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

Addendum

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

Summary

At its third session held from 29 October to 2 November 2007, the Committee of Experts on International Cooperation in Tax Matters discussed the report of the subcommittee on Improper Use of Treaties. A number of drafting changes were agreed to and the subcommittee was requested to finalize its report for presentation at the Fourth Session of the Committee.

This note includes a revised version of the report of the subcommittee that takes account of the decisions made at the third session. It is presented to the Committee for approval at its Fourth session, to be held from 20 to 24 October 2008.

[*] This document has been prepared by the subcommittee on Improper Use of Treaties (Coordinator: Mr. Lee). The views and opinions expressed are those of the author and do not necessarily represent those of the United Nations.

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1. During the Third Session of Tax Expert Committee, the subcommittee was requested to carry out further work on the issue of beneficial ownership, and it was noted that this could include whether or not the concept of beneficial ownership could apply with respect to other Articles of the Model Convention, such as Articles 13 and 21.

2. In order to address this request appropriately, the subcommittee, with the cooperation of the UN Secretariat, asked Professor Philip Baker to submit his consulting paper on the issue of beneficial ownership, especially focusing on whether or not this concept is applicable to other Articles of the UN Model Convention.

3. Consequently, Professor Baker submitted in May this year his paper titled "Possible Extension of the Beneficial Ownership Concept," which in most part was identical to the one attached to this report. Subsequently, the subcommittee members started discussions over that paper, spending one and a half months with a view to reaching a consensus on the conclusion of the issue.

4. There were largely two different schools of thoughts among subcommittee members. One group of the members proposed inserting a "free-standing beneficial ownership limitation provision" in the Commentary on Article 1 of the Convention as an optional provision.[1] The other group recommended that, instead of making any changes to the Commentary on Article 1, the Committee should undertake as a new project a review of the beneficial ownership concept, including the question of whether that concept is relevant for other Articles of the UN Model. The gap between the two groups has not been narrowed over time.

5. Around the end of July, having realized that it would be almost impossible for the subcommittee to reach a consensus as to how to proceed with the remaining tasks of the project during the time remaining before the Fourth Session of the Committee, the subcommittee agreed to request Professor Baker to submit his paper to the Committee - with some modification addressing certain points discussed among subcommittee

[1] The exact language could be that suggested in Professor Baker's report.

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

6. The subcommittee hoped to take this opportunity to observe the general view of the Committee on the issue of possible extension of the beneficial ownership concept. If the Committee *can* succeed in reaching a consensus on the future direction, the subcommittee would reflect it either in our draft new Commentary on Article 1 or in a separate note. If the Committee *cannot* reach a consensus on the future direction during the next Committee meeting, the Subcommittee would like to propose the following option:

(i) Not to make any changes to the proposed new Commentary on Article 1; and

(ii) To undertake, as a new project, a review of the beneficial ownership concept, including the question of whether that concept is relevant for other Articles of the UN Model.

7. The subcommittee looks forward to having a meaningful discussion of the attached paper prepared by Professor Baker during the Fourth Session of the Committee.

ANNEX

THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES: POSSIBLE EXTENSION OF THE BENEFICIAL OWNERSHIP CONCEPT[2]

Introduction

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

2. In this Report I discuss: a brief history of the beneficial ownership concept; the interpretation of the term "beneficial owner"; possible Articles of the UN Model Convention to which the beneficial ownership concept might

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

be extended; options for extending the beneficial ownership concept; some concluding comments.

A brief history of the beneficial ownership concept

3. Both the 1980 version of the UN Model Convention and the 2001 version contain the beneficial ownership concept in Articles 10, 11 and 12. The 1980 version adopted the formulation, "... if the recipient is the beneficial owner of the [dividends] [interest] [royalties], the tax so charged shall not exceed ...". The 2001 version, adopting the amendments made to the OECD Model in 1995, has the formulation, "... but if the beneficial owner of the [dividends] [interest] [royalties] is a resident of the other Contracting State, the tax so charged shall not exceed ..."[3].

4. The beneficial ownership concept was first adopted by the OECD in the OECD Model of 1976. This was an amendment to the 1963 Draft Convention which arose from discussions which took place between 1968 and 1970.[4] There was a concern, expressed in particular by the United Kingdom delegate, that the drafting of the Articles in the 1963 Draft Convention was defective in that the benefit of the Convention would be given where the income was paid to an agent or a nominee with a legal right to the income. To resolve this problem, the beneficial ownership concept was introduced (and was first included in the OECD report entitled "Revised Text of Certain Articles of the 1963 OECD Draft Double Taxation Convention", published in April 1972).

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[3]The formulation was changed, as explained in the Commentary, to cover the situation where the recipient of the dividends/interest/royalties was a nominee or agent or a resident of a third country, but the beneficial owner was a resident of the other Contracting State: in those circumstances, the original formulation might have denied the benefit of the reduced withholding tax, but the new formulation applied a form of "look through" and gave the beneficial owner the benefit of the Convention to which he was entitled as a resident of that Contracting State.

[4] The background to the decision to introduce the beneficial ownership concept into the OECD Model has been extensively researched by Professor Richard Vann to be published in a forthcoming book.

5. In practice, the beneficial ownership concept had already begun to be inserted into specific, bi-lateral conventions before 1968: see, for example, Articles 11, 12 and 13 of the United Kingdom-Netherlands Double Taxation Convention of 31st October 1967.

6. The original, 1976 Commentary to Articles 10 and 11 of the OECD Model contained only the following short explanation of the beneficial ownership concept:

> "Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State. States which wish to make this more explicit are free to do so during bi-lateral negotiations." (paragraph 12 of the Commentary to Article 10, paragraph 8 of the Commentary to Article 11, and paragraph 4 of the Commentary to Article 12).

7. The meaning of the beneficial ownership concept was discussed by the OECD in the Conduit Companies Report of 1986[5]. Consequent on that, the Commentaries to Articles 10, 11 and 12 of the OECD Model were amended in 2003 to contain the following, fuller explanation:

> "12. The requirement of beneficial ownership was introduced in paragraph 2 of Article 10 to clarify the meaning of the words "paid ... to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was immediately received by a resident of a State with which the State of source had

[5] **Double Taxation Conventions and the Use of Conduit Companies, OECD Committee on Fiscal Affairs, 1986.**

concluded a convention. The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

12.1 Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies" concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties."

8. Because the amended Commentary to the OECD Model was not adopted until 2003, the UN Model Convention of 2001 quotes the previous, shorter

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

The interpretation of the term “beneficial owner”

9. Though the beneficial ownership concept has been employed in double taxation conventions since the 1960s, its precise meaning remains unclear. This is an important factor for the Sub-committee and the Committee of Experts to consider in deciding whether to extend the use of the concept to other Articles of the UN Model Convention. If the meaning of the term remains unclear, the consequences of extending the term to other Articles will equally be unclear. It may be that the term has a narrow scope, simply to exclude nominees and agents, so that the inclusion of the term would achieve relatively little by way of combating the improper use of treaties; on the other hand, the term may come to be given a wide interpretation, in which case it might exclude some persons who might not be regarded as making improper use of a treaty. This is a risk in extending the use of the concept to further Articles of the Model Convention.

10. Several fundamental issues remain unresolved about the interpretation of the beneficial ownership concept.

11. First, does the term “beneficial owner” – as an undefined term in the Convention – take its meaning from the domestic law of the Contracting State concerned under Article 3(2) of the Model Convention? Alternatively, is this a situation where “the context otherwise requires” that the domestic law meaning of the term is not employed? If so, does the term “beneficial owner”

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

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

12. Secondly, is the beneficial ownership concept a narrow and specific anti-abuse rule, designed only to exclude clear cases of treaty shopping by the imposition of a nominee, agent or other conduit (being a conduit that has no power to enjoy the income and cannot, therefore, in any sense be regarded as the beneficial owner)? Alternatively, is the beneficial ownership concept a general principle designed to counter the abuse of tax treaties through treaty shopping?

13. My personal view on these two issues is as follows. The term "beneficial owner" should bear an "international fiscal meaning" and not take the meaning under the domestic law of the Contracting State concerned; this is a case where "the context otherwise requires" Article 3(2) not to apply. I take this view largely because the term was introduced into international fiscal usage through the work of the OECD, picked up and inserted into the UN Model, and is employed in double taxation conventions entered into by countries some of which employ the term "beneficial owner" in their domestic law, others of which do not. The term also has to be given a meaning consistent with its cognates in other languages: for example, the French version of the OECD Model (which bears equal authority with the English version) uses the term "*le bénéficiare effectif*". (I comment below on the different language versions of the UN Model Convention.)

14. I also take the view that the beneficial ownership concept is a narrow provision designed to counter only certain specific examples of treaty shopping: this is supported by the reference in the Commentaries to the OECD and UN Models to nominees and agents (and in the OECD Model to a conduit having very narrow powers which render it a mere fiduciary or administrator acting on account of another). I also take this view based upon

the advice found in the Commentaries to the OECD and UN Models that Contracting States may include more specific anti-shopping provisions. Finally, I base this view also on the practice of a number of States to include more elaborate and detailed anti-shopping provisions (for example, separate Limitation on Benefit Articles): if the beneficial ownership concept was a broad, general anti-treaty-shopping measure, some of those more detailed provisions might be unnecessary.

15. There has been a small number of court decisions around the world on the meaning of "beneficial owner". I am aware of only six such cases: these cases are summarised below. Unfortunately, they do not yet establish a common interpretation of the term.

16. The earliest case appears to have been the decision of the Dutch Hoge Raad of 6th April 1994, generally referred to as the "Royal Dutch" case.[7] That case concerned a taxpayer who had acquired the right to receive dividends on certain shares, but had not acquired the shares themselves. The Hoge Raad confirmed that the taxpayer was the beneficial owner of the dividends.

17. The Swiss Federal Commission of Appeal in Tax Matters, in the case of Re V SA[8] had to decide the case of a Luxembourg company which had acquired 100% of the capital in a Swiss company. The Swiss company paid a dividend to the Luxembourg company, but evidence showed that the

[7] Case No.28 638, reported in BNB 1994/217. That case has recently been cited in the Prévost Car Inc case, discussed below. That case contained an unofficial translation (by Professor Stef van Weeghel) of the Hoge Raad's decision as follows:

> **"The taxpayer became owner of the dividend coupons as a result of purchase thereof. It can further be assumed that subsequent to the purchase the taxpayer could freely avail of those coupons and, subsequent to the cashing thereof, could freely avail of the distribution, and in cashing the coupons the taxpayer did not act as voluntary agent (*zaakwaarnemer*, SvW) or for the account of the principal (*lasthebber*, SvW). Under those circumstances the taxpayer is the beneficial owner of the dividend. The treaty does not contain the condition that the beneficial owner of the dividend must also be the owner of the shares and further it is irrelevant that the taxpayer purchased the coupons at the time the dividend had already been announced, because the question who is the beneficial owner must not be answered at the time the dividend is announced, but at the time the dividend is made payable."**

[8] Decision of the 28th February 2001, Case No.JAAC65.86, published with an unofficial translation in (2001) 4 ITLR 191.

Luxembourg company had paid out by way of interest and charges of an unspecified nature all the income received by it. The Federal Commission concluded that the Luxembourg company was not the beneficiary of the dividends. The Commission stated: “The notion of ‘effective beneficiary’ [usually translated as beneficial owner] clearly envisages the person who in reality receives the dividend paid rather than the formal direct shareholder (see *Klaus Vogel on Double Taxation Conventions*, page 562)”[9].

18. An Austrian Supreme Administrative Court case,[10] N AG v. Regional Tax Office for Upper Austria, involved the refusal of the tax administration to grant the reduced treaty rate on dividends paid to a Swiss company, the shareholders of which were two Swiss lawyers. Though the case involves little discussion of the beneficial ownership concept, the Court upheld the decision of the tax administration to refuse the reduced treaty rate on the grounds that the Swiss company had failed to produce evidence to support its claim to treaty benefits.

19. The first extensive discussion of the beneficial ownership concept, in a United Kingdom court case, occurred in Indofood International Finance Ltd v. JP Morgan Chase Bank NA[11]. The issue arose in a civil action and not in the context of a tax case, and the tax authorities were not represented in the case. Sir Andrew Morritt, delivering the leading judgment, said the following about the term “beneficial owner”:

> “[42] The fact that neither the Issuer nor Newco was or would be a trustee, agent or nominee for the noteholders or anyone else in relation to the interest receivable from the Parent Guarantor is by no means conclusive. Nor is the absence of any entitlement of a noteholder to security over or right to call for the interest receivable from the Parent

[9] Ibid, para.7.a.
[10] Decision of 26th July, 2000, reported with an unofficial translation in (2000) 2 ITLR 884.
[11] Court of Appeal decision of 2nd March 2006, reported in (2006) 8 ITLR 653.

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

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

. . .

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

[12] Para. 43.

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

20. It is notable that the Court of Appeal regarded the term "beneficial owner" as having an international fiscal meaning, derived in large part from the Commentaries to the OECD and UN Models.

21. The French Conseil d'Etat in the Bank of Scotland case[13] considered an arrangement whereby the taxpayer had acquired a usufruct for three years over preference shares in a French company which had been issued for this purpose. The taxpayer claimed the payment of a dividend tax credit: the provision of the UK-France Double Taxation Convention which extended the dividend tax credit to residents of the other Contracting State did not employ the term "beneficial owner". The Commissaire du Gouvernement considered, however, that the concept of beneficial ownership applied also in the absence of an express reference to that term in the treaty. He took the view that the beneficial ownership concept was not limited only to cases where the immediate recipient transferred the benefits to a third party but was part of a broader "fraud on the law" (*fraude à la loi*) approach to taxation. The Commissaire concluded that the taxpayer company was not the beneficial owner of the dividend. The Conseil d'Etat concurred with this conclusion, though it is not explicit in the decision whether the Court accepted the reasoning of the Commissaire.

22. The most recent case on the meaning of beneficial ownership is the decision of the Tax Court of Canada in Prévost Car Inc. v. R[14]. That case concerned a Dutch company, "PH BV", owned as to 51% by the Swedish Volvo company and 49% by the UK Henlys company. The Dutch company

[13] Decision of 29th December 2006, Case No.283314, published with unofficial translation in (2006) 9 ITLR 683.
[14] Decision of 22nd April 2008, to be published in (2008) 10 ITLR xxx.

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

> "[100] In my view the 'beneficial owner' of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership. In short the dividend is for the owner's own benefit and this person is not accountable to anyone for how he or she deals with the dividend income. …. Where an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatary is acting or for whom the nominee has lent his or her name. When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it, for example, a stockbroker who is the registered owner of the shares it holds for clients. This is not the relationship between PH BV and its shareholders."

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

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

24. This scant international case law on the meaning of "beneficial owner" points to a number of factors to be considered by the Sub-committee and the Committee of Experts in deciding whether to extend the use of the beneficial ownership concept.

25. First, the term has, as yet, no clearly established definition, and courts have disagreed even on such basic questions as whether the term should take its meaning from the domestic law of the Contracting State concerned (e.g. Prévost Cars), or should be given an international fiscal meaning (e.g. Indofood).

26. Secondly, disputes as to whether or not a particular taxpayer is the beneficial owner have ended in relatively lengthy litigation in several jurisdictions. The use of a term without a clear meaning has the potential for giving rise to further litigation. Adopting the use of a term whose meaning may need to be clarified by litigation to the highest courts in a country is a significant consideration, particularly for developing countries.

27. There are further considerations that the Sub-committee and the Committee of Experts may wish to take into account relating to the interpretation of the beneficial ownership concept. Some of these factors may make it difficult to achieve a common understanding of the term "beneficial owner", unless that term is seen as having an international fiscal meaning.

28. First, the UN Model Convention is published in the six UN languages. Any interpretation should, ideally, be common to these languages; however, this may be difficult because of the differences in the terms employed. The English version employs the term "beneficial owner", while the French

version employs the term "*le bénéficiare effectif*". The Spanish version uses a term that is closer to beneficial owner (*el proprietario beneficiario*); the Chinese version uses a term which refers to the person who has the benefit from the dividend, interest or royalties (受益所有人). I am told that the Russian version (СОБСТВЕННИК БЕНЕФИЦИАР) is a straight translation of the term "beneficial owner", while the Arabic version (المستفيد الفعلي) is the equivalent of "the effective beneficiary". The different language versions all have the element of the person who benefits from the dividend, interest or royalties. However, they place different emphasis on the requirement of ownership as opposed to being the effective beneficiary of the income. This contrast between terms focusing on ownership and on beneficiary status is important: courts may be inclined to see the use of the term "owner" very much in a legal framework.

29. The second factor to take into account is that some countries may recognise the concept of beneficial ownership in their domestic laws, while others do not employ that term. In particular, in some common law countries the term "beneficial owner" is used in a narrow, technical sense to draw a contrast between, on the one hand, the legal owner (who may hold the title to property but does not have full enjoyment of that property) when contrasted with the beneficial owner (who has that enjoyment). This contrast is sometimes made in those jurisdictions which have derived part of their legal system from the rules of equity developed by the English Court of Chancery, and particularly apply that distinction to differentiate between the legal ownership by a trustee and the beneficial ownership by a beneficiary. It is generally accepted that the term "beneficial owner" is not used in this narrow, technical sense. Nevertheless, there is a danger that a court in a common law country might adopt this technical approach.

Possible Articles to which the beneficial ownership concept might be extended

30. Having identified some of the difficulties in achieving a common interpretation of the term "beneficial owner", I now turn to consider whether there are other Articles of the UN Model Convention to which the concept might be extended.

31. The three Articles in which the concept is presently found – Articles 10, 11 and 12 – all have a common form in the UN Model Convention. That is, they all involve an element of revenue sharing by the country of source accepting that it will limit its tax on dividends, interest or royalties to the maximum set out in the relevant Article; the country of residence of the beneficial owner then agrees to relieve double taxation by the credit method (in both versions of Article 23: see Article 23A(2) and 23B(1)).[15]

32. There is no reason in principle why the beneficial ownership concept should be limited to Articles which take the form of Articles 10, 11 and 12 of the UN Model Convention. The OECD Model adopts the approach of limiting the tax imposed at source only in Articles 10 and 11, but, by contrast, provides in Article 12 that royalties shall be taxable only in the state of residence of the beneficial owner. There are several provisions of the OECD Model and the UN Model Convention which – like Article 12 in the OECD Model – also provide that items of income, capital gains or capital shall be taxable only in one of the Contracting States. These provisions might attract treaty shopping, particularly if the item of income, capital gain or capital is subject to a low level of taxation, or no taxation, in the other Contracting State.

[15] **Of course, in practice neither Contracting State may exercise the tax jurisdiction which is recognised under the Convention: the state of source may impose no withholding tax at source, and the state of residence may in practice exempt the income; this is particularly so for dividends where a participation exemption may apply.**

Article 21: Other income

33. The first, potential candidate for inclusion of the beneficial ownership concept is the “other income” Article, Article 21. This provides that “Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention, shall be taxable only in that State.” In the OECD Model, taxation in the state of residence is exclusive (subject to the exceptions in Article 21(2)); in the UN Model Convention, by contrast, items of income arising in the other Contracting State may also be taxed in that State by virtue of Article 21(3).

34. Article 21 applies both (i) to types of income not dealt with elsewhere in the Convention, and (ii) to types of income to which other Articles apply but which arise either in the state of residence or in a third state. In the category of types of income not dealt with elsewhere in the Convention, for example, are certain types of payments relating to non-traditional financial instruments such as swap fees and certain payments under derivatives.

35. The possibility that taxpayers might establish entities resident in a Contracting State to take advantage of the treaty provisions of that State in connection with swap fees, for example, is less of a danger for the UN Model Convention than for the OECD Model, because of the existence of Article 21(3) in the UN Model Convention. If swap fees are paid from State A to a resident of State B who is not the beneficial owner of those swap fees, State A would nevertheless be entitled to impose taxation on the fees by virtue of Article 21(3).

36. The “classic” scenario of treaty shopping is where a resident of a third state – State C (which does not have a double taxation convention in force with the state of source, State A) – interposes an entity resident in a state – State B – which does have a convention in force with the state of source to

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

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

38. This second type of treaty shopping might be referred to as "reflexive" treaty shopping. That is, where a resident of a state interposes an entity in another state and assigns the right to receive income to that entity, with the aim of employing the double taxation convention as an argument against taxation of that income in his state of residence. This will often arise if the income is attributed to the taxpayer under domestic anti-avoidance legislation in the state of residence, and the taxpayer is seeking to employ the double taxation convention to override that domestic legislation. The extent to which such treaty shopping occurs in practice may be very difficult to ascertain, but members of the Sub-committee may have a view on this.

39. The consequence of the fact that Article 21(3) in the UN Model Convention preserves the right of the source state to tax the other income, is that the only real danger of treaty shopping using this Article would be if residents of State A used this Article to avoid tax on income arising in State B or in third states. This scenario might be one where domestic anti-avoidance legislation would apply, and so the issue would be whether the "other income" Article overrode the domestic anti-avoidance legislation. A beneficial

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

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

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

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

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

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

> "Items of income beneficially owned by a resident of a Contracting State, wherever arising, not dealt with in the foregoing articles of this Convention, shall be taxable only in that State."

42. It should be noted, however, that the US Model has no equivalent of Article 21(3) of the UN Model Convention.

43. UK treaty practice also includes similar wording in the "other income" Article (see, for example, Article 24(1) of the 2004 UK-France Double Taxation Convention).

44. The fact that inclusion of a beneficial ownership concept in Article 21 is already part of treaty practice by some states suggests that the inclusion of that concept in Article 21 of the UN Model Convention may be generally supported. However, as explained above, the existence of Article 21(3) makes this less pressing than for conventions based on the OECD Model, where there is exclusive residence state taxation.

Capital gains: Article 13

45. The second Article specifically mentioned in the Report of the Sub-committee as a potential recipient of the beneficial ownership concept is Article 13.

46. So far as Article 13(1), (2), (4) and (5) are concerned, these provide that the particular categories of property covered by each of these paragraphs – immovable property, business property, shares in companies owning immovable property, and substantial participations – may be taxed in the situs state: I do not think, therefore, that they give rise to any danger of treaty shopping.

47. The danger arises, if at all, from the provisions of Article 13(6) and (just conceivably) from Article 13(3). These two paragraphs both provide that the categories of property to which they refer shall be taxable only in one of the Contracting States.

48. The main concern here must arise from Article 13(6) which deals with all forms of property other than those covered by the first five paragraphs of the Article.

49. Unlike Article 21, this could give rise to "classic" treaty shopping. Suppose, for example, that a resident of State C (which has no convention in force with State A) owns assets situated in State A (not being immoveable property etc.) and that State A would tax the gain on disposal of those assets. He might acquire those assets through an entity in State B (which did have a convention in force with State A) so that the gain on disposal was exempt under the State A–State B Convention.

50. A similar, "reflexive" arrangement might be used by a resident of State A itself to avoid capital gains taxation on the disposal of assets situated in State A or in a third State. Thus, a taxpayer resident in State A might assign to a person resident in State B the ownership of assets not falling within the first five paragraphs: this might include, for example, ownership of shares in a company of State A (his state of residence) which is not a property company and where he does not hold substantial participation, or immoveable property situated in a third state. The taxpayer might then argue against a charge to tax on a capital gain attributed to him on the disposal of the assets that the gain is taxable only in State B under the equivalent of Article 13(6) of the State A–State B Convention.

51. It is certainly the case that some tax planning takes place utilising provisions equivalent to Article 13(6) of the UN Model Convention. A recent

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

52. If one assumes that the equivalent of Article 13(6) at issue in that case had contained a beneficial ownership limitation, one is still left with the question whether that clause would have prevented the type of arrangement illustrated by the case. It may be a rather difficult question as to whether the trustees were or were not the beneficial owners of the assets disposed of, or of the proceeds of the disposal. If the trustees were bare trustees – effectively in the position of nominees for the beneficiaries – then the beneficial ownership limitation might have countered the scheme: by contrast, the position might be different where the trustees have (as is more normal) a discretion over the distribution of the capital of the trust fund. The inclusion of the beneficial ownership concept in Article 13(6) may counter straightforward nominee/bare trustee arrangements. However, it will be difficult to apply in more complex arrangements.

53. The Report of the Sub-committee identifies some examples of tax treaty abuse involving the capital gains Article. However, the inclusion of a beneficial ownership limitation would not necessarily counter the transactions mentioned in those examples. The examples contained at paragraph 41 of the

[16] The gain would have been attributed to the settlors under domestic anti-avoidance legislation.

Report of the Sub-committee involve transfers of residence, where the taxpayer moves its residence to State B prior to the disposal. Such practices might be countered by a provision which allowed the State of former residence to continue to tax capital gains arising to a person for a period of, say, five years after that person has become resident in the other Contracting State. A beneficial ownership limitation would not necessarily counter the transactions given in those examples.

54. So far as I am aware, the inclusion of a beneficial ownership limitation in the capital gains article of specific, bi-lateral conventions is not part of the current treaty practice of any state.

55. There is also something of a conceptual gulf between applying the beneficial ownership concept to items of income – such as dividends, interest and royalties – and applying it to a capital gain. Dividends, interest and royalties all take the form of a flow of income: it is often possible to demonstrate that this flow of income effectively flows on, past the immediate recipient who is resident in the other Contracting State and who is claiming the benefit of the Convention, and flows into the hands of a resident of a third state. In the case of a capital gain, however, there is a disposal of an asset owned by a resident of one Contracting State; the disposal gives rise to a capital gain (being an excess of disposal value over acquisition costs); the proceeds of that capital gain (if any) may then be paid over to, or applied for the benefit of, a person who may be a resident of a third state. It is a little harder to identify the ultimate effective beneficiary of the capital gain. This may be difficult for all revenue authorities, but may be especially difficult for revenue authorities in developing countries as there be fewer staff trained to resolve this type of issue.

56. This conceptual difference can be illustrated from the opening words of the paragraphs in the 2003 revised Commentaries to the OECD Model

explaining the meaning of the beneficial ownership concept. These paragraphs (quoted above at paragraph 7) explain that the concept clarifies the meaning of "paid … to a resident". However, capital gains are not necessarily "paid to a resident" of a Contracting State. Rather, the capital gain is realised for the benefit of a person who must be a resident of a Contracting State, or the proceeds of the capital gain are paid to or applied for the benefit of a resident of a Contracting State.

57. If one focuses on the proceeds of a disposal and on the person who receives them, there may or may not be any proceeds which can then be traced into the hands of the ultimate recipient. Suppose, for example, that both State A and State B impose taxation on capital gains on a disposal by way of gift; if a resident of State A makes a disposal by way of gift of an asset situated in State B, and the gift is to a resident of a third state, then is it the resident of State A who is the real beneficiary of the gain, or the recipient in the third state who receives the asset with an enhanced value?

58. These theoretical differences between a flow of income – as in the case of dividends, interest and royalties – and the effective beneficiary of a capital gain, are not insurmountable. However, some explanation will need to be made – perhaps in the Commentaries – if a concept that was developed in the context of a flow of income paid to a person is extended to capital gains which are not paid to a person. It is also worth bearing in mind that there is something of a conflict in legal concepts in recognising that the owner of an asset who disposes of that asset may not be the beneficial owner of the capital gain arising from the asset.

59. A provision which introduces the beneficial ownership concept into Article 13(6) might be worded something like this:

> "6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the beneficial owner is a resident."

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

61. It seems hard to see an argument, therefore, for including a beneficial ownership limitation in Article 13(3).

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

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

Business profits: Article 7

63. In the absence of a permanent establishment in the other Contracting State, business profits are taxable only in the state of residence of the enterprise. Thus, Article 7 bears a similar formulation to Article 21(1) or Article 13(6) (or Article 12 of the OECD Model). To that extent, therefore, there is the possibility of treaty shopping to take advantage of Article 7.

64. One can imagine "classic" treaty shopping scenarios involving Article 7. Suppose that a resident of State C (which has no convention in force with State A, or has a convention in force but with a broader definition of permanent establishment) derives business profits from State A which would be taxable there in the absence of a convention (or under the broader definition of permanent establishment in the State C convention). He establishes an entity in State B to take advantage of the State A–State B convention.

65. Article 7 may also be part of "reflexive" arrangements which a resident of a state employs to avoid taxation of business profits in his own state of residence. Suppose, for example, that a resident of State A derives business profits from State A, but in a manner that does not require a permanent establishment: he establishes an entity in State B which derives the business profits, and then argues that those profits are taxable only in State B by virtue of the business profits Article of the State A–State B Convention.

66. To an extent, the arrangements which were considered in the UK case of Padmore v. IRC [1989] STC 493 involved this latter type of structure. A resident of the United Kingdom derived business profits from the United Kingdom and elsewhere through a partnership established in Jersey. The

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

67. It is also worth noting that provisions of the Finance Bill currently before the UK Parliament aim to prevent, through domestic legislation, current schemes that would rely upon the business profits articles of the UK's double taxation arrangements. Those schemes typically employed an entity – such as a partnership – established in a jurisdiction with which the UK has a double taxation convention. For example, a partnership would be formed between two trustees, the trust holding the income of the partnership for the benefit of a UK-resident person. It is interesting to consider whether, had the business profits articles of those arrangements contained a beneficial ownership limitation, these various schemes would never have got off the ground.

68. To a certain extent the introduction of the beneficial ownership concept into the business profits Articles would raise some of the same conceptual issues as for capital gains. In the case of dividends, interest and royalties there is a clear stream of income which may be shown to flow on past the interposed recipient; business profits are the numerical result of a computation which deducts from gross income the allowable expenses incurred. It may be more difficult, but by no means impossible, to identify who is the beneficial owner of those profits in the sense of the person who benefits from the surplus of gross income over allowable expenses.

69. So far as I am aware, the insertion of a beneficial ownership limitation in the business profits Article is not part of the regular, treaty negotiation policy of any state.

70. A provision which introduces the beneficial ownership concept into Article 7 might be worded something like this:

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

Other Articles

71. In principle, one can think of possible treaty shopping structures that might involve other articles of the Convention and which would be countered by a beneficial ownership limitation.

72. So long as the UN Model Convention contains an Article 14 (an issue which I understand is currently under consideration by another sub-committee) then similar considerations would apply to that as apply to Article 7.

73. Under Article 15, it is theoretically possible that an individual might use a company in another Contracting State to provide his employment services. However, one wonders if this is sufficiently common (other than in the circumstances of artistes and sportsmen which are dealt with by Article 17(2)) to merit any change in the wording.

74. If a pension recipient were to assign the benefit of a pension to a nominee in another Contracting State, he might do so in an attempt to argue that the pension should be taxable only in the state of recipient of the pension. This raises a difficulty as to whether the pension is paid to the nominee "in consideration of past employment". Again, it seems sufficiently unlikely that such schemes would arise not to merit any amendment.

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

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

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

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

77. One word of caution might be inserted at this point. If the UN Model Convention is amended so as to include the beneficial ownership concept in some Articles – for example, Article 21 – but not in others (for example, not in Article 13(6)) – then it might come to be argued that a nominee or agent is entitled to the benefit of those Articles that are not amended because they have specifically not had a beneficial ownership limitation inserted. In the proposed new Commentary, the Sub-committee might seek to address this by indicating that such a reverse implication is not intended.

78. To an extent, this issue is already present in the UN Model Convention: the beneficial ownership concept is found in Articles 10, 11 and 12, but not in other Articles. As has been explained above, the French Conseil d'Etat in the Bank of Scotland case followed the reasoning of the Commissaire who argued that the beneficial ownership concept was implicit in the double taxation

arrangement concerned, whether expressly included in the particular provision in question or not. One might in any event take the view that in the case of income flows such as dividends, interest and royalties the danger of interposing a nominee agent or other conduit is much greater than for other Articles of the Convention: this justifies the inclusion of a beneficial ownership limitation in Articles 10, 11 and 12 but not in other Articles.

A general beneficial ownership provision

79. One possible approach which might be worth considering is to take a leaf out of the Commissaire's conclusions in the Bank of Scotland case and introduce a general beneficial ownership limitation which applies to all provisions of the Convention. This might be phrased something like the following:

> "The benefits of this Convention (other than Articles 23 and 24) shall only apply if and to the extent that the beneficial owner of the profits, item of income, capital gain or other property is a resident of one or both of the Contracting States."

80. This might be included in Article 1 of the Model Convention. Alternatively, this provision might be placed in the Commentary to Article 1 as a suggested form of additional provision which might be adopted by states that considered they wished to include this in their bi-lateral convention.

81. The inclusion of such a provision would ensure that there was the basis for an argument in all cases against arrangements which employed a nominee, agent or other conduit to obtain the benefits of any of the provisions of the Convention.

82. In effect, this would be a general (though rather narrow) limitation on benefit provision. However, one wonders whether, if two Contracting States were minded to include a limitation on benefit provision, they would not be inclined to adopt a more detailed, specific provision rather than a general provision of this nature.

The options for amending the UN Model Convention

83. By way of summary, this section of this Report lists the possible options which the Sub-committee and the Committee of Experts might wish to consider for amending the UN Model Convention to extend the use of the beneficial ownership concept.

1. Do nothing

84. There is much to be said for this option. As explained above, the exact meaning of the beneficial ownership concept is far from clear, and there is obvious sense in not extending a concept whose meaning is less than entirely clear to other provisions of the Model Convention.

85. An argument can be made that, in the case of dividends, interest and royalties, there is a clear danger of the insertion of a nominee, agent or other conduit to obtain the benefits of a double taxation convention, and that this specific anti-abuse measure in Articles 10, 11 and 12 counters that abuse. The danger is not so clear with respect to other Articles of the Convention.

86. On the other hand, as has been shown, it is possible to conceive of arrangements that use other Articles of the Convention and might also be countered by a beneficial ownership provision.

2. Add the beneficial ownership concept in Article 21 only

87. This approach already reflects the treaty practice of some states and could, one assumes, be adopted with relatively little difficulty. It is worth pointing out, however, that the presence of Article 21(3) in the UN Model Convention (and the absence of an equivalent in the OECD Model), may make this somewhat less significant.

3. Add the beneficial ownership concept in Article 13(6) (and Article 22(4))

88. There are clearly some treaty shopping arrangements that use the equivalent of Article 13(6), and a beneficial ownership limitation could provide a counter to those arrangements. How prevalent those arrangements are, it would be hard to determine. There is also the theoretical difficulty of applying the beneficial ownership concept not to a stream of income but to a capital gain or the proceeds of the disposal of an asset.

4. Add the beneficial ownership concept in Article 7

89. There are also some treaty shopping arrangements that use Article 7, and again a beneficial ownership limitation might provide a means of countering those arrangements. Again, one cannot determine how prevalent are those arrangements. Currently, Article 7 is being redrafted by the OECD: on the one hand that might provide the opportunity for inserting the beneficial ownership concept; on the other hand, sensitivities over Article 7 are very high, and this might not be the opportune moment.

5. A free-standing beneficial ownership limitation provision

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

6. A free-standing beneficial ownership provision included only in the Commentary

90. An alternative to including a free-standing beneficial ownership provision in the Model Convention itself is to include it only in the Commentary as a suggested form of words which pairs of states might include in their bi-lateral convention if they considered that it would be useful as an anti-treaty shopping provision.

91. My personal inclination would be to rank the options in this order:

(i) Add the beneficial ownership concept in Article 21 only;

(ii) Do nothing;

(iii) Add the beneficial ownership in Article 21 and Article 13(6) only;

(iv) Introduce into the Commentary a form of free-standing beneficial ownership provision that applied to all benefits under the Convention and which contracting states might choose to add to their bi-lateral conventions.

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

Concluding comments

93. This Report has focused on the issue of the possible inclusion of beneficial ownership concepts in other Articles of the UN Model Convention. However, by way of concluding comments, I would like to emphasise two points.

94. First, whether the use of the beneficial ownership concept is extended in the UN Model Convention or not, it is important to try to clarify the meaning of "beneficial owner" so far as it is possible so to do. This is desirable of itself, whether the use of the beneficial ownership concept remains exactly as it is, or is extended. At the very least it is necessary to decide whether or not to amend the existing Commentary to Articles 10 and 11 (and provide equivalent wording in Article 12) to track the changes made to the OECD Model Commentaries in 2003.

95. In the light of the existing case law, including the Indofood case and the recent Prévost Cars Inc case, I wonder if it would be possible to reach agreement that "beneficial owner" has an international fiscal meaning, not dependent on the domestic law of the Contracting State concerned. The meaning excludes from the benefit of the Convention: nominees, agents and any other person who has such narrow powers which render it, in relation to the income, profits, capital gains or property concerned, a mere fiduciary or administrator acting on account of the true beneficial owner.[17]

[17] **It would be even more helpful if the Commentary explained that a person who receives income or the proceeds of a capital gain, and pays that income or those proceeds on to another person, is the beneficial owner thereof unless**

96. The second general comment that should be made is that the inclusion of the beneficial ownership concept is not a substitute for other, more specific anti-abuse provisions if the Contracting States consider that there is a danger of abuse. There are examples of other such specific provisions in the Report of the Sub-committee.

97. I trust this Report is helpful to the Sub-Committee and the Committee of Experts in deciding whether to extend the beneficial ownership concept to further Article of the UN Model Convention.

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the obligations that require the income or the proceeds to be paid on are of such a nature, either in law or in fact, that it has no possibility of benefiting from them and has no alternative other than to pay them on in accordance with those obligations.