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THE MEANING OF 'BENEFICIAL OWNERSHIP' AND THE USE THEREOF FOR TAX TREATY SHOPPING AND TAX AVOIDANCE

Mini dissertation by

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“Even if you know you will not succeed 100%, it does not give you the right not to give 100% all the time.”

ABSTRACT

The term 'beneficial ownership' is included in numerous tax treaties that are concluded between countries today but the majority of these treaties do not define the term. The purpose of this study is four fold. Firstly, to investigate what the meaning is of the term 'beneficial owner' for tax treaty purposes? Secondly, what factors should be taken into account to determine the beneficial owner, if any? Thirdly, what the meaning of the term 'beneficial ownership' is in the context of those tax treaties where the term has been incorporated, and lastly, if the term 'beneficial owner' should have a domestic law, international tax or tax treaty meaning?

The study was conducted by reviewing various articles, opinions, court cases and government publications, that deals with the issues raised in the preceding paragraph, and then to identify if there are answers to these questions that were raised?

The study concludes that there is no concrete on-line definition for the term "beneficial owner" and that various factors need to be considered in support of the term. The Chinese revenue authority has recently issued various circulars, setting out various factors that need to be considered in an attempt to identify the beneficial owner. Equally important is the factors that need to be considered as set out in the 'Limitation on Benefits' clause that appears in most US tax treaties.

The study also concludes that the findings of the Court in the *Indofood International Finance Ltd v JP Morgan Chase Bank NA* regarding the fact that the term 'beneficial owner' should have an international fiscal meaning is appropriate. Although there are counter arguments supporting the fact that an domestic tax law meaning pertaining to the specific taxes should prevail over any other meaning or that the term should be interpreted in a purely treaty framework, and not be referenced to domestic law, where there is a well established international law meaning for the term, an international fiscal meaning will result in a more consistent interpretation between Contracting States and limit misinterpretation due to differences in tax and legal systems.

OPSOMMING

Die term ‘voordelige eienaar’ is ingesluit in menige belasting ooreenkomste wat tussen lande gesluit word vandag, maar die meerderheid van hierdie ooreenkomste, definieer nie die term ‘voordelige eienaar’ in die ooreenkoms nie. Die doel van hierdie studie is vier voudig. Eerstens, om vas te stel wat die betekenis van die term ‘voordelige eienaar’ vir belasting ooreenkoms doeleindis is. Tweedens, watter faktore inaggeneem moet word in die vasstelling van die betokens van die term ‘voordelige eienaar’, indien enige. Derdens, wat die betekenis van die term ‘voordelige eienaar’ is in die belasting ooreenkomste waar die term reeds geïnkorporeer is en laastens, of die term ‘voordelige eienaar’ ‘n nasionale, internasionale of belasting ooreenkoms betekenis moet hê.

Die studie is uitgevoer deur artikels, opinies, hofsake en regering’s publikasies te hersien, wat met die vrae wat in die vorige paragraaf aangespreeks is handel, en om dan te identifiseer of daar antwoorde is op die vrae wat geopper is?

In die die studie wat gedoen is is gevind dat daar tans geen vaste een-lyn definisie is vir die term ‘voordelige eienaar’ nie, en dat menigde faktore inaggeneem moet word ter ondersteuning van die term. Die Chinese Belastingowerheid het onlangs menigde Omskrywings uitgereik wat menigde fatore uiteensit wat oorweeg moet word in ‘n poging om die voordelige eienaar te identifiseer. Ewe belangrik is die faktore wat oorweeg moet word soos uiteengesit in die ‘beperking op voordele’ klousule wat in meeste Verenigde State van Amerika belasting ooreenkomste voorkom.

Die studie het ook gevind dat die bevinding deur die Hof in die “*Indofood International Finance Ltd v JP Morgan Chase Bank NA”* saak rakende die feit dat die term ‘voordelige eienaar’ ‘n internasionale fiskale betekenis moet he toepaslik is. Alhoewel teen argumente ter ondersteuning is van die feit dat ‘n nasionale belasting wetgewing betekenis rakende die spesifieke belasting voorkeer moet kry bo enige ander mening van die term ‘voordelige eienaar’ of dat die term uitsluitlik in ‘n belasting ooreenkoms hoedanigheid geïntreperteer moet word, en nie moet verwys na nasional wetgewing waar daar reeds ‘n goed gevestigde internasionale wetgewing betekenis vir die term is nie, sal ‘n internasionale fiskale betekenis ‘n meer konsekwente interpretasie tussen Kontrakterende State tot

gevolg hê en die verkeerde interpretasie as gevolg van verskille in belasting sisteme en wetgewing voorkom.

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

In 1977 the term 'beneficial ownership' was incorporated into the Organisation for Economic Co-operation and Development ("OECD") Model Tax Convention ("MTC") and since then there has been much debate internationally about the meaning of the term (Olivier, Libin, Van Weeghel, & Du Toit 'Beneficial Ownership' *IBFD Bulletin* 2000 310 in Olivier & Honiball, 2008:410).

The definition of beneficial ownership is becoming more and more relevant in not only the local, but also the international arena. Cross border transactions taking place on a daily basis open the possibility for excessive tax avoidance in order to obtain lower tax rates by using double tax agreements' ("DTA") for not only dividends but also for royalties and interest.

MTC's were published by international organisations to standardize the contents of tax treaties. The international organisations are; the OECD, United States ("US") and the United Nations ("UN"). South Africa is not a member of the OECD but do have observer status.

A debate has originated due to the fact that the Common law seems to have more than one definition of the term 'beneficial owner' (Olivier & Honiball, 2008:414). In South Africa, as in the United Kingdom ("UK"), the debate is particularly relevant to tax treaties entered into by the Republic, as none of them contain a definition of the term 'beneficial owner', although it is recommended in the OECD Conduit Company Report (Schwarz *Tax Treaties: United Kingdom Law and Practice* 2002 paras 11–15 in Olivier & Honiball, 2008:414).

1.2 PROBLEM STATEMENT

In those tax treaties where 'beneficial ownership' has been incorporated, the question arises as to what is the meaning thereof (Olivier & Honiball, 2008:411)? International double taxation is the inherent risk to cross border trading in the international arena. The term 'double taxation' can be used in a juridical sense where it refers to where the same taxpayer is taxed on the same income in two different countries or in an economic context where the same income is taxed in the hands of two different taxpayers, i.e. in the hands of the company and its shareholders (Olivier & Honiball, 2008:4).

Relief may be provided under either domestic law or under a tax treaty in order to avoid double taxation. In the absence of particular tax incentives afforded by the one State, a tax treaty may oblige a State to grant a credit for the full notional foreign tax that would have been payable by the resident (Hosten, Edwards, Nathan & Bosman 1983 221 in Olivier & Honiball, 2008:413).

South Africa's legal system is based on the so-called Roman Dutch legal system although it has significant English law influences. South Africa is not regarded as a Common law State, despite being a member of the Commonwealth and formerly being a Dominion Territory of the British Empire. South Africa's Common law is primarily based on Roman Dutch law and not English law and therefore the term 'beneficial owner' as found in the English influences Common law states is unknown in South African Common law (Hosten, Edwards, Nathan & Bosman 1983 221 in Olivier & Honiball, 2008:413).

1.3 PURPOSE STATEMENT

The fact that the concept of beneficial ownership is unknown in South African Common law and, the term 'beneficial owner', is not defined in South African law applicable to income tax, the basis of the study is to address what the meaning is of the term 'beneficial ownership', factors that need to be considered, whether it must have a domestic law meaning, international tax or tax treaty meaning and the meaning of the term 'beneficial owner' in those treaties were the term has been incorporated?

1.4 SPECIFIC RESEARCH QUESTIONS

The specific questions to be addressed are as follows:

- What is the meaning of the term 'beneficial owner' for tax treaty purposes?
- What factors should be taken into account to determine the beneficial owner?
- What is the meaning of 'beneficial ownership' in the context of those tax treaties where the term has been incorporated?
- Should the term 'beneficial owner' have a domestic law, international tax or tax treaty meaning?

1.5 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

The term 'beneficial owner' plays an important role in determining which Contracting State will receive the tax benefit. The aim of the term 'beneficial ownership' in tax treaties is to prevent erosion of a country's tax base and tax treaty shopping. Little guidance is provided in the current OECD Commentary regarding the term 'beneficial owner', but it does however imply that a nominee or agent cannot be a beneficial owner (Schwarz 2002 paras 11–14 in Olivier & Honiball, 2008:417).

The concept of 'beneficial ownership' is not found in statute law for tax purposes and is unknown in South African Common law, despite some references in respect of dividends. None of the South African tax treaties which contain the term have defined the term (Olivier & Honiball, 2008:414). The question about whether the term 'beneficial owner' has an International tax, tax treaty or domestic law meaning in terms of art 3(2) of the OECD MTC is debatable (IBFD *International Tax Glossary* 2001 35 in Olivier & Honiball, 2008:410).

1.6 DELIMITATIONS AND ASSUMPTIONS

1.6.1 Delimitations

The study currently has a few limitations due to the fact that the term 'beneficial ownership' has not been tested severely in the courts. Although there have been recent cases on beneficial ownership in relation to dividends and interest, there has not been a case to determine the beneficial owner in relation to royalties. Royalties will therefore not form part of the core of the study.

Secondly, in the case *Indofood International Finance Ltd v JP Morgan Chase Bank NA,* which related to interest, the dispute was between two taxpayers and a revenue authority was neither the Applicant nor the Respondent, which therefore does not allow the proposed structures to be tested in court against a revenue authority.

It is therefore clear that there is currently only a limited amount of court cases that analysed the term 'beneficial ownership' on the facts provided in the separate cases.

1.6.2 Assumptions

Today, there is more than one law system used around the world, the assumption will be that there are only two law systems for the purpose of this study; Common law and Civil law. There will therefore be no analysis of the term 'beneficial ownership' in the Socialist law, Islamic law, or any other form of legal system around the world.

1.7 DEFINITION OF KEY TERMS

The following definitions are key terms to this document. As this proposal will be based on international research some definitions are from the OECD Model Convention.

Dividends: "The term 'dividends' … means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to

the same taxation treatment as income from shares by the laws of the Sate of which the company making the distributions is a resident." (OECD, 2008:29).

Interest: "The term 'interest' … means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article." (OECD, 2008:29).

Jurisdiction: "The geographical area within which a government's or a court's power may be applied." (Your dictionary.com, Not dated.)

Royalties: "The term 'royalties' … means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience." (OECD, 2008:30).

Tax avoidance: "Tax avoidance is the legal exploitation of the tax regime to one's own advantage, to attempt to reduce the amount of tax that is payable, by means that are within the law, whilst making a full disclosure of the material information to the tax authorities." (Economic expert.com, Not dated.)

Tax evasion: "Tax evasion is the general term for efforts by individuals, firms, trusts and other entities to evade the payment of taxes by breaking the law. Tax evasion unusually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting (such as under declaring income, profits or gains; or overstating deductions)." (Economic expert.com, Not dated.)

Table 1: Abbreviations used in this document

Abbreviation	Meaning
DTA	Double tax agreement
HMRC	Her Majesty's Revenue and Customs
MTC	Model tax conventions
OECD	Organisation for Economic Co-operation and Development
PRC	Peoples Republic of China
SAT	State Administration of Taxation
UN	United Nations
UK	United Kingdom
US	United States

1.8 RESEARCH DESIGN AND METHODS

A non-empirical research design would arguably be the best way to address the research questions posed, as the internet currently provides the most up to date international sources. This will involve a pure literature review as an analysis of government publications, court cases and published articles will be done.

As the study will not be limited to South Africa, international articles and publications will be easily accessible via the internet, and be of much value, as South Africa has not had much exposure to the research questions posed up to date. Court cases in the international arena will therefore form a significant part of the research.

Due to the fact that the research questions is more of a technical interpretation an empirical study would not be appropriate as the opinions of people obtained via sampling will not influence the interpretation of the technical terms.

CHAPTER 2

LITERATURE REVIEW

2.1 INTRODUCTION

Beneficial ownership is not defined in all tax treaties implemented between countries today which opens the door for disputes on the interpretation of the concept and the result can lead to tax treaty shopping and excessive tax avoidance.

Reducing the rates of withholding tax levied by the source State on dividends, interest and royalties paid to residents of the Contracting State is one of the major objectives of tax treaties and is addressed in Articles 10, 11 and 12 of the MTC respectively (Amatucci, Gonzales & Trzaskalik, 2006:169).

The notion of beneficial ownership is decisive in determining whether a person qualifies for tax treaty benefits in respect of cross border dividends, royalties and interest (South African Fiscal Association, Newsletter 4/2008).

The benefits of a tax treaty might be sought in one of two ways. Firstly, in a positive manner, which will for example, require the person to be the beneficial owner of the income. Secondly, in the case where a person may not benefit under the treaty if the person is not a resident of one of the Contracting States, as defined, for the purposes of the treaty. The latter is also referred to as the so-called ‘anti-treaty shopping’ or ‘Limitation on Benefits’ (“LoB”) clause (Olivier & Honiball, 2008:411).

Interesting enough, some writers are of the opinion that a company is not prevented from being the beneficial owner if it is not entitled to the corpus of the shares themselves but only to the dividends (Baker, 2007).

In South Africa only the term ‘change in beneficial ownership’ is defined in the Securities Transfer Tax Act No.25 of 2007 but does not provide much guidance on the international disputed issue. No two countries tax systems are identical. Due to different tax systems a

scenario can result where either party is liable for tax in both countries, therefore causing a double tax effect. Internationally DTA's play an important role in the economic arena due to the differences in countries' tax systems.

It is therefore important to understand the concept of the term 'beneficial ownership', as well as to look at current definitions thereof, in order to determine if a person qualifies for tax treaty benefits in respect of cross border dividends, interest and royalties.

2.2 CONCEPT OF BENEFICIAL OWNERSHIP

In 1977, the requirement that the recipient of the income be the beneficial owner thereof in order for the tax to be reduced in the source state was introduced into Article 10, 11 and 12 by the OECD Model Convention which deals with Dividends, Interest and Royalties respectively. Although the term has been translated by many countries, it is clear that there is still no universal accepted definition for the term 'beneficial ownership' (Van Weegel, 1998:64).

Tax treaties normally contain the term "beneficial owner" in the Articles dealing with dividends, interest and royalties which generally provides for lower withholding taxes. The availability to the lower withholding tax rates is limited by the inclusion of the term 'beneficial owner' in order to limit these benefits as the reduced rates is only available if the beneficial owner is a resident of the state which is a party to the treaty (Baker, 2007).

As previously stated, the term 'beneficial owner' was introduced to counter tax treaty shopping. It furthermore also counters the use of conduit companies in order to obtain reduced rates through states with attractive treaty provisions. The question posed by Philip Baker is: "How artificial must the conduit arrangement be for a treaty benefit to be denied?" (Baker, 2007).

The term, beneficial ownership, was introduced mainly to counter tax treaty shopping. Before the *Indofood International Finance Ltd v JP Morgan Chase Bank NA* (Court of Appeal, 2nd March 2006, (2006) 8 ITLR 653; [2006] STC 1195) case, there has been limited case law on the term 'beneficial ownership'. In a previous Dutch case, a UK

company become entitled to receive dividends on Dutch shares by means of a usufruct that was acquired. The *Hoge Raad* overturned the previous ruling in the case and held that "…the mere fact that the company had an entitlement only to the dividends and not to the corpus of the shares themselves did not prevent it from being a beneficial owner." (Baker, 2007).

An interesting fact to the MTC is that it does not, in respect of dividends, interest and royalties require the beneficial owner to be the beneficial owner of the income-generating asset as well. The wording deals specifically with beneficial ownership of the underlying asset and not the beneficial owner of for example, the owner of the shares. Ownership of a specific asset is therefore not a conclusive manner in deciding beneficial ownership (Ryynänen, 2003:358).

In certain countries the company law clearly state that the ownership of shares in a subsidiary, excludes the property of the subsidiary. This is due to the fact that the management of a company and its ownership is clearly separated (Ryynänen, 2003:362).

A question however is; where did it all begin? Does the definition of the term not lay at the origin of the term?

2.2.1 Origin of the term

Van Weeghel (1998:73) states that the origination of the term 'beneficial ownership' seems to be in the UK, particularly through the development of trust law, where the term 'beneficial ownership' is used to distinguish from legal ownership (Common law system).

In Ayerst (Inspector of taxes) v C&K (Construction) Ltd., H.L. [1975] S.T.C. 345 Lord Diplock said the following as to the concept of beneficial ownership:

> "The archetype is the trust. The 'legal ownership' of the trust property is in the trustee, but he holds it not for his own benefit but for the benefit of the cestui que trustent or beneficiaries. On the creation of a trust in the strict sense as it was developed by equity the full ownership in the trust property was split into two constituent elements, which

became vested in different persons: the 'legal ownership' in the trustee, and what came to be called the 'beneficial ownership' in the cestui que trust (the beneficiary, SvW)." (Van Weegel, 1998:64).

One can also not be the beneficial owner if, as Lord Donovan stated in Wood Preservation v Prior: *"…like a tree which the owner could not sell and could not cut down and of which he could enjoy none of the fruit*." *(*Van Weegel, 1998:64).

As can be noted from the above, reference is made to different legal systems in the world of which the mechanical workings most certainly would differ. The most familiar legal systems used today are the Civil Law and the Common law systems. It is thus important that one should understand the differences between these two law systems, as it can have a significant impact in deciding the beneficial owner in a transaction and if the person qualifies for tax treaty benefits relating to the transaction.

2.2.2 Civil Law vs Common Law

There are currently two law systems that dominate in the world; the Civil law of ancient Rome, and the Common law of England. These two law systems are in some cases very similar and in other cases very different (Wikipedia, 2009).

As part of finding an international fiscal meaning it is important to remember that the term is intelligible in Common law systems. Common law allows one person to be the legal owner of an asset and at one and the same time another to be the equitable (or beneficial) owner. However Civil law systems do not allow this dual ownership (Mehta, Habershon, Huntley and Sultman, 2006).

Decisions in previous court cases and similar tribunal's, referred to as case law, forms the basis of what is refer to as Common law. It is law that is created by judges' decisions. In Common law, judges have the ability to create precedent, dictate law, if there is no authoritative statement of the law available. The precedents created by judges have binding effect in future cases if applicable (Wikipedia, 2009).

Civil law, on the other hand, is not developed by judges, but are written into a collection, that applies to all citizens and which judges must follow (Wikipedia, 2009).

It is thus evident that more reliance is placed on court cases in a Common law system as the decisions taken by judges' forms precedent. The precedent is considered law. In Civil law less reliance is placed on the judicial precedent and more reliance is placed on academic literature. A judge can therefore interpret the statute more independently and freely and is not bound by precedent (Wikipedia, 2009).

2.3 CURRENT DEFINITIONS OF BENEFICIAL OWNERSHIP

2.3.1 Current definitions by various authors

The concept of beneficial ownership has been defined by previous authors, but even they have different views on the meaning thereof. Du Toit in Olivier and Honiball (2008:418) is of the view that the term has an international tax meaning in the context of royalties that states:

> "The beneficial owner is the person whose ownership attributes outweighs that of any other person."

However, Vogel in Olivier & Honiball, states that the beneficial owner is:

> "…the person who is free to decide (1) whether or not the capital or other assets should be used or made available for use by others or (2) on how the yields there from should be used or (3) both."

Further to the two different views above the term has up to date not received a concrete definition. As there has, up to date, not been a concrete definition, there are various definitions that are been used in the international arena as indicated below.

Moneyterms.co.uk (Not dated) defines beneficial owners as follows:

> "The beneficial owner of an asset is the person for whose benefit it is being held. Beneficial ownership arises when an asset is owned by one person (the "legal owner") who has a duty to use it on behalf of another; one person holds assets as trustee for another."

To find the ultimate beneficial owner, for whatever reason, is sometimes an exercise on its own as it needs to be traced through a long line of holding companies and trustees. This adds to the difficulty in enforcing regulations. The UK however has mechanisms to assist companies in determining the beneficial owners, such as they can demand that legal owners disclose information about beneficial owners (Moneyterms.co.uk, Not dated.)

Your Dictionary.com (Not dated) defines, that according to Webster's New World Finance and Investment Dictionary 2003, Beneficial owner definition - finance is as follows:

> "A person or company who has, direct or indirect, voting or investment power according to the Securities and Exchange Commission. A beneficial owner is also someone who has the benefits of ownership even though the title might be held in someone else's name. For instance, stock certificates may be held in the name of the brokerage firm, but the beneficial owner is the person who actually owns the certificate, not the brokerage firm."

IBM, in their investor relations report defined the term 'beneficial ownership' as:

> "A beneficial owner is someone who has the benefits of ownership of a security even though the security may be in the name of another entity such as a nominee or registered owner. The classic example is stock held in "street name" by a broker or client." (IBM Investor relations, 2009).

It is evident that there is no accurate definition and or meaning of the term 'beneficial owner'. As there are various definitions to the term, one can therefore come across a situation where the term is not defined in a tax treaty between the Contracting States. It is

therefore important to determine the way forward when the term is not defined in the tax treaty that is applicable.

2.3.2 Default if a term is not defined in a tax treaty

As mentioned previously, the term "beneficial ownership" is not always defined in tax treaties. The default situation in a case like that is that Article 3(2) of the OECD model provides as follows:

> "As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purpose of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State." (OECD, 2008:23).

The interpretation of Article 3(2) therefore states that a domestic tax law meaning pertaining to the specific taxes, shall prevail over any other meaning. It further states that any interpretation in force, when the treaty was signed, shall be subject to an interpretation when the tax is imposed. If the context does not require otherwise, the reference to the domestic law applies. The context referred to is determined in two ways. Firstly to determine the intention of the parties when signing the agreement and secondly any meaning that is given to a term by the other states' legislation (Ryynänen, 2003:349).

The International Fiscal Association ("IFA"), in The Concept of Beneficial Ownership in Tax Treaties, has strong support that terms should be interpreted in a purely treaty framework, and not be referenced to domestic law, where there is a well established international law meaning for the term. This will therefore promote consistent treaty application as some domestic law systems do not have a definition for beneficial ownership (Ryynänen, 2003:349).

As various treaties has been based on the current MTC one can assume that the contracting parties have adopt the term as a treaty concept, unless otherwise stated in the

specific treaty. The term will have the ordinary meaning in accordance with the Vienna Convention (Ryynänen, 2003:349).

Article 31 of the Vienna convention of 1980 states as follows:

> "1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
>
> 2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
>
> (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
>
> (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
>
> 3. There shall be taken into account, together with the context:
>
> (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
>
> (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
>
> (c) any relevant rules of international law applicable in the relations between the parties.
>
> 4. A special meaning shall be given to a term if it is established that the parties so intended."

Reference to domestic tax law is been advocated by some OECD member countries. This gives the source state the flexibility as to apply domestic anti-avoidance provisions. The domestic anti-avoidance tests of the source state can therefore be transferred to a treaty level, provided that the concept of a beneficial owner is defined by reference to domestic law (Ryynänen, 2003:350).

Reference is made to reciprocity on which a convention is based, once a treaty is concluded. This is referred to in order to prevent a contracting party to amend the scope of terms not defined in the treaty in its domestic law, in order to make a convention partially inoperative (Ryynänen, 2003:350).

2.4 CONCLUSION

Currently no universal accepted definition for the term ‘beneficial ownership’ exists, which evidently, leaves the door open for interpretation. This therefore reiterates the question; what is the meaning of beneficial ownership for tax treaty purposes? The term was originally introduced to counter tax treaty shopping and the use of conduit companies.

Where the term is not defined, it appears that the majority leans to the fact that the term will have the ordinary meaning in accordance with the Vienna Convention. Where there is a well established international law meaning for the term it should be used in a purely treaty framework as this will promote consistent treaty application. This will be investigated in more detail in Chapter 5 where the *Indofood International Finance Ltd v JP Morgan Chase Bank NA* case is discussed in more detail.

One also need to understand what a conduit company and tax treaty shopping is in order to better understand the reason for the introduction of the term ‘beneficial owner’ in tax treaties and the meaning thereof for tax treaty purposes. This will be investigated in more detail for Dividends, in Chapter 4, and for Interest in Chapter 5.

CHAPTER 3

TAX TREATY SHOPPING AND CONDUIT COMPANIES

3.1 INTRODUCTION

The term ‘beneficial ownership’ was introduced to counter tax treaty shopping and the use of conduit companies in order to obtain reduced withholding tax rates through states with attractive treaty provisions. The use of the lower withholding tax rates is limited by the inclusion of the term ‘beneficial owner’ in order to limit these benefits to the beneficial owner. The Beneficial owner must be a resident of the state which is a party to the treaty (Baker, 2007).

Countries referred to as tax havens are used as part of tax treaty shopping and the set up of conduit companies. There are various definitions for what a tax haven is, but all of them contain the same core essential for the jurisdiction to be classified as a tax haven; lower rate of taxation than average compared to other countries, or in some cases, no tax at all. In addition other forms of tax havens are countries that do not levy taxation on foreign earned income, meaning that if income was earned outside of their country they do not levy tax thereon (Escape Artist, 2008).

3.2 WHAT IS TREATY SHOPPING?

Treaty shopping arises where a tax treaty is utilized by third-country nationals and normally occurs with the intent to utilize or achieve tax treaty exemptions and beneficial withholding rates upon the repatriation of income to non-treaty nations.

In layman terms, treaty shopping allows a third country national to do indirectly what a particular treaty may not permit directly if that third party national is not a Resident of the Contracting State (Krishna, 2009).

Treaty shopping has been in the spotlight as it goes hand-in-hand with beneficial ownership. The most relevant case in this regard, was concluded in Canada. In *MIL Investments S.A. v The Queen, 9 ITLR 2006.25*, the Canadian Revenue Authority was unsuccessful in an attempt to apply the General Anti-Avoidance Rules in the tax treaty between Canada and Luxembourg as the court ruled that there is no abuse or misuse of any provision of the treaty or the Income Tax Act where a taxpayer decides to arrange its affairs in order to benefit from a particular provision of a tax treaty (Gadbois, 2009).

3.2.1 Resident of a Contracting State

The term "Resident of a Contracting State" is defined in Article 4 of the OECD MTC as follows:

> "…any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein." (OECD, 2008:6).

A person is deemed to include an individual, a company or any other body of persons. The term company is further defined in Article 3 of the OECD MTC as to mean any body corporate or any entity that is treated as a body corporate for tax purposes (OECD, 2008:6).

Some countries deem a person to be a resident if the company is incorporated in that country. This result in the situation that for example, a company, Company A, incorporated in Country A, can merely incorporate a company, Company B, in Country B, the Contracting State, to hold an investment in Country C to obtain benefits of a bilateral tax treaty between Country B and C and Country A and B instead of holding the investment directly.

3.2.2 Treaty shopping characteristics

Although there are various characteristics to look for to identify treaty shopping, the following features would normally be present:

- The beneficial owner, a third party national, does not reside in the Contracting State where the conduit entity is created;
- The conduit entity does not have any economical activity and or has a minimal presence in the Contracting State; and/or
- The Contracting State does not levy income tax on foreign income or levies a very low tax rate on foreign income that is received. (Krishna, 2009)

A practical example of treaty shopping and the impact thereof can be illustrated as follow (Please note that this is only an example and do not represent the true state of tax treaties and tax systems in the mentioned countries):

Company A is a resident of Malaysia and holds several investments in the US. Although the US does not have a tax treaty with Malaysia, a tax treaty is in place between the US and Indonesia. A territorial approach to taxation is followed by both Malaysia and Indonesia, meaning; only income arising from within its borders is taxed (Wacker, 1993).

Company A cannot obtain any tax treaty benefits between the US and Malaysia as there is no tax treaty in place. Company A therefore establishes a company in Indonesia, and repatriate profits to the Newco in Indonesia, from the US, that qualifies for the highly favourable treaty terms between the US and Indonesia. The Newco then repatriate the income to Company A, and since the income arose in the US and both Malaysia and Indonesia follow a territorial approach to taxation, the income is exempt from tax in Indonesia (Wacker, 1993).

Company A therefore repatriate profits from the US, with no withholding tax that was payable in the US. If the Company A repatriated the profits directly to Malaysia, Company A might have had a withholding tax expense of 12% of the profits that it wants to repatriate from the US (Wacker, 1993).

Form the example above, it is clear that in a person can reduce its tax liability by incorporating a company in a third state in order to obtain the benefits of a beneficial tax treaty.

Two very important questions arise when one take cognisance of the above:

- Will the incorporation of a conduit company, in a third party state, lead to legitimate or abusive tax avoidance, if the purpose thereof is to benefit from the third party state's treaty network?
- Should the incorporation of a conduit company be seen as abusive tax avoidance, should it be controlled through bilateral anti-treaty shopping provisions or domestic anti-avoidance provisions (Krishna, 2009)?

3.3 CONDUIT COMPANIES

In the 2002 reports related to the OECD MTC "Double Taxation Conventions and the Use of Conduit Companies" it was confirmed that a conduit company cannot normally be regarded as the beneficial owner if it only renders narrow powers as a mere fiduciary or administrator acting on account of the interested parties, in relation to the income concerned (OECD, 2002:26).

3.3.1 What is a "mere fiduciary"?

A "mere fiduciary" not being a beneficial owner, seems to be inconsistent. The reason therefore is that the Common law normally refers to a fiduciary as being the serious obligations that certain people or corporations are entrusted with. The responsibility that trustees have or that corporate directors are entrusted with for the administration of assets will earn them the title as a fiduciary (Krishna, 2009).

It is evident that the report therefore refers to a person that is under the direction of another person like a bare "agent or nominee" when it uses the term "mere fiduciary or administrator." (Krishna, 2009).

3.3.2 What is an "agent or nominee"?

The term 'agent' is not defined in the OECD's MTC and one therefore needs to revert to the specific law system for a definition. An agent is a person who is authorized, verbally or in writing, to act on behalf of another (referred to as the Principle) to create a legal relationship with other parties (Krishna, 2009).

3.3.3 The OECD's view on agents and nominees

In the OECD commentary to Article 10 paragraph 12, the OECD interpreted the view of the organisation. Paragraph 12 of the OECD commentary states that:

> "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 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." (OECD, 2002:154).

With the emphasis on agents, nominees and conduit companies acting as mere fiduciaries the OECD Commentary provided a rule of thumb for determining beneficial ownership. Any reserves / dividends that a mere fiduciary receives as a recipient entity, when it goes

into liquidation, would not be available for the general creditors. The true beneficial owner would claim these reserves / dividends unless the entity in liquidation is the true beneficial owner. In such a case the income would be available for the general creditors in the liquidation process (Baker, 2007).

3.3.4 Powers of management

The management of the conduit company's responsibilities would appear to have an influence in determining the beneficial owner of the shares and should be real for all practical aspects. Income should not purely flow through the company by way of predetermined contracts but the decision to distribute the income to its holding company should be that of the directors of the conduit company. The directors, as well as the entity itself, should therefore act according to what would be expected of directors and companies of a true nature, i.e. making independent decisions and acting as a true corporate entity (Krishna, 2009).

A conduit company will be seen to have a similar function to that of a nominee if it is under the obligation to pay all interest received by it to the party from which it borrowed monies, with very limited powers and without any discretionary powers (Van Weegel, 1998:73).

A corporate entity would normally have a bank account in order for customers to pay the income earned, as a result of its income producing activity, into the account of the entity and also for the company to pay its day-to-day expenses. Therefore, it would be a a disadvantage for the company in proving it is not just a conduit if it does not have its own bank account and accounts for example for dividends purely by way of journal entries instead of the cash actually flowing.

The nature and extent of rights and obligations retained by a party is important as to the determination of the beneficial owner. If the intermediary, interposed between the payer and recipient, is under a legal obligation to pay the amount received onwards, he cannot be regarded as the beneficial owner. The intermediary will be in a contract where he has limited powers and is acting as a mere administrator or fiduciary for the beneficial owner (Ryynänen, 2003:355).

Beneficial ownership is forfeited in the pre-mentioned scenario based on the fact that there is a legal obligation to on-pay the specific payment. In contrast, a recipient will be regarded as the beneficial owner if he is entitled to use the payment received to fulfil general obligations. An intermediary will also not be regarded as the beneficial owner when a third party has an enforceable right against the intermediary, thus the intermediary has an obligation to transfer and the third party has a legal right to acquire (Ryynänen, 2003:355).

In a case in the Netherlands however, Van Brunschot concluded that the *Hoge Raad* is of the opinion that a person can be considered to be the beneficial owner if he is contractually obligated to pay the largest part of the income to third parties (Van Weegel, 1998:77).

3.3.5 Characteristics of holding companies

Holding companies are usually set up in attractive locations (countries) were the following 4 criteria are present (Lowtax.net, Not dated):

- Incoming dividends: The jurisdiction in which the subsidiary is incorporated must either have low withholding tax rates or exempt dividends from tax if it is paid to the holding company.
- Dividend income received: On the other side of the coin, what is equally important is that the dividend that is received by the holding company from the said subsidiary and is not exempt from tax or be subject to very low corporate income tax rates.
- Outgoing dividends: As with incoming dividends the dividends that is paid by the holding company must also be subject to low withholding tax rates or be exempt from taxes if paid to the ultimate parent company.
- Capital gains tax on sale of shares: If the holding company sells the shares in the subsidiary, the profits realized must also, as with dividends, be subject to low capital gains tax rates or be exempt from taxes.

Where the criteria mentioned above is present, parent companies will set up various holding companies in order to make use of possible tax avoidance. In some cases this

would be conduit companies for the sole purpose of obtaining lower tax rates (Lowtax.net, Not dated). This can be used for interest, dividends and/or royalties.

3.3.6 Commercial reasons for holding companies

Valid business reasons often exist for the establishment of a holding company, which is not mainly driven by favourable tax treaties. Companies often incorporate holding companies to consolidate its foreign subsidiaries in a particular region or business section. This will therefore be beneficial for the main company as it now consolidates all its foreign subsidiaries under one foreign holding company. Multinationals, will normally use holding companies to manage investments in various subsidiaries in particular regions such as Europe, Africa or South America. This might not only be beneficial for management and reporting purposes but also create the opportunity for the foreign holding company to act as gateway for the creation of a platform in order to expand the group into new markets and regions and to expand business opportunities in these regions (Ernst & Young, 2009).

The creation of a foreign holding company can also be beneficial from a cash flow perspective. The holding company can hold all excess cash in the group and re-distribute the cash amount the foreign subsidiaries on loan account. The group therefore fund operations internally through intercompany loan accounts, instead of borrowing cash at banks at higher interest rates. This will improve the enterprise's capital structure due to better financial risk management and improved treasury efficiency (Ernst & Young, 2009).

3.3.7 Combating conduit companies

Various approaches have been designed by countries to attempt to deal with the issue of conduit companies. One solution is to deny treaty benefits if the company is not resident in one of the Contracting States. The company would therefore be only a "look through" (OECD, 2008:51).

The OECD proposes that the following paragraph is added to counter the "look through" approach:

> "A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State." (OECD, 2008:51).

This would be an adequate basis to use in countries with no tax or very low taxation but even in these cases it would sometimes be necessary to alter the provision to safeguard *bona fide* business activities in countries where little substantive business activities would normally be carried on (OECD, 2008:51).

3.3.8 Converting the nature of income

It is important to note that a company can also be seen as a conduit company even if it does not do a back-to-back dividend. A company can be seen as a conduit when it is used to convert the character of the income. This can be done in various ways. A very common occurrence is the method of interest-in-dividends-out or *visa versa*.

An example of the interest-in-dividends-out method can be explained as follows: Holdco is situated in Country A and has a subsidiary, Subco, in Country S. Country S and Country A does not have a tax treaty. Holdco incorporates a conduit, Conco, in Country C and sell the investment in Subco on an interest bearing loan account to Conco. Country S and Country C have a tax treaty in place with a very low withholding tax rate on dividends but a very high tax rate on interest. When Subco declares a dividend to Conco, Conco pays the interest on the loan account equal to the dividend received as the withholding tax rate on dividends is very low compared to the rate on interest between Country C and Country A.

The above example therefore illustrates that instead of Subco paying the dividend directly to Holdco, and becomes liable for withholding tax at a very high rate in Country S, it only incorporates a conduit to change the nature of the income and receive favourable withholding tax rates, although there are no employees or business activity in Conco.

Krishna, 2009 actually points out an additional example where companies operate in high tax jurisdictions, taking note that the conduit is allowed to deduct all its expenditure. The income that a company receives in Country A is channelled to a low tax jurisdiction through a third jurisdiction. Country A pays interest, dividends and royalties to the conduit company in Country B and takes advantage of the tax treaty between the two countries.

Instead of on-paying the income as dividends, interest and royalties to Company C in Country C, the income is paid as expenses in the form of interest, commission, services fees and management fees from Country B to Country C. The result is that Company A in the high tax jurisdiction has a “loss before tax” or very low profit before tax and does not pay significant tax in Country A. Company B breaks even as it paid all the income it received in the form of interest, dividends and royalties as interest, commission, service fees or management fees to Company C in Country C which has a very low tax rate.

3.3.9 Royalty conduit companies

The conduit company principle is not only relevant to dividends and interest, but can also be used in royalty payments where a company is placed between, for example a patent owner and the licensee, for the sole purpose of obtaining fiscal advantages. One country that is commonly used to set up conduit companies is the Netherlands (Lowtax.net, Not dated).

Although this research study excludes Royalties, the conduit company principle is explained by the following example for completeness purposes as it demonstrates a different angle of the use of conduit companies:

Software Ltd, a company based in Country 1, developed a security product for credit cards. Moneycards Ltd, a company based in Country 2 wants to make use of the software on their credit cards that they issue internationally to financial institutions. Software Ltd and Moneycards Ltd enter into an agreement whereby Moneycards Ltd will pay Software Ltd €0.15 for each card on which they install the security software of Software Ltd on a month basis.

For the use of this example please note the following:

- The DTA between Country 1 and Country 2 levies withholding tax at a rate of 10% on royalty payments from both countries to one another.
- Country 1 and the Netherlands have a DTA in which it states that royalty payments from Country 1 to the Netherlands or vice versa have a withholding tax rate of 0%.
- Country 2 also has a DTA with the Netherlands in which withholding tax is levied at a rate of 0% on royalty payments to and from the Netherlands.
- Transfer pricing and the arm's length principle is ignored for illustrative purposes.

The results of the above example are as follows:

If Moneycards Ltd pays Software Ltd the royalty fee that it is liable for, it must withhold 10% withholding taxes which must be paid over to their local revenue authority. Instead of licensing the software directly from Software Ltd to Moneycards Ltd, Software Ltd incorporates Sharpshoe Ltd in the Netherlands.

Software Ltd then enters into a contract in which it licences the software to Sharpshoe Ltd and gives it the right to on-licence the licence to any other party in Africa and must pay Software Ltd €0.15 for each card any sub-licensee issues .

Sharpshoe Ltd then enters into a licence agreement with Moneycards Ltd under the same terms that was applicable if Software Ltd contracted directly with Moneycards Ltd, i.e. €0.15 for each card on which they install the security software of Software Ltd.

The result of the above incorporation of Sharpshoe Ltd in the Netherlands is that Moneycards Ltd will not be required to pay over withholding taxes to their local revenue authority as the withholding taxes on royalties between Country 2 and the Netherlands is 0%.

Sharpshoe Ltd then pays over the royalty fee it is liable for over to Software Ltd. As the DTA between Country 1 and the Netherlands state that withholding tax is levied at 0% on

royalty fees, no withholding taxes is payable on the payment from Sharpshoe Ltd to Software Ltd.

The end result is thus that Software Ltd receives the full €0.15 and not €0.15 less 10% withholding taxes per card that is issued by Moneycards Ltd.

The Netherlands has since changed their tax system to include Advance Pricing Agreements and Advance Tax Rulings after 2001 in order to prevent pure flow through companies unless they can prove that there is both an operational and economical substance (Lowtax.net, Not dated).

3.4 RECENT DEVELOPMENTS

3.4.1 China

The Chinese State Administration of Taxation (“SAT”) is coming down very hard on conduit companies and issued circular Guoshuihan [2009] No. 601 (“Circular 601”) on 27 October 2009. In Article 1 of the circular, "Beneficial Owner" is defined as the person, being an individual, corporation or other organization, that has the ownership and control over the income or the rights or assets that generates such income, being dividends, interest and royalties and engages in substantive business activities (Ernst & Young, 2009).

The circular not only specifically excludes agents and conduit entities but also defines conduit entities as those entities that are established for the purpose of evading or reducing tax in the residence jurisdiction. These conduit entities barely have enough substance to meet the minimum legal requirements imposed by the residence countries and do not perform manufacture, distribution or management functions that are deemed to be substantive business activities (Ernst & Young, 2009).

3.4.2 Testing if beneficial ownership is present

In determining if beneficial ownership is present in a transaction, tax authorities often use one of two tests: the technical test or the substance-over-form test. The difference between the two tests is that with the technical test, the recipient's ownership of the income will be examined to determine whether or not restrictions apply thereto, i.e. is he entitled to the income? The substance-over-form test will look at the economic reality of the transaction, and ignore the legal form thereof (Ernst & Young, 2009).

Circular 601 further states that in the determination of the term "beneficial ownership" one should not limited oneself only to the outcome of the tests performed, but take the facts and circumstances of each case into account as well as the objectives of the DTA (i.e. to avoid double taxation and the prevention of fiscal evasion) between the two Contracting States (Ernst & Young, 2009).

In order to provide more clarity, in determining if the non-resident is entitled to the treaty benefits between China and the other Contracting State, the SAT issued a list of factors that are considered unfavourable in the determination of a non-residents status as the beneficial owner:

- The applicant is under obligation to distribute or pay all or a majority thereof (for example 60% or more) of the Chinese sourced income to a party in a third jurisdiction within a prescribed timeframe (for example within 12 months).
- The applicant does not perform any other substantial business activities that generates income, other than holding rights or properties that generates income, i.e. the applicant does not generate significant amounts of active income.
- The applicant is a corporation or operates in another form of business entity, and the income received is not in line with the type of business, taking into consideration the applicant's assets, market share, operations and amount of employees.
- The applicant bears little or no risk in generating income and has little or no right relating to the control or disposal of the assets, or rights, that generates the income or on the income itself.

- The applicant's country, or region, does not levy tax on foreign sourced income, has no taxes or tax the income at a very low rate (Ernst & Young, 2009).

The SAT went a step further and specifically included two sections, one relating to interest and one on royalties which states:

- The applicant have a loan, or deposit agreement, with another party that mirrors or resemble the same terms and conditions, i.e. interest rate, amount, payment terms, etc. as that of the primary loan agreement between the applicant and Chinese entity.
- The applicant does not generate royalty income from other parties on the same copyright, patents and technology that is licensed to the applicant and on similar terms and conditions (Ernst & Young, 2009).

It is evident that the amount of business activities of the applicant is an important factor (Ernst & Young, 2009).

3.4.3 Limitation on Benefits

The LoB provisions contains anti-treaty-shopping provisions that forms part of most new US tax treaties and focuses on the series of objective tests instead of the intention of the transactions. Thus, regardless of the reasoning behind a specific business structure, if a resident of a Contracting State satisfy any one of the tests provided, the resident will receive all the benefits. Article 22 consists of 5 paragraphs of which only certain paragraphs are discussed below (US Treasury, 2006).

3.4.3.1 Paragraph 1:

Paragraph 1 sets out that a resident will not automatically qualify for the benefits of a Convention, but needs to meet the requirement of a "qualified person" that is set out in paragraph 2 of Article 22. Article 22 therefore assists the authorities to determine if the party that wants to make use of the treaty has a sufficient connection to the Contracting State while the US, as most other countries, anti abuse provisions in its domestic law normally address the substance-over-form, conduit principles, etc. (US Treasury, 2006).

3.4.3.2 Paragraph 2:

Although paragraph 3 of Article 22 sets out criteria for residents to qualify for benefits, paragraph 2 sets out criteria for residents that will be entitled to all benefits of the treaty. Paragraph 2 has various subparagraphs to cater for various types of residents. Governments and Tax exempt organisations will not be discussed (US Treasury, 2006). Individuals that is resident in a Contracting State will be entitled to all benefits of the treaty unless the individual is acting as an agent and therefore not the beneficial owner of the income (US Treasury, 2006).

Companies are more complex as provision is made for principal class of shares, disproportionate class of shares, recognised stock exchange, primary place of management and control, aggregate votes and value of shares as well as indirect ownership situations (US Treasury, 2006).

Paragraph 2 of Article 22 provides that a resident company of a Contracting State will be a qualified person if the company's principle class of shares, as well as any disproportionate class of shares, is regularly traded on one or more recognised stock exchange. Furthermore the resident company must both have its primary place of management and control in the local Contracting State, or its principle class of shares must be primarily traded on the resident company's local recognised stock exchange (US Treasury, 2006).

Paragraph 5 of Article 22 defines "recognised stock exchange" as:

> "i) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; (ii) stock exchanges of […]; and (iii) any other stock exchange agreed upon by the competent authorities". (US Treasury, 2006).

Various companies have more than one type class of shares. Ordinary and Preferred shares are the most common types of classes of shares. A company with more than one

class of shares therefore needs to determine which class of shares is the “principle class of shares”. (US Treasury, 2006).

Paragraph 5 defines “principle class of shares” as:

> “…the ordinary or common shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. If no single class of ordinary or common shares represents the majority of the aggregate voting power and value of the company, the “principal class of shares” are those classes that in the aggregate represent a majority of the aggregate voting power and value of the company.” (US Treasury, 2006).

Article 22 also refer to "disproportionate class of shares", and companies with various classes of shares need to be careful not to have any "disproportionate classes of shares" as this might disqualify them from the benefits of the treaty even though there primary class of shares are primarily traded on a recognised stock exchange (US Treasury, 2006).

A "disproportionate class of shares" is defined as:

> “…any class of shares of a company resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other State by particular assets or activities of the company.” (US Treasury, 2006).

The terms regularly traded and primarily traded is not defined in the treaty. As per the general rule in tax treaties, if a term is not defined, it will have the meaning under the applicable law, domestic law, of the Contracting State to which the treaty applies (US Treasury, 2006).

With reference to the US interpretation, a class of shares will be regarded as “regularly traded” if for more than 60 days during the tax year, trades in the class of shares are made, but excludes days where only *de minimis* quantities were traded and as an additional requirement, the cumulative number of shares traded, being the same class of

shares that met the 60 days requirement, accounts for a minimum of 10% of the average shares outstanding during that tax year (US Treasury, 2006).

Shares will be “primarily traded” if the total number of principle class of shares that was traded, in any single foreign country outside the Contracting State where the company is resident, on an established securities market, does not equal or exceed the total number of shares, in the same principle class of shares, that is traded on all recognised stock exchanges in the Contracting State of which the company is resident (US Treasury, 2006).

Article 22 does however allow for relief if companies don’t meet the requirement of having its principle class of shares primarily traded on the resident company’s local recognised stock exchange. A company will be entitled to all the benefits if the company has its primary place of management and control in the local Contracting State (US Treasury, 2006).

Article 22 defines "primary place of management and control" as follows:

> “… a company's "primary place of management and control" will be in the Contracting State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that State than in any other state and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions in that State than in any other state.” (US Treasury, 2006).

The OECD Model uses the “place of effective management” principle which has been interpreted to where directors meet and hold the annual directors meetings. This differs from the "primary place of management and control" as the latter looks at the overall activities of the relevant persons (US Treasury, 2006).

The question however is; which persons are executive officers and senior management employees, as employees of subsidiaries might also qualify if they make strategic, financial and operational policy decisions. One can however not just look at the Board of

Directors as one must also determine if any special voting arrangements exist. Certain board members can possibly make decisions without the required participation of the other board members (US Treasury, 2006).

Listed companies normally have one or more subsidiaries in the same country that it is resident. Subsidiaries of which 50% of the aggregate vote and value of the shares (including 50% any disproportionate class of shares) is held, directly or indirectly, by five or fewer publicly traded companies, will also be entitled to all the benefits of the convention provided that where indirect holding occurs, each intermediate must be a resident of either of the Contracting States involved (US Treasury, 2006).

Article 22 also provides for persons, other than individuals, thus any other form of legal entity that is not previously dealt with, might qualify for treaty benefits if they are residents of either Contracting State and meet the requirements of the ownership and base erosion tests set out in paragraph 2(e) of article 22 (US Treasury, 2006).

The ownership test requires 50% of the aggregate voting power as well as 50% of all classes of shares and beneficial interests is held, directly or indirectly, by residents of that Contracting State, on at least half the days of the taxable year. The 50% ownership requirement must be held by persons that is entitled to all the benefits of the Convention under Article 22, paragraphs 2(a), (b), (c)(i) or (d) (US Treasury, 2006).

The base erosion test however focuses on the person's gross income, for the taxable year, as calculated in that person's State of residence. If the gross income, paid or accrued, directly or indirectly, to non-resident persons of either Contracting State, and the non-resident would have qualified for benefits of the convention under Article 22, paragraphs 2(a), (b), (c)(i) or (d), and the gross income paid or accrued is in the form of tax-deductible payments covered by the specific convention in the payer's State of residence, is less than 50%, the person will be entitled to the benefits of the Convention. Items such as depreciation and amortisation do not constitute payments as such and are disregarded for purposes of the test. Payments made for services and tangible property that are in the ordinary course of business and at arm's length are excluded (US Treasury, 2006)

3.4.3.3 Paragraph 3

In paragraph 3 provisions is made for a resident to be deemed a qualified person in order to enjoy treaty benefits with respect to certain income if the resident conducts an active trade or business. Paragraph 3 requires that the income is derived in connection, or is secondary to, that trade or business (US Treasury, 2006).

The US defines the in terms of section 367(a) the term “trade or business” as an integrated group of activities that could constitute an independent economic enterprise carried on for profit (US Treasury, 2006).

In the US explanatory memorandum to Article 22 it states that:

> “An item of income is derived in connection with a trade or business if the income producing activity in the State of source is a line of business that “forms a part of” or is “complementary” to the trade or business conducted in the State of residence by the income recipient.” (US Treasury, 2006).

The question that arises is when a business activity “form a part of” a trade or business? The manufacture, design or sale of the same products, will be considered a business activity if the main activity of the resident is that of manufacture, design or sale of the same products in the State of source. If similar services are provided it will also be deemed to “form a part of” the trade or business (US Treasury, 2006).

Dividends will be considered to be secondary from other earnings and profits and primarily from earnings of profits of the treaty-benefited trade or business (US Treasury, 2006).

Paragraphs’ 3 & 4 deal with various other matters and does not pertain to determine beneficial ownership relating to dividends and interest and is therefore not discussed in any further detail.

3.4.4 Circular 601 in line with previous court rulings

In 1971 the US Tax Court ruled in Aiken Industries, Inc. v. Comr. 56 T.C. 925 (1971), that mere "physical possession on a temporary basis" of income is not sufficient to be treated as the beneficial owner but that the recipient must have complete “dominion and control” over the income received (Ernst & Young, 2009).

Circular 601’s first unfavourable factor listed deals specifically with this matter where a recipient is obligated to distribute the income to another party that otherwise would not be entitled to the benefits listed in the Chinese tax treaty. The Aiken case however did deal with the question as to whether the recipient had substantial business operations is further listed by circular 601. The court found in the Aiken case that the conduit company cannot be the beneficial owner of the interest income generated by a back-to-back finance agreement which concurs with the aid of circular 601 (Ernst & Young, 2009).

3.5 EXAMPLE OF PROBLEM AREAS

3.5.1 Hidden beneficial owner’s

In cross-border investments, certain corporate vehicles make it difficult to identify the beneficial owner. These vehicles mainly consist of Corporations, Trusts and Foundations. Trusts normally separate legal ownership from beneficial ownership and is used primarily in Common law states. Some jurisdictions do not require a trust to register, which allows the legal owner to hide his or her identity as beneficial owner (Komisar, 2001). Examples of the integration of corporate vehicles in order to achieve anonymity in respect of beneficial ownership are discussed below.

Different jurisdictions is used, especially those where beneficial ownership is not maintained or not easily available. An international business corporation (“IBC”) is established in country A. IBC 1 is owned by IBC 2 which is established in Country B. IBC 2 is owned by a trust which is established in country C. Country C does not require trusts to be registered. It will therefore be a daunting task for the authorities to determine the beneficial owner of IBC 1 (Komisar, 2001).

Another mechanism for achieving anonymity is the use of bearer shares in certain countries. A bearer share is a negotiable instrument. The physical possession of the bearer share certificate accords ownership in the specific corporation. Bearer shares are not registered and do not contain the name of the shareholder. The company is normally exempt from the requirement to maintain a share register in respect of the bearer shares. Bearer shares are therefore an effective way to obscure ownership and have a high level of anonymity (Komisar, 2001).

3.5.2 United States of America

In a surprising step, The US Internal Revenue Service ("IRS"), have taken steps against banks to disclose information to them regarding tax cheats. Known as the "John Doe" summons, banks and or credit card companies are summoned to provide account information of all their U.S. clients with secret offshore accounts. The reason for this is that U.S. taxpayers' used sham companies. These companies are formed in tax havens to disguise beneficial ownership (Komisar, 2009).

The example given by Daniel Reeves, an IRS agent is as follows: "The U.S. taxpayer establishes an International Business Company ("IBC") in an offshore financial system, and then opens a brokerage account in the name of the IBC. The brokerage account then claims foreign status. The brokerage account, money and bank accounts are all in the U.S. But by claiming foreign status, it claims to be exempt from capital gains tax in the U.S." (Komisar, 2009).

3.6 CONCLUSION

A taxpayer can arrange its affairs in such a manner to benefit from a particular provision of a tax treaty as per MIH Investments S.A. v The Queen. It would appear that one of the criteria to be the beneficial owner would be that, there should not be any enforceable right that can force the intermediary to pay the majority of the amount received onwards within a specific timeframe. Further requirements would appear to be that the entity should be able to prove operation and economical substance as is evident from both Circular 601 and the LoB Article of the MTC of the US.

In proving that the company is not merely a intermediary, one might need to proof that the company has a fixed place of business located in that country, is suitably staffed with managerial and operational employees and has suitable equipment and facilities available for conducting the primary operations of that business, as per the Foreign Business Establishment criteria contained in Section 9D of the South African Income Tax Act 58 of 1962. The sharing of any of these criteria with other companies in the same group of companies might count against a company as proof that it is not just a conduit.

A company without a bank account, which operates purely on journal entries, appears also to encounter difficulty in proving that it is not purely a conduit company and can also be seen as a conduit company even if it does not have back-to-back loans or dividend payments but uses the dividends-in-interest-out concept. The focus is therefore that a company recipient must operate in such a way that it can be seen as an independent company which have both operational and economical substance.

CHAPTER 4

DIVIDENDS

4.1 INTRODUCTION

In Chapter 3, the concept of Tax treaty shopping and conduit companies was discussed in detail. As explained, treaty shopping arises where a tax treaty is utilized by third-country nationals and normally occurs with the intent to utilize or achieve tax treaty exemptions and beneficial withholding rates upon the repatriation of income to non-treaty nations (Gadbois, 2009).

Repatriation of income, being returns on a foreign investment, is normally in the form of a dividend. Companies might disguise dividends as services fees or management fees in order to obtain more beneficial tax rates than when profits are repatriated as a dividend.

Profits on investments, in the form of dividends, might be subject to withholding tax in the country of origin. There are various reasons for the levying of taxes on dividends. One of the reasons is that the government of the origin state wants to be compensated for the use of the infrastructure of the country, by the local company that is paying the dividend.

Tax jurisdictions have various laws regarding the taxation on income. Some jurisdictions tax a person if that person is resident, as defined in that country's tax law, in that county on its worldwide income while other countries tax persons based on the source of the income. Due to the differences in tax systems, the same income, and or dividend, might be subject to double taxation. Treaty relief is normally provided to the beneficial owner of the dividend.

It is important to identify when a dividend is paid, i.e. what a dividend is, even if it is disguised as management fees of service fees, but more importantly, one need to identify who is the true beneficial owner of the dividend, to determine if treaty benefits might be claimed if available.

4.2 MODEL TAX CONVENTION ON DIVIDENDS

4.2.1 Definitions of dividends

A dividend, in layman terms, is profits that are paid by the company to its shareholders. In a more technical sense the MTC and the UN Model defines a dividend as "…the income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident." (OECD, 2008:155).

The US Model takes a different road, but arrives at the same destination. The US Model defines "…for purposes of the Convention, the term "dividends" means income from shares or other rights, not being debt-claims, participating in profits, as well as income that is subjected to the same taxation treatment as income from shares under the laws of the State of which the payer is a resident." (US Treasury, 2006).

DTA's normally has a tie-breaker clause to determine in which Contracting State the resident will be deemed to be ultimately resident for DTA purposes, and therefore taxed. In some cases the dividend might be subject to taxation in both countries but at very low rates. Taking into consideration the differences in legal systems across the globe, Article 10 (2) of the OECD MTC (OECD, 2008:26) relating to dividends states that:

> "However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the Contracting State the tax so charged shall not exceed…"

4.2.2 OECD commentary on Article 10(2)

The OECD issued commentary to article 10(2) in order to explain its view on the matter and to provide some guidance. Their commentary is set out below.

In a partnership the profits of the partnership is that of the partners involved. The profits are theirs and they are taxed on it individually. In a company situation, the profits are not those of the shareholders but of the company. A shareholder is rewarded for the capital he made available to the company in the form of dividends. He is therefore only taxed on the profits that are distributed to him (OECD, 2008:150).

A question that arises is obviously, why not tax the dividends when it is paid in the country the company is resident? The reason therefore is that paragraph 1 of the Model Tax Treaty does not prescribe this principle or the principle of exclusively in the State of the beneficiary's residence of taxation on dividends. Taxing the dividends at the source is also not an option as some States do not have taxation on dividends at the source. All States, as a general rule, tax dividends received from non-resident companies by resident companies (OECD, 2008:150).

In order to avoid double taxation, fiscal evasion and avoidance, the term "beneficial ownership" was introduced in paragraph 2 of the MTC of article 10. It was also introduced to clarify the meaning of "paid… to a resident" in paragraph 1 (OECD, 2008:151).

An agent or nominee would normally not qualify for relief or exemption, even if they are residents of the Contracting State, due to the fact that they are not the beneficial owners and only act as a conduit for some shareholders (OECD, 2008:151).

Article 4, dealing with residents, supports this point with regard to income received by "fiscally transparent persons". According to the OECD Commentary to Article 10, certain persons that normally receive a dividend but in substance do not control it, may be disregarded in the source State as beneficial owner of the dividends (OECD, 2002:26).

4.3 CONCRETE DEFINITION FOR A DIVIDEND

As can be noted from the differences in definitions of the term dividend between the OECD MTC and the US MTC, various attempts have been made to conclude a definitive definition.

The OECD issued its view on Article 10(3), which contains its definition of a dividend, in its commentary which states:

> "In view of the great differences between the laws of OECD Member countries, it is impossible to define "dividends" fully and exhaustively. Consequently, the definition merely mentions examples which are to be found in the majority of the Member countries' laws and which, in any case, are not treated differently in them. The enumeration is followed up by a general formula. In the course of the revision of the 1963 Draft Convention, a thorough study has been undertaken to find a solution that does not refer to domestic laws. This study has led to the conclusion that, in view of the still remaining dissimilarities between Member countries in the field of company law and taxation law, it did not appear to be possible to work out a definition of the concept of dividends that would be independent of domestic laws. It is open to the Contracting States, through bilateral negotiations, to make allowance for peculiarities of their laws and to agree to bring under the definition of "dividends" other payments by companies falling under the Article."

It is clear that there is no concrete definition for what a dividend is and one therefore needs to revert to the domestic law of the applicable Contracting State.

In the technical explanation to Article 10 of the US Model Convention '96 it states that; "the beneficial owner of a dividend is understood generally to refer to any person resident in the Contracting State to whom that State attributes the dividend for purposes of its tax." (OECD, 2002:26).

4.4 RECENT DEVELOPMENTS

4.4.1 Canada

The term 'beneficial ownership' is not defined in the various tax treaties internationally. The default of tax treaties is that where a term is not defined, the undefined terms shall have the meaning attributed to them under the law of the state imposing the tax concerned (Marley & Samtani, 2009).

To date there is only a few court cases recorded worldwide that provide some guidance into the true meaning of the term 'beneficial ownership'. The most recent of these cases is the *Prévost Car, Inc. v. The Queen 2008 T.C.C. 231,* a case that was resolved in the Canadian courts pertaining to dividends (Deloitte, 2008).

The conduit company principle, which is sometimes used for tax avoidance, was especially discussed in the Prevost case. This became relevant as a Dutch intermediate company was incorporated to obtain a lower tax rate as per the DTA between Canada and The Netherlands instead of Canada and the UK. Something that was even more interesting in the case is the fact that the Dutch company had no employees, office or any significant assets. The only significant asset that the company held was the investment in Prevost (Deloitte, 2008).

The term 'beneficial ownership' was even reviewed extensively by the Judge in the Prevost case by consulting domestic and international case law, dictionary meanings and the OECD Commentary to the Model treaty (Deloitte, 2008).

The judge indicated that: "One do 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." (Deloitte, 2008).

The shortcoming and lack of a more exact interpretation of the concept of beneficial ownership and the considerable differences in opinion is regrettable, considering the constant international flow of dividends, interest and royalties. Although Article 3(2) of the OECD provides a general rule for terms not defined in a treaty the basic question whether the term is to be regarded as an independent treaty level concept or be interpreted in accordance with domestic law of a Contracting State, is also debatable (Ryynänen, 2003:349).

4.4.2 China

The SAT in the People's Republic of China ("PRC") issued various Circulars during 2009/2010 with reference to claiming beneficial withholding tax rates as provided for in the DTA between China and other Contracting States. In order to claim any reduced withholding tax rate, as provided for in a DTA with China, the SAT set out the following Circulars that a applicant need to comply with:

- Guoshuihan (2009) No. 81 ("Circular 81") – Implementation of the Dividends Article under DTA's;
- Guoshuihan (2009) No. 124 ("Circular 124") – Administrative Measures on Tax Treaty Treatment of non-residents; and
- Guoshuihan (2009) No. 601 ("Circular 601") – Interpretation and Recognition of "Beneficial Owner" under DTA's.

4.4.3 Circular 81

As a starting point, Circular 81 sets out criteria that need to be met in order to qualify for the beneficial rates under a DTA with reference to Dividends, between China and the other Contracting State:

- The non-resident recipient must be a tax resident of the other Contracting State;
- The non-resident recipient must be the beneficial owner (read with Circular 601) of the dividend;
- The dividend must be, a dividend or profit distribution as defined in China; and
- Any additional criteria set out by the SAT (PWC,2009).

In order for the applicant to make use of the treaty benefits, a minimum shareholding percentage might be required, which is currently not defined. Further to the above the SAT will disqualify an applicant if they do not meet the following additional criteria:

- The non-resident recipient must be a corporation;
- Both the participation rights and the voting rights threshold must meet the minimum shareholding requirements; and

- During the full 12 months preceding the dividend, the minimum shareholding threshold must be met for both the participation as voting rights (PWC,2009).

Once it has been established that the applicant qualifies for the beneficial rate, i.e. meets all the criteria above, the following documentation needs to be submitted by the recipient in order to obtain pre-approval from the SAT to claim the beneficial rate set out in the DTA:

- Tax resident certificate of the dividend recipient's Contracting State together with legal supporting documentation;
- The Tax profile of the dividend recipient's Contracting State, in relation to the dividends from China.
- If the non tax resident is also tax resident in a third tax jurisdiction, documentation regarding this;
- Whether the non tax resident recipient is also tax resident in the PRC?;
- Supporting documentation as proof that the dividend recipient, non tax resident, is entitled to the dividend;
- Documentary proof of the shareholding by the non-resident in the Chinese resident company (PWC,2009).

4.4.4 Circular 124

The SAT issued Circular 124 on 24 August 2009 and further sets out criteria for the pre-approval of non-residents to obtain treaty benefits. Circular 81 dealt with the jurisdiction's right to the beneficial rates, where Circular 124 focuses on the holding company and if it has substantial active business operations in the other Contracting State. Circular 124 require the applicant to submit the following documentation:

- Details of non-resident company's shareholders, but limited to the once that holds at least 10% of the shares in the company, and who are not residents of either the PRC or the other Contracting State jurisdiction;
- How the income is treated for tax purposes in the other Contracting State in which the applicant is incorporated;
- Ownership certificates, contracts, agreements, etc. relating to the income derived;

- Major operations and/or businesses of the non-resident company. However the SAT did not state if this is only in the non-resident company's jurisdiction or if it includes the jurisdictions in which the company's holding company operates;
- Gross income and number of employees of the non-resident company;
- Related party and intercompany transactions between the non-resident company and other entities outside the PRC (KPMG, 2009).

As part of the information above, various annexure's to Circular 124 also needs to be completed which forms part of the application.

4.4.5 Circular 601

A specific requirement to qualify for the treaty benefits, as per Circular 81, the non-resident recipient must be the beneficial owner of the dividends. In the previous chapter, the unfavourable factors of Circular 601 were discussed relating to Beneficial Ownership. As part of the ability to claim treaty benefits the non-resident recipient must be the beneficial owner as required by most DTA's.

The factors indicated in Circular 601 are only for indication purposes, which the SAT will use in its review. If the applicant passes the required tests, the SAT can still deem the applicant not to be the beneficial owner based on the review of all the information received. Applications will work on a case-to-case basis and will not set precedent for other investments.

4.5 CONCLUSION

It is without doubt that the SAT is aiming to allow beneficial treaty rates only to companies whose holding companies are operating as a proper business operation with employees, a fixed place of business, bank account, etc. The required time period the investment is held, both for participation and voting rights, will limit the abuse of structuring investments for short term tax treaty shopping.

The term ‘beneficial ownership’, in relation to dividends, can therefore not be limited to one sentence but is subject to various requirements currently. With the requirements set out by the SAT, it is evident that the requirements are what one expects from a normal business operation and could therefore form the basis of the term ‘beneficial owner’ in relation to dividends.

CHAPTER 5

INTEREST

5.1 INTRODUCTION

Tax treaty shopping is not limited to dividends but also exist for interest payments. This is due to the fact that some companies would create interest bearing loans with other companies in their group to extract cash from the business and therefore would need to pay withholding taxes on the interest that is paid. The group would therefore interpose an intermediate company with which both companies have favourable DTA's and then make back-to-back loans in order to obtain the beneficial withholding tax rates.

Interesting enough is that the only case up to date was not between a taxpayer and revenue authority to attack such a structure, but between two taxpayers. In the *Indofood International Finance Ltd v JP Morgan Chase Bank NA* the Court had four issues to deal with, but the most important one of these was whether a Dutch Special Purpose Vechicle ("SPV") would be the beneficial owner of interest payments made by Indofood for the purposes of the relevant DTA's (Baker, 2007).

5.2 MODEL TAX CONVENTION ON INTEREST

In Article 11 (2) of the MTC relating to interest it is stated that:

> "However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest …". (OECD, 2008:171).

The OECD commentary to article 11(2) states that interest generally mean remuneration on money lent. Interest differs from dividends on the tax field as it is not subject to double taxation. Interest is normally taxed only in the hands of the recipient. The problem with

interest arises when one of the Contracting States taxes at source and the other state on a resident level (OECD, 2008:171).

5.2.1 Recent developments

In the *Indofood International Finance Ltd v JP Morgan Chase Bank NA* case, the issue of beneficial ownership in relation to interest received was dealt with. An Indonesian company wanted to raise a loan for business purposes through a Mauritian company in order to obtain a lower withholding tax rate of 10% (Baker, 2007).

If the Indonesian company had done so directly, the rate would have been 20%. Indofood, with JP Morgan acting as trustee for the bondholders, obtained a 10% benefit on the interest paid between Indonesia-Mauritius Tax Treaty and the interest paid to the bondholders was not subject to withholding tax as it was paid from Mauritius (Baker, 2007).

The amount borrowed, as well as the interest rate, was identical to that which the Mauritian company borrowed and on-lend to the Indonesian parent. Although the documentation stated that the interest be paid by the Indonesian company to Mauritius on day 1, and on day 2 from Mauritius to the trustees the interest was paid directly from Indonesia to the trustees. None of the interest could be retained by the Mauritian subsidiary as it was obligated to on-pay all interest received (Baker, 2007).

The main instigator of the court case was the fact that the Mauritian-Indonesian Tax Treaty was cancelled resulting that the 10% beneficial rate is no longer available. JP Morgan suggested that a company in the Netherlands be incorporated. However two arguments were then raised to show that the Dutch company would not be appropriate.

Firstly, it would not be the beneficial owner of the interest and secondly it would not be a resident in the Netherlands for treaty purposes. One of the most important findings by the court is that the court decided that the term “beneficial owner” should have an international fiscal meaning, thus resulting in the fact that it would have the same meaning in all

countries. The biggest question is therefore how to find this international fiscal meaning (Baker, 2007).

5.2.2 Important confirmations from Indofood case:

In the judgement of the Indofood case the Court of Appeal explicitly relied on the OECD published reports and the 1986 and 2003 Commentaries on the OECD Model Convention on Income and on Capital. The judgement reiterated the commentary on articles 10 to 12 of the OECD and it therefore shows that the Court, in contrast to a "narrow technical" domestic law meaning, adopted an "international fiscal meaning" for the term 'beneficial owner' (HMRC, Not dated:c).

The court relied on various important sections. Paragraph 35 of the judgement reiterated:

> "Articles 10 to 12 of the OECD Model deny the limitation of tax in the State of source on dividends, interest and royalties if the conduit company is not its "beneficial owner". Thus the limitation is not available when, economically it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income…The Commentaries mention the case of a nominee or agent. The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has a similar function to those of a nominee or an agent. Thus a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary of an administrator acting on account of the interest parties". (HMRC, Not dated:c).

Paragraph 26 of the judgement continued with the Commentary of Article 11:

> "Where an item of income is received by a resident of a Contracting State acting in the capacity of agent of 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. …no potential double taxation arises … since the recipient is not

> treated as the owner of the income… 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 and agency of nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons … 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 …" (HMRC, Not dated:c).

The court also quoted the 2005 Commentary on Article 11:

> "The requirement of beneficial ownership was introduced in paragraph 2 of Article 11 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 interest income merely because that income was immediately received by a resident of a State with which the State of source had 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." (HMRC, Not dated:c).

The Court confirmed that recipients will not be the beneficial owner of income if they are obligated to pass on the income as the recipient, the beneficial owner under an international fiscal meaning, will not "enjoy the full privilege to directly benefit from the income" (HMRC, Not dated:c).

5.2.3 Guidence by the Her Majesty's Revenue and Customs ("HMRC")

The HMRC issued draft guidelines after the Indofood case as to their view on the term 'beneficial ownership' in relation to interest. The HMRC (Not dated:a) states that Beneficial ownership can be defined as "*the sole and unfettered right to use enjoy or dispose of*" the asset or income in question.

As stated before, the DTA normally only provides beneficial withholding tax rates to the beneficial owner of the assets of income in question. It is also important to distinguish between the beneficial owner of the asset itself and the beneficial owner of the income that is generated. Thus the beneficial owner of the tree and the beneficial owner of the fruit might be different. Most DTA's allows relief for the beneficial owner of the income while the beneficial owner of the asset will obtain relief under the FORTA (Free of Tax to Residents Abroad) regulations in the UK. FORTA status is applicable on all UK Government securities (HMRC, Not dated:b).

Where there is no distinction made between legal ownership and beneficial ownership in the Contracting State's, the DTA might not specify the beneficial owner condition for relief but the DTA will require in such cases that the income must be subject to tax in the other Contracting State. From a practicality perspective, the person that is subject to tax on the income will be deemed to be the owner (HMRC, Not dated:b).

The HMRC confirmed that where an intermediate company is inserted and the both the intermediate company and the underlying lender are residents in Contracting States with which the UK has DTA's, and the DTA's are essentially similar, they will not deem the intermediate to be part of fiscal evasion or avoidance as the result of the transaction would have been the same if no intermediate was imposed. However this is only for the determination of rates to be used (HMRC, Not dated:d).

5.3 CONCLUSION

The Indofood case shed some light on the term 'beneficial owner' in relation to interest payments. However, the same principal would apply for dividends as was confirmed by the SAT, that the recipient would not be the beneficial owner if it is obligated to pay the dividends onwards within a specific time frame.

The Court in the Indofood case ruled that the term 'beneficial owner' should not derive from domestic laws of Contracting States but should have an "international fiscal meaning" and quoted various OECD commentaries on the matter. The HMRC issued their guidance regarding beneficial ownership after the Indofood case and are in agreement with the

judgement handed down by the UK Court, even though a UK taxpayer was not involved. The Court of Appeal is also of the view that the term ‘beneficial owner’ must have an international fiscal meaning and shouldn’t be in interpreted in a very narrow technical sence.

It is therefore clear that the Court as well as the HMRC is of the view that the true beneficial owner must have the right to the income from the assets and to use the asset and income as it deems fit without interference from its shareholders or any other outside party.

CHAPTER 6

CONCLUSIONS

6.1 INTRODUCTION

In Chapter 1, four questions were raised that forms the basis of the research performed. The specific questions to be addressed were:

- What is the meaning of the term ‘beneficial owner’ for tax treaty purposes?
- What factors should be taken into account to determine the beneficial owner?
- What is the meaning of the term ‘beneficial ownership’ in the context of those tax treaties where the term has been incorporated?
- Should the term ‘beneficial owner’ have a domestic law, international tax or tax treaty meaning?

The four questions listed above have been discussed in the preceding chapters, with some of the findings supporting more than one of the questions that were raised. Below is a summary of the findings pertaining to each of these questions.

6.2 WHAT IS THE MEANING OF THE TERM ‘BENEFICIAL OWNER’ FOR TAX TREATY PURPOSES?

As discussed in Chapter 3, there is currently no universally accepted definition for the term ‘beneficial ownership’, which evidently, leaves the door open to interpretation. This therefore reiterates the question as to what is the meaning of beneficial ownership for tax treaty purposes. The term was originally introduced to counter tax treaty shopping and the use of conduit companies.

The term ‘beneficial ownership’, in relation to dividends and interest, cannot be limited to one sentence but is subject to various requirements currently. With the requirements set out by the SAT, it is evident that the requirements are what one expects from a normal

business operation and could therefore form the basis of the term 'beneficial owner' in relation to dividends.

The Court, in the Indofood case, as well as the HMRC, is of the view that the true beneficial owner must have the right to the income from the assets and to use the asset and income as it deems fit without interference from its shareholders or any other outside party.

One can conclude that, taking various factors into consideration, the applicant, being an individual, company or any other legal form, must have in the words of the HMRC (HMRC, Not dated:a) "*the sole and unfettered right to use and enjoy or dispose of the asset or income*" in order to be viewed as the beneficial owner.

One therefore need to take cognisance of the factors below to determine if the recipient has "*the sole and unfettered right to use and enjoy or dispose of the asset or income*", and thereby be defined as the beneficial owner (HMRC, Not dated:a).

6.3 WHAT FACTORS SHOULD BE TAKEN INTO ACCOUNT TO DETERMINE THE BENEFICIAL OWNER?

An individual would have paid for the shares and be able to do with the asset and income as he/she pleases. However, persons other than individuals, i.e. companies, etc. must therefore be in such a position that it replicates an individual or group of individuals. In order to establish the latter, various factors need to be addressed to determine if the legal form that is used can be deemed to have the same type of rights as the ultimate individual.

If a legal entity have the same rights as the ultimate individual, various factors need to be accounted for. For this reason one need to take cognisance of the factors that is set out in the Circulars issued by the SAT as well as LoB clause in Article 22 of the model US treaty for the identification of companies as qualified persons.

The LoB clause, aims to provide benefits to "qualified persons". If one takes the context of the clause into consideration, it is aimed at providing relief to an individual that is resident

in the Contracting State. As not all shares are held by individuals, the intermediate companies, trust, etc, should have such rights as what an individual would have had, had the individual at the end held the share directly. The LoB can therefore be aligned with the Circular's issued by the SAT.

The requirements set out in the various Circulars of the SAT, also set out requirements that the recipient must be tax resident in the other Contracting State and be the beneficial owner. In Chapter 3 the factors were set out that the SAT considers as unfavourable in the determination of the beneficial owner. Chapter 3 also dealt with conduit companies, a mere fiduciary, agent and/or nominee. These legal forms cannot use and enjoy or dispose of the income or asset as if it is his own

In proving that the company is not merely a intermediary, one might need to proof that the company has a fixed place of business located in that country, is suitably staffed with managerial and operational employees and has suitable equipment and facilities available for conducting the primary operations of that business, as per the Foreign Business Establishment criteria contained in Section 9D of the South African Income Tax Act 58 of 1962. The sharing of any of these criteria with other companies in the same group of companies might count against a company as proof that it is not just a conduit.

A company without a bank account, which operates purely on journal entries, appears also to encounter difficulty in proving that it is not purely a conduit company and can also be seen as a conduit company even if it does not have back-to-back loans or dividend payments but uses the dividends-in-interest-out concept. The focus is therefore that the company recipient operates in such a way as if it is independent and has operational and economical substance.

In Chapter 4, additional factors were listed that the SAT set out in order to be able to claim any beneficial rate provided for in a tax treaty with the PRC relating to dividends. The factors set out are clearly set out to prevent companies from setting up conduit companies in order to obtain beneficial rates that would otherwise not be available. The PRC look beyond the recipient company and examine the total structure of the group.

In Chapter 5, beneficial ownership regarding interest was discussed. The Court found in the Indofood case, that the true beneficial owner must have the right to the income from the assets and to use the asset and income as it deems fit, without interference from its shareholder or any other outside party.

The Indofood case also reiterated an important factor in determining the beneficial owner in relation to interest payments. However, the some principal would apply for dividends as was confirmed by the SAT; that the recipient would not be the beneficial owner if it is obligated to pay the dividends onwards within a specific time frame.

It would appear that some of the important criteria to be the beneficial owner would be that, there should not be any enforceable right that can force the intermediary to pay the majority of the amount received onwards within a specific timeframe. Further requirements would appear to be that the entity should be able to prove operation and economical substance as is evident from both Circular 601 and the LoB Article of the MTC of the US.

6.4 WHAT IS THE MEANING OF THE TERM 'BENEFICIAL OWNERSHIP' IN THE CONTEXT OF THOSE TAX TREATIES WHERE THE TERM HAS BEEN INCORPORATED?

What is the meaning of 'beneficial ownership' in the context of those tax treaties where the term has been incorporated? Some treaties incorporated the term but do not define the meaning of the term. The default situation in a case where a term is not defined is that Article 3(2) of the OECD model will be applicable as discussed in Chapter 2.

The interpretation of Article 3(2) states that a domestic tax law meaning pertaining to the specific taxes, shall prevail over any other meaning. It further states that any interpretation in force, when the treaty was signed, shall be subject to an interpretation when the tax is imposed. If the context does not require otherwise, the reference to the domestic law applies. The context referred to is determined in two ways. Firstly, to determine the intention of the parties when signing the agreement and secondly, any meaning that is given to a term by the other states' legislation (Ryynänen, 2003:349).

The International Fiscal Association ("IFA"), in The Concept of Beneficial Ownership in Tax Treaties, has strong support that terms should be interpreted in a purely treaty framework, and not be referenced to domestic law, where there is a well established international law meaning for the term. This will therefore promote consistent treaty application as some domestic law systems do not have a definition for beneficial ownership (Ryynänen, 2003:349).

As various treaties has been based on the current MTC one can assume that the contracting parties have adopt the term as a treaty concept, unless otherwise stated in the specific treaty. The term will have the ordinary meaning in accordance with the Vienna Convention (Ryynänen, 2003:349).

Reference is made to reciprocity on which a convention is based, once a treaty is concluded. This is referred to in order to prevent a contracting party to amend the scope of terms not defined in the treaty in its domestic law, in order to make a convention partially inoperative (Ryynänen, 2003:350).

6.5 DOMESTIC LAW, INTERNATIONAL TAX OR TAX TREATY MEANING?

In the Indofood case the Court found that the term should have an international fiscal meaning. An international fiscal meaning will ensure that advantage is not taken of a situation were different law systems are prevailing or that the interpretation of the term is different from one treaty to the next, even when it is defined.

The Court in the Indofood case ruled that the term 'beneficial owner' should not derive from domestic laws of Contracting States but should have an "international fiscal meaning" and quoted various OECD commentaries on the matter. The HMRC issued their guidance regarding beneficial ownership after the Indofood case and are in agreement with the judgement handed down by the UK Court, even though a UK taxpayer was not involved. The Court of Appeal is also of the view that the term 'beneficial owner' must have an international fiscal meaning and shouldn't be interpreted in a very narrow technical sense.

6.6 CONCLUSION

In order to standardize the contents and interpretation of tax treaties, one needs to look at the possibility of incorporating the various factors which need to be taken into account in the determination of the term ‘beneficial owner’, as set out in the previous chapters, in all new and existing tax treaties. The incorporation of these factors will ensure, not only an international fiscal meaning, but where the term has not been defined in a tax treaty, the interpretation of the term ‘beneficial ownership’ based on the factors mentioned, will limit the use of ‘beneficial ownership’ for tax treaty shopping and abusive tax avoidance.

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