Economic and Social Council
Committee of Experts on International Cooperation
in Tax Matters
Fourth session
Geneva, 20-24 October 2008

Note by the Coordinator of the Subcommittee on Improper Use of treaties: Proposed amendments

Addendum

Progress Report of Subcommittee on Improper Use of Tax Treaties: Beneficial Ownership *

Summary

Sum2 Nove.1(9(m)8 11.5ed)5r 1 07, -3oo

- 1. During the Third Session of Tax Expert Committee, the subcommittee was requested to carry out further work on the issue of beneficial ownership, and it was noted that this could include whether or not the concept of beneficial ownership could apply with respect to other Articles of the Model Convention, such as Articles 13 and 21.
- 2. In order to address this request appropriately, the subcommittee, with the cooperation of the UN Secretariat, asked Professor Philip Baker to submit his consulting paper on the issue of beneficial ownership, especially focusing on whether or not this concept is applicable to other Articles of the UN Model Convention.
- 3. Consequently, Professor Baker submitted in May this year his paper titled "Possible Extension of the Beneficial Ownership Concept," which in most part was identical to the one attached to this report. Subsequently, the subcommittee members started discussions over that paper, spending one and a half months with a view to reaching a consensus on the conclusion of the issue.
- 4. There were largely two different schools of thoughts among subcommittee members. One group of the members proposed

members - so that the Committee could discuss it during the allotted time for the subcommittee in the Fourth Annual Session of the Committee.

- 6. The subcommittee hoped to take this opportunity to observe the general view of the Committee on the issue of possible extension of the beneficial ownership concept. If the Committee *can* succeed in reaching a consensus on the future direction, the subcommittee would reflect it either in our draft new Commentary on Article 1 or in a separate note. If the Committee *cannot* reach a consensus on the future direction during the next Committee meeting, the Subcommittee would like to propose the following option:
 - (i) Not to make any changes to the proposed new Commentary on Article 1; and
 - (ii) To undertake, as a new project, a review of the beneficial ownership concept, including the question of whether that concept is relevant for other Articles of the UN Model.
- 7. The subcommittee looks forward to having a meaningful discussion of the attached paper prepared by Professor Baker during the Fourth Session of the Committee.

ANNEX

THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES: POSSIBLE EXTENSION OF THE BENEFICIAL OWNERSHIP CONCEPT²

Introduction

- 1. I have been asked to prepare a Report on the issue whether the concept of beneficial ownership, currently used in Articles 10, 11 and 12, should be extended to other Articles of the UN Model Convention, in particular Articles 13 and 21. The background, as I understand it, is as follows. In its report of 22nd October 2007 (Document E/C.18/2007/CRP.2), the Sub-committee on Improper Use of Treaties drew the attention of the Committee of Experts to four issues that it had examined in the course of its work which were not dealt with in that report: the first of these was the interpretation of the concept of "beneficial owner". In its Report on the Third Session (Document E/2007/45, also E/C.18/2007/19) the Committee of Experts requested the Sub-committee to carry out further work on the issue of beneficial ownership and it was noted that this could include consideration of whether or not the concept of beneficial ownership could apply with respect to other Articles of the Model Convention, such as Articles 13 and 21 (see Report on the Third Session, para.24). The Committee of Experts requested the Sub-committee to complete its work, taking into account such issues as the application of the concept of beneficial ownership to other Articles of the Model Convention (ibid, para.40).
- In this Report I discuss: a brief history of the beneficial ownership concept; the interpretation of the term "beneficial owner"; possible Articles of the UN Model Convention to which the beneficial ownership concept might

4

² This report was prepared by Professor Philip Baker – Secretariat Note.

explanation in the OECD Model (see paragraph 14 of the Commentary to Article 10, and paragraph 19 of the Commentary to Article 11).⁶

The interpretation of the term "beneficial owner"

- 9. Though the beneficial ownership concept has been employed in double taxation conventions since the 1960s, its precise meaning remains unclear. This is an important factor for the Sub-committee and the Committee of Experts to consider in deciding whether to extend the use of the concept to other Articles of the UN Model Convention. If the meaning of the term remains unclear, the consequences of extending the term to other Articles will equally be unclear. It may be that the term has a narrow scope, simply to exclude nominees and agents, so that the inclusion of the term would achieve relatively little by way of combating the improper use of treaties; on the other hand, the term may come to be given a wide interpretation, in which case it might exclude some persons who might not be regarded as making improper use of a treaty. This is a risk in extending the use of the concept to further Articles of the Model Convention.
- 10. Several fundamental issues remain unresolved about the interpretation of the beneficial ownership concept.
- 11. First, does the term "beneficial owner" as an undefined term in the Convention take its meaning from the domestic law of the Contracting State concerned under Article 3(2) of the Model Convention? Alternatively, is this a situation where "the context otherwise requires" that the domestic law meaning of the term is not employed? If so, does the term "beneficial owner"

8

⁶ The Commentary to Article 12 of the UN Model Convention does not contain any equivalent explanation of the beneficial ownership concept: it is assumed that there is no significance to this and that the equivalent explanations in the Commentaries to Articles 10 and 11 would be equally applicable.

have an "international fiscal meaning", to be ascertained, for example, from the terms of the Commentaries to Articles 10, 11 and 12?

12. Secondly, is the beneficial ownership concept a narrow and specific antiabuse rule, designed only to exclude clear cases of treaty shopping by the imposition of a nominee, agent or other conduit (being a conduit that has no power to enjoy the income and cannot, therefore, in any sense be regarded as the beneficial owner)? Alternatively, is the beneficial ownership concept a the advice found in the Commentaries to the OECD and UN Models that Contracting States may include more specific anti-shopping provisions. Finally, I base this view also on the practice of a number of States to include more elaborate and detailed anti-shopping provisions (for example, separate Limitation on Benefit Articles): if the beneficial ownership concept was a broad, general anti-treaty-shopping measure, some of those more detailed provisions might be unnecessary.

- 15. There has been a small number of court decisions around the world on the meaning of "beneficial owner". I am aware of only six such cases: these cases are summarised below. Unfortunately, they do not yet establish a common interpretation of the term.
- 16. The earliest case appears to have been the decision of the Dutch Hoge Raad of 6th April 1994, generally referred to as the "Royal Dutch" case.⁷ That case concerned a taxpayer who had acquired the right

Luxembourg company had paid out by way of interest and charges of an unspecified nature all the income received by it. The Federal Commission concluded that the Luxembourg company was not the beneficiary of the dividends. The Commission stated: "The notion of 'effective beneficiary' [usually translated as beneficial owner] clearly envisages the person who in reality receives the dividend paid rather than the formal direct shareholder

Guarantor. The passages from the OECD commentary and Professor Baker's observations thereon show that the term 'beneficial owner' is to be given an international fiscal meaning not derived from the domestic laws of contracting states. As shown by those commentaries and observations, the concept of beneficial ownership is incompatible with that of the formal owner who does not have 'the full privilege to directly benefit from the income'... [This is quoted from a circular letter issued by Director General of Taxes in Indonesia]

[43] The legal, commercial and practical structure behind the loan notes is inconsistent with the concept that the Issuer or, if interposed, Newco could enjoy any such privilege. In accordance with the legal structure the Parent Guarantor is obliged to pay the interest two business days before the due date to the credit of an account nominated for the purpose by the Issuer. The Issuer is obliged to pay the interest due to the noteholders one business day before the due date to the account specified by the Principal Paying Agent. The Principal Paying Agent is bound to pay the noteholders on the due date. 12

. . .

[44] But the meaning to be given to the phrase 'beneficial owner' is plainly not to be limited by so technical and legal an approach. Regard is to be had to the substance of the matter. In both commercial and practical terms the Issuer is, and Newco would be, bound to pay on to the Principal Paying Agent that which it receives from the Parent Guarantor. ... In practical terms it is impossible to conceive of any circumstances in which either the Issuer or Newco could derive any 'direct benefit' from the interest payable by the Parent Guarantor except by funding its liability to the Principal Paying Agent or Issuer respectively. Such an exception can hardly be described as the 'full privilege' needed to qualify as the beneficial owner, rather the position

12

¹² Para. 43.

of the Issuer and Newco equates to that of an 'administrator of the income'.

- 20. It is notable that the Court of Appeal regarded the term "beneficial owner" as having an international fiscal meaning, derived in large part from the Commentaries to the OECD and UN Models.
- 21. The French Conseil d'Etat in the Bank of Scotland case¹³ considered an arrangement whereby the taxpayer had acquired a usufruct for three years over preference shares in a French company which had been r0175 Tc.1845 Tw173the Comm

owned all the shares in a Canadian company: dividends paid by the Canadian company were paid on by the Dutch company to its two shareholders. The Tax Court concluded that the Dutch company was the beneficial owner of the dividend, explaining the concept as follows:

In my view the 'beneficial owner' of dividends is the person "[100] 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 beneficial owner of the 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. Where an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatary is acting or for whom the nominee has lent his or her name. When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it, for example, a stockbroker who is the registered owner of the shares it holds for clients. This is not the relationship between PH BV and its shareholders."

23. Rip ACJ in the Tax Court approached the meaning of "beneficial owner" by looking at the domestic law meaning, in accordance with Article 3(2) of the relevant Convention (and also the Canadian *Income Tax Conventions Interpretation Act*). He noted that the term "beneficial owner" is employed in common law systems, and also discussed the civil law approach in the

Province of Quebec. At the time of writing this Report, it is not yet known whether this case will proceed on appeal.

- 24. This scant international case law on the meaning of "beneficial owner" points to a number of factors to be considered by the Sub-committee and the Committee of Experts in deciding whether to extend the use of the beneficial ownership concept.
- 25. First, the term has, as yet, no clearly established definition, and courts have disagreed even on such basic questions as whether the term should take its meaning from the domestic law of the Contractin

Possible Articles to which the beneficial ownership concept might be extended

30. Having identified some of the difficulties

Article 21: Other income

33. The first, potential candidate for inclusion of the beneficial ownership concept is the "other income" Article, Article 21. This provides that "Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention, shall be taxable only in that State."

In the OECD Model, taxation in the state of residence is exclusive (subject to

receive that income. So far as the application of the "other income" Article to income from third states is concerned, this type of classic treaty shopping is unlikely to occur. It is unlikely that State A would seek to tax a resident of State C on income arising outside State A.

37. With respect to income arising in the state of residence or in third states, however, there is a potential danger of treaty shopping under the UN Model Convention. Suppose, for example, that a resident of State A earns substantial income from sources outside of State A. He might assign the right to receive that income to an entity in State B, arguing that such income from third states

ownership limitation would ensure that the domestic law provision was effective.

40. The position under Article 21 might be illustrated by some examples.

Example 1: a resident of State A derives significant sums in the form of swap fees from transactions having their source in State A. He assigns the right to receive those fees to an entity in State B, which has a convention with State A. This device has no impact as Article 21(3) preserves the taxing right of State A.

Example 2: a resident of State C (which has no convention in force with State A) derives significant sums in the form of swap fees from transactions having their source in State A. He assigns the right to receive those fees to an entity in State B, which has a convention with State A. This device has no impact as Article 21(3) preserves the taxing right of State A.

Example 3: a resident of State A derives significant sums from State B and from third states which would be taxable in his state of residence. He assigns the right to receive those sums to an entity in State B. Anti-avoidance legislation in State A ensures that he remains taxable on this income in State A. However, he argues that the convention gives exclusive right to tax this third-country source income to State B. A beneficial ownership limitation in Article 21(1) defeats this argument.

41. In some senses, the strongest argument for including the beneficial ownership concept in Article 21 is because this is already part of the treaty practice of a number of states. The 2006 US Model, for example, provides in Article 21(1):

- 47. The danger arises, if at all, from the provisions of Article 13(6) and (just conceivably) from Article 13(3). These two paragraphs both provide that the categories of property to which they refer shall be taxable only in one of the Contracting States.
- 48. The main concern here must arise from Article 13(6) which deals with all forms of property other than those covered by the first five paragraphs of the Article.
- 49. Unlike Article 21, this could give rise to "classic" treaty shopping. Suppose, for example, that a resident of State C (which has no convention in force with State A) owns assets situated in State A (not being immoveable property etc.) and that State A would tax the gain on disposal of those assets. He might acquire those assets through an entity in State B (which did have a convention in force with State A) so that the gain on disposal was exempt under the State A—State B Convention.
- 50. A similar, "reflexive" arrangement might be used by a resident of State A itself to avoid capital gains taxation on the disposal of assets situated in State A or in a third State. Thus, a taxpayer resident in State A might assign to a person resident in State B the ownership of assets not falling within the first five paragraphs: this might include, for example, ownership of shares in a company of State A (his state of residence) which is not a property company and where he does not hold substantial participation, or immoveable property situated in a third state. The taxpayer might then argue against a charge to tax on a capital gain attributed to him on the disposal of the assets that the gain is taxable only in State B under the equivalent of Article 13(6) of the State A—State B Convention.
- 51. It is certainly the case that some tax planning takes place utilising provisions equivalent to Article 13(6) of the UN Model Convention. A recent

example of that can be seen in the underlying facts in the UK Special Commissioners' case of Smallwood Trustees v. Revenue & Customs Commissioners (2008) 10 ITLR 574. That involved a scheme whereby assets held by non-resident trustees on behalf of **UK-resident** were settlors/beneficiaries. The trustees transferred their residence to a jurisdiction with which the UK had a double taxation convention containing the equivalent of Article 13(6). On a disposal of the assets, and the realisation of a capital gain by the trustees, it was argued that the double taxation convention prevented the taxation of the gain in the hands of the UK-resident settlors/beneficiaries. 16 The scheme failed not on any argument based upon beneficial ownership but rather on the application of the tie-breaker provision.

52. If one assumes that the equivalent of Article 13(6) at

- "6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the beneficial owner is a resident."
- 60. The other paragraph of Article 13 which provides for exclusive taxation in one of the Contracting States is Article 13(3) where gains from the alienation of ships, aircraft and boats are taxable only in the Contracting State in which the place of effective management of the enterprise is situated. Because this provision employs the connecting factor of effective management – which looks at the actual facts and circumstances – it is quite hard to see how this could be used in an abusive fashion. Suppose, for example, there is a company which is a resident of State A or State C and which operates aircraft in international transport: the effective management of the international transport enterprise is in State B. Assume that there is a gain on the disposal of aircraft and suppose that the gain would otherwise be taxable in State A (e.g. the aircraft might be physically located in State A): it seems a correct application of the Convention that this gain should be taxable only in State B, where the enterprise is effectively managed, even though the company which owns the aircraft is a resident of State A or State C.
- 61. It seems hard to see an argument, therefore, for including a beneficial ownership limitation in Article 13(3).

Shipping, inland waterways transport and air transport income: Article 8

62. For exactly the same reason – that the UN Model Convention employs the place of effective management as the connecting factor in both alternative versions of Article 8 – it seems hard to make a case for the inclusion of the beneficial ownership limitation in Article 8.

Business profits: Article 7

- 63. In the absence of a permanent establishment in the other Contracting State, business profits are taxable only in the state of residence of the enterprise. Thus, Article 7 bears a similar formulation to Article 21(1) or Article 13(6) (or Article 12 of the OECD Model). To that extent, therefore, there is the possibility of treaty shopping to take advantage of Article 7.
- One can imagine "classic" treaty shopping scenarios involving Article 7. Suppose that a resident of State C (which has no convention in force with State A, or has a convention in force but with a broader definition of permanent establishment) derives business profits from State A which would be taxable there in the absence of a convention (or under the broader definition of permanent establishment in the State C convention). He establishes an entity in State B to take advantage of the State A-State B convention.
- 65. Article 7 may also be part of "reflexive" arrangements which a resident of a state employs to avoid taxation of business profits in his own state of residence. Suppose, for example, that a resident of State A derives business profits from State A, but in a manner that does not require a permanent establishment: he establishes an entity in State B which derives the business profits, and then argues that those profits are taxable only in State B by virtue of the business profits Article of the State A—State B Convention.
- 66. To an extent, the arrangements which were considered in the UK case of Padmore v. IRC [1989] STC 493 involved this latter type of structure. A resident of the United Kingdom derived business profits from the United Kingdom and elsewhere through a partnership established in Jersey. The

partnership was held to be a resident of Jersey for the purposes of the UK-Jersey Double Taxation Arrangement, and (prior to amending legislation) the profits of the partnership were taxable only in Jersey.

67. It is also worth noting that provisions of the Finance Bill currently before the UK Parliament aim to prevent, through domestic legislation, current schemes that would rely upon the business profits articles of the UK's double taxation arrangements. Those schemes typically employed an entity – such as a partnership – esta

"1. If the beneficial owner of the profits of an enterprise of a Contracting State is a resident of that State, those profits shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein."

Other Articles

- 71. In principle, one can think of possible treaty shopping structures that might involve other articles of the Convention and which would be countered by a beneficial ownership limitation.
- 72. So long as the UN Model Convention contains an Article 14 (an issue which I understand is currently under consideration by another sub-committee) then similar considerations would apply to that as apply to Article 7.
- 73. Under Article 15, it is theoretically possible that an individual might use a company in another Contracting State to provide his employment services. However, one wonders if this is sufficiently common (other than in the circumstances of artistes and sportsmen which are dealt with by Article 17(2)) to merit any change in the wording.
- 74. If a pension recipient were to assign the benefit of a pension to a nominee in another Contracting State, he might do so in an attempt to argue that the pension should be taxable only in the state of recipient of the pension. This raises a difficulty as to whether the pension is paid to the nominee "in consideration of past employment". Again, it seems sufficiently unlikely that such schemes would arise not to merit any amendment.

75. Article 22 – with respect to those states that tax capital and have the equivalent Article in their double taxation conventions – operates in a fashion very similar to Article 13. To that extent, therefore, if there is an argument for putting a beneficial ownership limitation in Article 13(6), there is an equivalent argument for putting it in Article 22(4).

A summary on possible articles to which the beneficial ownership concept might extend

76. It seems, therefore, that the strongest arguments for including a beneficial ownership limitation relate to Article 21, Articles 13(6) and 22(4), Article 7 and Article 14. However, it is very difficult to gauge how extensive is treaty shopping which uses these Articles; this is a matter upon which the Subcommittee may have its own views.

Including the beneficial ownership concept in some Articles and not in others

- One word of caution might be inserted at this point. If the UN Model Convention is amended so as to include the beneficial ownership concept in some Articles for example, Article 21 but not in others (for example, not in Article 13(6)) then it might come to be argued that a nominee or agent is entitled to the benefit of those Articles that are not amended because they have specifically not had a beneficial ownership limitation inserted. In the proposed new Commentary, the Sub-committee might seek to address this by indicating that such a reverse implication is not intended.
- 78. To an extent, this issue is already present in the UN Model Convention: the beneficial ownership concept is found in Articles 10, 11 and 12, but not in other Articles. As has been explained above, the French Conseil d'Etat in the Bank of Scotland case followed the reasoning of the Commissaire who argued that the beneficial ownership concept was implicit in the double taxation

5. A free-standing beneficial ownership limitation provision

The discussion above suggested the possibility of a free-standing provision applying to all benefits under the Convention as a very limited form of limitation on benefits provision. This might have some attractions in providing an argument to counter all basic forms of treaty shopping.

- 6. A free-standing beneficial ownership provision included only in the Commentary
- 90. An alternative to including a free-standing beneficial ownership provision in the Model Convention itself is to include it only in the Commentary as a suggested form of words which pairs of states might include in their bi-lateral convention if they considered that it would be useful as an anti-treaty shopping provision.
- 91. My personal inclination would be to rank the options in this order:
 - (i) Add the beneficial ownership concept in Article 21 only;
 - (ii) Do nothing;
 - (iii) Add the beneficial ownership in Article 21 and Article 13(6) only;
 - (iv) Introduce into the Commentary a form of free-standing beneficial ownership provision that applied to all benefits under the Convention and which contracting states might choose to add to their bi-lateral conventions.

92. I would place the options in this order for several reasons, not least of which is my view of how likely such changes would be to win acceptance in treaty practice. I am also concerned at employing more extensively a term which lacks a clearly accepted meaning.

Concluding comments

93.

96.