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Persons Qualifying for Treaty Benefits

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Persons Qualifying for Treaty Benefits

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1. Introduction

The granting of treaty benefits can be a fraught issue for many countries; treaties are often regarded as an important part of a country's international tax policy and an important tool in attracting foreign investment, yet there is also a concern that treaties can be exploited by taxpayers to obtain benefits which were not intended by the countries concluding the treaty and which do not have any policy justification behind them. Assessing the relative weight of these two concerns can be a difficult balancing act for countries. This paper aims to assist the tax administrations that have to determine whether or not to grant treaty benefits in specific cases by shedding some light on the policy and technical issues that arise in this respect.

It focuses on the position of a source country that is asked to reduce or forgo the taxing jurisdiction it claims under its domestic law, as the issues are generally most acute, and arise most frequently, for source countries. Issues may also arise in residence countries if the double tax relief granted by a treaty is more generous than the double tax relief granted under domestic law; this could be the case if, for example, the residence state has conceded the creditability of a specific tax under the treaty that it would not regard as creditable under its domestic law, or if the treaty grants a participation exemption for dividends whereas domestic law grants a credit. The substantive issues in respect of residence state taxation are covered in a separate paper[1]. In the context of this paper, the important point is that the residence country also has to determine whether a taxpayer is entitled to treaty benefits and this determination involves the same elements as the determination made by the source country.

Entitlement to treaty benefits is often discussed in the context of the need to ensure that benefits are granted only to persons who are genuinely entitled to them, particularly in the context of treaty shopping. Treaty shopping is the phenomenon that taxpayers set up cross-border structures or flows of income, not for reasons related to the commercial aspects of their business or investment, but in order to make the income fall within the protection of a certain treaty. There is, however, also an opposite side to the coin, namely the need to ensure that treaty benefits are granted in appropriate

[1] See Peter Harris, Taxation of Residents on Foreign Source Income, Paper 3-A of this collection.

cases, even though the fact pattern presented to the tax authority does not fall neatly within the wording of the treaty.

Treaties cannot possibly deal in detail with every factual situation that may occur in the relationship between two countries. In order to provide the necessary flexibility in dealing with this complex, and continuously changing, relationship, treaties are worded in a rather abstract and general way, setting out basic principles rather than detailed rules. They raise many questions about interpretation and there may be situations in which policy considerations indicate that treaty benefits should be granted even though the treaty does not cater explicitly for the situation under consideration. It is therefore important for the tax authority to be aware of the general principles and policy issues underlying entitlement to treaty benefits in order to be able to make these decisions.

This paper starts by explaining the three basic steps that have to be taken in determining whether or not treaty benefits are available. It then pulls together the issues raised by various types of conduit structure, which are often a major concern of source countries. It concludes by looking at a number of structures which are not covered explicitly by the United Nations Model Double Taxation Convention between Developed and Developing Countries[2] ("UN Model Convention"), in each case highlighting the feature that causes problems and discussing its effect on treaty entitlement issues.

Dealing with these basic steps and structures requires a country applying a treaty to have information about the person claiming treaty benefits and the structure for which treaty benefits are claimed. This need for information can be a serious stumbling block for many source countries, in particular. Although there are a few multilateral tax treaties in existence, this paper assumes for the sake of simplicity that a tax treaty always has only two contracting states.

2. Persons qualifying for treaty benefits

The first step in determining whether a specific treaty applies in a given case is to identify the person who is potentially entitled to the benefits of the treaty. Art. 1 of both the UN Model Convention and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital[3] ("OECD Model Convention"), which is followed by most concluded treaties, states

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2 United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

3 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital*, (Paris: OECD, 2010) (looseleaf).

clearly that the treaty applies to "persons". Any claim to the benefit of one of the allocation articles must therefore be made and substantiated by a person.

In many cases it is clear what counts as a "person" for treaty purposes. Individuals are clearly "persons", as are companies, which are legal persons. The domestic law of most countries, however, also recognises various other structures and groupings to a greater or lesser degree. Within one state the domestic law is generally clear as to which of these structures or groupings are recognised as distinct taxpayers for income tax purposes, but difficulties can arise in a treaty context. Something that is a taxpayer under the domestic law of a state is likely to be regarded by that state as a "person" for treaty purposes, but the domestic civil law of the other contracting state may be different and then a question arises as to whether the other contracting state also recognises the person for treaty purposes.

Art. 3(1)(a) of the UN and OECD Model Conventions addresses this issue by providing that the term "person" includes an individual, a company and any other body of persons. This paragraph is only a partial solution, as it does not provide an exhaustive definition of the term and it leaves open the question of what is meant by a "body of persons". The Commentaries do state, however, that the term should be interpreted very broadly. Given the object and purpose of the allocation rules of treaties, a strong argument can be made that something that is capable of bearing an income tax liability in a state should qualify as a "person" for treaty benefits.

2.1. Types of person

The most straightforward types of person that can potentially claim treaty benefits are discussed in this section below. Partnerships, transparent companies and trusts all raise further issues and are discussed in Section 6. This paper does not cover the governments of countries and their subdivisions or sovereign wealth funds, all of which are subject to slightly different considerations.

2.1.1. Individuals

Individuals are generally rather straightforward in this context as they are so clearly "persons". Nevertheless, some issues for treaty entitlement can arise due to different domestic systems for taxing families.

Some countries do not tax each individual separately, but tax them rather in family units such as husband-and-wife units or, less commonly, a family as a whole. In these cases there may well be a mismatch between the domestic laws of the two contracting states. Family taxation regimes generally apply, however, only if all the family members concerned live in the same state, and it would be an excessively technical approach to deny treaty benefits because of this tension. The two contracting states would have to agree, however, whether a claim for treaty benefits should be made by the family unit as a whole or whether it should be made by the separate individuals within the family unit.

Other countries deal with the issues raised by families in a different way; these countries treat each individual as a separate taxpayer but they tax certain income of one family member in the hands of a different family member. A common example is the taxation of investment income received by a child in the hands of a parent, in order to prevent wealthy parents from transferring their investments to their children in an attempt to avoid the effects of progressive rates of tax on the income produced by the investments. In this case there is no doubt that the child and the parent are both separate "persons" for treaty purposes. The treaty issue here is not, in fact, with the first step of identifying a person, but rather with the third step, discussed below, of deciding which person can claim treaty benefits in respect of which income.

2.1.2. Companies

Companies, like individuals, are generally rather straightforward in this context as they are clearly legal persons and therefore clearly "persons" for treaty purposes. Indeed, Art. 3(1)(a) UN Model Convention specifically defines the term "person" to include companies.

Art. 3(1)(b), in turn, defines the term "company" to mean any body corporate and any entity that is treated as a body corporate for tax purposes. The latter part of this definition means that even a legal structure that does not have the form of a company can be regarded as a company for treaty purposes if it is taxed as a company under domestic law. Once it has been determined, however, that a structure is a "person" for treaty purposes, it is not important to its entitlement to treaty benefits whether or not it is a company.[4]

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[4] Subject to the one exception of Art. 10(2) where the different limits on source-state taxation depend partly on the whether or not the treaty claimant is a company.

Many countries allow companies in a corporate group to elect for a tax regime which recognises that the corporate group forms an economic whole. Such group taxation regimes take many different forms. One approach is to deal with different aspects of the group relationship separately, with one set of rules to deal with inter-corporate dividends, another set of rules to deal with transfers of assets among group members and yet another set of rules to allow the transfer of losses among group members. A more integrated approach requires a computation of profit by each group member separately but then aggregates all those results in the hands of the top company in the group and taxes only the top company.[5] At the most extreme end of the scale are countries which deal with all these aspects in one comprehensive regime which ignores the separate legal existence of the group members and imposes tax as if all the group members were branches of the top company in the group.

The latter type of group regime raises questions about the entitlement to treaty benefits of the companies in the group, but these questions do not arise during the first step that is discussed in this section. Even the most integrated group regime does not take away the legal personality of the separate companies in the group, but it does change the incidence of tax liability within the group and this change in the incidence of tax liability may have implications for steps two and three in the determination of entitlement to treaty benefits. This issue is discussed in Section 6.3 below.

2.1.3. Associations etc.

In addition to companies, most states have some other legal structures that can be used for business and/or investment purposes, such as associations, foundations and co-operatives. These are some of the most common structures that are not companies, but the civil law of different countries offers a wide array of possibilities, some of which may be unique to a specific country and many of which do not have an exact counterpart in countries with which treaties have been concluded.

If such a structure has legal personality according to the civil law under which it is created, there is no doubt that it is a "person" for treaty purposes and therefore potentially able to claim treaty benefits. Similarly, if a structure is taxed in the same way as a company in the country where it is

[5] In this case special rules might still be necessary to deal with the distribution of dividends within the group and the transfer of assets among group members, as this regime does not, of itself, remove the economic double taxation on inter-corporate dividends or the crystallisation of a gain on assets transferred within the group.

established, it is clear from Art. 3(1)(b) UN Model Convention that it is to be regarded as a company for treaty purposes.

At the other end of the scale are groupings and structures which do not have enough cohesion to be regarded as a body of persons under Art. 3(1)(a) UN Model Convention. A consortium, for example, is a term which is often loosely used to denote a number of companies working together on one project; consortia are generally not formally recognised as a grouping under civil law and the formation of a consortium generally does not have any tax consequences which could lead to it being regarded as a “body of persons” for treaty purposes.

In between these two extremes are structures which have some, but not all, of the hallmarks of legal personality.[6] Even though they are not treated as a company for tax purposes there may nevertheless be a tax charge on their income or profit. Although the UN Commentary states that the term “body of persons” used in Art. 3(1)(a) of the Model is to be given a very wide interpretation, many countries do have questions about the application of treaties to structures with such an intermediate status, especially if their civil law does not include the same legal structure.

Countries take various approaches to this issue. Some countries look for the nearest equivalent in their own civil law and apply the treaty accordingly. Other countries look for particular features as a determinant of whether a structure should be regarded as a person for treaty purposes, such as the ability of the unit or legal structure to conclude contracts. Other approaches are also possible, albeit less common, such as simply regarding all foreign legal structures as companies for tax purposes. Since the publication of the so called OECD Partnership Report,[7] however, there has been growing acceptance of the principle enunciated in that report, that the source state looks to the tax law of the residence state in determining which structures are regarded as taxable persons for treaty purposes. Partnerships are discussed in more detail in Section 6.2 below.

If a structure or grouping is not regarded as a person capable of claiming treaty benefits, there is then an issue as to whether another person is a potential claimant, such as the members of an association

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[6] For a discussion of the hallmarks of legal personality see: John F. Avery Jones et al, “Characterisation of Other States’ Partnerships for Income Tax”, 56 Bulletin for International Fiscal Documentation 7 (2002), pp. 288-320. Although this article deals with partnerships, which are discussed in Section 6 of this paper, it makes clear that legal personality has many characteristics and that it is possible for a given structure to have some of those characteristics but not others.

[7] “The Application of the OECD Model Convention to Partnerships”, adopted by the OECD Committee on Fiscal Affairs on 20 January 1999.

or the persons running a foundation. This is similar to the issues considered in Section 6 about the application of treaties to partnerships and reference is made to the discussion there.

2.1.4. Permanent establishments and fixed bases

Permanent establishments are mentioned briefly here in order to emphasize that they are not separate persons and are therefore not entitled to treaty benefits in their own right. If a company, for example, which is resident in one country, carries on part of its business through a permanent establishment in another country, it is the company that is the person carrying on business through the permanent establishment. This is so even if the permanent establishment operates quite independently of the rest of the company.

If the company receives income from a third state through the permanent establishment, this analysis leads to results which may appear to be at odds with the economic reality of a permanent establishment. An example may be useful to illustrate this issue. Company R is resident in State R and maintains a permanent establishment in State P. Company R receives a payment of interest from a source in State S which is clearly effectively connected with the permanent establishment.[8] State S has a domestic withholding tax of 25%. It has concluded a treaty with State R, which limits the source-state withholding tax on interest to 20%, and a treaty with State P, which limits the source-state withholding tax on interest to 15%.

As the interest, from an economic point of view, flows to the permanent establishment located in State P, an instinctive reaction to this situation is often that the State S withholding tax must be limited to 15% under the State S-State P treaty. This reaction forgets, however, the first step in determining entitlement to treaty benefits. The person to whom the interest is paid in this situation is the company; the company receives the interest through its permanent establishment, but there is only one person to whom interest is paid and that is the company. The company is the only "person" capable of being entitled to treaty benefits and therefore, assuming that the other conditions are

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[8] Income is effectively connected with a permanent establishment if it is a business receipt of the part of the enterprise's business that is carried on through the permanent establishment. For example, if the enterprise sells goods through the permanent establishment and extends customer credit for large orders, interest paid in respect of customer credit would be effectively connected with the permanent establishment if it was paid by a customer which purchased goods from the permanent establishment. Another example is a receipt of royalties in respect of a licence to use technology if the licence was granted by the part of the business that the enterprise carries on through the permanent establishment.

satisfied, it is the State S-State R treaty that applies to limit the State S withholding tax to 20%. A similar analysis applies to income that is effectively connected with a fixed base.

There is a growing body of opinion that, certainly in respect of substantial permanent establishments and fixed bases, this result is so inappropriate in economic terms that a permanent establishment or fixed base should be entitled to treaty benefits as if it were a person separate from the enterprise of which it is a part. Nevertheless, the analysis explained here is generally accepted as correct under current treaty law.

2.2. Identification numbers and registration requirements

Countries need to be able to monitor claims to the protection of their treaties in order to ensure that treaty protection is granted only in appropriate cases. They generally also wish to monitor the flows of income in and out of the country that are subject to treaty protection in order to determine their long-term policy in that respect. Both needs require the collection of information about claims to treaty protection.

The obvious way of ensuring that this information is available to the government is to permit the benefit of a treaty to be given only after a claim for treaty protection has been approved by the tax authority. This claim could be made by the person entitled to treaty benefits or in some cases it could be made by the person paying the income on behalf of the person entitled to treaty benefits.[9] This latter system might be more appropriate, for example, in the case of a bank which has a large number of deposit holders in the other contracting state and which already holds a certain amount of information about those persons. In either case the minimum information required would be what type of person the treaty claimant is, which treaty's benefits are claimed, the residence status of the

[9] As an alternative to a direct claim by the person entitled to treaty benefits, the claim could also be made by an intermediary on behalf of the person entitled to treaty benefits. This system is particularly appropriate for income that is derived by a collective investment vehicle (CIV) on behalf of a large number of small investors. The OECD TRACE project has investigated this possibility in detail, leading to the adoption on 23 January 2013 of an implementation package for authorised intermediaries such as CIVs. This report can be downloaded from < http://www.oecd.org/tax/exchange-of-tax-information/treatyreliefandcomplianceenhancementtrace.htm>.

treaty claimant in the other contracting state and the grounds on which that person claims treaty protection for that income.[10]

An alternative mechanism is to allow persons paying income to apply the treaty themselves and to require someone, either that person or the person claiming entitlement to treaty benefits, to report afterwards that the treaty has been applied. This alternative has the disadvantages, however, that it removes the incentive to make a timely application with the provision of full information and, if the treaty has been applied incorrectly, it leaves the tax authority in the difficult position of trying to correct the position afterwards.

In many cases a treaty claimant will continue to receive income from the same source over many years, and it would save administrative effort if the determination that treaty benefits are available has to be made only once. On the other hand, the tax authority also has to be aware that the circumstances may change over time. Requiring a self-certification from the taxpayer that the circumstances have not materially changed may help, although it does not obviate the need for the tax authority to remain alert.

Countries will generally want to assign tax identification numbers (TINs) to non-residents who receive domestic-source income, and it may be useful to employ a pattern of TINs which distinguishes between residents, non-residents who are entitled to treaty benefits and non-residents who are not entitled to treaty benefits. In respect of non-residents entitled to treaty benefits the TIN could also include a feature indicating which treaty applies. The residence country of treaty claimants would almost certainly assign its own TIN to a treaty claimant, and therefore it would also be useful for the source country to require this information as a condition of granting treaty benefits and to create a link between the two numbers in its registration system so that any information that is obtained from the residence country can be easily matched with the treaty claimant.[11]

Co-ordination with the tax authority of the residence country would in any event be useful to help monitor the entitlements to treaty benefits that are claimed. Obviously that has to be done within the

[10] Some of the practical considerations relevant to the determination of the residence status of the treaty claimant are discussed in Brian Arnold, Overview of Major Issues in the Application of Tax Treaties, Paper 1-A of this collection, Section 5.3.

[11] Further information about the administrative procedures for the granting of treaty benefits can be found in: Raffaele Russo, “Administrative Aspects of the Application of Tax Treaties”, 63 Bulletin for International Taxation 10 (2009), pp. 482-488.

confines of the exchange of information provisions of the applicable treaty and/or an additional tax information exchange agreement (TIEA).

3. Residence

Once a person has been identified who is potentially entitled to treaty benefits, the second step is to determine whether that person has the required connection with a treaty partner state. The UN and OECD Model Conventions use the residence concept to express this connection and define this concept in Art. 4. The general philosophy of this requirement is that a person is entitled to the benefits of treaties concluded by a country only if the treaty claimant has a personal connection with that country; in most cases the required connection is one that leads to the taxation of the person in that country on worldwide income. Although this general philosophy is clear, there are some difficult borderline issues.

This section first discusses the various elements of the residence definition in Art. 4 UN Model Convention, looking first at the basic requirements of Art. 4 and then at the issues that arise in connection with persons who have a residence connection with two countries. The discussion then turns to the phenomenon of limitation on benefit (LOB) provisions, which are included by a growing number of countries in their treaties to resolve the shortcomings they perceive of the residence requirement. It concludes with a brief look at the small number of treaty articles that apply regardless of residence.

3.1. Liability to tax

3.1.1. Liable to tax and subject to tax

The first part of the residence definition in Art. 4(1) looks for the “liability to tax” of the person claiming treaty benefits in the country claimed as residence state. In this respect an important distinction has to be made between two concepts, of being “liable to tax” and being “subject to tax”. There is general agreement as to the basic distinction between these concepts, although there are some difficult borderlines and neither concept is completely clear.

A person is subject to tax if the person has to pay some tax, however small the amount may be. A person is liable to tax if the person is within the scope of the tax charge, even though the person may

not be obliged to pay any amount of tax; this situation can occur for a variety of reasons, some of which are explored further below. What is clear is that being subject to tax is a narrower concept than being liable to tax; every person who is subject to tax is also liable to tax, but the group of persons who are liable to tax may also include some persons who are not subject to tax.

An individual, for example, who earns a salary and who pays tax on that salary each year is clearly both subject to tax and liable to tax. At the other extreme is something that is not covered by any tax law at all, for example a consortium of companies which does not feature in any list of taxable persons in a country's income or profits tax law and which does also not fall into any residual category in the income or profits tax law; such a grouping is not liable to tax and therefore also not subject to tax. In between these two extremes there are various grey areas in respect of both being subject to tax and being liable to tax.

Does the "subject to tax" concept, for example, cover a person who is taxable at a 0% rate? As being subject to tax implies a positive tax liability, most experts would regard such a person as not being subject to tax, as a 0% rate is incapable of producing a positive amount of tax to pay. Does the "subject to tax" concept cover a company which pays no tax on its profits in a year because it has losses to carry forward which exceed the year's profit? Opinions differ about this situation; the company does not have a positive amount of tax to pay in that year, but there is also an argument that the company is subject to tax because the reduction of the losses to be carried forward has the same practical effect as the imposition of a positive tax liability.

A company that incurs losses is, however, liable to tax. The losses mean that it has a zero tax bill, but it is nevertheless within the scope of the tax law. Similarly, an individual may have only a very small amount of income and therefore not pay any tax because his income is all within the nil rate band. In both these cases it is generally accepted that the person is liable to tax because the person is within the scope of the income or profits tax law and would be subject to tax if his/its factual circumstances change (the individual receives more income or the company starts to make profits).

In respect of the "liable to tax" concept, the difficult borderline issues arise primarily in respect of persons who enjoy exemptions for the whole of their income. Such exemptions take a variety of forms.

One example is a person whose entire income happens to be of a type that is exempt for reasons that are not related to the characteristics or status of the person. For example, an individual's only income

may be investment income, but even though the amount may be substantial it could all be exempt because it is derived from "green" investments and the legislation exempts the returns on "green" investments. In this case the individual would generally be considered to be liable to tax; the exemption of the entire income is due to the individual's choice of investments at that time and it is clear that the individual would be taxable in respect of other types of income.

Alternatively a person may be entitled to an exemption from profits tax for a limited period of time, for example a company which benefits from an incentive regime for five years. Here again, the company would generally be regarded as being liable to tax because the exemption is only a temporary carve-out from the scope of the profits tax.

A much more difficult and controversial example is a person which is within the scope of the income tax law, but which is entitled to an exemption for the whole of its income due to the nature of the person. An example would be a charitable foundation if the income tax law applies to foundations generally, but grants an exemption for charitable foundations. In such a case, however, the exemption is usually conditional on the person continuing to satisfy certain conditions, for example that the foundation carries on only charitable activities. In this case opinion is divided as to whether the foundation is liable to tax, a disagreement which is noted in the Commentary to the UN Model Tax Convention.[12] The prevailing opinion, however, is that the foundation is liable to tax because the exemption is conditional and therefore does not take the foundation out of the general scope of the income tax law. Similar issues arise in respect of pension funds, which are discussed in more detail in Section 6.1.

If, on the other hand, the foundation was excluded from the scope of the income tax law altogether it would not be liable to tax. So if, for example, the civil law of a country provides that foundations have legal personality and the income tax law applies to legal persons generally but excludes all foundations unconditionally, the foundation would not be liable to the income tax.

3.1.2. Extent of liability to tax

[12] Para. 6 of the Commentary on Art. 4, citing Paras. 8.6 and 8.7 of the Commentary on Art. 4 of the OECD Model Convention.

A second set of issues about the basic requirement of Art. 4(1) relates to the extent of the liability to tax that is required. The UN Commentary states[13] that this requirement refers to a comprehensive, or full, liability to tax and it is usually interpreted as referring to a liability to tax in respect of worldwide income. This interpretation is reinforced by the second sentence of Art. 4(1) which excludes from the definition persons who are liable to tax only on income from a source in the potential residence state.

This aspect of the definition can cause difficulties of interpretation in respect of a small number of countries which impose income or profits tax on a territorial basis, or in other words in respect only of income from a source in the country.[14] If the residence definition is interpreted as demanding liability to tax on worldwide income, it would simply not be possible for a person taxable on a territorial basis to qualify as a resident for treaty purposes, even if the person had a very substantial personal connection with that state. Most experts therefore agree that, in the case of persons subject to a territorial system, the residence definition does not make this demand but refers rather to liability to the full extent of the country's income tax system.[15]

Case law from India has highlighted a further issue in respect of the required liability to tax that tax administrations should be aware of. This issue emerges from a line of cases[16] on the extent to which a potential tax liability is sufficient to make a person "liable to tax" for treaty purposes. The cases arose in the context of the relationship between India and the United Arab Emirates (UAE) and the question before the courts was whether a person who had a strong personal connection with the UAE could be "liable to tax" in the UAE for treaty purposes even though the UAE did not impose a tax on income. The argument for accepting that this situation creates liability to tax was that, if the UAE did introduce an income tax, the person would most probably fall within its scope. The balance of the Indian case law now seems to be in favour of accepting such a potential tax liability as sufficient to give residence for treaty purposes.[17]

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[13] Para. 2 of the Commentary on Art. 4, citing Paras.3 and 4 of the Commentary on Art. 4 of the OECD Model Convention.

[14] A territorial basis of taxation sometimes applies only to certain types of taxpayer, such as companies.

[15] In this respect see Para. 8.3 of the Commentary on Art. 4 of the OECD Model Convention.

[16] For example: *Abdul Razak A. Meman In re*, Case no AAR No. 637 of 2004, 9 May 2005; and *Green Emirate Shipping & Travels Ltd v. Assistant Director of Income Tax*, Case no 99 TTJ 988, 30 November 2005.

[17] Palwe, S.S., and Kumar, P., "Liable to Tax: India versus OECD", *Tax Planning International Review: Latest Developments* (9 March 2011).

If one takes the philosophy that treaties are primarily instruments for preventing double taxation, one would expect a treaty to apply only if there were an actual tax liability in both states. But what the conclusion of the Indian courts reveals is a rather different philosophy about the function of treaties, which sees them primarily as instruments for allocating taxing claims between states. In this case, the threat of actual double taxation is less important and the reason for looking for liability to tax in a country is only that it indicates a sufficient personal connection between the treaty claimant and the country. A potential tax liability of the type considered in the cases would indicate the same personal connection and would therefore be sufficient. An issue that might be raised by this view, however, is a lack of certainty and clarity about which situations create a potential liability to tax that satisfies this test.[18]

3.2. Criteria for liability to tax

The liability to tax requirement in Art. 4(1) is intended to test the personal connection between a person claiming treaty benefits and the contracting state in which that person claims residence. Art. 4(1) therefore requires that the liability has to be imposed for a reason that indicates a personal connection and lists a number of factors that satisfy this test. The factors listed are domicile, residence, place of management and, in contrast with the OECD Model Convention, place of incorporation, but also “any other criterion of a similar nature”.

This residual sweeping-up category demands some consideration of the common element among the specific factors listed so that one is able to determine whether or not another factor is “similar”. Clearly all the listed factors relate to the personal circumstances of the person claiming treaty benefits. In practice, given the way in which countries generally define the reach of their taxes, any liability to tax on worldwide income or profit is likely to satisfy this condition.

The inclusion of the place of incorporation of a legal entity in this list of criteria may seem, at first sight, to be subject to a risk of abuse, as the place of incorporation is rather a formal criterion. It is possible, for example, for a company to be incorporated under the law of a country but to have no substantive connection with that jurisdiction at all because the shareholders are resident in other countries and the company's management and business are both carried on outside of that

[18] For two conflicting views on the correctness of this interpretation of the residence definition see: Baker, P., *Double taxation conventions: a manual on the OECD Model Tax Convention on income and on capital* (London: Sweet & Maxwell, loose-leaf), Sec. 4B.07 (September 2002); and Vogel, K. et al., *Klaus Vogel on double taxation conventions*, 3rd edn (London: Kluwer Law International, 1997), p. 229, Para. 24a.

jurisdiction. This situation can be the result of the historical development of the company and its business, but it can also be a deliberate strategy aimed at claiming the benefit of treaties concluded by the state. Such a strategy is, of course, increasingly feasible in an age in which global communication has become so easy that many activities can be carried on remotely.

On the other hand, it is questionable whether the specific mention of the place of incorporation is any different in substance from Art. 4 of the OECD Model Convention, as the place of incorporation would be included in the residual category in that model of "other criteria of a similar nature". Section 5 below, on conduit structures, discusses the dangers of this criterion and some possible responses by states.

3.3. Dual residence

The final aspect of the liability to tax requirement is that the liability has to be imposed by the domestic law of the contracting state in which treaty residence is claimed. In other words, the Model Convention relies on the view taken by the contracting states as to whether a person has a sufficient connection with a state to qualify as a resident there. So if, for example, a country taxes the worldwide profit of companies that maintain their headquarters in the country, all such companies would be resident in that country for treaty purposes, even though the country's treaty partners use different criteria for the imposition of tax on worldwide profit.

One of the consequences of this approach is that it is possible for one person to qualify as a resident of both the contracting states to a given treaty, because countries have different criteria for imposing unlimited taxation and also because many countries use alternative criteria for this purpose. In this case the dual residence has to be resolved before the allocation articles of the treaty can be applied, as these articles are based on the assumption that the person is resident in only one of the contracting states. Art. 4 therefore provides rules, known as the tiebreaker rules, for allocating the person's residence to one of the states for treaty purposes. It is important to note that the tiebreaker provisions apply only for treaty purposes; they do not change the domestic law of either contracting state, so the person remains resident in both contracting states under their respective domestic law.[19]

[19] The domestic law of some states does, however, remove the residence of the person if the state "loses" under the tiebreaker provision of an applicable treaty. The treaty itself does not change the domestic law of the contracting states; all it does it express the agreement between the two contracting states to limit the application of their domestic law. But the contracting states are free to adopt rules in their domestic law which apply when the application of the treaty leads to a certain result.

3.3.1. The tiebreaker provisions and unresolved dual residence

The UN Model Convention has two tiebreaker provisions, one for individuals and one for all other persons. The tiebreaker provision for individuals is Art. 4(2), which sets out a hierarchy of criteria, starting with a substantive and factual criterion and applying progressively more formal tests if the previous tests fail to resolve the dual residence. The substance of this tiebreaker provision is relatively straightforward, although there is always a risk of differing interpretations of the tiebreaker tests it uses by the two contracting states to a treaty.

The tiebreaker provision for companies and other persons who are not individuals is Art. 4(3), which provides only one substantive test, namely the place of effective management (POEM). In this case there is no recourse to progressively more formal criteria if the POEM test fails to provide a solution. Indeed a fall-back test is not necessary if one accepts, as the OECD Commentary states, that an entity can have only one POEM at any one time,[20] although the UN Commentary does not include this statement.

Both the UN and the OECD Commentaries on Art. 4(3) are rather short and they do not include any explicit discussion of many of the pressures that are increasingly placed on the POEM concept. Modern communications methods such as video-conferencing, for example, make this an increasingly difficult concept to apply.[21] The same holds true of modern management styles which do not confine the management of companies in a group to each individual company, but rather manage them in a "horizontal" fashion across the group.

Aside from these pressures, the interpretation of the term can also be subject to differences of emphasis and perception in respect of the level of management and the types of decision that it refers to and the relative importance of the factual and legal responsibility within the entity's structure. The context of the POEM concept suggests strongly that it should be given a single, treaty meaning; to do otherwise would defeat the very point of having a tie-breaker provision. Yet in practice the way in which it is interpreted may be coloured by the domestic law of the person applying the treaty.[22] If

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[20] Para. 24 of the Commentary on Art. 4.

[21] These difficulties have been discussed in a discussion paper published by the OECD in February 2001: "The Impact of the Communications Revolution on the application of 'Place of Effective Management' as a Tie Breaker Rule", available at <http://www.oecd.org/tax/treaties/1923328.pdf >.

[22] See: John F. Avery Jones, "Place of Effective Management as a Residence Tie-breaker", 59 Bulletin for International Taxation 1 (2005), pp. 20-24, reporting on a seminar discussion at the 2004 congress of the International Fiscal Association.

two treaty partner states disagree on the interpretation of the concept it would be necessary to use the mutual agreement procedure in order to resolve this disagreement.

The ease of modern communications and transport has also made it increasingly possible to manipulate the residence of corporations by moving their management to the desired country for tax planning purposes. These pressures have caused some states to use an alternative tiebreaker provision in their treaties which relies entirely on the mutual agreement procedure to resolve the dual residence of non-individuals. An example of such a provision is now included in the Commentary to the UN Model Convention.[23] This suggested provision requires the competent authorities only to "endeavour" to resolve the matter. It clearly contemplates the possibility that they will not be able to do so, stating that in that case the person is not entitled to the benefits of the convention at all except to the extent that the competent authorities agree to grant treaty benefits. Some concluded treaties go even further and do not even oblige the competent authorities to endeavour to resolve the matter, but provide only that non-individuals that are resident in both contracting states are denied the benefits of the treaty, except to the extent determined by the competent authorities.

In either case, subject to any relief granted by the competent authorities, a company or other person that does not have its dual residence resolved continues to be taxable in both states as a resident. It is, therefore, likely to be taxable on its worldwide income in both states, although this means that it would also be entitled to take deductions in both states and carry forward any losses in both states.

If the company receives income from a third state it would probably be able to claim unilateral double tax relief in respect of that income in both the residence states. If, in this case, both residence states apply the exemption method, the company would not suffer any double taxation. It would also not suffer any double taxation if one residence state applies the exemption method and the other residence state grants a credit for the third-state tax. But if both residence states use the credit method, there is a question as to whether either residence state would grant a credit for any residual tax levied by the other residence state on the third-state income. Some states, for example, may refuse to give a credit for tax that is not levied by the source state of the income.

The company may also receive income from one of the two residence states. In this case the residence state that is also the source state is unlikely to grant any double tax relief, although the other residence state may do so.

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[23] Para. 10 of the Commentary on Art. 4, citing Para. 24.1 of the Commentary on Art.4 of the OECD Model Convention.

3.3.2. Effect of successful tiebreaker application

If a tiebreaker provision of a treaty is applied to resolve the dual residence of a person, either an individual or an entity, it becomes possible to apply the allocation rules of that treaty. There is also an increasing acceptance of the argument that the resolution of dual residence under the treaty between a person's two residence states may also have implications for a treaty concluded between one of those residence states and a third state which is the source of income derived by the dual resident person.

This argument is now accepted in the Commentary to the UN Model Convention.[24] It is based on the second sentence of Art. 4(1), which excludes from the residence definition persons who are liable to tax in a contracting state only in respect of income from sources in the state. This exclusion was included originally to deal with diplomatic and consular staff, to ensure that they did not receive the benefit of treaties concluded by their work state but only the treaties concluded by their "home" state. It does, however, express the general intention of Art. 4 to restrict the benefits of treaties concluded by a country to persons whose connection with a country is considered strong enough to justify that country taxing the person on worldwide income.

This exclusion is now generally understood to support the argument that if a person is resident in two countries under their domestic law, and there is a treaty between those two countries which resolves the dual residence in favour of one of them, the person is entitled to treaty benefits only as a resident of that country. If, for example, a person is resident in both State L and State W and the tiebreaker allocates the person's residence to State W (the "winner state"), the overall effect of the allocation provisions in that treaty is that State W retains the right to tax the person on worldwide income, subject to the obligation to grant double tax relief in respect of income that may be taxed in State L. State L (the "loser state"), on the other hand, is permitted to tax only certain items of income from a source in State L.

If State L also has a treaty with a third state (State T), the issue then arises as to whether the person can claim the benefit of that treaty as a resident of State L. As the State L tax liability on the person is limited by the State L-State W treaty to income from sources in State L, the Commentary states that the person is excluded from claiming treaty residence in State L by the second sentence of Art. 4(1) in the State L-State T treaty.

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[24] Para. 4 of the Commentary on Art. 4, citing Para. 8.2 of the Commentary on Art. 4 of the OECD Model Convention.

This line of reasoning can be of assistance to states in combating the use of companies incorporated in a state in order to obtain the benefits of treaties concluded by that state. Take a situation in which a company incorporated in one state (State I), but effectively managed in a second state (State M), claims treaty benefits in respect of income from a source state (State S). If each pair of states has concluded a treaty, this line of reasoning prevents the company from claiming the benefit of the State S- State I treaty; it is entitled only to the benefit of the State S-State M treaty, or in other words the treaty between the source state and the state with which the company has the more substantial connection. The usefulness of this line of reasoning to the source state depends, however, on State I having concluded a wide treaty network.

3.4. LOB articles

The difficulties with the residence article in the model treaties have led an increasing number of states to include limitation on benefit (LOB) articles in their treaties. An LOB article, essentially, backs up the residence definition by requiring the person claiming treaty benefits to demonstrate more substance in the person's connection with the residence state. It is not usually the intention of states to demand full compliance with the LOB provision every single time that treaty benefits are claimed, but rather to give the tax authority a tool which can be invoked if the authority is dubious about a specific claim to residence. An LOB provision does this by enabling a tax authority which has been presented with a residence certificate to require the treaty claimant to demonstrate that it satisfies one of the tests in the LOB provision, thereby shifting the burden of proof back to the treaty claimant.[25]

LOB provisions are targeted at the persons most likely to be involved in structures set up in order to claim treaty benefits. They therefore do not usually apply to individuals or to the contracting states themselves. Although they can also apply to other persons, this section refers to companies for the sake of simplicity.

LOB provisions vary from one treaty to another, but there are a number of factors which are commonly specified as indicators of an acceptable connection with the residence state. One such factor is that the company is quoted on a stock exchange. Treaty shopping structures are unlikely to use quoted companies, as the widespread ownership of a quoted company is incompatible with the

[25] Para. 56 of the Commentary on Art. 1, citing Para. 20 of the Commentary on Art.1 of the OECD Model Convention, provides the text of a model LOB provision. Only the main features of this suggested text are commented on here.

aim of streaming income through a favourable structure to the persons who set up the structure. Details of this test that vary from one treaty to another are the percentage of the share ownership that has to be listed on a stock exchange, whether the listed share ownership has to be directly in the company or whether it can be indirect, and which stock exchanges are accepted for the purposes of this test.

Another common test, which applies to unlisted companies, consists of two factors which together indicate that the company is not being used to route income in order to obtain treaty benefits. One part of this test looks at the share ownership of the company claiming treaty benefits; if the ultimate owners of the company would have been entitled to comparable treaty benefits in their own right, it is unlikely that they have set up the company in order to route the income to themselves. The second part of this test looks at the flow of income through the company in order to ensure that it is not being used to route income to persons who would not have enjoyed treaty protection if the income flowed to them directly. Again, the detail of this test varies from one concluded treaty to another.

The first two tests described above apply to the company claiming treaty benefits. The third common test relates, in contrast, to specific items of income for which treaty benefits are claimed. This test looks at whether the income is received as a genuine receipt of an active business carried on by the company in its residence state. To the extent that this third test looks at specific items of income rather than the treaty entitlement of the company as such, it goes beyond the role of backing up the residence definition.

Most LOB provisions also include a sweeping-up clause which gives the tax administration discretion to grant treaty benefits in cases which are not covered by the specific clauses of the LOB provisions but in which the tax authority determines that the company is not part of a structure set up in order to obtain treaty benefits.

Although LOB provisions are becoming increasingly popular, they are complex. Drafting the detail of the tests they set out requires a thorough knowledge of the economy and tax system of the two contracting states to the treaty in order to ensure that the provision targets the appropriate structures. LOB provisions also require considerable effort on the part of the tax authority to apply satisfactorily, both in selecting the cases in which to use the provision and in assessing the information provided by the treaty claimant. For these reasons, countries with limited resources in their tax administration generally prefer to use simpler provisions to combat treaty shopping. Section 5 discusses some of these alternatives.

3.5. Articles for which no residence is required

Although residence is a vital element in determining entitlement to most of the benefits of a treaty, there are three articles that are explicitly stated to apply regardless of the residence of the taxpayers concerned. Two of these concern the administration of taxes: Art. 26 on the exchange of information; and Art. 27 on assistance in the collection of taxes, which was added to the UN Model Convention in 2011.

The third one is Art. 24, the non-discrimination article. The main rule of Art. 24 applies on the basis of nationality and explicitly states that it also applies to persons who are not resident in either state. Residence is relevant, however, to the extent that a difference in the residence situation of two persons is explicitly stated to justify a difference in the tax treatment of those persons.

A small number of the allocation articles in the Model do not refer explicitly to the residence of the taxpayer who enjoys the benefit of the article. This is the case, for example with Art. 8, on shipping, inland waterways transport and air transport, and two paragraphs of Art. 19, on government service. Nevertheless, these articles are not expressed to be an exception to the general residence requirement of Art. 1 and it is unlikely that they are intended to be such.

4. The income for which treaty protection is claimed

The third step in ascertaining whether treaty benefits are available concerns the specific item of income for which treaty protection is claimed. The treaty applies to persons who are resident in one or both contracting states, but the allocation articles apply to specific items of income or profit. Once it has been established that a person is entitled to treaty benefits as a resident of one of the contracting states, there still remains a question as to which items of income are covered by that treaty entitlement.

4.1. Derived by, paid to etc.

The UN and OECD Model Conventions use a variety of terms to denote the connection between a person and an item of income that gives the person entitlement to treaty benefits in respect of that item of income. The most common term used is that the income is “derived” by the person, but the Models also use other terms such as “paid to”, “received by” and the profits and gains “of” a person. It is unlikely, however, that any substantial difference among these terms is intended.

None of these terms is defined in the Models. Art. 3(2) therefore applies, with the direction that their definition is to be taken from the domestic law of the state applying the treaty, unless the context requires otherwise. There have been very few suggestions that the context does require a treaty meaning for these terms. Indeed, given the variety of ways in which states attribute income to a person[26] it would be extraordinarily difficult to establish a generally accepted meaning for them.

One provision in the Model does deal specifically with the connection between an item of income for which treaty protection is claimed and the person making the claim: the beneficial ownership requirement of Arts. 10, 11 and 12, which is discussed below. Art. 17(2) also has some relevance to this issue, although it does not lay down any requirements about the connection between the income for which treaty protection is claimed and the person making the claim. Quite the contrary, in fact, as the purport of this provision is that the lower threshold for the source-state taxation of remuneration paid to entertainers and sportspersons for their personal activities cannot be avoided by the simple expedient of having the remuneration paid to a different person.

The Commentary on Art. 1 of the UN Model Convention discusses various aspects of the connection between the person claiming treaty benefits and the income for which treaty protection is claimed in the context of treaty abuse and anti-avoidance law. The general tenor of these discussions is that artificially routing income to a person who is in a position to claim treaty entitlement should not be an effective method of obtaining treaty benefits. So, for example, para. 56[27] suggests a provision to combat the assignment of assets in order to create an artificial treaty route for the income produced by the assets. Similarly, para. 71 suggests a provision to deny treaty benefits for interest paid in back-to-back arrangements. Section 5 below, on conduit structures, discusses the artificial routing of income in more detail.

Although still part of the discussion on anti-avoidance measures, the Commentary on Art. 1 also makes the more general observation that the basic rules of domestic law for determining which facts give rise to a tax liability are not addressed in treaties and are not affected by them.[28] One aspect of

[26] On this point, see the general report and branch reports in: "Conflicts in the Attribution of Income to a Person", Cahiers de Droit Fiscal International, Vol. 92b, IFA, 2007.

[27] Citing Para. 21.4 of the Commentary on Art. 1 of the OECD Model Convention.

[28] Para. 21 of the commentary on Art. 1, citing Para. 22.1 of the OECD Commentary on Art. 1. This citation does not include the specific reference in Para. 22.1 of the OECD Commentary to domestic law that results in "a redetermination of the taxpayer who is considered to derive such income" but, given the manner in which the citation is made, it seems unlikely that any great significance should be attributed to this omission.

those basic rules of domestic law is the determination of which person is taxable in respect of which item of income. This observation, in other words, reinforces the conclusion drawn above that the determination of the taxable person is an issue for domestic law. This conclusion is not without its problems for the interpretation of treaties, however, and Section 6 below discusses some problematic issues in this respect.

4.2. Beneficial ownership

The beneficial ownership requirement of Arts. 10, 11 and 12 is one of the most extensively discussed concepts in the UN and OECD Model Conventions. The purpose of this section, therefore, is not to examine this concept in detail but only to highlight the questions that have led to discussion. A bibliography is provided at the end of this paper for those who wish to study this topic further.

4.2.1. Purpose of the term

Even the very purpose of the beneficial ownership concept is a question that is frequently posed. Is the beneficial ownership requirement an anti-avoidance rule, or does it have a more neutral, substantive role in determining which persons are entitled to treaty benefits in respect of dividends, interest and royalties? Proponents of the latter view argue that the concept is badly targeted as an anti-avoidance rule and that there are other, more effective ways of dealing with the abuse of treaties. The Commentary on Art. 1 of both the UN and OECD Model Conventions, however, comes down unequivocally on the side of the beneficial ownership requirement as an anti-avoidance measure.[29]

If beneficial ownership is used as an anti-avoidance concept, the question then immediately arises as to why its use is limited to three articles in the Model. The obvious answer is that the three types of income affected are the types most likely to be the subject of treaty shopping. Some concluded treaties do, however, apply the concept to other types of income; the US Model Convention applies it to pensions, annuities and income covered by the “other income” article; and in some concluded treaties the requirement applies to all the allocation articles in the treaty.[30]

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[29] In Paras. 31 and 55 of the UN Commentary and Para. 10 of the OECD Commentary.

[30] For example: Para. 4 Protocol to the Croatia–Israel treaty of 29 September 2006; Para. 1 protocol to the Pakistan–Spain treaty of 2 June 2010; Para.7 Protocol to the Portugal–Uruguay treaty of 30 November 2009; Para. 2 Protocol to the Spain–Senegal treaty of 5 December 2006.

4.2.2. Relationship with "paid to"

Another important question that has been raised in connection with the beneficial ownership requirement is whether it substantiates the wording in Arts. 10, 11 and 12 that refers to income "paid to" a person, or whether it is an additional requirement. In other words, is it enough that the beneficial owner is a resident of a contracting state, even if the formal payment is made to a person resident elsewhere? Or do these articles apply only if two conditions are fulfilled, namely that: the income is formally paid to a person resident in the other contracting state; and the beneficial owner is also resident in the other contracting state?

The wording of these three articles could be taken to suggest the latter interpretation, but this interpretation is generally regarded as incorrect. The Commentaries on the UN Model Convention[31] state that the limitation of the source-state tax applies if the beneficial owner of the income is resident in the other contracting state, even if the income is paid to an intermediary resident elsewhere.

Further support for this position can be drawn from a comparison with the OECD Model Convention which, in Art. 12, uses only the beneficial ownership concept and does not refer at all to the income being "paid to" a resident of a contracting state. Many concluded treaties also use the beneficial ownership in this way, in Art. 12 and/or Art. 11. In these treaty articles, in other words, beneficial ownership is the only factor connecting the treaty claimant with the income for which treaty protection is sought. One would not expect the reach of these articles to be materially different from the reach of comparable articles that use the "paid to" wording. This conclusion is further reinforced by looking at the consequences of interpreting "paid to" and beneficial ownership as two separate requirements, as this interpretation would create a considerable danger that no treaty benefits would be granted at all if income were paid to a person resident in one state while the beneficial owner were resident in a different state, even though both those states had a treaty with the source state.

4.2.3. Meaning of the term

[31] Para. 13 of the Commentary on Art. 10, Para. 18 of the Commentary on Art. 11 and Para. 5 of the Commentary on Art. 12, citing respectively the following parts of the Commentaries on the OECD Model Convention: Paras. 12 to 12.2 of the Commentary on Art. 10; Paras. 9 to 11 of the Commentary on Art. 11; and Paras.4 to 4.2 of the commentary on Art. 12 .

Perhaps the biggest question of all, however, is the meaning of the term “beneficial owner”, as it is not defined in the Model. An initial issue in this respect is whether the term has an independent, international treaty meaning, or whether it is defined, according to Art. 3(2), by reference to the domestic law of the state applying the treaty. There is a large body of opinion that in this case the context does require that the term is given a treaty meaning independent of domestic law. Certainly the discussion in the Commentaries[32] strongly suggests that at least the wider contours of the concept have an independent treaty meaning. Nevertheless, some of the literature is devoted to ascertaining various national meanings of the term.

Many possibilities have been offered as to the content of the beneficial ownership concept and consensus on this point is still very far away. Some of the suggestions for an independent treaty meaning are: that it simply excludes agents and nominees from obtaining treaty benefits; that it refers to a person who is liable to tax on the income in the person’s residence state; that it has a substantive meaning that can be derived from the common-law origins of the term; and that it has a substantive meaning that can be derived from the context in which it used. It is not within the remit of this paper to attempt to suggest which of these meanings, if any, is the correct one, and reference is made to the bibliography in this respect.

5. Conduit structures

Conduit structures are maybe the greatest threat to the integrity of a country’s tax treaty network. They take different forms and there are, accordingly, various remedies available to countries which are confronted with them. Although many of these issues have already been touched on in this paper, it is nevertheless useful to set them out here in the specific context of conduit structures.

This section starts by addressing the characteristics of conduit structures that cause problems in connection with the application of treaties. These problems generally arise in the context of the second and third steps discussed above in the determination of whether treaty benefits are available, and therefore the discussion here focuses on those two aspects. The specific characteristics of conduit structures do not usually give rise to problems in connection with the first step in this process, namely the determination of whether the legal forms used are “persons” for treaty purposes.

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[32] And the discussion paper published by the OECD on the beneficial ownership concept on 20 April 2011: “Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention”. A revised version of the proposals made this paper, published on 19 October 2012, is available at < http://www.oecd.org/ctp/treaties/Beneficialownership.pdf>.

Although many legal forms can be used for conduit purposes, they are usually forms that qualify as persons for treaty purposes.[33] This section will, for the sake of simplicity, confine the discussion to companies.

The Commentary on Art. 1 of the UN Model Convention includes an extensive discussion about treaty shopping and possible remedies against it. Those remedies include the application of general anti-avoidance principles and judicial remedies in domestic law. These general defences are discussed in a separate paper; this paper focuses on specific defences within the treaty.[34]

One of the problems faced by developing countries, in particular, in their attempts to combat conduit structures is a lack of information and the resources to obtain the necessary information. In addition to including the appropriate measures in a treaty, in other words, it is also necessary for countries to develop strong exchange of information networks. One measure that may help is a requirement for treaty claimants to provide a self-certification that they do indeed satisfy all the conditions for treaty entitlement. Alternatively, the requirement might be for certification by an independent auditor. It may not be workable to require a certification in every single case, in which case some guidelines would be necessary as to when the requirement applies. Experience might suggest that the certification is particularly appropriate in respect of certain treaties, for example, or in respect of treaty claimants with a certain type of ownership. Obviously the tax administration still has to remain vigilant in deciding whether or not to accept the certification.

5.1. Characteristics of conduit structures

The essence of conduit structures is that they route income in an artificial way so that it falls under the protection of a treaty that would not apply in the absence of the structure. Conduit structures take many forms, but what they have in common are two interrelated features: the artificial routing of income through multiple layers of ownership; and a disparity between the legal and economic views of the structure.

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[33] A mismatch between two countries in their characterisation of a particular legal form as a person for treaty purposes is sometimes deliberately created as part of tax avoidance strategy, but this issue is not discussed here as it is not a necessary element of a conduit structure.

[34] See Philip Baker, Improper Use of Tax Treaties, Tax Avoidance and Tax Evasion, Paper 9-A of this collection.

The income flow generally consists of income which is paid to the owner of an asset, such as dividends, interest, royalties and rent. This feature makes it possible to direct the income flow by placing the ownership of the assets in countries selected to create a favourable route. The income, in other words, is diverted away from the most direct route; instead it takes a more circuitous route, through multiple layers of asset ownership, before it reaches its final destination. The structure may also involve the use of unusual vehicles in a commercial context, such as foundations, if they are necessary to ensure that the domestic law of the countries through which the income flows does not negate the advantages of the structure.

This artificial routing of the income leads to the second common feature of conduit structures, namely the disparity between the legal and economic views of the structure. The claim to treaty benefits of a company that is part of a conduit structure relies on the legal view. The company is usually incorporated in the conduit state and therefore resident in that state under the state's domestic law. It is legally entitled to the income for which treaty protection is claimed and the income is usually paid to it. On the face of it, therefore, the company satisfies the conditions in the UN or OECD Model Convention for claiming treaty benefits in respect of the income. The economic view is rather different, however.

In an extreme case the conduit carries on very little activity in its residence state, or none at all, other than owning assets, collecting the income produced by the assets and making payments. It has minimal management which could, furthermore, be carried on outside the conduit state, often by employees of other companies in the corporate group which uses the structure or by employees of the group's advisers. Virtually all of the income collected by the company is used to make payments which are deductible in the conduit state, and those payments are made to other members of the group who are resident outside the conduit state. As a result, the tax liability of the conduit in its residence state is minimal.[35]

In this situation the economic view demands that treaty benefits are refused, as the economic connections between the company and its claimed residence state and between the company and the income for which it claims treaty protection are both so tenuous. The challenge for countries concluding and applying treaties is to discover the cases in which the legal view is so far removed

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[35] Conduit structures often also take advantage of certain features of domestic law, such as a participation exemption for incoming dividends, no withholding tax on outgoing payments or other favourable treatment of certain types of income. The discussion here, however, is restricted to the application of treaties.

from the economic reality that treaty protection should be refused, to define those situations with sufficient accuracy and to create appropriate legal tools for combating these structures.

5.2. Residence issues

One major point of concern in respect of conduit companies is the claim to residence for treaty purposes in a contracting state to a treaty. The fundamental problem here is that there are two different policy issues at play.

One policy issue is whether a state regards a company as resident for its domestic law purposes, such that it wishes to tax the worldwide profit of the company. In this case most states regard rather a moderate connection as a sufficient basis for residence, such as the simple formality of incorporation in the state. Few states require that the company, for example, carries on a substantive business in the state in order to be resident there, although this factor may be one of a number of alternative grounds leading to residence.

The other policy issue is whether a source state regards a company as having a sufficient personal, or residence, connection with another state to justify granting the benefit of a treaty it has concluded with that other state. Source states are generally reluctant to apply a treaty to reduce their domestic tax claim on the basis of a very slight connection between the company and the other contracting state.

Art. 4 of the OECD and UN Model Conventions does not, however, set out an independent treaty test of residence; it relies on the domestic law of the claimed residence state to specify the connecting factors that make a person resident there for treaty purposes. The treaty definition, in other words, refers to a source of law designed for a different purpose, thereby introducing a policy conflict into the treaty. It is for this reason that many countries have started using the limitation on benefit (LOB) clauses discussed above.

For countries that do not wish to engage in the complexities of LOB provisions, however, there are some alternatives. One possibility, suggested in the Commentary on Art. 1 of the UN Model Convention,[36] is that a shell company with no employees and no substantial economic activity may be disregarded for tax purposes by some countries on the basis of their general anti-abuse rules or judicial doctrines. This possibility is available, however, only in extreme cases.

[36] In Para. 72.

Other possible responses look at the liability to tax of the conduit company in its claimed residence state; if it is not liable to tax there on its worldwide income there may well be an argument that it does not qualify as a resident of that state for treaty purposes. One reason that it may not be liable to tax on its worldwide income is that it is subject to a special tax regime. In this respect there is a dividing line that has to be carefully observed; if the general tax regime of the claimed residence state does not impose liability on the foreign income of resident companies, it is difficult to argue that the company is not subject to the full extent of the country's tax regime. But if the company enjoys the benefit of a special territorial tax regime, particularly one designed to attract companies owned by non-residents, there is a strong argument that the second sentence of Art. 4(1) prevents it from claiming treaty residence in that state.[37]

Alternatively, a conduit company may not be liable to tax on worldwide income in its claimed residence state if its management is carried out in a third state. If there is a treaty between the state of incorporation and the third state, the residence tiebreaker provision of that treaty would generally assign the company's residence to the third state. In this case the source state can use the argument explained in Section 3.3.2. above to refuse treaty benefits.

5.3. Issues related to the income for which treaty protection is claimed

The second major point of concern in respect of conduit companies is their claim to treaty protection for specific items of income. In this case the company is able to defend its claim to residence for treaty purposes, maybe because it does carry out economic activity in that state and/or its management is carried out there, but the connection between the company and the income is too slight to justify giving treaty benefits to the company in respect of that item of income.

The obvious answer to this concern is the beneficial ownership requirement, if it is the protection of Art. 10, 11 or 12 that is claimed. If the conduit company does indeed do nothing more than collect income on behalf of another person, it is nothing more than an agent or nominee and therefore not the beneficial owner. In most cases, however, the conduit effect is achieved in a different way, by what is known as base erosion. Base erosion means that the income for which treaty protection is claimed is taxable as the income of the conduit company in its residence state, but that the conduit company also claims deductions for outgoing payments which greatly reduce, or erode, the income

[37] See in this respect also Para. 4 of the Commentary on Art. 4 of the UN Model Convention, citing Para. 8.2 of the Commentary on Art. 4 of the OECD Model Convention.

for which treaty protection is claimed. If, as is often the case, those payments are made to persons resident outside the conduit company's residence state, very little tax is collected by the conduit company's residence state on the income for which treaty protection is claimed.

A conduit structure of this sort can be created using a company which is set up specifically for this purpose, but it can also be created using a company which exists for genuine commercial purposes. In the latter case the conduit company could be part of the group using the conduit structure, but it could also be an unrelated company which carries on a separate business, such as a bank.

If the deductible outgoing payments are genuine business expenses, there is nothing artificial or abusive about the arrangement. Many large multinational groups of companies, for example, establish a company within the group to carry out a treasury function. Such a treasury company acts, in essence, as a private bank for the whole group; often some group companies have excess liquidity whereas others need funding and it is more efficient for the group as a whole to manage the flow of finance internally, rather than go to an external bank. If the treasury company is genuinely the "nerve centre" that regulates these flows of finance, both the company itself and the income flows in and out of the company have a business purpose. Similar considerations apply to a group company that manages the licensing of patents and trademarks and the resulting flows of royalties within the group.

The essence of a conduit structure, on the other hand, is that the incoming and outgoing payments are part of an artificial arrangement designed to achieve the result, in legal terms, that the incoming payments belong to the conduit company and therefore fall within the treaty entitlement of the conduit company. A consideration of the object and purpose of the treaty leads to the conclusion, however, that due to the base erosion there is not enough double taxation of the incoming payment to justify granting treaty protection for it.

The effectiveness of the beneficial ownership requirement in combatting these structures depends on various factors. The closer the match between the incoming and outgoing payments, the stronger the argument is that the conduit company is not the beneficial owner of the incoming payments. But if the outgoing payments are arranged to be quite different in composition, payment dates, etc., it may be difficult to argue that the conduit company is not the beneficial owner of the incoming payments. The tax authority of the source state also has the additional difficulty of discovering enough of the facts to contest the claim to treaty benefits. If the conduit structure does, for example, flow through an unrelated bank, the tax authority of the source state may have to examine the complete books of

the bank in order to discover the structure, which is not an easy task if it is a large commercial bank with thousands of genuine clients.

Here again, a strong exchange of information network is essential. What may also help are treaty provisions that provide a basis for the investigation by the source state. A provision, for example, that excludes the application of the treaty to back-to-back arrangements does not automatically prevent the granting of treaty benefits to abusive conduit structures, but it does provide the source state with a basis on which to ask pertinent questions.

If the incoming payment of the conduit company is not a dividend, interest or a royalty, the UN and OECD Model Conventions do not apply the beneficial ownership requirement. Countries that are concerned about conduit structures outside the reach of Arts. 10, 11 and 12 may therefore wish to consider anti-abuse provisions that apply to all the allocation articles. Alternatively, in this case it may be possible to apply parallel reasoning to argue that the income is not "derived by" the conduit company.

6. Special cases

6.1. Exempt entities (pension funds)

Exempt entities have already been discussed in Section 3 above, in connection with the second step in determining entitlement to treaty benefits, namely the residence requirement. Pension funds are discussed further here as an illustration of some further policy considerations which may apply.

In many states pension funds are exempt from tax on their income, provided they comply with the extensive regulations to which they are usually subject. The exemption is generally granted to the pension fund as such, raising the issue of whether the fund is "liable to tax" in the state in which it is established and therefore a resident of that state for treaty purposes.

Policy considerations, however, usually do demand that a pension fund is able to enjoy the benefit of the treaties concluded by the state in which it is established. An individual who invests his money directly in the source state would usually be entitled to treaty benefits and it would be inconsistent to deny treaty benefits because the investment is made indirectly through a pension fund. Furthermore, pension funds need to spread their investments geographically. It is therefore often in the interests of

both contracting states to prevent their tax systems from discouraging investments by pension funds of the other state.

All these considerations argue towards regarding a pension fund as a resident of the state in which it is established, despite its personal exemption from tax. One way in which this can be achieved is by accepting that a pension fund is indeed "liable to tax" because it is within the scope of the income tax law and its exemption is dependent on complying with the applicable regulatory requirements. Some states, however, feel unable to accept this line of reasoning and in this case it would be necessary to come to an explicit agreement with the other contracting state about the treaty status of pension funds, either in the treaty itself or in a mutual agreement.

6.2. Partnerships

Partnerships raise two sets of questions in connection with entitlement to treaty benefits which are discussed here.[38] One set of questions concerns the first and second steps discussed above in determining entitlement to treaty benefits; the issues here are whether a partnership is a "person" capable of claiming treaty benefits and being a resident of a contracting state for treaty purposes. The second set of questions focuses on which person is entitled to treaty benefits in respect of income derived by a partnership; is it the partnership or the partners? Or is it possible that more than one person is entitled to treaty benefits, or maybe no person at all? Other issues, such as the characterization of distributions made by a partnership to its partners are not directly relevant to the initial issue of treaty entitlement and are therefore not covered here.

The answers to the first set of questions are now relatively clear; the definition of "person" in Art. 3(1) includes a "body of persons" and there is international agreement that a partnership is a "body of persons". The Commentaries on Art. 3 of the UN and OECD Model Conventions state that partnership are persons for treaty purposes, either because they are taxed as companies or because they are bodies of persons.[39] In many states partnerships are taxable as such and, if that is the case, it would be rather inconsistent to argue that they are not "persons" for treaty purposes, given that the aim of treaties in this respect is to deal with the conflicting taxing claims actually made by states.

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[38] The report published by the OECD in 1999 on the application of tax treaties to partnerships examines these issues in more detail: "The Application of the OECD Model Convention to Partnerships", adopted by the OECD Committee on Fiscal Affairs on 20 January 1999.

[39] Para. 4 of the Commentary on Art. 3 of the UN Model Convention; Para. 2 of the Commentary on Art. 3 of the OECD Model Convention.

There is also general agreement that a partnership is capable of being a resident of a state for treaty purposes, provided it is the partnership as such that is liable to tax in that state. This is, however, only one of three possible approaches in domestic law to the taxation of partnership income. A second approach is to require the profit to be computed at the level of the partnership, but to apportion the profit out among the partners and tax the appropriate share of profit in the hands of each partner separately. The third approach is to ignore the partnership altogether for tax purposes and attribute all of the partnership's receipts, assets, expenses and liabilities to the separate partners, requiring each partner to make a profit computation as if the partner carried on a separate business. In the latter two cases it is not the partnership that is liable to tax on the partnership income, but the partners who are liable to tax on their share of the profit or income and therefore the partnership would not qualify as a resident for treaty purposes.

Much more difficult, however, is the set of questions that arises when countries take different approaches to the taxation of partnerships. The possible mismatches in this respect are not confined to the relationship between the source state of the income and the state in which a partnership is established; a partnership established in one country may have partners who are resident in a different country, considerably increasing the scope for mismatches of domestic law. These mismatches can cause double taxation as between the residence states of a partner and the partnership. Alternatively they can lead to there being no residence-based taxation at all. For the source state of partnership income, the question is what the implications are of these mismatches for the application of any treaties it has concluded with one or more residence states.

Neither the UN nor the OECD Model Convention deals explicitly with partners and partnerships, although an increasing number of concluded treaties do. But the Commentaries on both Model Conventions do include discussion of these issues, drawing on the work of the OECD in this respect.[40] The solutions adopted by the OECD do not, however, find universal acceptance among the members of the UN Committee of Experts.[41]

The solution proposed by the OECD to the problem of domestic law mismatches is that the source state looks at both the residence state of the partnership and the residence state (or states) of the

[40] See note 38.

[41] Para. 6 of the Commentary on Art. 4 of the UN Model Convention records the disagreement of some members with the proposition in Para. 8.8 of the Commentary on Art. 4 of the OECD Model Convention that partners of fiscally transparent partnerships can claim treaty benefits in respect of income derived by the partnership.

partners. Any of those persons who is liable to tax in respect of the partnership income is potentially entitled to treaty benefits. This means that it is possible for the partnership to be entitled to the benefit of the treaty between its residence state and the source state in respect of partnership income and for one or more partners to be entitled, at the same time, to the benefit of the treaty between their residence state and the source state in respect of their share of the partnership profit or income. The reverse situation is also possible, that neither the partnership nor the partners are entitled to treaty benefits because none of them is liable to tax in respect of any part of the partnership income. Note that that this solution looks at liability to tax as an indication of which person is entitled to treaty benefits in respect of which item of income, or in other words in connection with the third step discussed above in the determination of entitlement to treaty benefits.[42]

This solution accords with the philosophy that treaties are intended to deal with double taxation caused by the imposition of tax by both contracting states. We are assuming that the source state wishes to tax the income in question, otherwise it would not have to consider applying a treaty. The advantage of the OECD solution is that a treaty applies when the imposition of tax liability by a residence state poses an actual threat of double taxation but that no treaty applies when there is no such threat. On the other hand, some countries find it a disadvantage that the source state's approach to the taxation of partnership income is not relevant in determining whether treaty protection is available. This solution also means that a source state dealing with partnership income has to be aware of the domestic law of the residence state of the partnership and/or partners who are claiming treaty protection. The source state could, however, require those persons to provide sufficient information about that domestic law to substantiate their claim.

6.3. Transparent/hybrid entities and corporate group regimes

The term "transparent entity", or "flow-through entity" as they are sometimes called, is not an exact term; here it is used to describe an entity, usually a company, which is clearly a legal person but which is ignored for tax purposes in the country in which it is established. The income of the entity is, instead, attributed to the owners or shareholders and taxed in their hands as if they received it directly. Such rules are usually specific to the country in which the entity is established; if the entity receives income from another country, the source state very often regards the entity as the taxable person in respect of that income. There is therefore a mismatch between the two countries as to

[42] Paras. 54, 61, 71 and 73 of the OECD Partnership Report also conclude that a partnership or partner that is liable to tax in respect of dividends, interest or royalties is the beneficial owner of the income.

which person they regard as the taxable person. The term "hybrid entity" is often used to describe the entity in such a case.[43]

Although there are similarities between hybrid entities and partnerships, there is also a significant difference. The different approaches to partnerships stem from different domestic law concepts as to what constitutes a person for tax purposes. In the case of a hybrid entity, however, both states start from the position that the entity is a legal person and therefore a taxable person under the general tax law; the different approaches arise because one state applies a deeming rule attributing the income to the entity's owners/shareholders whereas the other state does not.

In this situation it might be more difficult for the source state to accept the tax treatment in the entity's state of establishment as a basis for granting treaty benefits. The consequence may well be a technical difficulty in applying a treaty between the two states. The entity is not "liable to tax" in the state in which it is established and therefore it does not qualify as a resident for treaty purposes. The owner/shareholder, on the other hand, generally does qualify as a resident of that state (transparent tax regimes often apply only if the owners/shareholders are resident in the state in which the entity is established), but it is not the owner of the income and therefore it does not satisfy the third step discussed above for claiming treaty benefits in respect of that income.

Exactly this problem arose in the TDS case, decided in Canada in 2010.[44] This case concerned a company, TD Securities (TDS), which was incorporated in the US. TDS was treated as a transparent entity in the US and all its income was taxable in the hands of its 100% shareholder, a US resident company for treaty purposes. TDS claimed treaty benefits in respect of the profit it earned through its permanent establishment in Canada. The court found that the technical problem described above could indeed prevent the application of the treaty, but it adopted a broad, purposive interpretation of the treaty and granted treaty protection. From a policy point of view this decision is easily defensible, as the profit in question both belonged to a company with a personal connection with the US and was taxed in the hands of a company with a personal connection with the US. Nevertheless, the technical obstacle in a case such as this remains in the UN and OECD Model Conventions.

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43 This is also not an exact term. Both the terms "transparent entity" and "hybrid entity" are also used to describe partnerships and other legal structures which are ignored for tax purposes or which are the subject of recognition mismatches in domestic law.

44 *TD Securities (USA) LLC v Her Majesty the Queen*, 2010 TCC 186.

Similar difficulties can arise in respect of corporate group regimes. The most integrated type of group regime also, in essence, turns the subsidiaries within the group into transparent entities as it treats them as branches of the top company. The subsidiaries within the group could therefore encounter the same difficulties in claiming treaty benefits.

A group regime with a less extreme form of integration may, on the other hand, avoid these problems if the mechanism of the regime is to compute profit in the hands of each group company separately but tax the profit in the hands of the top company. In this case there is an argument that the subsidiaries are liable to tax and are residents for treaty purposes. They are not ignored by the tax law and therefore they are liable to tax, although they are not subject to tax for as long as they remain within the group regime. Their position is, in other words, comparable with persons such as charitable foundations which enjoy a personal exemption; they are within the scope of the tax law, but they do not have a positive tax liability provided they continue to comply with certain conditions.

6.4. Trusts and trustees

Trusts are notorious for the problems that they cause in the application of tax treaties. They are equally notorious for being regarded as an essential feature of the legal landscape in many (common law) states, whereas other (civil law) states often regard them with a large degree of suspicion. Finding some common ground between these two points of view adds a further layer of difficulty to an already difficult task of determining how to apply a treaty to trust income.

The UN Model Convention deals explicitly with trusts only in Art. 13, in connection with capital gains from immovable property that are realised indirectly through an intermediate vehicle such as a company, partnership or trust.[45] Subject to this one provision, neither the UN Model Convention nor the OECD Model Convention deals explicitly with income derived by trusts. Many concluded treaties have some provisions on trusts, but there are extremely few concluded treaties, if any, which provide a comprehensive set of rules for dealing with them. This is so, even though a substantial amount of wealth is held in trusts in many countries.

It is impossible to consider the application of treaties to trusts without a good understanding of the trust concept. This section therefore starts by explaining the basic features of a trust. The trust concept has been adopted statutorily by an increasing number of civil-law jurisdictions, but these

[45] Para. 28.5 of the Commentary on Art. 13 of the OECD Model Convention suggests a comparable provision.

statutory adaptations follow the original judge-made concept with varying degrees of strictness. The discussion here, therefore, is confined to the major common law jurisdictions. It then goes on to sketch the various ways in which trust income is taxed in the major common law countries, as this is an equally important ingredient in understanding the treaty issues. Finally, the two most acute issues in connection with the application of treaties to trusts are examined.

Two common uses of trusts are as collective investment vehicles (CIVs) and real estate investment trusts (REITs). These types of trust raise specific issues which have been investigated by the OECD[46] and which are not discussed here.

6.4.1. The trust concept

An extremely important point to be made at the outset is that trusts are not legal persons or entities that are separate from the parties involved in the trust. Although it is very common to talk about trusts as if they were an entity,[47] this manner of speaking is simply a shorthand way of referring to the trust relationship. And it is the relationship between the trustees and the beneficiaries that is the essence of the trust concept.

A trust is an arrangement in which trustees own assets in a fiduciary capacity for the benefit of the beneficiaries. An alternative way of describing a trust is that it is an asset-holding and management structure, in which trustees own, invest and maintain the trust assets and collect the income from those assets, all for the benefit of the beneficiaries. The fiduciary nature of the arrangement requires trustees to put the interests of the beneficiaries before their own interests. Trusts are often discussed as if the beneficiaries are necessarily individuals, but it is equally possible for the beneficiaries to be companies or other legal entities and many trusts are established for purely commercial purposes.

One of the features of the trust relationship that causes problems for a tax system is that they are extremely flexible instruments. The interests of the beneficiaries can be defined in any way that appeals to the settlor or grantor (the person who creates the trust), the only restriction usually being

[46] "The Granting of Treaty Benefits with respect to Collective Investment Vehicles", report adopted by the OECD Committee on Fiscal Affairs on 23 April 2010, available at <http://www.oecd.org/tax/treaties/45359261.pdf>; "Tax treaty issues related to REITS", discussion draft published on 30 October 2007, available at <http://www.oecd.org/tax/treaties/39554788.pdf>. Many of the conclusions drawn in these documents have been added to the Commentaries on the OECD Model Convention.

[47] In some countries, such as Canada and the US, trusts are deemed to be persons for the purposes of the tax law.

that the terms of the trust may not be contrary to public policy (by being racially discriminatory, for example). It is, therefore, difficult to define neat categories of beneficial interests for tax purposes.

Nevertheless, there is one distinction that can be drawn in respect of different beneficial interests which is important for income tax purposes, namely the difference between trusts in which a beneficiary has an immediate right to the income of the trust and trusts in which this is not the case. A single trust does not necessarily fall entirely into one or the other category; it is possible for a trust to be in one category in respect of part of its income and in the other category in respect of the remainder of its income.

The first category of trusts gives one or more beneficiaries the right to receive the income of the trust as the income arises. This right might be limited, for example, to a fixed period or to the lifetime of the beneficiary but the important point is that, for as long as that right exists, the trustees are obliged to distribute that income to the beneficiary as soon as it arises. In this situation the collection of the income by the trustees is nothing more than an inconvenient administrative detour, and therefore the trustees sometimes request the source of the income to pay it directly to the beneficiary. A common example of this type of trust in a family situation is a trust set up in the will of a deceased individual, in which the spouse of the deceased individual is entitled to the income from the trust assets for his/her lifetime.[48]

The second category of trust is one in which there is no beneficiary who can claim the income as it arises. This could be because the trustees are obliged to accumulate the income and distribute it at a later date, possibly a very much later date, as capital. Alternatively, the trustees may have a discretion as to whether to distribute income to a beneficiary and, if so, how much income to distribute, when to distribute it and which beneficiary to distribute it to. This type of trust has a class of beneficiaries, which may be rather large, although there generally has to be some limitation on the members of the class.[49]

The first category of trust is often called a fixed trust, and the second category is often called an accumulation trust or a discretionary trust. These terms are, however, nothing more than convenient labels to describe a type of trust that is commonly found. In any given case it is essential to study the

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[48] Often the children of the couple receive the trust assets on the death of the second spouse.

[49] In many countries it is either not possible to create what is known as a purpose trust, or in other words a trust with no beneficiaries, or this is possible only in limited circumstances, for example if the trust has a charitable purpose.

terms of the trust carefully, as it is the trust terms that are the definitive source of information about the rights of the beneficiaries.

6.4.2. Domestic taxation of trust income

Although the trust concept is well known in most common law countries, it is not true that the tax system of these states is automatically able to accommodate trusts. Quite the contrary, in fact; the tax law of these jurisdictions often has to be made to apply to trusts, usually resulting in a large quantity of legislation devoted to them. It should be emphasized that all the information about the taxation of trusts that is provided here is of a highly generic nature and subject to a large degree of generalisation. In any given case it is essential to study the relevant tax law carefully, especially as the taxation of trust income is characterised in most common law countries by a great deal of complexity and sometimes also inconsistency.

The general aim of the income tax system in common law countries is to tax trust income at the rates that are applicable to the beneficiaries, as they are the persons who enjoy the benefit of the income. Although the detail differs, these countries generally reach this result in two cases: if the beneficiary is entitled to the income as it arises to the trust; or if the income is actually distributed to the beneficiary on the exercise of their discretion to do so by the trustees.

This overall policy aim in these cases is clear, but common law states have found many different ways of achieving it. One possibility is simply to tax the beneficiary on the trust income as it arises and ignore the trustee. A second possibility is to impose a tax charge on the trustee as a representative of the beneficiary; in this case the tax is computed taking into account the personal circumstances of the beneficiary, but the liability to pay the tax is imposed on the trustee. A third possibility is to tax both the trustee[50] in respect of the trust income and the beneficiaries in respect of income they receive from the trust, but to provide a mechanism to prevent the resulting economic double taxation of the income flow. One mechanism is to allow the trustees to deduct income distributions to beneficiaries from the trust income, and another is to grant the beneficiaries a credit for the tax paid by the trustees. All of these systems are in use and some countries use different mechanisms in different circumstances.

[50] Or the trust, in countries which deem trusts to be persons for tax purposes.

If, however, the trust income is accumulated and capitalised by the trustees, there never is a beneficiary that receives the income. At some point the trustees will distribute it to a beneficiary,[51] but by that time it will be a distribution of capital.[52] In this situation the only way to tax the trust income is in the hands of the trustees.

There is another possibility that is found in most common law countries, namely that the trust income is taxed in the hands of the settlor/grantor. The settlor/grantor is not necessary for the operation of a trust once it has been established; once he has provided the assets subject to the trust and set out its terms the trust is fully created. The settlor/grantor is not a party to the trust relationship, as it is the trustees who are responsible for administering the trust and the beneficiaries who have the right to enforce the trust. Nevertheless, one of the aspects of the flexibility of the trust concept is that it is possible for a settlor/grantor to reserve for himself various powers, such as the power to direct the trustees or the power to change the beneficial interests in the trust.[53]

Most common law states have some legislation which taxes trust income in the hands of a settlor or grantor who has reserved certain powers in this way. These rules commonly tax trust income in the hands of a settlor/grantor even though he does not receive the income and does not benefit from it in any way or only in an extremely indirect way. A very common rule is that trust income is taxed in the hands of a settlor/grantor who has reserved the power to revoke the trust, but outside this situation the circumstances in which the settlor/grantor is the taxable person vary a great deal from one country to another. In many countries these rules are regarded as anti-avoidance rules, but in the US, for example, they are regarded as an integral part of the trust taxation system rather than as a anti-avoidance measure.

6.4.3. Application of treaties to trust income

[51] Most common law countries have what is known as the rule against perpetuities; this rule prevents attempts to tie up capital in a trust for excessively long periods of time by imposing certain limits on the duration of a trust. Nevertheless, it is often possible for trusts to exist for periods of roughly 100 years. Eventually, however, the trust has to be wound up and the assets distributed to the beneficiaries at that time.

[52] Which may well have consequences for gift, estate or inheritance tax, if the country has such a tax, but this tax charge is not relevant to the application of an income tax treaty.

[53] It is also possible for the trust terms to give comparable powers to a person who is not the settlor/grantor, in which case that person is often the taxable person.

Unfortunately there is little case law and little available guidance on the application of treaties to trust income. Furthermore, the variety of domestic systems for taxing trust income makes it difficult to distil general principles in this respect. The primary difficulty is the third step in determining entitlement to treaty benefits, the issue of which person is entitled to claim treaty protection in respect of which income. In connection with trustees there are also some issues in respect of the second step, which are discussed in the following section.

There is one situation in which the application of a treaty is relatively easy; if a beneficiary is entitled to trust income as it arises, or actually receives specific trust income that is distributed at the discretion of the trustees, and the beneficiary is the only taxable person in respect of the income, it is rather obvious that the beneficiary should be the person who is potentially entitled to treaty benefits in respect of the income.

At the other end of the scale, in situations in which the trustees are the only persons who are taxable in respect of trust income, it may seem equally obvious at first sight that they are the persons who are potentially entitled to treaty benefits in respect of the income. Some countries, however, find it difficult to accept that trustees can claim treaty benefits because trustees, by definition, do not receive the income on their own behalf. Their position is a fiduciary one; they always receive the income for the ultimate benefit of the beneficiaries, even if the income does not reach the beneficiaries until after it has been accumulated and capitalised. In respect of dividends, interest and royalties, therefore, the argument is that the trustees cannot be the beneficial owners.

The danger with this objection is that it might prevent a treaty from being applied even though the income in question clearly has a substantial economic connection with a treaty partner state because it is paid to trustees in that partner state for the benefit of beneficiaries resident in that same state. One solution is to accept that the management functions of trustees in respect of the income are sufficient for the trustees to qualify as beneficial owners for treaty purposes.[54]

If trust income is subject to one of the other income tax regimes described in the previous section, and in the absence of specific rules in the treaty, there are many unanswered questions as to how a treaty should apply. The issue of which person is the right person to claim treaty benefits is

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[54] Most of the treaties concluded by New Zealand state explicitly that, if trustees are taxable in respect of trust dividends, interest and royalties, they are also regarded as the beneficial owner of the income for treaty purposes. The New Zealand domestic system of taxing trust income taxes either the trustee or the beneficiary as the income arises, depending on whether or not a beneficiary is entitled to the income or actually receives a distribution of the income.

particularly difficult. A complicating factor in this respect is that a further distinction can also be made among domestic systems in their characterisation of income distributed to beneficiaries. In some cases the income received by the beneficiary has the same characterisation as the income received by the trustees; in these cases it is easier to regard the beneficiary as the person potentially entitled to treaty benefits.[55] In other cases, however, the income received by the trustees becomes part of a general pool of trust income and, if it is distributed to a beneficiary, it has a different characterisation, such as an annuity. In this case it is much more difficult to trace the income from a source state through to a beneficiary and, here again, it may be that the only solution is to regard the trustees as the persons potentially entitled to treaty benefits.

If passive trust income is taxable in the hands of a settlor/grantor,[56] it is probably nevertheless the trustees or the beneficiaries who are the persons potentially entitled to claim treaty protection in respect of the income. The conditions for treaty entitlement are that the claimant is a person, that the person is resident in a contracting state and that the claimant has the required ownership connection with the income in question, such as beneficial ownership in the case of dividends, interest and royalties. The settlor/grantor may well satisfy the first two conditions, but it would often be difficult to argue that the settlor/grantor is the beneficial owner of the income if he does not receive any direct benefit from the income.[57]

6.4.4. Residence of trustees

A second set or problems arises in connection with the second step in determining entitlement to treaty benefits, namely the residence of trustees for treaty purposes.[58] This issue arises, of course, only if it is decided that the trustees are the correct persons to claim the benefit of a treaty.

Although it is possible for a trust to have only one trustee, many trusts have two or more. The trustees of a single trust are generally accepted to constitute a "body of persons" and are therefore

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[55] One of the possible problems here, however, is that this might be the case even though the distribution to the beneficiary is made a long time after the income was received by the trustees. Tracing the income through to the beneficiary might meant, therefore, that a treaty could not be applied until long after the income was paid.

[56] Or another person who has powers in respect of the trust.

[57] Unless one understands the beneficial ownership requirement to refer to the person who is liable to tax in respect of income, which is one of the possible meanings that has been advanced.

[58] Or a trust, in respect of countries which deem trusts to be persons for tax purposes.

capable of being a person for treaty purposes. In countries that recognise the trust concept, a body of trustees is almost always capable of bearing a tax liability and therefore the body of trustees is also capable of being a resident of a contracting state for treaty purposes.

But determining the state in which trustees are resident for treaty purposes is a much more difficult issue. The case law in common law countries is not consistent in this respect. Some case law looks at the personal residence of the companies or individuals who fulfil the role of trustee, but there is an obvious problem with this approach if the trustees have their personal residence in different states. Furthermore, the relevance of the trustees' personal residence is not immediately obvious as the trustees do not necessarily carry out their trustee activities in their personal residence state.

From a policy point of view, the preferable choice is the place where the management of the trust is carried out. This view seems to be gaining acceptance, although it is by no means universally adopted. In a Canadian case decided in 2012, for example,[59] the court held explicitly that, given the asset management functions of a trust, it was similar in this respect to a company and the correct test was the place where those management functions were carried out. Recent guidance from the UK tax authority[60] also focuses on the place where the trust is managed.

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