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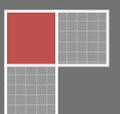
Interpretation of the concept of Beneficial Ownership:  
Trends, tensions, contradictions

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# Interpretation of the Concept of Beneficial Ownership: Trends, Tensions, Contradictions

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Abstract: The bird eye view

This paper is divided into three parts. The first part being the introductory aspect gives relevant information to the understanding of the study. It defines the objectives of the study as well its scope. The second part is the body of the study which is separated into two parts. The first part focuses on the pre-2000 development of the concept of beneficial ownership while the second part focuses on the post-2000 developments. The third part features the conclusion of this paper as well as tentative recommendations for consideration.

This paper adopts the view that the beneficial ownership concept should not be interpreted by reference to domestic laws of any state as provided under Article 3(2) of the OECD MC. It argues that because the beneficial ownership concept is a specific anti-avoidance provision, it should take its colour from an International Fiscal Meaning. Contracting State may then introduce elaborate anti-abuse provisions when negotiating tax treaties.

Control of the attribution of income is the most significant variable when assessing a recipient's position as a beneficial owner of the income it receives; in contrast to this view other scholars focus on the control of capital and assets; or ownership attribute that outweighs that of another person. The recent work of the OECD distinguishes the ownership of income from the control of the underlying asset that generates it.

This paper also takes the position that the beneficial ownership concept is far from clear as the proposed clarification by Working Party 1 creates more tensions and contradictions. Consideration is also given to the application of the benefits of the treaty to Trusts and possible extension of the beneficial ownership concept to Article 13 on Capital Gains.

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## List of Abbreviations

<b>Abbreviation</b>	<b>Full Reference</b>
BO	Beneficial Ownership
BIT	Bulletin for International Taxation
Bull. IBFD	Bulletin. International Bureau of Fiscal Documentation
CTJ	Canadian Taxation Journal
ET	European Taxation
GITCR	Grays Inn Tax Chambers Review
HMRC	Her Majesty's Revenue & Customs
ITLR	International Tax Law Reports
ITR	International Tax Review
LoN	League of Nations
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
UK	United Kingdom of Great Britain and Northern Ireland
UN	United Nations
US	United States of America
Tax Notes Int'l	Tax Notes International
TM Int'l Journal	Tax Management International Journal

## Table of Cases

<b>Case</b>	<b>Full Citation</b>
<i>Aiken Industries</i>	<i>Aiken Industries v. Commissioner</i> , 56 TC 925 (1971)
<i>Ayerst</i>	<i>Ayerst (Inspector of Taxes) v. C&amp;K (Construction) Ltd</i> [1975] STC 345 HL
<i>Azadi Bachao</i>	<i>Union of India v. Azadi Bachao Andolan and Anr.</i> (2003) 263 ITR 706
<i>Bank of Scotland</i>	<i>Ministre de l'Économie v Soc. Bank of Scotland</i> [2006] 9 ITLR 683 (Conseil d'Etat
<i>Chongqing Case</i>	<i>Chongqing State Tax Bureau</i> (2008)
<i>Diebold Courtag</i>	Case No. 191191, min. c/SA <i>Diebold Courtag</i> , RJF 12/99 No. 1492
<i>E Trade Mauritius</i>	<i>E Trade Mauritius Ltd v. ADIT &amp; Oris</i> (WP. No. 2134/2008)
<i>Fuzhou Case</i>	<i>Fuzhou Tax Bureau</i> (2009)
<i>Indab Kiat</i>	<i>PT Indab Kiat Pulp &amp; Paper v. US Bank National Association</i> [2006] 10 ITLR 1
<i>Indofood</i>	<i>Indofood International Finance Ltd v. JP Morgan Chase Bank NA</i> [2006] 8 ITLR 236 (HC); 653 (CA)
<i>J. Sainsbury</i>	<i>J. Sainsbury plc v. O'Connor (Inspector of Taxes)</i> [1991] STC 318 CA
<i>KSPG</i>	<i>KSPG Netherlands Holding BV</i> (2010) (AAR No. 818/2009)
<i>Market Maker</i>	<i>Royal Dutch Case</i> (1994) <i>Hoge Raad</i> , no. 28638, [1994] BNB 1994/217
<i>Montana Catholic Mission</i>	<i>Montana Catholic Missions v. Missoula Count</i> 200 U.S. 118 (1906)
<i>North Indiana</i>	<i>Northern Indiana Public Service Co. v. Commissioner</i> , 79 AFTR 2d 97-2862; 115 F.3d 506 (7th Cir. 1997)
<i>Prévost</i>	<i>Prévost Car Inc v R</i> (2008) 10 ITLR 736 (TCC); [2009] 11 ITLR 757 (FCA)
<i>PT Transportasi Gas</i>	<i>PT Transportasi Gas Indonesia v. Direktur Jenderal Pajak</i> [2008] 11 ITLR 407
<i>UPS</i>	<i>United Parcel Service of America v. Commissioner</i> , 87 AFTR 2d 2001-2565; 254 F.3d 1014 (11th Cir. 2001)
<i>Vodafone India</i>	<i>Vodafone International Holdings BV v. Union of India and another</i> [2010] 13 ITLR 59
<i>Wood</i>	<i>Wood Preservation Ltd v. Prior</i> [1969] 1 ALL ER 364
<i>Xinjiang Case</i>	<i>Xinjiang Tax Authorities</i> (2008)

## 1.0 INTRODUCTION\*

The improper use of a convention popularly known as ‘Treaty Shopping’ comes in different dimensions. As stated by the OECD in the Model Convention, it can involve a person acting through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly.<sup>1</sup> The UN ad hoc group of experts defines the term ‘abuse of treaty’ as the use of tax treaties by persons the treaties were not designed to benefit, in order to derive benefits that the treaty were not designed to give them.<sup>2</sup> In other words, it involves the routing of income arising in State X to a person resident in State Z through an intermediary in State Y to obtain unintended tax benefits of the treaty. In mathematical terms it is assumed that if  $A=B$  and  $B=C$ , therefore  $A=B=C$  so that  $A=C$ . For some countries this mathematical expression is important for their survival as a sovereign nation and cannot be considered improper while to other nations it is a robbery of their treasury and they will do everything possible to prevent the abuse of their treaties. In the 2003 decision of the Indian Supreme Court in the case of *Azadi Bachao Andolan* it was stated that:

‘Overall, countries need to take, and do take, a holistic view. The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries, are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy. Many of them do not appear to be too concerned unless the revenue losses are significant compared to the other tax and non-tax benefits from the treaty, or the treaty shopping leads to other tax abuses. Whether it should continue, and, if so,

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\* In the name of Allah the most gracious, the most merciful. All praises and glory is due to Allah, the lord of the worlds according to the number of times equal to his creatures and to the extent of his throne. I would like to express my gratitude to Prof. Philip Baker having been a source of inspiration throughout this MA year and the supervisor of this dissertation. I would also like to thank my family for their support. May Allah reward you all.

<sup>1</sup> Paragraph 7 OECD 2010 Commentary on Article 1

<sup>2</sup> Prevention of Abuse of Tax Treaties (UN Secretariat Fourth Meeting, Geneva, 1987) pg.3

for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations<sup>3</sup>

That expression confirms the history behind the allocation of fiscal jurisdiction under general international law which according to Albrecht is underpinned by the principles of, on the one hand, State sovereignty and non-interference in the domestic affairs of another state and on the other, the notion of equality of states.<sup>4</sup> This paper focuses on the prevention of treaty shopping within the context of Articles 10-12 of the OECD Model Convention.

## 1.1 The Background to the Study

The problem can be traced back to 1977 when the BO concept was introduced into the OECD Model Convention to counter specific types of treaty shopping. Article 11 on Interest for example provides that, the Contracting State where the interest arises may tax such income according to its law but the tax not exceeding 10 of the gross amount if the recipient is the beneficial owner of the interest. The Commentary to that Article made reference to the exclusion of agents and nominees as beneficial owners.<sup>5</sup> Subsequently in 1987, a report on Conduit companies was published which added to the exclusion list conduit companies akin to a mere fiduciary or administrator acting on account of the interested parties. However, these statements provided a rudimentary solution to the uniform understanding and application of the BO concept. Some States follow that domestic anti-abuse provisions are autonomous<sup>6</sup> while some

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<sup>3</sup> *Union of India v. Azadi Bachao Andolan and Anr* (2003) 263 ITR 706

<sup>4</sup> A.R. Albrecht, 'The Taxation of Aliens under International Law' (29 British Year Book of International Law 1952)

<sup>5</sup> See OECD Commentary on Articles 10-12 (1977 version)

<sup>6</sup> **These States are of the fact that taxes are imposed through provisions of domestic law.** Thus, any abuse of the Convention could also be characterised as an abuse of domestic provisions under which tax will be levied.

follow the notion of purposive interpretation of tax conventions.<sup>7</sup> The 2003 revision made some improvements on the relationship between domestic anti-abuse provisions and the treaty.

## 1.2 Statement of Problem

What would have been thought to be a useful tool to prevent certain types of avoidance became the object of confusion. Since the inclusion of the BO provision in the Model Convention it has been undefined. The problems that stem from this are whether Article 3(2) should apply or the context should otherwise require. If the former applies, two problems emerge. First, that not all Contracting States use the term in their domestic legislation (e.g. civil law states) and those that do (e.g. common law states) are presumed to have issues finding the most suitable definition. The second is the issue of the scope of the concept. For most of the years there has been insufficient guidance on the part of the OECD as well as limited case law in this area. The situation of Multinational Enterprises, with their present and evolving financial and holding structures is, as coined by A. McKie at the 22nd Tax Conference of the Canadian Tax Foundation, that: "The taxpayer hopes the treaty will prevent the double taxation of his income; the tax gatherer hopes the treaty will prevent fiscal evasion; and the politician just hopes."<sup>8</sup>

## 1.3 Objective of the Study

The specific objective of this study is an appraisal of the interpretation of the concept of BO with respect to Articles 10-12 of the OECD Model Convention. Pursuant to this, the study shall:

1. Identify and clarify the issues underlying the interpretation of the BO Concept;

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<sup>7</sup> These States consider the proper construction of tax Conventions and the provisions of Article 31 of the Vienna Convention on the Law of Treaties allow them to disregard abusive transaction.

<sup>8</sup> *Quoted by* P. Gravelle, "Tax Treaties: Concepts, Objectives and Types" (Bull. IBFD 1988) pg. 522

2. Explain the relevant background to the issue;
3. Draw out general comments and positions taken from the academic literature;
4. Draw out the positions taken by specific countries of relevance; and
5. Make some tentative recommendations for consideration before the final report on the Clarification of the concept of beneficial ownership.

#### 1.4 Justification of the Study

This study is taking place at an important point in time. The OECD is currently working on the clarification of the Concept of Beneficial Ownership. The 2003 revision approved the application of domestic anti-abuse provisions as far as they do not contradict with the intention of the Model Convention. The trends in the development of case law in this area shows that countries take different views, some which go beyond what was originally the intention of the Convention. Although the current work on the clarification of the concept is within the context of the OECD Model Convention but it is equally important for non-member countries of the OECD that follow the UN Model Convention since it is usually similar in most respect to the OECD Model. Most importantly, the concept will continue to be part and parcel of new and future Double Taxation Agreements. Therefore there is no better time to write on this concept.

#### 1.5 Scope and Limitation of the Study

The analysis of the interpretation of the concept of BO can be viewed from three angles. These are the Domestic Tax Laws of Contracting States, Double Taxation Conventions and European

Union International Taxation.<sup>9</sup> The reach of this study is limited to the analysis from the public international law of taxation with specific focus on the OECD Model Convention and domestic legislation on taxation. In doing so, this study covers mainly; Articles 10-12 on Dividends, Interest and Royalties respectively and in brief mentions Article 13 on Capital gains for which some states are ahead of the provisions of the OECD Model Convention.<sup>10</sup>

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<sup>9</sup> See The Interest and Royalty Directive and the Savings Directive of the TEU

<sup>10</sup> See The jurisprudence of the Chinese Authorities in *Fuzhou*

## 2.0 THE CONCEPT OF BENEFICIAL OWNERSHIP

### 2.1 What is Beneficial Ownership?

There have been debates among different schools of thought over what should be the precise, clear, reasonable, and most importantly uniform applicable interpretation to be given to the term '*Beneficial Ownership*'. One would expect that after almost 50 years of discussion a final resolution would have been met. However, the result is a divergence which can be said to have done more harm than good. An example is the conclusion of the IFA Congress discussion panel where David Oliver et al suggested three possible meaning of the term. First of which is the domestic law meaning in common law countries; a definition excluding agents and nominees; or the person to whom the income is attributable for tax purposes under the law of the resident State or the source State.<sup>11</sup> Other outstanding scholars like Prof. Klaus Vogel among others have also given their opinions on the interpretation of the concept. Vogel defines beneficial owner as the person who is free to determine the use of asset or capital and how the yields are to be used.<sup>12</sup> Danon defined a beneficial owner as 'the person who legally, economically or factually has the power to control the attribution of the income'.<sup>13</sup> According to Du Toit, a beneficial owner is 'the person whose ownership attributes outweighs that of any other person'.<sup>14</sup> Given that Countries' positions and the Courts' interpretation is the law, more focus should be directed towards the jurisdiction of the Courts that have impacted the interpretation of the concept.

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<sup>11</sup> J. David Oliver et al., "Beneficial Ownership" (IBFD Bulletin, July 2000)

<sup>12</sup> See Klaus Vogel, 'Double Taxation Conventions' (Kluwer Law International, 1997) Preface to Articles 10-12, m.no. 9

<sup>13</sup> Danon, Robert J., "Switzerland's Direct and International Taxation of Private Express Trusts", in Oberson, Xavier (ed.), *Droit Fiscal Suisse et International* (Zurich: Schulthess Juristische Medien AG, 2004), Vol. 1 at 347-349

<sup>14</sup> Du Toit, Charl, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* (Amsterdam: IBFD Publications, 1999), at 249.

## 2.2 Pre-2000 Development of the Concept of Beneficial Ownership

The concept's first appearance in a treaty was in the treaty between the UK and the US in 1966.<sup>15</sup>

The concept was subsequently incorporated into Articles 10, 11 and 12 of the OECD Model Convention in 1977, which then limited the benefit of a reduced source state taxation to a recipient who is the beneficial owner of the income. Other Model Conventions such as the UN Model Convention and the US Model Convention also enhanced the appearance of such requirement. Prof. Vogel opined that the concept was introduced to help prevent tax avoidance.<sup>16</sup>

### 2.2.1 The Beneficial Ownership Concept Excludes only Agents and Nominees

The 1977 Model and its relevance to the interpretation of beneficial ownership is apparent in the second paragraph to Article 10-11 of the 1977 Model which provided that 'dividend/interest may also be taxed according to the laws of the Contracting State in which it arises, but if the recipient is the beneficial owner of the dividend/interest the tax so charged shall not exceed...'

The notion of BO was not defined in the OECD Model or the commentary at that time but paragraph 2 of the commentary excluded any intermediary, such as an agent or nominee interposed between the beneficiary and the payer. With this giant step to incorporate such concept and the objective it purports to achieve into the Model, one would expect the term to have a clear unified meaning.<sup>17</sup> By contrast, past and recent trends have shown that the term is unclear and that the chance of having an acceptable universal meaning is minimal.<sup>18</sup>

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<sup>15</sup> See The 1966 Protocol to the 1945 Income Tax Treaty between United Kingdom and the United States

<sup>16</sup> See Vogel [n 12] Chapter 1, footnote 6, Preface to Articles 10-12, 6

<sup>17</sup> It is pertinent to note that very few treaties have a definition of the term. See, *inter alia*, the US-Germany DTC 1989 (Article 10 Protocol); Italy-Germany DTC 1989 (Article 9 Protocol); Germany-Norway DTC 1991 (Article 4 Protocol); Belgium-Turkey DTC 1987 (Article 5 Protocol); France-Turkey DTC 1987 (Article 3 Protocol)

<sup>18</sup> See John F. Avery Jones, Henri-Robert Depret, Et al, 'Treatment of Trust Under the OECD Model Convention', (ET, No 12, 1989) pg.379

## 2.2.2 The Concept of Beneficial Ownership and the 1987 Conduit Report

The OECD's work on the Conduit Report expressed the undesirability of using conduit companies for treaty shopping. Paragraph 12.3 of that report provided that treaty benefits should be denied to conduit companies with narrow powers. Paragraph 13 of that report also provides that companies that receive dividends, interest or royalties without effectively owning the underlying asset are to be denied treaty benefits. The 1987 Report recognizes other genuine reasons why conduit structures are used. It follows from the report that it is insufficient to conclude that a company created for the purpose of holding assets or rights is a mere intermediary to be denied treaty benefits. It exempts structures based on sound business reasons; entities with substantive business activities; corporations directly or indirectly quoted on a stock exchange among other provisions.<sup>19</sup> The report also *inter alia*, provided recommendations on anti-abuse measures. It stated that countries can make use of the look-through approach<sup>20</sup>, exclusion approach<sup>21</sup>, subject to tax approach<sup>22</sup> and the channel approach<sup>23</sup>.

## 2.2.3 Beneficial Ownership as a Concept inherent in all Tax Treaties

Tax treaties are agreements between Contracting States for the benefits of their residents. The titles of double taxation conventions 'Convention between the Government of X and the Government of Y for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and ....' means that third country residents are not to enjoy the benefits provided under such convention even though it is not expressly stated in the

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<sup>19</sup> See The Committee on Fiscal Affairs: Double Taxation Convention and the Use of Conduit Companies (OECD 1987) Para. I.A.3 (it was stated that floating intermediary companies might be necessary to access capital market or because of currency restriction or political situation).

<sup>20</sup> This approach allows the revenue authorities to pierce the veil of incorporation to determine the underlying beneficial owner.

<sup>21</sup> This approach excluded exempt or near exempt companies or income.

<sup>22</sup> This approach discourages double non taxation.

<sup>23</sup> This approach prevents treaty benefits where tax base are substantially eroded through payments to non-resident related entity.

convention. The Convention applies to persons who are residents of one or both Contracting States. It may seem that the opinion that there must be a limitation on benefit clause in all tax treaties to control the abuse of the treaties greatly exceeds the bounds of reason or moderation, since a resident of a non-party to the agreement should not automatically have access to the benefits of the treaty. Based on this premise, should the attribution terms such as 'paid to' 'derived by' and 'received by' generally be interpreted within the context of the treaty putting into consideration the shared expectation of the Contracting States? In that connection, the US for example shares this view while other countries take a different view. Several commentators have also disagreed over the relationship between the beneficial ownership concept and other attribution terms of the treaty. Certain scholars equate the term 'paid' to beneficial owner. According to Vogel and Pijl's arguments, the beneficial owner may be **contrived** onto the term 'paid to'. By contrast, Danon and van Weeghel were of the opinion that beneficial ownership should be different from attribution terms such as 'paid to' and 'received by'. Weeghel<sup>24</sup> argues that the Commentary on Articles 11 and 12 ascribes a very wide meaning to the term 'paid to' since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by the contract or by custom, it is irrelevant in strict legal sense, whether the creditor may, in turn, have the obligation to pay under a corresponding obligation to another creditor.<sup>25</sup> One of the earliest cases that support Vogel and Pijl's arguments is the United State's *Aiken Industries Case*<sup>26</sup>

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<sup>24</sup> Stef van Weeghel, *The Improper Use of Tax Treaties With Particular Reference to the Netherlands and the United States* (Kluwer, 1998) pg. 57

<sup>25</sup> See OECD 2002 Commentary on Article 11 and 12, paras. 5 and 4 respectively

<sup>26</sup> *Aiken Industries v. Commissioner*, 56 TC 925 (1971)

### 2.2.3.1 Aiken Industries

In *Aiken Industries*, the US Tax Court interpreted the term ‘received by’ to mean interest received by a corporation resident in either of the contracting States as its own and not with the obligation to transmit it to another. This judgement opens the door for, and provided great insight to a purposive interpretation of the concept of payment. The Court noted that: ‘In deciding whether a given taxpayer in a specific instance is protected by the terms of the treaty, they must ‘give specific words of a treaty a meaning consistent with the genuine shared expectations of the contracting parties,’ and in so doing, it is necessary to examine not only the language, but the entire context of the agreement’. By applying the above principles the US Tax Court found that the interest payments in question were not ‘received by’ a corporation of a contracting State. The terms ‘received by’ was interpreted not to mean a ‘mere temporary physical possession’ but a ‘complete dominion and control over’ the funds.

The implication of the Aiken case is that purposive interpretation of the concept of payment can be extended to the derivation of income from the source State for which the term ‘derived by’ applies. For instance, for the taxation of income from immovable property, Article 6(1) provides that the source state may tax the income derived by a resident of the other Contracting State from immovable property situated within its jurisdiction. If a resident of State Z, sets up a conduit in state Y and transfers the legal right to the immovable property situated in State X to that conduit so that it can benefit from the treaty between State X and State Y, assuming that State X (source State) decides to exempt such income for the purpose of the treaty between State X and State Y, whereas there is no treaty between State X and State Z but the income so derived by the conduit resident in State Y can be transferred tax free from that State to State Z. Following the United States Court’s judgment in Aikens, by analogy, State X can decide to deny the treaty benefits to the conduit based on a purposive interpretation of the term ‘derived by’ in view of the shared expectation of the Contracting States. First, the conduit is the legal owner of

the immovable property but not the beneficial owner of the income derived from the immovable property and in addition the real beneficial owner is not resident in State Y. Secondly, the Conduit has no dominion or control over the income but is under obligation to pass the payment to the ultimate owner.

#### 2.2.4 Application of Article 3(2) as a possible contradiction

In an existing tax treaty there are instances where the treaty interacts with the domestic law in various circumstances. An example is the definition of residence. For the purpose of undefined terms used in the convention Article 3(2) provides as follows:

As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purpose of the taxes to which the Convention applies....

As mentioned earlier that the BO requirement was inserted to act as an anti-avoidance provision, there is doubt whether other attribution terms prior to the introduction of BO were intended to be interpreted with particular reference to the domestic law of any Contracting State. The second sentence of paragraph 12 of the commentary to Article 3(2) states that the context is determined, in particular, by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State. The Model Convention placed reliance on Article 26 of the Model Convention on Exchange of Information. With the 1963 Draft and 1977 Model entitled “Double Taxation Convention on Income and on Capital”, it can be implied that the intention of the parties when signing a convention based on the above title is to prevent double taxation so that treaty benefits must be granted under the principle of *‘pacta sunt servanda’* even if considered improper where no

provision to counter treaty abuse exists.<sup>27</sup> This will suggest that the terms ‘paid to’, ‘derived by’ and ‘received by’ were not to prevent treaty shopping.

### 2.2.5 Beneficial Ownership needs no interpretation

The most fundamental problem faced since the inception of the concept of BO into the Model Convention has been its interpretation. Perhaps the most crucial rule governing the interpretation of treaties including double taxation conventions is enshrined in Article 31 of the Vienna convention, which requires that parties to a treaty must look to the ordinary meaning of the terms of the treaty seen in the context of the whole treaty. Before focus is placed on the issue of the OECD not defining the term when introducing it into the convention, I think we need to step back a little and ask ourselves whether the term really needs interpretation. It is pertinent to point out that the purpose of the concept of BO was expressed by one of the ‘common law States’ that made the first inclusion of the term in a tax treaty. In Du Toit’s research on beneficial ownership, he encountered a statement from the United Kingdom under the heading “Article 10: Dividends” in a 1967 document where it was said that:

‘In our view the relief provided for under these Articles ought to apply only if the beneficial owner of the income in question is resident in the other contracting State, for otherwise the Articles are open to abuse by taxpayers who are resident in third countries and who could, for instance, put their income into the hands of bare nominees who are resident in the other contracting State. You will no doubt have noticed that our recent protocols with the United States and with Switzerland we have introduced this test of beneficial ownership which clearly

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<sup>27</sup> OECD [n 19] Para. 43

reflects what was intended by the Committee when the Model Convention was prepared'.<sup>28</sup>

The conveyed message above is sufficient to explain the purpose of the concept of BO. In my opinion, since the majority of scholars accept that the term was adopted by the OECD in 1977 from the tax treaty between the UK and the US, then scholars and the Courts have focused on the wrong issue i.e. in the application of the term for the purpose of the relevant articles, the purpose of the term as expressed in the UK-US tax treaty was sufficient to be an 'international fiscal meaning' based on the OECD's endorsement through adoption into the Model Convention so that the inquiry into the meaning of the term under domestic legislations of any country would be irrelevant. Therefore, if it is accepted that the term is adequately clear within the context it was used, as it was, then it is not necessary to interpret the term or to apply Article 3(2) of the treaty even if the domestic law indicates another meaning or clarification.

## 2.2.6 Beneficial Ownership as a Concept taken from Common Law

Turning back to the controversy over the meaning of the concept of beneficial ownership, a reasonable starting point is to trace the concept back to its true origin, an origin that tends to refer to the term 'beneficial ownership' as the division between a legal right to an asset or capital and the right to the economic benefits derivable from the use of such asset or capital. According to Brown<sup>29</sup> and Brender<sup>30</sup>, the concept has no settled definition even under the common law. They came to a similar conclusion that for example the term is defined differently depending on the particular provision under the Canadian Income Tax Act. The findings in an article written by John F. Avery Jones et al on *The Origins of Concepts and Expressions used in the OECD Model and*

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<sup>28</sup> Charl du Toit, 'The Evolution of the Term of "Beneficial Ownership" in relation to International Taxation over the past 45 years' (BIT, Vol 64, No. 10, 2010) pg. 12

<sup>29</sup> C. Brown, 'Symposium: Beneficial ownership and the Income Tax Act' (51 CTJ 1 2003), pg. 424-427

<sup>30</sup> M.D. Brender, 'Symposium: Beneficial ownership and the Income Tax Act' (51 CTJ 1 2003), pg. 315-318

*their Adoption by States*<sup>31</sup> shows that ‘Beneficial Owner’ is used about 70 times and ‘Beneficial Ownership’ about 50 times in the UK tax legislation. In Australia as they reported, ‘Beneficial Owner (ship)’ appears hundreds of times in the Australian tax legislation, mainly in the context of changes of ownership of companies.<sup>32</sup> An important question to ask is which of the domestic interpretations if any is relevant for the purpose of applying a treaty in the context of Articles 10, 11 & 12. In the United States for instance in the case of *Montana Catholic Missions v. Missoula County*<sup>33</sup>, Justice Peckham noted that:

“The expression “beneficial use” or “beneficial ownership or interest” in property is quite frequent in the law, and means, in this connection, such a right to its enjoyment as exists where the legal title is in one person and the right to such beneficial use or interest is in another, and where such right is recognized by law, and can be enforced by the courts, at the suit of such owner or of someone in his behalf.”<sup>34</sup>

In the United Kingdom the term came into existence through the development of trust law. In that connection, in the case of *Ayerst (Inspector of Taxes) v. C&K (Construction) Ltd*<sup>35</sup> Lord Diplock said:

“The archetype is the trust. The “legal ownership” of the trust property is in the trustee, but he holds it not for his own benefit but for the benefit of the cestui que trustent or beneficiaries.”<sup>36</sup>

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<sup>31</sup> John F. Avery Jones (United Kingdom), Richard J. Vann (Australia) Et al, ‘The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States’ (BIT 6, 2006), Chapter 3.8, pg. 246 footnotes 318-320

<sup>32</sup> *Ibid*, They presumed that nevertheless Australia use ‘Beneficially Entitled’ in its treaties to bring in the tax concepts for trust under which a beneficiary receiving a distribution for a discretionary trust is treated as the presently entitled to the underlying income.

<sup>33</sup> 200 U.S. 118 (1906)

<sup>34</sup> *Ibid* at 127-128

<sup>35</sup> [1975] STC 345 HL

<sup>36</sup> *Ibid* at 349

Application of the concept in the UK can be traced to the provision of Section 258 of the Income and Corporate Taxes Act of 1970 which allows group relief where a subsidiary is 75 per cent owned by another member of the group. In *J. Sainsbury plc v. O'Connor (Inspector of Taxes)*<sup>37</sup> the Court considered that a Belgian partner was not the 'equitable owner' of the shares subject to an option since it could not claim specific performance until it had exercised its option.<sup>38</sup>

From the brief look at the evolution of the beneficial ownership concept in common law, it seems to me that the fact that the term is used and defined differently in the domestic laws of common law States does not pose a material menace to the application of the right interpretation for the purpose of Articles 10-12 if there is one. Paragraph 13.1 of the commentary to Article 3(2) tells us that for the purpose of paragraph 2, where a term is defined differently for the purpose of different laws of a Contracting State, *the meaning given to that term for the purpose of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purpose of other tax laws.*<sup>39</sup> (Emphasis Added). Revenue authorities of Contracting States as a matter of diligence and due care are not expected to be negligent. The authorities of the UK in its protocol with the United State and Switzerland in the document cited earlier showed that these common law countries had a clear objective to the use of the term.

### 2.2.7 Beneficial Ownership as a concept inherent in Civil Law

The first view of the author when pondering over the problems associated with the interpretation of the concept of BO was that if it is agreed that the concept was adopted into the OECD Model Convention from common law, and that Article 3(2) applies, then there should be an equivalent concept under the civil law even though the BO term is not used. Domestic Anti-Avoidance provisions and approach adopted by countries vary widely. Any countries are either a

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<sup>37</sup> [1991] STC 318 CA

<sup>38</sup> See also *Wood Preservation Ltd v. Prior* [1969] 1 ALL ER 364

<sup>39</sup> OECD 2010 commentary to Article 3(2)

common law country, civil law or both and the approaches employed by these nations in tackling internal and external fiscal problems are different. Some common law countries are well known to apply the substance over form approach or the business purpose rule. In civil law jurisdictions like France and Switzerland they refer to abus de droit (abuse of right),<sup>40</sup> the Netherlands applies the Fraus legis (abuse of law) to deal with tax avoidance when the legal form gives tax benefits that conflict with the purpose and intent of the law. These jurisdictions consider the abuse of rights as the manipulation of the intention or spirit of the law. The court disregards the legal form where transactions are undertaken solely to avoid tax.<sup>41</sup> These concepts are used to achieve similar results to the common law motive and artificiality test.

Evidence that the BO concept may exist in civil law can be extrapolated from the French *Diebold Courtage case*<sup>42</sup> where the French Tax Authorities (FTA) were trying to deny treaty benefits under the Netherland-France tax treaty. The FTA argued that the income received was not beneficially owned by Netherlands residents, but was mostly repaid to a Swiss affiliate. The *Conseil d'Etat*, despite the fact that the France–Netherlands tax treaty of 1976 does not include a reference to BO considered in details the arguments of the FTA. However, the FTA lost the case based on the failure to provide adequate proof that the Netherlands residents were not the true beneficiaries of the royalties. Bruno Gouthière notes that the beneficial ownership test is combined with the domestic abuse of right law.<sup>43</sup> In similar connection, there is also evidence from the French *Bank of Scotland*<sup>44</sup> case where the Commissaire du Gouvernement noted that the BO applies even if it is not expressly stated in the terms of the treaty, he said that BO is '*part of the broader fraud on the law approach to taxation*' (Emphasis Added). From the above, it seems to me that the divergence in political ideology, legal systems, and inherited pattern of thoughts, understanding and actions has significant effect on the approach to tax avoidance.

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<sup>40</sup> See Rohatgi Roy, 'Basic International Taxation' (2nd edn, Vol 2, BNA International Inc, 2007) pg. 143

<sup>41</sup> Ibid

<sup>42</sup> *Conseil d'Etat*, 13 October 1999, Case No. 191191, min. c/SA *Diebold Courtage*, RJF 12/99 No. 1492

<sup>43</sup> See Bruno Gouthière, 'Beneficial Ownership and Tax Treaties: A French View' (BIT May 2011) pg. 217

<sup>44</sup> *Ministre de l'Économie v Soc. Bank of Scotland* [2006] 9 ITLR 683 (Conseil d'Etat)

### 2.2.8 Reconciliation

It is obvious that the BO limitation was introduced to counter the channelling of income to the ultimate destination through an intermediary resident in a State with an attractive treaty with the source State. The first work of the OECD dealt specifically with representatives such as agents and nominees and subsequently covered conduit companies. The early part of the history of the interpretation of the BO concept considered whether other attribution terms can be assumed to have the BO provision even if the term is not included in treaties. However, research has shown that the BO concept was introduced into Article 10-12 because those three Articles are the provisions easily subjected to treaty abuse. Just as Joanna Wheeler notes that:

“The subsequent inclusion of the beneficial ownership requirement in only three articles of the OECD Model (Arts. 10, 11 and 12) suggests that the requirement adds something to that articles that is not to be found in the other treaty articles, but it is rather difficult to ascertain exactly what that “something” is”<sup>45</sup>

The next issue is whether the BO concept was intended to take its meaning from the domestic law of Contracting States by applying Article 3(2). This is a situation where the context should otherwise require. Although, there may not be many problems in finding the interpretation of BO in common law as many commentators suggest. In that connection, the commentary on Article 3(2) made reference to the most suitable meaning. The main controversy over the interpretation of BO, in my opinion is one of degree or scope and the risk of the application of the law of equity or trust law by common law Courts.

For instance, considering a tax case involving CIV's before a common law Court, a Jurist having relevant background knowledge in the law of equity and trusts, it would not be surprising if these

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<sup>45</sup> Joanna Wheeler, ‘The Attribution of Income to a Person for Tax Treaty Purposes’ (Bull. IBFD 2005) pg. 478

laws are applied by analogy to the case since the nature of CIV's, in principle, is similar to those of trusts. These issues even show that Article 3(2) is not suitable for the application of BO. In addition, the second sentence of paragraph 2 made an implicit reference to the principle of reciprocity on which the Convention is based i.e. the meaning in the other State. It requires the same scope of the BO concept but in reality the same scope would be difficult to maintain at this stage of clarity on the BO concept. The relevant interpretation and 'International Fiscal Meaning' should be the one that excludes only agents and nominees; conduit companies akin to mere fiduciary or administrator. Even any other 'specific exclusion list' as may be desired by Contracting States when negotiating tax treaties should be excluded from that attributed to the international fiscal meaning because it would vary from treaty to treaty.

The chief problem is the one of scope. How artificial must a structure be to be denied treaty benefits? I take this view based on the following premise. Assuming that in the 1977 Model, the OECD decided to control the improper use of Articles 10, 11 & 12 but without employing the use of 'beneficial ownership' but decides to rely on the attribution terms found in those articles. Assuming Article 10 provides as follows:

Article 10(1): Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

Article 10 (2): However, such dividends may also be taxed in the other Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but the tax so charged shall not exceed [.....].

In that connection, notwithstanding the preceding provision, the term 'paid to' shall exclude, from the benefit of reduced withholding tax, agents and nominees; conduit companies akin to mere fiduciary or administrator acting on account of interested parties.

In my opinion, Article 3(2) would not apply to the term 'paid to' as the concept of payment is generally understood. But the main problem is still the one of scope. Which conduit structure will fall foul of that provision? I.e. to distinguish between rights that are too limited to qualify as a beneficial owner and rights that are limited but still pass the BO test. Assuming further that the OECD decides to include a third paragraph:

Article 10(3): The competent authorities of the Contracting States may, if desired include more specific anti-avoidance provisions to paragraph 10(2) above.

The inclusion of this provision would support Article 10(2) that the anti-avoidance provision is not an elaborate one. Contracting States may then determine the scope of the anti-avoidance provision during treaty negotiations. In that respect, the BO limitation would generally apply to exclude agents and nominees and conduit companies based on the OECD's clarification on limited rights that qualifies as a beneficial owner and very limited rights that falls foul of the BO limitation. However, Contracting States may then decide to expand the scope of the term beyond that which the OECD expresses. But the standard would be the one set by the Model Convention. In addition, it would be difficult for one of the Contracting States to rely on ambulatory interpretation because the scope had already been mutually agreed and can only be mutually expanded. Article 27 of the Vienna Convention on the Law of Treaties provides that: 'A State may not invoke the provision of its internal law as a justification for its failure to perform a treaty'.

### 2.3 Post-2000 Development of the Concept of Beneficial Ownership

Great events that had significant effects on the interpretation of the concept of BO unfolded as a result of the work done by the OECD on the Model Convention after the new millennium. The subsequent amendments to the commentary on Articles 10-12 in the Model Convention immediately had an outstanding impact on two of the most important Court decisions in the history of beneficial ownership.

The OECD 2003 revision clarified the scope of the BO term compared to previous amendments. The revised version incorporated the 1977 provisions that excludes agents and nominees, as well as the 1987 report on ‘Double Taxation Conventions and the Use of Conduit Companies’ which excludes *inter alia*, conduit companies akin to a mere fiduciary or administrator acting on account of the interested parties. As regard the report on conduit companies, the commentary added a new phrase<sup>46</sup>, ‘as a practical matter’ before ‘very narrow powers’ which is essential in the determination of whether the concept of BO is a question of fact or a question of law. The BO concept previously had a narrow or legalistic view as at 1977<sup>47</sup> but interestingly, paragraph 13 of the Conduit Report indicated a practical approach by providing that companies that receive dividends, interest or royalties without ‘effectively’ owning the underlying asset are to be denied treaty benefits. The word ‘effectively’ equally points to actuality or reality or fact.

In addition to the above, the update also fundamentally changed the relationship between tax treaties and domestic anti-avoidance rules. Paragraph 7 of the OECD commentary to Article 1 specifically states that the principal purpose of double taxation conventions is to promote, by eliminating international double taxation exchange of goods and services, and the movement of

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<sup>46</sup> See Paragraph 12.1[Agent or nominee; conduit companies] OECD Commentary on Article 10

<sup>47</sup> The evidence given before the Court in *Prevost* by the Chairman of Working Party No. 1 of the OECD Committee on Fiscal Affairs in 1977.

capital and persons. *It is also a purpose of tax conventions to prevent tax avoidance and evasion.*<sup>48</sup> (Emphasis Added). The succeeding paragraph expressly approved the application of domestic anti-abuse legislation of Contracting States to counter improper use of their double taxation conventions.<sup>49</sup> Secondly, it was stated that the beneficial ownership term is not to be understood in a narrow technical sense, but should rather be viewed in light of the purposes and object of the model treaty, including avoidance of double taxation and prevention of tax abuse and tax avoidance.<sup>50</sup>

### 2.3.1 Development of Case Law

Since the introduction of the BO term in the OECD Model Convention, in principle, all concerned parties in the international tax arena ought to know the meaning of the concept. In 2006, there finally came a case that became the ‘centre of attention’ of international tax experts. Not because there has not been a case that dealt with the concept of BO but because the case was to be decided by the English Court of Appeal where the concept has its origin.

#### 2.3.1.1 Indofood International Finance Ltd v. JP Morgan Chase Bank NA<sup>51</sup>

The Indofood case supports the notion that the BO concept needs to be accorded an ‘international fiscal meaning’ not to be derived from the domestic laws of any nation. This is the first case in which ‘the context otherwise require’ so that Article 3(2) is not applicable.

### Background

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<sup>48</sup>Note 2003 addition; and deletion of (1977) ‘they should not, however, help tax avoidance or evasion

<sup>49</sup>Note 2003 addition, paragraph 7.1 [Domestic anti-abuse legislation]: Taxpayers may be tempted to abuse the tax laws of a State by exploiting the differences between various countries’ law. Such attempt may be countered by provisions or jurisprudential rules that are part of the domestic law of the State concerned.

<sup>50</sup> Paragraphs 12, 9 and 4 of OECD Commentary on Articles 10-12 respectively

<sup>51</sup> [2006] 8 ITLR 236 (HC); 653 (CA)

This case features PT Indofood Sukses Makmur Tbk (the parent guarantor) a company incorporated in Indonesia, Indofood International Finance Ltd (the issuer) a company incorporated in Mauritius and JPMorgan Chase Bank NA (the appointed trustee) a United Kingdom company. The facts are as follows. Indofood Indonesia needed debt finance for business concerns. It had two options; the first was to raise a direct loan which attracted a 20 per cent Indonesian withholding tax on interest payments; the second one was to take advantage of the reduced withholding tax rate of 10 per cent in the tax treaty between Indonesia and Mauritius if the terms specified in the agreement were met. To meet those terms Indofood International Finance Ltd was established in Mauritius to issue the loan. In 2002 as reported, the issuer issued loan notes and subsequently lent the capital to the parent guarantor at the same terms.<sup>52</sup> In the same year a trust deed was made under which JPMorgan Chase Bank NA was appointed as the trustee for the note holders and the principal paying agent.

Pursuant to the 2004 notice issued by the Indonesian authorities to the effect of terminating the tax treaty between Indonesia and Mauritius effective from 1st January 2005, the withholding tax rate reverted to the normal Indonesian domestic rate. However, the loan agreement as documented contained two clauses, the 'equalisation clause' and the 'burden clause'. The equalisation clause provided that in any case where the tax rate increases, the payer would have to gross up so that the fiscal position of the payee would remain the same as if the tax were deducted at 10 per cent. The burden clause nevertheless provided that the borrower had the option to pay the loan earlier if there were no reasonable steps to revert to the reduced rate of withholding tax. There was conflict of interest between both parties but a proposal was finally made to interpose a Dutch company between the Indonesian and Mauritius Company so as to benefit from the reduced withholding tax rate in the treaty between the Netherlands and Indonesia. To cut the rest of the story short, the question in this case was whether the

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<sup>52</sup> The issue, servicing and redemption of the loan notes and the loan to the parent guarantor were regulated by the same conditions endorsed on the loan notes

Indonesian authorities would consider the proposed Dutch company as the beneficial owner of the interest and if not, what would be the Indonesian Court's ruling?

### The Judgement

The United Kingdom CA reversing the decision of *Evans-Lombe J* considered that the proposed Dutch company would not be the beneficial owner of the interest payments. In deciding as it did, reference was made to the OECD Commentary and Philip Baker's written explanation and illustration which was instrumental in the Court's holding to seek an international fiscal meaning.<sup>53</sup> The Court came to the conclusion that: 'the meaning to be given to 'beneficial owner' is plainly not to be limited by a technical and legal approach. Regard is to be had to the substance of the matter. In both commercial and practical terms the issuer is, and Dutch company would be, bound to pay on to the principal paying agent that which it receives from the parent guarantor.'<sup>54</sup> This means in essence that the proposal would not be successful.<sup>55</sup>

#### 2.3.1.2 *Prévost Car Inc v R*<sup>56</sup>

The *Prévost* judgement unlike the approach adopted in *Indofood* did not disregard the legal aspect of the facts and circumstances of the case. The Court unlike in the *Indofood* case applied article 3(2).

### Background

The case features *Prévost Holdings BV* (holding company) incorporated in the Netherlands, *Volvo Bussar AB* (*Volvo*) a Swedish corporation, *Henlys Group plc* (*Henlys*) a UK company

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<sup>53</sup> See Philip Baker, '*Double Taxation Convention*' (Sweet & Maxwell 2003) [10B-09]-[10B-15]

<sup>54</sup> *Indofood* [n 51] 44

<sup>55</sup> See also *PT Indah Kiat Pulp & Paper v. US Bank National Association* [2006] 10 ITLR 1

<sup>56</sup> (2008) 10 ITLR 736 (TCC); [2009] 11 ITLR 757 (FCA)

and Prévost Car Inc (Prévost) a Canadian corporation. The facts are simple. Volvo was the sole owner of Prévost by acquiring all its shares in 1995. Volvo instantly transferred the shares to Dutch holdings, and then later sold 49 per cent of the shares of Dutch holdings to Henlys. In the agreement between Volvo and Henlys, it was provided that 80 per cent of the earnings of holdings would be distributed to the shareholders in accordance with the working capital requirement of the corporate group. Article 10 of the Canadian-Netherlands tax treaty reduces withholding tax on dividends to 5 per cent while if the tax treaty between Canada-Sweden and Canada-United Kingdom applied, the withholding tax rate on dividends would be 15 and 10 per cent respectively. The issue before the Court was to decide whether the Dutch holding was the beneficial owner of the dividends received from Prévost Canada.

#### The Judgement

The Canadian Tax Court held that the Dutch holding company was the beneficial owner of the dividend based on the fact that it was not 'bound' by the agreement; it had the custody and the free use and enjoyment of the dividend until the shareholders caused the funds to be paid to them as dividends.

#### 2.3.1.3 Analysis

The English Court in *Indofood* supports the finding of an international fiscal meaning and relying on the substance of the matter concluded that the proposed Dutch company will not be the beneficial owner of the interest. In Philip Baker's observation on the outcome he notes:

'Recall, the Mauritian company borrowed the identical amount that it on-lent, at the same interest at which it on-lent, and the Court of Appeal found as a fact that the Mauritian company could do nothing with the interest it received but use it to pay the identical amount of interest that it had to pay on. In this type of egregious

circumstance, is there any real surprise that the Dutch company which was proposed to take the place of the Mauritian company would not have been the beneficial owner? If beneficial ownership had any meaning at all, surely it would exclude the type of interposed entity which had no function whatsoever but to receive income and pay on the identical amount of income: in fact, it had so little function that according to the Court of Appeal, the actual flows of money missed it out completely'.<sup>57</sup>

How does the *Indofood* judgment fit together with *Aikens*? These two cases involved back-to-back-loans. In *Aikens*, the Court considered the conduit company (*Industrias*) to have a 'mere temporary physical possession' of the income. The Court noted that while *Industrias* was a valid Honduran corporation, it was merely a collection agent with respect to the interest it received from MPI. *Industrias* was a conduit for the passage of interest from MPI to ECL and cannot be said to have received the interest for its own beneficial interest. This was the same findings in the *Indofood* case, the Court found that the interposed entity (*Indofood International Finance Ltd, Mauritius*) which had no function whatsoever but to receive income and pay on the identical amount of income, cannot be the beneficial owner of the income. In similar respect, the proposed Dutch company would not have been the beneficial owner of the interest.

However, in *Prévost* the Canadian Court took a strict legal approach to the case rather than a substance-over-form approach but sought for the domestic interpretation of beneficial ownership.<sup>58</sup> Rip J considered:

'In my view the "beneficial owner" of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is the beneficial owner of the

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<sup>57</sup>Philip Baker, 'Beneficial Ownership: After *Indofood*' (GITCR, Vol. VI, No. 1, February 2007) pg 25

<sup>58</sup>Rip J considered the ordinary meaning, technical meaning, common law meaning, and Quebec's civil law meaning.

dividend is the person who enjoys and assumes all the attributes of ownership. In short the dividend is for the owner's own benefit and this person is not accountable to anyone for how he or she deals with the dividend income'.<sup>59</sup>

How does *Prévost* come to terms with *Indofood*? Notwithstanding the economic approach adopted in *Indofood* and the legal approach in *Prévost*, we should note that in *Indofood* the interposed company was 'bound' as a matter of fact to pass on the income while in *Prévost* the Dutch holding company was found not be 'bound' to pass on the income it received. Assuming in *Indofood*, the interposed company was in the same circumstances as the Dutch holding company in *Prévost*, one should expect similar outcome. If not, then the English Court would be deemed to have gone beyond the objective of the OECD BO limitation and vice versa.

To draw from these specific cases for more general cases, the Courts have relied on the issue of having control and dominion over the income and taking risk as an investor. In Philip Baker's hypothesis he indicated that:

'If the recipient entity went into liquidation, and it was a mere fiduciary, then any dividends etc., it had received could be claimed by the "real beneficial owner" and would not be available for general creditors in the liquidation. If, however, the dividends etc., really belonged to the entity in liquidation, then the income would be available for its general creditors and it would have been the beneficial owner of that income itself'.<sup>60</sup>

This is an indication of the risk (market or operational) and reward assumed by a beneficial owner of an income. Though this does not mean that an interposed company has to bear all the risk in any given situation, or has the full privilege to the benefit of the income, but circumstances must show that the interposed company has the power to control the use or

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<sup>59</sup> *Prévost* [n 56] at 100

<sup>60</sup> Baker [n 57] pg. 18

attribution of the income. For example, the US Court held in the UPS case that even though the level of risk undertaken was low, the simple presence of risk was sufficient.<sup>61</sup> In that case almost the entire insurance premium received was paid to another person as reinsurance premium. In another case, the US Court held that an intermediary that carried on a minimal business activity was the true owner of the interest received.<sup>62</sup> The interposed Mauritius Company in Indofood had no control over the interest received. By contrast, in *Prévost*, the Dutch holding company was not bound to pass the dividends received.

### 2.3.2 Recent Trends in International Jurisprudence

The current trends on the interpretation of BO after the Indofood and *Prévost* judgements were the issue of guidance from revenue authorities across OECD member countries and non-member countries. Subsequently after the Indofood decision HMRC issued draft guidance based on that judgement. The German revenue from 2007<sup>63</sup> denied intermediary foreign companies the reduction of the withholding under the treaty if one of the following are not met: The interposition of the foreign company is supported by economic motives or other significant reasons; The foreign company generates more than 10% of the total gross earnings of the relevant business year from its own commercial activities; The foreign company participates in the general trade with a business with adequate business equipment. However, it was provided that those conditions do not apply if the foreign company is listed on a recognised stock exchange and their shares are regularly traded.<sup>64</sup>

The current development from Asia involves China's issuance of Circular 601 in *Guo Shui Han* 2009 which provided guidance on the determination of the beneficial owner of income for the

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<sup>61</sup> *United Parcel Service of America v. Commissioner*, 87 AFTR 2d 2001-2565; 254 F.3d 1014 (11th Cir. 2001)

<sup>62</sup> *Northern Indiana Public Service Co. v. Commissioner*, 79 AFTR 2d 97-2862; 115 F.3d 506 (7th Cir. 1997)

<sup>63</sup> Pursuant to the 2005 amendment of section 50d93 of the German Tax Law (EStG)

<sup>64</sup> See Petra Ecki, Tightening of the German Anti-Treaty Shopping Rule (ET 3, 2007) pg. 120-125

purpose of the Chinese Double Taxation Agreements. Under that Circular the Chinese authorities define a beneficial owner of passive income as ‘a person that has the ownership and control over the income or the rights or assets that generates such income’. It provides further that the beneficial owner shall generally engage in substantial business activities.<sup>65</sup>

A case from China that follows this recent development is the *Fuzhou case* in October 2009 which involves the extension of BO concept to Capital Gains. In that case the Fuzhou Tax Bureau disregarded an intermediary holding company and denied the benefits of capital gains under the treaty. The facts are simple. A Chinese citizen resident in Hong Kong (Mr Cau) owned 38.1 per cent of the shares in Fuyao Glass Industry Group Co. a company resident in China through two wholly owned Hong Kong subsidiaries, Hongqiao Overseas (holding 15.6 per cent) and Sanyi Development (holding 22.49%) of Fuyao's shares. Subsequently, the shares held through the Hong Kong subsidiaries were sold and the capital gains realised were taxable in Hong Kong according to the Hong Kong-China tax treaty if the Hong Kong Company held less than 25 per cent equity interest in the Chinese subsidiary. The Mainland tax authorities pierced the veil of incorporation and considered Mr Cau as the beneficial owner of the capital gains.<sup>66</sup>

In similar connection is the Indian jurisprudence on the controversial *Vodafone case*<sup>67</sup> which was centred on the taxation of capital gains that arose outside the jurisdiction of India but effectively connected to an Indian based asset. The Indian Revenue Authorities in 2010 sought to tax the capital gains made on the sale of an Indian company by a German company through a wholly owned Netherlands subsidiary to another non-resident in the case of *KSPG Netherlands Holding BV*.<sup>68</sup> In accordance with the Indian-Netherlands tax treaty, capital gains on the alienation of shares of an Indian company are taxable in the Netherlands. The Indian authorities contended that the German-Indian tax treaty applied which ultimately gives taxing right on the gains to

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<sup>65</sup> See Article 1 of Circular 601

<sup>66</sup> See also Xinjiang Case and Chongqing Case

<sup>67</sup> *Vodafone International Holdings BV v. Union of India and another* [2010] 13 ITLR 59

<sup>68</sup> (2010) (AAR No. 818/2009); See also *E Trade Mauritius Ltd v. ADIT & Oris* (WP. No. 2134/2008)

India, that the Netherlands Company was interposed to avoid Indian tax and could not be the beneficial owner of the gains. The Court held that the Netherlands subsidiary was not a conduit, noting that it was a separate legal entity with its own directors and had made substantial investments in the Indian company.

Another instance is the more recent Indonesian regulation issued by the Directorate General of Tax targeted at minimising the abuse of their treaties. The decree stated among other things that an offshore company must have an active business activity with adequate staff and must not use more than 50% of its total income to fulfil its obligation to the other parties in form of interest or royalty.<sup>69</sup> Prior to this development was a case that dealt with whether a certificate of domicile could make a resident of a Contracting State the beneficial owner of income received? In 2008, the Indonesian Tax Court decided that the determination of whether a Mauritian consortium is the beneficial owner of the income lies with the country of residence (Mauritius), the certificate of domicile says so, but however, it is not a means of verifying the beneficial owner of the income received, an issue that is left for the Indonesian Authorities to prove.<sup>70</sup> This raises an issue of the relevance of the resident State in the BO analysis. It would be suitable for the Residence State to determine that a taxpayer qualifies as a resident of that State while the Source State then determines whether that taxpayer is the beneficial owner of the income arising in its jurisdiction. It is pertinent to note that much reliance should not be place on the Resident State because treaty shopping at the expense of the Source State may be beneficial to that State.

### 2.3.3 UN Discussion on the Concept of Beneficial Ownership

The League of Nations (LoN) was known to be the forerunner of the development of economic policies in the area of international taxation for the avoidance of double taxation in the 1920's.

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<sup>69</sup>See Decree No. 61/PJ./2009, No. 62/PJ./2009, No.24/PJ./ 2010, and No. 25/PJ./2010

<sup>70</sup> *PT Transportasi Gas Indonesia v. Direktur Jenderal Pajak* (2008)

This work was successively carried on by the inception of the United Nations (UN) in 1945, the Organisation for European Economic Co-operation (OEEC) and the OECD.<sup>71</sup> From 1963 onward, the OECD has done considerable more in the area of eliminating double taxation, a pace difficult for others to match. Although most of the work of the UN has uniquely been focusing on the relationship between developed and developing countries but much has been tapped from the work of the OECD. The history of BO concept in the UN model started from the adoption of the BO limitation found in Articles 10-12 of the 1977 OECD Model Convention into the 1980 UN Model Convention. The 2001 version of the UN Model adopted the 1995 amendments to the OECD Model Convention. Due to the uncertain nature of the concept, the UN Committee of Experts on International Cooperation on Tax Matters has been concerned about the clarification of the concept and its possible extension to other Articles of the Treaty, in particular, Article 13 on 'Capital Gains' and Article 21 on 'Other Income'.<sup>72</sup> In that regard, Prof. Philip Baker was requested to submit a consultation paper. In his observation, with considerable number of illustrations he proved that a possible extension of the concept to those other Articles is suitable but, it would not be such a good idea at this moment when the interpretation of the concept is unclear.<sup>73</sup>

In 2009 a fifth session was held and another in October 2010. The Committee's discussions were on the issues of BO and a proposal for changes to the UN Model Commentary. Much progress was not made in the 2009 session due to the level of uncertainty of the meaning of the concept in the international jurisprudence. The 2010 session however looked into the Technical Explanation of the US 2006 Model which was based on domestic interpretation of BO as well as the UK *Indofood* judgement which sought for an international fiscal meaning. Chinese Circular

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<sup>71</sup> See Ken Messere, 'The 1992 OECD Model Treaty: The precursors and successors of the new OECD Model Tax Convention on Income and Capital'(IBFD 8, 1993)

<sup>72</sup> See Committee of Experts on International Cooperation in Tax Matters: Improper Use of Treaties (E/C.18/2007/CRP.2, 2007; E/C.18/2007/19)

<sup>73</sup> See Philip Baker, 'The United Nations Double Taxation Convention between Developed and Developing Countries: Possible extension of the beneficial ownership concept'(E/C.18/2008/CRP.2/Add.1)

601 was also considered. In conclusion, the proposed changes was to the adopt some of the language in the OECD Model Commentary and disregard some other aspect of the Commentary.<sup>74</sup>

### 2.3.4 OECD Clarification of the Concept of Beneficial Ownership 2011

Working Party 1 of the OECD Committee for Fiscal Affairs in April 2011 proposed changes to the Commentary on Article 10, 11 & 12.<sup>75</sup> The proposed paragraph 12 of the Commentary on Article 10 was to be amended thus: It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was ‘paid direct to’ (immediately received by) a resident of a State with which the State of source had concluded a convention’.<sup>76</sup> Other similar paragraphs in Article 10 as well as in Article 11 & 12 were also to be changed to replace ‘immediately received by’ to ‘paid to’ and the ‘immediate’ recipient to the ‘direct’ recipient. A new paragraph 12.1 was also to be introduced to clarify the issue on the use of BO in a narrow technical sense such as the meaning that it has under the trust law of many common law countries.<sup>77</sup>

#### 2.3.4.1 OECD Definition of a Beneficial Owner

We have seen various definitions or interpretations of BO from academic scholars and particularly from Courts and Competent Authorities of Contracting States. From those definitions one would notice a great deal of diversion from what seem to be the intention of the BO limitation as expressed in the relevant Articles of the Model Convention. The issue in the

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<sup>74</sup> See Committee of Experts on International Cooperation in Tax Matters: Concept of Beneficial Ownership: Discussion of Key Issues and Proposal for changes to the UN Model Commentary (E/C.18/2010/CRP.9)

<sup>75</sup> The Committee on Fiscal Affairs: Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention (OECD 2011)

<sup>76</sup> *Ibid* pg. 3

<sup>77</sup> *Ibid*

discussion draft was the requirement for the recipient of an income to qualify as the beneficial owner, the proposed paragraph 12.4 notes as follow:

“The recipient of a dividend is the “beneficial owner” of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the full right to use and enjoy the dividend; also, the use and enjoyment of a dividend must be distinguished from the legal ownership, as well as the use and enjoyment, of the shares on which the dividend is paid.”<sup>78</sup>

The language in that paragraph requests that a beneficial owner must have full right to use and enjoy the income. On a comparability level, this proposed context seems to go way beyond what was originally the intention of the BO limitation. According to John Avery Jones, Richard Vann and Joanna Wheeler:

“This text appears to look for full ownership of the income, whereas the beneficial ownership of income is primarily an issue in situations at the opposite end of the scale, in which a person has only very limited rights over income.”<sup>79</sup>

The concluding part of the proposed interpretation of BO where WP1 stated that ‘also, the use and enjoyment of a dividend must be distinguished from the legal ownership, as well as the use and enjoyment, of the shares on which the dividend is paid’ clarifies the divergence on the point of reference of BO. The application of the concept in most common law States focuses on the underlying asset while the OECD Model Convention concentrates on the beneficial owner of

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<sup>78</sup> *Ibid* pg. 4

<sup>79</sup> John Avery Jones, Richard Vann and Joanna Wheeler, ‘OECD Discussion Draft ‘Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention’ (2011)

income. A relevant case is the **'Royal Dutch Case'** In the *Market Maker Case*<sup>80</sup> a taxpayer who acquired the right to receive dividends on some shares without acquiring the shares themselves was held by the Supreme Court to be the beneficial owner of the dividend even if he does not own the underlying asset. As defined by WP1, the taxpayer had the right to full use and enjoyment of the dividend without any obligation to pass it to another person. A relevant question at this juncture is whether the definition is helpful to determine whether previous cases like the Indofood and Prévost were well decided and whether it helps to define the scope of the BO limitation as intended.

#### 2.3.4.2 Re: Analysis of Indofood and Prévost in light of the new definition

In Indofood the interposed entity had no function but to receive income and pay on the identical amount of income as shown from the facts. In the Prévost case the Canadian Court noted that the holding company was not under any obligation to pass on the income received and thus it was the beneficial owner of the dividends received. Here the OECD definition does not make any reference to the level of artificiality that nullifies a recipient from being the beneficial owner. But based on the requirement of the right to full use and enjoyment of the income, can the Dutch holding be held to be the beneficial owner? What does right to full use and enjoyment mean? Is the OECD trying to indicate that on a factual basis when income is received, the recipient must hold on to the full income and make reasonable financial or commercial decisions as to the use of the income, even though at a later period, part or majority of it would be paid on as dividends or interest to related parties or another person. If so, is it slightly in line with the Prévost decision? If we recall, Rip J made reference to a beneficial owner as the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she receives. We do not know for sure whether the right

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<sup>80</sup> *Royal Dutch Case* (1994) *Hoge Raad*, no. 28638, [1994] BNB 1994/217

to full use and enjoyment of the income according to the OECD works in similar context to the Prévost case.

#### 2.3.4.3 Test on a Hypothetical Transaction

Let's assume this scenario. IALS (UK) licenses 'PB' (Intellectual Property) to Vienna (Mauritius) for 12 years to teach a special course: Taxation of Islamic Financial Instruments (TIFI) for fixed annual royalties. Vienna teaches no other course, it has very few employees and a rented building as lecture hall. After the first year, Vienna decided to offer the course once in 3 years due to the limited amount of candidates that took the course. Since it will still have to pay royalties to IALS, it decided to sub license PB to Leiden (India) every year in consideration for the same royalties it is obliged to pay the IALS and at the same terms and conditions.

1. Who is the beneficial owner of the royalties received from Leiden in the 3<sup>rd</sup> and 4<sup>th</sup> year Vienna does not offer the TIFI?

In the first question, Vienna should be the beneficial owner of the royalties because it has control over the income, it just happens to have a matching liability to IALS. Let's change the facts a bit. Assuming that during those periods of sub-licence, Vienna had very few applications in consideration of the 5<sup>th</sup> year. The management decided to quit offering the TIFI, offer other courses and sub-licence the intellectual property to Leiden for the remaining period.

2. Assuming Leiden issues a note at hand to the Vienna which in turn was endorsed to IALS. Who is the beneficial owner of the royalties from Leiden?

In the second question, Vienna has control over the income even though it endorses the promissory note received from Leiden to IALS. The assignment of the notes was not obliged by

IALS but a decision by Vienna to fulfil an obligation. It may be argued based on the new definition that IALS is the beneficial owner of the royalties because Vienna has no full right to enjoy and use the income.

3. What if Vienna renegotiates the agreement with IALS to pass the royalties received from Leiden to IALS for a 15 per cent commission. Can Vienna be considered the beneficial owner since it benefits from the royalties and it has economic substance?

In the third, IALS is obviously the owner of the royalties. The passing of the royalties was bound under contractual terms and Vienna can no longer be deemed to have control over the income.

4. Assuming the agreement stipulates further that before the contract ends Vienna will still be obliged to pay royalties even if Leiden terminates the agreement. Who should be considered the beneficial owner of the royalties received from Leiden?

The fourth question may be very difficult to answer. Vienna is still passing all the royalties to IALS for a commission but is also still obliged to make payments if it cannot sub-licence. It may be extremely difficult to find an interpretation that solves all beneficial ownership problems.

#### 2.3.4.4 Effect of the discussion draft on Trusts

Article 1 of the OECD MC applies to persons who are residents of one or both of the Contracting States. For the purpose of the Convention a person is defined in Article 3(1)(a) as including an individual, a company and any other body of persons. Based on the inclusion of any

body of persons within the definition, there is consensus that Trustees should be entitled to the benefits of a Convention in their own rights as persons.<sup>81</sup>

The recent discussion draft has created confusion on the application of the convention to trusts. The footnote to paragraph 12.1 in that draft provided that where the trustees of a discretionary trust do not distribute dividends earned during a given period, these trustees, acting in their capacity as such, could constitute the beneficial owners of such income. On the contrary, the requirement to qualify as the beneficial owner of an income as newly defined excludes all trusts from the scope of BO since they are under fiduciary obligation to pay out the trust income. In addition, the adoption of the 2009 work on CIV's in the 2010 updates to Article 1 also creates some confusion. At paragraph 33 of the CIV report, it was provided that:

In the case of a CIV, 'it is the manager of the CIV that has discretionary powers to manage the assets on behalf of the holders of interests in the CIV. In general managers exercise this authority within the parameters that they have set for themselves in the offering documents they use to gain subscribers to the CIV. Although they may have practical or legal obligations to distribute the CIV's income in order to qualify for preferential treatment, this obligation does not constrain their ability to vary investments.'<sup>82</sup> Paragraph 35 further provides that the CIV should be treated as the beneficial owner of the income it receives, so long as the managers of the CIV have discretionary powers to manage the assets'.<sup>83</sup>

By this paragraph, in principle, all trusts should be the beneficial owners of the income they receive. As explained by Roy Saunders, a trust is formed when an individual or a corporation (the settlor) transfers cash or asset (the trust fund) to individuals or corporation (the trustees) on the

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<sup>81</sup> See Philip Baker, 'The application of the Convention to Partnerships, Trusts and Other, Non-Corporate Entities'(GITCR Vol. II No. 1, 2002)

<sup>82</sup> The Committee on Fiscal Affairs: The Granting of Treaty Benefits with respect to Income of Collective Investment Vehicles (OECD 2009) paras. 31-35

<sup>83</sup> See Paragraph 6.14 of the Commentary on Article 1

understanding as expressed in writing in the trust deed that the trustees will invest, administer and distribute the income and capital of the trust fund for the benefit of specified parties, or a class of persons (the beneficiaries).<sup>84</sup>

If there is a legal obligation to distribute the income of the CIV to the investors and that is seen not to exclude the CIV from being the beneficial owner of the income it receives because that obligation is seen not to constrain the discretionary powers of the CIV managers to invest, by analogy, a trust where the beneficiaries are entitled to the income as it arises under the trust deed should also be treated as the beneficial owner of the income received because I see no reason why the trustee's power to administer the asset would be affected either. It would be desirable to apply the Convention the same way to all trusts so that the ability of a discretionary trust to qualify as the beneficial owner of the income received would not depend upon whether income is held or distributed. This can even be seen as a limitation on the ability of the trustees to apply their discretion for the benefits of the beneficiaries.

Unlike the CIV, the situation of trusts as regards recognition is worse. The legal and tax treatment of trusts in some civil law countries is still uncertain. The effort of the Hague Convention of 1985 on the Law Applicable to Trusts and their Recognition has achieved very little consensus. However, as erroneously provided in case of CIV's, a discretionary trusts should be treated as the beneficial owner of the income it receives, so long as the trustees have discretionary powers to manage the asset, so long as it also meets the requirements that it be a 'person' and a 'resident; of the State in which it is established.<sup>85</sup>

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<sup>84</sup> See Roy Saunders et al, *The Principle of International Tax Planning*(Corpus Publishing Ltd, 2005) pg. 61

<sup>85</sup> See OECD [n 82] para. 35

### 2.3.5 Reconciliation

The post-2000 development of the BO concept features the consideration of a domestic interpretation (Prevost) or international fiscal meaning (Indofood). The recent work of the WP1 has leaned towards the international fiscal meaning. The eagerly awaited determination of the international fiscal meaning of the BO concept by the OECD finally came. The OECD proposed to interpret the beneficial owner of income as the recipient that has the full right to use and enjoy the income unconstrained by a contractual or legal obligation to pass the payment received to another person. Whereas, the preceding argument that sought clarity concerned rights that were too limited to survive the BO limitation. This was the argument of the Court in Prevost. Prevost Netherlands had little substance but the Canadian Court found that the UK and Swedish owners had no means of enforcing the shareholders' agreement against the Netherlands Company, nor was the Netherlands Company under any legal obligation to declare a dividend. What if an interposed company that has little substance and unconstrained by any legal obligation decides to pay 80 per cent of the income it receives up, does that conduct make such an entity a mere conduit akin to fiduciary for interested parties? According to the new proposed language this may be difficult to answer. As noted earlier, the Court in Prevost used similar language i.e. use and enjoyment, but this is to be viewed from the angle of control over the income. Is the WP1 adopting this view?

In addition, in a BO analysis other factors such as risk and control may be very relevant. This was shown in the US UPS case cited about and in particular from the test of a hypothetical transaction. In that practical illustration it was assumed that Vienna decided to quit offering the TIFI course, offer other courses and sub-licence the intellectual property to Leiden for the remaining period. It was also assumed that Leiden issued a promissory note to Vienna which in turn was endorsed to IALS. Here, if Vienna cannot sub-licence the IP, it will still be liable to pay royalties to IALS. Therefore the fact that it passes the whole royalties directly to IALS should

not make Vienna a non-beneficial owner. At least it has control over the income but circumstances gave it no option but to pass the income even though not bound to. What the BO limitation is there to prevent is the ability of a third country resident to control the attribution of income. There is nothing as such here but I doubt whether the proposed definition would protect such situations. In similar connection is the bizarre provision of the Indonesian Authorities that the beneficial owner must not use more than 50% of the total income to fulfil its obligation to the other parties in form of interest or royalty.

Another issue to reconcile is the application of the convention to trusts. The proposed commentary has created more contradictions in this area by stating that a discretionary trust can qualify as the beneficial owner of income received if that income is not disbursed. Whereas the interpretation given to BO does not support this provision but contradicts it because in no case does the trustee of a trust have the right to the full use and enjoyment of the income. The beneficiaries of a trust are always those that enjoy the income of the trust whenever the trust decides to disburse the income. For the purpose of the Convention, for both CIVs and discretionary Trusts be treated in similar ways. Reference should not be made to the ability to diversify investments in the case of CIVs and the ability to hold the income in the case of Trusts. These requirements are inconsistent with what the BO concept is about.

## 2.4 Conclusion and Recommendations

The BO concept was intended to address the problem of treaty shopping from the use of ordinary attribution terms such as 'paid to' in relation to Articles 10-12. Therefore, it would be inappropriate to consider a meaning developed in order to refer to the individuals who exercise ultimate effective control over a legal person or arrangement. This discards the proposed

interpretation by scholars like Vogel whose focus was on the control of capital, asset and the use of the yield and Du Toit's interpretation that points at the person whose ownership attribute outweighs that of another. The language of the discussion draft focuses only on ownership of income. BO can be inferred from the work of WP1 looks at the intensity of the ownership attributes enjoyed by the recipient over the item of income but the way or rather the language used in the clarification is not consistent with the original intention of the 1977 Model and the subsequent 1987 Conduit Report. The original notion is that in all circumstances under consideration i.e. that falls within the context of BO, there are always two groups of recipient that have limited rights. The issue to clarify is which of these two limited rights passes the BO limitation and which one fails. Better put, which right is too limited to qualify for treaty benefits? Now that the language looks for the person that has the full right to use and enjoy the income there is little or no chance that any interposed company with limited rights or trusts would ever qualify as a beneficial owner. The use of 'full right to 'use' and enjoy' the income is misguided. Looking at the development of this concept and the recent focus on the ownership of income, the use of the word 'control' of the income would have been the most appropriate term to use. The beneficial owner should be the person that has control over the attribution of income.

## Recommendations

The exclusive purpose of the introduction of the BO limitation into Articles 10-12 is to prevent treaty shopping by excluding custodians of income and other persons or body of persons in similar position. The good thing about the revised work since 2003 up until the recent work of WP1 in 2011 is the expression that the BO concept should be understood differently from trusts law and most importantly the focus on the ownership of income rather than the control of the

underlying assets. The bad thing was the requirement of the right to full use and enjoyment of the income which is rather incompatible with the motive of the OECD when the term was introduced. Based on the foregoing, the following are tentatively recommended:

1. The beneficial owner of an income should be interpreted as the recipient that has control over its attribution unconstrained by any legal or contractual obligation that usurps such power. In that connection, agents and nominees, conduit companies akin to a mere fiduciary or administrator for interested parties or any other recipient in similar position cannot be seen to have the power to control the attribution of the income received. It is pertinent to note that the fact that the recipient later decides to pay such income to interested parties should not change their status as beneficial owners.<sup>86</sup>
2. The OECD should provide practical examples to the interpretation of BO they adopt in the commentary on Articles 10-12. A good starting point is the facts in *Prevost* and *Indofood* and other body of case law on the concept. The illustrated examples will be helpful in understanding the scope of the concept since the OECD Commentary is a widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions.<sup>87</sup>
3. In relation to CIVs, it should be the discretionary powers of the managers to deal with the income they receives that should be the determinant factor on whether or not a CIV qualifies as the beneficial owner of the income. The focus on the discretionary power to manage the assets that generates the income is unreasonable.

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<sup>86</sup> The important element of treaty shopping is the ability of interested parties to compel the interposed company by any means to transfer the income received to them.

<sup>87</sup> *See* Vogel [n 12] pg. 43

4. In relation to Trusts, as the present paragraph 6.14 of the commentary on Article 1 stands, by analogy, the trustees of discretionary trusts have the power to manage the assets that generates the income received. The application of the convention to a discretionary trust should be included in Article 1, providing that the trustees of a discretionary trust are to be regarded as the beneficial owners of the income received provided they have discretionary powers to control or deal with the income. The provision that the status of the trustees as the beneficial owner of income depends on whether they disburse the income or not is a limit on their discretionary power to deal with such income.<sup>88</sup>
5. In relation to Article 13, international jurisprudence of some authorities has shown the extension of the BO requirement to Capital Gains. It seems that Article 13 is even more subjected to treaty abuse than Articles 10-12. I recommend that the BO limitation should be extended to Article 13 in the convention. In that connection, the focus would be on the underlying asset rather than income. The beneficial owner of the capital gains received should be the person that has control over the alienation of the assets.
6. In the process of determining the beneficial owner of income the domestic law of the resident State should not be considered irrelevant. A reasonable starting point is for the source State to confirm whether the recipient is a resident of the other contracting State. Thereafter it can then apply the OECD interpretation of the BO concept.

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<sup>88</sup> Jefferson VanderWolk notes in a section at the IALS on US International Taxation that the IRS may not tax the beneficiaries of a foreign trust so far that beneficiary have no control over the income or asset bought with such income. In his example he notes that a foreign trust may decide to buy a building for the benefits of a beneficiary schooling in the US. The beneficiary would not be taxed in the US so far the trust can tell the beneficiary to vacate the building at anytime. Trusts should not be disregarded as the beneficial owner of the income they receive anytime they disburse the income because that decision is part of their discretionary power to manage the income received.

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