RECENT CASES OF INTEREST

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THE MEANING OF "BENEFICIAL OWNER/BENEFICIARE EFFECTIF" IN INCOME TAX TREATIES

Joel Nitikman
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OECD MODEL TREATY-BENEFICIAL OWNER ENTITLED TO REDUCED WITHHOLDING ON INTEREST, DIVIDENDS AND ROYALTIES

3

Concept studied extensively over a number of years:

- 1998 IFA Congress London
- 1999 textbook on beneficial ownership of royalties
- 1999 IFA Congress Eilat
- 2001 British Tax Review
- 2006 IFA Italy
- 2006 IFA Singapore
- 2007 ABA Tax Section, Florida

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Original explanation: US Senate Report on 1966 Protocol to UK-US Treaty. Ensure only Americans benefit from reduced withholding required under 1965 UK Finance Act.

5

1966 US Technical Explanation--concept implicitly included in all prior treaties.

6

OECD added “beneficial owner” to draft 1974 Model. Intended to disentitle “intermediary such as an agent or nominee” from reduced withholding.

1980 and 2001 UN Commentaries same.

7

2005 OECD Commentary, "beneficial owner" not used in technical sense; understood in light of object and purposes of Convention-avoiding double taxation and prevention of fiscal evasion and avoidance.

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2005 OECD Commentary: example is agent or nominee or mere fiduciary or administrator. Any difference from 1974 version?

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“BENEFICIAL OWNER” NOT DEFINED-ARTICLE 3(2)-GO TO DOMESTIC LAW? OR DOES “CONTEXT” REQUIRE INTERNATIONAL DEFINITION?

SHOULD UK DOMESTIC LAW PREVAIL, PER 1966 HISTORY?

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In Canada, “the adjective “beneficial” is used in a variety of contexts and it appears not to have a precise legal meaning.”

Williams (2005 TCC)

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In Canada, primary attributes of beneficial ownership are possession, use and risk.

Wardean (1969 Ex. Ct.); IT-170R

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INDOFOOD (2006 UK CA)

13

Indonesian parent with Mauritius sub. Sub. borrowed money under debenture, re-lent funds at same rate to parent.

Under Treaty, 10% withholding tax (20% in Indonesia).

14

Redemption allowed if adverse tax change, unless parent could avoid.

Treaty repealed.

15

Trustee suggested setting up new sub. in Netherlands. Parent said would not be "beneficial owner."

16

UK CA agreed--“beneficial owner” has international fiscal meaning. Article 3(2) not applied.

17

Beneficial owner must have ‘full privilege to directly benefit from the income’ with no legal and practical requirement to pass it on.

18

Is tax avoidance policy satisfied by saying recipient is a resident of other State?- OECD Commentary section 12.1 says no, but reasoning not clear.

19

Is tax avoidance policy satisfied by saying recipient must be owner for bankruptcy purposes?

(Indofood UK Ch.D.)

20

UK HMRC published guidelines on application of Indofood.

Guidelines not clear. Depend on presence or absence of "treaty shopping".

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1996 U.S. Model Technical Explanation: beneficial owner refers to resident of Contracting State to whom State attributes dividend for tax purposes. Source State may disregard persons that nominally receive dividend but in substance do not control it.

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2006 U.S. Model Technical Explanation:
"beneficial owner" not defined in Convention—domestic law applies.

23

"Beneficial owner is person to which income is attributable (taxable?) under laws of source State."

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Prevost (September 2007 TCC) may consider “beneficial owner” of dividends. Same as interest?

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INTERNATIONAL FISCAL ASSOCIATION

Recent Cases of Interest - U.S.A.

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May 17, 2007

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IRS Over-Reaching: Kohler Company v. United States, 468 F. 3d 1032 (7th Cir. 2006)

- "We think the Internal Revenue Service had either to prove against all probabilities that its assessment was correct or pick a number that was prima facie plausible."
- "[IRS] played all or nothing, lost all, so gets nothing."

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Other Judicial Determinations of IRS Over-Reaching

- Caracci v. Commissioner, 456 F.3d 444 (5th Cir. 2006) (Commissioner's position "can only be seen as one aimed at achieving maximum revenue at any cost")
- McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) (IRS's valuation position in excess of its expert "exemplifies a practice of the IRS that we see with disturbingly increased frequency, e.g., a grossly exaggerated amount asserted in a notice of deficiency")

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Cause and Effect of IRS Over-Reaching

- Potential Causes
  - Stretched IRS resources
  - Less rigorous Compliance analysis
  - Independent judicial review
- Potential Effects
  - Shifting burden of proof
  - Valuation cases
  - Transfer pricing cases

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Recent GAAR Jurisprudence and the Role of Economic Substance
Where do we stand to-day?

John R. Owen,
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The Role of Economic Substance under the GAAR

- Economic substance over form and the related business purpose test have been soundly rejected as general doctrines of Canadian income tax law
  - *Stubart* (1984)
  - *Shell Canada* (1999)
- In 1988, the Government introduced the general anti-avoidance rule (GAAR). This rule was not considered by the Supreme Court of Canada until 2005, when it heard two cases*: Canada Trustco* and *Mathew*
- In *Canada Trustco*, the Court revived the debate as to the relevance of "economic substance" in Canadian income tax law

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The Role of Economic Substance under the GAAR

- The Court held that the GAAR “does not consider a transaction to result in abusive tax avoidance merely because an economic or commercial purpose is not evident”. However, the Court identified economic substance as a factor to be considered
  - Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations …
- The Supreme Court rejected the Minister's argument that the "circular" lease arrangement effected by the leasing company taxpayer lacked economic substance and was therefore abusive, holding that “cost” was to be given a strictly legal meaning

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The Role of Economic Substance under the GAAR

- The Supreme Court emphasized that:
  - The central enquiry is focused on whether the transaction was consistent with the purpose of the provisions of the [*Income Tax Act*] that are relied upon by the taxpayer…
- Unfortunately, no further guidance was provided by the Court
- The emphasis on statutory context and purpose adopted by the Supreme Court in applying the GAAR is not far removed from the approach of Justice Learned Hand in *Gregory v. Helvering*:
  - [I]f what was done here was what was intended by [the statute], it is of no consequence that it was an elaborate scheme to get rid of income tax…

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The Role of Economic Substance under the GAAR

- The lower court judgments on GAAR following *Canada Trustco* have at least implicitly acknowledged the relevance of economic substance but have not clearly defined its role
  - In *CECO Operations* (2006), the Tax Court focused on the economic result of the taxpayer's transactions (to extract from a partnership tax free the economic value of an accrued gain) in concluding that the transactions abused the "rollover" provisions relied upon
  - In *Lipson*, the Tax Court (2006) and the Federal Court of Appeal (2007) focused on the economic result of the taxpayer's transactions (to purchase a house with borrowed money) in finding abusive tax avoidance contrary to the purpose of the interest deduction provision
  - In both *McMullen* (2007) and *MacKay* (2007), the Tax Court was influenced in its analysis by the economic substance (or commercial circumstances) of the transactions in finding no abuse

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