Report on the proceedings of the Subject II

Prepared by Dr. Carlo Romano (Italy) in cooperation with Mr. Antonio Russo, LLM (Netherlands)

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Subject II: Plenary Session - Conflicts in the attribution of income to a person

The Plenary Session on Subject II deal with the conflicts in the attribution of income to a person. The panel selected a number of case studies as well as real cases to demonstrate that the topic is not only a theoretical exercise but has a significant impact in practice.

As a introductory remarks, the General Reporter mentioned the fundamentals to the operation of tax systems such as the liability to tax, the entitlement to treaty benefits, the entitlement to double taxation relief (unilateral or bilateral) and to credit of withholding tax. It was pointed out that there is very little guidance in existing treaties on how to attribute income to a person; the terminology "paid to", "derived by", "beneficial ownership" is far from being clearly settled. Similarly, the branch reports showed that there is very little guidance also in domestic law. It was mentioned that, for example, income may be transferred without the underlying asset in some countries (Austria, Mexico, South Africa, Sri Lanka, Sweden, Switzerland) while this is not possible in other countries (Denmark, Germany, India, Italy, Korea, Luxembourg, Norway, Peru, US).

Treaty attribution of income as source state is also very different from one state to another; in order to decide who can claim treaty benefits there are countries applying their own domestic law (Austria, Belgium, Canada, Finland, France, Germany, Israel, Korea, Malaysia, Mexico, Netherlands, Norway, South Africa, Sweden, Uruguay, US) and countries following the approach of the residence state (Argentina, Chile, Czech Republic, Italy, Japan, Luxembourg, Portugal).

The discussion was structured along the lines of five segments, all implying the underlying question to whom should income be attributed for treaty purposes, namely personal service companies, CFCs and conduit companies, trusts, group taxation, dividend usufruct and transfer of dividend coupons.

Segment I – Personal service companies

An individual advisor resident in State R provides his/her services to a customer resident in State S; the remuneration that the advisor receives is taxed in its full amount in State R according to the individual income tax law of the latter State. Then, the individual envisages the formation of a personal service company in his/her country of residence so that he/she renders the services to such a company and the latter provides its services to the customer. The benefit may derive from a lower taxation in State R of companies as compared to individuals if the entire remuneration is not distributed/imputed to the individual. Alternatively, the company is set up in a low taxed jurisdiction with significant tax advantages. The issue is to whom such income should be attributed.

From a strict legal standpoint, income belongs to the company although that income substantially derives from the activities performed by the individual. It was mentioned that State R might react in various manner, so to apply transfer pricing adjustment to the salary received by the employee/advisor, or to impose a deemed dividend if he/she is shareholder of the company, or to attribute income directly to the individual by applying specific legislation on personal service companies or on the basis of their general anti-avoidance rules or also based on their general attribution principles by looking to the economic entitlement to that income. In the latter three

cases, the problem might be whether such an individual to whom income is attributed is entitled to double tax relief in State R. As far as the company and the individual are resident in State R, State S would apply however the treaty with State R. In other words, according to the branch reporters it does not matter to whom income is attributed. Complex issues may arise if the company is instead set up in a third State.

The General Reporter raised the question whether the treaty is aimed at resolving conflicts in the attribution of income rules and whether treaties contain independent attribution rules. It was also questioned what is the relationship between attribution under treaties and attribution under domestic law. One of the panellists argued by mentioning the rules for dependent personal income under Art. 15(2) OECD MC that the form versus substance test should be applied (reference was also made to para 8 to Art. 15(2) OECD MC). It was also advocated in this respect the position of Prof. Vogel in 1990 under which an enterprise hiring out labour is normally considered to be the employer.

Segment II – CFCs and conduit companies

Both CFC and conduit rules can give rise to conflicts in the attribution of income to a person.

Under CFC rules the profits realized by the controlled foreign company is attributed to the shareholder and taxed in the State of residence of the latter. Under the conduit rules the issue in the State of source is to attribute the conduit income to the conduit shareholders which are often the economic owners of that income. One of the panellists pointed out that CFC rules may be essentially grouped in two different regimes, namely the imputation-type rules - under which the country of residence of the CFC shareholder attributes income to the shareholder (and sometimes also recognizing foreign tax credit relief) - and the deemed dividend approach - under which income earned by the CFC is deemed to be paid out to the shareholders, thus giving rise more to timing rather than to attribution issues.

The position of the OECD is that CFC rules do not conflict with Arts. 7(1) and 10(5) of the OECD MC. However, it was pointed out the high number of observations to these OECD rules such as those of Belgium, Ireland, Luxembourg, Netherlands and Switzerland. The OECD underlying reasoning is that income attribution rules are domestic rules and not treaty rules; therefore, the latter do not affect the former. However, it was also argued that attribution rules do affect the application of treaty rules. According to the OECD, Art. 7(1) does not limit the right of the country of residence of the shareholder to tax CFC income under its own domestic rules. Similarly, it was argued that Art. 10(5) OECD MC does not have an impact on the taxation in the State of residence under the CFC rules. However, such a view is not unanimously shared around the world such as the existing case law demonstrates.

In the *Schneider Electric* case (French *Conseil d'Etat* No. 232276 of 28 June 2002), a French parent company held shares in a Swiss company (CFC company); under the French CFC rules, CFC income was imputed to the French parent company. According to the *Conseil d'Etat*, the Swiss company was considered to be taxed in France; this was in violation of Art. 7 of the France-Switzerland treaty since the Swiss company did not have a PE in France. It was pointed out that this decision is not in line with the OECD approach as well as with the *Bricom Holdings Ltd* decision rendered by the UK Court of Appeal on 3 April 1996 or with the *A Oyi Abp* decision rendered by the Finnish Supreme Administrative Court on 20 March 2002. In the latter two cases, the Courts ruled that there was no violation of the treaty. In *Bricom Holdings Ltd*, CFC income is taken into account only for the purposes of measuring the profits (notional income) but it is still income of the parent company to which CFC rules apply. Similarly, in the *A Oyi Abp* case the Finnish Supreme Administrative Court ruled that there was no conflict with Art. 7(1) since the CFC rules followed

the object and purpose of the treaty. Part of the panel concluded by arguing that there is no conflict between CFC rules and treaty allocation rules.

In a case decided by the Austrian Supreme Administrative Court (Case 93/13/0185 of 10 December 1997), there was an Austrian subsidiary owned by a UK parent company; to mitigate the high withholding tax on dividends, it was set up an intermediary company in the Netherlands interposed with very little substance between the UK parent and the Austrian subsidiary. The Court denied the application of the Austria-Netherlands tax treaty since it found that under domestic law no income could be attributed to the Dutch company due to its lack of substance and of economic functions. This judgement was exclusively based on domestic law and, in particular, in the attribution rules provided by the Austrian tax system which impeded the application of the Austria-Netherlands tax treaty. It was argued that probably the Court decided the case assuming that there is no attribution rules in a treaty since these rules are left to domestic law.

In the *Prevost Car Inc* case, which is currently pending before the Canadian Courts, the key issue is the beneficial ownership concept. Is a Dutch holding company – whose shares are held 49% by a UK company and 51% by a Swedish company - the beneficial owner of the dividends paid by a Canadian company ? Under the Canada-Netherlands treaty there was a 5% dividend withholding tax while under the Canada-Sweden treaty the dividend withholding tax was equal to 15% and under the Canada-UK treaty this is equal to 10%. Dividends received by the Dutch holding company were immediately redistributed to the shareholders. Although there was no debate about the fact that the Dutch company was the legal owner of the dividends, the Canadian authorities argued that the Dutch company was not the beneficial owner of the dividend income.

One of the panellists pointed out that two different question should be addressed in dealing with similar cases; the first question is to whom is the income to be attributed, and only when that question is answered the second question on whether the person to whom the income is attributed is also the beneficial owner should be addressed. In the *Prevost* case, this could result in a denial of the reduced withholding tax under all tax treaties at stake. The Canada-Netherlands tax treaty would not apply because the Dutch company is not the beneficial owner as well as the Canada-Sweden and the Canada-UK tax treaties would not apply because the Swedish and the UK companies are not in any case the legal owner of the income.

In the Indofood case, there was an Indonesian company using a Special Purpose Vehicle (SPV) in Mauritius to issue debt securities so to benefit of the reduced interest withholding tax (10%) under the Mauritius-Indonesia tax treaty. After the setting up of the structure, the latter treaty was terminated; thus, in order to benefit of a treaty reduced withholding tax it was interposed a Dutch holding company. The UK Court of Appeal overruled the lower court decision and held that the Dutch intermediary company was not to be considered the beneficial owner of the income under the Indonesia-Netherlands tax treaty. The Court based its decision on an international fiscal meaning of the concept of beneficial ownership; the latter should not be derived by domestic law but is a genuine treaty concept. The panel seemed to agree with this approach. However, the difficulties consist in the international fiscal meaning of the concept of beneficial ownership; in this case, this is dependent upon the economic obligation for the Dutch intermediary company to pass on the income to the SPV. It was however pointed out that it is extremely difficult to ascertain when a company is not bound in commercial and practical terms to pass on its income, in particular in refinancing situations.

Then, the panel introduced some historical remarks about the origin and the development of the concept of beneficial owner. The latter to be found in Arts. 10, 11 and 12 of the OECD MC is used in the taxation of earnings from capital invested in another country. In the 1963 OECD MC there

was no beneficial owner requirement; it was only required that income was paid to a recipient who was resident in the other contracting State. According to the then paragraph No. 34 of the Commentary, the avoidance of abuses was left to the bilateral negotiations of the contracting States. Before 1977 the Committee of Fiscal Affairs considered first the introduction of a subject to tax clause but then abandoned this idea for the various allocation questions that would have raised. In 1977 the beneficial ownership concept was introduced for the first time in Art. 10(2) of the OECD MC so to deny treaty benefits when an intermediary, agent or nominee is interposed. In 1992 an additional paragraph was inserted in the Commentary to Art. 12 OECD MC under which it is said that the term beneficial owner should not be used in a narrow technical sense but in its context and in the light of the object and the purposes of the treaty (avoidance of double taxation and prevention of tax avoidance and evasion). Some criticism was addressed to this last change which has created uncertainties in the application of tax treaties since it links. The scope of the beneficial ownership concept was further expanded in 2003 when the OECD Commentary stated that there was in any case no double taxation if the recipient is not treated as the owner of the income for tax purposes in its State of residence. One of the panellists argued that it was wrong to confuse the beneficial ownership concept with tax avoidance principles.

Segment III – Trusts

As an introduction, it was first clarified that a trust is not an entity but a relationship whereby the settlor transfers property to the trustee who becomes the legal owner of the property for the benefit of the beneficiary. It was also mentioned that the terms revocable, irrevocable, fixed, discretionary, accumulation and so on are used to describe the characteristics of the trust we are dealing with but are not well defined categories of trusts. Taxation may be imposed on the trustees, who are the legal owners of the income, on the beneficiaries, who are the beneficial owners of the income or also on the settlors (which is the term used in UK as opposed to the term grantor used in North America) if they retain some powers (e.g. veto powers) on the property or for other reasons. In some jurisdictions (e.g. US and Canada) the trust itself is taxed as a fictitious entity.

In the case study the settlor and the trustee are resident in State R; the trust is revocable so under State R legislation income sourced in State S is attributable to the settlor. Under State S domestic law, however, income is attributed to the beneficiary resident in State S so creating a double taxation situation if State R does not recognize any foreign tax credit mechanism. One of the panellists argued that, also in light of the OECD partnership report, the State S-State R tax treaty should apply so that State R should recognize the foreign tax credit for the taxes paid by the beneficiary in State S. To this approach it was opposed that obviously the majority of the countries would argue that State S is taxing income from sources in its territory in the hands of its own residents and thus no treaty rules should be applied. Moreover, it was contested that this approach is conceptually wrong since the treaty would be applied to the income rather than to a person, thus violating Art. 1 of the OECD MC under which a treaty applies to persons resident of one or both contracting States.

Segment IV – Group taxation

Under the separate entity approach, each group member calculates its own profit or loss on a standalone basis under the rules of a given country. Normally, after such a computation the individual results are aggregated at the level of the company controlling the other companies belonging to the same group. This aggregation is ordinarily repeated up the chain until all results are pooled together at the group parent company level. In the case study it was envisaged the existence of company A and B both resident of State R; company B receives interest income from company C which is resident in State S. Then, it was assumed that companies A and B enter into a

group taxation arrangement under which company B income is attributed to company A. The chairman pointed out that, notwithstanding such attribution of income, company B should be entitled to the treaty in force with State S because company B is a "person" and is liable to tax in its country of residence (similarly to a taxpayer benefiting of a tax exemption on its income). As a consequence, State S should reduce the domestic withholding tax. But should company B or company A benefit of a foreign tax credit under the treaty ? Again, the chairman argued that company A should not be entitled to a foreign tax credit since it is not the beneficial owner of the interest derived from State S and company B does not pay taxes. Thus, it was concluded that the separate entity approach may lead to double taxation.

Then, the panel discussed the absorption approach which may occur at two different levels, namely at the level of the parent company that 'absorbs the subsidiary' ending up to one taxable subject or at the level of the taxable basis ending up to two different subject but with no taxable income for the subsidiary that has transferred its income to the parent. The treaty issue is whether the subsidiary which is part of the group taxation is still to be considered as liable to tax. It was argued that the subsidiary should be considered as a treaty resident since it is liable to tax under the domestic law of its State of residence; if not liable to tax under domestic law, the subsidiary would probably not be entitled to be part of the group taxation. Such as under the separate entity approach the problem is who is the beneficial owner of the income and whether the subsidiary might be considered as such. This issue might become relevant especially where the parent company is a foreign resident company with a PE in the State of residence of the subsidiary holding the shares of the latter and forming the group taxation with the latter.

Segment V – Dividend usufruct and transfer of dividend coupons

Dividend usufruct and transfer of dividend coupons primarily consist in separating the income from the assets, either over a period of time (usufruct) or through a transfer of a single coupon (coupon transfer). It was then introduced the issue of whether income should be attributed to the usufructer, or to the coupon holder, or to the bare owner of the asset. Is the holder of the income and not the owner of the asset the beneficial owner of the income?

In the 2006 Royal Bank of Scotland case it was discussed the interaction of three paragraphs of the Commentary explaining the beneficial ownership concept with the tax avoidance. A US corporation obtained a loan from the UK resident company, Bank of Scotland. The loan was to be repaid through the issuance by the US corporation of non-voting preference shares from its subsidiary in France and the assigning of the usufruct on these shares for three years to the Bank of Scotland.

Due to the dividend tax credit provisions contained in the France-UK tax treaty, the Royal Bank of Scotland would have received a substantially larger amount. French tax authorities argued that

a) the assignment of the usufruct was an artificial arrangement masking the real transaction which was a loan from the US corporation;
b) Royal Bank of Scotland was not the beneficial owner of the dividend;
c) there was a fraud based on an abusive transaction remunerating the lender not from the borrower but from the French treasury.

The Court held that this was an artificial transaction based on French domestic law and that Royal Bank of Scotland was not the beneficial owner of the dividend. It was argued that while the first issue might depend on the degree of risk in each single transaction in light of domestic law some criticism was addressed to the rewriting by the Court of the beneficial ownership concept on the basis of tax avoidance and treaty shopping principles. It was argued indeed that Bank of Scotland did not act as a nominee or as an agent on one's behalf but it had full right of disposal of the income and should have been considered as the beneficial owner of the income.

This Court decision was also criticized because the Court recharacterized the entire transaction based on the beneficial ownership concept (beneficial owner was deemed to be the US corporation) without following a necessary two-step approach that consists first in a recharacterization of the dividend in interest and then in assessing whether the recipient is the beneficial owner of the income.

The panel then presented the 1994 Royal Dutch case where a Luxembourg company held shares in Royal Dutch. The Luxembourg company was not entitled to the treaty benefits under the Netherlands-Luxembourg tax treaty. Dividend coupons were sold to a UK resident company against a remuneration equal to 80% of the dividends. The Dutch Supreme Court looked at the moment at which it must be assessed whether the UK company is the beneficial owner and argued that this should be done at the time of the dividend payment and not at the moment of the declaration. It was argued that this is consistent with the text of Art. 10 under which the recipient must be the beneficial owner of the income and not of the shares. The Court defined the beneficial owner using various criteria such as the legal ownership (in this case, of the UK resident company), the possibility of freely disposition of the coupon and the circumstance that the UK company did not act as an agent in cashing the coupon.

One of the panellists criticized this Court decision since the Court disregarded the adjective 'beneficial' and focused on the civil law concept of ownership. It was argued that the economic element should be more carefully addressed in order to deal with the beneficial ownership concept. The panel took different views on the necessity to identify the beneficial owner from an economic perspective.

It was however pointed out that Royal Bank of Scotland was a 2006 decision while Royal Dutch was handed down in 1994 at a time when there was a simpler definition of beneficial ownership. More importantly, apparently documents submitted to the lower court showed that the US company virtually guaranteed repayment of the loan.

The Panel discussion showed that there are no clear tax treaty provisions or principles with regard to treaty attribution rules with the related risks of double taxation or double non-taxation. The question thus arises whether explicit attribution rules should be incorporated in tax treaties or in the OECD Model Convention or the Commentary.

Two different definitions of the term beneficial owner were put forward by panel members. The first definition states that the beneficial owner is "*the person who legally, economically or factually has the power to control the attribution of the income*". However, some panellists considered such a definition too ambiguous since it is based on subjective elements and it could lead to numerous issues of interpretation. The second definition states that the beneficial owner is the "*person who de facto, to the exclusion of others, has power to exercise or in fact is shown to exercise, control over the disposal of the income, including through nominees and agents but not including shareholders, partners or other such persons exercising de jure control indirectly without anything else to the contrary. The exercise of such rights as beneficial owner must not be on anyone's behalf, but in his own right*".

At the end of the panel discussion, the chairman after having pointed out that the issue of attribution of income is fundamental to the application of tax treaties argued that the beneficial ownership might be considered as a different concept from the problem of attribution of income under tax treaties.