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Conduit companies, beneficial ownership, and the test of substantive business activity in claims for relief under double tax treaties*

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Abstract

If interpreted in a strict legal sense, beneficial ownership rules in tax treaties would have no effect on conduit companies because companies at law own their property and income beneficially. Conversely, a company can never own anything in a substantive sense because economically a company is no more than a congeries of arrangements that represents the people behind it. Faced with these contradictory considerations, people have adopted surrogate tests that they attempt to employ in place of the treaty test of beneficial ownership. An example is that treaty benefits should be limited to companies that are both resident in the states that are parties to the treaty and that carry on substantive business activity. The test is inherently illogical. The origins of the substantive business activity test appear to lie in analogies drawn with straw company and base company cases. Because there is no necessary relationship between ownership and activity, the test of substantive business activity can never provide a coherent surrogate for the test of beneficial ownership. The article finishes with a Coda that summarises suggestions for reform to be made in work that is to follow.

1. INTRODUCTION AND CONTEXT

1.1 Double Taxation

Most countries tax income on the basis of both residence and source.¹ As a result, cross-border transactions risk being taxed twice, both in the source country and in the country of residence. This is known as double taxation. One response is for states that have

* This article builds on a theme in Saurabh Jain, *Effectiveness of the Beneficial Ownership Test in Conduit Company Cases* (IBFD Amsterdam, 2013). Some text is developed from material in Dr Jain's book, and several transaction diagrams originally appeared in the book. Translations from foreign judgments and statutes that are not available in English are by Saurabh Jain, with the assistance of Kevin Holmes, Nicole Schlegel, René Andersen, Sarah Binder and Stephan Gerschewski, whose help is very gratefully acknowledged, as is the permission of the International Bureau of Fiscal Documentation.

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¹ For example, the *Income Tax Act 2007* (New Zealand) provides that both the worldwide income of a New Zealand tax resident and New Zealand sourced income are subject to New Zealand tax laws.

trading or investment relationships to enter treaties, known as ‘double tax treaties’, whereby the states that are parties to the treaty each agree to restrict their substantive tax law to ensure that income is not taxed twice. Double tax treaties are also known as ‘double tax conventions’ or ‘agreements’.² Most double tax agreements hew broadly to the form of the Model Tax Convention on Income and on Capital³ promulgated by the Organisation for Economic Cooperation and Development, known as the OECD Model Convention. This model, and most treaties, contain articles that address the taxation of dividends, interest and royalties, collectively known as ‘passive income’.⁴

Where passive income flows from a source in one treaty partner to a resident of another treaty partner double tax treaties usually partially or fully exempt the income from withholding tax imposed by the state of source. For example, subject to Articles 10(3) and 10(4), Article 10(2) of the Convention between New Zealand and the United States of America limits the tax that contracting states may levy on dividends paid by companies that are resident within their jurisdiction where the dividends are beneficially owned by residents of the other contracting state.⁵ Understandably, the intention of the contracting states is that only their own residents will obtain treaty benefits. It is possible, however, for residents of a non-contracting state to obtain the benefits of a tax treaty by interposing a company in a contracting state, a company that subsequently forwards passive income to the residents of the non-contracting state. This scheme subverts the intention of the contracting states to confine benefits to their own residents. Companies interposed in this manner are sometimes called ‘conduit companies’. Conduit company cases usually turn on whether the company in question should be characterised as the beneficial owner of passive income that it receives, or as a conduit that merely forwards passive income to people who are not residents of one of the states that are parties to the treaty in question.

1.2 Conduit Companies, Beneficial Ownership and Corporate Personality

Conduit companies are able to obtain treaty benefits because of two factors. First, people establishing companies destined to serve as conduit companies contrive to ensure that the conduit qualifies as resident in the jurisdiction of a treaty partner pursuant to the residence rules of the partner in question. Ordinarily, this objective can be achieved by simply incorporating the company in the state in question. Take, for instance, the Mauritius Income Tax Act 1995. Section 73 of that Act provides that a company that is ‘resident’ in Mauritius means a company incorporated in Mauritius. Secondly, as far as companies are concerned, treaties operate on a formal, legalistic basis rather than on a substantive basis.⁶

² An example is the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-N.Z., July 23, 1982, 35 U.S.T. 1949 [hereinafter U.S.-N.Z. Convention] updated by protocols in 1983 and 2010.

³ Organisation for Economic Co-operation and Development [hereinafter OECD] Committee on Fiscal Affairs *Model Tax Convention on Income and on Capital* (2010).

⁴ For example, Art. 10, 11 and 12 of the U.S.-N.Z. Convention, *supra* note 2, address the taxation of dividends, interest and royalties respectively.

⁵ U.S.-N.Z. Convention, *supra* note 2.

⁶ See OECD COMMITTEE ON FISCAL AFFAIRS, *Commentary on Article 10 concerning the Taxation of Dividends*, in MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 186, para. 1 (2010): ‘Under the laws of the OECD member countries, such joint stock companies are legal entities with a separate juridical personality distinct from all their shareholders’.

By virtue of these factors, a company established in a country that is a party to a treaty takes advantage of the benefits that the treaty confers on residents even though in substance the company is acting on behalf of a resident of a third country.

The OECD Model Convention, and treaties that are drafted in accordance with it, attempt to frustrate this strategy by anti-avoidance rules that limit relevant treaty benefits to a resident who derives income as the ‘beneficial owner’⁷ of that income. Treaties sometimes use terms such as ‘beneficially entitled’,⁸ and ‘beneficially owned’⁹ in order to achieve the same result. Thus, Articles 10(2), 11(2) and 12(2) of the OECD Model Convention respectively limit treaty benefits to a recipient who is the ‘beneficial owner’ of the dividends, interest, or royalties in question. As the following paragraphs of this article will argue, the problem is that, as a matter of linguistic logic, of company law, and of economic analysis, the expression ‘beneficial owner’ is not capable of fulfilling the anti-avoidance role that treaties assign to it.

From an economic perspective, conduit companies are not capable of owning income beneficially. The object of a company is to make profits for the benefit of its shareholders. It is merely a vehicle through which shareholders derive income. As Thuronyi has pointed out, in substance a company is no more capable of beneficially owning anything than it is capable of having a blood group.¹⁰ Thus, a conduit company is not beneficially entitled to treaty benefits. Rather, it is the shareholders, residents of a non-contracting state, who substantially enjoy the benefit of passive income. It follows that in order to ensure that a resident of a contracting state who claims treaty benefits is entitled to treaty benefits in *substance*, double tax agreements should be interpreted in a *substantive economic sense*.

Nevertheless, the traditional and formal legal view is that companies have separate legal personality, and are therefore not only the legal but also the beneficial owners of their income. The observations of Justice Pitney in the case of *Eisner v Macomber*¹¹ reflect this view. Although *Eisner v Macomber* did not concern the issue of beneficial ownership of assets by companies, Justice Pitney observed that companies hold both legal and beneficial title to their assets:¹²

... [T]he interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it ... Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole.

The Commentary on the OECD Model Convention follows this approach. The Commentary explains that double tax agreements recognise the legal personality of

⁷ E.g. Convention for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Indon.-Neth., art. 10(2), Jan. 29, 2002), 2287 U.N.T.S. 107.

⁸ E.g. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Austl.-Can., art. 10(1), May 21, 1980, 1334 U.N.T.S. 235.

⁹ E.g. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Neth.-U.K., art. 10(1), Nov. 7, 1980, 1249 U.N.T.S. 209.

¹⁰ Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 78 (1990).

¹¹ *Eisner v. Macomber*, 252 U.S. 189, 193 (1920).

¹² *Id.* at 206, emphasis added.

companies.¹³ From the perspective of legal analysis and of the meaning of the word ‘ownership’, it follows that conduit companies are the beneficial owners of income that they derive and are entitled to treaty benefits.

1.3 Surrogate Tests of Beneficial Ownership

Courts appreciated that the beneficial ownership test was intended to frustrate conduit company arrangements. However, in the light of the traditional legalistic view of companies, and of the meaning of ‘ownership’, it seems that courts decided that they were unable to apply the beneficial ownership test literally. As a result, in order to prevent residents of non-contracting states from obtaining treaty benefits by means of the interposition of conduit companies, courts adopted two surrogate tests in place of the literal beneficial ownership test. These surrogate tests focus not on ownership of income by the company in question but on some other factual matter that is thought to be relevant. The tests can be categorised as ‘substantive business activity’ and ‘dominion’. ‘Dominion’ may be used to refer to such concepts as effective control of a company. These surrogate tests have not only been used by courts to decide conduit company cases, but have also been embodied in statute by some legislatures. This present article focuses on the first of the surrogate tests, the test of substantive business activity. The authors plan a second article on dominion.

1.4 Substantive Business Activity Test

The substantive business activity test examines whether a company carries out its own business activity. It is also referred to as the ‘substantive business operations’¹⁴ test or ‘economic activity’¹⁵ test. Originally, courts developed the substantive business activity test as a substance over form rule to determine whether the law should recognise domestic straw companies and foreign base companies as separate taxable entities. Since about 1987, the OECD, the German legislature, and the courts have extended the application of the substantive business activity test. The OECD included the substantive business activity test in the Commentary on its Model Convention on Income and Capital.¹⁶ The German legislature has incorporated the substantive business activity test into s 50d(3) of the German Income Tax Act, which is a specific anti-avoidance rule aimed at preventing abuse of double tax treaties. Courts often use the substantive business activity test to decide conduit company cases.¹⁷

This article argues that substantive business activity should not be considered to be an indicator of beneficial ownership because there is a logical contradiction in using the presence of activity, substantive or not, to indicate ownership of any kind, let alone beneficial ownership. Even if one assumes that the fact that a company does not carry out a substantive business activity may indicate that a company lacks substance, and therefore cannot beneficially own income, the presence of business activity does not logically show that a company does beneficially own income sourced from another

¹³ OECD COMMITTEE ON FISCAL AFFAIRS, *Commentary on Article 1 concerning the Persons Covered by the Convention*, in MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 45 (2010).

¹⁴ OECD COMMITTEE ON FISCAL AFFAIRS, *Double Taxation Conventions and the Use of Conduit Companies*, in INTERNATIONAL TAX AVOIDANCE AND EVASION: FOUR RELATED STUDIES (ISSUES IN INTERNATIONAL TAXATION, No 1) 87, para. 42(ii) (1987) [hereinafter *Conduit Companies Report*].

¹⁵ Einkommensteuergesetz [ESTG][Income Tax Act], Oct. 16, 1934, REICHSGESETZBLATT, Teil I [RGL. I] at 1005, § 50d(3) (Ger.).

¹⁶ OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 6.

¹⁷ See, e.g., *N. Indiana Pub. Serv. Co. v. Comm’r* 105 T.C. 341 (1995) (discussed in detail below).

country. That is, there is no necessary link between substantive business activity and beneficial ownership.¹⁸ A company may carry out a substantive business activity, but have the additional purpose of forwarding income to a resident of a non-contracting state, and, therefore, not be the beneficial owner of the income.

This article also argues that by treating substantive business activity as a sufficient criterion for entitlement to treaty benefits, courts have sometimes recognised even tax avoidance as a substantive business activity. In summary, courts use substantive business activity to indicate beneficial ownership, but, when analysed carefully, OECD reports¹⁹ and cases support the argument that there is no logical link between substantive business activity and beneficial ownership.

1.5 The Substantive Business Activity Test in the OECD Commentary and Reports

The Conduit Companies Report²⁰ and the OECD Commentary²¹ set out certain provisions that negotiators may include in double tax treaties to frustrate conduit company schemes. These provisions will be referred to as ‘safeguard provisions’. The object of these safeguard provisions is to ensure that the entity that is claiming treaty benefits owns, controls, or is ultimately entitled to the income in question. That is, the focus of these provisions is on substantive economic ownership or beneficial ownership. One safeguard provision sets out this ‘look-through’²² approach. According to this 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.

This safeguard provision focuses on determining who has ownership or control of income, gains or profits. If the word ‘owned’ in this provision merely referred to legal ownership of the income in question, the provision would be illogical because the company unquestionably legally owns its income. In this provision, ‘owned’ must refer to substantive economic ownership or to beneficial ownership, reflecting the intention of treaty partners to limit treaty benefits to residents of contracting states.

Such safeguard provisions have a broad scope in the sense that they apply to a wide range of situations. Thus, there is a danger that the provisions will prevent a company claiming treaty benefits when it is genuinely entitled to them. The OECD Commentary and Report therefore recommend that the safeguard provisions should be applied with certain provisions that aim to ensure that treaty benefits are granted in genuine situations. The OECD Commentary and Report refer to these provisions as ‘bona fide provisions’. For the purposes of this article, the most important bona fide provision is the ‘activity provision’, which states that the safeguard provisions:

... shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from

¹⁸ See *supra* Part 1.6

¹⁹ See *supra* Part 1.6.

²⁰ OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 14, at para. 42(ii).

²¹ OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 13, at para. 13.

²² *Id.* at para.13. See also *Conduit Companies Report*, *supra* note 14, at para. 23.

taxation claimed from the other Contracting State is with respect to income that is connected with such operations.

The effect of this provision is that the look through approach and other safeguard provisions that attempt to frustrate conduit company schemes will not apply where a company is engaged in substantive business operations in the territory of a treaty partner provided that the income in question is connected with those operations. For instance, where there is a treaty between states B and C, it would appear that a bank that is resident in state B may claim relief in respect of interest received from State C even if the bank's shareholders reside in state A and even if economically the bank's loan to a state C resident was funded by a deposit in the bank by a resident of state A.²³

The natural corollary of this provision is that where a company carries out a substantive business activity the company is entitled to claim treaty benefits, whether or not the company is the substantive economic or beneficial owner of the income. Essentially, the substantive business activity criterion determines entitlement to treaty benefits and therefore overrides the substantive economic ownership requirement imported by the safeguard provisions. The OECD Model Convention and Commentary thus treat substantive business activity as in effect changing the incidence of ownership because they proceed on the basis that substantive business activity is somehow indicative of ownership of income; that is, that there is a logical link between substantive business activity and beneficial ownership.

1.6 Lack of Logic and the Substantive Business Activity Approach

Paragraph 119 of the 1998 report of the OECD on Harmful Tax Competition²⁴ also seems to proceed on the assumption that there is a logical link between substantive business activity and beneficial ownership. Paragraph 119 states that companies with no economic function incorporated in tax havens can be denied treaty benefits *because* these companies are not considered to be the beneficial owners of certain income formally attributed to them. This statement that companies without an 'economic function' or substantive business activity cannot be beneficial owners of income suggests that there is a causative relationship between substantive business activity and beneficial ownership. However, as argued in Part 1.4, it is illogical to use substantive business activity as an indicator of beneficial ownership. The reason is that the mere absence of business activity does not logically prevent a person from owning anything. But even if one assumes that the absence of business activity is a robust indicator of lack of beneficial ownership, the presence of business activity does not logically show that a company does own income beneficially.

The following example, elaborated from the example three paragraphs above, illustrates the argument. There are three jurisdictions, A, B, and C. C charges withholding tax on outward flowing interest. There is a standard form tax treaty between B and C, which eliminates tax on interest that flows between residents of those jurisdictions but there is no other relevant treaty. Investor is a resident of A. He owns Bank, a banking company that is incorporated in and that carries on business in B. In a separate transaction,

²³ This hypothetical case is similar in relevant respects to *Ministre de l'Economie, des Finances et de l'Industrie v. Société Bank of Scotland*, 9 I.T.L.R. 683 (2006) considered in Part 6.9 of this article.

²⁴ OECD COMMITTEE ON FISCAL AFFAIRS, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998).

Investor lends money at interest to Borrower, a resident of C. C charges withholding tax on the interest that Borrower pays to Investor.

In order to avoid the withholding tax charged by C, Investor rearranges his loan. Now, Investor lends to Bank, his company in B, which on-lends to Borrower in C. When Borrower pays interest to Bank, Borrower and Bank claim the benefit of the B-C treaty. Bank is not a mere conduit. It carries on a substantial banking business. But should this activity qualify Bank for exemption from tax imposed by C on the outward flowing interest? The answer should be 'no', because the substantive owner of the interest is Investor, a resident of A. But legally, as an independent legal personality, Bank owns the interest. Bank certainly carries on a substantive business and the interest appears to be connected with the operations of that business. Should this business qualify Bank to benefit under the B-C treaty in respect of interest that Investor owns in an economic sense? To grant this benefit to Bank would be contrary to the intent of the B-C treaty, because the economic beneficiary of the exemption is Investor, who is not a resident of one of the states that are parties to the treaty. This example illustrates that there is no logical link between beneficial ownership and substantive business activity.

On April 29, 2011, the Committee on Fiscal Affairs of the OECD published a discussion draft, 'Clarification of the Meaning of 'Beneficial Owner' in the OECD Model Tax Convention'.²⁵ As its name suggests, the draft attempts to address difficulties with interpreting 'beneficial owner'. It does so by putting forward possible amendments to some of the clauses in the Commentary to Articles 10, 11, and 12 of the OECD Model Tax Convention. The draft offers some insight into some of the problems of applying the Model to passive income, but as the present authors read it, the draft does not address the fundamental illogicality of treating activity as an indicium of ownership. The draft therefore sheds little light on the problems thrown up by the example discussed here. Part 7 of this article visits other aspects of the discussion draft.

The Swiss case of *A Holding ApS v Federal Tax Administration*²⁶ further illustrates that there is no logical link between beneficial ownership and substantive business activity.

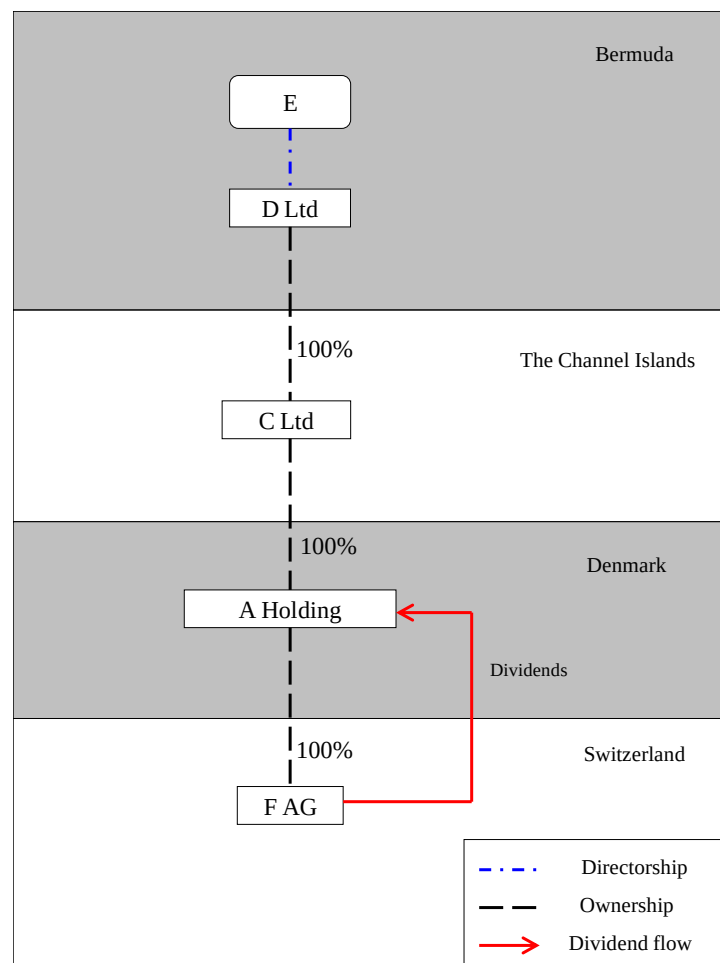
2. BENEFICIAL OWNERSHIP, SUBSTANTIVE BUSINESS ACTIVITY AND ABUSE OF LAW BEFORE THE SWISS COURTS

2.1 A Holding ApS v Federal Tax Administration: Facts

A Holding ApS v Federal Tax Administration involved a group of companies that were controlled by Mr E, a resident of Bermuda. Mr E was the director of D Ltd, a Bermudian corporation. D Ltd held all the shares in C Ltd, a subsidiary in the Channel Islands. C Ltd in turn wholly owned A Holding ApS (A Holding), a Danish holding company. A Holding was the taxpayer. It acquired the entire issued share capital of F AG, a Swiss company. A Holding did not have its own offices or staff in Denmark, and had no entries for assets, leasing or personnel expenditure in its books. F AG distributed dividends to A Holding, which were subjected to a 35 per cent withholding tax under Swiss tax law.

²⁵ OECD COMMITTEE ON FISCAL AFFAIRS, CLARIFICATION OF THE MEANING OF 'BENEFICIAL OWNER' IN THE OECD MODEL TAX CONVENTION: DISCUSSION DRAFT (2011).

²⁶ *A Holding ApS v. Fed. Tax Admin.*, 8 I.T.L.R. 536 (2005) (Federal Court, Switz.).

Figure 1: A Holding ApS v Federal Tax Administration

A Holding applied for a refund of the withholding tax under Article 26(2) of the Switzerland-Denmark double tax treaty of 23 November 1973.²⁷ The Swiss Federal Tax Administration and the Higher Tax Administration rejected A Holding's application.

Since the Switzerland-Denmark double tax treaty did not have a beneficial ownership provision²⁸ both courts applied the abuse of law doctrine.²⁹ They found that A Holding did not carry out a real economic activity. They therefore held that A Holding was interposed solely for the purpose of obtaining benefits of the treaty. The Higher Tax Administration, however, considered A Holding to be the beneficial owner of the dividends. The Swiss Federal Court confirmed the decision of the Higher Tax

²⁷ Agreement for the Avoidance of Double Taxation with Respect to Taxes on Income and Fortune, Den.–Switz., art. 26(2), Nov. 23, 1973, 958 U.N.S.T. 27 [hereinafter Den.-Switz. Double Taxation Agreement]. It provides, '... the tax withheld (at the source) shall be reimbursed upon application, in so far as the levying thereof is restricted by the Agreement.'

²⁸ The beneficial ownership requirement was introduced to the Den.-Switz. Double Taxation Agreement, *id.*, in August 2009.

²⁹ See generally, Zoë Prebble & John Prebble, *Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law*, BULL. FOR INT'L TAX'N 151 (2008).

Administration and explained its reasons for applying the abuse of law doctrine and the substantive business activity test.

2.2 Abuse of Law and Beneficial Ownership

On appeal before the Swiss Federal Court, A Holding argued that in the absence of a beneficial ownership provision in the Switzerland-Denmark double tax treaty the abuse of law doctrine could not be read into the treaty. Secondly, A Holding argued that it was the beneficial owner of the dividend, which, it argued, excluded the application of the abuse of law doctrine.³⁰

The Federal Court rejected A Holding's first argument, and held that the abuse of law doctrine could be read into the Switzerland-Denmark double tax treaty because the doctrine was consistent with the aim and purpose of the OECD Model Convention.

In relation to A Holding's second argument, the court accepted that A Holding was the beneficial owner of the dividend, but observed:³¹

Although the Higher Tax Administration has regarded [A Holding] as the beneficial owner of the dividends in accordance with art 10 [of the Switzerland-Denmark double tax treaty] one can assume an abuse. The assumptions of the court of lower instance were based on the fact that the distributed dividends are in principle attributable to [A Holding] for taxation in Denmark ... this does not answer the question whether the convention was invoked abusively ...

This observation suggests that the court distinguished between the beneficial ownership test and the domestic anti-abuse principle, because the court held that although A Holding was the beneficial owner of the dividend, this finding did not preclude the application of the anti-abuse principle. Furthermore, the court's analysis shows that the deciding principle in the case was the abuse of law doctrine, not beneficial ownership.

2.3 Abuse of Law and Substantive Business Activity

In the process of applying the abuse of law doctrine, the Swiss Federal Court based its decision on the criterion of whether there was a relevant business activity.

As discussed in Part 1.5 of this article, the commentary on Article 1 of the OECD Model Convention³² recommends certain provisions that negotiators may include in double tax treaties in order to frustrate conduit company schemes. This article refers to these provisions as 'safeguard provisions'. Part 1.5 of this article discussed the 'look through' provision as an example of a safeguard provision. Since the Switzerland-Denmark double tax treaty had no beneficial ownership provision, the Swiss Federal Court in *A Holding* implemented the abuse of law doctrine using the look-through provision, which it referred to as the 'transparency provision',³³ to determine whether A Holding was entitled to treaty benefits. The transparency provision had not been incorporated into the treaty. In a broad-brush exercise of treaty interpretation the Federal Court simply took the transparency provision from the Commentary on the Model

³⁰ *A Holding ApS*, 8 I.T.L.R. at 554.

³¹ *Id.* at 559.

³² OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 13.

³³ See *supra* Part 1.5 for quotation of the 'look-through' or 'transparency' provision.

Convention³⁴ and applied it to the case, almost as if it was a rule in its own right.³⁵ Applying the transparency provision, the court recognised that the corporate structure allowed Mr E to control A Ltd. Therefore, any refund would go directly to Mr E, a resident of a non-contracting state.³⁶

As discussed in Part 1.5 of this article, the OECD Model Convention recommendations suggest that courts should apply safeguard provisions to limit the grant of treaty benefits to bona fide situations. In this case, the Court applied the ‘look through’ provision together with the substantive business activity approach. It observed:³⁷

If the convention does not contain an explicit anti-abuse provision-[as] in the present case-an abuse can, based on the transparency provision, *only be assumed if* [A Holding] additionally does not carry out a real economic activity or an active business activity ... It follows that the objection of an abuse of a convention is unfounded if the company demonstrates that its main purpose, its management and the acquisition as well as the holding of participations and other assets from which the income in question arises is primarily based on valid economic grounds and not aimed at the obtaining of advantages of the applicable double tax convention (so called ‘bona-fide’-provision). The same applies if the company pursues effectively a commercial activity in its state of residence and the tax relief claimed in the other contracting state relates to income connected to this activity (so-called activity provision).

The court found that A Holding was not engaged in a business activity and therefore held that A Holding was not entitled to a withholding tax refund under the Switzerland-Denmark double tax treaty. The observation of the court that an abuse of law ‘can ... only be assumed if’ a company does not carry out a substantive business activity suggests that the court viewed the presence or absence of substantive business activity as the overriding factor in determining whether the abuse of law doctrine applied: that is, that there is a logical link between substantive business activity and an abuse of law.

2.4 Beneficial Ownership, Abuse of Law and Substantive Business Activity: Separate Tests?

In *A Holding*, the Swiss Federal Court considered the abuse of law doctrine to be separate from the beneficial ownership test, because, although the court considered A Holding to be the beneficial owner of the dividend, this conclusion did not preclude the application of the abuse of law doctrine. The Swiss Federal Court also considered the absence of substantive business activity to be an indicator of an abuse of law, because it stated that an abuse of law could only be assumed if there was a lack of business activity. A natural inference is that in the opinion of the court, beneficial ownership (which was found to be present) and substantive business activity (which was found to be absent) are two different tests. The decision of the Federal Court therefore suggests that there is no logical link between the criterion of substantive business activity and the criterion of beneficial ownership. On the other hand, it is difficult to reconcile the decision of the Swiss Federal Court that A Holding was a conduit company with the finding by the Higher Tax Administration that A Holding was the beneficial owner of

³⁴ OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 13, at para. 13.

³⁵ *A Holding ApS*, 8 I.T.L.R. at 560.

³⁶ *Id.* at 560.

³⁷ *Id.* (emphasis added).

the dividend. It seems that the Higher Tax Administration applied the beneficial ownership test in a formal, legalistic manner. That is, the Higher Tax Administration took the view that a company was capable of being the beneficial owner of dividends, in contrast to the substantive economic view of ownership, that is that shareholders are the beneficial owners of dividends.

3.5 Should Business Activity be a Sufficient Criterion for Deciding Conduit Company Cases?

As discussed in Part 2.3 of this article, in *A Holding* the court held that, in the absence of an explicit anti-abuse provision, abuse of a treaty ‘can ... only be assumed if [the company in question] ... does not carry out a real economic activity or an active business activity ...’³⁸ As further explained in Part 2.3, this formulation of the rule seems to have led the court and judges to think that the presence of ‘real economic activity or an active business activity’ is sufficient to dispel the contention that an intermediary is a mere conduit.

The business activity test may have led the court to the correct conclusion in this conduit company case. It is illogical, however, to base the decision in conduit company cases solely on the presence or absence of business activity. The fundamental error of logic is that the presence of business activity that is connected with the passive income that is in issue does not necessarily mean that an interposed company should not be classed as a conduit company. Nevertheless, courts have considered substantive business activity to be a sufficient criterion for deciding conduit company cases. (One might add that it is equally illogical to conclude that whether there is an abuse in fact depends on whether the relevant law—that is, the treaty—includes an anti-abuse provision). For this reason, it is important to examine the rationale behind decisions involving conduit companies.

3. WAS SUBSTANTIVE BUSINESS ACTIVITY ORIGINALLY A TEST FOR DECIDING CONDUIT COMPANY CASES?

3.1 Introduction

The argument in the following parts of this article has several strands. This paragraph and the next attempt to provide an introductory guide to that argument. Originally courts did not develop the substantive business activity test for conduit company cases. It was a substance over form test developed for cases involving foreign ‘base companies’. United States courts have also applied the substantive business activity test for determining tax issues in cases involving domestic ‘straw companies’. The paragraphs that follow cite examples of both these categories. Base company cases and straw company cases tend to turn on whether the companies in question are taxable entities separate from their shareholders. Courts have generally treated the presence or absence of business activity as a sufficient criterion to determine that issue.

Tax planning schemes involving base companies and straw companies resemble conduit company cases. The reason is that the corporate structures used by taxpayers to obtain a tax advantage are similar. As a result, the courts have transposed the application of the substantive business activity test from straw company and base company cases to conduit company cases. They have failed to recognise, however, that a conduit company case turns on a completely different issue. The issue in conduit

³⁸ *Id.*

company cases is whether the shareholders of the conduit company are the substantive economic owners of the income of the company such that the company is entitled to the benefits of a tax treaty. On that basis, a conduit company case cannot be determined solely by the application of the substantive business activity test. Before explaining the distinction, it is helpful to describe straw companies and base companies.

3.2 Straw companies

‘Straw companies’ or ‘nominee companies’ are often used for non-tax reasons in business transactions involving real estate. In the present context, the word ‘straw’ in the expression ‘straw companies’ is a United States usage. A straw company merely holds legal title to a property. Its shareholders, or a third party, beneficially own the property.

Non-tax reasons for employing a straw company may include: avoidance of personal liability for loans obtained to acquire, improve or refinance property in real estate ventures;³⁹ protection from the claims of creditors of the beneficial owners of the property transferred to the company;⁴⁰ facilitation of management or conveyance of property owned by a group of investors;⁴¹ and concealment of the identity of the beneficial owners of the property.⁴²

Beneficial owners of property of straw companies anticipate that courts will ignore the existence of the company or will recognise the company’s agency status when attributing income, gains or losses. If courts treat a straw company as a separate taxable entity there may be adverse tax consequences. For example, property dealings between the company and its shareholders may result in taxable gains or losses of holding periods. Income and losses from the property may be attributed to the company during the time it holds the property, and shareholders may not be able to deduct those losses when they eventually receive income from the property.

In attempting to escape these adverse tax consequences, taxpayers argue that courts should disregard straw companies for tax purposes. They argue that a company’s activities are not sufficient to justify its treatment as a separate taxable entity.⁴³ That is, the courts apply a substantive business activity test to determine whether a straw company is a separate taxable entity.

3.3 Difference between Straw Company Cases and Conduit Company Cases

Both straw companies and conduit companies, as legal owners of income, forward the income to their shareholders, who are generally the beneficial owners. Prima facie the two situations are similar. However, they involve two very different issues.

In straw company cases, courts are aware that a straw company is not the beneficial owner of the company’s property. The issue is, rather, whether a company exists as a taxable entity separate from its shareholders, so that the company can be regarded as the *recipient* of the income for tax purposes. In contrast, in conduit company cases, courts are not concerned with whether the company incorporated in a foreign

³⁹ *E.g., Bruce L. Schlosberg v. U.S.*, 81-1 U.S.T.C (CCH) P9272 (1981).

⁴⁰ *E.g., Moline Properties Inc. v. Comm’r*, 319 U.S. 436 (1943).

⁴¹ *E.g., Roccaforte v. Comm’r*, 77 T.C. 263 (5th Cir. 1981).

⁴² *E.g., Jones v. Comm’r*, 640 F.2d 745 (5th Cir. 1981).

⁴³ *E.g., Nat’l Carbide Corp. v. Comm’r* 336 U.S. 422 (1949). Taxpayers may accept the existence of the company as a separate tax entity, but argue that the straw company acts on their behalf as an agent.

jurisdiction is a separate taxable entity. The issue is whether the company owns passive income beneficially.

In conduit company cases, courts also decide effectively to ignore or to recognise the existence of an intermediary company for tax purposes. However, this decision is a consequence of the application of the beneficial ownership test. In straw company cases, on the other hand, this decision is a result of the application of the substantive business activity test.

The point is that the presence of a substantive business activity may be sufficient to treat a company as a taxable entity separate from its shareholder. However, as explained in Part 1.4, substantive business activity is not an indicator of beneficial ownership, and the presence of business activity does not necessarily mean that an intermediary is not acting as a mere conduit. Thus, this test may be appropriate for deciding straw company cases, but it is inappropriate for deciding conduit company cases.

3.4 Base Companies

Base companies are predominantly situated in a low tax or no-tax country, typically a tax haven. The main function of a base company is to shelter income that would otherwise directly accrue to taxpayers, for the purpose of reducing the tax that they have to pay in their home countries.⁴⁴ A supplementary function of a base company is to facilitate the improper use of tax treaties in a contracting state. A taxpayer who establishes a base company for this purpose may be a resident of the other contracting state,⁴⁵ or may be a resident of a third state. The key consideration for the taxpayer in setting up this scheme is the treaty network of the tax haven where the base company is located.

Most tax havens have either a very limited treaty network or none at all, though there are some treaties between havens and major industrial countries that allow domestic withholding tax to be reduced or eliminated, allowing the taxpayer to make a substantial saving.⁴⁶ Taxpayers avoid taxation of this income through the technique of 'secondary sheltering'.⁴⁷ Secondary sheltering involves changing the nature of income in order to benefit from exemptions contained in tax treaties or domestic rules in the taxpayer's country of residence. In order to change the nature of income, a taxpayer can use tactics such as re-ploughing income by loans to a shareholder or alienating a holding in a base company to realise capital gains that may be exempted or taxed at a lower rate.⁴⁸

A base company is able to shelter income from taxation in the resident state because it exists as a legal entity separate from the taxpayer. Income that it collects does not fall under the normal worldwide taxation regime of the resident state. Thus, the taxpayer is

⁴⁴ OECD COMMITTEE ON FISCAL AFFAIRS, *Double Taxation Conventions and the Use of Base Companies*, in INTERNATIONAL TAX AVOIDANCE AND EVASION: FOUR RELATED STUDIES (ISSUES IN INTERNATIONAL TAXATION, NO 1), *supra* note 14, at 60, para. 1 [hereinafter *Base Companies Report*].

⁴⁵ See *Decision of the Bundesfinanzhof of 5 March 1986*, IR 2001/82, published in the Official Tax Gazette, Part II, 1986 at 496. See also Rijkele Betten, *Abuse of Law: Treaty Shopping through the Use of Base Companies*, E.T. 323 (1986).

⁴⁶ E.g., in the case of *N. Indiana Pub. Serv. Co. v Comm'r* 105 T.C. 341 (1995) see *infra* Part 4.1, the U.S.-Neth. double tax treaty extended to the Netherlands Antilles, which was then used as a tax haven.

⁴⁷ OECD COMMITTEE ON FISCAL AFFAIRS, *Tax Havens: Measures to Prevent Abuse by Taxpayers*, in INTERNATIONAL TAX AVOIDANCE AND EVASION: FOUR RELATED STUDIES (ISSUES IN INTERNATIONAL TAXATION NO 1), *supra* note 14, at 20, para. 27.

⁴⁸ *Id.*

not liable to pay tax on income received by the base company.⁴⁹ Courts commonly use a substantive business activity test to decide whether to recognise a base company or to look through it to the ultimate owner of the income.

3.5 Why is Substantive Business Activity a Test for Base Company Cases?

Countries and courts have taken a number of measures to prevent tax avoidance that employs base companies. Some countries have enacted controlled foreign company legislation. Additionally, courts apply general anti-avoidance rules or judicial anti-avoidance doctrines like the abuse of law doctrine in civil law jurisdictions and the substance over form approach in common law jurisdictions.⁵⁰ In the United States in particular, the courts have applied judicial doctrines such as the business purpose test and the sham transaction doctrine to decide base company cases.⁵¹

As mentioned in Part 3.4, a base company is able to shelter income from tax in the resident state because the base company is an entity in its own right and is recognised as such in the resident country.⁵² For this reason, taxpayers in base company cases are often taxed on a ‘piercing of the corporate veil’ approach.⁵³ Cases involving the application of this approach turn on whether a base company can be disregarded for tax purposes with the result that its activity, or income derived from its activity, may be attributed to the taxpayer.⁵⁴ Taxpayers often claim that the income cannot be attributed to them because it is derived from a substantive business activity. That is, courts apply the substantive business activity test to ascertain the nature of the activities of a base company.⁵⁵ If a court finds that a base company does nothing more than receive passive income that would have directly accrued to the taxpayer, then it may attribute income of a base company to the taxpayer.⁵⁶

3.6 Difference between Base Company Cases and Conduit Company Cases

Base company cases involving parties from more than two jurisdictions may appear to be similar to conduit company cases in two respects. First, the structures of the corporate groups or chains that are involved are similar. Secondly, in both cases income accrues in an economic sense to the taxpayer in the resident country, so courts in both base company and conduit company cases effectively decide the question of whether income of an intermediary can be attributed to the taxpayer. Courts may apply the substantive business activity test to conduit company cases because of these similarities.⁵⁷

Notwithstanding the apparent similarities between the two kinds of cases, it is inappropriate to treat base company and conduit company cases in the same manner because there are crucial differences.

⁴⁹ *Base Companies Report*, *supra* note 44, at para. 10.

⁵⁰ See Prebble & Prebble, *supra* note 29.

⁵¹ *Id.* at 164-166. See also DANIEL SANDLER, TAX TREATIES AND CONTROLLED FOREIGN COMPANY LEGISLATION: PUSHING THE BOUNDARIES 8 (1998).

⁵² *Base Companies Report*, *supra* note 44, at para 10.

⁵³ See also *id.* at para. 24.

⁵⁴ See, e.g., *Hosp. Corp. of Am. v. Comm’r*, 81 T.C. 520 (1983), considered in Part 4.6 of this article.

⁵⁵ *Id.*

⁵⁶ *Id.*, though in *Hosp. Corp. of Am. v. Comm’r* the court found sufficient business activity to determine that the company in question was not merely an inactive base company.

⁵⁷ See, e.g., *N, Indiana*, 105 T.C. 341, discussed in Part 4.1 of this article.

A base company seeks to minimise tax in a taxpayer's country of residence. The base company, located in another jurisdiction, shelters income from taxation that would otherwise apply in the taxpayer's residence and in the process circumvents domestic tax law. For this reason, courts of the resident state decide a base company case in accordance with their domestic tax law. In contrast, a conduit company secures tax benefits in the country of source of passive income. A conduit company structure minimises tax by the improper use of double tax treaties that limit the source state's right to impose withholding tax. Because the conduit company secures benefits through a treaty, the courts of the source state decide conduit company cases in accordance with treaty law. To repeat the point in a slightly different way, base company structures shelter income from tax imposed on the basis of residence while conduit company structures reduce or eliminate tax imposed on the basis of source.

3.7 Purpose of Law as to Base Companies and Conduit Companies

Although courts may adopt a substance over form approach when deciding both kinds of cases, treaty law functions differently from domestic tax law. Treaty law applies the beneficial ownership test in order to ensure that an intermediary that is a resident of a contracting state by virtue of its incorporation enjoys passive income and does not pass the income on to residents of a third state. That is, the beneficial ownership test operates with the object and purpose of limiting treaty benefits to residents of contracting states. The application of the substantive business activity test to base company cases has a different purpose. That purpose is to determine whether (i) income that is derived by and retained by a base company should nevertheless be taxed to taxpayers who are resident in the state of residence on the basis that the income belongs in substance to those residents, or (ii) that it is not appropriate to tax the income to the residents to whom it belongs in substance because the base company has a good reason for deriving the income in its jurisdiction, namely that the income is derived in the course of a substantive business activity that is carried on in that jurisdiction.

On the other hand, although an intermediary that carries out a substantive business activity may be able to satisfy the requirements of the domestic tax law applicable to a base company case, such an intermediary may still act as a conduit, forwarding passive income to a resident of a third state.

Considerations of policy lead to the same conclusion. Take taxpayer A, a resident of country X, who owns a company, 'Baseco', that is resident in country Y. The policy question for country X is, should X tax the income of Baseco to its resident, A?

In essence, just because a base company case has been decided in favour of an intermediary on the basis of the company's business activity, it does not follow that a case that involves a conduit company that carries on a substantive business activity should also be decided in favour of the intermediary. That is, it is illogical to draw an analogy between base company cases and conduit company cases.

Nevertheless, courts have sometimes taken this quantum leap in conduit company cases. The case of *Northern Indiana Public Service Company v Commissioner of Internal Revenue* is a good example.⁵⁸

⁵⁸ *N. Indiana*, 105 T.C. 341; *N. Indiana Pub. Serv. Co. v. Comm'r*, 115 F.3d 506 (7th Cir. 1997).

4. CONDUIT COMPANIES, BASE COMPANIES, AND STRAW COMPANIES BEFORE THE COURTS

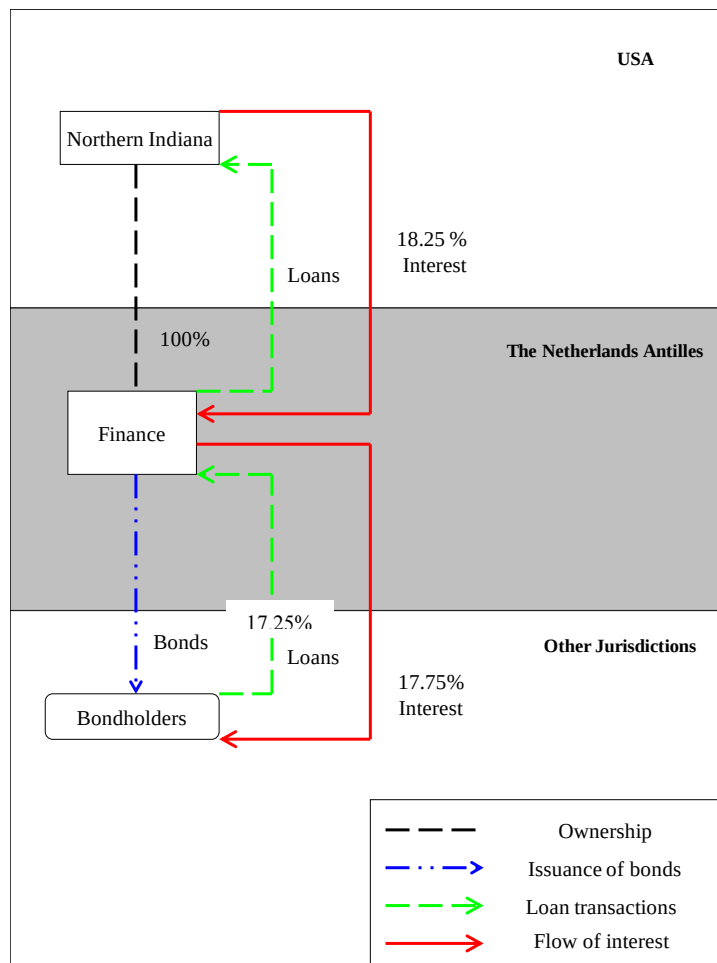
4.1 Northern Indiana Public Service Company v Commissioner of Internal Revenue: Facts

The *Northern Indiana* case involved Northern Indiana, a United States company that wished to raise funds on the Eurobond market. If Northern Indiana had borrowed funds directly from the Eurobond market it would have had to withhold United States withholding tax at the statutory rate on interest payments to the Eurobond holders, making Northern Indiana's offer less attractive in that market.

Article viii(1) of the United States-Netherlands double tax treaty of 29 April 1948,⁵⁹ which extended to the Netherlands Antilles, provided for a full withholding tax reduction on United States-sourced interest paid to companies in the Netherlands Antilles. Furthermore, the Netherlands Antilles charged no tax on such interest, irrespective of whether it flowed in to residents or out to non-residents.

In order to avoid paying United States withholding tax, Northern Indiana established a wholly owned Antillean subsidiary, which will be referred to as 'Finance'. The purpose of the structure was for Finance to borrow money from lenders in Europe, and to issue Eurobonds in return, rather than for Northern Indiana to do so. Instead, Finance on-lent the money borrowed from the bondholders to Northern Indiana. Finance lent money to Northern Indiana at an interest rate that was one per cent higher than that at which Finance borrowed from Eurobond holders. There were two consequences. First, Finance claimed the benefit of the US-Netherlands treaty described in the previous paragraph. Secondly, Finance earned a profit in the Antilles that it invested to produce more income. Eventually Northern Indiana repaid the principal amount with interest to Eurobond holders through Finance, and then liquidated Finance.

⁵⁹ Supplementary Convention Modifying and Supplementing the Convention with Respect to Taxes on Income and Certain Other Taxes, U.S.-Neth., Dec. 30, 1965, 17 U.S.T. 896. [hereinafter U.S.-Neth. Supplementary Convention]. The relevant part of art. viii(1) provides: 'Interest on bonds, notes, ... paid to a resident or corporation of one of the Contracting States shall be exempt from tax by the other Contracting State.'

Figure 2: The Northern Indiana case

Northern Indiana did not deduct withholding tax from interest payments to Finance. The Commissioner issued a notice of deficiency to Northern Indiana, declaring it liable to pay the tax that it did not withhold.

4.2 Arguments and Decision in the Northern Indiana Case

It was not disputed that Northern Indiana structured its transactions with Finance in order to obtain the full withholding tax reduction under the United States-Netherlands double tax treaty.⁶⁰ The Commissioner argued that Finance was a mere conduit in the borrowing and interest-paying process, so Finance should be ignored for tax purposes, and Northern Indiana should be viewed as having paid interest directly to the Eurobond holders.

The United States Tax Court observed that: ‘Normally, a choice to transact business in corporate form will be recognised for tax purposes so long as there is a business purpose or the corporation engages in business activity.’⁶¹ Because Finance was involved in the business activity of borrowing and lending money at a profit, the court recognised it as

⁶⁰ *N. Indiana*, 115 F.3d 506.

⁶¹ *N. Indiana*, 105 T.C. at 347.

the recipient of interest payments from Northern Indiana.⁶² The court held that the interest payments were exempt from United States withholding tax. The Court of Appeals for the Seventh Circuit agreed with the Tax Court. Because the Tax Court based its decision on the business activity of Finance, the Tax Court effectively considered substantive business activity to be a sufficient criterion to determine whether Finance qualified for treaty benefits.

4.3 Northern Indiana: an Illogical Analogy

The Tax Court considered substantive business activity to be a sufficient criterion because it drew an analogy with straw company and base company cases that were decided on the basis of the substantive business activity test. It seemed to have confused the facts of the *Northern Indiana* case for the following two reasons.

First, according to the Tax Court, Finance was created for a business purpose, namely ‘to borrow money in Europe and then lend money to [Northern Indiana] in order to comply with the requirements of prospective creditors’.⁶³ This role is similar to that of a straw company. However, the fact that Finance was created for a business purpose was irrelevant to what the court should have seen as the real issue, which was whether Finance was the beneficial owner of the interest payments. Finance was not the beneficial owner of the interest payments; rather the Eurobond holders were the beneficial owners of the interest payments. The reason is that *Northern Indiana* involved the application of a double tax treaty, not the application of United States domestic tax law. The court, therefore, should have analysed the facts in the light of the object and purpose of the double tax treaty. The treaty in question did not use the term ‘beneficial owner’. Rather, it exempted interest from tax that was ‘paid to a resident corporation of one of the contracting states’. As explained in Part 1.1 and 1.2 of this article, this provision should be interpreted substantively. Receipt by a mere conduit that contrives to be resident in a contracting state does not satisfy the policy of the treaty.

Secondly, as with a taxpayer in a base company scheme, Northern Indiana (the taxpayer) established a foreign subsidiary to avoid tax in the United States, the country of its residence. However, Northern Indiana was a source company; unlike the position in base company structures, Northern Indiana interposed Finance to obtain a reduction in United States withholding tax under the United States-Netherlands double tax treaty. Moreover, Eurobond holders, rather than Northern Indiana, benefited from the treaty-based elimination of United States withholding tax on interest payments. This result was obtained even though Finance was not related to Eurobond holders. That is, the *Northern Indiana* case was a conduit company case, not a base company case.

The last paragraph says that Eurobond holders benefited from treaty-based elimination of withholding tax. This statement does not ignore that Northern Indiana was the ultimate beneficiary, in that by exploiting the treaty it was able to borrow at a rate of interest that was cheaper than the rate that it would have suffered had the Eurobond holders received their interest subject to United States withholding tax. In that eventuality, the bondholders would have required the interest to have been grossed up to a rate that would have yielded a net return to the bondholders equivalent to the net return that they received via the scheme that Northern Indiana in fact adopted. In this

⁶² *Id.*, at 348.

⁶³ *Id.* at 354.

economic sense Northern Indiana benefited from the elimination of withholding tax on interest that it paid to Finance. However, this is not the sense in which we must use 'benefit' in connection with tax treaty benefits in respect of passive income. The focus is on benefits that treaties bestow on recipients of passive income, not on concomitant economic benefits that payers of passive income may derive as a result. In the *Northern Indiana* case the treaty conferred benefits on Finance, as a resident of the Netherlands Antilles, a benefit that Finance passed on to the bondholders.

By drawing an analogy between conduit company cases and base and straw company cases, the court in *Northern Indiana* analysed the facts within the wrong frame of reference. This point is further illustrated by comparing the *Northern Indiana* case with two other cases referred to by the court, namely *Moline Properties Inc v Commissioner of Internal Revenue*,⁶⁴ a straw company case, and *Hospital Corporation of America v Commissioner of Internal Revenue*,⁶⁵ a base company case.

4.4 Moline Properties Inc v Commissioner of Internal Revenue

In *Moline Properties*, Mr Thompson mortgaged his property to borrow money for an investment that proved unprofitable. Thompson's creditors advised him to incorporate Moline Properties Inc (Moline) to act as a security device for the property. He conveyed the property to Moline in return for all of its shares. Moline also assumed the outstanding mortgage. Thompson then transferred the shares as collateral to a trust controlled by his creditors.

Until Thompson repaid the original loans, Moline carried out a number of activities, including assuming Thompson's obligations to his original creditors, defending proceedings brought against Moline, and instituting a suit to remove prior restrictions on the property. After Thompson discharged the mortgage and gained control over Moline, Moline entered into several transactions involving the property. These transactions included mortgaging, leasing, and finally selling the property. Moline kept no books and maintained no bank account. Thompson received the proceeds from the sale, which he deposited into his bank account. Although initially Moline reported the gain on sales of the property in its income tax returns, Thompson filed a claim for a refund on Moline's behalf and reported the gain in his own tax return.

The issue before the United States Supreme Court was whether the gain from the sale of the property was attributable to Moline. In order to answer that question, the court considered whether Moline should be disregarded for tax purposes, which turned on whether Moline carried on a business activity. The court observed:⁶⁶

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

⁶⁴ *Moline Properties Inc. v. Comm'r*, 319 U.S. 436 (1943).

⁶⁵ *Hosp. Corp. of Am. v. Comm'r*, 81 T.C. 520 (1983).

⁶⁶ *Moline Properties*, 319 U.S. at 438.

According to the court, Moline's activities were sufficient to recognise it as a taxable entity separate from Thompson, and the court attributed the gain on sales to Moline.

4.5 Difference between Northern Indiana and Moline Properties

It is difficult to understand how the court logically relied on *Moline Properties* when applying the substantive business activity test in *Northern Indiana*. The court in *Moline Properties* was aware that Mr Thompson was the beneficial owner of the property and of the income from its sale. The issue was whether Moline received income as a taxable entity separate from Thompson. In that context, the presence of business activity was sufficient to determine that Moline existed as a separate taxable entity. In contrast, in *Northern Indiana*, it was clear that Finance received payments. The issue should have been whether Finance was the beneficial owner of interest payments and was therefore entitled to treaty benefits, or was acting as a mere conduit. Nevertheless, the conclusion of the Tax Court in *Northern Indiana* shows that it focused on the issue of whether Finance was the recipient of the interest payments not on whether it was the beneficial owner of those payments.⁶⁷ At the risk of labouring the point, the issue in *Moline Properties* was receipt. Receipt was not in issue in *Northern Indiana*, which concerned ownership, a different matter.

The court in *Northern Indiana* considered Article viii(1) the United States-Netherlands double tax treaty. Although the provision did not use the term 'beneficial owner',⁶⁸ the focal issue should have been whether Finance was the substantive economic owner of the interest payments. That is, Finance was the beneficial owner, to use the term in its ordinary sense. The result was that, although the context of the double tax treaty required the court to interpret the provision from a substantive economic perspective, the court in fact interpreted it from a formal legalistic perspective.

The Tax Court observed: '*Moline Properties, Inc. v. Commissioner* ... stands for the general proposition that a choice to do business in corporate form will result in taxing business profits at the corporate level.'⁶⁹ This observation shows that the court in *Northern Indiana* interpreted the treaty provision and considered the facts by applying the analytical framework that satisfied the domestic law requirements exemplified in *Moline Properties*. As a result, the court mistakenly drew an analogy with domestic straw company cases and concluded that tax should be levied at the corporate level rather than at shareholder level. In contrast, the relevant issue for treaty interpretation is not so much who receives the income but who owns it. In other words, is the recipient the owner of the income in the relevant, substantive sense?

4.6 Hospital Corporation of America v Commissioner of Internal Revenue⁷⁰

As mentioned in Part 4.3, the Tax Court in *Northern Indiana* also referred to *Hospital Corporation of America*, a base company case. In this case, Hospital Corporation of America (Hospital Corporation), entered into a management contract with King Faisal

⁶⁷ *N. Indiana*, 105 T.C. at 348.

⁶⁸ U.S.-Neth. Supplementary Convention, *supra* note 59. The relevant part of art viii(1) provides: 'Interest on bonds, notes, ... paid to a resident or corporation of one of the Contracting States shall be exempt from tax by the other Contracting State.'

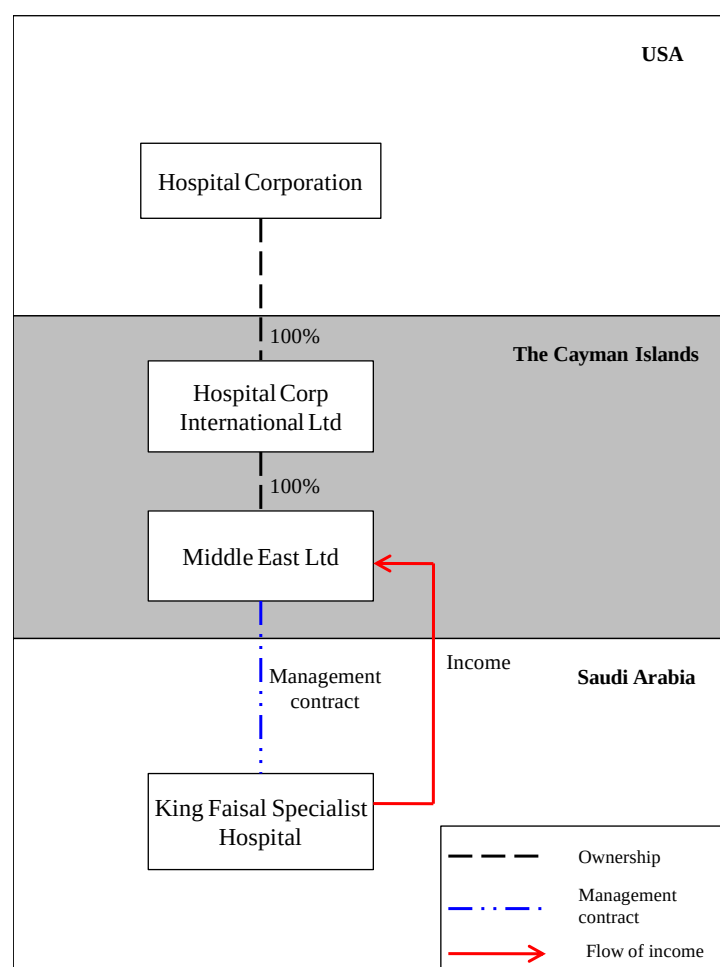
⁶⁹ *N. Indiana*, 105 T.C. at 351.

⁷⁰ *Hosp. Corp*, 81 T.C. 520.

Specialist Hospital in Saudi Arabia. Hospital Corporation established the following corporate structure.

Hospital Corporation incorporated Hospital Corp International Ltd, a wholly owned subsidiary in the Cayman Islands. Hospital Corp International Ltd held all the shares in Hospital Corporation of the Middle East Ltd (Middle East Ltd), also incorporated in the Cayman Islands. Middle East Ltd and Hospital Corporation had the same officers and directors. Middle East Ltd did not have its own office. Rather, it shared an office with the law firm that prepared its incorporation documents. Hospital Corporation decided to administer the management contract through Middle East Ltd, which acted as a base company. That is, Middle East Ltd had the role of trapping income in a tax haven, the Cayman Islands.

Figure 3: The Hospital Corporation of America case



There were two issues before the court: first, whether Middle East Ltd was a sham corporation that should not be recognised for tax purposes; secondly, whether its

income was attributable to Hospital Corporation under section 482 of the Internal Revenue Code.⁷¹

The United States Tax Court found that Middle East Ltd ‘carried out some minimal amount of business activity’.⁷² The court observed:⁷³

[Middle East Ltd] possessed the ‘salient features of corporate organization.’ [Middle East Ltd] was properly organized under the Companies Law of the Cayman Islands. In 1973, [Middle East Ltd] issued stock, elected directors and officers, had regular and special meetings of directors, had meetings of shareholders, maintained bank accounts and invested funds, had at least one non-officer employee, paid some expenses, and, with substantial assistance from [Hospital Corporation], prepared in 1973 to perform and in subsequent years did perform the [King Faisal Specialist Hospital] management contract. All of these are indicative of business activity.

The court explained that the quantum of business activity needed for a company to be recognised as a separate taxable entity ‘may be rather minimal’.⁷⁴ Because Middle East Ltd carried out the above business activities, the court held that Middle East Ltd was not a sham corporation, and was a separate taxable entity for the purpose of federal income tax. However, the court held that 75 per cent of the net income of Middle East Ltd was allocable to Hospital Corporation because Hospital Corporation performed substantial services for Middle East Ltd without being paid.

4.7 Difference between Northern Indiana and Hospital Corporation of America

It did not make sense for the court in *Northern Indiana* to rely on the reasoning of the court in *Hospital Corporation of America*. In *Hospital Corporation of America*, the court used the substantive business activity criterion to determine whether Middle East Ltd existed as a sham, or whether the company should be recognised as a separate entity for tax purposes. The activities that the court considered to be business activities seemed nothing more than those that necessarily preserve the existence of a company. The court was primarily concerned with the issue of the existence of Middle East Ltd as a separate taxable entity. For this reason, a minimal amount of activity was sufficient to satisfy the test that the court in *Hospital Corporation* had to apply. By contrast, in *Northern Indiana*, the issue should have been whether Finance received income substantively, that is, whether Finance owned the income in a substantive sense, or whether it functioned as a mere conduit.

Unlike *Northern Indiana*, *Hospital Corporation of America* did not concern a double tax treaty. It follows that the case was not decided in the context of the object and purpose of a treaty. The court in *Hospital Corporation of America* applied the sham transaction doctrine in the context of the United States domestic tax law, and found that the presence of business activity indicated sufficiently that Middle East Ltd was not a sham. On the other hand, *Northern Indiana* concerned the United States-Netherlands double tax treaty, and should have been decided in the context of the object and purpose

⁷¹ Section 482 of the Internal Revenue Code provides that the Secretary of the Treasury may allocate gross income, deductions and credits between or among two or more taxpayers owned or controlled by the same interests in order to prevent evasion of taxes or clearly reflect income of a controlled taxpayer.

⁷² *Hosp. Corp*, 81 T.C. at 584.

⁷³ *Id.*

⁷⁴ *Id.* at 579.

of that treaty. The fact that Finance carried out a business activity did not necessarily show that the arrangement was within the object and purpose of the treaty. Regardless of whether Finance was engaged in a substantive business activity, it was undisputed that Northern Indiana located Finance in the Netherlands Antilles in order to obtain treaty benefits. The application of the sham transaction doctrine cannot be equated with the application of the beneficial ownership test, even if the sham transaction doctrine deploys a substance over form approach. Nevertheless, in *Northern Indiana*, the Court of Appeal for the Seventh Circuit used the words ‘conduit’ and ‘sham’ interchangeably with reference to *Hospital Corporation of America*,⁷⁵ not, it seems, appreciating that, in *Hospital Corporation*, Middle East Ltd was not a conduit company at all. Indeed, Middle East Ltd’s purpose was the opposite, to act as a base company to trap income, not as a conduit through which income would flow. In short, the reasoning of the courts in *Northern Indiana* was mistaken.

A related point that emerges from this analysis is that the substantive business activity test logically works as a one-way test in conduit company cases. That is, the absence of business activity may establish that the interposition of an intermediary lacks substance; however, the fact that an interposed company has business activity does not necessarily show that the interposed company is not a conduit. This argument is further illustrated by the reasoning of the Bundesfinanzhof in decisions concerning section 50(3) of the German Income Tax Act,⁷⁶ as it stood before 19 December 2006.

Section 50d(3) deals with conduit company situations; however, as with the courts in *Northern Indiana*, the German legislature transposed the substantive business activity test from base company cases to conduit company cases. For this reason, the application of section 50d(3) resulted in inconsistent decisions in similar sets of facts before the provision was amended in December 2006.

5. THE SUBSTANTIVE BUSINESS ACTIVITY TEST IN GERMAN LEGISLATION AND LITIGATION

5.1 Section 50d(3) of the German Income Tax Act

Section 50d of the German Income Tax Act (abbreviated as ‘ESTG’) deals with cases where there has been a reduction in capital gains and withholding tax under German double tax agreements. Section 50d(3) of the ESTG is a countermeasure enacted to frustrate the abuse of treaties and abuse of the Parent-Subsidiary Directive of the Council of the European Communities.⁷⁷ The German legislature introduced section 50d(3) of the ESTG in 1994. Section 50d(3), before its amendment in December 2006,⁷⁸ read:⁷⁹

A foreign company is not entitled to full or partial relief under sections 1 and 2 if and to the extent that persons with a holding in it would not be entitled to reimbursement or exemption had they received income directly, and if there is

⁷⁵ *N. Indiana*, 115 F.3d 506.

⁷⁶ Einkommensteuergesetz [ESTG] [Income Tax Act], Oct.16, 1934, RGL. I at 1005, § 50d(3) (Ger.).

⁷⁷ Council Directive 90/435/EEC, on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, 1990 O.J. (L 225).

⁷⁸ Einkommensteuergesetz [ESTG] [Income Tax Act], Oct. 16, 1934, BGBl I at 3366, as amended by Jahressteuergesetzes [Finance Law], Dec. 13, 2006, BGBl I at 2878, § 50d(3).

⁷⁹ Einkommensteuergesetz [ESTG] [Income Tax Act], Oct.16, 1934, RGL. I at 1005, § 50d(3).

no economic or other relevant reason for interposing the foreign company and the foreign company does not have a business activity of its own.

Because the provision is not expressly restricted to dividends and withholding tax, it may be inferred that the provision also deals with conduit company situations in general.⁸⁰

Section 50d(3) of the ESTG is a special anti-avoidance rule. It acts as a supplement to section 42 of the German General Tax Code⁸¹ (abbreviated as 'AO'), which is the German general anti-avoidance rule. In wording section 50d(3), the legislature relied heavily on the principle developed in the context of section 42 of the AO by case law on the use of foreign base companies by German residents.⁸² That is, as with the United States courts, the German legislature borrowed the substantive economic activity test from base company cases. As a result, the Bundesfinanzhof has drawn analogies with base company cases when interpreting and applying section 50d(3). A good example is the decision of the Bundesfinanzhof of 20 March 2002, which will be referred to as *G-group 2002*.⁸³

Section 50d(3), as it stood before December 2006, was worded in the negative. That is, it set out conditions where a conduit company would not be entitled to a reduction of German withholding tax. In the decision of 31 May 2005, which will be referred to as *G-group 2005*,⁸⁴ the Bundesfinanzhof held that in order to deny tax relief the facts of a case should show that both economic or other valid reasons for the interposition of a corporation, and economic activity of the corporation itself, were absent at the same time. That is, when deciding whether to refuse treaty benefits, the court considered the conditions for refusal to be cumulative. To frame the test positively, in the view of the courts taxpayers qualify for benefits, and are not disqualified by section 50d(3), if they show that either there are economic or other valid reasons for the interposition of a company or that there is economic activity on the part of the company itself.

With deference appropriate to people who do not speak German, the authors venture that section 50d(3) appears to require the opposite, that is that taxpayers desiring to take advantage of relevant treaty benefits must satisfy both conditions. Be that as it may, in the context of conduit company cases even the existence of both conditions should not necessarily qualify companies for tax relief. Nevertheless, in the *G-group* cases, to be considered here, the Bundesfinanzhof treated the conditions as alternatives, either of which would allow tax relief under section 50d(3).⁸⁵ In effect, it regarded economic

⁸⁰ See Rolf Fuger & Norbert Rieger, *German Anti-Avoidance Rules and Tax Planning of Non-Resident Taxpayers*, 54 BULL. INT'L BUREAU FISCAL DOCUMENTATION 434, 441 (2000). See also Wilhelm Haarmann & Christoph Knodler, *German Supreme Tax Court Limits the Scope of the German Anti-Treaty Shopping Rule and Redefines Substance Requirement for Foreign Companies*, 34 INTERTAX 260, 260 (2006).

⁸¹ Abgabenordnung [AO] [The General Tax Code], Mar. 16, 1976, BUNDESGESETZBLATT, TEIL I [BGBL.] at 3366, as amended, § 42. According to § 42, the legal effects of provisions of the tax code may not be avoided by abusive behaviour on the part of the taxpayer. In the event of such behaviour, tax will be imposed as if the taxpayer had structured the situation using the appropriate form.

⁸² See Fuger & Rieger, *supra* note 80, at 440.

⁸³ *Re a Corporation*, 5 I.T.L.R. 589 (2002) (BFH) (Ger.).

⁸⁴ Bundesfinanzhof [BFH] [Federal Tax Court] May 31, 2005, BUNDESSTEUERBLATT Teil II [BStBl. II] 14 (para. 27) (Ger.).

⁸⁵ *Id.* at para. 31(bb) (emphasis added).

activity as sufficient to qualify for double tax relief. In reaching this conclusion the Bundesfinanzhof relied on reasoning in base company cases.

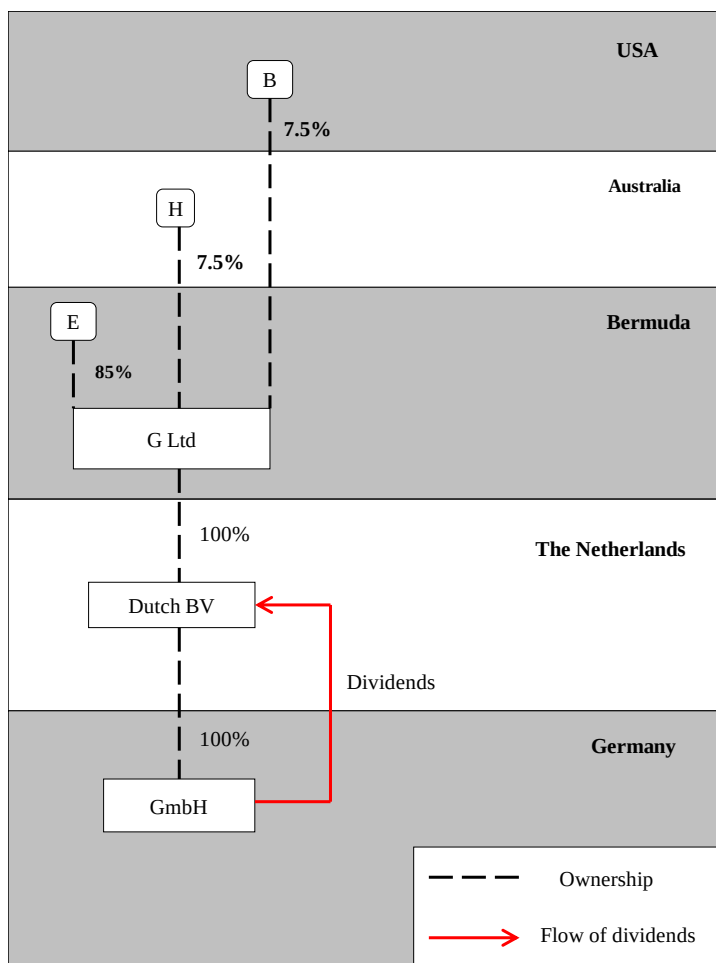
The cases of *G-group 2002* and *G-group 2005* concerned the same group of companies. The two cases had similar facts and gave rise to the same considerations of policy. The same issues arose in each case. They both involved conduit companies, but they came to opposite conclusions. The reason was that in both cases the Bundesfinanzhof applied reasoning appropriate to base company cases.

On the facts, base company reasoning made the cases appear to be distinguishable. In the first case the conduit company was virtually a shell. In the second case the conduit appeared to carry on business activity that might be described as ‘substantive’. The court distinguished the cases on the basis of this factor, which, on policy grounds, should have been irrelevant to the question of whether the taxpayer that derived the income in question and that claimed the relevant treaty benefits was in substance the beneficial owner of that income. Analysis of the facts of the cases illustrates these points.

5.2 The G-group 2002 Case: Facts and Decision

The *G-group 2002* case⁸⁶ concerned the G-group of companies, which were involved in the television sector. The corporate structure of the G-group started with Mr E, a resident of Bermuda, who held 85 per cent of the shares in G Ltd, a Bermudian corporation. Mr B, a resident of the United States, and Mr H, a resident of Australia, each held 7.5 per cent of the shares. G Ltd in turn owned Dutch BV, a company incorporated in the Netherlands. Dutch BV was the taxpayer. It used the business premises and other office equipment of another Dutch member of the G-group. Dutch BV held all the shares in GmbH, a German corporation.

⁸⁶ *Re a Corporation*, 5 I.T.L.R. 589.

Figure 4: G-group 2002

GmbH paid dividends to Dutch BV, and deducted withholding tax from the payment. Dutch BV claimed a refund of German withholding tax under the German-Netherlands double tax treaty of 16 June 1959.⁸⁷ The German tax authority granted a partial reimbursement. This reimbursement corresponded to the participation of Mr H and Mr B in G Ltd in accordance with the respective German double tax treaties with Australia and the United States. The tax authority, however, denied any further reimbursement on the basis that Mr E, who was the majority shareholder, was a resident of Bermuda, which does not have a double tax treaty with Germany. The matter was heard before the Bundesfinanzhof.

The Bundesfinanzhof held that, because Dutch BV was ‘a *base company* without real economic function’,⁸⁸ the withholding tax relief could be refused under section 50d(3) of the ESTG,⁸⁹ as well as under section 42 of the AO. That is, although *G-group 2002* involved a conduit company scheme, the court referred to Dutch BV as a base company.

⁸⁷ Agreement for the Avoidance of Double Taxation with Respect to Taxes on Income and Fortune and Various Other Taxes, and for the Regulation of Other Questions Relating to Taxation, Ger.-Neth., June 16, 1959, 593 U.N.T.S 3 [hereinafter Ger.-Neth. Double Taxation Agreement].

⁸⁸ *Re a Corporation*, 5 I.T.L.R. at 599 (emphasis added).

⁸⁹ § 50d(3) of the ESTG was § 50d(1a) of the ESTG at the time of the decision.

5.3 G-group 2002: Another Analogy with Base Company Cases

The Bundesfinanzhof was of the opinion that section 50d(3) had similar requirements and, therefore, a similar aim, to the aim of section 42 of the AO.⁹⁰ Although the language of section 50d(3) clearly showed that the provision applied to conduit company cases, the court still drew an analogy with base company cases when interpreting the provision. It observed:⁹¹

According to the jurisprudence of the [Bundesfinanzhof] ... , intermediary base companies in the legal form of a corporation in a low tax regime country fulfil the elements of abuse if economic or otherwise acceptable reasons are missing. If income received in Germany is 'passed through' a foreign corporation, this is also true if the state of residence of the foreign corporation is not a low tax regime The court accepts as a principle that tax law respects the civil law construction. But there must be an exception for such constructions [where they possess] only the aim of manipulation.

Although it was clear from the facts of the case that it involved the taxation of outward flowing income that had originated in Germany, the courts framed its reasons in terms of language appropriate to a case of income that flows inwards to Germany. The court used phrases such as 'intermediary ... in the legal form of corporation', 'tax law respects the civil law construction', and 'exception for such constructions'. These words suggest that the court was preoccupied with the issue of when the separate entity of an intermediary could be ignored for tax purposes. As discussed in part 5.1, the German legislature's reliance on base company cases when drafting section 50d(3) seems to be the reason for the court's approach.

5.4 Is Business Activity a Conclusive Criterion for Deciding Conduit Company Cases?

In *G-group 2002*, the Bundesfinanzhof noted that Dutch BV had no employees, premises or office equipment. The court also considered the fact that the director of Dutch BV was serving as the director of other affiliated companies. It did not accept the contention of Dutch BV that its interposition was for reasons of organisation and co-ordination, establishment of customer-relationships, costs, local preferences, and the conception of the enterprise. The court observed:⁹²

All these aspects make plain the background of the construction of the G-group, they make plain why and how European engagement of the group was concentrated within the Netherlands. But they cannot explain convincingly and justify why the foundation of [Dutch BV] as a letterbox corporation without economic or otherwise acceptable grounds was necessary.

The Bundesfinanzhof was not convinced that Dutch BV had developed its own economic activity.⁹³ It held that Dutch BV's participation in GmbH, without any managing function, did not fulfil the requirement of economic activity under the provision.

⁹⁰ *Re a Corporation*, 5 I.T.L.R. at 599.

⁹¹ *Id.* at 600 (emphasis added).

⁹² *Id.* at 601.

⁹³ *Id.*

Although the Bundesfinanzhof came to the correct conclusion, its logic does not make sense. The problem with the judgment is that the court analysed the facts in the light of reasoning in base company cases, rather than in the light of the context and purpose of the German-Netherlands double tax agreement.

Because of the analogy with base company cases, the Bundesfinanzhof's reasoning implied that the presence of economic activity was sufficient under section 50d(3) to allow treaty benefits. This reasoning is not explicit in *G-group 2002* because the court found that the activities of Dutch BV did not constitute 'economic activity' under section 50d(3).

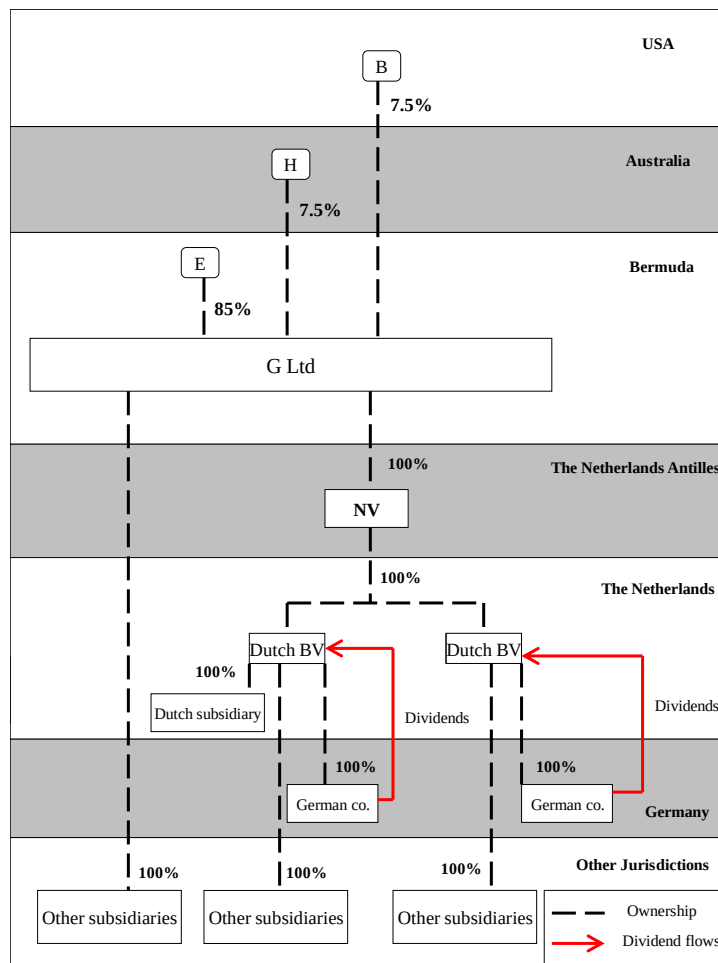
This approach was evident, however, in *G-group 2005*, where the Bundesfinanzhof, dealing with very similar facts, found that the activities of the Dutch subsidiaries did constitute economic activity under section 50d(3).⁹⁴

5.5 The G-group 2005 Case

G-group 2005 concerned the same group of companies that were involved in *G-group 2002*. The corporate structure in *G-group 2005*, however, was slightly different. In *G-group 2005*, G Ltd wholly owned NV, a subsidiary incorporated in the Netherlands Antilles. In addition, G Ltd wholly owned other Dutch, European and non-European subsidiaries. NV, in turn, wholly owned two Dutch subsidiaries.

The main difference between *G-group 2002* and *G-group 2005* was that in *G-group 2005*, each Dutch subsidiary also held shares in other European and non-European corporations in addition to shares in a German company. As in *G-group 2002*, the Dutch subsidiaries in *G-group 2005* had no employees, business premises or equipment. Each subsidiary used the facilities of another affiliated Dutch company. The German companies paid dividends to the Dutch subsidiaries and deducted withholding tax.

⁹⁴ BStBl. II 14 (para. 27) (Ger.).

Figure 5: G-group 2005

As with *G-group 2002*, the German tax authority in *G-group 2005* granted a reimbursement in proportion to the participation of Mr H and Mr B, who were residents of Australia and the United States respectively, but denied a reimbursement to Mr E, who was a Bermudian resident. The Bundesfinanzhof, however, allowed the refund under section 50d(3) of the ESTG.

The court found that the facts satisfied both of the requirements of section 50d(3). That is, there were economic and other relevant reasons for the interposition of the Dutch subsidiaries, and that the subsidiaries were involved in economic activities of their own.

5.6 Interpretation of Section 50d(3) in the Light of Base Company Cases

In a similar manner to the judicial reasoning in *G-group 2002*, the Bundesfinanzhof based its argument in *G-group 2005* on base company cases. When interpreting section 50d(3), the court observed:⁹⁵

[Section 50d(3) of the ESTG] excludes the right of a foreign corporation to be tax exempted or to pay a lower tax ... according to a double taxation convention, if persons participating in that corporation would have no right to

⁹⁵ *Id.*

a reduction of tax had they received the dividends directly, and—first—there is no economic or otherwise valid reasons for the interposition of the corporation and—second—the corporation does not have an economic activity of its own. The latter two requirements are cumulative for the tax relief to fail.

It is clear that the court was of the opinion that the facts of a case must satisfy both conditions at the same time for the court to refuse a reduction in withholding tax under section 50d(3).

The Bundesfinanzhof noted that the Dutch subsidiaries were part of the G-group along with European and non-European affiliates engaged in active business.⁹⁶ Within the G-group, the Dutch subsidiary held the shares of some of these affiliates, including the German companies. The court regarded the mere holding of shares as economic activity.⁹⁷

According to the Bundesfinanzhof, all affiliates confided the holding of shares within the group to independent corporations such as the Dutch subsidiaries. It found that this strategic outsourcing of the role of holding company was a long-term activity. It therefore concluded that in the present case the activity was not undertaken for the purpose of obtaining a withholding tax refund under the German-Netherlands double tax treaty. It noted that the Netherlands was the centre of the business of the European corporations of the G-group. Thus, the Dutch subsidiaries were not located in the Netherlands solely for the purpose of obtaining treaty benefits. The court, therefore, was of the opinion that the Dutch subsidiaries were entitled to treaty benefits by virtue of being residents of the Netherlands.⁹⁸

On the basis of these findings the Bundesfinanzhof concluded:⁹⁹

... [The Dutch subsidiaries] fulfilled their business purpose—holding of shares in foreign corporations—on their own account and autonomously. That is, the interposition of the Dutch subsidiaries had economic or other valid reasons. The absence of such reasons, however, is essential to deny a tax relief under [section 50d(3) of the ESTG]. Since [section 50d(3) of the ESTG] expressly refers to the (alternative) requirement of economic and other valid reasons, it is a special rule for abuse of law as compared to [section 42 of the AO], and may also be applied conclusively without reference to [section 42 of the AO].

5.7 Critique of the Reasoning of the Bundesfinanzhof

Two points emerge from this conclusion. First, the Bundesfinanzhof considered the *absence* of economic or other valid reasons to be essential when *refusing* tax relief under section 50d(3). However, when allowing treaty benefits under section 50d(3), the presence of economic or other valid reasons seem to be alternative requirements. That is, the requirement of economic or other valid reasons for interposition of the company in question and the requirement of economic activity seem to be alternatives when allowing treaty benefits. Thus, it could be inferred that if a company carried out an economic activity, the Bundesfinanzhof would allow the company to claim treaty

⁹⁶ *Id.* at para. 30(aa).

⁹⁷ *Id.* at para. 32.

⁹⁸ *Id.* at para. 31(bb).

⁹⁹ *Id.* (emphasis added).

benefits. Effectively, the court considered economic activity to be a criterion sufficient to qualify the company in question for relief.

Secondly, the court equated the presence of ‘economic or other valid reasons’ with business purpose. In this respect, the reasoning of the Bundesfinanzhof resembles the reasoning of the United States Tax Court in the *Northern Indiana* case,¹⁰⁰ where the court drew an analogy with base company cases, and was of the opinion that a withholding tax reduction was available ‘so long as there is a business purpose or the corporation engages in business activity’.¹⁰¹ It follows that, as with the court in *Northern Indiana*, the Bundesfinanzhof decided the case using an incorrect frame of reference.

Moreover, the holding of shares of affiliates seems to be a weak form of economic activity. Even if the holding of shares is an economic activity, there were no strong economic or other relevant reasons for interposing the Dutch subsidiaries. The considerations that the Bundesfinanzhof regarded as ‘economic and other relevant reasons’ for the interposition of Dutch holding companies seemed to be reasons for the organisation and co-ordination of the G-group.¹⁰² In sharp contrast, the court in *G-group 2002* had rejected such reasons on the basis that they merely clarified the corporate structure and business engagements within the group.¹⁰³

The analysis of *G-group 2002* and *G-group 2005* shows that when applying the substantive business activity test at least some courts draw analogies with base company cases. As a result, they decide conduit company cases erroneously, treating business activity as a sufficient criterion to qualify for tax relief.

It seems illogical to base a decision in a conduit company case on whether there is business activity. The discussion so far has shown that, logically, the criterion of business activity has merit as a one-way test in conduit company cases. For instance, judgments in *G-group 2002* and the *A Holding* case¹⁰⁴ show that the absence of business activity establishes that the interposition of a company lacks substance and, therefore, that the company can be categorised as a conduit. However, judgments in *G-group 2005* and the *Northern Indiana* case¹⁰⁵ fail to show convincingly that the presence of business activity necessarily indicates that the intermediary company does not act as a conduit.

6. WHAT CONSTITUTES SUBSTANTIVE BUSINESS ACTIVITY?

6.1 Introduction

Importing the test of substantive business activity from base company cases to conduit company cases is only a first step. Having taken that step, a court faces the dual questions of what amounts to ‘business’ activity and how much such activity must exist to earn the term ‘substantive’. The sections that follow examine cases that address these questions. Generally, courts conflate the two questions, asking simply, ‘was there substantive business activity’? Sometimes, there is not much going on, but the court

¹⁰⁰ *N. Indiana Pub. Serv. Co. v. Comm’r*, 105 T.C. 341 (1995)

¹⁰¹ *Id.* at 347 (emphasis added).

¹⁰² *Id.*

¹⁰³ *Re a Corporation*, 5 I.T.L.R. 589, 601 (2002) (BFH) (Ger.).

¹⁰⁴ *A Holding ApS v. Fed. Tax Admin.*, 8 I.T.L.R. 536 (2005) (Federal Court, Switz.).

¹⁰⁵ *N. Indiana*, 105 T.C. 341; *N. Indiana Pub. Serv. Co. v. Comm’r*, 115 F.3d 506, 510 (7th Cir. 1997).

will nevertheless find ‘substantive business activity’. Sometimes, the mere holding of shares and the management of passive income seems to constitute substantive business activity: a result that begs the question before the court, which is whether a holding of shares that undoubtedly exists amounts to a substantive business activity. On examination, such an activity (if holding shares can legitimately be called an ‘activity’ at all) often appears to have little purpose apart from obtaining treaty benefits.

The examination of what amounts to ‘substantive business activity’ that follows goes to the question of whether a company that claims to be carrying on a substantive business activity by virtue of holding shares should be dismissed as a mere conduit in two senses. First, assuming, contrary to the thesis of this article, that substantive business activity is an appropriate criterion, does such activity exist? Secondly assuming that the appropriate test for according treaty benefits is substantive ownership by a resident, it may be that whether there is substantive business activity may contribute to that test. Put another way, while the presence of substantive business activity should not, in the submission of this article, satisfy a court inquiring whether a company qualifies for treaty benefits as a resident, the absence of substantive business activity might be thought to disqualify the company.

6.2 Does Profit Spread Indicate Business Activity?

As discussed in Part 4.1, in the *Northern Indiana* case¹⁰⁶ there was a spread of one per cent between Finance’s inward and outward interest rates, which yielded a profit to Finance. Finance invested that profit to produce more income. According to the United States Court of Appeals for the Seventh Circuit, this transaction by Finance had economic substance. Thus, the court recognised Finance’s activity of borrowing and lending money as meaningful business activity.

The United States courts have used what is commonly known as a two-pronged test to determine whether a transaction has economic substance. First, a court must find that a taxpayer subjectively had a non-tax purpose for the transaction. That is, a transaction should be related to a useful non-tax business purpose that is plausible in the light of the taxpayer’s conduct and economic situation.¹⁰⁷ Secondly, there must be an objective possibility of a pre-tax profit. That is, the transaction must result in a meaningful and appreciable enhancement in the net economic position of a taxpayer (other than to reduce its tax).¹⁰⁸ This test has not been applied in a uniform manner.¹⁰⁹

As discussed in Part 4.3, the United States Tax Court found that Finance was established for a business purpose. It seems that the United States Court of Appeals was referring to the second prong when it considered the profit spread in the *Northern Indiana* case. It observed:¹¹⁰

Here, a profit motive existed from the start. Each time an interest transaction occurred, Finance made money and [Northern Indiana] lost money. Moreover,

¹⁰⁶ *N. Indiana*, 115 F.3d 506.

¹⁰⁷ E.g., *James A. Shriver v. Comm’r*, 899 F.2d 724 (8th Cir. 1990).

¹⁰⁸ *Knetsch v. United States*, 364 U.S. 361 (1960).

¹⁰⁹ Courts have applied the two-pronged test disjunctively and subjectively. Some courts have not used the two-pronged test. These courts have viewed business purpose and economic substance as mere precise factors to determine the issue of whether the transaction had any practical economic effect rather than the creation of some tax losses. See *Transcapital Leasing Assocs 1990-II LP v. U.S.*, 97 A.F.T.R.2d 2006-1916 (2006).

¹¹⁰ *N. Indiana*, 115 F.3d at 514 (emphasis added).

Finance reinvested the annual ... interest income it netted on the spread in order to generate additional interest income, and none of the profits from these reinvestments are related to [Northern Indiana].

6.3 Re-invoicing and Diverted Profits

Finance's activity of earning a profit on the inward and outward interest flows corresponds to a conventional re-invoicing transaction, which is generally regarded as tax avoidance. Re-invoicing involves back-to-back transactions that manipulate prices to inflate deductions. Re-invoicing is usually used for buying and selling transactions, typically for exporting or importing. It involves three parties: a corporation that owns a business, an intermediary that can be located either in a foreign low tax jurisdiction¹¹¹ or in the country of the business owner;¹¹² and customers. Although the intermediary is often an affiliate of the business owner, in some situations the business owner uses disguised ownership.

Re-invoicing is considered to be a tax avoidance practice. The reason is that it involves a deliberate manipulation of prices charged between related parties, often based in different jurisdictions, with a view to allocating part of the combined profits to the jurisdiction with the lowest effective tax rate. The *Northern Indiana* case is a special case of price manipulation in which the interest spread was the price charged by Finance. Thus, when the court recognised the activity of Finance as a business activity, it effectively recognised tax avoidance as a business activity. Moreover, since it was undisputed that the transaction was structured in order to obtain a tax benefit,¹¹³ the court effectively justified one technique of tax avoidance, treaty abuse, with another, re-invoicing.

Further, although Finance invested its profits in unrelated investments and thereby earned additional income, the position remained unchanged because Finance was wholly owned by Northern Indiana. Finance was created for a limited purpose and was liquidated after that purpose was accomplished. Within a predetermined time the profits reverted to Northern Indiana.

Where a corporate structure diverts profit to a subsidiary for that profit to revert to the parent company, it is a misuse of language to say that the diverted profit is an indication of business activity. *Revenue Ruling 84-153*¹¹⁴ illustrates the point. That Ruling involved facts similar to those of *Northern Indiana*, including the interposition of a profit-making Antilles subsidiary.

6.4 Revenue Ruling 84-153: Profit Spread is Not Relevant At All

Revenue Ruling 84-153 involved a United States parent company that maintained two wholly owned subsidiaries: one in the Netherlands Antilles and the other in the United States. The United States parent arranged for the Antilles subsidiary to raise funds by issuing Eurobonds. The Antilles subsidiary then on-lent the proceeds to the United

¹¹¹ E.g., *HIE Holdings Inc. v. Comm'r*, T.C. Memo 2009-130.

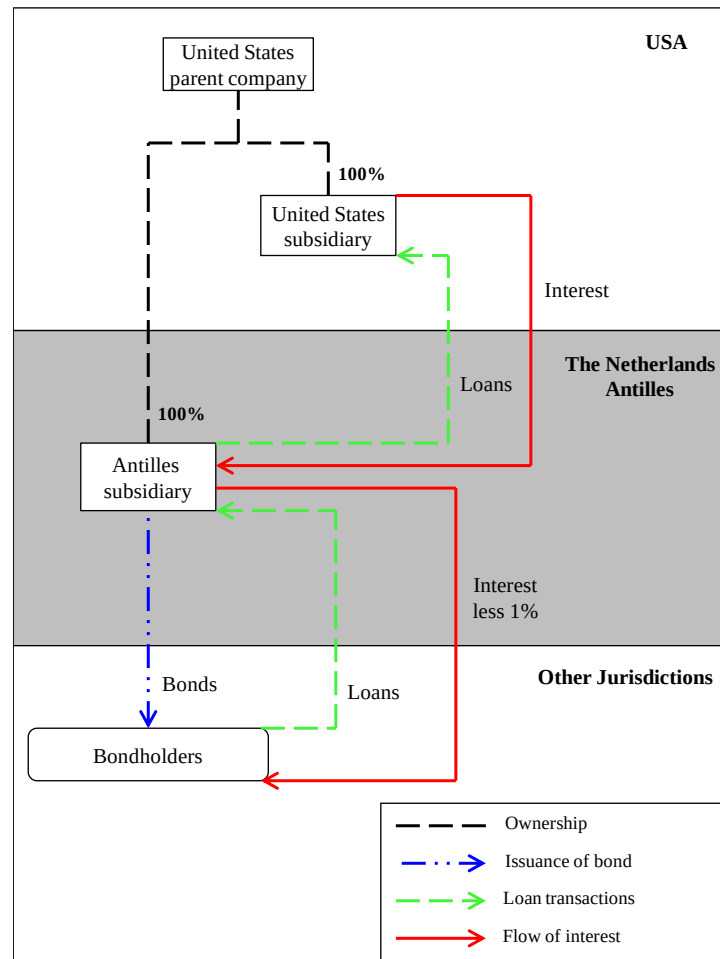
¹¹² E.g., *Cecil Bros Pty. Ltd. v. Fed. Comm'r of Taxation* (1964) 111 CLR 430 (Austl.); *Liggett Group Inc. v. Comm'r*, T.C. Memo 1990-18.

¹¹³ *N. Indiana*, 115 F.3d at 511.

¹¹⁴ Rev. Rul. 84-153, 1984-2 C.B. 383.

States subsidiary at an interest rate that was one per cent higher than the rate payable to the Eurobond holders. In the process, the Antilles subsidiary earned a profit.

Figure 6: Revenue Ruling 84-153



The Internal Revenue Service ruled that the interest payments from the United States subsidiary to the Antilles subsidiary were not exempted from United States withholding tax under Article viii(1) of the United States-Netherlands double tax treaty of 29 April 1948.¹¹⁵ The Internal Revenue Service found that the use of the Antilles subsidiary in the transaction was motivated by tax considerations and lacked 'sufficient business or economic purpose to overcome the conduit nature of the transaction, even though it could be demonstrated that the transaction might serve some business or economic purpose'.¹¹⁶ That is, although the Internal Revenue Service seemed to acknowledge the existence of the profit spread, it did not consider the spread to be relevant.

¹¹⁵ Convention with Respect to Taxes on Income and Certain Other Taxes U.S.-Neth., Apr. 29, 1948, 32 U.N.T.S. 167 [hereinafter U.S.-Neth. Tax Convention]. The relevant part of Article viii(1) read: 'Interest (on bonds, securities, notes, debentures, or on any other form of indebtedness) ..., derived from sources within the United States by a resident or corporation of the Netherlands not engaged in trade or business in the United States through a permanent establishment, shall be exempt from United States tax ...'.

¹¹⁶ Rev. Rul. 84-153, 1984-2 C.B. 383, 383.

The Internal Revenue Service based its ruling on the object and purpose of double tax treaties. When interpreting Article viii(1) of the United States-Netherlands double tax treaty, the Internal Revenue Service observed:¹¹⁷

The words ‘derived ... by’ refer not merely to [the Antilles subsidiary’s] temporarily obtaining physical possession of the interest paid by [the United States subsidiary], but to [the Antilles subsidiary] obtaining complete dominion and control over such interest payments ... [F]or purposes of the interest exemption in Article viii(1) of the Convention, the interest payments by [the United States subsidiary] will be considered to be ‘derived ... by’ the foreign bondholders and not by [the Antilles subsidiary].

The Internal Revenue Service’s emphasis on the words ‘derived ... by’ shows that it focused on the issue of whether the Antilles subsidiary was the substantive economic owner of the interest payments. It interpreted Article viii(1) from a substantive economic point of view, which was consistent with the context in which double tax agreements function. This approach seems more appropriate than that adopted by the courts in *Northern Indiana*.

As discussed in Part 4.3, the court decided *Northern Indiana* by adopting reasoning from straw company and base company cases. It did not decide the case in accordance with the object and purpose of double tax treaties. If it is assumed that the court in *Northern Indiana* did consider the object and purpose of double tax treaties,¹¹⁸ the court misinterpreted Article viii(1).¹¹⁹

The Court of Appeals for the Seventh Circuit observed that ‘Under the terms of the Treaty, interest on a note that is ‘derived from’ a United States corporation by a Netherlands corporation is exempt from United States taxation’.¹²⁰ Although the interest payments in question were made between 1982 and 1985, the United States Court of Appeals surprisingly chose to refer to Article viii(1) as it stood before its amendment in 1965.¹²¹ The relevant part of Article VIII(1), before its amendment in 1965, read:

Interest ... derived from sources within the United States by a resident or corporation of the Netherlands not engaged in trade or business in the United States through a permanent establishment, shall be exempt from United States tax ...

The court’s interpretation of the provision shows that it emphasized the words ‘derived from’, rather than the words ‘derived ... by’ that the Internal Revenue Service emphasized in the *Revenue Ruling 84-153*. The court’s observation suggests that, rather than focusing on the issue of whether the substantive economic owner of the interest payments was resident in the Netherlands, the court was preoccupied with the fact that the taxpayer, *Northern Indiana*, was located in the United States. This observation reaffirms that the court analysed the facts erroneously.

¹¹⁷ *Id.* at 383.

¹¹⁸ *N. Indiana*, 115 F.3d at 510.

¹¹⁹ U.S.-Neth. Tax Convention, *supra* note 115, art. viii(1).

¹²⁰ *N. Indiana*, 115 F.3d.

¹²¹ U.S.-Neth. Tax Convention, *supra* note 115, art. viii(1).

6.5 Reasons for the Existence of Interposed Company

On an analysis of the facts of the *Northern Indiana* case in the light of the object and purpose of double tax treaties, it is difficult to conclude that there were legitimate reasons for the existence of Finance, the company that was interposed between borrower and lender.

The United States Court of Appeals for the Seventh Circuit observed:¹²²

The Commissioner has suggested that [Northern Indiana's] tax-avoidance motive in creating Finance might provide one possible basis for disregarding the interest transactions between [Northern Indiana] and Finance. The parties agree that Taxpayer formed Finance to access the Eurobond market because, in the early 1980s, prevailing market conditions made the overall cost of borrowing abroad less than the cost of borrowing domestically. It is also undisputed that [Northern Indiana] structured its transactions with Finance in order to obtain a tax benefit—specifically, to avoid the thirty-percent withholding tax. What is in dispute is the legal significance of [Northern Indiana's] tax-avoidance motive.

This passage rests on assumptions about tax avoidance that the court neither articulated nor, it seems, recognised.¹²³ These assumptions do not withstand scrutiny. The first such assumption is that avoiding tax may be justified if the taxpayer's motive is to achieve an increased return on the business or investment in question, if necessary by avoiding tax. But this motive surely drives any tax avoidance: why avoid tax if not to retain more of one's pre-tax income? If this justification were accepted it is hard to see any circumstances where the revenue could successfully challenge business or investment structures that are adopted for tax avoidance purposes.

The reasoning in the previous paragraph is stated broadly, being framed in terms of tax avoidance in general. The reasoning may be re-phrased to focus on the form of avoidance that is relevant for purposes of this article, namely avoidance by exploiting a tax treaty. Revisiting the passage quoted from the *Northern Indiana* case in the light of this sharper focus suggests that the passage assumes that an arrangement that frustrates the purpose of a double tax treaty by contriving to confer treaty benefits on residents of a third state is justified, or at least may be justified, if the reason for the arrangement is to reduce tax that would otherwise be suffered. To quote again the pertinent words, '[Northern Indiana] structured its transactions ... to avoid ... withholding tax'. The court rejected the Commissioner's challenge to the structure that Northern Indiana adopted to achieve that result. That is, the court seems to have accepted that a motive of avoiding withholding tax justifies tax avoidance. That reasoning is circular. It is tantamount to saying that avoiding tax is justified if one's motive is to suffer less tax. In short, the court's assumption does not withstand scrutiny.

¹²² *N. Indiana*, 115 F.3d at 510.

¹²³ The authors use 'tax avoidance' to label the middle category in the tri-partite framework of 'mitigation' (that is, reducing tax by legitimate means); 'avoidance', (meaning reducing tax by means that frustrate the intention of the law or, in civil law terms, by abuse of law); and 'evasion' (meaning reducing tax by concealment or other illegality). Prebble & Prebble, *supra* note 29, at 151, adds detail to this explanation. The 18th Congress of L'Académie Internationale de Droit Comparé, Washington DC, 2010, adopted the analytical framework of mitigation, avoidance, and evasion for its study of tax minimisation: A COMPARATIVE LOOK AT REGULATION OF CORPORATE TAX AVOIDANCE 1 (Karen B. Brown ed., 2012).

The first assumption, just discussed, focuses on the objective purpose of the arrangement in question, in the *Northern Indiana* case that purpose being also the purpose of the taxpayer. Consider now a second apparent assumption lying behind the passage from *Northern Indiana*. This second assumption focuses on the subjective motive of the taxpayer. The court seems to assume that an arrangement that avoids tax by contriving to obtain treaty benefits for residents of a third country may survive the Commissioner's challenge if the taxpayer's motives are unexceptionable. That is, even if from an objective perspective the arrangement itself has the purpose of avoiding tax the arrangement may be invulnerable to attack by the revenue if the taxpayer's subjective motives did not involve tax avoidance. An example might be where, for instance, it had not occurred to the taxpayer that the arrangement in question might reduce tax. In the opinion of the court, another example appears to be the case where the taxpayer wishes to take advantage of a source of funds available for borrowing that offers cheaper rates than domestic lenders, even though after tax that source would be more expensive because interest would be subject to withholding tax (absent the interposition of a treaty-shopping structure).

Such an argument should be untenable. Indeed, in general principle a court should disregard as self-serving a taxpayer's evidence that an arrangement that avoids tax by frustrating the objective of a treaty was driven by subjective reasons that do not involve tax avoidance. To summarise these points, even if one assumes that taxpayers' subjective motives are pure (at any rate, that the motives involve considerations other than tax avoidance), it does not follow that taxpayers' arrangements should escape challenge by the revenue. Taxpayers' motives may differ from the objective purpose of arrangements that they construct. It follows that it would be odd if taxpayers could defend avoidance arrangements by pleading that they had no intention to avoid tax, even if their pleas are true.

An analogy with Christian belief may help. Take the sixth Beatitude: 'Blessed are the pure in heart: for they shall see God'.¹²⁴ To Paul, this and other Biblical passages mean that '[A] man is justified by faith without the deeds of the law'.¹²⁵ In the *Northern Indiana* case the Court of Appeals for the Seventh Circuit appears to take a Pauline approach: if taxpayers' hearts are pure, justification is vouchsafed to them (at any rate they qualify for a reduction in tax). But the kind of faith that in Paul's view may be sufficient for justification hardly suffices in a fiscal context. When it is a question of minimising tax, taxpayers should be judged objectively, by their works, that is by the nature of the structures that they contrive.¹²⁶ As James wrote, 'You see that a man is justified by works and not by faith alone'.¹²⁷

The Pauline approach of the Court of Appeals for the Seventh Circuit suggests that the court focused on *Northern Indiana*'s motive and analysed the company's borrowing structure in the light of that motive. The court emphasised that *Northern Indiana* wished to raise funds for its business and that the main reason for introducing Finance between lenders and borrower was to escape the higher rates of interest imposed in the United States. The court considered the motive of *Northern Indiana* to be related to business and therefore approved by law.¹²⁸ The court therefore concluded that the arrangement

¹²⁴ *Matthew* 5:8.

¹²⁵ *Romans* 3:28.

¹²⁶ *C.f., Newton v. Fed. Comm'r of Taxation* [1958] AC 450 (P.C.) 465-466 (appeal taken from Austl.).

¹²⁷ *James* 2:24.

¹²⁸ *N. Indiana Pub. Serv. Co. v. Comm'r*, 115 F.3d 506, 512 (7th Cir. 1997).

withstood the Commissioner's challenge because it related to a business purpose. The court pointed out that the interposition of financing subsidiaries in the Netherlands Antilles was 'not ... an uncommon practice',¹²⁹ a practice acknowledged by the legislative history of the Federal Deficit Reduction Act 1984. This argument is tantamount to saying that an avoidance structure withstands challenge if everyone climbs on board, or, contrary to James, a pure heart is enough, do not be concerned with what the taxpayer actually does.

If this was indeed the view of the judges, it is odd. It is most unlikely that negotiators of double tax treaties or legislators in approving treaties would have in mind that residents of third states should obtain treaty benefits by the simple expedient of establishing a subsidiary in one of the states. In particular, how could a court sensibly attribute such a policy to the Senate of the United States? It is plausible to consider that United States legislators might take the view that the United States should not impose tax on foreigners who derive interest that flows to them from sources within the United States. Indeed, Congress later came to that conclusion.¹³⁰ But if legislators were of that opinion the obvious action was to repeal the tax, not to require foreign lenders who wished to take advantage of that policy to get their borrowers to establish financing subsidiaries in the Netherlands Antilles. Such a hypothetical policy would be incoherent.

Because the court in *Northern Indiana* analysed the facts from the wrong perspective, it focused on the fact that the taxpayer was a resident of the United States. In doing so the court seems to have overlooked that Eurobond holders who were residents of states other than the states that were parties to the treaty obtained tax advantages that the states parties had intended to go only to their own residents.

Even if it is assumed that Finance had a business activity, its activity seemed uncomplimentary to the business activity of Northern Indiana, a domestic utility company. Moreover, as discussed in Part 4.1, Finance was liquidated soon after Northern Indiana completed the payment of the principal amount plus interest to the Eurobond holders. These facts suggest that in the corporate structure Finance was merely a conduit for passing on interest to Eurobond holders.

6.6 Can Holding Shares Constitute a Business Activity?

As discussed previously,¹³¹ in *G-group 2002*¹³² the only business activity of Dutch BV was to hold shares of GmbH. Dutch BV had no personnel or business premises. The business director of Dutch BV served as the business director of other affiliated companies in the Netherlands. According to the Bundesfinanzhof, Dutch BV's activity did not constitute 'economic activity' under section 50d(3) of the EStG. It observed:¹³³

¹²⁹ *Id.* at 513.

¹³⁰ 'Section 127 of the Tax Reform Act of 1984 generally repealed the former 30 percent United States withholding tax on interest derived by non-resident aliens ... from certain debt obligations issued after July 18, 1984, by United States corporations, the United States government, and certain foreign corporations engaged in a substantial amount of business activity in the United States.' Roger E. Pront & Roger M. Zatieff, *Repeal of the United States Withholding Tax on Interest Paid to Foreigners*, 3 INT'L TAX & BUS. LAW. 191 (1986). More formally, the Tax Reform Act 1984 was the Deficit Reduction Act of 1984, Pub. L. No 98-368, 1, 98 Stat. 494 (1984).

¹³¹ See *supra* Part 5.4.

¹³² *Re a Corporation*, 5 I.T.L.R. 589, 602 (2002) (BFH) (Ger.).

¹³³ *Id.* at 601(emphasis added).

Additionally, there is no proof that the plaintiff has developed its own economic activity. To hold the participation [that is, the shares that the plaintiff company held] in the German G-GmbH without any *managing function* does not fulfil the requirements that can be expected for such an activity. The fact that the Parent-Subsidiary directive of the European Union ... in art 2 uses the wording ‘company of a Member State’ without any requirements of an activity does not change the statement. Even if it were conclusive that, according to the Directive, to hold one single participation in a corporation and, therefore, the existence of a pure holding corporation were sufficient ..., a simple letterbox-company with only formal existence like the plaintiff, however, would not correspond to the supranational requirements.

This observation implies that regardless of the number of companies in which an intermediary holds shares, this activity does not fulfil the requirement of ‘economic activity’ unless the intermediary carries out its own directorial functions. The Bundesfinanzhof followed this approach in *G-group 2005*.

As discussed in Part 5.5 in *G-group 2005* the affiliates out-sourced the passive shareholding activity to the Dutch subsidiaries. The Bundesfinanzhof considered holding of shares to be an economic activity. It emphasized two facts. First, the Dutch subsidiaries were holding shares of their own accord, and were functioning autonomously. Secondly, the Dutch subsidiaries held shares in other foreign companies in addition to shares in the German companies.¹³⁴

Holding shares should not be regarded as an economic activity, even if the company manages its own operations. This argument applies even if the intermediary holds shares in more than one company. Holding shares is a weak form of business activity, and the fact that an intermediary that holds shares also has an active board of directors does not necessarily add any substance to the shareholding activity, at least not in the context of double tax treaties. Such an intermediary can still act as a conduit.

As explained in part 5.3 of this article, the reason why the Bundesfinanzhof in *G-group 2002* accorded importance to management functions seems to be that the court decided the case in the light of reasoning in base company cases. As explained in part 5.3, because the court drew an analogy with base company cases it was preoccupied with the issue of the recognition of an intermediary for tax purposes. As illustrated by *Hospital Corporation of America*,¹³⁵ courts in base company cases tend to consider the presence of an active board of directors to indicate that a corporation carries out substantive business activity and therefore can be recognised for tax purposes.¹³⁶ Nevertheless, *G-group 2002* and *G-group 2005* were conduit company cases, and, therefore, should have been decided in the light of the purpose of the Germany-Netherlands double tax treaty.¹³⁷ In *G-group 2005* ‘managing function’ acted as a misleading label that hid the conduit nature of the Dutch subsidiaries and allowed them to obtain treaty benefits improperly. By recognising ‘management function’ as ‘economic activity’ under section 50d(3), the Bundesfinanzhof effectively recognised the improper use of tax treaties as economic activity.

¹³⁴ Bundesfinanzhof [BFH] [Federal Tax Court] May 31, 2005, BUNDESSTEUERBLATT Teil II [BStBl. II] 14 (para. 32) (Ger.).

¹³⁵ *Hosp. Corp of Am. v. Comm’r* 81 T.C. 520 (1983).

¹³⁶ At 584.

¹³⁷ Ger.-Neth. Double Taxation Agreement, *supra* note 87.

6.7 Reasons for the Existence of the Dutch Subsidiaries

It is difficult to find a reason for the existence of the Dutch subsidiaries in the G-group apart from obtaining the benefit of a full withholding tax reduction under the German-Netherlands double tax treaty. The diagram in Part 5.5 shows that apart from treaty benefits there seems to have been no point in the existence of the sub-holding companies inserted in the structure between G Ltd in Bermuda and the operating companies in Europe.

Double tax treaties between the Netherlands and the resident states of most of the affiliates provided for a full reduction of withholding tax on dividends. Thus, the location of the Dutch subsidiaries ensured that dividends flowed from affiliates in general and German companies in particular ultimately to Bermuda with a minimum tax impost.

As mentioned in Part 5.5, the Dutch subsidiaries within the G-group acted as conduits. The Dutch subsidiaries had no employees, business premises or equipment. Their business director served several other affiliates. They had no activity apart from holding the affiliates' shares.

As discussed in Part 5.6, the Bundesfinanzhof accorded importance to the activities of the other affiliated companies.¹³⁸ It noted that the Dutch subsidiaries formed part of a group of companies involved in the television sector. Within the group, they functioned as long-term shareholders in the other affiliated companies. The court regarded these facts as 'economic and other valid reasons' for the interposition of the Dutch subsidiaries.¹³⁹

In contrast, when examining the activity of Dutch BV in *G-group 2002*, the Bundesfinanzhof observed:¹⁴⁰

Finally, it is without any relevance in this connection that [Dutch BV's] sister-companies, also resident in the Netherlands, might fulfil the requirement of an economic activity and play an active functional part of the G group. Assuming that this is true, the only economic activity of the sister-corporations may not be attributed to [Dutch BV] in a way that [Dutch BV] could be treated as a managing holding corporation.

This observation illustrates that economic activity that is irrelevant to the income in question cannot be considered relevant when determining whether an intermediary is entitled to treaty benefits in respect of that income. In *G-group 2005*, the activity of the Dutch subsidiaries did not serve the economic interests of the affiliates. It follows that their activity did not add to the significance of Dutch subsidiaries in the G-group.

The German legislature amended section 50d(3) of the ESTG on 19 December 2006. In the amended section 50d(3) the German legislature specifically addressed the loopholes exploited by the taxpayer in *G-group 2005*. The provision, however, still uses business activity as a criterion, and fails to explain why an intermediary's

¹³⁸ BStBl. II 14 (para. 32) (Ger.).

¹³⁹ *Id.* at para. 31(bb).

¹⁴⁰ *Re a Corporation*, 5 I.T.L.R. at 601.

economic activity should entitle the intermediary to be treated as a resident owner of the income.

6.8 The Amended Section 50d(3) of the ESTG

Section 50d(3), as it stands after its amendment on 19 December 2006, reads:¹⁴¹

¹A foreign company is not entitled to a full or partial relief under sections 1 and 2 if and to the extent persons with a holding in it are not entitled to reimbursement or exemption, had they received income directly, and

1. There is no economic or other relevant reason to establish the foreign company or
2. The foreign company does not earn more than 10 per cent of its gross income from its own economic activity or
3. The foreign company does not participate in general commerce with business premises suitably equipped for business purposes.

²Only the circumstances of the foreign company shall be taken into account; organisational, economic and other significant features of companies that have close relations to the foreign company... shall not be considered. ³The foreign company shall be regarded as having business operations of its own, as long as the foreign company earns its gross returns from the management of assets or a third party is in charge of their essential business operations.

⁴Sentences 1 to 3 shall not be applied if the main class of the shares of the foreign company is traded substantially and regularly on a recognised stock exchange or the foreign company is subjected to the rules and regulations of the Investment Tax Act.

By quantifying ‘economic activity’, and by clarifying its meaning, the provision may prevent companies without a business activity from obtaining the benefit of a withholding tax reduction under a double tax treaty. However, the provision fails to capture situations in which an interposed foreign company should be treated as a mere conduit despite being involved in a genuine business activity. This was the position in *Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland*.¹⁴² Although *Bank of Scotland* was a French case and did not concern section 50d(3) of the ESTG at all, it is relevant in the present context because it illustrates that section 50d(3) would have failed to function effectively if it had been applied to that case.

6.9 The Bank of Scotland Case

Pharmaceuticals Inc was a company resident in the United States. It held all the shares in Marion SA, a French company. In 1992 Pharmaceuticals Inc entered into a three-year usufruct contract with the Bank of Scotland, a company resident in the United Kingdom, under which the bank acquired dividend coupons attached to some shares of Marion SA. The Bank of Scotland acquired the usufruct in consideration for a single payment to Pharmaceuticals Inc. Under the contract, the bank was entitled to receive a

¹⁴¹ Einkommensteuergesetz [ESTG] [Income Tax Act], Oct., 16, 1934 BGBl I at 3366, as amended by Jahressteuergesetzes [Finance Law], Dec., 13, 2006 BGBl I at 2878, § 50d(3). The numbering system adopted with superscript numbers 1 to 4 is the numbering system of the Einkommensteuergesetz. These superscript numbers appear in the beginning of sentences, not paragraphs.

¹⁴² *Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland*, 9 I.T.L.R. 683 (2006).

predetermined dividend from Marion SA in each of the three years of the usufruct. Pharmaceuticals Inc guaranteed the payment of dividends.

By French law, dividends that Marion SA paid to foreign recipients were subject to a 25 per cent withholding tax. Article 9(6)¹⁴³ of the France-United Kingdom double tax treaty of 22 May 1968 reduced French withholding tax to 15 per cent on dividends distributed to a company resident in the United Kingdom. The France-United States double tax treaty of 28 July 1967 contained a similar provision. But Article 9(7)¹⁴⁴ of the France-United Kingdom treaty also provided for a refund of the *avoir fiscal* that France imposed after the deduction of withholding tax.

Pharmaceuticals Inc designed its usufruct arrangement with the Bank of Scotland in order to obtain the benefit of the provisions of the France-United Kingdom double tax treaty. The arrangement would have allowed Pharmaceuticals Inc to obtain *both* a withholding tax reduction of 10 per cent (from 25 per cent to 15 per cent) and a refund of the *avoir fiscal*. Further, by the end of the three years of the usufruct, the Bank of Scotland would have received both its three years of dividends and a refund of the *avoir fiscal*. The aggregate of dividends and *avoir fiscal* would have exceeded the price that the Bank of Scotland paid to Pharmaceuticals Inc for the assignment of the right to dividends from Marion SA at the inception of the scheme. (No doubt the excess represented the bank's share of French tax that Pharmaceuticals Inc had hoped to save by means of the scheme.)

If Pharmaceuticals Inc had received dividends directly from Marion SA it would have paid 15 per cent French withholding tax under the France-United States double tax treaty but would not have qualified for a refund of the *avoir fiscal*.¹⁴⁵

In 1993, Marion SA distributed dividends to the bank after deducting 25 per cent French withholding tax. The bank applied to the French tax administration for a partial refund of the withholding tax and a reimbursement of the *avoir fiscal* tax credit under France-United Kingdom double tax treaty.

Figure 7: The Bank of Scotland case

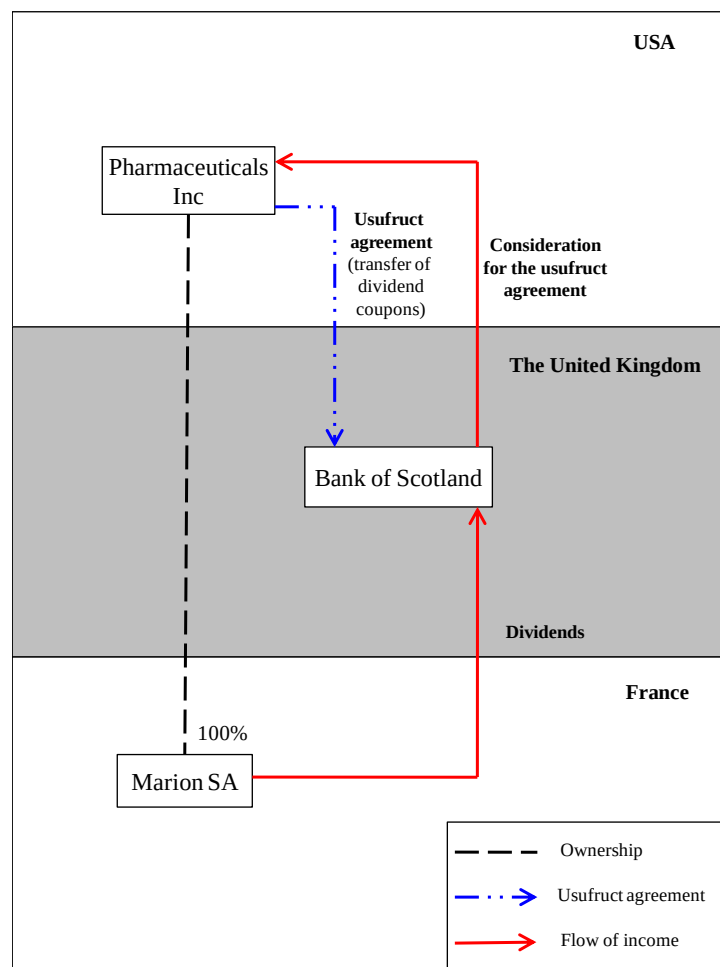
¹⁴³ Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Fr.-U.K., art. 9(6), May 22, 1968, 725 U.N.T.S. 3 [hereinafter Fr.-U.K. Convention]. It provided: 'Dividends paid by a company which is a resident of France to a resident of the United Kingdom may be taxed in the United Kingdom. Such dividends may also be taxed in France but where such dividends are beneficially owned by a resident of the United Kingdom the tax so charged shall not exceed:

(a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which controls the company paying those dividends;

(b) in all other cases 15 per cent of the gross amount of the dividend'.

¹⁴⁴ *Id.* at art. 9(7). The relevant part of art. 9(7) provided 'A resident of the United Kingdom who receives from a company which is a resident of France dividends which, if received by a resident of France, would entitle such resident to a fiscal credit (*avoir fiscal*), shall be entitled to a payment from the French Treasury equal to such credit (*avoir fiscal*) subject to the deduction of the tax provided for in sub-paragraph (b) of paragraph (6) of this Article.'

¹⁴⁵ *Id.* at art. 10(2)(b).



The French tax administration denied the request on the grounds that the Bank of Scotland was not the beneficial owner of the dividends. The tax administration characterised the transaction as a loan made by the bank to Pharmaceuticals Inc, which was repaid by the dividends from Marion SA.

The Supreme Administrative Court ruled in favour of the French tax administration. The court reasoned that the France-United Kingdom double tax treaty¹⁴⁶ entitled only the beneficial owner of dividends to both a refund of withholding tax and a reimbursement of the *avoir fiscal*. After analysing the contractual arrangements that comprised the usufruct, the court was of the opinion that Pharmaceuticals Inc was the beneficial owner of the dividends. Further, the price that the Bank of Scotland paid to Pharmaceuticals in consideration for the three-year dividend stream from Marion SA was in effect a loan, with the dividend stream repaying both interest and principal. That is, Pharmaceuticals Inc had delegated the repayment of the loan to Marion SA.¹⁴⁷ The court found that the sole purpose of the agreement was to obtain the benefit of *avoir*

¹⁴⁶*Id.*

¹⁴⁷ *Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland*, 9 I.T.L.R. 683, 703 (2006).

fiscal tax credit available under the France-United Kingdom tax treaty,¹⁴⁸ which was not available under the corresponding treaty between France and the United States.¹⁴⁹

The outcome has a certain irony. The Supreme Administrative Court refused treaty benefits to the Bank of Scotland because it considered that the bank was not the beneficial owner of the dividends. That is, the court denied to the bank both (a) the reduced treaty rate on dividends and (b) a refund of the *avoir fiscal*. Had the parties not put the scheme into effect, and had Marion SA simply paid dividends to its shareholder, Pharmaceuticals Inc, the dividends would have qualified for the France-United States treaty rate, which, as mentioned, was 15 per cent, the same rate as under the France-United Kingdom treaty. By trying both to have its cake (a reduced treaty rate on dividends) and to eat it (a refund of the *avoir fiscal*) the bank lost both benefits. The case is an example of a tax planning own goal.

A theoretical argument might have partially saved the day for the Bank of Scotland. As mentioned, the court denied the 15 per cent France-United Kingdom treaty rate to the bank because the bank was not the beneficial owner of the dividends. But the beneficial owner was in the wings, namely Pharmaceuticals Inc, of the United States. It follows that in principle the dividends qualified to be taxed at 15 per cent by virtue of the France-United States treaty. The Bank of Scotland does not seem to have advanced this argument before the Supreme Administrative Court. No doubt the argument would have failed, if only because France delivers relevant treaty benefits not by reducing initial withholding tax but by refunding the taxpayer who has suffered the withholding in question. In the *Bank of Scotland* case that taxpayer was the bank, not Pharmaceuticals Inc.

6.10 Would The German Section 50d(3) Have Worked in the Facts and Circumstances of The Bank Of Scotland Case?

If the Bank of Scotland (or a taxpayer in a corresponding position) were to employ the scheme in the *Bank of Scotland* case to obtain benefits under a German tax treaty, it is possible that the bank, as a foreign company, would be allowed a withholding tax reduction by virtue of the business activity test under section 50d(3) ESTG. On the assumption that the Bank of Scotland's structure and business remained as it was at the time of the Pharmaceuticals Inc-Marion SA scheme, it would seem that the bank would satisfy the conditions of that provision. The Bank of Scotland was involved in a business activity and earned more than 10 per cent of its gross income from that business activity. It had business premises, and it participated in general commerce. Although there were no economic or other relevant reasons for interposing the bank into the investment structure, seemingly the bank would still be entitled to treaty benefits because its shares were traded substantially and regularly on a recognised stock exchange, or, at least, they were at the time of the case.

This result appears to be contrary to the policy of double tax treaties. The bank could not be considered to be the owner of the income in a substantive economic sense, regardless of the fact that it was involved in genuine business activity.

This analysis demonstrates that although the absence of business activity may establish that an intermediary is a mere conduit the converse is not necessarily true. The fact that

¹⁴⁸ Fr.-U.K. Convention, *supra* note 143.

¹⁴⁹ Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.S.-Fr., Aug. 31, 1994, 1963 U.N.T.S. 67.

an intermediary is involved in business activity does not necessarily show that it is not acting as a conduit or, to avoid the double negative, a company may act as a mere conduit even though it carries on substantive business activity.

7. REFORM AND CONCLUSION

7.1 The OECD Discussion Draft of April 29 2011

The question of conduit companies has remained under official review for some years. In 1987 the OECD published the Conduit Companies Report.¹⁵⁰ The Commentary to the OECD Model Tax Convention and the Model itself, are always the subject of study. On April 29, 2011 the OECD published a Discussion Draft on the Clarification of the Meaning of 'Beneficial Owner'.¹⁵¹ However, it is submitted that, while reform is necessary, prospects of progress are modest at best if policy makers follow the approach in the discussion draft.

Among the fundamental problems that this article addresses, two stand out: the illogicality of accepting activity as an indicium of ownership; and the problem of deciding between legal and substantive perspectives of corporations, especially corporations that act as conduit companies. As the authors read it, the OECD discussion draft of 2011¹⁵² does not address the first of these problems, the illogicality of accepting activity as an indicium of ownership. In short, the discussion draft does not address the subject-matter of this article. The draft thus hobbles its attempts to clarify the meaning of 'beneficial owner' by failing to address the fundamental illogicality of a test—substantive business activity—that, as this article demonstrates, is a major component of existing attempts to clarify that meaning. This shortcoming of the draft leads the authors to conclude that the draft is likely to shed only limited light on the subject that it addresses.

7.2 The Discussion Draft and Corporate Personality

While it does not say much about the test of substantive business activity, the draft does, at least indirectly, address a related problem of the meaning of 'beneficial owner', namely the problem of whether treaty law must respect the corporate form, or should look past corporate form to discover whether owners of a company are entitled to treaty benefits as residents of one of the states that are parties to the treaty in question. This article adverts to that problem in Part 1.2. Briefly to return to that issue, the authors add here a short comment on the manner in which the discussion draft addresses that issue.

While the draft does have something to say on the point, as the authors read it the draft is somewhat imprecise. One could make the point by referring to a number of parts of the draft, but analysis of some of the text of a single example suffices. Take draft paragraph 12.4, which explains that:

(1) The recipient of a dividend is the 'beneficial owner' of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment on to another person. [Note in passing the false dichotomy between 'contractual' and 'legal'. What obligation is 'contractual' but not 'legal'?] (2) Such an obligation will

¹⁵⁰ *Conduit Companies Report*, *supra* note 14.

¹⁵¹ OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 25.

¹⁵² *Id.*

normally derive from relevant legal documents (3) but may also be found to exist on the basis of facts and circumstances ... showing that, in substance, the recipient clearly does not have the full right to use and enjoy the dividend; (4) also, the use and enjoyment of a dividend must be distinguished from legal ownership [Numbers added for purposes of discussion].

Let us call each numbered section a 'text'. Text 1, referring to enjoyment, defines 'beneficial ownership' in terms of legal ownership. But text 4 says that enjoyment of a dividend must be distinguished from legal ownership. Text 3 tells us that enjoyment may exist as a matter of fact, without legal rights

The observation in text 3 is helpful until one compares text 3 with text 1, since text 3 seems to suggest that full factual enjoyment is correctly called 'beneficial ownership', and until one at the same time compares text 3 with draft paragraph 12.5, which says that, 'The concept of 'beneficial owner' deals with some forms of tax avoidance (i.e., those involving the interposition of a recipient who is obliged to pass the dividend to someone else) ...'. That is, draft paragraph 12.5 uses 'beneficial owner' to refer to a legal owner who is nevertheless obliged to act as a conduit.

Now compare text 1, on one hand, with text 2 and text 3 on the other. Text 1 refers to a recipient who enjoys a category of benefit that is 'unconstrained by a contractual or legal obligation'. That is, text 1 locates itself in the context of legal obligations and legal freedoms and powers. The recipient has legal freedom or power to enjoy the dividend and no inconsistent legal obligation constrains that freedom or power. Text 2 occupies the same territory; the recipient derives her freedoms and powers from 'relevant legal documents'. In contrast, text 3 identifies an agent (in the sense of an actor, not in the legal sense of the complement of a principal) who is not the recipient but who, nevertheless, enjoys dominion over the dividends in question. Unlike the recipients in texts 1 and 2, the recipient in text 3 does not enjoy such dominion; instead, the recipient is subject to an obligation to pass the dividend on to the agent. But text 3's enjoyment by the agent is not based in law; the enjoyment is factual and circumstantial, in short, substantive. Likewise, for reasons of substance, not of law, the recipient itself does not enjoy dominion over the dividends that it receives. That is, text 2 and text 3 address concepts that differ (law and substance) and address recipients that differ in respect of the dominion that they enjoy over dividends that they receive: dominion for the recipient in respect of text 2, but no dominion in respect of text 3.

The inference to be drawn from the analysis in the previous paragraph is that the categories that are the subjects of text 2 and text 3 can be interpreted sensibly only as mutually exclusive sub-sets of the category that is the subject of text 1. But this inference makes sense in respect of text 2 only. The subject matter of text 1 locates itself in the territory of law, as does the subject matter of text 2. That is, text 2 can logically form a sub-set of text 1. But the subject matter of text 3 relates to fact, circumstance, and substance, not to law. The subject matter of text 3 cannot be a sub-set of the subject matter of text 1, either linguistically or logically.

It is not enough to say in defence of the draft, 'The language may be loose, but we know what the Committee on Fiscal Affairs intends'. As first sight, that may appear to be so. But the analysis in the foregoing paragraphs shows that no, the draft is not coherent enough for us to know what the Committee intends; the Committee's meaning slides elusively from one signification to another. This result is unsurprising. When people

try to use the same language to express opposing concepts confusion is almost inevitable.

Is the criticism in the preceding paragraphs ungenerous? The Committee on Fiscal Affairs does its best with the weapons available to it. But the sword of beneficial ownership shatters on the anvil of corporate personality. If one tries to reduce this area of the law to anything resembling a rule or series of rules felicitous results are unlikely.

7.3 Conclusion

Although different reports of the OECD and courts substitute the substantive business activity test for the beneficial ownership test, that test is not related to the concept of ownership at all.

Originally, courts applied the substantive business activity test to cases involving straw companies and base companies. The focal issue in those cases is whether a corporation should be recognised for tax purposes. Courts considering base companies and straw companies considered the presence of substantive business activity to be sufficient to recognise a corporation as a separate taxable entity. Conduit company cases *prima facie* appear similar to straw company cases and base company cases. Probably for this reason, some courts have applied the test of substantive business activity to conduit company cases by transplanting the reasoning adopted in cases involving straw companies and base companies.

Unlike cases involving straw companies and base companies conduit company cases should be determined in the light of the object and purpose of double tax treaties. Although the absence of a business activity indicates that the interposition of an intermediary lacks substance for the purpose of qualifying for treaty benefits, its presence does not necessarily indicate that the interposition of an intermediary does not contradict the object and purpose of a double tax treaty. It follows that the business activity criterion works best as a one-way test in conduit company cases: no business activity, no treaty benefit. But the test cannot logically be applied to qualify a company for treaty benefits.

7.4 Coda

This article is part of a larger project. In work to follow, the authors plan to address related topics, which include:

- The surrogate test of dominion.
- Interpretation of beneficial ownership provisions as non-specific anti-avoidance provisions.
- Limitation of benefits provisions.
- Medium and long-term solutions to the problem of conduit companies.

The authors will argue that the medium-term solution is to interpret ‘beneficial ownership’ according to the apparent objective of those who introduced the concept into the text of the OECD Model Convention. That objective was not to introduce a formal, technical, test. Rather, it was to prevent residents of third countries from contriving to take advantage of tax benefits that states that are parties to double tax

treaties intend to confer on and to limit to their own residents.¹⁵³ The objective may be achieved by interpreting beneficial ownership provisions as anti-avoidance rules, following reasoning reminiscent to the reasoning of the Swiss Federal Court in *A Holding ApS v Federal Tax Administration*,¹⁵⁴ which is discussed in part 2 of this article.

¹⁵³ ‘Extracts from OECD Working Documents of 1968 to 1971 in respect of Beneficial Ownership’, being an appendix to a Response by John Avery Jones, Richard Vann, and Joanna Wheeler to ‘OECD Discussion Draft, ‘Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention’, available at <http://www.OECD.org/tax/taxtreaties/publiccommentsreceivedonthediscussiondraftonthemeaningofbeneficialownerintheOECDmodeltaxconvention.htm>, last accessed Aug. 31 2012.

¹⁵⁴ *A Holding ApS v. Fed. Tax Admin.*, 8 I.T.L.R. 536 (2005) (Federal Court, Switz.).