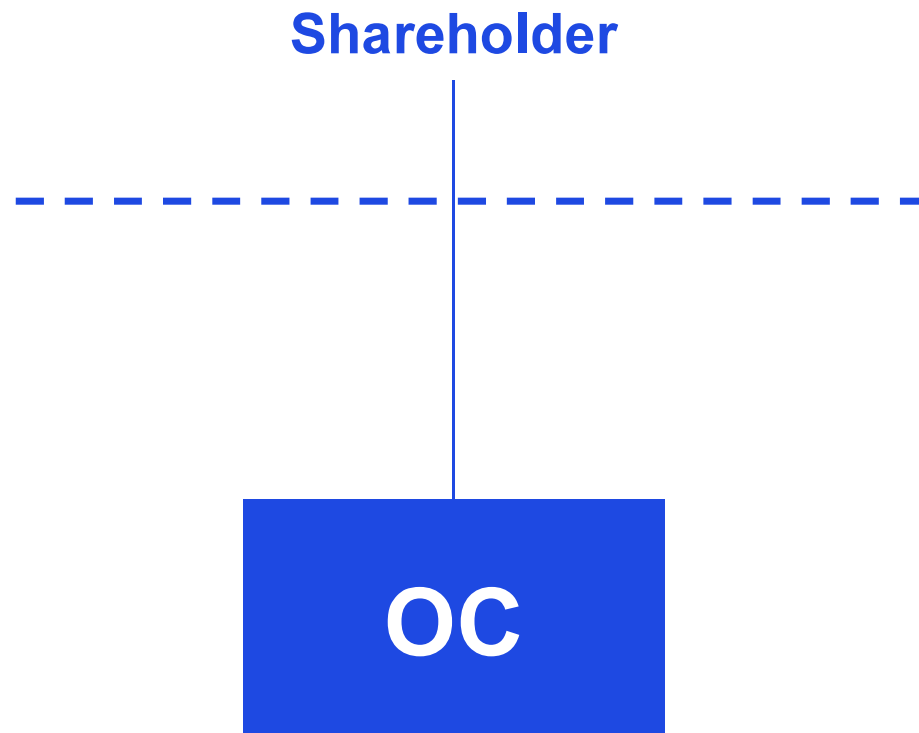
Abuse and treaty shopping

- **OECD Model as of 2017: combatting tax avoidance**
 - Preamble (Art. 6 MLI): tax treaty intends to avoid creating opportunities for tax avoidance
 - Including through treaty shopping arrangements
- **Treaty shopping can be in line with main object and purpose of tax treaties**
 - Removing obstacles to the development of economic relationships between countries
 - Treaty shopping should be part of decision-making process of where to invest and how to invest
 - Contributing to increase of welfare; not incurring a welfare loss
 - Tax is just a cost like any other costs
 - Treaty shopping constitutes **abuse** if the structure results in **a welfare loss**

Source: IFA subject 2 presentation slides

Rule shopping

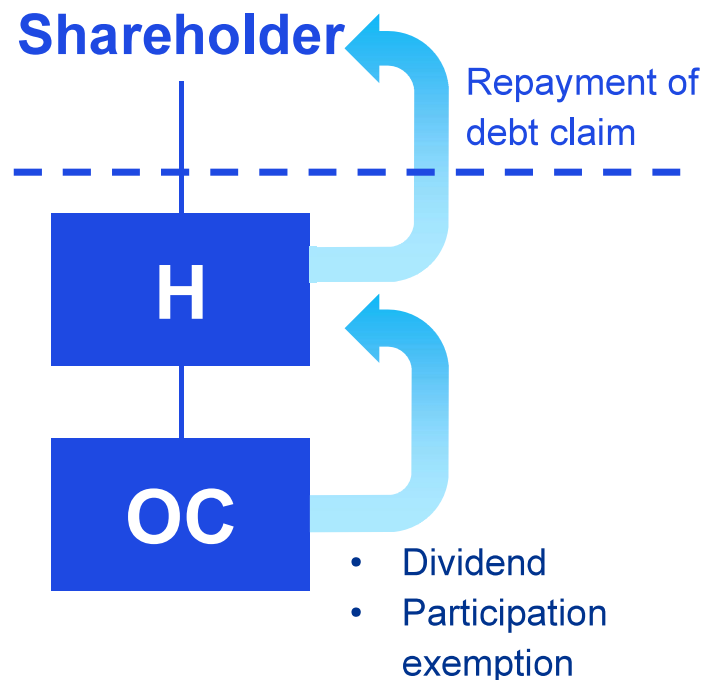
Conversion of dividend into capital gain onshares under OECD Model Tax Convention



- OC is not an immovable property company
- OC is loaded with undistributed profits

Source: IFA subject 2 presentation slides

Conversion of dividend into capital gain onshares under OECD Model Tax Convention



- OC is not an immovable property company
- OC is loaded with undistributed profits
- Inconsistent allocation rules of dividend and capital gains on shares (rule shopping)
- Anti-abuse law?
 - Alienation of shares to H is considered to constitute a (construed) dividend?
 - Alienation of shares by Shareholder to H is ignored: dividend payment from OC to Shareholder?
 - Does Principal Purpose Test of Art. 29(9) OECD Model apply?
 - If not, limited tax jurisdiction source State is avoided

Source: IFA subject 2 presentation slides



The view that non-taxation in the Netherlands would constitute a misinterpretation of object and purpose of the treaty cannot be supported by the text of or the explanations to the treaty.

The treaty does not show that it meant to include benefits like the ones in this case.

Abuse is established due to double non-taxation, even if the treaty does not contain an anti-abuse clause.

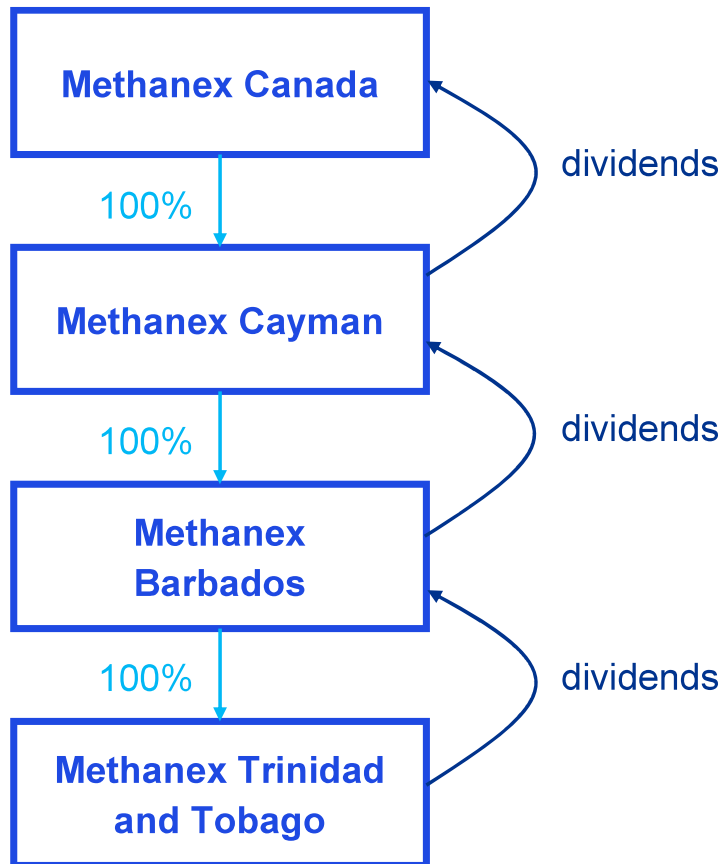
The principle of economic reality must be applied even if it is not provided for in the treaty.



Source: IFA subject 2 presentation slides

Treaty shopping & Domestic GAAR and SAAR

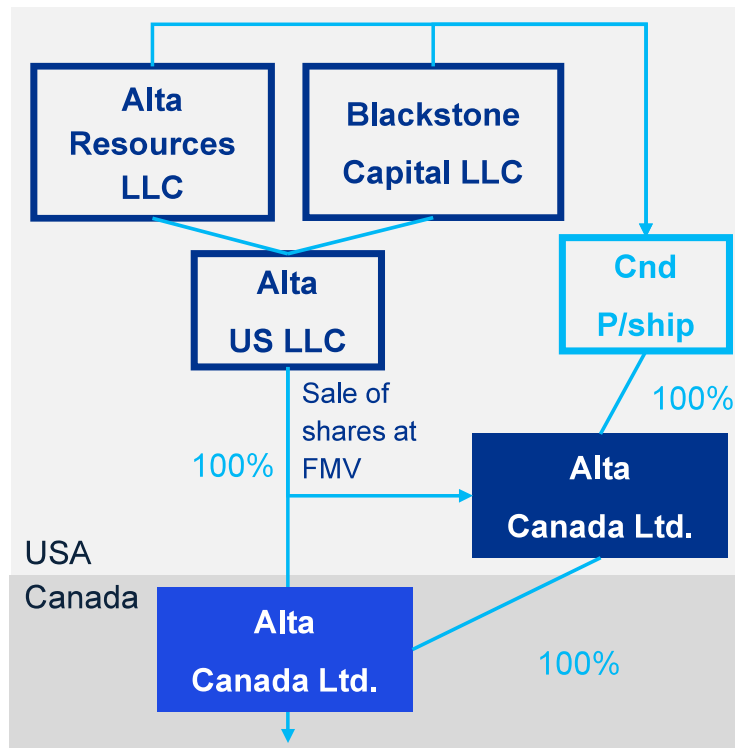
UK: Methanex



Source: IFA subject 2 presentation slides

- Treaty shopping arrangement
 - No “beneficial owner” test in the treaty
 - Issue: treaty rate for dividends NA under domestic GAAR (“artificial” or “fictitious” test)?
 - Privy Council (UK):
 - The dividend payment was not artificial: “it cannot be artificial to execute commercial decision by the only available legal means” [para.43]
 - The arrangement is not fictitious as it is “normal” investment environment to have intra-group holding structures
 - Courts cannot imply terms into the treaty that were not there
- [similar approach as in Alta Energy]

Canada: Alta Energy

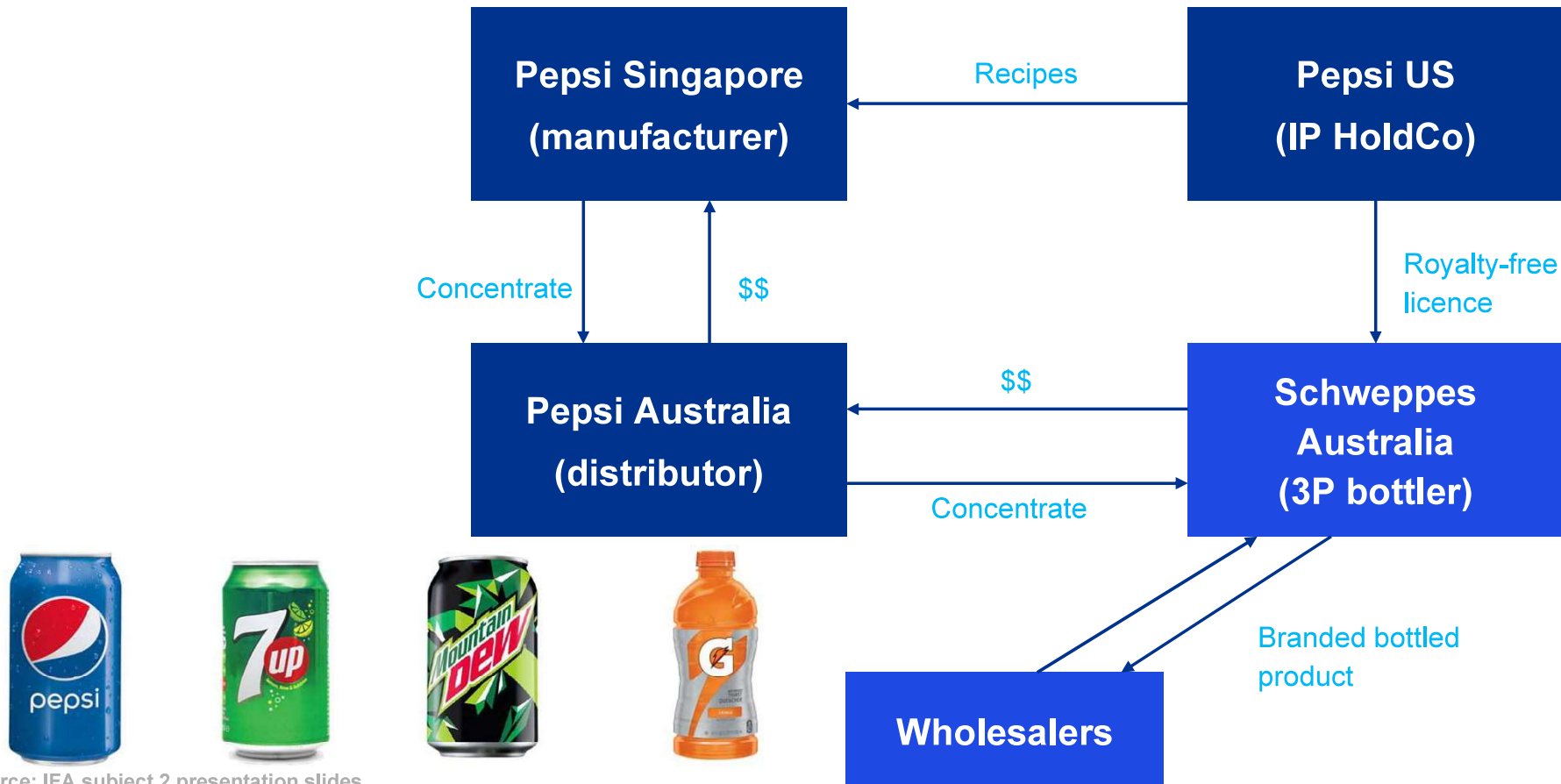


Acquire and develop oil and gas properties in Alberta (rights to drill and recovery rights under licenses issued by Alberta)

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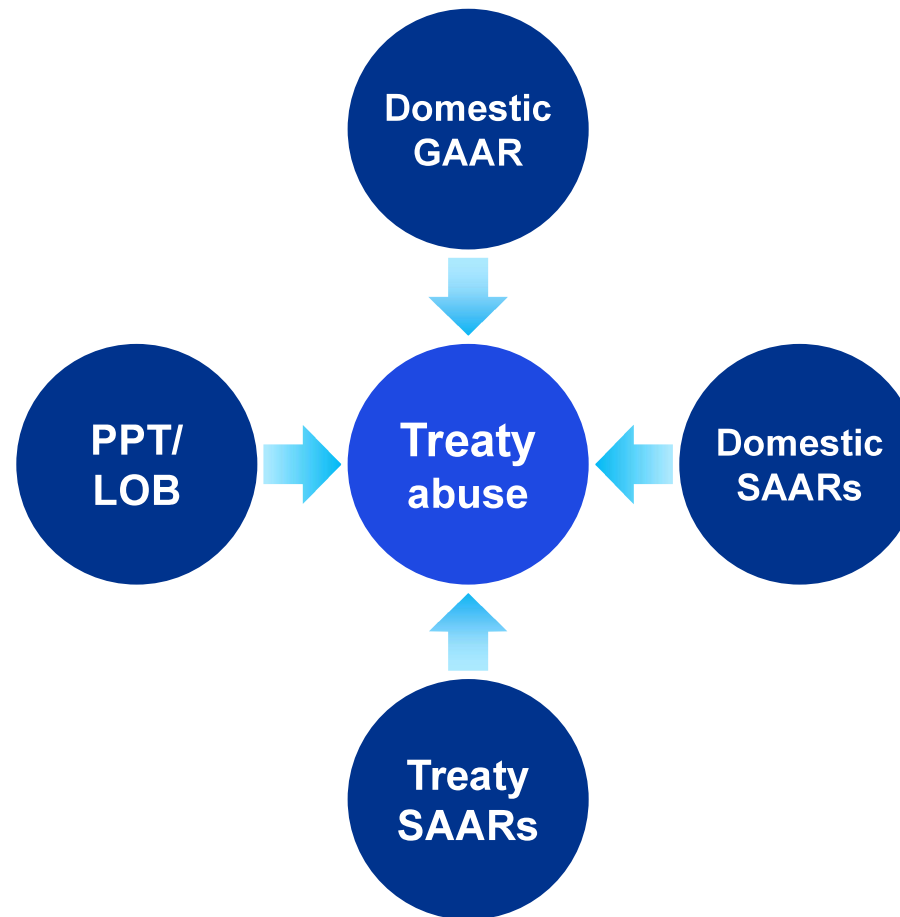
- Typical treaty shopping arrangement
- Luxembourg residence was accepted by the Canada Revenue Agency outside the GAAR
 - Issue: Is the arrangement ‘abusive’ under Canadian GAAR?
 - SCC –Majority: No
 - The government failed to prove “clear abuse”
 - Treaty benefit was not intended to be limited to companies with sufficient economic connections to Luxembourg
 - The GAAR cannot be applied to “judicially amend or renegotiate a treaty”
 - Purpose of art.13(4): encourage investment in Canada
 - Relevant context for finding purpose:
 - Absence of anti-shopping SAARs
 - Circumstances, such as Luxembourg is a small country, known for its favorable tax regime

Australia: Alta Energy



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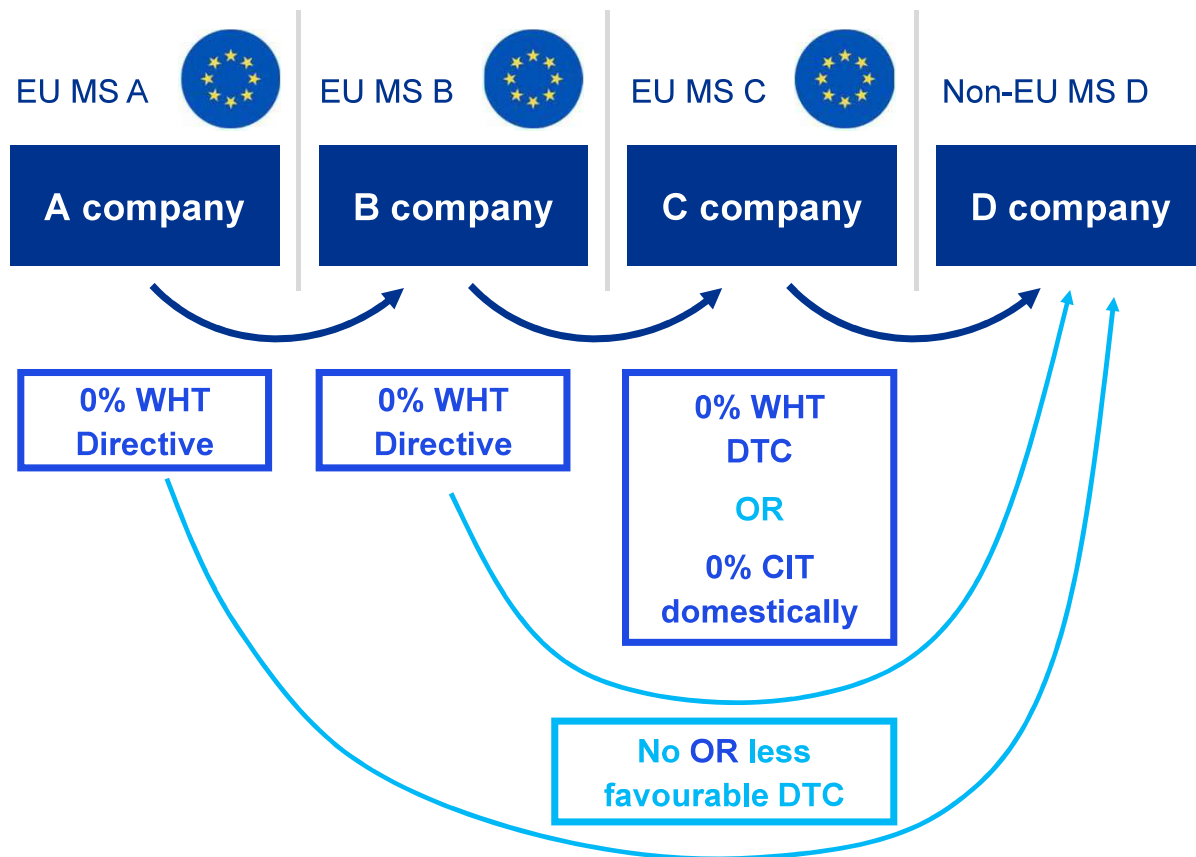
Source countries' anti-abuse arsenal



Source: IFA subject 2 presentation slides

Beneficial owner: Court of Justice of the European Union (Danish cases)

Court of Justice of EU: Conduit company



Source: IFA subject 2 presentation slides

European Union specificity

EU Directives vs Member States' tax treaties

- Council Directive 2011/96/EU “Parent-Subsidiary” (PSD) –no WHT for intra-group dividends (10% participation)
- No beneficial ownership requirement, but anti-abuse measures applicable
- Council Directive 2003/49/EC “Interest-Royalties” (IRD) –no WHT for intra-group interest/royalties (25% participation)
- Beneficial ownership requirement and anti-abuse measures applicable

Source: IFA subject 2 presentation slides



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European Union (Danish cases)

Two sets of cases on interpretation of PSD and IRD

- Cases C-115/16, C-118/16 and C-119/16, N Luxembourg 1 and Others (IRD) and C-116/16 and C-117/16, T Danmark and Y Danmark (PSD)
- CJEU: WHT exemption cannot be claimed in abusive circumstances
- Abuse exists if the recipient is ‘a conduit company’
- Numerous indicia of ‘conduit company’ related to (both) substance and contractual relationships (open list)
- Open question: if a conduit company ≠ beneficial owner?

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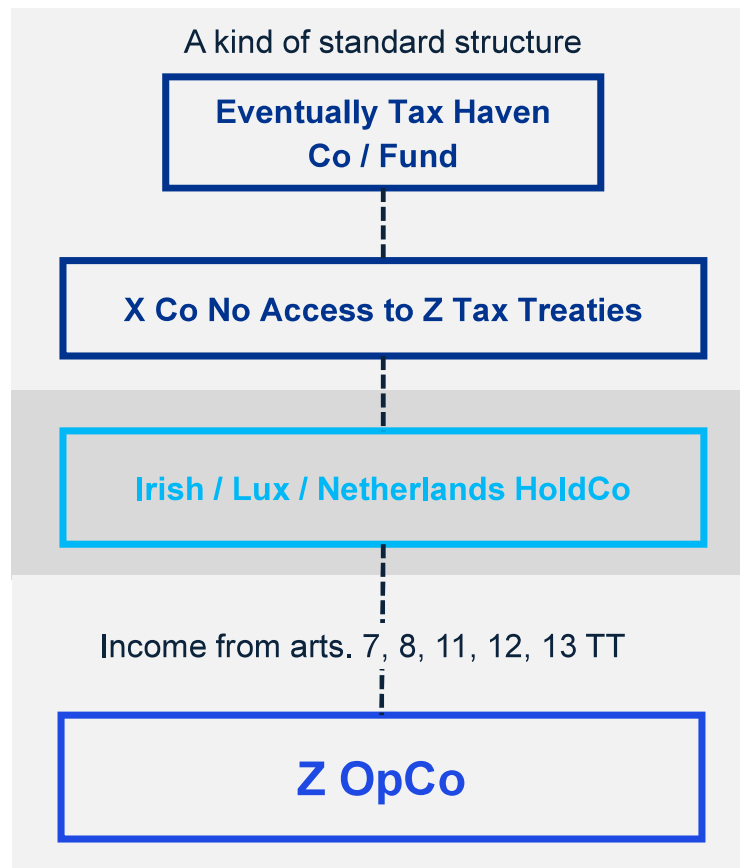
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	EU General principle “Abuse of rights” – case-law based	PPT (Art. 29(9) OECD MC) – statutory	GAAR (Art. 6 ATAD1) – statutory
Subjective element / motive test	The intention to obtain an advantage from the EU rules by artificially creating the conditions for obtaining it.	It is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction (...) that resulted directly or indirectly in a benefit, unless (...).	(...) having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law.

Source: IFA subject 2 presentation slides

The PPT Clause

The PPT in theory and practice: a critical view



Source: IFA subject 2 presentation slides

- **Action 6 minimum standard: 3 different ways to achieve it, with equivalent results?**

- Linking the PPT and the LOB provisions:
 $PPT = (PPT + LOB) = (LOB + \text{Anti-Conduit Rules})$
- Different results due to the differences in the nature of the rules

- **The PPT is a clause with two elements:**

- Subjective test: ...is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes...
- Objectivetest: ...granting that benefit in these circumstances would be **in accordance with the object and purpose** of the relevant provisions of this Convention

When is Purpose Relevant in Treaties with Objective LOB Tests?

Discretionary Treaty Benefits in the United States

- U.S. tax treaties contain objective LOB tests to address treaty shopping
 - Objective LOB tests look to the characteristics and activities of the entity and/or its owners
 - If an objective test is satisfied, the treaty resident's purpose or intention is irrelevant
- In some cases, objective LOB test may not be satisfied even where no treaty shopping is occurring
- U.S. tax treaties permit a treaty resident to seek a discretionary determination from the U.S. competent authority, granting some or all of the benefits of the treaty

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When is Purpose Relevant in Treaties with Objective LOB Tests?

Discretionary Treaty Benefits in the United States

- Standards for discretionary determinations look to the taxpayer's purpose
 - Many U.S. treaties state that the competent authority should consider whether the establishment, acquisition or maintenance of such person and the conduct of its operations had “as one of its principal purposes” the obtaining of treaty benefits
 - U.S. procedures for obtaining a discretionary determination also require the applicant to demonstrate (among other things):
 - If benefits are granted, “neither the applicant nor its direct or indirect owners will use the treaty in a manner inconsistent with its purposes”
 - Substantial nontax nexus to the residence country
 - Applicant does not qualify under objective LOB provisions.

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Some “surprises”

PPT v. LOB

PPT v. Guiding Principle

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Some “Predictions”

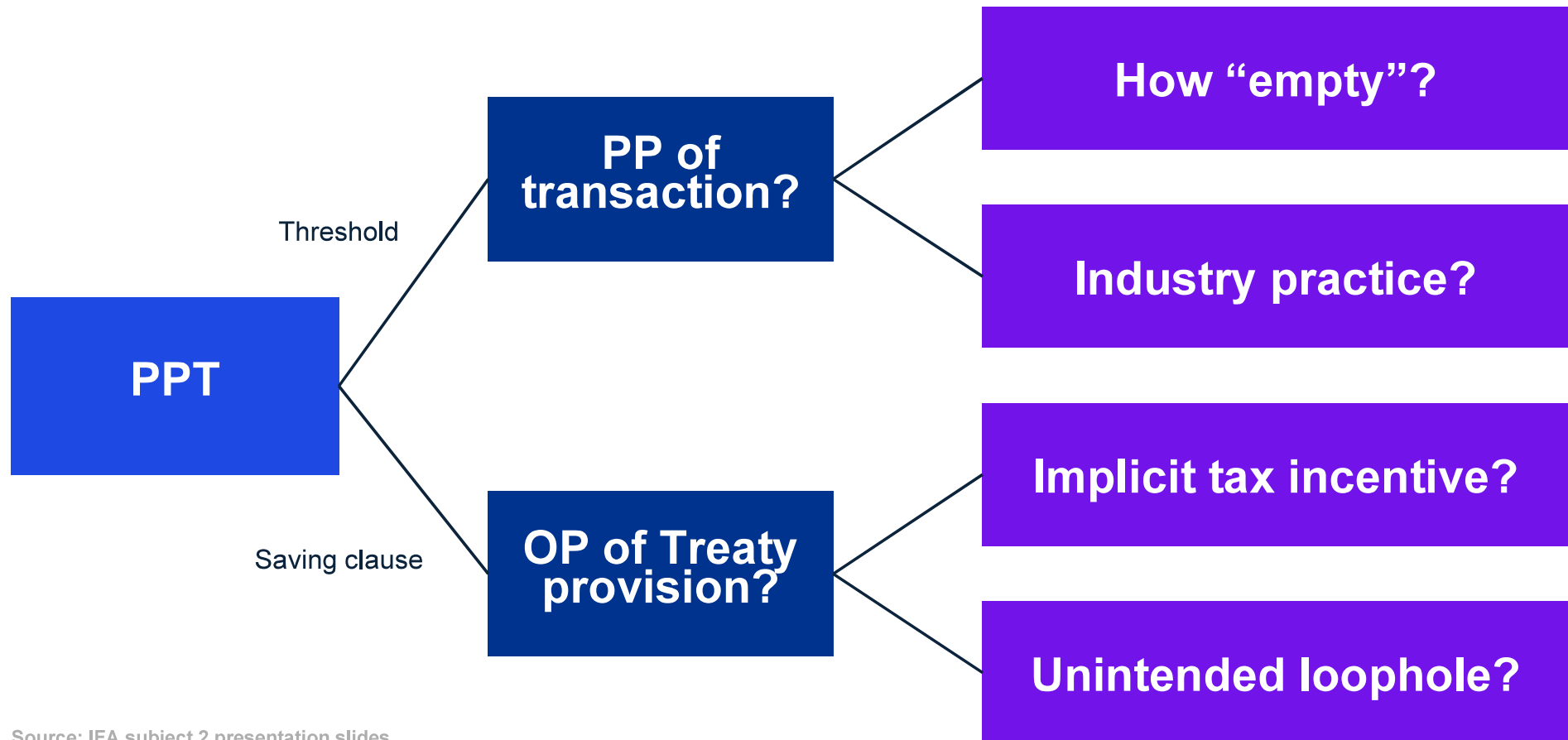
- **Strong “local flavors” of the PPT**
- **Divergent application of PPT v. Guiding Principle**
 - a) Experience with “beneficial ownership”
 - b) Divergence in domestic GAARs
- **Rising controversies**
- **Usefulness of MAP/arbitration mechanism**

Source: IFA subject 2 presentation slides



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Some Musings



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