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trading or investment relationships to enter treaties, known as ÷double tax treatiesø, 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 conventionsø or ÷agreementsø.[2] Most double tax agreements hew broadly to the form of the Model Tax Convention on Income and on Capital[3] 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 incomeø.[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 companiesø. 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

By virtue of these factors

companies.[13] From the perspective of legal analysis and of the meaning of the word ÷ownershipø, 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 ÷ownershipø, 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 activityø and ÷dominionø. ÷Dominionø 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.

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 reports[19] 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 Report[20] and the OECD Commentary[21] 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 provisionsø. 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-throughø[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 ÷ownedø 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, ÷ownedø 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 provisionsø. For the purposes of this article, the most important bona fide provision is the ÷activity provisionø, which states that the safeguard provisions:

> í "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

> 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 r

Administration and explained its

Convention[34] and applied it to the case, almost as if it was a rule in its own right.[35] Applying the transparency

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

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 companiesø or ÷nominee companiesø are often used for non-tax reasons in business transactions involving real estate. In the present context, the word ÷strawø in the expression ÷straw companiesø 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 vjg" eqorcp{øu 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. Vjg{"ctiwg"vjcv"c"eqorcp{øu" 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

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 compan

A base company seeks to minimise tax in a tazrc{gtøu"eqwpvt{"qh"tgukfgpeg. The base company, located in another jurisdiction, shelters income from taxation that would otherwise apply kp"vjg"vczrc{gtøu"tgukfgpeg"cpf"kp"vjg"rtqeguu"ektewoxgpvu"fqoguvke" 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 vjcv"nkokv"vjg"uqwteg"uvcvgøu" 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, ÷Basecoø, 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 kpvgtogfkct{"qp"vjg"dcuku"qh"vjg"eqorcp{øu"dwukpguu"cevkxkv{."kv"fqgu"pqv"hqnnqy"vjcv"c" 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).

the recipient of interest payments from Northern Indiana.[62] The court held that the

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 ÷benefitø 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.

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 activityø.[72] The court observed:[73]

> [Middle East Ltd] possessed the ÷salient features of corporate organization.ø í 0"]Okffng"Gcuv"Nvf_" ycu"rtqrgtn{"qticpk|gf"wpfgt"vjg"Eqorcpkgu"Ncy"qh" 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 ÷

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 ÷conduitø and ÷shamø 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, Okffng"Gcuv"Nvføu 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 ÷ESTGø) 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

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[75] *N. Indiana,* 115 F.3d 506.

[76] Einkommensteuergesetz [ESTG] [Income Tax Act], Oct.16, 1934, RGBl. 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, RGBl. 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 Code[81] (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

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 ÷substantiveø. 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* case[86] 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

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.

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]

> Ceeqtfkpi"vq"vjg"lwtkurtwfgpeg"qh"vjg"]Dwpfguhkpcp|jqh_" í "."kpvgtogfkct{"dcug" 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. Kh"kpeqog"tgegkxgf"kp" Igtocp{"ku"÷rcuugf"vjtqwijø"c"hqtgkip"eqtrqtcvkqp."vjku" is also true if the state of residence of the foreign corporation is not a low tax tgikog" í ". The court accepts as a principle that tax law respects the civil law construction.

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 Bundesfinanzhoføu" tgcuoning

> a reduction of tax had they received the dividends directly, and ô first ô there is no economic or otherwise valid reasons for the interposition of the corporation and ô second- ô 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

will nevertheless find ÷substantive business activityø. 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 ÷activityø at all) often appears to have little purpose apart from obtaining treaty benefits.

The examination of what amounts to ÷substantive business activityø 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.

> Hkpcpeg"tgkpxguvgf"vjg"cppwcn" í "kpvgtguv"kpeqog"kv"pgvvgf"qp"vjg"urtgcf"kp"qtfgt" 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

Hkpcpegøu" 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 jurisdiction[111] 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 wd interest 745(d)

The Internal Revenue Service

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

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 Eqo okuukqpgtøu"ejcnngpig"kh"vjg"vczrc{gtøu motives are unexceptionable. That is, even if from an objective perspective the arrangement itself has the purpose of avoiding tax vjg" cttcpigogpv" oc{" dg" kpxwnpgtcdng" vq" cvvcem" d{" vjg" tgxgpwg" kh" vjg" vczrc{gtøu" 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-ugtxkpi"c"vczrc{gtøu"gxkfgpeg"vjcv"cp"cttcpigogpv"vjcv"cxqkfu"vcz"d{" frustrating the objective of a treaty was driven by subjective reasons that do not involve tax avoidance. Vq" uwo octkug" vjgug" rqkpvu." gxgp" kh" qpg" cuuwogu" vjcv" vczrc{gtuø"

ykvjuvqqf"vjg"Eqookuukqpgtøu"ejcmgpig"dgecwug"kv"tgncvgf"vq"c"dwuiness purpose. The court pointed out that the interposition of financing subsidiaries in the Netherlands Antilles was ÷pqv" í "cp" wpeqooqp" rtcevkeg",[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 h

> 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 í kp" ctv" 4" wugu" vjg" yqtfkpi" ÷eqorcp{" qh" c" Ogodgt" Uvcvgø" ykvjqwv" cp{" 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 uwhhkekgpv" í ."c"ukorng"ngvvgtdqz-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 activityø 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

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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.

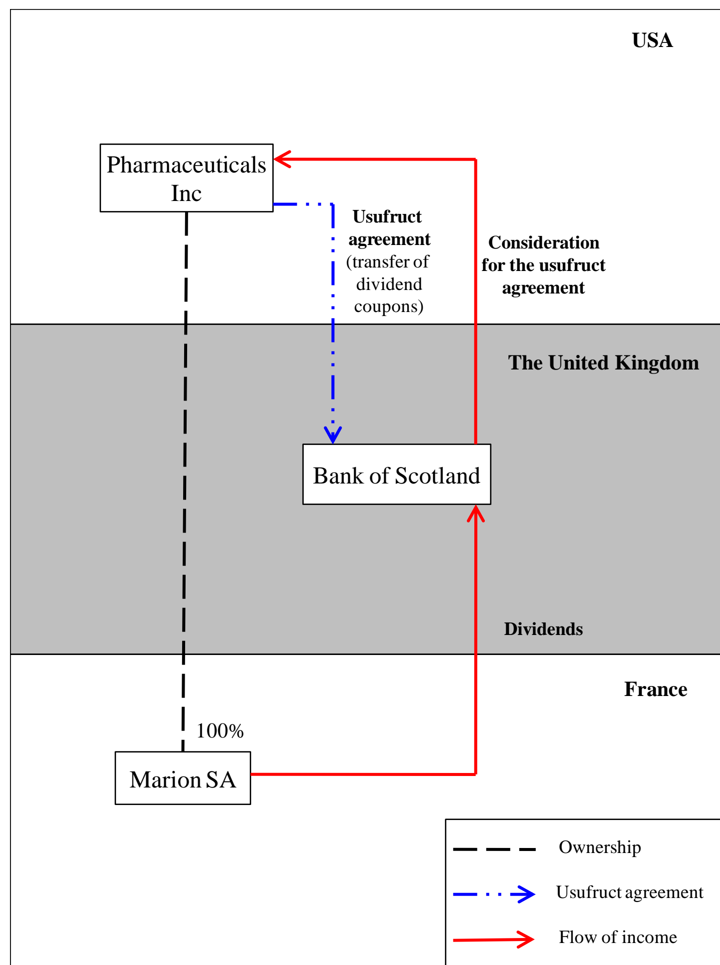
As mentioned in Part 5.5, the Dutch subsidiaries within the G-group acted as conduits.

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]

> [1]A 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 parti



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 treaty[146] 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 Scotlandøu"uvtwevwtg"cpf"dwukpguu"tgockpgf"cu"kv"ycu"cv"vjg" 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 8(t)-4((t)hie)p le tSrep6(b)1.893T EMC

normally derive from relevant legal documents (3) but may also be found to gzkuv"qp"vjg"dcuku"qh"hcevu"cpf"ektewouvcpegu" í "ujqykpi"vjcv."kp"uwduvcpeg." 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 qypgtujkr" í . [Numbers added for purposes of discussion].

Let us call each numbered section a ÷textø. Text 1, referring to enjoyment, defines ÷beneficial ownershipø 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 ownershipø, and until one at the same time compares text 3 with draft paragraph 12.5, which says that, ÷Tjg"eqpegrv"qh"÷dgpghkekcn"qypgtø"fgcnu"ykvj"uqog"hqtou"qh"vcz"cxqkfcpeg"*i.e., those involving the interposition of a recipient who is obliged to pass the dividend to uqogqpg"gnug+" í ø. That is, draft paragraph 12.5 uses ÷beneficial ownerø to refer to a legal owner who is nevertheless obliged to act as a conduit.

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,

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