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The Missing Keystone of Income Tax Treaties

This thesis reveals a fundamental flaw in the OECD Model, namely that it pays no attention to the person who is liable to tax in respect of the income for which treaty benefits are claimed. This “missing keystone” causes two major problems of interpretation. One problem arises if the contracting states attribute the income to different persons; the myriad ways in which such a conflict can occur is illustrated by an extensive comparison of the domestic law of the Netherlands and the United Kingdom in this respect.

This missing keystone also causes a disconnection between the two principal conditions for treaty entitlement. The treaty residence of the claimant is based on a general liability to tax in a contracting state, whereas the distributive articles focus on the ownership of the income. Interpretation problems arise if domestic law imposes a tax liability on a person who is not the owner of the income, for example under anti-avoidance legislation or a corporate group regime.

In order to eliminate this fundamental flaw, the thesis proposes a “new approach” in which the criterion for treaty entitlement is liability to tax on the income, backed up by substantial connections between the income and the treaty claimant and between the treaty claimant and the residence state. The new approach is tested in various situations, many of them decided cases, and proves to give appropriate policy results while respecting the tax sovereignty of states. The thesis includes a proposal for a re-draft of the OECD Model on this basis.

Joanna Wheeler

Joanna Wheeler is a member of the IBFD academic group. She has been with IBFD for many years, where she has had various responsibilities, including regular teaching commitments at a number of universities. She was one of the founding editors of the IBFD database on the taxation of trusts and in 2007 she was the general reporter for the Kyoto Congress of the International Fiscal Association on the topic “Conflicts in the attribution of income to a person”.



Joanna Wheeler

The Missing Keystone of Income Tax Treaties

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THE MISSING KEYSTONE OF INCOME TAX TREATIES

THE MISSING KEYSTONE OF INCOME TAX TREATIES

ACADEMISCH PROEFSCHRIFT

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aan de Universiteit van Amsterdam
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Chapter 1

Introduction

It is not surprising that the issue of entitlement to treaty benefits is currently one of the hottest topics in international tax law. Business and legal structures become ever more complex, causing questions to arise as to which person is the correct taxpayer in respect of a given item of income. At the same time, individuals, legal persons and many types of asset become ever more mobile, thereby coming into contact with increasing numbers of countries. Both developments put pressure on domestic tax systems, which often respond with increasing amounts of increasingly complex legislation.

Tax treaties, by comparison, look very simple; they have fewer provisions by far than most domestic laws and their drafting also looks very simple by comparison. This relative simplicity of treaties is not necessarily a problem. Treaties have to be capable of regulating the interface between (usually) two states, which may have quite different legal traditions and domestic tax systems. They are therefore formulated in general, abstract terms, which also enable them to adapt to the continuing changes in the domestic law of the states that have concluded a treaty.

There will, therefore, always be a need to interpret treaties to deal with the multitude of detailed issues that they have to regulate. But the number of issues that are found to raise relatively basic questions of interpretation has grown dramatically since the publication of the first version of the Model in 1963, as witnessed by the growth in the Commentaries to the OECD Model. This growing burden of interpretation is a reflection of the increasing complexity of domestic law and the sheer size of the legislation and body of case law in many countries. Again, this is not necessarily a problem if the most basic principles of a treaty are clear and coherent.

But there is a problem if the basic treaty structure is flawed, and this thesis argues that there is a fundamental flaw in the way that the route to treaty protection is currently defined. At a certain point it becomes impossible to deal with a structural flaw through the interpretation of a treaty, and we are now approaching that point in respect of the issue of entitlement to treaty benefits. This thesis centres on that structural flaw; it suggests how the flaw could be remedied and offers a thought experiment that considers what the treaty structure would look like if this remedy were adopted.

Chapter 2 starts by observing some of the major issues with the application of treaties today. Chapter 3 digs deeper and discusses some more structural problems with the structure of treaties that lie at the root of the problems discussed in Chapter 2. It concludes by going to the core of the problem and explaining the fundamental flaw in the current treaty framework, the missing keystone referred to in the title of this thesis. Chapter 4 proposes a different route to establishing entitlement to treaty benefits, built on a sound conceptual basis, and explains how this new approach would work in respect of the most important aspects of treaty law. Chapter 5 provides some examples of how this new approach would apply to some current problem areas and decided cases. Chapter 6 concludes by drawing out the essential features of the new approach. Appendix I consists of some suggested texts to introduce the new approach in the OECD Model, together with a brief commentary which explains these texts and highlights the major differences from the current OECD Model. Appendix II contains a study which was carried out to provide some of the groundwork for this thesis and which consists of a detailed comparison of the domestic law of the Netherlands and the United Kingdom. This study looks at a range of situations in both countries in which questions arise as to the attribution of income to a person and amply illustrates the complexity of this issue.¹

The discussion in this thesis focuses on the various qualitative reasons for which states attribute income to a person. It assumes that there is no dispute as to the identification of possible taxable persons, so it does not discuss partnerships and the entity classification issue as such, although it does consider whether the principles developed in the OECD Partnership Report² can be used to resolve the problems at the core of this issue. The discussion also covers situations in which a state recognizes the existence of a potential taxable person, generally a company, but makes a policy decision to attribute the company's income to its shareholders for tax purposes. It further assumes that there is an actual payment of taxable income, and does not discuss whether a payment or benefit constitutes taxable income, the characterization or quantification of income, or issues raised by fictitious income.³ Nor does it make any distinction between income and capital gains.

1. Further evidence to support this assertion can be found in: Wheeler, J.C., "General Report", in: International Fiscal Association, "Conflicts in the Attribution of Income to a Person", in: *Cahiers de droit fiscal international*, Vol. 92b (Amersfoort, the Netherlands: Sdu Fiscale & Financiële Uitgevers, 2007), pp. 17-58.

2. OECD Committee on Fiscal Affairs, *The Application of the OECD Model Tax Convention to Partnerships* (Paris: 2000).

3. On the interaction between treaties and domestic-law fictions generally, see: Wattel, P.J., "Characterization of fictitious income under OECD-patterned tax treaties", 43 *European Taxation* 3 (2003), pp. 66-79.

Chapter 2

Issues and Solutions within the Current Treaty Framework

2.1. Introduction

The current approach to granting treaty benefits can be traced through Arts. 1, 3 and 4 of the OECD Model. Art. 1 requires us to find a person to whom the treaty is to apply, and this person is to be resident in one or both states. The term “person” is purportedly defined in Art. 3, although this definition is actually a description rather than a definition.⁴ The term “resident” is defined in Art. 4, primarily by reference to the domestic law of the contracting states to the treaty.

At this stage it is already worth noting that the definition of residence relies on the imposition of a tax liability by domestic law. The OECD work on partnerships has also established that, in this context at least, whether it is the partners or the partnership as such that is entitled to treaty protection depends on the choice made by domestic law as to which person’s circumstances are relevant in computing the amount of the liability.⁵

Once a person has been found, who is resident in one or both contracting states, the distributive rules of the treaty can be applied. The required connection between the income and the person in these articles is expressed in terms such as “paid to” or “derived by” the person. Arts. 10 and 11 also require a consideration of whether that person is the beneficial owner of the income, whereas in Art. 12 beneficial ownership is the only concept used in this context. The following discussion considers all these elements of the OECD Model, highlighting the problems that they have posed in connection with the issue of who is entitled to treaty benefits.

Various solutions to the problems raised by the need to attribute income to a person are also discussed. The essence of the problems posed by this element is neatly illustrated by two recent cases, the *Aznavour* case,⁶ de-

4. Art. 3(1)(a) states that “the term ‘person’ *includes* an individual ...” (emphasis added).

5. OECD Committee on Fiscal Affairs, Paras. 40 and 47; OECD Commentary on Art. 1, Paras. 5 to 6.4.

6. France: *Conseil d’Etat*, 28 March 2008, No. 271366, Tax Treaty Case Law IBFD. A diagram of this case is given in 5.2.1., where the case is discussed in more detail.

cided by the *Conseil d'Etat* in France, and the *Russell* case,⁷ decided by the Federal Court of Australia. Both cases concerned the interaction between a treaty and the domestic law of one state under which fees paid for the activity of an individual were attributed directly to the individual for tax purposes, even though the fees were actually paid to a company. Both cases were decided in the state that attributed the income to the individual. In *Aznavour*, France was the source state of the income; the individual and the company were both resident outside France, in two different states. In *Russell*, Australia was the residence state of the individual; the company was resident in a different state and the fee income was derived both from Australia and from a third state.

In both cases the court had to decide whether the company was entitled to treaty benefits, even though the domestic law of the court attributed the income to the individual. In other words, there was a clash between the attribution of the income under domestic law and the attribution terminology of the treaty, and the issue was which attribution rule prevailed. The answer in both cases was that the domestic attribution rule prevailed, as both courts took their own domestic law as their starting point and concluded that the company was not entitled to treaty benefits. These cases are discussed more extensively in 5.2.; they are highlighted here simply to illustrate that, in respect of the attribution of income for treaty purposes, even such a fundamental question as the starting point is still not settled.

2.2. The treaty claimant

The first step in determining whether treaty benefits are available is to find the person who is the potential treaty claimant,⁸ but this basic requirement creates an immediate problem in respect of states in which it is possible for one person to have two or more taxable capacities. The most important example of this problem is the taxation of trustees in many common law states. The property law of states in the common law tradition allows one person to own separate estates⁹ in a fiduciary capacity as trustee, in addition to the person's own estate. Although the legal owner of all the estates is the same person, each estate is entirely separate from the others. The owner is not permitted to mix the assets of the estates held in a fiduciary

7. *Russell v. Commissioner of Taxation* [2011] FCAFC 10. A diagram of this case is given in 5.2.2., where the case is discussed in more detail.

8. OECD Model Art. 1.

9. Or patrimonies, in civil-law parlance.

capacity, and creditors of one such estate have no claim against the assets of the others.

The tax law of common law countries generally recognizes this possibility, and imposes a separate tax liability on the person in respect of each separate estate. A professional trustee, for example, may own hundreds of trust estates and therefore be subject to hundreds of separate reporting and taxpaying duties. Although it is the same legal owner carrying out these duties, this is nothing more than a coincidental connection.

On the other hand treaties do appear to attach consequences to this coincidental connection, as their wording refers to a person and makes no qualifications in respect of the possibility that a person may have different taxable capacities under domestic law. If the wording of treaties is taken at face value, therefore, it could lead to inappropriate results. Yet there is nothing in the OECD Commentaries to suggest that this is the wrong conclusion. This problem has been highlighted by Prebble, who draws the obvious conclusion that treaties should work by reference to the various taxable capacities that a person may have, but concludes that this is not how they actually do work.¹⁰

It is also possible for a liability to tax to be imposed on something that is not a legal person. In the international context the issue that usually springs to mind in this respect is the tax liability that is sometimes imposed on a partnership that is not a legal entity, but states also have to make other decisions about the taxable unit, such as whether to tax families as one unit or to whether to tax the individual family members separately. As Nikolakakis puts this issue, the question is how visible an entity has to be to the tax system of a country before it is capable of being regarded as liable to tax under the laws of that country.¹¹

In the context of the application of treaties to investment funds, Bongaarts and Ed answer that question by proposing that investment funds should be entitled to treaty benefits and regarded as a person for treaty purposes, regardless of their legal form, if the fund performs a stewardship function, is genuinely open to a multiplicity of investors and is regulated in terms of

10. Prebble, J., "Trusts and Double Taxation Agreements", 2 *eJournal of Tax Research* 2 (2004), pp. 192-209 at p. 198.

11. Nikolakakis, A., "Commentary", *TD Securities (USA) LLC v. HM the Queen*, 12 ITLR 783, at p. 798h. This case concerned the treaty entitlement of a transparent entity and is discussed further in 5.3.1.1.

its transparency of purpose and independence.¹² They state that “[i]n our view there will be then enough of an entity for treaty purposes for the following reasons. ... All that is needed is that the fund is able to participate in legal traffic as an entity with its own identity.” This proposal is subject to the proviso that the fund is open to the public, in order to prevent it from being used to hide another party.

The OECD report of 2010 on collective investment vehicles (CIVs) is more hesitant about granting general recognition to CIVs as persons,¹³ although the general tenor of this report is also that the role of a CIV in managing assets is what gives it entitlement to treaty benefits, provided that it is widely held and, in effect, has a separate economic existence from its investors.¹⁴ An addition made to the OECD Commentary in 2010 states that treatment of a CIV as a taxpayer by the domestic law of the state where it is established “would be indicative that the CIV is a ‘person’ for treaty purposes”.¹⁵

The focus on persons remains, however, a source of tension in the interpretation and application of treaties.

2.3. Residence¹⁶

2.3.1. The general definition – unlimited liability to tax

Once a person has been found as a potential treaty claimant, the next step is to investigate whether that person is resident in one or both of the contracting states. In the current OECD Model the concept of residence for treaty

12. Ed, L.J., and Bongaarts, P.J.M., “General Report”, at p. 53 in: International Fiscal Association, *Cahiers de droit fiscal international*, Vol. LXXXIIb (Amersfoort, the Netherlands: Sdu Fiscale & Financiële Uitgevers, 1997), pp. 21-59.

13. OECD Committee on Fiscal Affairs, *The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles* (Paris: 2010), Para. 26, available at <http://www.oecd.org/dataoecd/59/7/45359261.pdf>.

14. *Ibid.*, Para. 61.

15. OECD Commentary on Art. 1, Para. 6.10.

16. For an extensive discussion of the history and interpretation of the residence test in the current OECD Model, see: Vann, R., “‘Liable to tax’ and Company Residence under Tax Treaties”, pp. 197-272 in: Maisto, G. (ed.), *Residence of Companies under Tax Treaties and EC Law*, EC and International Tax Law Series Vol. 5 (Amsterdam: IBFD, 2009); and Dirkis, M., “The expression ‘liable to tax by reason of his domicile, residence’ under Article 4(1) of the OECD Model Convention”, pp. 135-51 in: Maisto, G. (ed.), *Residence of Individuals under Tax Treaties and EC Law*, EC and International Tax Law Series Vol. 6 (Amsterdam: IBFD, 2010).

purposes depends on a person being subject to an unlimited liability to tax in a contracting state. This concept of the personal connection with a state that gives entitlement to treaty benefits is now well established, although it has not always been defined in this way. The early model treaties focused on nationality¹⁷ and some older UK treaties, for example, defined the residence of companies by looking directly at their management and control rather than going through the route of their tax liability.¹⁸

The route now taken by Art. 4 OECD Model, via the unlimited liability to tax of a potential treaty claimant, causes a number of problems. Domestic law, for example, sometimes imposes liability to tax on the basis of formal criteria, such as the incorporation of a company in the state, thereby bringing those taxpayers within the ambit of treaties concluded by the state even though the policy considerations of domestic law and treaties in this respect are usually diametrically opposed to each other. It is for this reason that treaties increasingly include comprehensive limitation-on-benefits provisions to back up the residence definition.¹⁹

The requirement for unlimited tax liability also poses a problem in respect of states that have a territorial system of taxation, as taxpayers subject to this system do not strictly qualify under the wording of Art. 4(1). The OECD Commentary acknowledges that this aspect of the definition “has inherent difficulties and limitations”,²⁰ and explains the problem away in a manner that is not entirely satisfactory.

The following subsections consider some further problems with this definition.

2.3.2. Tax-exempt persons

Taking a general liability to tax as the starting point has led to many discussions about the treaty entitlement of persons that enjoy an exemption or another measure that eliminates their tax liability. There is a scale of non-taxability, which runs from the use of losses or personal allowances to reduce

17. Hattingh, P.J., “Article 1 of the OECD Model; Historical Background and the Issues Surrounding It”, 57 *Bulletin for International Fiscal Documentation* 5 (2003), pp. 215-21.

18. Avery Jones, J.F., “The Definition of Company Residence in Early UK Treaties”, *British Tax Review* 5 (2008), pp. 556-86.

19. As suggested since 2003 in the OECD Commentary on Art. 1, Para. 20.

20. OECD Commentary on Art. 4, Para. 8.3.

the tax bill to zero, through the exemption of a specific item of income, an exemption for income from certain types of activity and an exemption for certain types of person, to the complete exclusion of a person from the reach of the income tax system.²¹ One of the interpretation problems of the current OECD Model is to know at which point along this scale a person ceases to be “liable to tax” and is therefore not entitled to treaty protection.

This dividing line is difficult to draw in respect of legal persons that receive only non-taxable income, either as a matter of practice or due to the application of a regulatory regime. In this case the determination of whether a person is “liable to tax” may depend on whether the legislation first imposes a general liability and then exempts the income or person,²² or whether it excludes taxation of the person from the start. This difficulty was already noted in 1985 during a seminar at an IFA Congress.²³ It has still not been entirely resolved; it came up in a recent case in the Netherlands,²⁴ and Van Weeghel in his comment on the case observes that it seems ridiculous that entitlement to treaty benefits should depend on exactly how the domestic legislation chooses to achieve the non-taxability, when the end result is the same in practical terms.²⁵ Yet this does appear to be the effect of the current OECD Model.

21. Viersen, A. and Oliver, J.D.B., “Status as a resident of a Treaty Country; an Intervention”, pp. 65-6, in: International Fiscal Association, *International Tax Problems of Charities and Other Private Institutions with Similar Tax Treatment*, IFA Congress seminar series, Vol. 10 (Deventer, the Netherlands: Kluwer, 1986).

22. OECD Commentary on Art. 4, Para. 8.6 states that such a person is considered to be liable to tax in many states.

23. Oliver, J.D.B., “Introduction” in: International Fiscal Association, note 21, pp. 1-2.

24. *Hoge Raad*, 4 December 2009, No. 07/10383, BNB 2010/177 (with conclusion by Advocate-General Niessen and comment by S. van Weeghel), Tax Treaty Case Law IBFD.

25. In an article on this case and the discussion of the meaning of the term “liable to tax”, de Graaf and Pötgens make two suggestions for resolving these problems. One suggestion is to delete the second sentence from Art. 4(1) OECD Model and, in the first sentence, replace the words “liable to tax” with the words “comprehensively (fully) liable to tax”. Their alternative suggestion is to add a new paragraph to Art. 4 OECD Model to the effect that a legal person is deemed to be “liable to tax” in a state for treaty purposes if it is governed by the laws of that state or it has its place of management in the state. They add that states might then also find it necessary to add a further provision excluding a legal person from treaty benefits if the person enjoys the benefits of a special tax regime. De Graaf, A., and Pötgens, F., “Worrying interpretation of ‘liable to tax’: OECD clarification would be welcome”, 39 *Intertax* 4 (2011), pp. 169-177.

2.3.3. Liability to which tax?

Curiously, the first sentence of the definition in Art. 4 OECD Model requires only that a person be “liable to tax” without specifying which kind of tax. A flippant argument could maybe be made, therefore, that liability to any kind of tax that is imposed “by reason of domicile, residence, place of management or any other criterion of a similar nature” gives access to the benefit of the entire treaty.

On the other hand, the second sentence of Art. 4(1) does refer specifically to tax on income. This limitation, combined with Art. 2 OECD Model and some common sense, suggests that the first sentence should be interpreted as referring only to income tax. Nevertheless, the very general wording of the first sentence is not without its dangers. In the *Chiron Behring* case in India²⁶ the court found that a partnership was entitled to the treaty rate of withholding tax on dividends, even though the partnership was not liable to income tax in Germany but only to trade tax. The treaty did cover the German trade tax, but it does not seem likely that the treaty negotiators had intended to give the benefit of the lower rate of withholding tax on royalties in the source state to a person that was not liable to income tax in the residence state. This decision makes one wonder about other mismatch possibilities of this sort. If a treaty covers both income tax and gift tax, for example, does liability to one of those taxes give an individual access to all the benefits of the treaty even if his residence state does not levy the other type of tax?²⁷

2.3.4. The policy behind the residence requirement

It is clear that the function of the residence concept in treaties is to limit the application of a treaty concluded by a state to persons who have a certain connection with the state. But there is a fundamental disagreement as to the very reason for concluding treaties, and the view one takes on this point determines how one defines the required connection and how the residence test in the current OECD Model is interpreted.

One school of thought starts from the premise that the reason for concluding a tax treaty is to prevent double taxation; the other argues that the allo-

26. India: ITAT, 30 September 2010, *Chiron Behring GmbH & Co KG*, ITA No. 3860/Mum/08, Tax Treaty Case Law IBFD.

27. The author is grateful to Jan de Goede, IBFD, for pointing out this question to her.

cation of taxing rights in a treaty has a wider function and that the application of a treaty is therefore not restricted to cases of double taxation. The practical difference between these two points of view is found in cases in which a person has a substantial connection with a contracting state, but the state does not impose any income tax on that person. There is, in other words, a potential liability to tax but not an actual one.

Even the major textbooks on treaties disagree on this point. Baker finds it hard to see how a person could be “liable to tax” in a state that imposes no tax.²⁸ Vogel, on the other hand, argues that bearing a general liability to tax is an indication of the residence issue rather than the crux of it, and that a person who has “that personal attachment to [a state] ... which *might* result in him becoming subject to full tax liability” should be regarded as resident in that state for treaty purposes.²⁹

The same disagreement extends through other writings and judicial decisions on this issue.³⁰ Couzin has explored this issue extensively, and finds it far from clear what is meant by “liable to tax” in this context.³¹ He looks at a number of examples of a potential liability to tax and concludes that “[i]f potentiality of taxation as a test of liability seems to follow from the examples above, it is challenged in other examples explored below.” As regards the policy of treaties, however, he states that “[t]ax treaties seek to avoid double taxation but they also allocate taxing jurisdiction and such allocation often occurs in a context where double taxation is in no way involved.”³²

Van Weeghel considers that the residence requirement does serve to limit the application of treaties to situations in which there is double taxation.³³ But he also points out that the “liable to tax” condition achieves only a gross approximation of this aim, because conduits may be able to claim treaty benefits even though their tax liability is rendered meaningless by

28. Baker, P., *Double taxation conventions: a manual on the OECD model tax convention on income and on capital* (London: Sweet & Maxwell, loose-leaf), Sec. 4B.07 (September 2002).

29. Vogel, K. et al., *Klaus Vogel on double taxation conventions*, 3rd edn (London: Kluwer Law International, 1997), p. 229, Para. 24a (emphasis in the original).

30. Pötgens, for example, explains the differing views of the Supreme Court of the Netherlands and the Ministry of Finance of the Netherlands on this point: Pötgens, F.P.G., “Verdragstoegang en Inwonerschap in de Notitie Fiscaal Verdragsbeleid 2011” 140 *WFR* 6903 (2011), pp. 532-8.

31. Couzin, R., *Corporate Residence and International Taxation* (Amsterdam: IBFD, 2002), Sec. 3.1.1.

32. *Ibid.*, Sec. 3.1.1.1.

33. Van Weeghel, note 24, Para. 2.

the erosion of their tax base, and because entity classification conflicts can lead to economic double taxation. On the other hand, Duff argues that looking for an actual liability to tax as the key to residence “is questionable to the extent that it makes treaty benefits subject to actual tax liability in the contracting state, which is ultimately a matter of each state’s fiscal sovereignty.”³⁴

The Indian courts have struggled to resolve this issue, especially in respect of persons with a substantial connection to the United Arab Emirates (UAE), which does not generally impose income tax.³⁵ In *Re Abdul Razak A. Meman*³⁶ the Authority for Advance Rulings discussed some of the previous case law and held that an individual who lived in the UAE was not entitled to the benefit of the India–UAE treaty. On the other hand, in the *Green Emirate Shipping* case³⁷ the Income Tax Appellate Tribunal stated explicitly that liability to tax for the purpose of Art. 4 OECD Model includes the potential general liability to tax of a person in a state on the basis of the person’s “locality related attachments” with the state, even if the state chooses not to exercise its right to impose the liability.

The Swedish Administrative Court also came to the latter conclusion in a judgment in which it discussed this question explicitly as a policy issue.³⁸ It found that the purpose of a treaty is not restricted to the prevention of double taxation but that treaties have a more general function of allocating taxing rights. It therefore held that it was sufficient that a person’s connection to a state could result in an unlimited tax liability, and that it was not relevant that the state in fact refrained from imposing such a liability.

One of the weaknesses of this approach is that it has to rely on an undefined concept of the connections that would lead to an unlimited tax liability in a state if the state decided to introduce a comprehensive income tax. In other words, it has to rely on an international “norm” for the imposition of unlimited tax liability, when in fact there is no such thing. Undoubtedly, there are

34. Duff, D.G., “Responses to Treaty Shopping: A Comparative Evaluation”, Sec. 3.1.1. in: Lang, M., et al. (eds.), *Tax Treaties: Building Bridges between Law and Economics* (Amsterdam: IBFD, 2010).

35. Palwe, S.S., and Kumar, P., “Liable to Tax: India versus OECD”, *Tax Planning International Review: Latest Developments* (9 March 2011).

36. India: AAR, 9 May 2005, *Abdul Razak A. Meman In re*, Tax Treaty Case Law IBFD.

37. India: ITAT, 30 November 2005, *Green Emirate Shipping & Travels Ltd v. Assistant Director of Income Tax*, Tax Treaty Case Law IBFD.

38. Sweden: RR, 2 October 1996, RÅ 1996 ref 84 (6301-1994), Tax Treaty Case Law IBFD.

many straightforward cases in which most states would concur in imposing unlimited liability, but one cannot know in advance what the potential claim to taxing jurisdiction will be in a state. If an income tax were subsequently adopted with a slightly (or very) idiosyncratic scope, the odd result might be that a person is entitled to treaty protection as long as there is no tax, but then loses the protection when the tax is adopted because he falls outside its scope. That is, as Baker points out, on the assumption that the treaty does apply to the tax when it is enacted.³⁹ This approach also risks opening up an argument that all individual citizens of a state are entitled to the protection of treaties concluded by the state because they have a personal connection that could lead to the imposition of an unlimited tax liability, even though the state chooses not to use that option at the moment.⁴⁰

2.3.5. Conclusion

Whatever one's view on potential liability to tax as a basis for treaty residence, there is a general consensus that a person that does have an unlimited liability to tax in a state does have the required connection with that state. But it is not clear to the current author why it matters at all that a person claiming treaty benefits in respect of one item of income is subject to a tax liability on other items of income. If the point of looking for an unlimited tax liability is to determine a person's economic connection with a state, why would one not go directly to the substantive aspects of that concept, rather than taking such an indirect route?

Maybe the true problem is simply that too much is expected of the residence definition. There are many more aspects to this concept than have been mentioned here and Vann, in an extensive discussion of the residence concept in respect of companies, summarizes this point very neatly when he concludes that a flexible approach is needed, especially for entities, but also states that "it is difficult to extend that flexibility to cover territorial tax systems, tax-exempt charities and other cases while using it to exclude dual resident and conduit companies."⁴¹

39. Baker, note 28.

40. This point was raised by Jacques Sasseville during a seminar discussion at the 2011 congress of the International Fiscal Association in Paris.

41. Vann, note 16, at pp. 269-70.

2.4. Attribution of income

The final element in determining entitlement to treaty benefits relates to the specific item of income in question; a person who is resident in one of the contracting states for treaty purposes is able to claim treaty benefits in respect of an item of income only if he can show that he has the required connection with the income. This subsection considers some structural issues in respect of this element and the most important sources of law in this respect.

As discussed in 2.4.2., the OECD Model uses a variety of terms to denote the connection that has to be demonstrated between income and a person in order for the person to claim treaty benefits in respect of the income. Unlike the elements of “a person” who is “resident” in one or both treaty partner states, the Model does not even attempt to define any of these attribution terms. Art. 3(2) OECD Model therefore requires the domestic law of the state applying the treaty to define these terms by reference to its own domestic law, unless the context requires otherwise. This latter possibility is considered further in 2.4.4. in the context of the principles enunciated in the OECD Partnership Report.⁴²

Even before any discussion of the OECD Model is broached, however, this section starts by exploring domestic law in respect of the attribution of income to a person. Treaties rest on the foundation of domestic law, and it is domestic law that determines whether a state wishes to impose a tax liability on a person in respect of an item of income. It is therefore useful to explore this point in order to sketch out the nature and magnitude of the issues that can arise as a result of domestic law differences in this respect.

2.4.1. Domestic law

This subsection is based on an extensive comparative study of the law of the Netherlands and the United Kingdom on the attribution of income to a person, which is reproduced in Appendix II. The choice of these two countries was dictated primarily by practical considerations, but it has the considerable advantage that the Netherlands has a civil law legal system whereas the United Kingdom has a common law system. This study reveals an interesting kaleidoscope of differences and, although its scope is limited

42. OECD Committee on Fiscal Affairs, note 2.

to two countries, it provides an ample illustration of the ways in which the domestic law of states can diverge in this respect.⁴³

As one might expect, the very broad principles in both countries are similar. For example, in both countries the basic principle for income from an activity, such as carrying on a business or exercising employment, is that the income is attributed to the person who carries on the activity. Similarly, the legal ownership of an asset provides the initial indication as to the attribution of income derived from the asset. These principles work in the most straightforward cases, but the divergences start to appear as soon as an extra element is added to the fact pattern. Rather than repeat the findings of the study, which are summarized in its conclusion,⁴⁴ this subsection highlights the features which lie at the root of these divergences, in order to demonstrate the many reasons for which the domestic law of countries can differ in respect of the attribution issue.

An initial point of fundamental importance is the differing civil law of the two countries, especially as regards the ownership of property. The differences in property law can lead to the use of quite different legal structures in order to achieve the same practical result, making a direct comparison between the two countries impossible in respect of these structures. The clearest example of this phenomenon is the trust structure, which is recognized in the United Kingdom but not in the Netherlands. The trust structure makes it possible for income to be received without any specific person being entitled to the benefit of the income. The United Kingdom has, accordingly, responded by accepting the imposition of tax on a person who by definition derives no personal benefit from the income, such as a trustee - a possibility which is not found in the Netherlands.

Turning to the tax legislation, there is an immediately obvious difference between the grounds named for the attribution of income to a person in the two countries.⁴⁵ The main principle in the Netherlands is that income is attributed to the person who “enjoys”⁴⁶ the income. Only the dividend withholding tax is imposed on the person who is “entitled”⁴⁷ to the dividend. The United Kingdom legislation, by contrast, uses a number of terms to denote the connection between income and a person that leads to the attri-

43. Further evidence of the differences among countries in this respect can be found in: International Fiscal Association, note 1.

44. See Appendix II, Section 7.

45. See Appendix II, Section 2.

46. In Dutch: *genieten*.

47. In Dutch: *gerechtigd tot*.

bution of the income to that person. Corporation tax is levied on the profits “of” companies, capital gains tax is levied on gains “accruing to” a person, and income tax⁴⁸ is generally levied on income in the hands of the person who “receives or is entitled to” the income.

Of course case law has been necessary to delineate the precise contours of these terms in both countries. Some of this case law deals with aspects that are not specifically regulated by the legislation; it is only very recently, for example, that case law in the Netherlands has determined how, in certain cases, a marital property regime interacts with the legal ownership by one spouse of the assets that produce the income when it comes to deciding which spouse has the enjoyment of the income.⁴⁹ Other cases arise from imperfections in the law which sometimes lead to odd results; case law in the Netherlands, for example, has held that the effect of the legislation is that part of the credit for the dividend withholding tax is not available to any person if the shares are subject to a usufruct.⁵⁰

In the United Kingdom the case law has largely focussed on the attribution grounds of receipt and entitlement found in the income tax legislation, which applied across the board until the introduction of corporation tax and capital gains tax in 1965. This case law is hard to follow at first sight, and maybe also at second and third sight, but a closer investigation reveals an important problem with the legislation which may explain the confusion. One result of the historical development of the legislation is that it attempts to do two things at the same time: one of its aims is to impose a more objective system of income taxation, in which the choice of the taxable person is less important than the taxation of the income; and the other aim is to impose a more subjective system, in which the choice of the correct taxable person is paramount.⁵¹ As both aims are captured in the same concepts of “receipt” and “entitlement”, it is small wonder that the judges have found it difficult to follow a consistent line in this respect.⁵²

48. Capital gains tax is levied only on individuals and trustees, and capital gains derived by companies are subject to corporation tax, but the taxation of all capital gains is governed by separate legislation dealing specifically with capital gains. Income tax applies to the income of both individuals and trustees.

49. See Appendix II, Sections 3.1.1. and 3.1.2.1.

50. See Appendix II, Section 3.2.2.

51. See Appendix II, Section 2.1. for a discussion of the characteristics of subjective and objective systems of income taxation.

52. See Appendix II, Sections 6.3.2.3. and 6.3.2.4. for a discussion of this aspect of the United Kingdom law.

These different imperfections in the legislation inevitably lead to differences in the way in which income is attributed to a person in the two countries. On the other hand, the case law can sometimes also be consistent; in both countries, for example, the courts have attributed income to a person primarily in order to prevent the income from escaping taxation altogether.⁵³

Another major cause of differences between the two countries is their anti-avoidance legislation; indeed, in the United Kingdom, anti-avoidance regimes constitute much of the legislation on the attribution of income. The anti-avoidance regimes of both countries attribute income to a person on the basis of a connection with the income that is often considerably more remote than the connection required under the basic legislation, but the outer reaches of these legislative schemes can be quite different. In the United Kingdom, for example, income can be attributed to an individual on the basis that he used to own the asset that produces the income and still has “power to enjoy” the income,⁵⁴ a term which is interpreted very widely and which is not found as an attribution factor in the Netherlands. On the other hand, the Netherlands sometimes attributes income to an individual who has an indirect connection with the income and who never owned the assets that produce it, which the United Kingdom does not do.⁵⁵

Finally, it is also possible that the legislation obviates the need for income to be attributed to a person altogether. This is the case with the Netherlands system for taxing the investment income of individuals, known as the “Box 3” system, which taxes individuals on a deemed rate of return on their investment assets and pays no attention to any entitlement to, or enjoyment of, the actual income.⁵⁶ The United Kingdom legislation on corporate loan relationships similarly creates a notional scheme of payments in which the actual income arising is not attributed to a person in its own right, but is rather just one element that is used in creating the notional structure on which the tax charge is based.⁵⁷

There are, in other words, many reasons for which domestic law on the attribution of income to a person can differ from one state to another. The consideration of the factors used in the attribution of income in both countries, in Section 5 of Appendix II, also provides ample illustration of the differing ways in which their basic attribution principles have been fleshed out.

53. See Appendix II, Sections 6.2.1.1. and 6.2.2.

54. See Appendix II, Section 3.4.2.2.

55. See Appendix II, Section 3.4.1.3.

56. Arts. 5.1 to 5.3 Wet inkomstenbelasting 2001, Stb. 2000, nr. 215.

57. See Appendix II, Section 3.2.3.2.

2.4.2. The OECD Model

Having noted the ways in which the attribution of income to a person can differ from one state to another, let us now turn to the OECD Model, to see how it deals with this issue. The term most often used by the OECD Model in respect of the attribution of income is that the income is “derived by” the person, but the Model also uses a variety of other terms, such as the income being “paid to” the person or simply that the income is “of” a person.⁵⁸ One article in the OECD Model, Art. 12, relies solely on the beneficial ownership concept to denote the connection between income and a person, whereas Arts. 10 and 11 use the beneficial ownership concept in addition to the term “paid to”.⁵⁹

The variety of attribution terms in the OECD Model suggests that little thought was given to this issue when the provisions of these articles were first drafted.⁶⁰ These terms have generally gone largely unexplored, certainly by comparison with, and perhaps because of, the huge amount of attention that has been devoted to the beneficial ownership concept. The beneficial ownership concept is discussed further below; this section confines itself to the law dealing specifically with the initial attribution of income.

The OECD Commentaries make some sparse references to this issue, but there is no extensive consideration of it. One statement is found in an unexpected place, the Commentary to Art. 10, in Paras. 29 and 30. These paragraphs consider the possibility that the source state of a disguised dividend is confronted with the attribution of the dividend to two persons resident in two other states and states that this is a matter that can be resolved only through the mutual agreement procedure.

Another reference is in the Commentary to Art. 1, Para. 22.1 which states that the attribution of income to a person is a matter for domestic law, and is therefore not affected by treaties. It also states that a treaty is to apply taking into account a “redetermination” under domestic law of the taxpayer who is considered to derive income. This paragraph is, however, written

58. For a fuller discussion of some of the issues discussed in this section see: Wheeler, J., “The attribution of income to a person for tax treaty purposes”, 59 *Bulletin for International Fiscal Documentation* 11 (2005), pp. 477-88.

59. In the UN Model, Art. 12 follows the same pattern as OECD Model Arts. 10 and 11.

60. Ault has also noted that treaties do not contain any general rules linking items of income to specific taxpayers: Ault, H.J., “Issues Related to the Identification and Characteristics of the Taxpayer”, 56 *Bulletin for International Taxation* 6 (2002), pp. 263-4.

specifically in the context of anti-avoidance legislation, and it is not clear whether it is intended to apply outside that context. Nor is it clear whether it also means that the “redetermination” of the taxpayer is capable of changing the treaty that applies in a given situation.

Art. 17 appears at first sight to contain an attribution rule of its own, but a further examination reveals that Art. 17(2) is not a treaty attribution rule but rather the acceptance of a possible domestic attribution rule. Para. 8 of the Commentary to Art. 17 explicitly accepts the possibility that the domestic law of a state looks through a company and attributes a performance fee directly to the individual, even though the fee is not actually paid to the individual. The recent OECD discussion draft on Art. 17⁶¹ proposes to add a new Para. 11.5 to the Commentary on Art. 17 stating that the two provisions of Art. 17 should not lead to the result that the remuneration is taxed twice, once in the hands of the individual and again in the hands of a “star company”. A state that, in accordance with the treaty, taxes both the fee paid to the company and the remuneration paid to the individual should therefore allow the company to deduct the remuneration paid to the individual.

Although there is no comprehensive consideration of this issue in the OECD materials, the statements mentioned here do have in common a reliance on domestic law to determine the attribution of income to a person. There is, however, no consideration of what to do when the contracting states disagree on this point, other than the suggestion in the Commentary on Art. 10 to use the mutual agreement procedure. The recommendation in respect of Art. 17 for preventing the double taxation of the remuneration is not directed at a conflict in the attribution of income, but rather at a consistent application of the domestic law rule that is applied. This recommendation still does not provide an answer if two states have qualitatively different rules for the attribution of the income, as in the example given by the Commentary on disguised dividends.

61. OECD Centre for Tax Policy and Administration, *Discussion Draft on the Application of Article 17 (Artists and Sportsmen) of the OECD Model Tax Convention*, (Paris: 2010), available at <http://www.oecd.org/dataoecd/31/15/45058769.pdf>.

2.4.3. Beneficial ownership⁶²

A great deal has been written about the beneficial ownership requirement in treaties, especially about the meaning that should be given to the term.⁶³ It is not the intention to repeat that discussion here, but rather only to set out the structural problems with the concept, which are also considerable.⁶⁴

62. On 29 April 2011 the OECD issued a discussion draft on the beneficial ownership requirement: OECD Centre for Tax Policy and Administration, *Clarification of the Meaning of "Beneficial Owner" in the OECD Model Tax Convention*, (Paris: 2011). This discussion draft proposes some changes to the Commentaries on Arts. 10, 11 and 12 to clarify the meaning of the term "beneficial owner". These amendments state that the term is not intended to refer to any technical meaning it has under the law of the contracting states, although the domestic law meaning would be relevant to the extent that it is consistent with the Commentaries. They also state that a person that "does not have the full right to use and enjoy" income is not a beneficial owner of the income, that a contractual or legal obligation to pass the income to another person can negate beneficial ownership and that treaty protection is not automatically granted to a beneficial owner as it still has to be considered whether the claim should be rejected as being part of a treaty shopping scheme. Many of the reactions received criticize the suggested amendments on the basis that they would not in fact help to clarify the concept. It remains to be seen whether any amendments are in fact made to the Commentaries. Both the discussion draft and the reactions are available at http://www.oecd.org/document/39/0,3746,en_2649_33747_48391591_1_1_1_1,00.html.

63. See for example: Oliver, J.D.B., et al., "Beneficial Ownership", 54 *Bulletin for International Fiscal Documentation* 7 (2000), pp. 310-25; Edge, S., "Legal Esperanto", *The Tax Journal* 833 (2006), pp. 11-2; Fraser, R., and Oliver, J.D.B., "Beneficial ownership: HMRC's draft guidance on interpretation of the Indofood decision", *British Tax Review* 1 (2007), pp. 39-57; Bernstein, J., "Beneficial Ownership: An International Perspective", 45 *Tax Notes International* 12 (2007), pp. 1211-6; Baker, P., "The United Nations Model Double Taxation Convention between Developed and Developing Countries: Possible Extension of the Beneficial Owner Concept", in *Committee of Experts on International Cooperation in Tax Matters: Fourth Session: Geneva, 20-24 October 2008* at 4 (United Nations Economic and Social Council 2008), available at http://www.un.org/esa/ffd/tax/fourthsession/EC18_2008_CRP2_Add1.pdf; Martín Jiménez, A., "Beneficial Ownership: Current Trends", 2 *World Tax Journal* 1 (2010), pp. 35-63; Du Toit, C., "The evolution of the term 'beneficial ownership' in relation to international taxation over the past 45 years", 64 *Bulletin for International Taxation* 10 (2010), pp. 500-9. De Broe even wonders whether the concept is about ownership at all, and points out that the French and Dutch equivalents of the term avoid any mention of ownership; de Broe, L., *International tax planning and prevention of abuse: a study under domestic tax law, tax treaties and EC law in relation to conduit and base companies*, Doctoral Series, Vol. 14 (Amsterdam: IBFD, 2008), Para. 451.

64. See also Prebble, note 10, for a discussion that is particularly pertinent to the issues discussed in this thesis.

It is, for example, not clear whether the beneficial ownership requirement is a substantive attribution rule or an anti-avoidance rule.⁶⁵ The OECD Commentary on Art. 1, Para. 10 presents it as an anti-avoidance provision, and the structure of Arts. 10 and 11 OECD Model also suggests that it is used in those articles as an anti-avoidance rule, but in Art. 12 it seems to be used as an attribution rule. Yet it seems hardly conceivable that it is intended to have a different function in different treaty articles. Or does it simply perform both functions in Art. 12?

The answer to this question is maybe tied up with the answer to another issue, namely the relationship of the beneficial ownership requirement with the term “paid to” that is used in the first paragraphs of Arts. 10 and 11.⁶⁶ In other words, does a treaty claimant under these articles have to satisfy two tests – that he is the beneficial owner of the income and that the income is paid to him? The Commentaries on these articles state that the treaty applies even though an agent or nominee is interposed between the source and the beneficial owner, implying that beneficial ownership is the only test. Or maybe these parts of the Commentaries are simply stating that payment to an agent or nominee amounts to payment to the beneficial owner.⁶⁷ In a discussion with experts working for a large bank the author was told that they do pay attention to this point and ensure that a treaty claimant satisfies both tests apparently laid down in Arts. 10 and 11. There seems to be no decided case that has explicitly decided that these articles lay down a double condition for treaty protection, but this element was implicitly present in the Netherlands case BNB 1990/45, discussed in 5.3.2., and the Italian case 4600, discussed in 5.1.1.

Whether the requirement is a substantive attribution principle or an anti-avoidance rule, there is also a hotly debated question as to whether it has a self-standing definition for treaty purposes or whether it takes its definition from the domestic law of one of the contracting states to a treaty. The 2010 OECD report on collective investment vehicles states⁶⁸ that “[b]ecause the term ‘beneficial owner’ is not defined in the Model, it ordinarily would

65. Li, J., “Beneficial Ownership in Tax Treaties: Judicial Interpretation and the Case for Clarity”, in: Baker, P., and Bobbett, C. (eds.), *Tax Polymath: A life in international taxation* (Amsterdam: IBFD, 2010), pp. 187-210.

66. On this point see: De Broe, note 63, Secs. 7.1.1. and 7.1.1.1.; van Weeghel, S., *The Improper use of Tax Treaties with particular reference to the Netherlands and the United States*, in: Doernberg, R.L., et al. (series eds.), *Series on International Taxation*, Vol. 19 (Kluwer: London, 1998), Secs. 6.4.2 and 6.4.4.

67. For a discussion of the possible meanings of “receipt”, the corollary of “payment to”, see Appendix II, Section 5.3.

68. OECD Committee on Fiscal Affairs, note 13, Para. 31.

be given the meaning that it has under the law of the State applying the Convention, unless the context otherwise requires.” This view has been criticized by, for example, Bammens and De Broe, who “strongly reject the idea that as the OECD Model fails to define the term ‘beneficial owner’, it can be construed in accordance with the domestic law of the state applying the treaty, i.e. the source state.”⁶⁹ Nevertheless, a great deal of time and effort has been devoted in the literature to consideration of national definitions of beneficial ownership.⁷⁰

The case law that is developing in respect of the beneficial ownership concept is also not helpful. In the words of Arnold: “The international case law on beneficial ownership for treaty purposes is growing and inconsistent. Some courts consider the term to have a domestic law meaning; others give it an international meaning. Some courts treat it as an anti-avoidance concept; others do not.”⁷¹ These problems are not exclusive to the OECD Model; the concept is also under consideration by the UN Committee of Experts, for exactly the same reasons.⁷²

One can even question whether the beneficial ownership requirement adds anything useful to treaties that could not be achieved by a common-sense interpretation of their other terms, as exemplified, for example, by the US *Aiken* case.⁷³ Loh concludes that the beneficial ownership condition is

69. Bammens, N., and De Broe, L., “Treaty Shopping and Avoidance of Abuse”, Sec. 4, in: Lang, et al. (eds), note 34.

70. See for example: De Broe, note 63, Sec. 7.1.2.5; McKee, M., “The Concept of Beneficial Ownership in China’s Treaties”, 57 *Tax Notes International* 1, pp. 59-61; Ryyänen, O., “The concept of a beneficial owner in the application of Finnish tax treaties”, *Defensor legis* 3 (2003) pp. 448-66; Gibert, B., and Ouamrane, Y., “Beneficial ownership – a French perspective”, 48 *European Taxation* 1 (2008), pp. 2-9; Rossi, M.Q., “An Italian perspective on the beneficial ownership concept”, 45 *Tax Notes international* 11 (2007), pp. 1117-34; Pijl, H., “Beneficial ownership and second tier beneficial owners in tax treaties of the Netherlands”, 31 *Intertax* 10 (2003), pp. 353-61; Morrison, P.D., “Treasury’s New Model Convention Tries to Clarify a Definitional Problem”, 36 *Tax Management International Journal* 2 (2007), pp. 95-7. See also: Messineo, A.E., et al., “The viability of treaty shopping with respect to host country”, 29 *Tax Management International Forum* 3 (2008).

71. Arnold, B., “Tax Treaty News”, 1. More on Beneficial Ownership, 63 *Bulletin for International Taxation* 5/6 (2009), p. 175 et seq., at p. 176. See also: van Weeghel, S., General Report, Sec. 3.4.3., “Tax treaties and tax avoidance: application of anti-avoidance provisions”, in: International Fiscal Association, *Cahiers de droit fiscal international*, Vol. 95a (The Hague: Sdu Uitgevers, 2010).

72. United Nations Committee of Experts on International Cooperation in Tax Matters, *Report on the Sixth Session (18-22 October 2010)*, available at http://www.un.org/esa/ffd/tax/sixthsession/Report_AUV.pdf at pp. 20-1.

73. *Aiken Industries, Inc. Successor by Merger to Mechanical Products, Inc., Petitioner v. Commissioner of Internal Revenue* 56 TC 925. In this case the court interpreted

largely ineffective to combat treaty abuse in respect of inbound investment in Australia.⁷⁴ And Prebble writes “one should note that in a number of countries the beneficial ownership condition is thought to have relatively little effect in practice.”⁷⁵ This is because the beneficial ownership of income is, in practice, not questioned by the tax authority, although Prebble also states that some tax authorities are becoming more alive to the question.

There is at least one modern treaty, the treaty of 2000 between Austria and Finland,⁷⁶ in which the term has not been used.⁷⁷ On the other hand, courts sometimes consider the beneficial ownership of income even though the requirement is not stated explicitly in the treaty, for example in the French *Diebold* case discussed in 5.1.3. Similarly, in the Indian *E*Trade Mauritius* case,⁷⁸ the Authority for Advance Rulings considered the beneficial ownership of a capital gain for treaty purposes even though the relevant treaty article did not impose any beneficial ownership requirement. In doing so, the Authority took its cue from the tax authority, which argued against treaty entitlement on the basis that the applicant was not the beneficial owner of the gain, but it did so without explaining why this requirement could be imported into the capital gains article.

the treaty term “received by” to refuse treaty benefits to a company that did not have a sufficiently substantive claim over the income in question.

74. Loh, T., “Treaty Shopping Defence Provisions: Part 1”, 14 *The Tax Specialist* 1 (2010), pp. 90-100. The same author argues that the beneficial ownership requirement may be effective in respect of outbound investment from Australia, although much depends on the source jurisdiction: Loh, T., “Treaty Shopping Defence Provisions: Part 2”, 14 *The Tax Specialist* 3 (2011), pp. 136-45.

75. Prebble, note 10.

76. Arts. 10, 11 and 12 Austria–Finland treaty of 26 July 2006.

77. The author wishes to express her gratitude to Antero Toivainen, Director of the International Tax Affairs Unit in the Ministry of Finance of Finland, for carrying out some research into the background of this treaty for her. The Finnish parliamentary history of the treaty does not shed any light on why the beneficial ownership requirement was not included, but the negotiations started already in April 1989. At that time, Finland had an imputation system in respect of dividends, which may have caused some difficulty with the formulation of the beneficial ownership condition. The condition would therefore also have been left out of Arts. 11 and 12, for the sake of consistency. Not including the beneficial ownership requirement was, however, in line with the Finnish tax treaty policy at that time.

78. India: AAR, 22 March 2010, *E*Trade Mauritius Ltd v. ADIT & Others*, 826 of 2009; 12 ITR 5 (2010), pp. 701-24. Para. 10 of the ruling states: “the tax residency certificate issued by the Mauritius authorities is at least a presumptive evidence of the beneficial ownership of the shares and the gains arising therefrom, even if it does not give rise to a conclusive presumption.”

2.4.4. Partnership Report principles

One possible source of law in respect of the attribution issue is the OECD Partnership Report,⁷⁹ which did deal with the attribution of income, although only as a knock-on effect of its discussion on entity classification. Nevertheless, it has been argued that the principles of this report might be useful by analogy in other situations.⁸⁰

The basic principle embraced in the Partnership Report is that the essential features that determine the tax liability of a person are the province of domestic law; tax treaties are based on the foundation of domestic law and must therefore take these domestic law features as their starting point. The function of a treaty is to resolve overlapping claims to taxing jurisdiction. In order to fulfil this function, treaties must be capable of dealing with mismatches in those features of domestic law and the report sets out principles by which this aim can be achieved.

In respect of the main issue addressed by the report, the determination of the taxable unit, the report gives the prerogative for treaty purposes to the residence state. This state, in other words, decides whether its tax liability is imposed on the partnership or the partners and the source state applies the treaty accordingly,⁸¹ even though in a mirror image situation it would have come to a different decision. In respect of the characterization of sums paid from a partnership to its partners, both states maintain their own view, but the residence state accepts the source state interpretation of the treaty and adapts its double tax relief mechanism accordingly if necessary. The question is whether either solution could be used in respect of attribution conflicts.

The latter solution is clearly not capable of dealing with mismatches of attribution. The conclusion of the report in respect of the characterization of income is predicated on the assumption that both states are applying the same treaty, and this solution is designed to apply within the confines of that one treaty. Mismatches of attribution, however, could mean that states would apply different treaties. If the source state “goes it alone”, as France

79. OECD Committee on Fiscal Affairs, note 2.

80. For example, specifically in respect of trusts: Danon, R., “Conflicts of Attribution of Income Involving Trusts under the OECD Model Convention; the Possible Impact of the OECD Partnership Report”, 32 *Intertax* 5 (2004), pp. 210-22.

81. Subject to the exception for closed domestic situations discussed in examples 16 and 17 of the report and accepted by a majority of OECD Member countries.

did in the *Aznavour* case,⁸² questions remain open about taxation in the residence state or states. This solution might work from the perspective of the source state, but it does not promote a consistent application of the treaty network.

The first solution, giving the prerogative to one state, most likely also the residence state in the context of attribution, is attractive, but poses a problem that did not trouble the drafters of the Partnership Report. What happens, namely, if the source state finds the attribution in the residence state quite unacceptable? The Partnership Report assumes that income is attributed to a person, either a partner or a partnership, who carries on a business activity or who makes an investment. Both of these grounds are generally accepted as a basis for the attribution of income. But, as will be discussed below, states sometimes go beyond these well-worn paths and attribute income to a person on the basis of much less direct connections with the income. In these circumstances it is rather doubtful that a source state would be willing simply to accept the residence state attribution without question and grant treaty benefits accordingly. The United States is probably the country that has put most thought into these issues but still “... the U.S. Treasury Department (and U.S. treaty partners) continue to struggle with whether treaty benefits should be allowed in certain circumstances where, due to differing views of the status of the relevant entities, the parties to the applicable treaty have fundamentally different views of who, if anyone, earned what income.”⁸³

There is also a fundamental, qualitative difference between the mismatch at the heart of the entity classification issue and the mismatch at the heart of the attribution issue. Each state has to decide for the purposes of its domestic law whether it wishes to regard a conglomeration (to use a neutral word) of persons and maybe assets as a taxable unit. This is so in respect of individuals, for example whether a state taxes individuals separately or in family units, and in respect of business structures, for example which legal structures are regarded as taxable units. This question concerns only one end of the treaty relationship and it is logical that the answer is determined solely by the state imposing the liability.

The attribution of income, on the other hand, concerns the direction of flow of the income and necessarily concerns the two points at either end of the

82. Note 6.

83. Miller, M.J., and Stone, M., “The Evolution of Limitation on Benefits, Beneficial Ownership, and Similar Rules: Recent Trends and Future Possibilities”, *37 TM International Journal* (2008), p. 719 et seq. at p. 733.

flow. In respect of treaties, this element is what determines how a connection is made between two treaty partner states in order to determine which treaty applies, if any. It therefore concerns the states at both ends of the flow. A taxable person is needed who is entitled to treaty benefits, and it makes sense to follow the flow of income until one reaches a taxable person. But determining the direction taken by the income flow is a prior stage that should not be determined by one state alone. It is not satisfactory to give the initiative in this respect to the residence state, leaving the source state to combat an attribution that it finds unacceptable by using a concept as problematic as beneficial ownership.

It is also notable that in neither the *Aznavour* case nor the *Russell* case did the court consider the view of a potential residence state as a treaty partner. If the principles of the Partnership Report are applied to the facts of the *Russell* case by analogy, the facts fall within the exception for a closed domestic situation.⁸⁴ The judges in the actual decision started from their own domestic law, and arguably that was all they needed to do in order to arrive at a result congruent with the Partnership Report principles, but it is notable that they did not even consider the report. The *Aznavour case*, however, which did not fall within this exception, took an approach that was clearly contrary to the principles of the Partnership Report.

2.4.5. Concluded treaties

Maybe the best indication of the structural lack of attention for the attribution of income in the OECD Model is the variety of provisions found on this point in concluded treaties dealing specifically with the attribution issue, a number of which are noted here. The difficulty of finding these provisions, which is partly due to the lack of any international standard in this respect, means that what follows is a rather haphazard selection of provisions known to the author.

A small number of treaties include an explicit rule dealing directly with the attribution of income. The Nordic Convention, for example, provides⁸⁵ that if income is taxable in the hands of an estate resident in one country it is not taxable in the hands of an heir resident in another country.⁸⁶ The treaties

84. OECD Committee on Fiscal Affairs, note 2, examples 16 and 17.

85. Art. 24, Nordic Convention of 23 September 1996.

86. See also: Maisto, G., General Report, in: International Fiscal Association, "Death as a Taxable Event and its international Ramifications", *Cahiers de droit fiscal international*, Vol. 93b (The Hague: Sdu Uitgevers, 2010), Sec. 5.2.2.2.2., which reports that

concluded by the United Kingdom with Hong Kong⁸⁷ and Norway⁸⁸ provide that if trustees resident in the United Kingdom distribute trust income to a beneficiary resident in the other state, the trust income is deemed to flow directly to the beneficiary and the beneficiary is deemed to have borne the tax paid by the trustees on the income.

Other treaties include provisions that address income derived through transparent entities. The best-known example is the US Model,⁸⁹ which provides that income derived by or through a fiscally transparent person is to be treated as derived by a resident to the extent that it is treated as the income of a resident or citizen under the law of the state that applies the transparent treatment. This provision ensures that treaty protection is granted in these circumstances, but it does not say explicitly to which person the income is attributed for treaty purposes.⁹⁰ A similar provision is included in the treaty between Australia and New Zealand.⁹¹

The United Kingdom–United States treaty⁹² also includes this provision and the Exchange of Notes to this treaty explicitly allows⁹³ a double attribution of the income of a fiscally transparent entity if the two contracting states each attribute the income to a resident. It also states that this treaty provision “exceptionally” covers certain anti-avoidance legislation of the United Kingdom, and goes on to provide that if this double attribution applies to a trust settlor resident in one contracting state and a beneficiary resident in the other, the residence state of the settlor is obliged to grant a credit for the tax paid by the beneficiary in his residence state. The Netherlands–United Kingdom treaty also deems income derived through a fiscally transparent person to be derived by a resident to the extent that it is taxable in the hands of a resident, and the treaty itself explicitly allows both states to tax the income if they attribute it to different persons.⁹⁴

in the preliminary work of the OECD in 1957 for the OECD Model Inheritance Tax Convention, the working party addressed the situation in which a deceased individual’s estate is taxable in one country and an heir is taxable in a different country and recommended that the exclusive taxing right be allocated to the country taxing the estate.

87. Art. 20(2) Hong Kong–United Kingdom treaty of 21 June 2010.

88. Art. 21(2) Norway–United Kingdom treaty of 12 October 2000.

89. Art. 1(6) United States Model.

90. In the *TD Securities* case, discussed in 5.3.1.1., the judge (in Para. 46 of the judgment) had trouble with the way in which this provision is worded, and found that a literal interpretation of the treaty would have led to a denial of treaty benefits.

91. Art. 1(2) Australia–New Zealand treaty of 26 June 2009.

92. Art. 1(8) United Kingdom–United States treaty of 24 July 2001.

93. Exchange of notes of 24 July 2001 on Art. 1(8) United Kingdom–United States treaty of 24 July 2001.

94. Art. 22(3) and (4) Netherlands–United Kingdom treaty of 26 September 2008.

Other provisions deal with collective investment schemes. The protocol to the treaty between Slovenia and the United Kingdom,⁹⁵ for example, deems certain investment schemes and pension schemes to be an individual resident in the state where they are established and the beneficial owner of the aggregate income on which residents of that state are taxable. There is also a mutual agreement between France and Spain⁹⁶ in respect of French collective investment vehicles which provides for treaty entitlement in proportion to the number of participants resident in France.

A number of treaties include provisions in connection with the beneficial ownership concept. Probably the best known of these is the provision in most treaties concluded by New Zealand which provides that trustees are regarded as the beneficial owner of trust income if they are taxable in respect of the income.⁹⁷ Some older German treaties define beneficial ownership by reference to domestic law of one or both states, but these definitions are rather inconsistent.⁹⁸ The Exchange of Notes to the new Japan–Netherlands treaty⁹⁹ refers explicitly to the OECD Commentary in connection with the beneficial ownership requirement. The memorandum of understanding to the Netherlands–United States treaty¹⁰⁰ deals with the beneficial ownership of dividends in a stock lending transaction. The Japan–United States treaty¹⁰¹ excludes the intermediary in a back-to-back structure from being considered the beneficial owner of passive income. There is an assortment

95. Protocol to Slovenia–United Kingdom treaty of 13 November 2007.

96. “Spain accepts France’s proposal to apply treaty to French OPCVM” (6 August 2009), News IBFD.

97. The domestic system of New Zealand makes a choice when trust income arises as to whether to tax it in the hands of the trustees or the beneficiary; income taxed in the hands of trustees is not generally subject to any further taxation if it is subsequently distributed to a beneficiary. Australia applies a similar system to the taxation of trust income, but it is not known to the author why Australian treaties do not include a similar provision in respect of beneficial ownership. See further 5.4. on the taxation of trusts.

98. Art. 9 of the 1989 protocol to the Germany–Italy treaty of 18 October 1989 and Art. 4 of the protocol to the Germany–Norway treaty of 4 October 1991 state that a recipient of dividends, interest and royalties is the beneficial owner if he is entitled to the right upon which the payments are based and the income is attributable to him under the tax laws of both states. Art. 43 of the Germany–Sweden treaty of 14 July 1992 deems a person to be the beneficial owner of dividends, interest and royalties if, generally, they are attributable to that person under the law of the residence state. Art. 7 of the protocol to the Germany–Australia treaty of 24 November 1972 is slightly different, as the wording of Arts. 10 to 12 of this treaty does not include the beneficial ownership requirement; this provision defines the term “paid to” used in these articles, in effect, by reference to the law of the source state. See also: Vogel, note 29, p. 60 et seq.

99. Art. 2 Exchange of Notes to the Japan–Netherlands treaty of 25 August 2010.

100. Para. VI Memorandum of Understanding of 8 March 2004 to the Netherlands–United States treaty of 18 December 1992.

101. Arts. 10–12 Japan–United States treaty of 6 November 2003.

of treaties that include a general beneficial ownership provision expressed to apply to the whole treaty.¹⁰² A number of treaties concluded by Turkey provide that the beneficial ownership requirement is to be interpreted as preventing third-state residents from obtaining treaty benefits.¹⁰³

Some treaties deal specifically with treaty shopping structures by excluding interest, in particular, from treaty benefits if it is paid in a back-to-back loan structure or, if the treaty provides a greater restriction on the source state taxation of bank interest, excluding back-to-back interest from the benefit of that provision. These provisions are found, for example, in treaties concluded by Australia,¹⁰⁴ Mexico,¹⁰⁵ the United States¹⁰⁶ and occasionally some other states.¹⁰⁷ Other treaties include provisions specifically excluding income paid in conduit structures from the benefit of the treaty.¹⁰⁸

Some treaties include provisions that apply to the obligation of the residence state to give double taxation relief. German treaty policy is to include a switchover provision that allows Germany to grant a foreign tax credit, rather than an exemption, if an attribution mismatch would otherwise lead to double non-taxation or excessively low taxation.¹⁰⁹ The United King-

102. For example: Para. 4 Protocol to the Croatia–Israel treaty of 29 September 2006; Para. 1 protocol to the Pakistan–Spain treaty of 2 June 2010; Para.7 Protocol to the Portugal–Uruguay treaty of 30 November 2009; Para. 2 Protocol to the Spain–Senegal treaty of 5 December 2006.

103. For example: Para. 5 Protocol to the Belgium–Turkey treaty of 2 June 1987; Para. 3 Protocol to the France–Turkey treaty of 18 February 1987; Para. V Protocol to the Italy–Turkey treaty of 27 July 1990; Para. 4 Protocol to the Pakistan–Turkey treaty of 14 November 1985; Art. 3(1)(j) Romania–Turkey treaty of 1 July 1986; Para. 3 Protocol to the Sweden–Turkey treaty of 21 January 1988.

104. For example: Art. 11(4) of the treaties with Finland (20 November 2006), France (20 June 2006), Japan (31 January 2008), New Zealand (26 June 2009), Norway (8 August 2006), South Africa (protocol of 31 March 2008) and the United States (6 August 1982).

105. For example: the treaties with Iceland (protocol to the treaty of 11 March 2008), Russia (protocol of 7 June 2004) and the Slovak Republic (protocol to the treaty of 13 May 2006).

106. For example: the treaties with Bulgaria (23 February 2007), Chile (4 February 2010), Mexico (18 September 1992) and New Zealand (protocol of 1 December 2008).

107. For example: Art. 11(5) Hong Kong–New Zealand treaty of 1 December 2010; and Art. 11(3) Bahrain–United Kingdom treaty of 10 March 2010.

108. For example: Para. 5 Chile–Switzerland protocol to the treaty of 2 April 2008; India–Singapore protocol of 29 June 2005; Art.11 India–Switzerland protocol of 30 August 2010; Art. X Mexico–Switzerland protocol of 18 September 2009; Switzerland–United Kingdom protocol of 26 June 2007; Arts. 3, 10, 11, 12 and 22 United Kingdom–United States treaty of 24 July 2001.

109. Lüdicke, J., “Exemption and Tax Credit in German Tax Treaties – Policy and Reality”, Sec. 4.2.2., in: Baker and Bobbett, note 65. See also Vogel, note 29, pp. 60-3.

dom–United States treaty includes a provision¹¹⁰ which removes the UK obligation to give an indirect credit in respect of dividends received from a US company in dividend stripping situations in which the two states attribute the dividend to different persons. The Denmark–Netherlands treaty¹¹¹ provides that, for double tax relief purposes, the Danish tax on the undivided estate of a deceased person is to be regarded as tax on the income of a beneficiary to the extent that the income accrues to a beneficiary who is a resident of the Netherlands.

This brief overview is undoubtedly incomplete, but it does serve to demonstrate that the provisions in concluded treaties on the attribution of income form rather a patchwork of piecemeal solutions to specific problems.

2.4.6. Conclusion

Clearly the attribution of income to a person raises plenty of questions in the current treaty framework. Given that the function of treaties is to regulate the interface between the tax systems of two countries, the obvious starting point in their application would seem to be domestic law, particularly as treaties themselves pay so little attention to the attribution issue. But it is precisely the differences among countries, as noted in 2.4.1., that give rise to the questions in the treaty context. The *Aznavour* and *Russell* cases¹¹² perfectly illustrate a situation in which states may come to very different conclusions about the attribution of income, with one state attributing the income on the basis of the company's ownership of the income and the other state attributing it to the individual on the basis that the individual's activity produced the income. A similar conflict also underlies the example given by the OECD Commentary of the attribution of a disguised dividend by two states to two different persons at the same time, as discussed in 2.4.2. It is, perhaps, surprising that some general principle has yet to be found for dealing with these differences, but that is the inevitable conclusion of the discussion in this section.

Is it maybe possible to distil some guidance from the domestic law of states that could inform the application of treaties, such as an expression of the factors that govern the attribution of income to a person for treaty purposes? The factors that might be used for this purpose are relatively easy to ascertain; the obvious candidates are the legal and economic entitlement

110. Art. 24(4) United Kingdom–United States treaty of 24 July 2001.

111. Art. 30(3)(b) Denmark–Netherlands treaty of 1 July 1996.

112. See 2.1.

to income, control over the application of income and possibly the receipt of income. But establishing the relative weight of these factors in various situations is a different matter altogether. Appendix II attempts to do so in the context of just one pair of countries, the Netherlands and the United Kingdom, but the difficulties encountered in that exercise are such as to cast severe doubt on the feasibility of extracting principles at a level of generality which would be useful in that specific treaty relationship, let alone in a wider international context such as a model treaty.

If it is not possible to draw up independent treaty principles for the attribution of income, is it then possible to develop a satisfactory way of giving priority to the law of one of the contracting states to a treaty? One way of doing this would be to adopt principles similar to those of the Partnership Report, but 2.4.4. has already explained the conceptual objection to this solution.

A further problem with this solution concerns the use of treaties for tax avoidance purposes. Under both domestic law and treaties, avoidance strategies sometimes rely on the attribution of income to a person who is in a more favourable tax position than the “original” owner. But the focus of the strategies differs, and therefore the concerns of states also differ. Under domestic law, the aim of the taxpayer is generally to shift income away from a person with a high tax liability. Domestic law therefore generally focuses on maintaining the attribution of the income to its original, or “true”, owner. Under treaties, on the other hand, the aim of the avoidance strategy is generally to shift income to a person in a favourable treaty position. The focus of source states in this regard is therefore to block the attribution of the income to the new owner, without necessarily any concern to discover the “true” owner. This difference means that a simple reliance on the response of states in the domestic context would not necessarily lead to an appropriate result in the treaty context.

This discrepancy is especially apparent in respect of conduit structures. A source state faced with a possible conduit structure would want to investigate how much substance there is to the receipt of the income by the conduit company. The residence state of a conduit company, on the other hand, simply applies its own domestic law, which is what causes the source state’s problem in the first place. Any solution that relies on domestic law would therefore have to include some mechanism to prevent reliance on the domestic law of the residence state in conduit situations. But it is hard to see how, in the current treaty framework, that mechanism could be anything other than an anti-avoidance rule which, in essence, reintroduces the

problem of defining a substantive attribution principle, albeit in a negative form.

An alternative possibility for giving priority to the law of one of the contracting states to a treaty could be a tiebreaker rule, which would list a hierarchy of connections between a person and income to determine which attribution takes priority. This solution would run into the problem that each tiebreaker would operate only within the context of one bilateral relationship, whereas attribution conflicts easily create triangular situations. In particular, if two residence states agree on a hierarchy between them it is not immediately obvious why a third-state source state should consider itself bound by that hierarchy. But this problem is an inevitable result of applying bilateral treaties to a multilateral world and should therefore not be dismissed for that reason alone. Of course, a tiebreaker provision would also require choices to be made among the factors used in attributing income to a person, but it is undoubtedly much easier to develop a hierarchy of the grounds for attribution than it is to draft a stand-alone principle. This solution seems, in other words, to show some promise for dealing with attribution conflicts. It would be difficult to implement in the current treaty framework, however, because the OECD Model pays no attention to this issue.¹¹³

Is it, then, possible to find a comprehensive solution for the attribution issue within the current treaty framework? It will be argued in 3. that it is not. Chapter 3. looks at some more fundamental issues with the current framework and comes to the conclusion that it has a fatal flaw which lies at the root of the problems discussed so far and which stands in the way of a satisfactory solution that could operate at a general level.

113. For a more extensive consideration of this possibility, see Wheeler, note 58; and Kumar Gupta, V., "Conflicts of qualification and conflicts of allocation of income", in: Burgstaller, E. and Haslin, K. (eds.), *Conflicts of qualification in tax treaty law*, 58 Schriftenreihe zum Internationalen Steuerrecht (Vienna: Linde Verlag, 2007), pp. 39-56.

Chapter 3

Fundamental Issues with the Current Structure of Treaties

3.1. Introduction

This chapter considers two fundamental and interrelated problems with the OECD Model which lie at the root of the problems discussed in 2. Resolving these fundamental issues makes it possible to ask the right policy questions in respect of entitlement to treaty benefits. The first problem is that it is not entirely clear whether treaties operate on a subjective or on an objective basis. In other words, is treaty relief available to a specific person only? Or is treaty relief available in respect of certain items of income, with the person who bears the tax liability taking a secondary importance?

The second problem is that the current treaty framework places no structural importance on the liability to tax of a person in respect of a specific item of income. As a consequence, it is not clear what the role is of the attribution of income in the application of a treaty. Should treaties always be concerned with the attribution issue, or are treaties required to step in only if there is an attribution mismatch between two potential treaty partners?

3.2. Subjective/objective nature of treaties

One aspect of treaties that is not clear is whether they follow a subjective system, in that they apply to persons, or whether they follow an objective system, in that they apply to income. This issue may appear to be rather theoretical and not immediately relevant to the application of treaties. Yet, as explored below, it has arisen in some cases in a way that determined the extent to which treaty protection was available.

3.2.1. OECD Model

The current OECD Model is worded in Art. 1 to apply to persons, rather than to income. This article suggests that the entire model is subjective in its approach, yet the distributive articles contain a mixture of subjective and objective elements. One of the simplest examples is that the exemp-

tions granted by treaties sometimes apply to persons, such as an exemption for interest received by a bank, and sometimes apply to income, such as an exemption for interest paid by a bank.

On a more fundamental level, entitlement to the benefit of a specific treaty may not be determined on quite the subjective basis that is suggested by Art. 1. Hattingh, for example, in a study of the history of Art. 1,¹¹⁴ has concluded that its role and function remain unclear. He sees its role primarily as a corollary to, and a safeguard of, the distributive rules of the OECD Model. But even though the very early treaties appeared to function perfectly well without this provision, Hattingh finds that it is an essential element of the current Model.

The history of the subjective and objective elements in the OECD Model on a more general level has been traced by Avery Jones,¹¹⁵ who explains that the very early models had a first part dealing with impersonal, or objective, taxes which could be levied by the source state and a second part dealing with personal, or subjective, taxes which could be levied only by the residence state. But it was a draft that did not maintain this distinction that was used as a basis for what is now the OECD Model.

The wording of Arts. 10, 11 and 12 in the current Model seems to assume that the tax that is targeted by these articles, the source state tax, is levied on an impersonal, or objective, basis. This assumption probably explains the use of the term “paid to a resident” in Arts. 10 and 11. An objective system can operate only with income that is objectively observable; there must be something that is already detached from the source that can be classified as income, and the “paid to” terminology reflects this feature. But although the point of imposing an objective tax at source under domestic law is often to avoid having to attribute the income to a person, it is that very enquiry that has to be made in order to determine whether the treaty applies.¹¹⁶

114. Hattingh, note 17, and Hattingh, P.J., “The Role and Function of Article 1 of the OECD Model”, 57 *Bulletin for International Taxation* 11 (2003), pp. 546-53.

115. Avery Jones, J., “Categorising income for the OECD Model” in: Hinnekens, L., and Hinnekens, P. (eds.), *A vision of taxes within and outside European borders: Festschrift in honor of Prof. Dr. Frans Vanistendael* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2008), pp. 93-109; Avery Jones, J., “Problems of categorizing income and gains for treaty purposes”, *British Tax Review* 5 (2001), p. 382 et seq.

116. Although in the UK *Bricom* case, which concerned primarily the effect of a treaty on the application of the United Kingdom’s CFC regime, the tax authority accepted that Art. 11 of the relevant treaty, which allocated the exclusive taxing right over interest to the residence state, operated to “exempt the interest itself from United Kingdom corporation tax and not merely the resident of the Netherlands who receives it. The benefit of the exemption, therefore, is capable of enuring to the [CFC’s parent]

By contrast with the passive income articles, Art. 15 uses the term “derived by a resident”, a more subjective term which approaches the attribution more from the point of view of the taxable person. In keeping with the increasingly subjective nature of income taxation in most countries generally during the past century, the OECD Model has also become slightly more subjective since 1963. In the 1963 Model, Arts. 6(1) and 13(1) applied to income or a gain from immovable property as such, but in the subsequent models these articles apply to income or a gain that is derived by a resident of a contracting state. The definition of residence in Art. 4 has been clearly subjective throughout, focusing on the features of the particular person.¹¹⁷

The difference between the subjective and objective approaches to taxation is also reflected in the different taxable bases that are addressed in the OECD Model.¹¹⁸ As noted above, the articles on passive income are based on the assumption that the income is taxed on a gross basis in the source state; certainly the limits on source state taxation are expressed as a percentage of the gross amount. Arts. 7 and 8, on the other hand, are expressed to apply to “profit”, implying that a subjective approach is required which takes into account the expenses of the person entitled to treaty benefits. Yet other articles, such as Arts. 15 and 21, are not explicit on this point.

3.2.2. Economic double taxation – the subjective or objective nature of the treaty distributive rules

One of the aspects of treaties that sometimes provoke discussion is whether the scope of the distributive articles is strictly limited to juridical double taxation, or whether it can also extend to economic double taxation. This debate emerges naturally from a consideration of whether, in this respect, the distributive rules of treaties are subjective or objective in nature. If they are subjective in nature, they apply to a specific person and therefore serve to prevent only juridical double taxation, or in other words two levies of tax on one person. If, on the other hand, they are objective in nature, they apply to income as such, regardless of the person on whom the charge is imposed,

company.” The tax authority accepted, in other words, that the treaty granted an objective exemption; *Bricom Holdings Ltd v. Commissioners of Inland Revenue*, 70 TC 272; [1997] STC 1179; United Kingdom: CA, 25 June 1997, Tax Treaty Case Law IBFD. 117. See also the commentary by Nikolakakis on the *TD Securities* case: Nikolakakis, note 11.

118. This point was made by Malcolm Gammie during an invitational seminar on tax treaties held in 2001. For a report of this seminar see: Arnold, B.J., Sasseville, J. and Zolt, E., “Summary of the proceedings of an Invitational Seminar on Tax Treaties in the 21st Century”, 56 *Bulletin for International Taxation* 5 (2002), pp. 233-45.

and therefore treaties are capable of giving protection against economic double taxation.

This issue was one of the main points before the court in the *Padmore* case¹¹⁹ in the United Kingdom. An individual resident in the United Kingdom was a partner of a partnership established in Jersey and carrying on business there; in fact most of the partners were individuals resident in the United Kingdom. Art. 3(2) of the arrangement between Jersey and the United Kingdom¹²⁰ provided that the “profits of a Jersey enterprise shall not be subject to United Kingdom tax unless the enterprise is engaged in trade or business in the United Kingdom through a permanent establishment situated therein”; it was not in dispute that the partnership had no permanent establishment in the United Kingdom. One of the questions before the court was whether Art. 3(2) operated to protect the individual partner from taxation in the United Kingdom on his share of the partnership profit. The court held that it did, interpreting this provision as an objective rule which applied to the profits as such; as the individual received a share of those profits, the treaty protection also extended to that share.

A similar focus on the income was found in the Canadian *TD Securities* case,¹²¹ although the issue in this case was the initial entitlement to treaty protection rather than the interpretation of one of the distributive rules. Here the question was whether an LLC established under US law was entitled to the benefit of the Canada–United States treaty in respect of its branch in Canada. The LLC was not itself liable to tax, but its income was attributed to its parent company (the sole shareholder) and taxed in the parent company’s hands. The issue before the court was whether the LLC could claim treaty protection even though, as Nikolakakis puts it in his comment on the case, “the structural problem ... would be that the *wrong person* is liable to tax.”¹²² He argues¹²³ that the “liable to tax” test in the residence definition applies to a person, rather than to income as such. The court, however, focused much of its decision on the taxation of the income, and held that

119. *Padmore v. Inland Revenue Commissioners* [1989] STC 493; United Kingdom: CA, 19 May 1989, Tax Treaty Case Law IBFD. A diagram of this case is given in 5.2.3., where the case is discussed in more detail.

120. The Double Taxation Relief (Taxes on Income) (Jersey) Order 1952, which has the same function as a treaty between the two jurisdictions.

121. *TD Securities (USA) LLC v. Her Majesty the Queen* 12 ITLR (2010) 783, 2010 TCC 186. A diagram of this case is given in 5.3.1.1., where the case is discussed in more detail.

122. Nikolakakis, note 11, at pp. 797-8. Emphasis in the original.

123. *Ibid.* at p. 796.

the LLC was entitled to the benefit of the treaty because all its income was taxable in the United States, albeit in the hands of its parent company.

This debate has been particularly controversial in connection with the interaction between treaties and controlled foreign company (CFC) regimes. The difference between the subjective and the objective approach in this respect is exemplified by the *Schneider* case¹²⁴ in France, in which the question before the *Conseil d'Etat* was whether the France–Switzerland treaty prevented the application of the French CFC regime. The *commissaire du gouvernement* took a subjective approach; he looked primarily at the person who was subject to the tax charge, the parent company, and advised the court to hold that the charge fell within the “other income” article and was therefore not prohibited by the treaty. The court rejected this reasoning, however, in favour of a more objective approach; it focused more on the profit as such, holding that the CFC charge was imposed on the profit of the subsidiary and therefore came to the conclusion that it was prohibited by the business profits article of the treaty.

A comparable dichotomy runs through most of the discussion about the subjective or objective nature of treaties. Baker¹²⁵ agrees with the *Conseil d'Etat*, arguing that the business profits article of treaties operates by reference to profits, not by reference to the taxable person, and that it makes no difference whether the taxation is imposed on the company that realizes the profits or the parent company under CFC legislation. Other commentators have also pointed out that there is no explicit condition in the distributive rules of treaties that the income should be taxed in both the source and the residence state in the hands of the same person, and that therefore the distributive rules could be interpreted to prohibit economic double taxation.¹²⁶

124. *Re Société Schneider Electric*, 4 ITLR 1077; France: CE 28 June 2002, Case No. 232276, Tax Treaty Case Law IBFD.

125. Baker, P., “Editor’s Note”, *Glaxo Kabushiki Kaisha v. Director of Kojimachi Tax Office: 2008 (Gyo-Hi) No 91*, 12 ITLR 644, at p. 645.

126. For example, Portner, R., “Validity of CFC rules in a changing world: a German perspective”, 27 *Tax Notes International* 14 (2002), pp. 1679-93, states at p. 1692: “Conventions do not, however, contain any indication that the convention benefits require the same income to be taxed in the hands of the same person.” Sandler, D., *Tax Treaties and Controlled Foreign Company Legislation; Pushing the Boundaries*, 2nd ed. 1998 (The Hague: Kluwer Law International, 1998), states at p. 19: “Nowhere does the text of the OECD Model, as opposed to its Commentary, suggest that the distributive rules in Chapter III concern only juridical double taxation and not economic double taxation. In other words, it is open to question whether the distributive rules refer to the division of the tax base of a particular taxpayer or to the division of the income comprising the tax base, regardless of in whose hands it is taxed.”

On the other hand, plenty of authority can also be found for the opposite point of view. One is a decision of the Japanese Supreme Court¹²⁷ with which Baker disagrees. This decision started by stating that the first part of Art. 7(1) applies to profits as such, but then goes on to say that the second part of Art. 7(1) applies to the specific enterprise and that this same limitation has to be implied into the first part of the provision, concluding that the whole provision operates only to prohibit juridical double taxation. As Miyatake points out, however,¹²⁸ the court did seem to be rather uncomfortable with its own answer and went on to provide a further justification of it.

The Australian court in the *Russell* case,¹²⁹ however, came to the same conclusion. This case concerned the application of the Australian personal services company legislation, which attributed the income of a company resident in New Zealand to an individual resident in Australia. One of the questions before the court was whether the business profits article of the Australia–New Zealand treaty prevented Australia from applying this legislation and taxing the income in the hands of the individual. In the lower court,¹³⁰ the judge expressed sympathy with the taxpayer’s argument that a refusal of treaty benefits would lead to economic double taxation, but after an extensive consideration of this issue¹³¹ held that the treaty applied to the enterprise rather than to the profits, and therefore did not prevent the Australian tax charge on the individual. The Federal Court¹³² did not consider this point explicitly but instead pointed out that,¹³³ under the Australian legislation, the fees paid for the individual’s services were not attributable to the company and therefore taxation on the individual’s personal services income was not taxation of the company’s profits.

A similar point arose in the UK *Willoughby* case.¹³⁴ Most of the argument in this case concerned the interpretation of domestic anti-avoidance legislation, but before the Special Commissioner one of the points raised¹³⁵ was

127. *Glaxo Kabushiki Kaisha v. Director of Kojimachi Tax Office*, note 125.

128. Miyatake, T., “Commentary”, *ibid.*, pp. 645-7.

129. Note 7.

130. *Russell v. Commissioner of Taxation of the Commonwealth of Australia* [2009] FCA 1224.

131. In Para. 113 et seq. of the judgment.

132. Note 7.

133. Para. 37 of the leading judgment of Dowsett J.

134. *IRC v. Willoughby* [1995] STC 143 (Special Commissioner and Court of Appeal); United Kingdom: SpC, 23 March 1993, Tax Treaty Case Law IBFD. The case was also appealed to the House of Lords; [1997] STC 995. Neither the Court of Appeal nor the House of Lords considered the point discussed here. A diagram of this case is given in 5.2.2., where the case is discussed in more detail.

135. *Ibid.*, [1995] STC 143, at p. 146 and pp. 167-8.

the effect of the business profits article in the arrangement between the Isle of Man and the United Kingdom¹³⁶ on that legislation. The case concerned an individual resident in the United Kingdom who had invested in bonds with a company resident in the Isle of Man. If the anti-avoidance legislation under discussion in the case had applied, it would have attributed the income from the investments made on behalf of the individual directly to the individual, so that that income would have been taxable in his hands. The subsequent question was whether the business profits article of the arrangement, which essentially followed Art. 7 OECD Model, would prevent that charge. The Special Commissioner held that it would not, stating that one cannot apply the treaty provision twice, nor could one apply it to two different persons.

In yet another context, the Secretary of State of the Netherlands has asserted that a double attribution is a form of economic double taxation that is not prohibited by treaties. He concludes therefore that if an individual resident in the Netherlands settles property on trust in another country, the Netherlands is free to tax the trust income in the hands of a settlor even though the income is also taxed in the hands of trustees resident in a treaty partner state.¹³⁷

Arts. 23A and 23B OECD Model, the double tax relief articles, are rather interesting in this respect because they appear to be slightly different from each other.¹³⁸ Art. 23A starts “where a resident derives income” and makes no further reference to the taxable person, whereas Art 23B later does make a subsequent reference to “that resident”. A strict interpretation of these articles could mean, in other words, that Art. 23A applies on an objective basis and Art. 23B on a subjective basis.¹³⁹ Yet it is hardly conceivable that such a difference in scope is intentional.

Vogel, on the other hand, does not find the debate about the nature of the double taxation that is combated by treaties a useful one. He states that “[a]pplication of tax treaties, however, is merely a matter of interpretation of the respective treaty. What conceptually is – and what is not – ‘double taxation’ is, therefore, of no importance for the treaty’s application.”¹⁴⁰ This

136. Art. 3(2) Isle of Man–United Kingdom arrangement of 29 July 1955. This arrangement has the form and the function of a double taxation treaty.

137. Brief van de staatssecretaris van Financiën van 6 oktober 2009, DB2009/00592 M.

138. This point was made by Kees van Raad during an invitational seminar on tax treaties held in 2001. For a report of this seminar, see note 118.

139. See also the discussion by Bullen, A., “Norway”, pp. 489-510 at pp. 508-9, in: International Fiscal Association, note 1.

140. Vogel et al., note 29, p. 10, Para. 4.

approach was recently taken by the Canadian court in *Sommerer v. R.*¹⁴¹ in which one of the issues addressed, albeit *obiter*, was the interpretation of a treaty provision which allocated the right to tax a capital gain to the residence state of “the alienator”. The court found that the alienator was a trust resident outside Canada, but the Canadian legislation imposed a tax charge in respect of the gain on an individual resident in Canada who had transferred assets to the trust. One of the arguments of the tax authority was that this treaty provision did not prevent economic double taxation and therefore did not prevent Canada from taxing the individual. The judge preferred, however, not to enter into this discussion, and dealt with the question as one of the interpretation of what he found to be an unambiguous treaty provision, which did indeed prevent the Canadian tax charge. Interestingly, he also considered the Canadian legislation to be in line with the treaty because, rather than deeming the individual to be the alienator, it recognized the trust as the alienator but treated the gain as belonging to the individual.

3.2.3. Vicarious treaty benefits

A different angle to the question about the subjective or objective nature of treaties is the question of whether treaties can operate to give “vicarious benefits”.¹⁴² This term refers to the possibility that the real benefit of a treaty is not enjoyed by the person who is entitled to claim treaty benefits, but by another person who would actually suffer the tax charge.

This point was in issue in the Canadian *Garron* case,¹⁴³ which concerned two trusts which had realized substantial gains on sales of shares. The lower court judge held that the trusts were resident in Canada and that therefore Canada was entitled under the relevant treaty to tax the gains. She then went on, however, to consider a number of other issues, including the effect

141. *Peter Sommerer v. H M The Queen* 2011 TCC 211, Paras. 111-122. This case is under appeal.

142. This term was coined by Philip Baker in his commentary on the UK *Smallwood* case, in which this issue was not raised but should maybe have been discussed: Baker, P., “Commentary”, *Smallwood and another v. Revenue and Customs Commissioners*, 11 ITLR 943, pp. 945-55. This comment was written on the High Court decision, which was subsequently reversed by the Court of Appeal. The *Smallwood* case is discussed further in 5.2.4.

143. *Garron et al v. Her Majesty the Queen*, Case No. 2006-1405(IT)G. This case was appealed to the Federal Court of Appeal in *St. Michael Trust Corp., as Trustee of the Fundy Settlement v. Her Majesty the Queen* 2010 FCA 309, but the appeal concerned only the residence of the trustees and did not consider the issue of vicarious treaty benefits.

of the treaty on a provision of Canadian domestic law,¹⁴⁴ which attributed gains realized by trustees to the settlor in certain circumstances. The judge held that this provision did not apply in the circumstances of the case, but went on to consider how it would interact with the treaty if it did apply. She did not need much time¹⁴⁵ to decide that this charge would have been prohibited by the treaty, even if the gains had been realized by a resident of another state. She found the treaty provision with respect to the residual category of capital gains¹⁴⁶ plain and unambiguous, stating that it operated to prohibit Canada from taxing share gains derived by a trust resident in Barbados, even though the Canadian charge would have been imposed on the Canadian resident settlor.

The UK *Smallwood* case¹⁴⁷ contained the same element in a more acute form, as in respect of this point the facts were similar to the *Garron* case but the comparable provision of UK domestic law¹⁴⁸ did apply to attribute the taxable gain to the settlor. Yet the tax authority did not take the point that applying the treaty to the trustees, so that the United Kingdom was prohibited from taxing the gain, would have led to a benefit for the settlor, who was the person who would actually have suffered the tax charge. Baker finds it puzzling that this point was not taken; he states that “[I]logically, this argument is unimpeachable”, although he argues that it does run counter to previous case law in the United Kingdom.¹⁴⁹

A more extreme form of vicarious benefits is found in a rather old case, the Canadian *Hunter Douglas* case.¹⁵⁰ This case concerned a treaty provision which was the equivalent of Art. 10(5) in the current OECD Model, a provision that is notorious for its problems of interpretation. This decision raised an issue that was rather different, however, from the usual problems. The case concerned a company that was resident in the Netherlands for the purposes of the Canada–Netherlands treaty, and which had distributed stock dividends to shareholders resident in Canada, the Netherlands and third states. The Canadian tax authority asserted that the dividends paid to third-state residents were subject to Canadian withholding tax, as the

144. Sec. 75(2) Income Tax Act.

145. Paras. 327-40 of the judgment.

146. Art. XIV(4) Barbados–Canada treaty of 22 January 1980.

147. *HMRC v. Smallwood and another*, [2010] EWCA Civ 7; 12 ITLR 1002; [2010] STC 2045; United Kingdom: CA, 8 July 2010, Tax Treaty Case Law IBFD. A diagram of this case is given in 5.2.4., where the case is discussed in more detail.

148. Sec. 77 Taxation of Chargeable Gains Act 1992.

149. Baker, note 142, at pp. 954-5.

150. *Hunter Douglas Ltd v. Her Majesty the Queen*, 79 DTC 5340; CA: FC, 7 September 1979, Tax Treaty Case Law IBFD.

company was deemed to be resident in Canada under Canadian domestic law and, if any treaty applied to these dividends, it should be the treaty between Canada and the residence state of the shareholders. In any event, the third-state shareholders should not be able to invoke the protection of the Canada–Netherlands treaty.

The court held, however, that all the dividends were protected from Canadian withholding tax under the equivalent of Art. 10(5) in the current OECD Model.¹⁵¹ The obvious objection to this reasoning is that a withholding tax on dividends is imposed on the shareholders and so, in respect of the third-state shareholders, the court was indeed looking at the wrong treaty. But the court held that the company was entitled to invoke this provision because the withholding tax had been levied as a result of an assessment made after the distribution and the assessment had been made on the company, not the shareholders. The court came to this conclusion even though the assessment had been made this way at the request of the company, in order to make the proceedings more convenient for all the parties.

As the assessment was made on the company one could maybe argue that this liability is no different from the company's liability on its profit, which also reduces the funds available for distribution to the shareholders, and therefore the court came to the right result. Yet one would have expected the withholding tax to be regarded by Canadian domestic law as part of the dividend and, if that was so, the result was that the shareholders did, in effect, receive the benefit of the treaty as a result of the company's treaty residence. This point was, however, not discussed in the case.

3.2.4. Conclusion

It has been noted elsewhere that there has always been some tension in treaties between the taxation of income and the taxation of persons.¹⁵² The scope of the treaty is defined by reference to persons, but the distributive provisions deal with various classes of income and so may appear to focus on the income rather than on the person, although the extent to which they do so varies. Yet, as Lang puts it in the context of the debate about the treaty compatibility of CFC regimes, “[i]t would hardly be acceptable if, in some cases, the protective effect of the individual distributive rules applied only to the income recipient and, in other cases, it was detached therefrom and

151. Art. IV(5) Canada–Netherlands treaty of 2 April 1957.

152. See Arnold, Sasseville and Zolt, Note 118, at p. 240.

objectified, especially when one considers that there is neither a clear indication in the relevant documents (e.g. the OECD Commentaries) nor any other obvious reason for such a differentiation.”¹⁵³

Can these tensions be eliminated? Or are they just an inevitable reflection of a comparable tension in the domestic law of many countries, which have to find a balance between the need to find the correct taxpayer and the need to ensure that income does not escape taxation? Is the inherent tension between these subjective and objective elements of domestic income tax systems,¹⁵⁴ in other words, bound to have an impact on the interpretation of treaties? Perhaps the better question is whether it is necessary to attempt to eliminate this tension for treaty purposes, and it will indeed be argued below that a different approach to granting treaty benefits would mean that it no longer poses a problem in this respect.

3.3. Liability to tax on a specific item of income

The second fundamental problem with the current treaty framework is that it is not clear what the role is of liability to tax on a specific item of income under domestic law. Consequently, it is sometimes also not clear what the role is of the attribution of income to a person for treaty purposes. This subsection explores various aspects of the relationship between, on the one hand, the attribution of income to a person under domestic law leading to the imposition of a tax liability on that person in respect of that income and, on the other hand, entitlement to treaty benefits in respect of that item of income.

3.3.1. Liability to tax on specific income as a negative factor

The current OECD Model does not require that a person is liable to tax in the residence state in respect of a particular item of income in order to claim treaty benefits in respect of that income, nor does it afford any other structural importance to the liability to tax on a specific item of income.¹⁵⁵

153. Lang, M., “CFC Regulations and Double Taxation Treaties”, 57 *Bulletin for International Taxation* 2 (2003), pp. 51-8, at p. 55.

154. For a comparative analysis of this issue in the Netherlands and the United Kingdom, see Appendix II, in particular Section 6.3.2. in respect of the United Kingdom.

155. Danon, R., “Switzerland’s direct and international taxation of private express trusts”, in: Oberson, X. (ed.), *Droit fiscal Suisse et international*, Vol. 1 (Zurich: Schulthess, 2004), p. 279.

As long as the person is subject to a general tax liability, derives or receives the income and, in respect of passive income, is the beneficial owner, the treaty gives protection, whether or not the person is liable to tax on that specific item of income.

Yet liability to tax on the specific item of income clearly is a concern of states in connection with the granting of treaty benefits, as witnessed by the subject-to-tax conditions, remittance base clauses and switchover clauses they sometimes include in their treaties. Base erosion problems are another aspect of this concern, but in the OECD Model there is no structural place to deal with this aspect either. In concluded treaties it appears both as an element of the limitation-on-benefits clauses that back up the residence definition and as an element of the provisions that sometimes exclude the application of the passive income articles to conduit structures.

In some of these cases the concern focuses on whether there is a liability to tax on the specific income at all, whereas in other cases the concern focuses on the adequacy of the tax liability that is imposed. As will be discussed further in 4.9.2., this latter point is the crux of the problem with conduit structures, in which there is a mismatch between the treaty relief granted by the source state on the gross income and the tax liability imposed by the residence state on the net income. What these issues all have in common is that they manifest a concern of states about being obliged to grant treaty benefits even though the taxation of the income in the treaty partner state is perceived as inadequate as a basis for treaty entitlement.

3.3.2. Liability to tax on specific income as a positive factor

There is also a mirror image question, as to whether the imposition of tax liability by a state on an item of income necessarily leads to entitlement to treaty benefits in respect of that income. In the specific context of partnerships, the OECD view is that liability to tax on an item of income is indeed the key to access to treaty benefits. Although much of the report focuses on residence for treaty purposes, the report takes the imposition of a tax liability on a person in respect of a specific item of income as the key indication that that is the correct person to claim treaty benefits in respect of the income.¹⁵⁶ It also equates being liable to tax in the residence state on a specific item of income with being the beneficial owner of that income.¹⁵⁷ A

156. This basic philosophy is set out in OECD Committee on Fiscal Affairs, note 2, Example 3, Paras. 51-54.

157. *Ibid.*, Para. 61.

similar approach is taken by the OECD in respect of collective investment vehicles.¹⁵⁸ And the OECD Commentary on Arts. 10-12 also suggests this approach when it states that an agent or nominee receiving income would not be the beneficial owner of the income because “no potential double taxation arises as a consequence of that [residence] status since the recipient is not treated as the owner of the income for tax purposes in the State of residence”.¹⁵⁹

Various other indications also point to this as a favoured interpretation. Foremost among these is the approach of the United States, which takes liability to tax in respect of an item of income as its general starting point for treaty entitlement in respect of that income.¹⁶⁰ The conduit regulations¹⁶¹ move away from this position in certain specific situations, however, and focus, instead, on the substantive connection between the person claiming treaty benefits and the income in respect of which treaty protection is claimed. The *TD Securities* decision,¹⁶² discussed in 3.2.2., regarded the imposition of a tax liability on the income as the essential factor determining the entitlement to treaty benefits, even though the liability was imposed on the “wrong” person. And it has also been asserted in the literature that beneficial ownership is primarily about bearing a tax liability on the income, for example by De Broe, who writes “[o]bviously, the ‘beneficial owner’ of income must in the first place be the person who is liable to tax on the income received.”¹⁶³

On the other hand, in the *Aznavour* case,¹⁶⁴ explained briefly in 2.1., the French *Conseil d’Etat* decided which treaty to apply without even considering the liability to tax on the income in question in the potential treaty partner states. And in the *Russell* and *Willoughby* cases,¹⁶⁵ discussed in 2.1. and 3.2.2., the individual in each case was found to have no entitlement to treaty benefits, despite being liable to tax in respect of the income concerned. In *Willoughby* the Special Commissioner pointed out that the individual did not have any ownership in the income concerned, unlike

158. OECD Commentary on Art. 1, Para. 6.10 and OECD, note 13.

159. OECD Commentary on Art. 10, Para. 12.1, OECD Commentary on Art. 11, Para. 10, OECD Commentary on Art. 12, Para. 4.1.

160. For an overview of US law in this respect, see: Daub, P., “United States”, Sec. 1.1.2. in: International Fiscal Association, note 1.

161. Reg. § 1.881-3 Conduit financing arrangements.

162. Note 121.

163. De Broe, note 63, Paras. 454 and 461.

164. Note 6.

165. Notes 7 and 134.

the individual partner in the *Padmore* case.¹⁶⁶ This distinction highlights a further issue in respect of the relationship between treaty entitlement and liability to tax, namely the possibility that a tax liability is imposed in respect of income on a person who does not own the income.

3.3.3. Separation of ownership and tax liability

The allocation rules of the OECD Model are expressed to apply to the person who has various connections with the income, all of which seem to be based on ownership of the income rather than the obligation to pay tax in respect of it. Yet under the domestic law of many countries it is possible that one person owns income but that a different person is taxed on it. This was the situation in the *Russell* and *Willoughby* cases, as in both cases the income was paid to, and legally owned by, the company whereas the legislation in question attributed the income to the individual.

In both these cases the tax charge on the individual was imposed under anti-avoidance legislation, but the same phenomenon can also be found outside the avoidance context. The Netherlands, for example, allows companies within a fiscal unity to shift the tax liability of a subsidiary to its parent company. This is achieved by deeming the assets and activities of the subsidiary to belong to the parent for tax purposes,¹⁶⁷ so that the tax liability also falls on the parent, although the subsidiary remains the owner of the income.

Nevertheless, it is probably anti-avoidance legislation that most often imposes a tax charge in respect of income on a person who does not own it. One common example is the attribution of the investment income of minor children to their parents, in order to prevent income splitting to take advantage of the lower rates in a progressive rate table. Another common measure may resemble the UK provision which attributes the capital gains of closely held non-resident companies to their UK resident shareholders, in proportion to their shareholdings, if they have a shareholding of at least 10%.¹⁶⁸ This UK provision “carries the very real risk that a taxpayer will be liable to CGT without being able to secure the payment or get his hands on any of the gain.”¹⁶⁹

166. Note 119.

167. Art. 15, Wet op de vennootschapsbelasting 1969.

168. Sec. 13 Taxation of Chargeable Gains Act 1992.

169. Gordon, K.M., Montes-Manzano, X. and Tiley, J., *Tiley and Collison's UK Tax Guide 2010-11*, 28th ed. (United Kingdom: LexisNexis, 2010), Sec. 36.54.

Another UK example is the legislation on transfers of assets abroad,¹⁷⁰ which is the legislation that was under consideration in the *Willoughby* case. This legislation attributes income derived from assets to a resident individual who was the original owner of the assets and who transferred them to a non-resident if the individual retains “power to enjoy” the income, with the concept of “power to enjoy” being defined very widely.¹⁷¹ A similar provision is also found in the South African legislation,¹⁷² seemingly with an even wider scope than the UK legislation. If a resident makes any “donation, settlement or other disposition” and, as a consequence, income is received by a non-resident, the income remains attributable to the resident transferor for tax purposes.¹⁷³ The legislation does not limit the operation of this provision to situations in which the resident transferor can obtain any benefit from the income, nor is there any escape clause if the transferor can demonstrate that the transfer was not made for tax avoidance reasons.

In the Netherlands, recent anti-avoidance legislation¹⁷⁴ has been adopted in respect of trusts, which quite consciously attributes income to a person who may never receive any benefit from the income. If an individual resident in the Netherlands settles property on a discretionary trust, the law may now attribute the trust income to the settlor and, after the settlor’s death, to his/her heirs, regardless of whether they have any benefit from, or control over, the income or even whether they know about the trust.¹⁷⁵ Doubtless many other examples can be found in different countries, although they may not be as extreme as some of the legislation discussed here.¹⁷⁶

In all these situations, the question arises as to the relevance for treaty purposes of the tax liability being imposed on a person who is not the owner

170. Secs. 714-751 Income Tax Act 2007. This legislation is discussed further in: Appendix II in particular in Section 3.4.2.2.

171. For an explanation of how widely this legislation is drawn, see: Gordon, Montes-Manzano and Tiley, note 169, Sec. 36.33.

172. Sec. 7(8) Income Tax Act 1962.

173. Unless the transfer is to a public-benefit organization or the income is received by a company that is a controlled foreign company in relation to the transferor.

174. Art. 2.14a Wet inkomstenbelasting 2001, introduced by Wet van 17 december 2009, Stb. 2009, 564. A comparable amendment was also made to the law on gift and inheritance tax, the Successiewet 1956.

175. For an English-language explanation of the law in the Netherlands in this respect, see: Auerbach, X., “Taxation of Trusts in the Netherlands”, in: Danon, R., Chenaux, J.-L., and Tissot, N. (eds.), *Taxation of Trusts in Civil Law Jurisdictions*, Centre de Droit Commercial, Fiscal et de l’Innovation, Vol. 4 (Geneva: Schulthess Éditions Romandes, 2010). For a shorter description, see: Appendix II, Section 3.2.1.4.

176. See, for example, International Fiscal Association, note 1.

of the income. The Netherlands clearly thinks that this is not an issue in the context of the fiscal unity regime; the law was changed in 2003 to use the mechanism described above precisely so that the subsidiary would continue to be able to claim treaty benefits.¹⁷⁷ The previous law deemed the subsidiary to be a branch of the parent company, thereby removing its personal liability to tax altogether and causing it to fail the residence test in Art. 4 OECD Model. The current mechanism, of retaining the potential personal tax liability of the subsidiary but then shifting the attribution of the income to the parent company, in other words relies on the lack of structural importance given by the OECD Model to the liability to tax on the specific item of income.

Is the converse also true, that a person who does not own income but who is liable to tax in respect of it cannot claim treaty benefits? On the face of the treaty wording it would seem that this person cannot claim treaty benefits, as the income is not “paid to”, “received by” or “derived by” this person. If the income is passive income, there is a further hurdle in that the person claiming treaty benefits on the basis of his tax liability would have to argue that he is the beneficial owner of the income even though he is not the owner. In the *Willoughby* case the Special Commissioner did indeed draw a distinction between a partnership case, in which both parties have some ownership interest in the income, and the case before him, in which income was deemed to belong to the individual although it was not his “in reality”.

Yet this is an extremely difficult distinction to draw; at which point does the legislation lose touch with reality? Much anti-avoidance legislation is based on the underlying notion that the avoider does have some ownership connection with the income, even though the connection has deliberately been made rather remote in legal terms. The legislator would usually assert that the effect of the legislation is to restore reality, not distort it.

Anti-avoidance legislation of this type that applies in a cross-border situation also raises another issue, as the result is often that the income is taxable in the hands of two persons, the legal owner in one state and the person subject to the anti-avoidance regime in another state. Even if the anti-avoidance regime grants a credit for tax paid by the legal owner of the income, the liability of both persons in respect of the full amount of the income remains.

177. Nota naar aanleiding van het verslag Wijziging van de Wet op de vennootschapsbelasting 1969 c.a. (herziening regime fiscale eenheid) Kamerstukken II 2000/2001, 26 854, No. 6, Sec. 3.1.

3.3.4. Multiple attributions – or none

If the issue is seen from the point of view of a third state that is faced with two attributions in two different states, the problem becomes very clear. If there is a liability in both states, there is potential double taxation in the relationship of both residence states with the source state. A double claim to treaty benefits could be answered by the technical objection that income can be “paid to” or “received by” only one person at a time or, in respect of passive income, that there can be only one beneficial owner at a time. Yet the imposition of a tax liability on the person subject to the anti-avoidance attribution creates a clear example of juridical double taxation, which one would have thought should be covered by the treaty between that person’s residence state and the source state.

If a double attribution occurs in two residence states as a result of differing entity classifications, the approach of the OECD Partnership Report is that both treaties are indeed applicable.¹⁷⁸ On the other hand, the OECD Commentary on Art. 10 discussed in 2.4.2.¹⁷⁹ implies that a double treaty entitlement should be avoided. Is there, then, a distinction to be drawn according to the cause of the double attribution? There is no obvious conceptual reason to confine the principles of the Partnership Report to entity classification mismatches and Danon argues, for example, that their application should be extended to income derived through trusts.¹⁸⁰

But allowing a double attribution resulting from the application of anti-avoidance legislation to lead to a double claim to treaty protection might well be seen as rather too generous by the source state. On the other hand, making a distinction in this respect requires a line to be drawn between a double attribution which occurs as a result of a state’s anti-avoidance defences and a double attribution which occurs for other reasons. This is an impossible distinction to make, as state views on what constitutes an anti-avoidance measure and what is part of a “normal” tax system vary enormously. Furthermore, a double attribution from an “innocent” cause may itself be part of an avoidance strategy, and states would want to be able to retain their defences in this respect.

Or is it more important that the double attribution causes a particular type of constellation among states? Anti-avoidance legislation of the type men-

178. OECD Committee on Fiscal Affairs, note 2, Example 9.

179. Paras. 29 and 30.

180. Danon, note 80.

tioned in the previous subsection is likely to lead to a double attribution of income in cross-border situations, but double attributions are not confined to cross-border situations, nor are they necessarily the result of the application of anti-avoidance legislation. An example of a double attribution that is neither can be found in Ireland and the United Kingdom, where the income of a trust may be attributable to both the trustee and a beneficiary.¹⁸¹ Double taxation of the income is prevented by granting the beneficiary a credit for the tax paid by the trustee, but this credit does not take away the liability of both parties in respect of the full amount of the income.

An example of a double attribution within one country as a result of anti-avoidance legislation can be found in Canada. This legislation¹⁸² applies if the right to income is transferred between non-arm's length parties, and it attributes the income to the transferor without removing the attribution to the transferee. The tax authority has stated that it will seek to impose tax only on the transferor if the transfer does not constitute a deliberate attempt to avoid or evade tax,¹⁸³ but the double attribution in the legislation remains.

If a double attribution occurs within one state it seems intuitively obvious that a treaty concluded by that state should apply. It is less obvious which person is the correct treaty claimant, which may cause a problem if, for example, the income in question is a dividend and two different limits on the source state tax are at stake. In respect of trusts there is maybe an argument in respect of passive income that only a beneficiary can be a beneficial owner of trust income, and therefore the only possible treaty claimant, although it is submitted that this argument takes an overly simplistic view of the beneficial ownership concept.

In other words, a double attribution within one state may often be capable of resolution in a pragmatic manner, but this approach does not help when the two attributions are in different states. This latter case can be divided into two basic constellations, one in which the income in question has its source in one of the two states that attribute it to a resident, and another in which the income has its source in a third state.

181. In respect of Ireland: McAvoy and Associates, *Irish Income Tax 2010* (Haywards Heath, United Kingdom: Bloomsbury professional, 2010), Sec. 15.3. In respect of the United Kingdom: Hardy, A., *United Kingdom – Trusts*, Sec. 4.3., Topical Analyses IBFD (accessed 25 February 2011). As regards the United Kingdom, see also: Appendix II, Sections 3.2.1.2. and 3.2.1.3.

182. Sec. 56(4) Income Tax Act.

183. Interpretation Bulletin IT-440R2, *Transfer of Rights to Income*, Para. 10. Available at <http://www.cra-arc.gc.ca/E/pub/tp/it440r2/README.html>.

The first of these constellations was the situation in the *Russell* and *Wiloughby* cases.¹⁸⁴ In both these cases there were two persons who were liable to tax in respect of the same income. One was the company in each case, which was the legal owner of the income and not suggested in any way to be a nominee of the individual, and which was liable to tax in its residence state. The other was the individual who was taxable on the income under an anti-avoidance regime in the court's domestic legislation. In these circumstances it was relatively easy for the court to preserve the application of the domestic anti-avoidance legislation. Indeed, in the *Russell* case the court stated explicitly that it could not have been the intention of Parliament to allow the application of the legislation to be avoided simply by using a New Zealand company.

If the income has its source in a third state, the considerations for the source state are quite different, as the source state is faced with either making a choice between the two attributions or giving benefits under two treaties. The *Aznavour* decision¹⁸⁵ made a choice between the two treaty entitlements,¹⁸⁶ not on the basis of any consideration of the attribution principles in the two residence states but on the basis of the domestic law of the source state. Indeed, the decision contains no consideration at all of the possible liability to tax in respect of the income in the two other states.

There is of course also the converse question, whether it is possible that no treaty protection is available at all, even though treaties have been concluded between all the pairs of states involved in a given situation. One of the conclusions of the Partnership Report is that no treaty benefits should be available in respect of income that is not attributed to anyone by the domestic law of those states.¹⁸⁷ In this case, in other words, the lack of a domestic attribution does prevent the application of a treaty, even though there must be ownership of the income somewhere along the line of the partnership and partners.

3.3.5. Role of attribution in treaty entitlement

What emerges from this discussion is that it is not clear what the role is of the attribution of income to a person for treaty purposes. There are indica-

184. Notes 7 and 134.

185. Note 6.

186. This assumes that the company in the case would have been liable to tax in respect of the fees in the United Kingdom, which is highly probable.

187. OECD Committee on Fiscal Affairs, note 2, example 7.

tions both that a person's liability to tax in respect of a specific item does, or should, determine entitlement to treaty benefits in respect of that income, and indications of the reverse. More importantly, it is not even clear whether treaties always include an autonomous attribution rule, or whether it is necessary for treaty purposes only to resolve mismatches between the domestic law of the contracting states.

Assume, for example, that one contracting state has a personal services company regime which attributes fees for consultancy activities directly to the individual who carries out the consultancy work, and that both the company and the individual are resident in the same state. If the fees have their source in the other contracting state, which does not have a comparable regime, there is an attribution mismatch; the source state attributes the fees to the company and the residence state attributes them to the individual. In this case it seems obvious that some determination in respect of the attribution has to be made for treaty purposes,¹⁸⁸ leaving aside for the time being the question of how that determination is to be made.

But what happens if the source state introduces a regime identical to that of the residence state, so that both states attribute the fees directly to the individual? Does the treaty question simply disappear, so that the treaty applies to the individual in respect of the fees? Or is there still a treaty attribution rule which applies independently of the domestic law attribution of the two contracting states and which takes cognizance of the company's legal entitlement to, and receipt of, the fees? Even the answer to this question appears to be open for discussion.

3.4. Conclusion – the missing keystone

The issues considered so far indicate that there is a structural problem in determining whether a person is entitled to treaty benefits. Some of these issues stem from the ambivalence of the OECD Model as to whether it deals with income or persons. Others can be traced back to the problems of interpreting the "liable to tax" requirement in Art. 4 OECD Model. Indeed, Couzin has carried out an extensive investigation of the term "liable to tax" used in Art. 4 OECD Model¹⁸⁹ and discovered a wide range of problems with it.

188. Danon considers, however, that in this situation it is not important to identify the treaty claimant: Danon, note 80, pp. 215-7.

189. Couzin, note 31, Sec. 3.1.1.1.

One of Couzin’s conclusions is that this “liable to tax” requirement is often misinterpreted. He considers the argument that a company is liable to tax if it receives income that is offset against a loss, because the income increases the company’s overall tax liability over a period of years, and states that “[t]his explanation is, however, misguided. It relies upon a reorganisation of the syntax of Article 4(1). The phrase ‘liable to tax’ modifies the word ‘person’. Indeed, there is no reference to income in the first sentence of Article 4(1). The justification of Company A’s treaty residence status based upon the indirect taxability of the income treats ‘liable to tax’ as an attribute of the income rather than the person.”

In using the phrase “liable to tax” to modify the word “person” the OECD Model maybe also requires us to carry out an impossible exercise. Persons cannot be liable to tax in the abstract; they can only be liable to tax in respect of something, whether that thing is income, sales, assets or whichever other items a state may choose to tax – even the person himself, in the case of a poll tax. Of course one can easily read into this phrase that it refers to a liability to tax in respect of income, but it is the focus on the person that is the cause of the problems identified by Couzin.

The structural problem of treaties is, however, even more fundamental than these difficulties with the “liable to tax” concept. It is, rather, that there is a missing link in treaties, the missing keystone referred to in the title of this thesis. That keystone is the liability to tax of a person in respect of a specific item of income.

This missing link means that the two basic conditions of treaty entitlement do not join together properly. The OECD Model defines the residence of a person in a state on the basis of a general, or unlimited, liability to tax imposed by that state on that person. It then allocates the taxing rights between the states on the basis that the person has some ownership connection with the item of income for which the benefits are claimed. But there is no requirement that the person is liable to tax in the residence state in respect of the specific item of income for which treaty protection is claimed.

This system works in straightforward cases but, as legal and economic structures become more sophisticated and domestic tax systems respond, it becomes more and more common to find situations in which there is not one single, straightforward owner of income and a corresponding liability to tax imposed on that person in respect of the income. The peripheral role

in the OECD Model of the liability to tax on a specific item of income is, accordingly, more and more likely to cause problems.

From a systemic point of view, however, and given that the point of the distributive provisions in tax treaties is to resolve overlapping claims, or potential claims, to tax a specific item of income, this specific liability should be the starting point. As discussed above, some attempts have already been made to focus on liability to tax on the income as the essential feature that gives entitlement to treaty benefits, but these attempts inevitably require some distortion of the current treaty wording. In the *TD Securities* case¹⁹⁰ the court in effect admitted that it had to resort, maybe not to a distorted interpretation of the treaty text, but at least to an interpretation that led to a different result from the result that would have been found by applying the literal text of the treaty.¹⁹¹ The approach of the United States, of interpreting the beneficial ownership concept as an indication of the person who is liable to tax in respect of income, also requires a jump in logic to get to that position from the wording of the treaty. And De Broe has also noted that a rather distorted interpretation of the terms “paid to” and “beneficial ownership” is necessary in order to reach the right policy result.¹⁹²

The better conceptual answer, of course, is to redraft treaties so that they set out a logical path to entitlement to treaty benefits, and the following chapter considers what is necessary in order to do that. This exercise will use many of the building blocks that form part of the current treaty structure, but will use them in a different construction and, vitally, will give a prominent place to the missing keystone, liability to tax on the income for which treaty protection is claimed.

190. Note 121.

191. In Paras. 51, 75, 87, 88, 94 and 96-10 of the decision.

192. De Broe, note 63, Para. 441 et seq.

Chapter 4

A New Approach

4.1. Introduction

In order to design a treaty framework that is conceptually sound, it is necessary to start from the fundamental principles underlying treaties. First and foremost of these is that the imposition of tax is a matter of domestic law; it is domestic law that determines in each state when and how income is taxable, in whose hands it is taxed and whether it is taxable at all. The primary function of a tax treaty in this respect is to resolve the double taxation that occurs when these domestic systems overlap with the result that two (or more) states wish to tax the same income. The solution employed by treaties is to allocate the taxing rights over the income between the two states that have concluded a treaty.¹⁹³

The new approach that will be suggested here takes these fundamental principles as its starting point, and seeks only to regulate the minimum that is necessary to make the allocation rules of the treaty work. Nevertheless, if this approach is applied rigorously it does lead to some structural changes in the way that treaties are drafted. It also requires a number of policy decisions to be made, either by states individually or, preferably, by consensus through the OECD and the UN; these policy issues are highlighted throughout this chapter as the explanation of the new approach progresses.

The following subsection provides a brief outline of the steps involved and the rest of 4. examines the proposed new approach to determining the entitlement to treaty benefits in more detail. The explanation in this chapter is given in a rather theoretical way, and 5. considers the application of the new approach in a number of concrete situations, many of them cases decided by the courts of various countries.

193. Some multilateral treaties have been concluded in respect of income taxation, but the number is so small that they are not considered further here. A multilateral treaty does make it easier to resolve some of the triangular problems that will be discussed later in this section among the signatory states to the treaty, but the same also applies to the current treaty framework.

4.1.1. The new approach in outline

The starting point of the new approach is the autonomy of states in deciding when, whether and how to impose liability to tax on income, and on which person to impose that liability. It is therefore the imposition of a tax liability in respect of a specific item of income under domestic law that constitutes the first step towards entitlement to the benefit of a treaty. In most cases both states would impose their tax liability on the same person, but this is not a condition for the granting of treaty protection. Section 4.7. considers situations in which two states attribute income to different persons.

Once a liability to tax in respect of the income has been established on a residence basis in one or both contracting states to a treaty, a state that is asked to grant treaty benefits would first consider whether the tax liability in the other state is a sufficient basis on which to grant treaty benefits. This determination is intended to test whether the tax liability of the other state is within the margins considered acceptable by the state making the determination, as it will not wish to give treaty benefits on the basis of a liability that it considers unjustified or insufficient.

In order to make this determination, a state would look at various factors supporting the tax liability in the other state. If the state asked to grant treaty benefits is the source state,¹⁹⁴ two of the factors that it is likely to consider reflect current treaty practice, namely whether the connection between the income and the person claiming treaty benefits is substantial enough; and whether that person has a factual connection with the other contracting state that is substantial enough. The source state may also wish to investigate whether the tax liability imposed in the residence state is sufficient as a basis for treaty benefits; this aspect is particularly important in respect of conduit structures, as will be discussed in 4.9.

If a state wishes to impose a tax liability in respect of the income on a person that it regards as a resident, its concern would be twofold. The initial concern would arise if the other contracting state also wishes to impose a tax liability in respect of the income on a residence basis. The liability in the other contracting state could be imposed because the other contracting state regards the same person as a resident; in this case the treaty would resolve the matter in a manner similar to the current tiebreaker rules. It is also possible that the liability in the other state is imposed in respect of the

194. It is assumed here that there is no dispute as to the geographical source of the income.

same income but on a different person, and in that case the treaty would determine which liability takes precedence; this issue is discussed further in 4.7.

If the treaty does not grant the exclusive taxing right to the residence state, the second consideration is whether it is required to grant double tax relief in respect of the tax imposed in the other contracting state. The factors that it would consider in this respect would focus on the nature of the tax liability and, if the liability is imposed on a specific person, the substantive connection between the income and that person. This issue is considered further in 4.6. and 4.7.

As the starting point for entitlement to treaty benefits would be liability to tax in respect of a specific item of income, the basic rules of the treaty would not extend its protection to persons that are exempt from tax, such as pension funds in some countries, or to income that is not taxable in one or both states. The contracting states could, however, add specific provisions granting treaty protection to these persons or income if they so wished. The factors that would be used in defining the scope of this extension of treaty protection would probably be similar to the factors that would be used to support a regular claim to treaty benefits. This issue is discussed further in 4.5.

The difference between the new approach and the current framework lies in the route to determining entitlement to treaty benefits. Making the claim for treaty protection is a different issue; essentially this is just a question of mechanics and, as in the current framework, the person who actually makes the claim could be different from the person whose tax liability gives rise to the treaty entitlement. The OECD Commentary,¹⁹⁵ for example, includes a suggested provision that would allow a collective investment vehicle (CIV) to claim treaty benefits on behalf of its investors. The scope of this provision is limited to investors who are resident in the state in which the CIV is established, although the subsequent text of the Commentary considers the possibility of extending its scope to investors resident in other states. This suggestion has already been taken up in practice by the Netherlands, which has concluded a mutual agreement with some treaty partners allowing certain investment funds established in the Netherlands to claim treaty benefits on behalf of their investors, even if the investors are resident in other states and therefore entitled to the benefit of a treaty other than the treaty between

195. OECD Commentary on Art. 1, Para. 6.28. See also: OECD Committee on Fiscal Affairs, note 13, Paras. 36-40.

the Netherlands and the source state.¹⁹⁶ There is no reason why a similar facility could not be provided under the new approach.

4.1.2. Supporting factors – margins of discretion

As explained in the previous subsection, the new approach would take a liability to tax in respect of a specific item of income as the starting point for entitlement to treaty benefits, but would allow the contracting states to a treaty to test the justification for giving treaty protection on that basis by reference to various substantive factors. The precise choice and definition of those factors would be a matter for negotiation between the two states, and would reflect their domestic law to a certain extent, but the factors should be named in the treaty and, ideally, would also reflect a general consensus among states.

The reason for considering these supporting factors is to determine whether the liability imposed by the other contracting state is sufficient as a basis for granting treaty benefits. But it is not the intention of the new approach that a state would recognize a tax liability in the other state for treaty purposes only if that liability is imposed in exactly the same conditions as its own. The point is not that the supporting factors are an exact match of those of the state applying the treaty, but only that they are acceptable to it. In order to achieve the aim of treaties, states should not take an excessively narrow view of what is acceptable in this respect, although the margin of discretion allowed to them under a treaty might vary from one factor to another.

A similar issue already arises in the current treaty framework in connection with the residence requirement of the OECD Model. The OECD Commentary on Art. 4 states¹⁹⁷ that treaties “do not lay down standards which the provisions of the domestic laws on ‘residence’ have to fulfil in order that claims for full tax liability can be accepted between the Contracting States.” It is submitted, however, that this statement is manifestly wrong, as Art. 4 does set a standard by defining residence by reference to a liability to tax that is imposed according to a person’s “domicile, residence, place of management or any other criterion of a similar nature”.

196. De Bruin, M., et al., “Dutch closed mutual fund may apply for tax treaty benefits on behalf of its investors”, 12 *Tax Planning International: European Tax Service* 6 (2010), pp. 10-11. Mutual Agreement No. IFZ2010/534M of 25 August 2010 with the United Kingdom, for example, is available at <https://zoek.officielebekendmakingen.nl/stcr-2010-13491.html>.

197. In Para. 4.

Aside from this discrepancy, there must in any event be some limit on how far states are obliged to accept another state's residence definition for treaty purposes. Imagine, for example, that the Netherlands adopts legislation which deems every individual whose family name begins with an "N" to be resident in the Netherlands for tax purposes. Why would the source state of income that is owned by a Mr Nicholls, who lives in the United Kingdom and who has no substantive connection whatsoever with the Netherlands, be obliged to grant benefits under its treaty with the Netherlands? There is no reason to oblige source states to respect such an absurd rule. In fact a less extreme example is already found in current treaty practice, as most treaty partners of the United States are not willing to extend treaty protection to non-resident citizens, even though those citizens are liable to tax in the United States in respect of their worldwide income.¹⁹⁸

Another fundamental element in the application of many treaty articles is the determination of the source of income. Again, states determine under their domestic law how they define the source of income, but the OECD Model contains implicit source rules which restrict the ability of states to determine the source of income for treaty purposes to a rather narrow margin. In this way they avoid the double taxation that could otherwise ensue if states disagreed about the source of income and the residence state refused to grant double tax relief in respect of income that it regarded as having a domestic source. States also have a discretion in deciding why they impose a liability to tax in respect of income and in selecting the person on whom they impose that liability, and domestic law on these points can vary considerably from one state to another, as demonstrated by Appendix II.¹⁹⁹

One of the benefits of the new approach is that it focuses attention on these policy decisions, which are at the core of determining entitlement to treaty benefits. It also gives the contracting states to a treaty the possibility of finding that a tax liability of the other state is not acceptable as a basis for granting treaty benefits. This is a possibility which they do not have in the current framework, and this gap has had to be compensated by the use of other considerations, leading to some of the problems outlined in 2. and 3. The margin that should be left to states in respect of these issues is the subject of much of the rest of 4.

198. The author is grateful to Dan Berman, Boston University School of Law for pointing this out to her.

199. See also Wheeler, note 1.

4.2. The treaty claimant

4.2.1. In general

The introduction to the new approach in the previous subsection discussed treaty entitlement in terms of the application of treaties to persons, as does much of the rest of this thesis. The focus in the current treaty structure on persons creates problems, however, as discussed in 2.2. Two of the primary examples of this problem are the entity classification issue and the separate ownership and taxpaying capacity of a trustee; indeed, a professional trustee may have hundreds of separate taxpaying capacities, and in this case the focus of the OECD Model on the person is clearly inaccurate. The obvious solution is that treaties should apply to each taxpaying capacity separately, and this solution would be the natural result of applying the new approach. The rest of this thesis generally refers to persons who are entitled to treaty benefits in the interest of readability, but it should be borne in mind that it is intended to refer to the specific taxable capacity of the person or unit that bears the liability to tax.

More importantly, the new approach is more objective in this respect than the current OECD Model, which means that the problem of identifying the treaty-entitled person becomes much less acute.²⁰⁰ This difference also brings the new approach closer to the fundamental aim of the distributive rules of tax treaties, namely to resolve overlapping claims to taxing jurisdiction by states.

Entitlement to treaty benefits is predicated on a substantive connection between the destination of the income and one or both of the contracting states to the treaty, and the current treaty framework identifies the destination of the income through the person who owns the income. The current path to treaty entitlement looks for two connections: a residence connection between a person and the tax system of a contracting state; and an ownership connection between the income and the person. The person is

200. Danon also recommends that treaties take a more objective approach than at present, although he does not go as far as the new approach suggested here. He argues that "... the concept of international double taxation contained in the OECD Commentary should preferably be refined so as to focus more on the allocation of taxing claims between the parties and on their exercise of taxing jurisdiction over the latter, rather than on the so-called 'identity of subject' requirement inherent to juridical double taxation." Danon, note 155, at p. 365. See also Danon, note 80. Prebble has also considered a more substantive interpretation of the current treaty framework, but rejected it because the text of the OECD Model so clearly deals with persons, rather than income: Prebble, note 10, at p. 198.

the pivotal point that brings these two connections together, and it is for this reason that the identification of the person has acquired paramount importance in current treaty law.

But using the person as the pivotal point is also what causes many of the difficulties in current treaty law because, as argued in 3.4., the two connections that have to be made in order to establish entitlement to treaty benefits do not join up properly. There is a tension between them that manifests itself at the pivotal point where they are supposed to join, namely the person. This was the problem of the Canadian court in the *TD Securities* case,²⁰¹ where the court felt instinctively that the treaty should apply but had difficulty in squeezing the facts within the text of the treaty. Many of the problems discussed by Couzin in respect of the residence definition in the current treaty framework²⁰² also stem from the focus on the person and the huge range of possibilities in which liability to tax in respect of income can be imposed, or not imposed, on a person.

The new approach removes this tension by starting from the most direct connection between an item of income and a state's tax system, namely the imposition of liability to tax in respect of the income. The taxable unit, or taxable capacity, on which the liability is imposed is a matter for the state to determine, and the new approach accepts this determination as a consequence of its starting point.

In order to ensure that there is a minimum substantive connection between the destination of the income and at least one of the contracting states, further conditions would have to be fulfilled to support the claim to treaty benefits. Those conditions relate to the ownership of the income and to the residence of the person or capacity on whom the liability is imposed, but they take a more objective approach than the current framework. Provided all the supporting elements are found within one state, it would be clear that the treaties concluded by that state apply, even if the supporting elements do not join together in one person. If the supporting elements are found in different states, policy choices would have to be made as to which treaty applies, or whether any treaty applies at all; this issue is discussed in 4.8.

201. Note 121.

202. Couzin, note 31, Sec. 3.1.1.

4.2.2. Permanent establishments

As something of an aside to the previous subsection, because this point is not the focus of this thesis, the new approach also offers a way to resolve a particular problem related to permanent establishments. That problem is that the current focus of treaty law on the person who is entitled to treaty benefits means that, when an enterprise resident in one state receives passive income from another state through a permanent establishment that it maintains in a third state, the limitation of the source state tax is governed by the wrong treaty in economic terms.²⁰³

The new approach could solve this problem by recognizing the tax liability of the enterprise in respect of its permanent establishment as a liability imposed on it in a taxpaying capacity distinct from the taxpaying capacity of the enterprise as a whole. The permanent establishment would, in other words, be regarded as capable of having a “treaty capacity” and therefore be capable of claiming the benefit of the treaties concluded by the state in which it is situated. This suggestion is not new; it has already been made by Avery Jones²⁰⁴ and by Vann,²⁰⁵ who states that “there is a policy basis for such a result” but who sees problems with the application of bilateral nature of treaties to the triangular situations in which this solution would be applied.

Indeed, a number of qualifications have to be made to this solution, but they all reinforce the basic philosophy of the new approach. One is that this approach would be necessary only to the extent that the enterprise is liable to tax in the state of the permanent establishment in respect of income from worldwide sources derived through the permanent establishment.²⁰⁶

Rather more importantly, this solution is not appropriate for all types of permanent establishment. As Schön has noted,²⁰⁷ the OECD has been tak-

203. Avery Jones, J. and Bobbett, C., “Triangular treaty problems: a summary of the discussion in Seminar E at the IFA congress in London”, 53 *Bulletin for International Taxation* 1 (1999), pp. 16-20.

204. Avery Jones, J.F., “The David Tillinghast Lecture: Are Tax Treaties Necessary?”, 53 *Tax Law Review* 1 (1999), pp. 1-38 at p. 27.

205. Vann, note 16, at pp. 248-50.

206. There seems to be no universal consensus on this point: Baker, P., and Collier, R.S., General Report, at p. 42 in: International Fiscal Association, *Cahiers de droit fiscal international*, Vol. 91b (Amersfoort, the Netherlands: Sdu Fiscale & Financiële Uitgevers, 2006), pp. 21-67.

207. Schön, W., “Attribution of Profits to PEs and the OECD 2006 Report”, 46 *Tax Notes International* 10 (2007), pp. 1059-72.

ing the concept of a permanent establishment in two directions in the past decade or so. One direction is the lowering of the threshold for finding that a permanent establishment exists.²⁰⁸ The other is increasing the notional independence of a permanent establishment in order to determine the profit attributable to it. The first direction diminishes the separate identity of a permanent establishment, whereas the second direction reinforces it. Schön has therefore suggested the introduction of two definitions in the OECD Model: a low threshold for source state taxation; and a high threshold for the computation of profit according to a full notionally separate entity approach.²⁰⁹ In the new approach, recognizing the status of a treaty-entitled person would be suitable only for permanent establishments that exceed the higher threshold.

As regards triangular situations, the treaty entitlement of a permanent establishment would be in addition to the treaty entitlement of the enterprise as a whole, but it would have to take priority over the entitlement of the whole enterprise in respect of the income attributable to the permanent establishment. The relationship between the permanent establishment and the enterprise as a whole would also still have to be regulated by treaty. Both of these requirements could be achieved in a manner similar to that proposed in 4.8. in respect of double residence state attributions of income; a high-threshold permanent establishment does, after all, have many features of a resident taxpayer.²¹⁰

Subject to some brief discussion in 4.4.3. and 4.7.4., this thesis will not, however, go into an extended discussion of the merits or otherwise of treating permanent establishments as taxable capacities capable of being entitled to treaty benefits; the issue is mentioned only because it is a logical consequence of the new approach that is proposed.

208. In this respect, see also: van Raad, C., “New sources of tax revenue for transit countries: can a (rail) road qualify as a permanent establishment?” in: Baker and Bobbett, note 65, pp. 125-30.

209. Schön, W., “Persons and territories: on the international allocation of taxing rights”, *British Tax Review* 6 (2010), pp. 554-62 at p. 560.

210. Vann, R., “Reflections on business profits and the arm’s-length principle”, in: Arnold, B.J., Sasseville, J., and Zolt, E. (eds), *The taxation of business profits under tax treaties* (Toronto: Canadian Tax Foundation, 2003), pp. 133-69, especially at pp. 142-8.

4.3. Liability to tax

4.3.1. The basic principle

The central feature of the new approach is that the starting point for determining whether treaty benefits are available in respect of an item of income is the imposition of a liability to tax on that income under domestic law. Unlike the current treaty framework, therefore, a person who owns income, but who is not liable to tax in respect of that income under the tax system of a state, would not be able to claim the benefits of treaties concluded by that state. So if, for example, a trustee is not liable to tax in respect of trust income, because the income is paid directly to the beneficiary and the only liability is imposed directly on the beneficiary,²¹¹ the trustee would not be entitled to treaty protection in respect of that income. The beneficiary would, of course, be entitled to claim treaty benefits, subject to the conditions discussed in the remainder of 4. Similarly, if a state uses the remittance basis in respect of certain types of income, no entitlement to the benefit of treaties concluded by that state would arise until the income is actually remitted and becomes subject to a tax liability there.

This thesis focuses on the application of treaties to overlapping tax claims in a source and a residence state, or in two residence states, but under the new approach there is no conceptual reason that prevents treaties from also dealing with double claims to source taxation. A treaty could include a hierarchical list of the factors that underlie state claims to tax on a source basis, and provide that a factor higher in the list takes priority over a factor lower down on the list. As liability to tax on the income forms the entry requirement to treaty entitlement, a person who is resident in neither state would still be able to claim the benefit of such a provision in order to resolve competing claims to source taxation. This possibility is not pursued here any further, however, as the aim of this thesis is to propose a solution for the structural problem in respect of entitlement to treaty benefits that besets the existing treaty framework. It is therefore assumed in the remainder of this

211. This could be the case, for example, in Australia and New Zealand, as their domestic law distinguishes between “beneficiary income” and “trustee income” and imposes a tax liability on trustees only in respect of trustee income. It could also happen in the United Kingdom, if a beneficiary has an immediate right to the income as it arises and the trustees mandate payment of the income directly to the beneficiary. See: Gillies, P., *Australia - Trusts* sec. 4.3., Tomlinson, P., Morrison, K., and Alston, A., *New Zealand - Trusts* sec.4.3. and Hardy, A., *United Kingdom - Trusts* sec. 4.3., Topical Analyses IBFD (accessed 3 March 2011). The application of the new approach to trusts is discussed in detail in 5.4.

discussion that only residents of one or both contracting states are entitled to treaty benefits.

The reliance of the new approach on a liability to tax in respect of an item of income would invoke the same distinction between “liable to tax” and “subject to tax” that is made in the current treaty framework. So there would be a liability to tax in respect of income even if no tax is immediately payable in respect of the income, for example because the payment enters into a net profit computation that results in a loss or because it falls within the tax-free income band of an individual. This aspect of the new approach may seem, at first sight, to reintroduce all the “liable to tax” problems of the current treaty framework, but that is not so.

The difference is that in the new approach the “liable to tax” concept applies to a specific item of income, not to a person. There are so many variations in the mixtures of liability and non-liability that can be imposed on a person that it is hardly possible to treat this requirement in respect of a person as a simple yes/no question.²¹² Single items of income, by contrast, are not subject to the same mixtures of liability and non-liability. In respect of one item of income, it is usually clear whether or not it falls within the scope of a state’s tax system and therefore a yes/no answer is readily found. There might be a question about the sufficiency of the tax liability as a basis for treaty benefits, however, and that issue is discussed in 4.3.2.

It is unlikely that states would be prepared to accept the imposition of tax liability by other states without question, and so further conditions would be necessary. In respect of the tax liability in a residence state, these concerns would be addressed by the conditions relating to the tax liability discussed in the remainder of 4.3. and the ownership and residence conditions discussed in 4.4. These conditions would take over many of the functions currently fulfilled by limitation-on-benefits provisions in the current treaty framework and serve to demonstrate the economic nexus between the income and the residence state. By separating out the various elements required to substantiate a claim to treaty benefits, however, they make the underlying issues clearer than in the current limitation-on-benefits provisions. These substantive elements would also be integrated into the basic approach to granting treaty benefits, rather than being added on

212. On this point, see: Couzin, note 31, Sec. 3.1.1; and Nikolakakis, note 11, pp. 255-63.

as anti-avoidance provisions after the route to treaty entitlement is defined or brought into the treaty through its interpretation.²¹³

The decision as to whether a specific tax liability of another state justifies entitlement to treaty benefits is the mirror image of the decision that states have to make when shaping their own taxing policy. States have to make many decisions as to when and on whom to impose tax and some states may go much further than others in imposing tax on a person who has only a remote connection with the income. Section 3.3.3. discussed some examples of states imposing tax in circumstances which might be regarded as too extreme by other states. In the current treaty framework, a person who is subject to such a tax liability might well be refused treaty benefits on the basis that he does not “derive” the income or is not the beneficial owner. But this approach disguises the real issue to a certain extent, if the underlying problem is that another state finds the liability in these circumstances too extreme. If another state does, indeed, disagree as to the policy justification for imposing such a tax liability, there seems to be no reason why it should be obliged to grant treaty benefits on the basis of that liability.

Anti-avoidance legislation is not the only situation in which this issue may arise. Grundy, for example, has argued in the context of the current treaty framework that²¹⁴ “[t]here seems no reason in principle why a person who is a ‘resident of the United Kingdom’ should be denied the benefit of the tax treaties to which the United Kingdom is a party because he is a trustee,

213. Two recent pleas for an integral approach have been made in: Lang, et al. (eds), note 34. Duff (Duff, D.G., “Responses to Treaty Shopping: A Comparative Evaluation”, Sec. 5), for example, writes “While each of these responses has a role to play in preventing abusive treaty shopping, this paper questions whether the interpretation of residence and beneficial ownership can prevent abusive treaty shopping, and the extent to which references to an inherent anti-abuse principle and/or domestic general anti-avoidance rules represent a fair and effective response, given uncertainty over the line between acceptable tax planning and abusive treaty shopping. For this reason, it concludes that the best response to treaty shopping involves the inclusion of detailed LOB and subject-to-tax provisions in tax treaties.” Bammens and De Broe (Bammens and De Broe, Sec. 6) consider the economic perspective on treaty entitlement and conclude that “the objective component of most anti-avoidance mechanisms hinges on the question whether there is an economic justification for granting the taxpayer the relevant tax benefits. ... The question thus arises whether there is a universal threshold that must be met in order for tax treaty benefits to be available. In other words, is it possible to formulate an economic-substance test to replace the beneficial-ownership requirement, LOB provisions, etc.? Assuming that tax treaties should only be applied to situations that further the economic objective sought by the treaty, this test could be seen as an implicit anti-abuse mechanism, inherent in all tax treaties and intended to confine treaty application to situation where a sufficient economic nexus warrants it.”

214. Grundy, M., “The Uses of Trusts”, IX *GITC Review* 3 (2010), p. 13 et seq., at p. 17.

unless the relevant treaty so provides, or unless he is a mere nominee or has a beneficiary with an interest in possession. But the effect is anomalous: it can indirectly confer the benefit of the tax treaty on individuals who – one would think – have no business enjoying it.” If there is an anomaly in this situation, however, it does not lie in the treaty entitlement of the trustees but rather in the tax liability that is imposed on them in the first place. To put it another way, if the source state does indeed think that the residence state has no business taxing trustees, why should it be obliged to grant them treaty benefits?²¹⁵

The basic principle should be that, if it is justifiable to impose a tax liability on an item of income, it is also justifiable to grant treaty protection in respect of that income. Of course states may disagree as to whether the liability is justifiable, and this disagreement may lead to specific formulations of the elements that have to be demonstrated in order to support a claim to treaty entitlement. Possibly a treaty could also include provisions that deny treaty benefits in respect of certain specified types of liability under the domestic law of one state that are not acceptable to the other state. In any event, a disagreement of this sort would ideally be made explicit, so that it is clear why a particular type of tax liability does not lead to treaty entitlement.

4.3.2. The sufficiency of the tax liability

As it is the tax liability imposed by a state that is the key to treaty protection, the treaty partners of that state may also wish to lay down certain standards that the tax liability must meet in order to give entitlement to treaty benefits. For a source state, this would mean that it is not obliged to grant treaty benefits if the liability in the residence state is not sufficient. For the residence state this would mean that treaty exemptions do not apply or that they are replaced by a credit.

In many cases the state granting treaty benefits may be content simply to rely on the other state’s tax system to impose a sufficient amount of tax, but there may also be situations in which states find it necessary to specify further conditions about the tax liability. One simple condition could refer to the nominal rate of tax, but this is often not representative of the amount of tax that is actually collected. The alternative is to look at the effective rate of tax, although in that case it would be necessary to determine how to

215. The application of the new approach to trusts is considered in detail in 5.4.

compute the effective rate on a single item of income that forms part of a larger basket of taxable income in the residence state.

A common concern in this respect is base erosion, and as Rosenbloom writes in respect of limitation-on-benefits provisions in the current treaty framework, “[b]ase erosion provisions attempt to ensure that the country of asserted residence collects an amount of tax that is not substantially lower than the normal or expected amount because deductions are used to reduce the local tax base in favor of persons resident elsewhere. What happens, however, if the residence country employs credits, rather than deductions, as a means of reducing its tax?”²¹⁶ A general test of the sufficiency of the tax liability in the residence state that looks at the effective rate of tax could indeed deal with the use of tax credits to lower the effective rate. Base erosion is considered in more detail in 4.9.

Another possibility is that a tax levied in the residence state is the subject of a refundable credit in the hands of another person within the same state. This may happen, for example, with trust income; in some systems income received by a trustee is taxable in the hands of the trustee, and a beneficiary who receives a trust distribution is able to credit the tax paid by the trustees and obtain a refund of any excess above his own personal tax liability. The point here is not that the refund may reduce the final amount of tax, but that the trustee’s liability is not sufficient because it is not permanent. The credit mechanism, in effect, shifts the tax liability from the trustee to the beneficiary, and for that reason only the beneficiary would be entitled to claim treaty benefits. This issue is discussed further in 5.4.2.3.

4.3.3. Fragmented and dislocated tax liability

A liability to tax on a specific item of income is usually clearly imposed by domestic law on one person, but occasionally the liability is fragmented, in that the amount of tax is computed by reference to the characteristics and circumstances of one person, but the legal liability to pay the tax is imposed on a different person. Both Australia and the United Kingdom, for example, in some circumstances impose a tax liability on trustees in respect of trust income, but compute the amount of tax by reference to the circumstances of the beneficiary.²¹⁷ Holmes notes in respect of Australia that this legisla-

216. Rosenbloom, D, “Limiting Treaty Benefits: Base Erosion, Intermediate Owners, Equivalent Beneficiaries”, 58 *Tax Notes International* 8 (2010), pp. 649-52, at p. 650.

217. In Australia: Sec. 98 Income Tax Assessment Act 1936. In the United Kingdom: Secs. 23-45 Finance Act 2005. A similar mechanism applies in the United Kingdom in

tion causes difficulties in determining which person is entitled to claim treaty benefits in respect of the income.²¹⁸ The UK legislation sometimes also achieves a comparable result but in a different way; in some circumstances the legislation imposes a tax liability on a trust settlor in respect of trust income, but grants the settlor the right to recover the tax so charged from the trustees.²¹⁹

It seems hardly likely that a tax liability would be fragmented across the borders of a state and it is assumed here that, if a tax liability is fragmented in this way, the fragments are all found within the same state. Under the new approach, these fragments could be aggregated in order to fulfil the initial condition for claiming the benefits of the treaties concluded by that state. Nevertheless, it might be important to identify a person in respect of the treaty claim if, for example, the income in question is a dividend.

It is submitted that in this case the treaty protection should be based on the person whose characteristics and circumstances determine the amount of tax, as this is the aspect of the tax liability that has the more substantive connection with the state's tax system. Some support for this proposition can be found in the OECD Partnership Report, which also finds this feature the determinative one in the identification of the person to whom a treaty applies.²²⁰ In the context of the new approach this is, however, a policy decision rather than a "systemic" one, and states could choose the person who bears the obligation to pay the tax.

A rather different possibility is that the design of the tax charge dislocates the liability to tax from the income. One of the best examples of this phenomenon is the Netherlands system for taxing the passive income of individuals, known as the "Box 3" system.²²¹ Under this system, individuals are not taxable in respect of their actual income from assets but rather on a deemed rate of return on the investment assets they own. Although there are many arguments that this charge is a wealth tax, rather than an

certain cases on a change of ownership of company, when the tax authority is permitted to assess certain persons connected with the company to any unpaid tax due from the company, but gives that person a right of indemnity against the company: Secs. 710-8 Corporation Tax Act 2010.

218. Holmes, K., *International tax policy and double tax treaties: an introduction to principles and application* (Amsterdam: IBFD, 2007), at p. 117.

219. Chap. 5, Part 5, Income Tax (Trading and Other Income) Act 2005, in particular Secs. 622, 624, 629 and 646.

220. OECD Committee on Fiscal Affairs, note 2, Para. 40.

221. Arts. 5.1 to 5.3 Wet inkomstenbelasting 2001.

income tax,²²² it is generally covered by the treaties concluded by the Netherlands. Another example is the corporate loan relationships scheme of the United Kingdom,²²³ which creates a scheme of taxation based on notional payments. When this scheme applies, the amounts taxed as income in the hands of a company do not necessarily coincide with the amounts of income that are actually paid, and the legal and economic ownership of sums actually paid are only indirect factors in determining the tax liabilities of the parties.²²⁴

Cases such as these cause the same difficulty under the new approach as in the current treaty framework: that a liability to tax is imposed on something that does not correspond with a payment recognized as an income payment by the other contracting state to a treaty. One solution is that the contracting states agree to regard the tax liability as being equivalent to a liability on the income that is actually paid, although this solution raises issues about matching the tax liability to actual income payments. Alternatively, under the new approach, treaty protection could be granted on the same basis as would be used in respect of exempt persons, which is discussed in 4.5. Under the new approach there is, in effect, no difference between the two, as in both cases treaty benefits would be granted to a person in respect of income even though that person is not liable to tax in respect of that exact item of income.

4.4. The supporting factors in the residence state

Once a liability to tax on an item of income has been established in a residence state, the next step under the new approach is to determine whether or not that liability is acceptable as a basis for access to treaty benefits. One part of that determination would focus on the connection between the income and the person on whom the liability is imposed; the second part would focus on the connection between the person and the residence state. In applying the conditions explained below, the source state is testing whether the residence state is justified in levying tax on the item of income

222. An overview of these arguments, with references to the relevant literature, is given in Sillevius, L.W. and van Kempen, M.L.M., *Cursus Belastingrecht (Inkomstenbelasting)* (Deventer: Gouda Quint, loose-leaf), Sec. 5.0.6.A.d. (March 2010). In the opinion of the current author, the most persuasive argument, which is not given in this overview, is that, if an asset is subject to a usufruct, the bare owner is liable to a Box 3 charge even though the bare owner, by definition, is not entitled to the income.

223. Now found primarily in Parts 5 and 6 Corporation Tax Act 2009.

224. An example of how this scheme works is given in Appendix II, Section 3.2.3.2.

so that, as a corollary, it is justifiable to grant treaty benefits in respect of the income.

This testing has two aspects. One aspect is whether the tax liability in the residence state is acceptable of itself; this aspect raises issues about whether the residence state steps outside an acceptable margin in imposing tax on persons who have only a remote connection with the income or with the state. The other aspect is whether the person claiming treaty benefits has manipulated the circumstances in order to fall within a state's tax system in order to be able to claim the treaty benefits. These are two sides of the same coin, and the side that receives attention will depend on the circumstances of the case.

This section focuses on these questions in respect of one person; 4.8. deals with the situation when different attributes of treaty entitlement are divided among two or more persons. States may also wish to grant treaty protection to certain persons or to certain items of income in the absence of a tax liability. In this case they would probably rely on factors similar to those that would support a treaty claim via the normal route. This possibility is considered in 4.5.

4.4.1. The connection between the income and the person

The first element that would have to be demonstrated in order to support a claim to treaty protection would be a sufficient connection between the income and the person claiming protection. The two most obvious connections are either that the person has ownership of the income or that the person derives the income from carrying on an activity. The issue is not that simple, however, as both factors can be found in respect of active income, not necessarily in the hands of the same person, and the ownership connection can be divided into a number of different aspects. This section considers whether one specific connection between income and a person is sufficient to give entitlement to treaty protection; 4.8. considers the issues that may arise when different persons have different connections.

In respect of active income, the primary connection would be with the person that carries on the activity in respect of which the income is paid. Indeed, in respect of certain types of active income derived by an individual, it is possible that this connection is the only one that is recognized for treaty purposes; this may be the case with employment income or remuneration for services that have a highly individual character. In respect of a

business, it may not always be easy to pinpoint the person who is carrying on the business,²²⁵ but this would again undoubtedly be the primary connection in this case. Some specific considerations that apply to business receipts are discussed in 4.4.3.

The ownership connection is likely to be more problematic, particularly in respect of passive income, as is already the case in the current treaty framework. Ownership has many attributes,²²⁶ and there is therefore a policy decision to be made as to how much ownership is needed in order to claim treaty benefits, or which ownership attributes are sufficient. The two main factors that are likely to play a role in this respect are economic entitlement to income and control over the application of the income. The ownership connection could, in the alternative or in addition, be defined in a negative way to exclude persons whose only connection with the income is their legal entitlement and/or the simple receipt of income.

Note, however, that the positive factors would not, of themselves, lead to entitlement to treaty protection. A *bewind* in the Netherlands, for example, is a legal figure in which a *bewindvoerder* is appointed to deal with the financial affairs of another person, such as an individual under an incapacity. The *bewindvoerder* has control over the application of that person's income, but this control would not lead to treaty entitlement as the *bewindvoerder* is not liable to tax in respect of the income.

The ownership condition in the new approach would be less fraught than the beneficial ownership requirement in the current framework because it would have to carry much less of an anti-avoidance burden. As will be discussed in 4.9., the current problem with conduit structures would be solved primarily at the initial stage of evaluating the tax liability that gives entitlement to treaty benefits. The further condition, discussed below, as to the connection between the treaty-entitled person and the state would provide further safeguards.

On the other side of the coin, the law of some states may raise a question when it attributes income to a person who has rather a remote connection with the income. This question would apply, for example, to anti-avoidance measures such as those described in 3.3.3. It might also be raised by source states in connection with attribution rules that are often regarded as more basic, such as those of many common-law states that attribute the income

225. See Appendix II, in particular Section 4.2.

226. See Appendix II, in particular Section 3.

of a trust to the settlor on the basis of factors such as the settlor's ability to recover the trust property. For states in the position of source state, the policy issue here is whether they are prepared to accept this type of tax liability as a good basis for granting treaty benefits. Residence states would also have to make a policy decision as to whether they wish to include specific provisions in their treaties in this respect; maybe in some cases they would not do so, in order to maintain the deterrent effect of anti-avoidance rules.

Clearly, the choice of connecting factors would be an important policy decision. No doubt a large degree of consensus could be achieved on the most usual factors, which could be expressed in the OECD Model. The advantage of the new approach is that, unlike the current treaty framework, it requires that this aspect is explicitly addressed.

As a subsidiary point, it is questionable whether the income categories defined in the distributive provisions of the current OECD Model are the most appropriate for this purpose. Probably the best example is Art. 11, which applies to all payments of interest, regardless of whether the interest is received as a receipt of an active business, as a return on a multimillion corporate financing deal or as the investment income of a small private investor.²²⁷ Redefining the categories of income in the OECD Model would not only make it easier to define suitable connecting factors; it would also make it easier to define suitable thresholds for source state taxation. This issue is not discussed further here, however, as the suggestion has already been made elsewhere in a different context²²⁸ and a consideration of the current income categories in the OECD Model is beyond the scope of this thesis.

4.4.2. The connection between the person and the state

The second element that would have to be demonstrated in order to support a claim for treaty benefits is a sufficient connection between the person on whom the tax liability is imposed and the state from which treaty protection is claimed, or in other words a residence connection. The conditions in this respect would relate to the taxable capacity in which the tax liability is borne, as discussed in 4.2.1., so the residence of a trustee, for example, could be different from the residence of the person who happens to fulfil

227. Although the Commentary on Art. 11 does recognize this issue to a certain extent in Paras. 7.1 to 7.9.

228. Vogel, K., "The schedular structure of tax treaties", 56 *Bulletin for International Taxation* 6 (2002), pp. 260-1.

the role of trustee. Unlike the current OECD Model, this test would not look for a general, or unlimited, liability to tax, but rather at the substantive factors that connect a person with a state. It would probably contain a number of alternative factors, each of which are accepted by the contracting states to a treaty as a sufficient basis on which to claim the protection of treaties concluded by that state.

For individuals this test would probably name various elements similar to those now used in the first two paragraphs of the tiebreaker provision in Art. 4(2) OECD Model, although the precise elements named in each treaty would reflect the residence connections used by the contracting states in their domestic law. Policy decisions would have to be made as to the acceptability of more formal connecting factors, such as an individual's registration in a state's civil registry. If a state imposes an extended liability to tax for a period after an individual ceases to be resident in the state, a policy decision would also be required as to whether the existence of a substantial connection in the past is acceptable as a basis for granting treaty benefits.

In respect of companies, the basic idea behind the test would be the same, but here the matter is complicated by the clash between the domestic and treaty policies of many states that already causes problems in the current treaty framework. On the one hand, most states regard a company as resident if it is incorporated under the state's domestic law and accordingly impose taxation on the company's worldwide income. On the other hand, states are increasingly reluctant to grant treaty benefits to a company on the sole basis of its incorporation under the domestic law of a treaty partner state.

This difficulty is compounded by the thinness of the concept of a company as a legal person. A company can be used for an extremely limited purpose, in which case there may be almost no substance with which to test its personal connection with a state. This problem is illustrated by the UK case of *Wood v. Holden*,²²⁹ in which a company simply played a role in a scheme that had been designed in advance. Its role was solely to buy shares and then sell them, and all that it was required to do was to make the decisions to buy and sell. The residence of the company was not the crux of the decision, but the Court of Appeal stated that if it had had to decide this point it

229. *Wood and another v. Holden (Inspector of Taxes)* [2006] STC 443, United Kingdom: CA, 26 January 2006, Tax Treaty Case Law IBFD. In this case the Court of Appeal held that the determination of a shell company's residence could be based on the small number of decisions that were required to implement a scheme that had been designed in advance.

would have had to look at those two decisions alone, as there was nothing else in the company to manage.

In the current treaty framework, the policy clash in respect of the place of incorporation as a connecting factor has led to the adoption of limitation-on-benefits provisions in an increasing number of treaties. These provisions usually contain a mix of conditions; shareholder tests relate to the company's ownership, active-business tests relate to the activity that generates the income and base erosion provisions relate to the substance of the tax burden on specific items of income in the claimed residence state. In a recent critique of the limitation-on-benefits provisions in US treaties, Rosenbloom has described them as "convoluted and formulaic" and largely ineffective.²³⁰ It is submitted that part of the problem here is that limitation-on-benefits provisions have to deal with too many things at the same time. The mix of tests they employ reflects the indirect route to determining residence that is taken by the current OECD Model, and their defensive character does little to clarify what it is precisely that does give entitlement to treaty protection.

One of the advantages of the new approach is that it separates out the various elements that are required in order to substantiate a claim to treaty benefits, and so allows the discussion to focus on one element at a time. The liability to tax in respect of a specific item of income is the basic condition for obtaining treaty protection and there is, therefore, no need to build this aspect into the residence definition. The residence definition would, rather, look at the substantive, non-tax factors connecting a company with a state that are found to justify granting treaty benefits. This is, of course, an extremely important policy question.

The problems in this respect in the current treaty framework have already led various commentators to suggest alternatives. At one end of the scale, Van Weeghel has argued that the "place of effective management" concept is no longer useful as a tiebreaker rule and should be replaced by a more formal test, such as place of incorporation, possibly backed up by an anti-abuse provision.²³¹ At the other end of the scale, Vann has argued for

230. Rosenbloom, note 216, at p. 652.

231. Van Weeghel, S., "The tie-breaker revisited: towards a formal criterion?", in: *A vision of taxes within and outside European borders: Festschrift in honor of Prof. Dr. Frans Vanistendael* (Alphen aan den Rijn, the Netherlands: Kluwer, 2008), pp. 961-9. See also: van Weeghel, S., "Article 4(3) of the OECD Model Convention: An inconvenient truth" in: Maisto (ed.), "Residence of Companies under Tax Treaties and EC Law", note 16, pp. 303-7.

a much more substantive test to determine the treaty entitlement of companies, arguing that “a substantial argument can be mounted that a PE test is appropriate for granting treaty benefits in place of or in addition to a residence test for companies”.²³² In respect of this latter suggestion it is interesting to note a point made by Couzin²³³ in his analysis of the *De Beers* case;²³⁴ the statutory background to the case meant that “it was not open to the courts to decide that ‘residing’ should mean, ‘carrying on business in the jurisdiction’, although such a meaning might otherwise have been acceptable.” The “management and control” test enunciated in that case, which has dominated so much thinking about corporate residence, was chosen because the statute seemed to require an analogy with individual residence.

Although this background suggests that states might choose a different test of residence if they could start afresh from a clean slate, it remains necessary to apply the new approach to treaty entitlement in the existing world. The criteria that would be named in a treaty as acceptable connections between a company and a state would probably reflect the connections used in domestic law, and/or might resemble the factors named in the 2003 OECD discussion draft²³⁵ on a possible revision of the corporate tiebreaker rule.

Of course the most controversial policy decision remains whether or not incorporation in a state is a sufficient connection as a basis for treaty protection. If the incorporation connection is not accepted, states may wish to include a derivative benefits provision for a company that cannot demonstrate any of the named connections with the claimed residence state, but is nevertheless liable to tax on the income due to its incorporation there. Under this test, the company would be able to claim treaty protection to the extent that its shareholders would be able to do so if the income in question were paid to them directly. If the shareholders are resident in the company’s incorporation state, it is obvious which treaty applies.

If the shareholders are resident in a different state from the company, there is a policy decision to be made as to whether they would have to be entitled

232. Vann, note 16, at p. 269.

233. Couzin, note 31, Sec. 2.1.

234. *De Beers Consolidated Mines, Limited v. Howe (Surveyor of Taxes)* 5 TC 198; [1906] A.C. 455.

235. OECD Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits, *Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention* (Paris: 2003), available at <http://www.oecd.org/dataoecd/24/17/2956428.pdf>.

to the benefit of the actual treaty with their residence state if the income were paid to them directly, or whether the treaty with the company's residence state should be used for the purpose of applying this test. If the treaty with their actual residence state is used, there is then a question as to which treaty applies to determine the extent of the benefits granted. As the entitlement to treaty protection in this case is formed, in effect, by aggregating the partial entitlements of the company and the shareholders, it would usually be the less favourable treaty that applies, as the aggregation should take the treaty protection only to the limit of the lesser part. Derivative benefits given in this way would have to be granted on a proportional basis according to the shareholders' interests. These computations might become very complex, but if the company has a large number of shareholders it is likely to be managed in the state where it is incorporated and be able to demonstrate its residence on that basis. Furthermore, this basis for granting treaty benefits is a last-resort measure, and it would have to be accepted that, the more tenuous a company's connection with a state becomes, the more difficult it becomes to demonstrate the required residence connection.

It would still be necessary to include a residence tiebreaker provision in treaties, as the risk of one person being resident in both contracting states for treaty purposes would still be present. The tiebreaker provision could give a hierarchy of connecting factors; if the hierarchy used the same connecting factors that are used to demonstrate the residence connection in the first place, there would be no danger of the tiebreaker pointing to a third state, as can happen under the current OECD Model in respect of companies.²³⁶

Unlike the current OECD Model, the residence tiebreaker would not automatically be applied every time a person has a residence connection with both states. It would be necessary to resolve cases in which both states wish to tax the same person on a residence basis, as in the current treaty framework. It would not, however, be necessary to apply it if both states wish to tax the same item of income on a residence basis, but in the hands of different persons, even if one or both persons has a residence connection with both states.²³⁷

236. OECD Business Profits Technical Advisory Group, *The impact of the communications revolution on the application of "place of effective management" as a tie breaker rule* (Paris: 2001), available at <http://www.oecd.org/dataoecd/46/27/1923328.pdf> at p. 9.

237. An example of the latter situation is the *Smallwood* case discussed in 5.2.4.

4.4.3. Business receipts

Some specific considerations apply to the application of a treaty to business receipts. In respect of the connection that would have to be demonstrated between the income and the person claiming treaty benefits, an alternative factor to ownership would be that the item of income is a genuine receipt of a genuine business activity carried on by the person on whom the tax liability is imposed. Prebble has argued²³⁸ that this is not an appropriate criterion because the person carrying on an activity is not necessarily the true owner of the profit from the activity. This argument may be correct in the current treaty framework, with its emphasis on the ownership of income, but it begs the whole question of why treaty benefits are granted in any given case.

It is submitted that the correct approach should be, rather, the philosophy stated in 4.3.1. which underlies the new approach that if it is justifiable for a state to impose a tax liability in respect of an item of income, then it is also justifiable for that income to benefit from the treaties concluded by that state. If a person carries on a business activity, it is generally found justifiable to impose a tax on that person in respect of the business profits; equally, if a payment of income is a receipt of a business it is generally found justifiable to grant treaty benefits to the person carrying on the business in respect of that income. This philosophy has already found its way into many of the limitation on benefits clauses currently included in treaties, which often allow treaty benefits in respect of income that is derived in connection with the carrying on of business in the residence state of the treaty claimant.²³⁹ It is notable that this part of the limitation on benefits provision generally applies to each item of income separately.²⁴⁰ So although the current treaty structure generally looks at the treaty entitlement of a person as whole, this aspect anticipates the new approach by focussing on the justification for granting treaty protection to each specific payment of income. Of course it remains a problem to identify payments

238. This argument was made by John Prebble during a seminar at a congress of the International Fiscal Association (IFA). The PowerPoint presentation used during this seminar is available to IFA members at <http://www.ifa.nl/CongresDocumenten/2010SemCPPP.pdf>.

239. For a history of this development see: Berman, D.M. and Hynes, J.L., "Limitation on Benefits Clauses in U.S Income Tax Treaties", 29 *Tax Management International Journal* 12 (2000), pp. 692-710.

240. In the suggested text of the limitation on benefits provision in the OECD Commentary, the relevant paragraph starts with the words "A resident of a Contracting State will be entitled to benefits of the Convention *with respect to an item of income ...*" (emphasis added); OECD Commentary on Art. 1, Para. 20.

that do not meet the condition of being a genuine business receipt, but this is an evidential problem rather than a structural one and it is already to be addressed in the application of limitations on benefits clauses.

In respect of income that is effectively connected with a permanent establishment, the two conditions for treaty protection are automatically joined together. A finding that an item of income is a business receipt that is effectively connected with a permanent establishment would establish the connection between the income and the taxable capacity of the permanent establishment, and the very existence of the permanent establishment would already have determined the connection between the treaty-entitled “person” and the state from which treaty benefits are claimed. This result follows from the dual nature of the permanent establishment concept, which encompasses a residence element in respect of its gross receipts in addition to a source element in respect of its net profit.²⁴¹

This feature of the permanent establishment concept also highlights a problem that may arise with granting treaty benefits for business profit on the basis of ownership. Business profit may be owned by someone other than the person who carries on the business, but that person may own the net profit, rather than owning the gross receipts that go into the net profit computation and being liable for the debts. Treaty benefits often have to be granted in respect of the gross payments, and in some cases the only possible attribution might be to the person who carries on the business.

4.5. Treaty protection without liability to tax

Under the new approach, the usual route to treaty protection starts from the imposition of a tax liability on the specific item of income in question. This is a fundamental difference from the current framework, in which the entitlement to treaty protection depends on the imposition of a general liability to tax on the person claiming treaty benefits. The new approach avoids the problem of the current treaty framework that treaty benefits might be available to a person who is not taxable in respect of the specific item of income in question. It also avoids the difficulties discussed in 2.3.2. in respect of exempt entities and questions about the point at which an exemption from tax means that a person is no longer “liable to tax”.

241. On the dual nature of the permanent establishment concept, see: Vann, note 210; and Schön, W., “International Tax Coordination for a Second-Best World (Part I)”, 1 *World Tax Journal* 1, pp. 67-114 (2009) at pp. 104-5.

But there is a policy issue that remains, as to whether treaty protection should also be afforded to persons who are not liable to tax. This issue already exists in the current treaty framework, but the new approach throws it into sharper relief. If states do wish to grant treaty protection in the absence of a residence state liability to tax, there is no structural reason that prevents them from doing so. In the new approach this protection could be given easily enough by including a specific treaty provision to that effect. The advantage of this approach is that the answer as to the availability of treaty benefits would depend on a conscious policy decision, rather than on a fraught question of interpretation.

This issue has two aspects which are considered separately below. One is the possible application of a treaty to income that is not taxable because the person who receives it is exempt or the income itself is exempt. The second is the possible application of treaties on the basis of a potential liability to tax rather than an actual one.

4.5.1. Tax-exempt persons and income

The interpretation issues raised in the current treaty framework by entities that are exempt from tax, or that receive only non-taxable income, were discussed in 2.3.2. Under the basic principle of the new approach it would be clear that treaty protection is not available to such persons, whichever way their non-taxation is achieved. It is also clear that treaty protection is not available for income if it is of a kind that is not taxable in a state, even though it belongs to a resident of the state.

In both cases, however, states may wish to grant treaty protection through a specific provision in the treaty. One of the most common types of income for which it would usually be felt desirable to include a provision of this sort is dividends that are subject to a participation exemption in the hands of a parent company. States with a territorial income tax system may also wish to obtain treaty protection for their residents. Under the new approach a specific provision to grant treaty benefits would be necessary in all these cases. This is also the route to treaty protection preferred by Van Weeghel²⁴² and Couzin²⁴³ in respect of non-taxable entities in the current treaty framework.

242. Van Weeghel, note 24.

243. Couzin, note 31, Sec. 3.1.1.3.

A provision of this sort would obviously have to name the persons or income to which it applies, and specify the conditions under which it applies. The conditions in respect of exempt persons are likely to be similar to, if not the same as, the conditions discussed in 4.4., namely one connection between the income and the person and a second connection between the person and the residence state. Alternatively, for entities such as pension funds or collective investment vehicles, the personal connection with the state could be derived from the application of the state's regulatory regime. It is unlikely that states would wish to grant a blanket entitlement to treaty protection in the absence of any tax liability, as that would deprive them of any opportunity to consider the merits of specific situations.

What such a provision would not do, however, is resolve the cross-border tax problems of institutions that generally enjoy a tax-exempt status. It would entitle such organizations to benefit from the limits on source state taxation that are agreed in the treaty, but this is by no means the only issue they face. A charitable organization, for example, often loses its non-taxable status when, or to the extent that, it ventures outside the state where it is established, both in respect of its own liability and in respect of donations and other funding. Treaties do not provide a solution for most of these problems because they are written to prevent double taxation, not to preserve non-taxation. These issues have been explored by this author elsewhere in respect of charities²⁴⁴ and a discussion of them would go well beyond the scope of this thesis. States may, in other words, agree to extend treaty benefits to tax-exempt persons, but this should not be mistaken for a general policy of preserving their tax-exempt status.

4.5.2. Potential liability to tax

The second aspect of granting treaty protection in the absence of a tax liability requires consideration of a fundamental policy issue, namely the reason for which tax treaties are concluded. Section 2.3.4. discussed whether the definition of residence in the current treaty framework includes persons who are potentially, but not actually, subject to an unlimited tax liability in

244. Wheeler, J., "The Tax Treatment of Charitable Organisations", 34 *European Taxation* 1 (1994), pp. 9-16. After this article was published, it was criticized in a private letter by Prof. Ole Gjems-Onsted, who pointed out that it was written as though charitable organizations should be able to retain their non-taxable status across national borders, whereas there may be good policy reasons for states to restrict their favourable tax rules to domestic organizations. That criticism is accepted, and the article is referred to here solely as a discussion of the technical difficulties faced by charities in this respect.

a state and noted disagreement on this point. That section also noted that the answer to this question depends on the policy view one takes as to the function of treaties.

If one takes the view that the purpose of treaties is restricted to preventing double taxation, there would be little reason to extend their protection to persons who are only potentially liable to tax. If, on the other hand, one sees treaties as having a wider function of allocating taxing rights, the new approach would have to be adapted for those countries where this issue is relevant. In this case it would be necessary to extend the scope of the treaties concluded by a state that does not levy a comprehensive income tax to persons who are potentially subject to an unlimited tax liability in that state.

This is the approach already taken by Hong Kong, for example, in many of its treaties. It was also adopted in the India–UAE treaty in response to Indian court decisions granting the benefit of that treaty even though the UAE did not levy any income tax on the person concerned.²⁴⁵ No doubt the reason for India to amend the treaty in this way was to ensure that the conditions for obtaining treaty benefits were defined in advance by the contracting states, rather than being left to the courts to define through an interpretation of the treaty.

An extension of treaty protection in this way under the new approach would have to rely on the connections discussed in 4.4. that would have to be demonstrated to support a claim to treaty protection via the regular route to treaty entitlement. The definition of the factors in both cases is likely to be similar, if not the same. One could question why, if this view of the purpose of tax treaties is taken, the route to treaty protection would not just go straight to the connecting factors in all cases. For countries that do levy a comprehensive income tax, however, the basic structure of the new approach would be preferable because the entitlement to treaty benefits would follow the actual tax liability. Going straight to the connecting factors would simply reinstate the structural problem with the current treaty framework, unless extreme care was taken to ensure that the factors used always matched the reasons for which income is attributed to a person under the domestic law of the two states concerned.

245. Palwe and Kumar, note 35.

4.6. The residence state

The primary obligation imposed by a treaty on the residence state in connection with the distributive rules is to grant double taxation relief in respect of the tax levied by the source state. A large part of the law in this respect, however, is domestic law rather than treaty law, as treaty provisions on double tax relief generally do no more than to express this obligation in broad terms and refer to the law of the contracting states in respect of its application. In considering whether to grant double tax relief, residence states look at a number of factors that are not relevant to the topic of this thesis, such as whether the tax is one that is comparable in nature to the income tax of the residence state and whether the residence state agrees that the source of the income is in the other state.²⁴⁶ Most treaties, however, name the taxes to which they apply and also contain source rules for this purpose.

But there is one important issue that is relevant to the discussion in this thesis, namely whether it is necessary for the source and residence states to agree on the attribution of income in order for double tax relief to be granted. Although this issue is primarily one of domestic law, it is useful to consider it as a complement to the new approach in respect of treaty entitlement. And there is also a question as to whether treaties should deal with this issue.

If the tax levied in the source state is a withholding tax, it is possible that it is not levied in the name of anyone at all, but is simply imposed on the income as such. But if treaty protection has been claimed, the source state will have had to make a determination of who the taxpayer is in respect of the income. In nearly all cases, therefore, in which a treaty is in play the source state has to find a person in respect of its tax liability. The residence state, of course, also has to make this determination, and the issue is whether any entitlement to double tax relief in the residence state should be conditional on both states making the same determination as to the person.²⁴⁷

If both candidates for double tax relief have the required personal connection with the residence state, the answer is clear. As discussed in 4.2.1., the

246. But see 4.3.1. in respect of disagreements on the source of income.

247. In respect of the current law, see: Mortier, F., "Is Subject Identity Required under Article 23 of the OECD Model Convention?", in: Lang, M. (ed.), *Freistellungs- und Anrechnungsmethode in den Doppelbesteuerungsabkommen*, Schriftenreihe zum Internationalen Steuerrecht Vol. 24 (Vienna: Linde Verlag, 2002), pp. 181-98. See also: Bullen, note 139.

new approach takes a more objective view than the current treaty framework, in that it places less focus on the specific person who derives income. The corresponding response from the residence state should be to grant double tax relief to the person that it sees as the taxable person in respect of the income, on the basis that the income has suffered a tax liability in the source state, even though the source state imposed its liability, or granted treaty benefits, in the name of a different person. This element of the new approach is actually not so very new, as it has already been adopted by the OECD in respect of partnerships.²⁴⁸ In accordance with the more objective nature of the new approach, however, it would have to be clear that double tax relief would be available even though the two states impose tax in the name of different persons. The situation is more complex if the attributions of the source and residence states are to persons connected to different states; this issue is considered in 4.7.

One of the pressures on this solution is the correct identification of the income under consideration but, again, this element of the new approach is not very new. It can be illustrated in the context of the current treaty framework by reference to a recent UK decision, *HMRC v Anson*,²⁴⁹ which concerned an individual resident in the United Kingdom who was a member of a Delaware LLC. The question before the court was whether he was entitled to credit a share of the United States tax paid by the LLC on its profit against his United Kingdom tax liability on his income from the LLC. The relevant treaty provision stipulated that a credit was to be granted in the United Kingdom if the tax in the two states was computed by reference to the same profits or income, and therefore the issue was whether the payments received by the individual were the same as the profit of the LLC. The First-Tier Tribunal and the Upper Tribunal took different views on that issue, with the result that the First-Tier Tribunal allowed the credit²⁵⁰ but the Upper Tribunal refused it.²⁵¹ The difficulty of determining what constitutes the same stream of income is, in other words, not a novel feature of the new approach.

248. OECD Committee on Fiscal Affairs, note 2, Para. 139.

249. *HMRC v Anson* FTC/39/2010. At the time of writing, no further reference was available.

250. The decision of the First-Tier Tribunal was reported with a different name: *Swift v. Revenue and Customs Commissioners* 12 ITLR (2010) 658.

251. For a criticism that the court failed to take into account a provision in the new treaty between the United Kingdom and the United States which might have led to a different result, see: Delaney, C., "Tax treaty interpretation, conflicts of entity classification and the curious case of *George Anson*", *Tax Planning International Review News Archive* (2011), BNA Tax and Acctg. Ctr.

4.7. Attribution conflicts in the new approach

So far the discussion of the new approach has considered what would be necessary to substantiate a single claim to treaty protection. This section considers the application of the new approach when the domestic law of two states attributes one item of income to two different persons. Part of the problem of dealing with attribution conflicts is the almost limitless number of constellations in which such a conflict can arise. It would be impossible to deal with every single variant within the confines of this thesis and this section is therefore limited to the most obvious constellations. It also assumes that there is no disagreement on the source of the income.

Section 4.7.1. considers a general treaty solution for resolving double attributions. The following subsections then consider the specific issues in three different constellations, divided according to the residence of the two persons involved. The first constellation is the classic triangular case of a double attribution; two states both attribute one item of income to a person resident in the state, and the income has its source in a third state. In the second constellation the source of the income is moved to one of the residence states. In the third constellation the persons are both resident in one state and the income has its source in another state. Permanent establishments are considered separately in between the second and third constellations.

Just as in the current treaty framework, one person may have a residence connection with more than one state under the new approach, but this issue is not discussed here because it is not necessary to resolve dual residence in the situations discussed here. It is necessary to resolve dual residence in the classic case in which one person has a sufficient residence connection with two states and in both states is liable to tax on an item of income. But if a person has a sufficient residence connection with both contracting states and is liable to tax on an item of income in only one of those states, whereas a different person is liable to tax on the same item of income in the other state, it is not necessary to resolve the dual residence of the first person. A concrete illustration of the application of the new approach to this situation is given in the discussion of the *Smallwood* case in 5.2.4. The conflicts discussed here are, in other words, conflicts of attribution, not of residence, and therefore the solution to the problems they cause has to be found by looking at the attribution issue.

4.7.1. Hierarchy of attributions

An important initial point to make in respect of attribution conflicts is that, under the new approach, a double attribution of income under domestic law does not necessarily lead to a double treaty entitlement. States may attribute income to a person in many different ways under their domestic law, as evidenced by the study in Annex II.²⁵² These differences can lead to one item of income being attributed to different persons, but an essential element of the new approach is that it allows states to test a claim to treaty protection by looking at whether the income has a sufficient connection with the person making the claim. One of the claims to treaty entitlement may therefore fail because the attribution that underlies the tax liability is to a person whose connection with the income is too remote.

If there are nevertheless two persons who can substantiate a claim to treaty protection, some sort of tiebreaker or priority rule would be necessary in order to resolve the competing residence state tax claims. The new approach requires, in any event, that some conscious thought be given to the grounds on which income might be attributed to a person, and this exercise could be continued into the development of an attribution hierarchy.

The basic structure of this hierarchy would preferably be developed through the auspices of the OECD and the UN, although concluded treaties would obviously have to cater for the specific needs and views of their contracting states. The highest place in the hierarchy would undoubtedly go to the attribution of active income to the person carrying on the activity. In respect of income from individual activity, it is also possible that states would agree that only the attribution to the individual should be accepted for treaty purposes. The remaining steps in the hierarchy would probably be based on different aspects of the ownership of income, so that the full hierarchy might be as follows:

- (1) for individuals, carrying out the employment or performing services for which the income is paid;
- (2) for business receipts, carrying on the business;
- (3) full ownership of the income;
- (4) economic entitlement to the income;
- (5) the ability to control the application of the income, for example the control exercised by trustees over the application of trust income;
- (6) the ability to obtain the income, for example by the settlor of a revocable trust.

252. See also: Wheeler, note 1.

The term “economic entitlement” is used in this list in preference to the term “beneficial ownership” simply because, as discussed briefly in 2.4.3., the latter term has accumulated too much, too inconsistent, definitional baggage to be useful. Legal entitlement to the income is not included, as it is assumed that an attribution on the basis of legal entitlement alone would not be sufficient to give entitlement to treaty benefits.

It may, in addition, be necessary to provide that an attribution to the person who has a more direct connection with the income takes priority over an attribution to a person who has a less direct connection. This priority would be needed primarily to deal with conflicting attributions on the basis of ownership, such as in the UK *Bayfine* case,²⁵³ which is discussed in 5.2.5.

4.7.2. The triangular case

The classic case of a double attribution is one in which income has its source in one state, and two other states both attribute the income to a resident person. In this constellation there are two types of relationship to consider: the relationship between the two residence states; and the relationship of the source state with the two residence states.

Starting with the relationship between the two residence states, the treaty is the obvious forum for resolving the double taxation caused by the double attribution, and the attribution hierarchy discussed above is the obvious means of doing so. It is possible that the loser state would concede its taxing right entirely in this case, although it is more probable that it would retain its tax claim but grant double tax relief in respect of the tax payable in the winner state. In keeping with the more objective nature of the new approach, this double tax relief would be granted even though the two states impose their tax liability on different persons.²⁵⁴

The source state would be faced with two residence state tax liabilities and two potential claims to treaty benefits. Its first step would be to determine whether both of those liabilities give entitlement to treaty protection. Clearly, the question mark in this respect applies to the possible claim by

253. *Bayfine UK v. The Commissioners for her Majesty's Revenue and Customs* [2010] EWHC 609 (Ch); [2011] STC 717; United Kingdom: CA, 23 March 2011, Tax Treaty Case Law IBFD. A diagram of this case is given in 5.2.5., where the case is discussed in more detail.

254. This solution has been adopted in a specific case in respect of trust income in the United Kingdom–United States treaty; see 2.4.5.

the resident of the loser state, and there are two elements that might prevent that claim. One possibility is that the effective tax liability in the loser state is not sufficient to found a claim to treaty protection, due to the double tax relief it grants in respect of the winner state liability. The other possibility is that the connection between the income and the person resident in the loser state is not strong enough to support a claim to treaty protection; this is, by definition, the weaker connection as it is lower down in the attribution hierarchy and it might be too weak to be acceptable to the source state.

If the source state does accept the treaty claims of both persons, there is a policy issue as to whether it should apply both treaties and therefore, in effect, apply the most favourable treaty, or whether it should be entitled to choose which one to apply. If the decision is that only one treaty should apply, it would have to be possible for the entitlement under the treaty between the source state and the loser state to be overridden on the basis of the attribution hierarchy in the treaty between the two residence states. Possibly a specific treaty article could be drafted that would achieve this result.

If the result of the source state deliberations is that it is entitled to levy tax, subject to the limitations of one or both treaties, the winner residence state would clearly be obliged to grant double tax relief. If the loser state applies the credit method of double tax relief, it would ideally allow a credit for both the source state tax and the winner state tax.

Almost inevitably, a situation such as this will throw up all manner of mismatches among the three treaties involved and the domestic law and policy of the states involved. This is not entirely satisfactory, but it is the consequence of applying bilateral solutions to triangular situations, and is not a problem that is specific to the new approach.

4.7.3. Source and residence state attributions

In the second constellation, the attributions are made to residents of two different states and the source of the income is in one of those states. Conceptually, the obvious answer is to use the attribution hierarchy to determine which state's claim to residence-based taxation prevails. Having made that determination, two consequences are possible; one possibility is that the loser state concedes its tax claim on a residence basis altogether, although it might still have taxing rights on a source basis.

The consequence that is more likely to gain acceptance, however, is that the loser state retains a residual taxing right but grants double tax relief in respect of the winner state's tax. If the source of the income were in the loser state, and the treaty allowed source state taxation of the category of income involved, there would then be three steps in the application of the treaty: the loser state would apply its source-based tax subject to any restrictions in the treaty; the winner state would apply its residence-based tax, giving double tax relief in respect of the source tax; and the loser state would apply its residual residence-based tax, giving relief for the winner state tax. Again, in keeping with the more objective nature of the new approach, the relief would be granted in both states even though they levy tax on different persons.

In practice, however, a state that sees income coming from a source in the state, which it attributes to one of its own residents, may not be willing to concede any of its taxing jurisdiction over that income to another state. This issue is similar to Examples 16 and 17 of the OECD Partnership Report.²⁵⁵ The OECD records disagreement as to whether the state that saw a closed domestic situation was obliged to apply a treaty, but the majority view was that it was not.

In the partnership examples, the attribution mismatch arose as a result of differing views on the entity classification issue. In the context of the discussion in this thesis, the differing attributions might arise because the two states take differing views on the weight of substantive attribution factors, or because one or both states attribute income to a person on the basis of alternative connections, or as a result of anti-avoidance legislation. The extent to which a state would be prepared to concede any of those claims to taxing jurisdiction would be a matter of negotiation between the two states and would probably depend on the balance of income flows between them and the respective reach of their domestic law in this respect.

If the attribution in the loser state is made under anti-avoidance legislation, it may already grant a credit for tax payable in another state as a part of that legislation. This is not always so,²⁵⁶ however, and in that case there is a

255. OECD Committee on Fiscal Affairs, note 2, Paras. 125-33.

256. In the United Kingdom, for example, some anti-avoidance law that uses an attribution solution to achieve its aim gives no double tax relief to the person to whom the income is attributed. See the response of STEP (the Society of Trust and Estate Practitioners) to the EU Commission consultation on factual examples of double taxation: Society of Trust and Estate Practitioners, *European Commission Consultation: Double Tax Conventions and the Internal Market*, 2010, available at http://ec.europa.eu/taxation_customs/common/consultations/tax/index_en.htm. The paper is also available

policy issue as to whether it should agree under the treaty to grant a credit for the liability in the winner state.

4.7.4. Permanent establishments

A brief excursion to the issue of permanent establishments is useful at this point, even though they do not cause any particular problems under the new approach. The comments here are, however, restricted to higher-threshold permanent establishments which are capable of being treated as a notionally separate entity, as discussed in 4.2.2.

Once the notion is accepted that a permanent establishment constitutes a separate taxable capacity of the enterprise as a whole, the new approach leads automatically to an appropriate application of treaties to them. If income is effectively connected with a permanent establishment, the connection between the income and the taxable capacity that is required for treaty purposes is clearly present. The finding that there is a permanent establishment also determines the required personal connection between the permanent establishment and the state in which it is situated. The result is, in effect, a double attribution of the income, once to the permanent establishment and once to the enterprise as a whole.

It is then possible to apply the new approach as discussed above. If the income has its source in a third state, the attribution hierarchy would give priority to the attribution to the permanent establishment. The residence state of the whole enterprise would retain its taxing right, but grant relief for the tax levied in the state of the permanent establishment. From the source state perspective, there would again be a question as to whether both treaties apply or only one of them. Assuming that the choice is made to apply one treaty only, there would be little doubt that the attribution to the active business of the permanent establishment should prevail over the attribution to the enterprise as a whole.

If the income has its source in the residence state of the whole enterprise or the state where the permanent establishment is situated, the attribution hierarchy would again give priority to the attribution to the permanent establishment. If the source of the income is in the residence state of the enterprise as a whole, there is a danger that that state would take the view that

to STEP members at <http://www.step.org/pdf/STEP%20response%20EU%20DT%20final.pdf>.

this is a closed domestic situation, as discussed in 4.7.3. On the other hand, in the current treaty framework states already accept that in this situation the attribution to the permanent establishment takes priority, so there is a very strong case for doing the same in the new approach.

4.7.5. Double attribution within one state

A constellation that seems very simple at first sight is a double attribution of income within one state. This could occur, for example, in respect of trust income if both the trustee and the beneficiary are liable to tax. One's instinctive response is that of course treaty benefits should be granted. This is indeed the result under the new approach, although the answer is not as simple as it first appears. It would be exceptional for one state to impose full double taxation on the same item of income in the hands of two different persons; if income is attributed to two persons there would usually be a mechanism in domestic law to prevent double taxation, and the treaty consequences of that mechanism are discussed below.

As noted in 3.3.4., one of the exceptional cases in which there might be a full liability to tax on the same income in the hands of two persons resident in the same state is anti-avoidance legislation which makes income liable to tax in the hands of the tax avoider but does not take away the liability of the person who receives it. In this case, if the source state accepts the tax liability on the avoider as a basis for treaty entitlement, there would be two entitlements to treaty benefits. For the source state, subject to the formal question of which person makes the claim, there would often be no problem as the treaty limit on its taxing claim would be the same either way. If the treaty entitlements of the two potential claimants differ, for example if the income in question is a dividend, the attribution hierarchy could be applied to determine which treaty claim prevails.

The more usual case, however, is one in which two persons are liable to tax in respect of payments that are regarded by the residence state as being the same item of income, but the residence state applies a mechanism to prevent economic double taxation. The mechanism is likely to be either granting one person a credit for tax paid by the other, or allowing one person to deduct the income when it is paid through to the other person. Either mechanism might well mean that the tax liability on one of the persons is not sufficient to found a claim to treaty protection.

Taking the example of a trust, both mechanisms could mean that the trustee is not able to claim treaty benefits. If the trustee is allowed a deduction for distributions to the beneficiary, the deduction may mean that the trustee is, in effect, a conduit for the income and is therefore not able to claim treaty benefits because he does not bear a sufficient tax liability on the income; this issue is discussed in more detail in 4.9. On the other hand, as we have assumed that the beneficiary is regarded in the residence state as receiving the same income, the beneficiary would be able to claim treaty benefits. If the tax payable by the trustee is creditable by the beneficiary, the trustee may again not be able to claim treaty benefits because, to the extent that the tax liability is shifted to the beneficiary, the trustee's tax liability is not a permanent one. But again, as the assumption is that the same income is also attributed to the beneficiary by the residence state, the beneficiary would be entitled to treaty benefits. Section 5.4. considers the application of the new approach to trusts in more detail.

4.8. Fragmented treaty entitlement

4.8.1. Separation of direct ownership and tax liability

Whereas the previous section considered what happens when there is potentially a double entitlement to treaty benefits, this section considers what happens when one potential claim is fragmented between two persons. More specifically, it considers situations in which one person owns income, but liability for tax on the income is imposed on a different person. This can happen, for example, due to the application of anti-avoidance legislation or a flow-through attribution. The question considered here is whether the separate fragments of tax liability and ownership can be aggregated to form one complete treaty entitlement. It is assumed throughout that there is no issue as to the residence connection between the persons and the states involved and also no issue as to the source of the income.

The two examples given above are not qualitatively different examples, but rather form two ends of a spectrum. Although they are both given as examples of a tax liability imposed on a person who is not the legal owner of the income, the tax liability in such cases is usually imposed on the basis of something that is regarded as a form of indirect ownership. Such attribution rules, in other words, impose the tax liability on a person who has indirect ownership of the income, rather than the person who has direct ownership. For the purposes of this discussion, the most important feature

of these rules is that the strength of the indirect ownership connection varies considerably from one case to another.

The strongest connection is found in the case of a flow-through attribution, such as the attribution of the income of a fiscally transparent entity to the members of the entity. In this case it is, essentially, only a question of time before the members receive the benefit of the entity's income. Their indirect ownership of the income is therefore very clear. This is a different issue from the entity classification issue; what is under discussion here is the situation in which there is clearly a legal entity, but the income of the entity is attributed to its members.

Legislation on personal service companies is often somewhere in the middle of the scale. This type of legislation can be seen as a flow-through regime, in that it attributes the income of a company to the individual who owns it indirectly through the company. Alternatively, it could be regarded as an anti-avoidance regime that attributes income directly to the individual who, in effect, uses the company as his alter ego. The precise point on the scale occupied by a specific regime would depend on the detail of the scheme.

At the other end of the scale are regimes that attribute income to a person on the basis of more remote ownership connections. These are the regimes that attribute income to a person who may be able to obtain the benefit of the income, such as the settlor of a trust who is able to recover the trust property. Often this type of attribution is adopted as an anti-avoidance measure, although the United States, for example, regards its domestic law attributing the income of a trust to a settlor as part of the basic tax system. These regimes already take the attribution of income beyond the range of persons who would be regarded as the owner of the income in any conventional sense of the word, but anti-avoidance regimes such as some of those discussed in 3.3.3. extend the range even further.

One could argue that there is a break in the continuum in the anti-avoidance end of the scale. That break could be the point at which the person to whom the income is attributed does not receive any factual benefit from the income. Alternatively, if one regards the ability to obtain income plus a decision to allow it to flow to someone else as the equivalent of receiving the income and giving it away, the break would be at the point at which the person who is liable to tax is not even able to receive any benefit.

The break in the continuum would occur because at one of these points the attribution rule arguably acquires a different nature from a flow-through attribution. In a flow-through situation, there is a consensus as to the direction in which income flows and the only issue is the point along that flow at which a taxable person or capacity is found, so that a tax liability can be imposed. But if a tax liability is imposed on a person who does not or cannot benefit from the income, one could argue that the attribution rule superimposes a second, notional, flow of income in addition to the flow that it already has to the person who does receive an actual benefit. The following discussion does not pay specific attention to this possible break in the continuum, however, other than to note that the nature of the attribution rule in question might determine its acceptability to another state for treaty purposes.

4.8.2. Fragments within one state

If the tax liability on income and the direct ownership of the income are both found in one treaty partner state of the source state, albeit in the hands of two different persons, one would instinctively argue that treaty benefits should be granted by the source state. This is essentially what was decided in the *TD Securities* case,²⁵⁷ which is discussed further in 5.3.1.1.

When such an attribution rule operates within one state, its effect is usually to shift the attribution of the income from one person to another. In other words, the law attributes the income to a person who has an indirect connection with the income and at the same time takes away the attribution to the person who has a more direct connection. This type of fragmentation can be accommodated quite easily by the new approach; even if the source state would not attribute the income in the same way itself, the income is subject to a tax liability in the correct state for treaty purposes. In this case, in other words, the tax liability of one person would be supported by the direct ownership of another in order to reach a full entitlement to treaty benefits. This solution is consistent with the more objective nature of the new approach, which requires only that the constituent elements of a treaty entitlement are found within one state, as opposed to the current treaty framework which requires that they are found together in one person.²⁵⁸

257. Note 121.

258. Bongaarts and Ed support this approach in the context of the current treaty framework. In their discussion of collective investment vehicles, they wonder whether it is relevant to the application of a treaty that there is some form of integration between the fund and the investor and, if so, whether it matters how that integration is designed.

A possible technical difficulty in this respect is that it might be a net profit that is attributed to the indirect owner, rather than each item of income separately together with the related expenses. In this case the tax liability would be imposed on a different item of income from the item for which treaty protection is claimed. Nevertheless, the contribution of the income for which treaty protection is claimed to the net profit would be clearly traceable, so the flow of the income would be clear, and there would be only one liability to tax within the state on that flow of income. Some flexibility could therefore be expected on the part of the source state in this respect.

If the two persons have different treaty entitlements, for example if the income is a dividend, there is a policy decision to be made as to which treaty limitation applies to the source state. This decision could be made by choosing either the tax liability or the supporting ownership of the income as the more important connection for treaty purposes. On the other hand, as the point of aggregating the fragments is to arrive at one whole treaty entitlement, states would probably be willing to grant treaty protection only to the extent that the two fragments have the same reach. In other words, the less favourable limitation would apply.

The concept of granting treaty benefits to one person on the basis of the attributes of another person is not new. In the context of partnerships, for example, the OECD has stated that “[t]he provisions of tax conventions, however, may then intervene to restrict or eliminate the taxing rights originating from domestic law where a person, usually but not necessarily the taxpayer identified under domestic law, is eligible for the benefits of the tax convention in relation to that income.”²⁵⁹ What is new is a systematic approach with a less intense focus on the person claiming treaty benefits, which enables the various elements of treaty entitlement to be aggregated without doing any violence to the wording of the treaty.²⁶⁰

In their opinion it does not matter in respect of domestic funds, when the same taxing authority has the ability to tax either the fund or the investor, but it should matter in the context of an international fund which has investors resident outside the host country's taxing jurisdiction. In other words, they also look at the ability of a state to tax the item of income, and are less concerned about the person in whose hands it is taxed. Bongaarts and Ed, note 12, at p. 45.

259. OECD Committee on Fiscal Affairs, note 2, Para. 27.

260. The US Model Convention of 2006 does provide for this approach in Art. 1(6). See also the technical explanation on Art. 1(6) and on Art. 10(2).

4.8.3. Fragments in different states

If an attribution rule of the type under discussion here applies across a national border, it is more likely to lead to a double attribution than a fragmented treaty entitlement. A state can attribute income to a resident person that has an indirect connection with the income, but it cannot remove the attribution of the income by another state to a person that has a more direct connection. A double attribution of this type would be subject to the considerations discussed in 4.7.

In the exceptional case that the residence states of the direct and indirect owner both attribute the income to the indirect owner, different considerations apply. In a two-state constellation there should be no problem with the application of the treaty, as both states agree on the attribution. If the source of the income is in the residence state of the taxable person, that state sees a closed domestic situation and the other state does not wish to tax the income anyway. If the source of the income is in one state and the taxable person is resident in the other state, the treaty would apply to limit the source state tax. As stated above, however, it is less likely that a state would cut off its tax claim in this way, by shifting the attribution of income to an indirect owner who is a non-resident.

The same observation applies to a three-state constellation, in which the source of the income is in a third state. If both the potential residence states really do attribute the income to the indirect owner, there is only one tax liability that can form the basis of a treaty entitlement. The source state may, however, consider the connection between the income and the indirect owner to be too weak to support the treaty claim. But the notion of a fragmented treaty entitlement could also apply in this case. If the imposition of a tax liability on the direct owner would have led to treaty protection for the direct owner, that direct ownership connection could be aggregated with the tax liability on the indirect owner to form one single treaty entitlement. The treaty protection would reach only to the extent of the lesser entitlement, so in other words it would be the less favourable treaty that applies.

A three-state example of a fragmented treaty entitlement is more likely to occur in practice if there is disagreement between two potential residence states about the attribution of income. One example is the *Aznavour* case,²⁶¹ and 5.2.1. explains how the notion of a fragmented treaty entitlement would

261. Note 6.

apply to this case. Another example is discussed in 5.3.2., which concerned a slightly different situation in which a treaty entitlement would be fragmented between two different states.

4.9. Artificial ownership structures

4.9.1. Introduction

Two issues that cause difficulty in the current treaty framework, conduit structures and base erosion, are both discussed in this section as they have a great deal in common. Both phenomena are often discussed in the context of tax avoidance and treaty abuse, although the conduit notion, in particular, is not necessarily confined to this context. A trustee may be described as a conduit, for example, if there is a beneficiary who is entitled to trust income as it arises and the only function of the trustee in respect of the income is to collect it and pay it to the beneficiary. This section considers both phenomena, however, primarily in their manifestation as artificial structures to obtain treaty benefits. The discussion in the remainder of this section refers to companies, as it is primarily the corporate form that is used for treaty shopping purposes, but the substance of the discussion could apply to any person.

As strategies to obtain treaty benefits, both phenomena rely on an artificial arrangement that places the ownership of income in the state where it is needed for treaty purposes, at the same time allowing the income to flow to a person that is not entitled to the benefit of the treaty under which protection is claimed. In both cases the company claiming treaty benefits in respect of the income exercises the ownership rights over that income in a way that reveals the contrived nature of the ownership. That the responses to these strategies are found in different places in treaties at the moment is a result of the inconsistencies in the current route to establishing treaty entitlement.

The following subsections analyse the nature of the problem and go on to explain how this problem would be addressed by the new approach. The basic tools for the response are an integral part of the new approach, although it might be necessary to include a treaty provision prescribing how the basic tools should be applied in these specific cases. A policy decision would be necessary as to whether these provisions would apply across the board, or whether their application would be limited to cases regarded as abusive.

As regards the risk of treaty abuse under the new approach, two initial points should be made. One is that a company which is incorporated in a state, but which has only a small substantive connection with the state, may not be able to demonstrate the personal connection needed in order to claim treaty benefits, as discussed in 4.4.2. A pure conduit company, which does nothing but receive income and pass it on to the ultimate beneficiaries, may therefore fail to substantiate its claim to treaty benefits for this reason. If, however, the company is able to claim derivative treaty benefits through its shareholders, the provisions discussed in this section would still be necessary. And it is, of course, also possible to run a conduit structure through a company that does have a substantial connection with its claimed residence state.

The second point is that the structures discussed in this section rely on an ownership connection between the income and the company claiming treaty benefits. The treaty response discussed below would therefore not apply to a payment that is received as a genuine receipt of an active business carried on in the residence state. In that case the connections between the income and the company and between the company and the residence state would clearly be sufficient to support the claim to treaty benefits.

The next subsection analyses the issue specifically with respect to conduit structures and the discussion in the following subsection builds on that analysis with respect to base erosion.

4.9.2. Conduit structures

The current treaty framework offers two solutions to a source state faced with a conduit structure. One is the beneficial ownership requirement, which allows the source state simply to refuse treaty benefits for the payment that is the first leg of the structure. The multitude of problems that beset the beneficial ownership requirement in general terms was discussed in 2.4.3. In the context of this section, the particular problem with the concept is that it is not very effective as a means of combating conduit structures. Its chequered case law history in this respect is well known.²⁶² More importantly, the theoretical basis for using beneficial ownership to combat conduit structures is shaky.

262. See for example: du Toit, C., note 63; and Martín Jiménez, A., note 63, Sec. 2.

Baker suggests that one way of testing whether a company is the beneficial owner of an item of income that it receives is to ask what happens if the company goes bankrupt before it pays the income over to the ultimate recipient.²⁶³ The company that first receives the payment is not the beneficial owner if, but only if, the ultimate recipient could claim the funds as its own. This suggestion also accords with the conclusion drawn by Van Weeghel that the beneficial ownership concept serves only to exclude agents and nominees from claiming treaty protection.²⁶⁴ Under this test, most payments in the second leg of a conduit structure would not deprive the conduit company of its beneficial ownership of the payment in the first leg. As argued by De Broe, even an enforceable obligation to make the payments that form the second leg of the structure would generally not be enough to negate the company's beneficial ownership.²⁶⁵

There is an enormous policy clash in this respect between states in the position of source state and in the position of residence state. In a purely internal situation the Netherlands and the United Kingdom, for example, are very hesitant to accept that the attribution of income can be changed by the simple expedient of agreeing to pay it to another person,²⁶⁶ and it is likely that the domestic law of most other countries is similar. Indeed, the whole point of a conduit structure is that the residence state of the conduit company does attribute the income to the conduit. Most countries in the position of residence state of the conduit simply apply their domestic attribution rule and levy tax on the conduit in respect of the income, although the deductions available to the conduit generally reduce the taxable base of the income to a small margin.²⁶⁷ In their position as source state, however, a different set of considerations takes over and the treaty context becomes vitally important.

The alternative to the simple refusal of treaty protection to a conduit that fails the beneficial ownership test is the approach of the US conduit regulations,²⁶⁸ which treat the two payments in a financing structure as one

263. Baker, note 28, Sec. 10B-15 (May 2003).

264. Van Weeghel, note 66, pp. 89-91.

265. De Broe, note 63, at p. 496.

266. See Appendix II, Section 5.5.

267. The Netherlands is an exception, in that it does pay specific attention to its position as a conduit state. For a translation into English of the relevant rulings, see: 8 *International Transfer Pricing Journal* 5 (2001), pp. 181-3. See also: Kamphuis, E., "New ruling policy regarding companies that provide intra-group financial services", *ibid.*, pp. 153-9.

268. Sec. 7701(l) Internal Revenue Code and Treas. Reg. 1.881-3. These regulations are not of general application, as they apply only to financing arrangements made in the

payment of income from the source directly to the ultimate recipient. The conduit is treated as if it receives the income as the agent or nominee of the ultimate recipient, and therefore does not enjoy treaty protection, although the ultimate recipient is able to claim treaty benefits. The conditions for the application of these regulations focus on a complex of matters, such as whether the parties are connected with each other, the time between the underlying transactions, the activity of the parties involved and the ability of the intermediate company to provide funds from its own resources. In effect, the regulations reason backwards, from the evidence of a factual connection between the payments in a structure to a determination that there is an obligation on the intermediate company to pass on the payments to the ultimate recipient. But although the conditions are designed to single out artificial structures that are set up in order to take advantage of a treaty, it is still questionable whether payments that fall foul of these regulations would fail the ownership test proposed by Baker.

The problem with both responses is that they focus on the ownership of the income for which treaty protection is claimed. Yet it is difficult to find a sound conceptual basis for arguing that the conduit is not the owner of the income it receives, unless it receives the income specifically on behalf of another person. Even if income is received by a shell company, it is not necessarily true that the company does not own it; the company's internal structure may mean that it is incapable of giving full consideration to the exercise of its ownership powers, but that limitation does not take away its ownership. Not having ownership is a different thing from having ownership but lacking the ability to deal with it; at the risk of making a comparison that might be found rather tasteless, a mentally handicapped individual may be quite incapable of dealing with her income, but that does not mean that she cannot own any income.

But it is not necessary, or even appropriate, to look for an ownership solution, because the treaty problem is not an ownership problem. It is, rather, the mismatch of tax liabilities between the source and residence states. The conduit issue arises almost exclusively in connection with passive income, under Arts. 10, 11 and 12 OECD Model.²⁶⁹ If the source state applies one of these articles it grants treaty relief by reference to the gross income, whereas the tax liability in the residence state is based on the net income.

context of a tax avoidance plan. They are cited here only as an example of an alternative approach to the treaty problem.

269. For the conceptual problems of applying the beneficial ownership concept to other types of income, in particular capital gains, see Baker, note 63.

And the whole problem with conduit structures is that that net amount is usually very different from the gross.

As it is this mismatch of tax liability that is the real problem, the solution should also focus on the tax liability. The new approach makes it possible to address this issue directly, by determining that the tax liability in the residence state is not sufficient as a basis for granting treaty benefits. Before the solution is canvassed, however, the next subsection continues the analysis to the base erosion issue.

4.9.3. Base erosion

The base erosion issue, like the conduit issue, relates to structures that are designed to obtain treaty benefits in an artificial way through reliance on the ownership connection between income and a person. And, also like the conduit issue, base erosion allows the income for which treaty protection is claimed to flow to another person in the form of deductible payments. Unlike the conduit issue, however, base erosion does not relate to one specific flow of income, but rather to the entire taxable base of the company claiming treaty benefits.

It would be even more difficult to combat base erosion by challenging the ownership of the income for which treaty benefits are claimed than it is in respect of conduit structures, as in a base erosion structure the flow of income cannot be traced through the company in the same way to correlate incoming payments with outgoing ones. And indeed, in the current treaty framework, base erosion provisions are not usually found in an ownership context but rather in a limitation-on-benefits provision, which is designed to support the residence definition. The basic residence definition in Art. 4 OECD Model looks at the general liability to tax of the treaty claimant. Base erosion provisions refine that definition by reference to the overall taxable base of the company; if the taxable base is reduced too much by certain deductible payments, the company fails the residence test. The deductible payments that are taken into account for this purpose do not include legitimate business expenses; broadly speaking, they are payments made in respect of another person's ownership of assets.

As with the conduit issue, the solution that has been found for the base erosion problem focuses on the wrong aspect of treaty entitlement. The solution has been made part of the residence concept, whereas the core of the problem is, again, the mismatch of tax liabilities between the source

and residence states. Although base erosion provisions usually apply to all types of income, their real target is situations in which the source state is required to give treaty relief on gross income whereas the residence state taxes the net income. Again, therefore, the solution should be found by looking at the tax liability in the treaty claimant's residence state.

4.9.4. Identification of the target structures

As stated earlier, one of the advantages of the new approach is that it separates out all the elements that are necessary in order to establish a claim to treaty protection, making it possible to focus on each element individually. The current treaty framework, by contrast, in the residence definition combines the elements of tax liability and a person's substantive connection with a state in a way that invites inconsistency and complexities. On the other hand, the current treaty framework does not give any structural role to the liability to tax on a specific item of income. And it is precisely this element that is put at stake by conduit structures and base erosion, albeit in different ways.

In a conduit structure the problem is that the effective tax liability on the payment in the first leg of the structure is drastically reduced by the payment in the second leg of the structure, leaving only a small margin on the income flow to be taxable in the conduit's residence state. The new approach to treaty entitlement starts from a person's tax liability in respect of a specific item of income, but if one looks at the conduit's tax liability on the incoming conduit payment as a portion of its tax liability on its entire income, the small margin on the conduit income may well be washed out. The solution therefore has to focus on isolating the conduit income in order to determine the tax liability on that specific income flow.

One of the difficulties of drafting a treaty provision that hits the right target is that it has to take account of a dividing line that is relatively easy to state but sometimes very hard to draw in practice. On one side of the line are arrangements made in respect of income that reduce a person's ownership of income below a level that would be sufficient for treaty purposes; if the legal owner of income is reduced to a mere nominee, that person would not be able to claim treaty benefits under the new approach because there is not a sufficient ownership connection between the income and the person.

The provision considered here would target a different phenomenon, however, on the other side of the line. This is the phenomenon that a person

does have sufficient ownership of the income for treaty purposes, but exercises the ownership rights in a way that reveals the contrived nature of the ownership. In effect, the ownership of the income by the conduit company amounts to nothing more than a temporary staging post. De Broe takes the same view when he describes conduit structures as a form of avoidance in which one operation is broken down into two or more operations which have the same economic effect as the single operation.²⁷⁰ The problem therefore is how to identify a single flow of income for this purpose, the determination that is the most difficult aspect of this provision.

In respect of base erosion the problem is, in a sense, the opposite of the conduit problem. Here the issue is not that a small taxable margin on one specific item of income is washed out by the company's profit computation as a whole, but rather that deductions made in the profit computation as a whole have the effect of reducing the taxable base of each incoming payment. In this case the solution has to focus on the effect of these deductions on the whole profit computation. This provision would look at payments made by the company, other than payments of genuine business expenses, in order to determine whether they reduce the overall taxable margin of the company below an acceptable level.

Neither provision would be particularly easy to draft or to apply, as the core of both issues is a complex of factual elements, rather than legal relationships. As with a number of other elements, however, this is not a specific feature of the new approach, and the problem would remain whatever the approach taken to determining entitlement to treaty benefits. The new approach does, however, at least focus attention on the correct aspect of the problem and respond to that aspect.

4.9.5. Solutions

Once the target ownership structures have been identified, the final step is to decide whether, and if so how, the treaty should be applied. One option is simply to deny treaty benefits altogether, but this option is rather harsh. A possibility that is less harsh is to apply the treaty only to the proportion of the income that is taxable in the company's residence state. In the case of conduit structures this margin would be easily determinable by comparing the payments in the two legs of the conduit structure. In the case of base erosion, the margin used to determine whether the structure is covered by

270. De Broe, note 63, Sec. 1.1.1, Para. 10.

this provision would have to be applied to the whole payment to determine which part of it is protected by the treaty.

If the deductible payments that bring the structure within this provision are made to persons who would be entitled to the benefit of a different treaty if they received the payments directly, there is even less reason to deny treaty benefits altogether. The current treaty framework already recognizes this point by granting derivative benefits in certain cases. In respect of base erosion, this mechanism grants treaty benefits to the company if the base-eroding payments are made to persons who would have been entitled to treaty benefits that are at least as favourable if the income for which protection is claimed had been paid to them directly. The latter part of this condition creates a gap if the person who receives the base-eroding payments would have been entitled to treaty protection, but under a treaty that is less favourable.²⁷¹

In respect of conduit structures, there is no generally applicable concept of derivative benefits in the current treaty framework if a payment does not satisfy the beneficial ownership condition. The US conduit regulations do, however, achieve this effect in practical terms, as they treat a payment for treaty purposes as though it is paid to the ultimate recipient and that person is the beneficial owner.²⁷²

In the new approach, a consistent result could be achieved across the board by using the notion of a fragmented treaty entitlement explained in 4.8., although the fragmentation is a different one. In the situations discussed in that section, the fragmentation arises because one person is liable to tax in respect of an item of income but a different person has an ownership connection with the income. The notion of a fragmented treaty entitlement would allow those two fragments to be aggregated in order to form one claim to treaty protection.

In the case of conduits and base erosion structures, the company claiming treaty benefits has ownership of the income and is taxable on the income, but that tax liability is not sufficient to give treaty protection. If the outgoing payments are made to a person who does bear a sufficient tax liability

271. On this point in respect of the current treaty framework, see: Mason, R., "When Derivative Benefits Provisions Don't Apply", 43 *Tax Notes International* 7 (2006), pp. 563-7; and Miller, M.J., "Anti-Deferral and Anti-Tax Avoidance: when derivative benefits and zero withholding on dividends collide: are any treaty benefits available?", 33 *International Tax Journal* 5 (2007), pp. 5-10.

272. Note 161, Para. (a)(3)(ii).

in respect of those payments, and who would be entitled to treaty benefits if the payments in the first leg of the structure were made directly to that person, then that person's liability could be aggregated with the company's ownership in order to form one full entitlement to treaty benefits. As with the fragmented entitlement discussed in 4.8., it would be the less favourable treaty that would apply, as the source state would be prepared to grant treaty benefits only to the extent of the lesser of the two fragments.

In respect of conduit structures, a policy decision is required as to whether the payment in the first leg of the structure is split into a conduit and a non-conduit part for this purpose, or whether the characterization of a payment as a conduit payment is an all-or-nothing determination. In a base erosion situation, this solution would have to be applied proportionally according to the destination of the various base-eroding payments. This solution would give rise to some complex calculations, but it is likely to be applied only in cases of suspected treaty abuse.

Granting treaty benefits on the basis of a fragmented entitlement is not a perfect solution, because there is still the treatment to consider of the actual payments from the conduit company to the ultimate recipients, both under the domestic law of their respective residence states and any treaty concluded between those two states. As with some other issues noted in this thesis, however, this is an inherent problem of applying bilateral treaties to triangular situations.

Chapter 5

The New Approach Applied

In order to illustrate the new approach, this chapter looks at a selection of concrete examples to see what would happen if the relevant treaties had been drafted following the new approach. These examples are grouped into a number of categories in order to make the issues easier to follow, although there is a certain overlap among the groups.

Sections 5.1. to 5.3. are based on decided cases from various countries, each time explaining the actual decision and then explaining how the new approach would apply. Section 5.1. looks at a variety of flow-through situations, which provide useful illustrations of the general principles. The next two sections consider two important elements that would be introduced by the new approach; 5.2. considers how it would resolve cases in which there is a double attribution of income, and 5.3. considers how the notion of a fragmented treaty entitlement would be applied. Section 5.4. concludes by looking at the application of the new approach to trusts in common-law countries, as the various systems they have adopted for the taxation of trusts throw up almost every conceivable challenge for a theory on entitlement to treaty protection.

5.1. Flow-through situations

5.1.1. Case 4600²⁷³

In Case 4600, the Italian *Corte di Cassazione* rejected a claim to treaty protection in respect of income that flowed through a number of entities. The claim was made in respect of dividends paid by a company resident in Italy to its shareholder, a US limited liability partnership (US LLP), which was transparent in the United States for tax purposes. A participation in the US LLP was held by a Japanese bank, as agent for a Japanese pension fund. The pension fund claimed the protection of the Italy–Japan treaty in respect of the dividends. The dividend article of this treaty did not include the ben-

273. Italy: CC, 1 March 2009, Case No. 4600, Tax Treaty Case Law IBFD. See also: Gusmeroli, G., “The Supreme Court Decision in the Government Pension Investment Fund Case: A Tale of Transparency and Beneficial Ownership (in Plato’s Cave)”, 64 *Bulletin for International Taxation* 4 (2010), pp. 198-210.

official ownership requirement; it applied simply to dividends “received by a resident of the other contracting state”.

The Court held that the pension fund could not claim treaty benefits; the entirety of its reasoning seems a little confused, but it did clearly find that the dividends were not “received by” the pension fund, but rather by the US LLP. The pension fund was the ultimate beneficiary of the income flow, but that was not enough to give it entitlement to treaty benefits, as what the pension fund received was a different item of income, namely the results of the investments made by the bank. Further, the participation in the US LLP was owned by the bank and not by the Japanese fund. The Court did suggest that the bank might have been able to claim treaty benefits, although it was not asked to adjudicate on this question and therefore gave no decision in this respect. The Court paid some attention to the beneficial ownership question, although it is questionable whether the inclusion of the beneficial ownership requirement in the treaty would have helped the pension fund, as this requirement is usually an addition to the other attribution wording in the dividend article provision, not a substitute for it.

Under the new approach, it is clear that the US LLP would not be able to claim treaty benefits, as it was transparent in the United States and therefore not liable to tax in respect of the income. It is not entirely clear from the decision where the court thought that the flow of the income ended. At times the court seemed to regard the US LLP as a company that received the Italian dividends and then distributed a new dividend which broke the income flow; if that was indeed so, this case would be similar to the situation in the ruling discussed in the following subsection.

Assuming, however, that the income received by the US LLP was attributed as such to its partners, it is highly likely that the Italy–Japan treaty would apply, as the income flow would have ended in Japan. There seems to be an inconsistency in the actual decision, as the bank is described as an agent for the pension fund, yet the court also stated that what the pension fund received was only the final outcome of the investment made through the bank, implying that the income changed its character as it passed through the bank. In order to determine precisely how the treaty would apply under the new approach it would be necessary to know how the Japanese tax system applied to the bank and the pension fund.

If the bank was indeed nothing more than an agent for the pension fund, the claim for treaty protection would obviously be made by the pension fund. The claim would also be made by the pension fund if the bank acted

as a conduit, receiving the income as its own but making payments to the pension fund that were substantially the same income as the dividends that emanated from Italy. As stated in 4.9., this concept is not necessarily confined to abusive or artificial situations. If, on the other hand, the income stream from Italy ended at the bank, the claim would be made by the bank; this would be the case if the income was received by the bank as a business receipt. The payments from the bank to the pension fund would then be business expenditure of the bank, and these income payments would be a purely internal question in Japan.

This analysis highlights the importance of correctly identifying the stream of income, in particular where the income stream ends. It may seem that this issue would acquire an excessive importance under the new approach, yet this problem is already there; it is just as acute in the current treaty framework as it would be in the new approach, but it tends to be overshadowed by the problems caused by the structural flaw that besets the current treaty framework. The new approach cuts away those structural problems, leaving this difficult, but non-structural, issue exposed to view.

5.1.2. Ruling 17 of 2006²⁷⁴

Another decision from Italy, this time a ruling from the tax authority, denied the availability of treaty benefits altogether in an incomplete flow-through situation. Dividends were paid by a company resident in Italy to a common contractual fund (CCF) established in Ireland. The CCF was an investment fund, and most of the participations in it were held by pension funds resident outside Ireland. The CCF was not liable to tax in Ireland, and Irish tax law did not attribute the income to the fund's participators. The CCF was not obliged by its statutes to distribute all its income.

The Italian resident company argued that the CCF was a flow-through entity for Italian tax purposes, and requested a ruling that the dividends were subject to the treaties concluded by Italy with the residence states of participators in the CCF. The tax authority ruled, however, that no treaty applied at all. The treaty with Ireland did not apply, as the CCF was not liable to tax in Ireland. The treaties with the residence states of the participators did not apply either, because the CCF was not a true flow-through entity; Irish tax law did not attribute the income to the participators, nor was the CCF required by its own statutes to distribute all its income each year.

274. "Ruling No. 17 of 27 January 2006: Italian tax authority rules on treaty entitlement of Irish pension fund" (16 June 2006), News IBFD.

Under the new approach, the same result would probably have been reached, for similar reasons. A claim to the benefit of the Ireland–Italy treaty would have floundered on the lack of tax liability in Ireland, except that under the new approach it would have been the lack of tax liability on the specific dividend that led to this result rather than the lack of tax liability on the CCF as a person. Whether the participators in the CCF would have been entitled to treaty benefits on the Italian dividend would depend on whether the income they received from the CCF was substantially the same as the Italian dividend. From the facts it seems that this was not the case, and therefore no treaty protection would be available in the absence of a specific treaty provision to this effect.

This case illustrates the important policy issue that would become very visible in the new approach, as to whether treaty protection should be available in respect of an item that is not liable to tax in a treaty partner state. If the purpose of double tax treaties is only to prevent double taxation, the result in this case is correct both in the current treaty framework and under the new approach. If, on the other hand, the purpose of double tax treaties is to protect any income that has a sufficient connection with the taxing jurisdiction of a state that has concluded a treaty, this result is wrong. In that case, however, the treaty should state explicitly which substantive connections are sufficient to lead to treaty protection, as required by the new approach, rather than getting to the required result through a fraught and contentious interpretation of the residence definition, as in the current treaty framework.

5.1.3. *Diebold* case²⁷⁵

The *Diebold* case, decided by the French *Conseil d'Etat*, illustrates the effect of the receipt of income as a business receipt. This case concerned lease payments, which were classified as royalties for treaty purposes and which were paid from a source in France to a *besloten commanditaire vennootschap*, or CV, established in the Netherlands. The CV was transparent for tax purposes in the Netherlands and therefore did not qualify as a resident under the France–Netherlands treaty. Its partners, however, were

275. “Ruling on application of France–Netherlands treaty to Netherlands partnership – *Diebold*” (17 February 2000), News IBFD. See also: Gouthière, B., “Eligibility of Foreign Partnerships for Treaty Benefits: Decision of the Supreme Administrative Court of 13 October 1999”, 40 *European Taxation* 5 (2000), pp. 195-8; and Baranger, S., “New Guideline on Recognition of Transparency Principle for Foreign Partnerships”, 47 *European Taxation* 8/9 (2007), pp. 420-3.

resident in the Netherlands for treaty purposes and the Court held that they were entitled to treaty benefits.

The tax authority argued that treaty protection should nevertheless be denied because the payment of the royalties to the Netherlands CV was part of a treaty shopping structure; a large proportion of the royalties, 68%, was paid as fees and other remuneration to an associated company resident in Switzerland. The Swiss resident company did not qualify for the benefit of the France–Switzerland treaty as it fell foul of an anti-abuse provision in that treaty. The tax authority argued that the Swiss company was the beneficial owner of the royalties and that therefore the treaty with the Netherlands did not apply, even though the treaty did not include the beneficial ownership requirement in the royalties article. The Court held, however, that the treaty did apply to the extent that the payments from the CV to the Swiss company were an arm’s length remuneration for the services provided by the Swiss company, as to that extent it could not be said that the partners of the CV received the royalties as a conduit.

Under the new approach, it would also be the partners of the CV who would claim treaty benefits, as the tax liability in the Netherlands was imposed on them. As discussed in 4.4.3., if the royalties were genuine business receipts treaty protection would be available, even if the taxable base was reduced by deductible expenses to the point that the business incurred a loss. Whether or not the outgoing expenses were paid at an arm’s length rate would not of itself determine the treaty entitlement of the partners, although it might be a strong indication that the CV did not carry on a genuine business. The important point would be, rather, whether the incoming royalties were received as a genuine business receipt; in other words, it is the arm’s length character of the royalties themselves that would count.

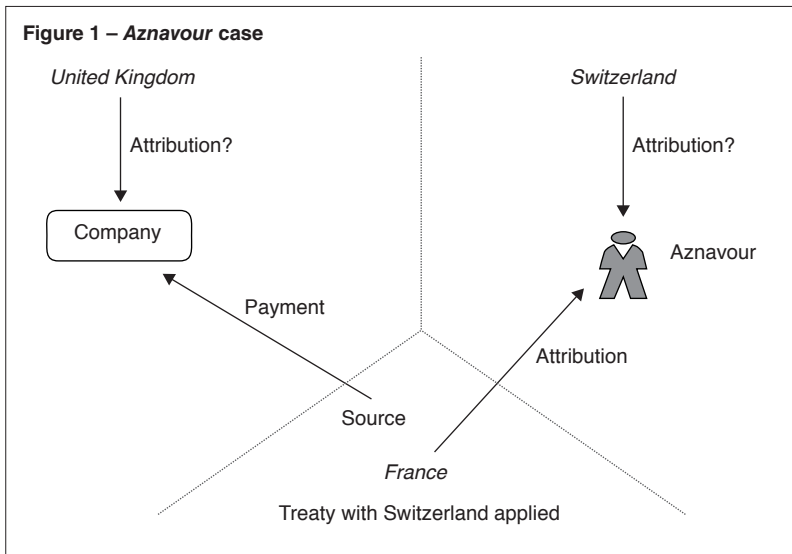
If the royalties were not received as a genuine business receipt, the partners might still be able to claim treaty protection on the basis of their ownership, but in this case the erosion of the royalties through the payments to the Swiss company would be relevant, as it might result in the tax liability of the partners in respect of the royalties being too low to claim treaty benefits. Whether the payments to the Swiss company would be tackled through the conduit concept or through the base erosion concept would depend on how closely those payments could be correlated to the incoming royalties. In either case, it might be too harsh to deny treaty benefits for the entire amount of the royalties, as only 68% of them were paid to the Swiss company as expenses, so treaty benefits could possibly be given for the remaining 32% in the hands of the partners. In this case it had already

been established that the Swiss company was not entitled to the benefit of the France–Switzerland treaty, so it would not be possible to use the notion of a fragmented entitlement in order to claim treaty benefits for the 68%.

5.2. Double attributions

This subsection discusses a number of situations in which one item of income is attributed to two different persons by different states. Most of the following subsections look at cases which highlight the lack of explicit attention in the current treaty framework for the attribution of income. The *Aznavour* case was decided in a state that had only a source connection with the income, whereas the other cases were decided by one of the residence states. What all these cases make clear, however, is that the distributive provisions of treaties are not written for double attributions and do not provide any clear guidance for them. This subsection concludes by looking at controlled foreign company regimes as a possible cause of a double attribution of income.

5.2.1. *Aznavour* case²⁷⁶



276. Note 6.

5.2.1.1. The actual decision

Aznavour, a famous singer resident in Switzerland, gave a concert in France. The fee for the concert was paid to a company resident in the United Kingdom, but French domestic law²⁷⁷ attributed the fee to the individual for tax purposes. There must have been some connection between Aznavour and the UK company, but the precise nature of the connection is not explained in the decision. The relevant French legislation attributed income to the individual in three circumstances: if the individual controlled the company either directly or indirectly; if the individual was unable to establish that the company carried on a predominant substantial commercial or industrial activity other than the provision of services; or if the company benefited from a privileged tax regime in a foreign country.

The issue before the court was whether treaty protection applied to prevent the taxation of Aznavour in France. The *Conseil d'Etat* started its reasoning with the French domestic law, which taxed the fee in the hands of Aznavour. The Court therefore looked at the treaty with Switzerland and found that it did not prevent the French tax charge as it contained a provision comparable with Art. 17(1) OECD Model. This provision was enough to dispose of the matter; the treaty with the United Kingdom did not apply, because the UK company was a different taxpayer and therefore, in effect, irrelevant. The Court did not give any explicit consideration to the taxation of the fee in the hands of either Aznavour or the company in their respective residence states, although it is assumed here that the fee would have been taxable in the United Kingdom in the company's hands. One cannot assume as easily that Switzerland would have taxed the fee in Aznavour's hands (although Switzerland would undoubtedly have taxed any remuneration or dividend derived by him from the company), but this question was also irrelevant to the Court's reasoning.

The *Conseil d'Etat* also explained that the correct approach to the application of a treaty is to determine first whether domestic law imposes a tax liability and, if so, what the basis of that liability is and subsequently to determine whether the treaty prevents the imposition of that liability. Taking this approach, the logic of the Court is impeccable. Nevertheless, it does not accord with the principles of the OECD Partnership Report,²⁷⁸ which, by analogy, would have required France to take into account the attribution of the fee to the company in the United Kingdom and apply the treaty with the United Kingdom in addition to the treaty with Switzerland.

277. Art. 155 A *Code Général des Impôts*.

278. See 2.4.4.

Under the latter approach, the only argument that would have prevented the application of the treaty with the United Kingdom, aside from an anti-avoidance reasoning, would have been one based on the wording of the UK treaty that was applicable at the time.²⁷⁹ But Art. 6, which was the relevant provision, applied (in the English-language version) to profits “of” an enterprise, a wording that did not leave a great deal of scope for refusing treaty benefits on the basis that the fee was paid for the performance by Aznavour and would indirectly benefit him.

5.2.1.2. The new approach

France was the source state in this situation; the first step for the Court would therefore have been to look for states that imposed a tax liability on the fee on a residence basis. It is assumed here that there was no issue as to the residence connection of Aznavour with Switzerland or the company with the United Kingdom. The course to be taken by France would then depend to a certain extent on whether Switzerland also attributed the fee directly to Aznavour.

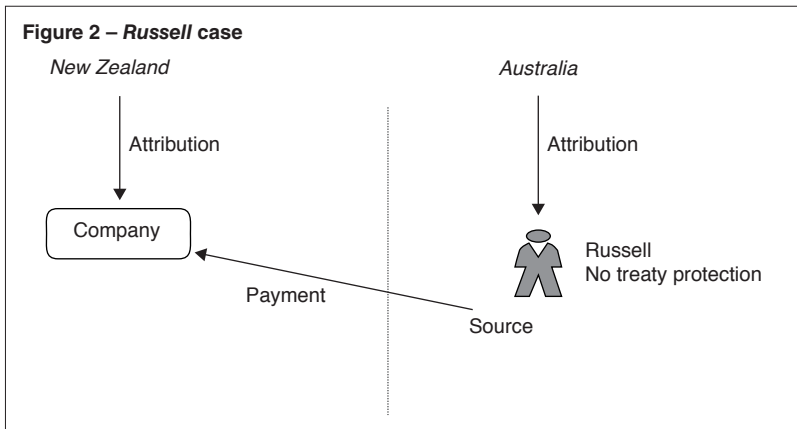
If that was the case, there would have been two attributions of the fee, one to the company in the United Kingdom, and another to Aznavour in Switzerland. The question for France would then have been whether it accepted both of those connections between a person and the income. Possibly the enquiry would stop here, because France would pursue its domestic law and find the connection between the income and the company too weak. As explained in 4.1.2., however, the issue is not whether a state applies the same attribution rule (which, incidentally, France may well have done in a mirror image situation), but whether it can accept the liability in the other state. The taxation of income in the hands of a company that is legally entitled to the income should *prima facie* be acceptable, in the absence of indications that the company’s entitlement to the income is part of an avoidance scheme. In particular, France should accept this attribution if the company was carrying on a genuine business of managing the public performances of the individual. If France did accept both connections, the policy questions discussed in 4.7.2. would apply as to whether France should apply both treaties, or whether it would apply one treaty and, if so, the basis on which that choice is made.

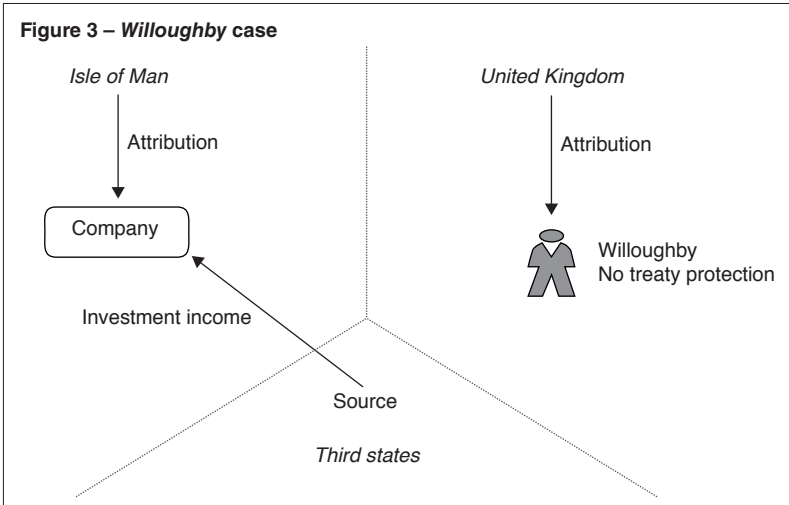
If Switzerland did not attribute the income to Aznavour, there would have been only one residence state wishing to impose a tax liability on the fee

279. France–United Kingdom treaty of 22 May 1968, as amended.

as such, namely the United Kingdom. France would then have to decide whether the company's connection with the fee was acceptable as a basis for granting treaty benefits. Again, if the company carried on a genuine business of managing Aznavour's public performances there should be no problem. Possibly the company's legal entitlement to the fee would not have been enough to satisfy France, but this refusal of treaty benefits would probably be predicated on the argument that the real benefit of the fee flowed to Aznavour. In that case France might still grant treaty benefits on the basis that the treaty entitlement was fragmented, as discussed in 4.8.3. This solution would depend on a finding that there was one flow of income through the company to Aznavour, so that the tax liability and legal entitlement of the company could be aggregated with the economic entitlement of Aznavour to the income. If there was a difference between the benefits granted by the two treaties, the less favourable one would apply, as France would most probably not extend treaty protection beyond the point that these two fragments ran in parallel.

5.2.2. *Russell* case and *Willoughby* case





5.2.2.1. The actual decisions

Russell was an individual resident in Australia, who provided services through a company incorporated in New Zealand which formally employed him. Although the company was wholly owned by his wife, it fulfilled all the conditions for characterization as a personal services company in Australia and, accordingly, the company’s income was directly attributable to Russell as personal services income under Australian domestic law.²⁸⁰ Most of the services provided by the New Zealand company were provided to a single client resident in Australia; there was some evidence of rather dubious value that the New Zealand company also provided services to clients in Vanuatu,²⁸¹ but these possible payments from Vanuatu did not play any substantive role in the decision.

The case raised a number of questions,²⁸² but the one that is important here is whether it was contrary to the treaty between Australia and New Zealand

280. Part 2-42 Income Tax Assessment Act 1997. One of the issues in the lower court (note 130) was the applicability of this legislation, and in particular whether it applied to a company resident outside Australia. The lower court judge held that it did apply, but this part of the decision was not appealed. As the discussion on this point is not germane to this thesis, it is not discussed further.

281. If a certain portion of the company’s income was from sources outside Australia, the legislation on personal services companies would not have applied. The percentage of payments claimed to have been derived from Vanuatu was just enough to bring the non-Australian-source income above the critical threshold in this respect.

282. See Para. 11 of the judgment of the lower court, note 130.

for Australia to tax the income of the New Zealand company in Russell's hands as his personal services income. The courts held that it was not, and consequently that Russell remained liable to tax in Australia on that income. In the lower court²⁸³ the judge set out one of the few detailed judicial considerations of the interaction between treaties and domestic attribution rules.

Russell had argued against the liability in Australia on the basis that it constituted double taxation of the income that was contrary to the treaty – once in the hands of the company in New Zealand and again in Russell's hands in Australia. The lower court judge was sympathetic to this argument “[a]t a general level of abstraction and from an *economic* point of view”,²⁸⁴ but concluded that the law did indeed lead to this result. Reading the treaty as a whole, he found that the business profits article focused on the profits of an enterprise, not on profits as such. After looking at various authorities²⁸⁵ he stated that the intention of both the business profits article and the double tax relief article was to prevent juridical double taxation, not economic double taxation. In other words, although the judge did not express this point in these terms, the treaty was subjective in scope and applied to persons; as Russell was a different person from the company, the company's tax liability was irrelevant to his claim to treaty benefits. The Federal Court²⁸⁶ came to the same conclusion via a slightly different route, stating that the phrase “profits of an enterprise” in Art. 7 refers to the profits of an identifiable taxpayer, but that Australian law attributed the income to the individual and not to the company. The Australian tax liability on the individual did not, therefore, constitute taxation of the company that was prohibited by the treaty.

The *Willoughby* case²⁸⁷ has a number of similarities with the *Russell* case, which are explained here, and one important difference, which is explained below. The similarities are that both cases were decided in the residence state of an individual who was subject to (or potentially subject to) anti-avoidance legislation, and in both cases the income in question was a business receipt of a company resident in the treaty partner state. In *Willoughby* the anti-avoidance legislation was held not to apply, because the individual's tax avoidance motive was not strong enough. At the end of his deci-

283. Note 130.

284. Para. 113 of the judgment. Emphasis in the original.

285. Although not the *Aznavour* case.

286. Note 7.

287. Note 134.

sion, however, the Special Commissioner²⁸⁸ did consider briefly whether, if the legislation had applied, the tax charge would have been prevented by the arrangement between the Isle of Man and the United Kingdom,²⁸⁹ which included a business profits article which essentially followed Art. 7 OECD Model. He held that it did not, stating that one treaty article could not be applied twice, nor could it be applied to two different persons.

The basic purport of the *Willoughby* decision was, in other words the same as the *Russell* case, namely that the protection offered by the treaty was subjective and applied only to the enterprise that directly derived the profit. What both cases also have in common is that they required the court to apply a treaty provision to a situation for which it was not written; the distributive provisions of a treaty are premised on overlapping source and residence claims to tax the same person, not on overlapping residence claims to tax different persons.

5.2.2.2. The new approach applied to the *Russell* and *Willoughby* cases

Although these cases raised primarily a residence state issue, whereas *Aznavour* raised only a source state issue, the starting point would be the same under the new approach, namely to determine which other states wished to impose a tax liability on the income. Looking first at *Russell*, and ignoring for the time being the possibility of source taxation in Vanuatu, the only other possible liability in respect of the income was on the company in New Zealand. The first issue would be whether or not both states were indeed taxing the same item or stream of income, Australia taxing it in the hands of the individual and New Zealand taxing it in the hands of the company.

This question is maybe the most difficult aspect of the new approach. In the actual case the answer would have been easy, as the Australian legislation clearly did attribute the same income to the individual, but other legislation of this type may not be so clear in this respect. What is attributed to a person under anti-avoidance legislation may, for example, be an amount computed by reference to the income in question, rather than the income itself. What is important, however, is whether both persons are taxable in respect

288. *Ibid.*, [1995] STC 143, at pp. 146 and 167-8. The Special Commissioner's decision was appealed to the Court of Appeal and then to the House of Lords, but this point was not raised in the higher courts.

289. Art. 3(2) Isle of Man–United Kingdom arrangement of 29 July 1955. This arrangement has the form and the function of a double taxation treaty.

of substantially the same income or stream of income, and the answer to this question should not be determined to an excessive extent by the formalities of the legislation.

On the assumption that both countries were seeking to tax the same income, the next step for Australia would be to consider whether that New Zealand liability was a sufficient reason for Australia to step back in some way from its own taxing claim. The first part of that process would require Australia to consider the claim to treaty protection of the New Zealand company. Did the company have a sufficient connection with the income for treaty purposes? Did the company also have a sufficient residence connection with New Zealand? If the company's claim failed on one of these grounds, the enquiry into treaty protection would stop there. Assuming, however, that the company satisfied both tests, the crux of the issue is the competition between the attribution rules of the two residence countries which, under the new approach, would be resolved by applying the attribution hierarchy discussed in 4.7.1.

The route to be taken in the *Willoughby* case would be the same, but at this point the difference between the two cases might become important. The *Russell* case concerned fees paid for the individual's activity, whereas the *Willoughby* case concerned income from assets transferred by the individual to the company. In *Willoughby* the anti-avoidance legislation would have attributed the income to the individual on the basis that he retained "power to enjoy" the income. This connection with the income is very much more remote than the connection in the *Russell* case, where the fees were paid as a direct result of the individual's activity.

It is likely, therefore, that the attribution hierarchy would produce different results in the two cases. In *Russell*, the attribution to the individual would take priority, as the attribution of remuneration for personal services to the individual performing services would probably be at the top of the attribution hierarchy, taking priority over the attribution of the remuneration to the company as a business receipt of the company. Australia would therefore not be prevented by its treaty with New Zealand from taxing the income in the hands of the individual.

In *Willoughby*, on the other hand, the attribution to the company would probably take priority over the attribution to the individual, as Willoughby's power to enjoy the income would be considerably lower down in the hierarchy than the attribution to the company. This would be true whether or not the income was regarded as a business receipt of the company; even if the company's ownership of the assets and income was limited by its

obligations towards Willoughby, its ownership of the income would still take priority over Willoughby's power to enjoy it. It is even possible that the attribution to Willoughby would not have been strong enough to found a claim to treaty protection, although one might expect the United Kingdom, as the state imposing a tax charge on this basis, to ensure that it was covered by the treaty. In this case, therefore, the United Kingdom would be obliged either to refrain from taxing or to grant double tax relief in respect of the tax liability of the company, even though the two charges were on different persons.

5.2.2.3. The further consequences of the new approach in the *Russell* case

As an illustration of the new approach, it is also useful to consider the further consequences of the fact pattern in the *Russell* case. In order to prevent double taxation of the income, it would be necessary for the company to make a treaty claim in New Zealand on the basis that the treaty gave priority to the attribution in Australia. New Zealand would either be prohibited from taxing the income in the hands of the company, or would be allowed to tax but would be obliged to give double tax relief in respect of the Australian tax. In the latter case it would have to be clear that this treaty obligation would apply even though the tax charges in the two countries were imposed on different persons. This is, however, the logical consequence of the new approach which, by comparison with the current treaty framework, places a greater emphasis on the income than on the person.

In order to make its treaty claim, the company would have to be aware of the conflicting attributions of the income, but in any case in which there is a conflict of attribution this point is not likely to be a problem. A conflict of attribution generally arises when the legal or economic rights over income are divided in some way, and it is hard to conceive of a situation in which a division of this sort would occur without the parties being aware of it.

In the actual case there was some brief discussion in the lower court about the possibility that some of the income had its source in Vanuatu, although the evidence about the source of the income was rather suspect and this possibility did not play a major role in the case. Assuming that some of the income really did have its source in Vanuatu, and that there was source basis taxation in Vanuatu, the first issue that would arise in this respect would be the application of any treaties concluded by Vanuatu with the two residence states. The considerations for Vanuatu in this respect would be the same as for France in the *Aznavour* case discussed in 5.2.1.

Assuming that Vanuatu was not prevented from levying tax by its treaty obligations, and that the Australia–New Zealand treaty gave the primary taxing right on a residence basis to Australia, the primary obligation to grant double tax relief in respect of the Vanuatu tax would also fall on Australia. If there was a treaty between Australia and Vanuatu, that obligation would be regulated in that treaty and would apply even if Vanuatu attributed the income to the company under its domestic law.

If the Australia–New Zealand treaty granted a residual taxing right to New Zealand, and New Zealand used the credit method, there would then be an issue in New Zealand as to the amount of the credit. The philosophy of the new approach is that New Zealand accepts that its tax claim ranks in priority behind both Vanuatu as source state and Australia as the primary residence state, and therefore it should grant a credit for the taxes imposed by both the other states. This could be achieved either by crediting the amount of tax actually paid in both other states, or by granting a credit for the amount of the tax due in Australia before the Australian credit for the Vanuatu tax.

In order to complete the analysis, it is also instructive to consider how the new approach would apply if any of the income had its source in New Zealand. In this case, the Australia–New Zealand treaty should not deny New Zealand the taxing rights it would have had on a source basis in a straightforward case without any double attribution. If the company’s activity in New Zealand passed the permanent establishment threshold, therefore, New Zealand would have an unlimited right to tax the profit of the permanent establishment part of the company. If the treaty granted a residual residence state taxing right to New Zealand, the hierarchy of taxing rights would be as follows: New Zealand would be able to tax the profit of the permanent establishment on a source basis; Australia would have a primary residence state taxing right in respect of Russell, with double tax relief being given in respect of the source tax; and New Zealand would have a residual residence state taxing right in respect of the company as a whole, with double tax relief being given in respect of the two previous two liabilities.

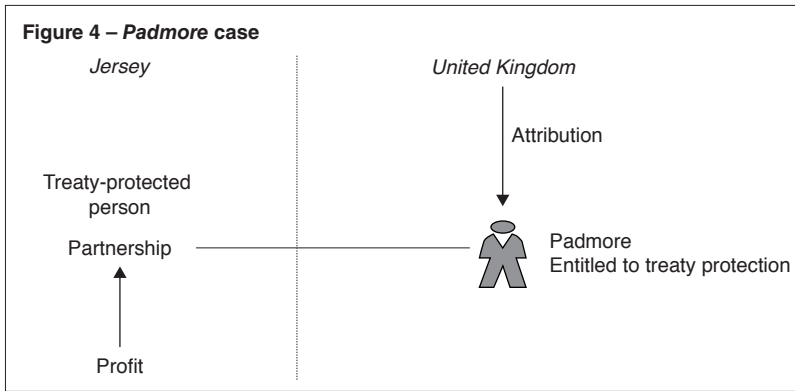
A consequential complication of the attribution mismatch between Australia and New Zealand is that the two countries would probably also disagree about the taxation of the salary paid by the company to Russell. One would expect Australia to refrain from taxing Russell on his salary, as the remuneration for his services would already have been taxed in his hands from the Australian point of view. New Zealand, on the other hand, regarded the

original income as attributable to the company; it would therefore probably regard the salary as a different item of income and see no problem in taxing it in Russell's hands under its domestic law. New Zealand may also be permitted under the treaty to tax the salary attributable to Russell's activities in New Zealand on a source basis, either because the salary was paid by a company resident in New Zealand or because it was attributable to the permanent establishment part of the company in New Zealand.

On the other hand, New Zealand would also allow the company a deduction for the salary, reducing the company's taxable base and therefore also reducing the amount of tax from the company. If Australia used the credit method of double tax relief, there would be a mismatch between the net profit taxed in the company's hands in New Zealand on a source basis and the fee income taxed in Russell's hands in Australia on a primary residence state basis. This mismatch may just have to be accepted as an unavoidable consequence of the sovereignty of states in shaping their domestic tax systems.

Alternatively, the mismatch could be resolved under the new approach if Australia accepted that Russell's salary constituted the same stream of income as the fees derived by the company. Australia would also have to be willing to grant a credit to Russell for the New Zealand tax on the salary, even though the two states characterized the taxable income in different ways for domestic purposes and, most probably, levied their tax at different times. This solution leads to results which are a little complex, but conceptually sound.

Australia would grant Russell a credit for the New Zealand tax on the salary for the activities carried out in New Zealand against its own tax on the portion of the fee income that corresponded to that part of the salary. If New Zealand was also permitted by the treaty to tax part of the company's net profit on a permanent establishment/source basis, Australia would also grant a credit to Russell for that New Zealand tax. In this case Australia would, in effect, recognize that the New Zealand source-based tax on the fee income was in two parts, one part on the salary and a second part on the net profit of the company. The resulting net amount of tax due from Russell in Australia would be the Australian tax on a primary residence state basis, after granting double tax relief for the tax levied by New Zealand on a source basis. The picture would be completed by New Zealand's residual residence state taxation of the net profit of the company, subject to the obligation to grant double tax relief for the Australian tax.

5.2.3. *Padmore* case²⁹⁰

5.2.3.1. The actual decision

Padmore, an individual resident in the United Kingdom, was a member of a partnership which was established in Jersey. In both Jersey and the United Kingdom, the amount of tax due on partnership income was computed by reference to the tax chargeable on each partner's share, but the profit was assessed to tax in the name of the partnership. There was some discussion in the case as to whether the partnership was a person and a resident of Jersey for treaty purposes,²⁹¹ but it was held that the partnership was a person for treaty purposes, that the liability in Jersey was due to the residence of the partnership in Jersey, and that the partnership was entitled to treaty protection. It was clear that the partnership had no permanent establishment in the United Kingdom, so the United Kingdom was prohibited from taxing the profits of the partnership.

The issue was then whether the treaty also served to protect the individual partner from taxation in the United Kingdom. Like the *Russell*²⁹² and *Willoughby*²⁹³ cases, in other words, the Court was asked to apply a treaty distributive rule to a situation for which it was not written. Unlike those cases, however, and to the surprise of many commentators, the Court of Appeal held that the treaty did prevent the United Kingdom from taxing;

290. Note 119.

291. Jersey–United Kingdom arrangement of 24 June 1952, which has the same form and function as a double taxation treaty.

292. Note 7.

293. Note 134.

as the treaty prohibited the United Kingdom from taxing the entirety of the profits of the partnership, the Court reasoned that it must also prohibit the United Kingdom from taxing a share of them.²⁹⁴

Contrary to the *Russell* and *Willoughby* cases, in other words, this court interpreted the treaty allocation rules in an objective manner, by applying the prohibition on taxation in the United Kingdom to the profit rather than to a person. This decision turned on the finding that the liability of the partner in the United Kingdom and the liability of the partnership in Jersey related to the same profit.²⁹⁵ Although the *Russell* and *Willoughby* cases also concerned the same item of income, this element may have received more weight in *Padmore* because it was the clearest flow-through situation of the three. The Court found that the business profit belonged to the partners as it was realized, so that the tax liability on the partnership was merely an incident on the route of the profit as it flowed to the partners who already owned it. In the other two cases, by contrast, the income did not flow automatically to the individual; the attribution to the individual was a deeming rule imposed by the legislation for anti-avoidance reasons, and what the individual actually received, if anything, would not have been the same income.

5.2.3.2. The new approach

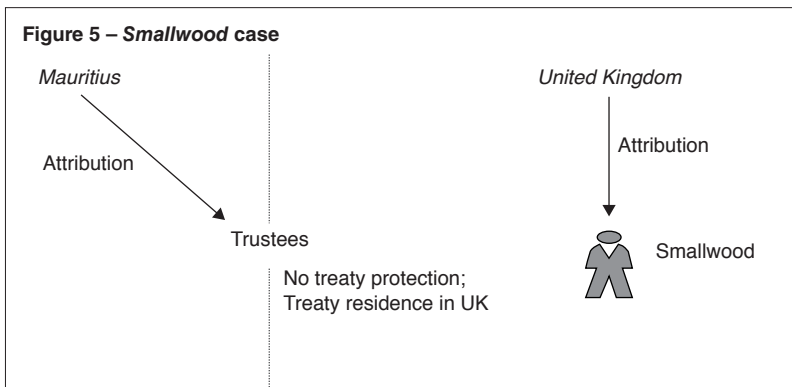
Applying the new approach to this case, the Court would first have had to identify the income in question, which it found rather an easy question to answer, and then ascertained which tax liabilities were imposed on the profit under consideration. There were two; the partnership was liable to tax in Jersey on the whole profit, and in the United Kingdom the partner was liable to tax on his share of the profit. The court would then have considered whether both of those connections between the (share of) profit and the person were sufficient to be recognized for treaty purposes. The United Kingdom's own liability on the partner obviously would have been sufficient in its own eyes. The Jersey liability would most probably also have been sufficient, as it was the partnership that carried out the business activity from which the profit was derived.

294. The United Kingdom then introduced legislation to reverse the decision: Sec. 62 Finance (No. 2) Act 1987, amending Sec. 153 Income and Corporation Taxes Act 1970. In a subsequent case the High Court found that the legislation was effective to overturn the first decision (although it also stated that the legislation was in breach of the treaty): *Padmore v. Commissioners of Inland Revenue (No. 2)* [2001] STC 280.

295. See also the *Anson* case, which turned on the same point: note 249 and the accompanying text.

Assuming that the residence connection of both the partnership and the partner with their respective states was acceptable for treaty purposes, the next step would have been to apply the attribution hierarchy discussed in 4.7.1. Here the conflict is between one attribution to the taxable capacity, the partnership, which carried on the business activity, and another attribution to the partner, who owned the income. The attribution hierarchy would most probably give priority to the attribution to the partnership. Possibly the individual would also be found to be carrying on the activity, but the more direct connection was with the partnership and so, again, the attribution to the partnership would prevail. The United Kingdom would either have to refrain from taxing the partner, or would be permitted to tax him but would be obliged to grant double tax relief in respect of the tax levied in Jersey in the name of the partnership on his share of the income.

5.2.4. *Smallwood* case²⁹⁶



5.2.4.1. The actual decision

The *Smallwood* case concerned a series of transactions openly acknowledged by the taxpayer to be an avoidance scheme. Smallwood was an individual who had, some time before the facts of the case arose, settled a large number of shares on trust. The shares had substantially increased in value and, in an attempt to sell the shares and realize the gain without incurring any tax, a scheme known as the “round-the-world scheme” was used.

²⁹⁶. *HMRC v. Smallwood and anor*, note 147.

The scheme was designed around two specific provisions of the UK legislation, one anti-avoidance provision and one more general provision. The anti-avoidance provision²⁹⁷ applied only if the trustees were not resident in the United Kingdom at any time during the tax year. In order to prevent the application of this provision it was therefore necessary to ensure that the trustees were resident in the United Kingdom for at least part of the year. The more general provision²⁹⁸ imposed liability to capital gains tax realized during the entire tax year on persons who were resident in the United Kingdom for any part of the year. This provision would have resulted in UK capital gains tax being due from the trustees after all, but the aim of the scheme was to enable the trustees to block this liability by claiming treaty protection. If the trustees were not able to prevent their liability in this way, the legislation also included a provision²⁹⁹ which would attribute the gain to the settlor, Smallwood.

At the commencement of the scheme the sole trustee was a company resident in Jersey. The Jersey company retired as trustee in December 2000 and a company resident in Mauritius was appointed in its place. The Mauritius trustee sold the shares and realized the gain. The tax year for these purposes ran from 6 April to 5 April, so the Mauritian trustee retired in March 2001 and Smallwood appointed himself and his wife, both resident in the United Kingdom, as trustees. The Mauritius–United Kingdom treaty gave the exclusive taxing right over capital gains realized on shares to the residence state of the alienator,³⁰⁰ and the trustees³⁰¹ claimed the protection of this provision to prevent any tax charge in the United Kingdom. Mauritius did not levy tax on capital gains.³⁰²

In essence, the sole question in the case was whether the trustees were able to claim the benefit of the Mauritius–United Kingdom treaty, but in order to answer that question many aspects of treaty law had to be considered.³⁰³ What is particularly interesting in the context of the discussion in this thesis

297. Sec. 86 Taxation of Chargeable Gains Act 1992.

298. Sec. 2(1) Taxation of Chargeable Gains Act 1992.

299. Sec. 77 Taxation of Chargeable Gains Act 1992.

300. Art. 13(4) Mauritius–United Kingdom treaty of 11 February 1981.

301. Although different persons were trustees at different times, for UK tax purposes (and in most other countries that know the trust concept in their domestic law) trustees are regarded as a continuing body of persons which continues to exist irrespective of the specific persons who happen to fulfil the role of trustee from time to time.

302. The move from Jersey to Mauritius was necessary because the arrangement between Jersey and the United Kingdom did not give the same protection.

303. For an excellent analysis of the arguments and decisions at the various levels of the judicial system, see: Cleave, B., “Summary and editor’s notes”, United Kingdom: CA, 8 July 2010, *Smallwood and anor v. HMRC*, Tax Treaty Case Law IBFD.

is the question it raised about the role of liability to tax in the application of a treaty. The trustees were resident in the United Kingdom under its domestic law for only a small part of the tax year, but they were liable to tax in the United Kingdom under its domestic law on capital gains derived throughout the whole tax year. Which was the crucial factor in determining their entitlement to treaty benefits: their residence under domestic law for a small part of the year; or their liability to tax for gains realized throughout the whole year?

The Court of Appeal³⁰⁴ unanimously held that the treaty concept of residence does not refer to residence as defined by the domestic law of the contracting states, but rather focuses on tax liability due to a residence connection between the taxpayer and a contracting state.³⁰⁵ It concluded that the trustees were dual residents for treaty purposes and the residence tiebreaker had to be applied. The court upheld by a 2:1 majority the factual finding of the Special Commissioners that the place of effective management of the trustees was in the United Kingdom and that therefore the treaty did not prevent the UK tax charge on the gain.

In coming to this conclusion the Court perhaps dealt with the residence issue a little too easily. The UK tax liability on the gain was imposed on a residence basis, in the sense that it was triggered by the trustees' UK residence for part of the year, but the extension of the liability to tax on gains realized during the whole year does not, of itself, make the trustees liable to tax as required by Art. 4(1) for the whole year. As Arnold puts it, "Art. 4(1) is intended to identify taxpayers who are subject to unlimited taxation (taxation on their worldwide income). If the trust was subject to UK tax only on its capital gains and not on its worldwide income, it is questionable whether or not under Art. 4(1) the trust is a resident of the United Kingdom for purposes of the tax treaty."³⁰⁶ The Court of Appeal, however, looked at the fiscal year as a whole³⁰⁷ and found it sufficient that the capital gains tax liability of the trustees was triggered by their physical residence in the United Kingdom during some part of the year. In doing so the Court clearly rejected the approach that had been taken in the High Court, the level below

304. There is one further step in the UK judicial hierarchy, namely the Supreme Court, but leave to appeal to the Supreme Court was refused. The Court of Appeal decision is therefore final.

305. For a discussion of the importance of this aspect of the decision, see: Baker, note 142.

306. Arnold, B., "Tax Treaty News", 64 *Bulletin for International Taxation* 12 (2010), p. 603 et seq.

307. Which was not what the Special Commissioners did, even though the Court of Appeal purported to follow them in this respect; see Cleave, note 303.

the Court of Appeal, of confining the enquiry to the domestic law residence of the trustees on the single date of the share disposal.

Although the Court of Appeal resolved the case by applying the residence tiebreaker clause to the trustees, the tax authority had argued that the trustees did not have one period of dual residence but rather two successive periods of single residence. Their argument was that the capital gains tax article of the treaty only prevented the source state from taxing share gains, and did nothing to limit the taxing rights of the residence state. The consequence of this line of reasoning was that the only limit on the taxing rights of either residence state was the obligation imposed to grant double tax relief, but this argument floundered on the difficulty of determining which state's taxing claim should take priority and which state should give relief.

What is not addressed in the judgments at any level, and does not appear to have been raised in argument, is the point that any UK tax liability would actually be imposed on Smallwood as settlor of the trust, rather than on the trustees.³⁰⁸ As Smallwood had no personal connection at all with Mauritius in his capacity as settlor, it would arguably be extremely odd if he were, in effect, to receive the benefit of the United Kingdom's treaty with Mauritius, but this was precisely the result that Smallwood was trying to achieve.

5.2.4.2. The new approach

The case remains a complex one, but it demonstrates that the new approach is able to provide an answer without throwing up any problems of treaty interpretation other than the perennial problem of drawing difficult dividing lines. In one respect, the new approach might have given a very simple answer indeed; Mauritius did not tax capital gains under its domestic law, so the claim to treaty protection might have ended there. The question about treaty protection could, nevertheless, have arisen if the treaty granted benefits even though there was no tax liability on the gain in Mauritius, as discussed in 4.5. If Mauritius did tax the gain, but at a very low rate, there would have been an issue as to whether that tax liability was sufficient to make the usual rules for the allocation of taxing rights kick in, as discussed in 4.3.2.

But let us assume, for the sake of argument, that there was a tax liability in Mauritius that was sufficient to cause the treaty to apply. In that case there would have been two tax liabilities on the same gain, one liability imposed

308. See note 149 and accompanying text.

by Mauritius on the trustees and another one imposed by the United Kingdom on Smallwood. There would therefore be two potential claims to treaty protection. The first step would be to determine whether those claims could be substantiated and, assuming that one or both of them could be substantiated, the second step would be to determine how the treaty resolved the overlapping tax claims.

The first step requires an examination of the connecting factors of both parties. Taking first the connection between the gain and the persons, the connection with the trustees as the persons legally entitled to the gain is obvious. If their legal entitlement was a mere formality, so that they realized the gain, in effect, as an agent or nominee, that connection would probably not be enough to substantiate a claim to treaty protection. In this case, however, their ownership of the gain seems to have had more substance than mere legal entitlement.

Smallwood's connection with the gain is more problematic. The relevant UK legislation attributed a gain to a settlor who retained "an interest in the settlement"; this legislation applied to Smallwood because he was also one of the beneficiaries of the trust. If his interest as beneficiary had given him some direct entitlement to the gain realized by the trustees, he might have had a sufficient economic entitlement to be able to claim treaty protection on that basis. It is not clear from the facts of the case, however, what the extent of his beneficial interest was.

If, as seems likely, the trust was a discretionary one, his interest in the gain may have been too remote to substantiate a claim to treaty protection, unless an attribution of this kind were specifically covered by the treaty. Smallwood could, however, use the notion of a fragmented treaty entitlement as discussed in 4.8. The trustees were the persons with legal entitlement to the gain and, as observed above, their ownership seems to have been more than a mere nominee structure. They were also physically present in the United Kingdom for part of the year and it seemed that their presence would continue afterwards. It is true that they were not physically present in the United Kingdom on the date that the gain was realized, but nevertheless their personal connection with the United Kingdom would seem sufficient to allow their ownership connection to be aggregated with the tax liability on Smallwood to form one treaty entitlement in the United Kingdom. This is rather an ironic conclusion in this case, as Smallwood the individual fulfilled both the role of settlor and, together with his wife, the role of trustee during the last part of the tax year. Nevertheless, it is important to keep these two functions separate, as they are two different taxable capacities.

As regards the personal connections of the two treaty claimants with the state imposing a liability on them, there is no issue as to Smallwood's connection with the United Kingdom, as he was physically resident there throughout the period in question. The actual case was decided on the basis of the dual residence of the trustees, but under the new approach it would not be necessary to consider this issue. There would be only one, relatively simple, question in this respect: was the personal connection of the trustees with Mauritius sufficient to support their claim to treaty benefits? It is not necessary to consider their personal connection with any other state, because they were not liable to tax on the gain in any other state and therefore could not claim treaty protection as residents of any other state. For the same reason, it is also irrelevant to this point that the UK tax liability extended through the whole year even though the trustees were physically present there for only part of the year. The claim to treaty protection on the basis of the UK liability would be made by Smallwood, and he clearly was physically present in the United Kingdom.

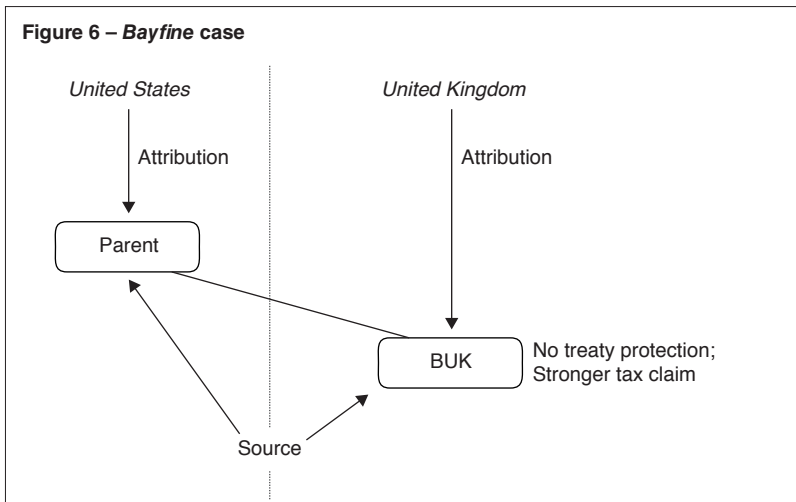
The trustees' presence in Mauritius was a very temporary affair, and therefore the answer to the question about their personal connection with Mauritius may well have been "no". In that case, only Smallwood would be able to claim treaty protection. As the United Kingdom was taxing him as a resident, his treaty protection would be limited to the application of the double tax relief article. The more objective nature of the new approach means that there would be no problem in this respect that the tax liability in Mauritius would be imposed on the trustees.

What might be a problem, however, would be the determination by the United Kingdom as to the weakness of the trustees' personal connection with Mauritius. If this connection was too weak to justify granting treaty benefits to the trustees, it might also be found to be too weak to justify granting double tax relief in respect of any tax imposed on them by Mauritius. This result may seem rather harsh, but it simply highlights the inherent tension that already exists between domestic law and treaties. Many states claim a taxing right under their domestic law in situations in which they are reluctant, in a mirror image situation, to grant treaty benefits. The basic philosophy of the new approach is that it respects the sovereignty of states, not only in shaping their own tax system, but also in determining the acceptability of liabilities imposed by other states as a basis for granting treaty benefits. On the other hand, one might expect the United Kingdom to be more lenient in respect of double tax relief for Smallwood than in respect of a claim to treaty entitlement from the trustees.

If both Smallwood in the United Kingdom and the trustees in Mauritius were able to substantiate a claim to treaty protection, it would be necessary to apply the attribution hierarchy discussed in 4.7.1. in order to determine which state’s taxing right would take priority. The result of this determination would be either that the “loser” state would not be able to tax, or that the treaty would oblige the “loser” state to grant double tax relief in respect of the “winner” state’s tax, even though the two liabilities are imposed on different persons.

In this case the hierarchy is rather more difficult to determine than in the other cases discussed so far in this section. Which factor should have more weight: the direct entitlement to the gain of the trustees; or the indirect economic entitlement of Smallwood? Possibly the hierarchy would be drafted to make this depend on the extent of the economic entitlement in question. From the facts of the case, it seems that Smallwood actually retained a large degree of control over what happened in the trust; if control were one of the factors in the hierarchy, Smallwood’s control over the application of the gain might well take priority over the trustee’s legal entitlement, but the answer to this question depends on the exact nature of the connection of both persons with the income.

5.2.5. *Bayfine* case³⁰⁹



309. Note 253.

The UK *Bayfine* case considered the issue of double tax relief granted under a treaty when the two overlapping tax liabilities were both imposed by a residence state. The facts as stated in the case are complex but, stripped down to its essentials, the case concerned two debt contracts entered into by two companies within the same corporate group. One contract would produce a loss and the other a gain of the same amount, but it was not known which was which until a certain date specified in the contracts. Both companies were resident in the United Kingdom, and they were both wholly owned by two different companies resident in the United States. The UK company that made the gain, BUK, was a disregarded entity in the United States under the check-the-box regulations, so the gain was also taxable in the United States in the hands of its parent company.

One of the issues in the case was the claim made by BUK under the United Kingdom–United States treaty to credit the US tax payable by its parent company on the gain against its own liability in the United Kingdom. Interestingly, the different identities of the two companies in the case did not prevent the granting of a credit. Indeed, in respect of the United Kingdom the Special Commissioners³¹⁰ found that the wording of the treaty meant that the taxable person was irrelevant and that all that mattered was that the tax liability in both states was computed by reference to the same profits.

The real issue in the case was the disagreement as to which state was obliged to grant a credit for the tax levied by the other state. The only provision in the treaty that could apply was the usual double tax relief article, but this provision gave no guidance when the two tax charges were imposed on different persons. The Special Commissioners undertook an extensive consideration of this question,³¹¹ taking into account the US saving clause in Art. 1 of the treaty, the deemed-source rule in the double tax relief article and the extra complicating factor that both states regarded the gain as having a domestic source from their own point of view.

After negotiating some conceptual circles, in the end they came to the conclusion that the solution was to consider which state had the stronger taxing right. In this case they found that “[u]ndoubtedly this is the UK. We are taxing a UK resident on ... UK source income, that is to say taxing on a residence plus source basis. The US is disregarding the UK taxpayer, but impliedly acknowledging that the UK has the better right to tax by saying that its taxation is by virtue of the saving clause. ... Accordingly, the first

310. *Bayfine UK Products and another v. Revenue and Customs Commissioners* [2009] STC (SCD), 43.

311. *Ibid.*, Paras. 34-70.

taxing right is with the UK.” The result was that the UK taxing right took priority and any double tax relief was to be granted by the United States. The case went on appeal to the High Court,³¹² which reversed the decision, and from there to the Court of Appeal. The Court of Appeal agreed with the Special Commissioners, although the leading judgment expressed a dislike for treating the issue as one of primary and secondary taxing rights, stating that the answer was to be found by focusing on the drafting of the treaty and applying a purposive interpretation in order to apply the treaty as it was intended that it should apply.

Clearly, the problem in this case was the lack of any explicit guidance in the double tax relief article to determine which state’s tax claim took priority. The approach taken by the Special Commissioners, which was endorsed by the Court of Appeal, found a priority rule in the US saving clause, which gave the United States the right to tax the gain, but subject to the obligation to grant double tax relief in respect of the UK tax. In the words of the Special Commissioners, “[i]t is clear ... that the US recognises that if it disregards a UK resident entity it will have to accept the UK’s right to tax that entity.”

Under the new approach, the result would be similar, but it would be reached through the attribution hierarchy discussed in 4.7.1. In this case it would be the rule giving priority to a direct attribution over an indirect attribution that would apply, as the conflict here was not due to the use of different attribution factors but rather to the different domestic treatment of the UK company by the two states. The United States had, in effect, already accepted that its attribution of the gain was less direct than the attribution in the United Kingdom, because it could only be reached by disregarding the UK company.

5.2.6. CFC and comparable regimes

A great deal has been written about the interaction between controlled foreign company (CFC) regimes and treaties, in particular about the treaty compatibility of CFC regimes,³¹³ and it might be surprising to see CFC regimes covered under the heading of double attributions. CFC regimes use

312. *Bayfine UK v. Revenue and Customs Commissioners* [2010] STC 1379; 12 ITLR 935; United Kingdom: HC 23 March 2010, Tax Treaty Case Law IBFD.

313. A small selection of these articles is, for example: Sandler, D., “Case Notes: Tax treaties and controlled foreign company legislation”, *British Tax Review* 1 (1998), pp. 52-61; Portner, note 126; and Lang, M., note 153.

various mechanisms to achieve their aim, and they do not commonly use a direct attribution of the CFC's income to its shareholders in addition to the attribution to the CFC itself in the CFC's residence state.³¹⁴

Yet the essence of CFC regimes is generally that they attempt to rectify an attribution of income to a CFC that is regarded as artificial and contrived. Much of the discussion on their treaty compatibility has focused on whether it is the same income that is being attributed to both the CFC and its parent company,³¹⁵ and this question has been the focal point of some court decisions. In the UK *Bricom* case,³¹⁶ for example, the essential point of the decision was that the amount that was taxed in the hands of the parent company was not the same as the income of the subsidiary CFC. This issue was even more acute in the French *Schneider* case,³¹⁷ as the difference of opinion in that case between the court and the *commissaire du gouvernement* on this point led to their different conclusions on the case. The *Conseil d'Etat* found that the French CFC regime did tax the profit of the subsidiary and that therefore its application was prevented by the treaty.

Couzin warns that “[i]t is hazardous to compare decisions of courts in different jurisdictions, with different interpretive frameworks and legal traditions”.³¹⁸ But he goes on to surmise that “the variation in result is due to the manner in which the UK and French CFC rules operated. In the United Kingdom, and in Canada, the income taxable in the hands of [the parent company] is defined as an amount determined by a formula, which in turn includes the intended classes of income. In France, it seems that [the parent company] is taxable on the very same income.” He concludes his discussion by arguing that the policy issue as to the compatibility of CFC regimes with treaties “should not depend upon the mechanical means by which the CFC legislation is implemented.”

It would certainly be ridiculous if a simple change of mechanics could turn an incompatible tax charge into a compatible one. But in dismissing the notion that the precise mechanics of a CFC tax charge can influence the response as to the regime's treaty compatibility, it is easy to lose sight of the fundamental policy question underlying this issue. Regardless of the precise mechanics used to achieve their aim, the tax liability imposed by

314. Garfunkel, N., “Are all CFC regimes the same? The impact of the income attribution method”, 59 *Tax Notes International* 1, pp. 53-74.

315. The discussion here refers to a parent company as the shareholder of a CFC, but the scope of a CFC regime is not necessarily limited to corporate shareholders.

316. *Bricom Holdings Ltd v. Inland Revenue Commissioners*, note 116.

317. *Re Société Schneider Electric*, note 124.

318. Couzin, note 31, Sec. 4.3.1.

CFC regimes on a parent company is triggered by the receipt of income by the subsidiary CFC. It *should* make a difference to the application of the treaty if the amount that is liable to tax in the hands of the parent company is, in substance, the same as the income of the subsidiary. This determination should not depend on the mechanism of the CFC regime, however, but rather on how close the connection is between the income of the CFC and the amount attributed to the parent company. Of course, this determination is not an easy one to make, and might be dismissed on purely practical grounds, but this solution is the only one that is consistent from a conceptual point of view.

Assuming that this solution is followed and this determination can be made in a satisfactory manner, the application of the new approach would be clear. If the tax charge on the parent company is found to relate to something different from the income of the subsidiary, the new approach would not be engaged or change the treaty issues. For example, the question of whether a treaty permits the residence state of the parent company to treat it as having received a deemed dividend would still remain open.³¹⁹

If, on the other hand, the tax charge on both companies is found to be imposed on substantially the same income, there is a double attribution of the income for treaty purposes, which can be resolved by applying the attribution hierarchy discussed in 4.7.1. The “loser” state would either refrain from taxing, or retain its right to tax the income subject to an obligation to give double tax relief in respect of the tax levied in the “winner” state. This is, in effect, what most CFC regimes do on a unilateral basis anyway, except that the residence state of the parent company has no choice but to accept that the tax charge on the subsidiary takes priority. Bringing this aspect into the treaty would allow, or require, the two states to negotiate the relative priority to be given to their tax charges, rather than perpetuating a system of unilateral action and retaliation.

5.3. Fragmented treaty entitlement

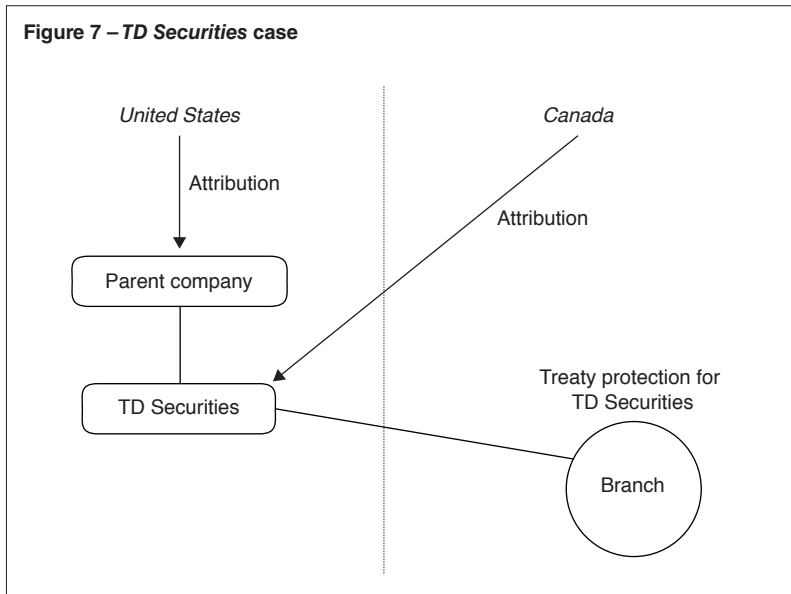
This section considers a number of cases in which the courts had to give themselves rather a large margin of interpretation in order to reach the right result under a treaty but in which, under the new approach, the notion of a fragmented treaty entitlement could have been used in order to grant treaty protection. The most usual case of a fragmented entitlement is the impo-

319. On this point, see, for example, Lang, note 153.

sition of a tax liability in respect of income on a person who is not the owner of the income, and the first subsection considers some relatively straightforward cases in which this type of fragmentation occurred within one state. As discussed in 4.8., in cross-border situations a fragmentation is less likely to occur than a double attribution, but the second subsection discusses one case in which a cross-border fragmentation did arise of the ownership of income and liability to tax on the income. The third subsection considers a different type of fragmentation which may occasionally occur and which could possibly also be applied to increase the treaty benefits available to a person who already has a full entitlement to treaty protection.

5.3.1. Fragmentation within one state

5.3.1.1. *TD Securities* case³²⁰



TD Securities (TDS) was an LLC incorporated in the United States which had a branch in Canada. There was no dispute that the branch constituted a permanent establishment for the purposes of the Canada–United States treaty, and the only issue was whether TDS was able to claim a reduction of

³²⁰. Note 121.

the Canadian branch tax granted by the treaty. The sole shareholder of TDS was a company resident in the United States and the United States treated TDS as a flow-through entity, attributing all of its income to the its parent company for tax purposes. The Canadian tax authority argued that TDS was not liable to tax in the United States and therefore did not qualify as a resident of the United States for treaty purposes.

The judge found that both the OECD and the two contracting states in this case took an “ambiguous” approach to the treaty entitlement of transparent entities.³²¹ Taking a purposive reading of the treaty, he held that TDS was entitled to treaty benefits because all of its income was taxed in the United States, albeit in the hands of a different person. Although this decision is questionable in terms of the wording of the relevant treaty,³²² it does highlight the problem that the current wording of treaties does not always give treaty benefits in situations in which the policy aim of treaties would suggest that treaty protection should be given. Arnold, for example, states in respect of *TD Securities* that the decision is controversial although “[i]n terms of the policy of the tax treaty, the result in the case appears to be correct.”³²³

One troublesome aspect of the decision is that, having reviewed the treaty treatment of US S-corporations, partnerships, exempt entities and government entities, the judge found that it would be an anomaly to exclude LLCs from treaty benefits. His conclusion was that “from the overwhelming consistency of the Canadian government’s approach to fiscally transparent entities and to other entities that are not liable to tax under a treaty partner’s domestic legislation, that it was not intended that an entity whose income was fully and comprehensively taxed in the other contracting state would be denied the benefit of a treaty simply because its income was taxed by the other country at the level of its shareholders, members or partners.”³²⁴ Some of these examples, however, are conscious decisions to grant the benefit of the treaty to persons who would not otherwise be entitled to treaty benefits, and others are with legal forms of doing business that are not as easily comparable with an LLC as the judge seemed to believe.³²⁵

321. Para. 101 of the judgment.

322. For a detailed analysis of the decision, see: Nikolakakis, note 11. The decision is dismissed by Van Weeghel, note 24, as an opportunistic one (in Dutch: “*gelegenheids-arrest*”).

323. Arnold, B., “Tax Treaty News”, 64 *Bulletin for International Taxation* 10 (2010), pp. 494-9, at p. 499.

324. In Para. 87 of the decision.

325. Nikolakakis, note 11.

Another troublesome aspect is that the judge found these considerations enough to decide the case, but then went on to state that it was necessary to decide whether TDS was a resident of the United States and liable to tax in the United States by reason of one of the grounds enumerated in the residence article. The residence definition in this treaty followed the usual pattern in the current treaty framework, which requires the tax liability that leads to treaty residence to be imposed on the person who claims residence for treaty purposes. Yet the judge still concluded that TDS was liable to tax and a resident of the United States.

This case illustrates very clearly the fundamental flaw in the current treaty structure observed in 3.4., that the route to treaty protection goes through two conditions that do not join together properly. On the other hand, it is a textbook example of a situation in which the fragmented entitlement approach would apply, as discussed in 4.8.2. The claimant company was the legal and economic owner of the profit in question, while the liability to tax on the profit was imposed on the parent company. Both companies had a personal, residence connection with the United States, and so all the fragments of the treaty entitlement were within the United States. The benefit of the Canada–United States treaty would therefore clearly have been available. In essence, the judge in this case did apply the new approach suggested here, but if the treaty had been drafted accordingly he could have done so without doing any violence to its wording.

5.3.1.2. S-corporation case³²⁶

A German *Bundesfinanzhof* case on the treaty entitlement of an S-corporation established in the United States provides an illuminating comparison with the *TD Securities* case. The S-corporation in this case had elected for transparent tax treatment in the United States, which meant that all its income was attributed for tax purposes to its sole shareholder, an individual resident in the United States. The S-corporation held a 50% shareholding in a company resident in Germany, and the issue before the Court was which treaty provisions applied to limit the German withholding tax on dividends distributed by the German company to the S-corporation. Was it the provision for substantial shareholdings held by companies, so that the German tax was limited to 5%, or the provision for other shareholdings, in which case the German tax was limited to 10%?

326. Germany: BFH 20 August 2008, case No. I R 39/07, Tax Treaty Case Law IBFD.

The Court held, on the basis of a literal reading of the treaty, that the 5% rate applied, although it also acknowledged that a purposive interpretation of the treaty would have led to the application of the higher limitation. Although there was no economic double taxation, because the corporation was not taxable in the United States, the Court found that it could deviate from the literal wording only if the literal wording led to an unreasonable result. That was not the case here, however, as applying the lower limitation would not have led to a lower tax burden on the company and its shareholder, but only to a different allocation of taxing rights between the two states.

Whatever the merits of this decision in the current treaty framework, it is clear that under the new approach it would have been the higher limitation that applied. It was the individual shareholder who was liable to tax in respect of the income, and therefore the claim for treaty protection would have emanated from the individual on the basis of that liability. The shareholder would have had to apply the notion of a fragmented entitlement, using the S-corporation's ownership of the income as a factor to support his claim, but the extent of the treaty claim would not have gone further than the lesser of the two fragments.

5.3.1.3. *Linklaters* case³²⁷

A comment on the Indian *Linklaters* case is useful here, as this case looks superficially very much like the *TD Securities* case. *Linklaters* was a partnership based in the United Kingdom, which rendered services to clients in India. Much of the decision in this case was concerned with the extent to which the India–United Kingdom treaty allowed India to tax the fees paid by the Indian clients, but the interesting issue for the purposes of this discussion was the initial entitlement of the firm to the benefit of the treaty.

Indian domestic law imposed a tax liability on the partnership in respect of the fees paid by Indian clients. Under the UK domestic law, the amount of tax due on the partnership profit was determined by apportioning the profit to the partners and computing the tax by reference to their personal circumstances, although the tax assessment was issued in the name of the partnership. The tax authority's argument was that the partnership was not entitled

327. *Linklaters LLP v. Income tax Officer – International Taxation Ward 1(1)(2)*, Mumbai, ITA No. 4896/Mum/03 and 5085/Mum/03, 13 ICLR (2010) 245; India: ITAT, 16 July 2010, Tax Treaty Case Law IBFD.

to treaty benefits, because it was not liable to tax in the United Kingdom and therefore not a resident of the United Kingdom for treaty purposes.

Curiously, the taxpayers do not seem to have relied on the *Padmore* case, discussed in 5.2.3., even though it would have provided them with a strong argument. The UK regime for the taxation of partnerships was the same in the years in question in both cases and in *Padmore* it was held that the treaty protection applied to the partnership as such; the protection also extended to the partners in that case because what they received was held to be the same as the partnership's income.

The judge in the *Linklaters* case, however, described the partnership as transparent and described the UK law as taxing the partnership profit "not in its own hands but in the hands of the partners". He therefore looked at the *TD Securities* case, discussed in 5.3.1.1., to support his finding that the partnership was entitled to treaty benefits.³²⁸ As in *TD Securities*, he explicitly took a broad, purposive view of the treaty, rather than a narrow, technical interpretation. He went on to hold that it is the taxability of the income in the treaty partner state that is the vital element, rather than the person in whose hands the income is taxed. He explicitly avoided the question of what would happen if some of the partners were not resident in the United Kingdom,³²⁹ apparently assuming that all the income was taxable there.

At the end of his discussion of this issue,³³⁰ he observed that India had rejected the conclusion of the OECD Partnership Report that it is the partners who are entitled to treaty benefits if the amount of tax is computed by reference to their circumstances.³³¹ That avenue was, therefore not open to him, but he clearly thought that, as the income was taxable in the United Kingdom, treaty protection should be available. His only recourse was to grant treaty protection to the partnership. Like the *TD Securities* case, Arnold finds the *Linklaters* decision "controversial but understandable".³³²

Linklaters does provide support for the basic philosophy of the new approach, but it is not a good illustration of the notion of a fragmented treaty entitlement. The partners were both the owners of the income and

328. For a full analysis of the differences between the *Linklaters* case and the *TD Securities* case, and a comparison with the *Padmore* case, see Nikolakakis, A., "Commentary", 13 ITLR (2010) 245.

329. In Para. 56 of the decision.

330. Paras. 77 and 78 of the decision.

331. Non-OECD Economies' Positions on the OECD Model Tax Convention, Positions on Art. 1, Para. 3.

332. Arnold, B., note 306, at 606.

the persons whose circumstances determined the amount of tax, so under the new approach they would clearly be the treaty claimants. The only element of fragmentation was that the tax assessment was issued in the name of the partnership; this was, in other words, an example of a fragmented tax liability as discussed in 4.3.3., rather than a fragmented treaty entitlement. This is quite different from the *TD Securities* case, in which one company owned the income and another company was taxable on it. What the judge did in the *Linklaters* case was more comparable with granting vicarious treaty benefits, precisely one of the phenomena that the new approach would prevent.

5.3.2. Cross-border fragmentation

5.3.2.1. BNB 1990/45³³³

Case BNB 1990/45, decided by the *Hoge Raad* of the Netherlands, concerned a dividend paid by a company resident in the Netherlands. The original shareholder was a company resident in Canada, but a company resident in the Antilles was interposed after the dividend had been declared but before it became payable, so the dividend was actually paid to the Antilles company. The Antilles company then claimed the benefit of the *Belastingregeling voor het Koninkrijk*³³⁴ (BRK – the “treaty” between the European territory of the Netherlands and the Netherlands Antilles). The dividend article in the BRK did not make treaty benefits conditional on the recipient being the beneficial owner of the dividend, but on the recipient having enjoyment of the dividend, a concept borrowed from the domestic law of the Netherlands, which generally attributes income to the person who enjoys it.³³⁵

The Court refused to apply the full benefit of the BRK, because the Antilles company had been interposed purely for tax avoidance reasons, a decision supported by the finding of the lower court that the Antilles company did not enjoy the dividend. Although the lower court had not stated explicitly

333. *Hoge Raad* 28 June 1989, No. 25 451, BNB 1990/45 (with conclusion by Advocate-General van Soest and comment by Hoogendoorn).

334. *Rijkswet van 28 oktober 1964, houdende Belastingregeling voor het Koninkrijk, Stb. 1964, nr. 425*. The BRK is technically a domestic law adopted by the Kingdom of the Netherlands, but it has the same practical effect as a treaty between the European territory of the Netherlands and the dependencies.

335. Art. 2.1 Wet inkomstenbelasting 2001 (Income Tax Law) and Arts. 7(2) and 17(2) Wet vennootschapsbelasting 1969 (Company Tax law). For an extensive discussion of this concept, see Appendix II.

which party did enjoy the dividend, the *Hoge Raad* found it implicit in the lower court's findings that it was the Canadian company that enjoyed it. The Court did not refuse treaty benefits altogether, however, but went on to observe that, if the dividend had been paid to the Canadian company, that company would have been entitled to the protection of the Canada–Netherlands treaty. To that extent, therefore, the BRK was not being used for tax avoidance purposes and the Court accordingly granted the protection that would have been available to the Canadian company under the treaty with Canada.

The Court did not go so far as to state that the treaty with Canada applied rather than the BRK, maybe because the dividend was not “paid to” the Canadian parent, as required by that treaty³³⁶ at the time. Indeed, one of the objections raised by the tax authority to the solution found by the Court was that the implementing regulations for the two treaties were different. The Court did not find this a sufficient obstacle, however, stating explicitly that it did not matter that the benefits were being given to the extent available under the Canadian treaty but in accordance with the implementing regulations for the BRK.³³⁷

5.3.2.2. The new approach

This case can also be used to illustrate the notion of a fragmented treaty entitlement, although the fragmentation arose in a different way from the *TD Securities* case. So whereas, in that case, the fragments were both found within one state, in this case they were found in two different states. And whereas, in *TD Securities*, the fragmentation was caused by the flow-through attribution imposed by the legislation of the residence state, in this case it was caused by the view of the source state as to which party had enjoyment of the dividends in question. In both cases, however, the fragmentation split the liability to tax on the income from the ownership connection with the income that supported a claim to treaty benefits.

336. Art. VII of the Canada–Netherlands treaty of 2 April 1957.

337. In Austria a comparable case has been heard by the *Verwaltungsgerichtshof*, but the case was referred back to a lower court because the tax avoidance purpose had not been sufficiently established by the tax authority. The *Verwaltungsgerichtshof* did state, however, that if it were clear that an interposed company did not exercise real functions, then domestic anti-avoidance law would apply to attribute its income directly to its shareholders. Austria: VG, 10 December 1997, Case 93/13/0185, Tax Treaty Case Law IBFD.

In BNB 1990/45 the Antilles company bore a tax liability in respect of dividends, albeit at a low rate, but was not regarded by the Netherlands as having enough of an ownership connection with the dividends to support a claim to treaty protection. The Canadian company had a sufficient ownership connection, as it was regarded by the Netherlands as the person that enjoyed the dividends, but was not liable to tax on them. In other words, these two companies between them had all the features that would give entitlement to treaty benefits, yet neither of them would be able to claim the benefit of their respective treaty.

In these circumstances there would be no policy reason to deny treaty benefits altogether, as the Netherlands had concluded a treaty with both states. The personal connection between both companies and their respective residence states was not in issue. The concept of a fragmented treaty entitlement could be applied, provided the Canadian company would have been entitled to the protection of the Canadian treaty if it had received the dividends directly as shareholder. If, for example, the Canadian company had a legal form that was excluded from the scope of the Canada–Netherlands treaty, the notion of a fragmented entitlement could not be applied. Assuming that that was not the case, however, the two fragments could be aggregated to form one full treaty entitlement. The level of treaty protection would reach only as far as the lesser of the two fragments, in this case the protection given by the Canadian treaty. In other words, the new approach would give the same result as the Court, but it would not be necessary to read words into the treaty in order to achieve that result.

The result set out here is only the view from the Netherlands, and the question remains of the treatment of the Antilles company and the Canadian company in their respective residence states. The Antilles company would be entitled to a credit for the tax levied in the Netherlands, although the amount that is creditable in the Antilles would probably remain limited to the amount that would have been levied in the Netherlands if the entire treaty entitlement had been found in the Antilles. Canada would undoubtedly tax the Canadian company on income received from the Antilles company, but it seems unlikely that Canada would regard that income as being substantially the same as the dividend paid by the Netherlands company. If it did do so, however, it would have to determine whether it would grant double tax relief in respect of both the Netherlands tax and any tax levied in the Antilles on payments received from the Antilles company. These mismatches are probably not capable of resolution through the new approach, but again simply illustrate the problems of applying a bilateral treaty network to a multilateral world.

5.3.3. Other fragmentations

The discussion so far about the notion of fragmented treaty entitlement concerns situations in which the tax liability in respect of income is split from the ownership connection with income. Other types of fragmentation are also possible, albeit less probable, but one example is a provision in the limitation-on-benefits article in the Netherlands–United States treaty.³³⁸ The active business provision of this article provides that activities carried on by a person connected with the treaty claimant are deemed to be carried on by the treaty claimant. The treaty, in other words, recognizes that one of the fragments of treaty entitlement required by the limitation-on-benefits provision, carrying on an active business, might belong to a different person and allows that fragment to be aggregated with the characteristics of the treaty claimant in order to come to a full treaty entitlement.

Finally, some consideration might be given to a rather different angle on the notion of a fragmented treaty entitlement, namely whether a treaty entitlement that is already complete can be enhanced by adding supporting factors of another person in order to claim more favourable treaty benefits. This possibility would be rare in practice, but one example is a signed “record of discussions” between Japan and the United States.

The Japan–United States treaty of 2003 allows source state taxation of interest up to a maximum of 10% as a general rule, but prohibits source state taxation of interest paid to certain financial institutions.³³⁹ One of the conditions for the residual category of financial institutions concerns the assets of the institution. In a record of discussions signed between the two states,³⁴⁰ the two states have agreed that this condition can be fulfilled by looking at the assets of a company claiming treaty benefits on a consolidated basis together with its subsidiaries. The treaty claimant can, in other words, use the character of a qualifying financial institution of its subsidiaries in order to support its own claim. The difference between this provision and the provision in the treaty with the Netherlands discussed above is that here this fragment is added to a full treaty entitlement in order to claim a more favourable treaty benefit.

338. Art. 26(4)(c) Netherlands–United States treaty of 18 December 1992, as amended by protocols of 13 October 1993 and 8 March 2004.

339. Art. 11(3)(c) Japan–United States treaty of 6 November 2003.

340. Record of discussions (with respect to the Convention between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income Signed at Washington on November 6, 2003) of 19 May 2004. See also: Bell, K.A., “U.S., Japan use Novel Approach to Clarify Treaty”, 34 *Tax Notes International* 9 (2004), p. 921.

5.4. Trusts³⁴¹

5.4.1. Introduction

The tremendous flexibility of the trust concept makes it difficult to capture in any tax system, and the application of treaties is no exception. It is particularly the enormous range of powers and obligations that trustees may have in respect of trust income that makes trusts such a difficult concept to deal with in any system of law relating to income taxation.³⁴² At one end of the scale are trusts in which the trustee is obliged to hand specific income over to a specific beneficiary as soon as it arises, and at the other end of the scale are trusts in which the income is accumulated and capitalized so that no beneficiary ever receives it as income. In between there is an enormous range of obligations and discretions to deal with the income in various ways. The many different ways in which domestic systems deal with the taxation of trust income add a further layer of complexity to an already complex problem in respect of the drafting of treaties.

One issue is, however, extremely clear in respect of trusts, and that is the need to draft treaties to apply to taxable capacities rather than persons, as discussed in 4.2.1. Trusts are the primary example of this point, as the separation between the trust estate and a trustee's own estate lies at the heart of the trust concept. This separation is reflected in the domestic tax law of the major common-law countries that are mentioned below, with Canada and the United States treating a trust as a fictitious person for tax purposes,³⁴³ whereas the others tax the trustees as a body of persons. This difference should not make any difference to the application of the new approach to treaties, except perhaps that treatment as a fictitious person makes it clearer that a separate taxable capacity is in existence. One difficult issue in the current treaty framework in respect of trusts is the residence of trustees for treaty purposes,³⁴⁴ but this issue is not discussed here as it goes too far

341. For a detailed discussion of the problems of applying the current treaty framework to trusts, see: Avery Jones, J.F., et al., "The Treatment of Trusts under the OECD Model Convention", 29 *European Taxation* 12 (1989), pp. 379-405. See also: Cadesky, M., and Pease, R., *Trusts and International Tax Treaties* (Haywards Heath, United Kingdom: Tottel Publishing, 2006); and Prebble, note 10.

342. Cadesky, M., "Introduction and overview of issues", in: Cadesky and Pease, note 341, p. 1 et seq., at p. 15.

343. In Canada, Sec. 104(2) Income Tax Act; in the United States Sec. 7701(a)(1) Internal Revenue Code. Canada deems a trust to be an individual, whereas the United States deems a trust to be a legal person but imposes tax on it in the same way as on an individual.

344. See, for example, Avery Jones et al., note 341; Prebble, note 10; Boidman, N., and Kandev, M.N., "The Canadian decision in RCI Trust and Treaty Residence", 55

outside the scope of this thesis. It is, however, undoubtedly easier to answer once the taxable capacity of a trustee has been separated from the trustee's personal taxable capacity.

This section focuses on the taxation of trust income in the major common-law jurisdictions, as trusts pose further issues for civil-law jurisdictions which take the discussion too far away from the core of this thesis. Section 5.4.2. discusses the broad lines of the domestic systems of common-law countries and considers how a treaty should apply to the main systems if the trust income is taxed in the hands of the trustees and/or the beneficiaries. The following subsection delves further into the justifications for the application of treaties to trustees, and the final subsection considers the issues raised by domestic law that attributes trust income to the settlor. The discussion assumes throughout that all the persons involved clearly have a personal, or residence, connection with one state only and that the source of the trust income is not in dispute.

The remainder of this section is written with not a little trepidation, bearing in mind the warning given by a respected commentator, David Ward, that “[t]he OECD and others should not underestimate the difficulty of finding widespread support for provisions to be included in the OECD Model that would deal adequately and fairly with the taxation of trust income while avoiding double taxation.”³⁴⁵ He issues this warning because there is so little uniformity in the taxation of trust income, even in the countries that have known the concept for centuries, that it would be extremely difficult to create a structure of general application that is capable of dealing with all the particularities of the issue. Nevertheless, it is submitted that this task does become easier once the basic structural flaw of the OECD Model has been identified and mended.

5.4.2. Different domestic systems³⁴⁶

The major common-law countries all pursue the same broad policy goal in respect of trust taxation, namely to tax income passing through a trust once only, preferably at a level appropriate to the beneficiary who receives

Tax Notes International 4, pp. 299-303; Wyse, M., “Settling problems of dual residency under the Canada-U.S. treaty”, 53 *Tax Notes International* 6, pp. 531-3.

345. Ward, D.A., “Canadian Domestic Law Provisions and Canadian Tax Treaties dealing with the Income of Trusts” in: Cadesky and Pease, note 341.

346. For overviews of the domestic tax systems of the countries discussed in this section see: Gillies, note 211; Tomlinson, Morrison, and Alston, note 211; Hardy, note 211; and Brown, C., *Canada – Trusts* sec. 4.3., Hickson, J.H., *Ireland – Trusts* sec. 4.3., and

it. The mechanisms for achieving this goal vary considerably, however, and different systems may sometimes be found within one country.

What also varies considerably is the extent to which the income received by the trustees is taxable in the hands of the beneficiaries as if it were received by the beneficiaries directly from the source. At one end of the scale is income to which a beneficiary is immediately entitled as it arises to the trust; in this case it is generally true that the beneficiary is taxed as if he received the income directly, although in Canada the income acquires a different character as it passes through the trust unless the trustees make an election for it to retain its character. At the other end of the scale is income that is accumulated by the trustees and capitalized; this income never reaches a beneficiary as income and, if it is to be taxed as income, the only possibility is to tax the trustees or trust. In the middle of the scale it is tempting to say that almost anything is possible; certainly there are myriad variations in the way that the income is attributed between the trust/trustees and the beneficiaries and variations as to whether the income retains its character as it passes through the trust. In addition to this range of possibilities, the distinction made by most common-law countries between recurrent income and capital gains often causes complications in determining the attribution of trust income and gains. The many foreign elements that can be introduced into the flow of income through a trust add yet another layer of complexity.

In the current treaty framework, one of the main problems arises when it is the trustee who is taxable on the trust income, particularly in respect of passive income. The trustee is clearly the legal owner of the income, but not the equitable owner. Very often, when the trustee is the taxable person, the income has not yet been distributed to any beneficiary, which makes searching for a beneficial owner for the purposes of Arts. 10, 11 and 12 OECD Model rather a perplexing exercise. This problem is perhaps an inevitable consequence of defining the route to treaty entitlement on the basis of the ownership of income, given that the trust concept not only has a parallel ownership at its core, but also allows one layer of that ownership to be divided among the beneficiaries in an almost limitless variety of ways.

One possibility for applying a treaty in the current framework is to wait until the trust income is distributed to a beneficiary and apply the treaty to the beneficiary at that time, but there seems to be a general expectation that a treaty can be applied as the income is paid out of the source state.

Kozusko, D.D. and Vetter, S.K., *United States – Trusts* sec. 4.3., Topical Analyses IBFD (accessed 4 April 2011).

Baker has suggested a mechanism specifically to deal with this problem, which would allow the adjustment of the source state withholding tax if this proves to be necessary within a certain number of years after the income is paid.³⁴⁷ If the distribution is made after that period the incorrect treaty application in the source state would be accepted. The more practical solution is to apply the treaty to the trustee, and indeed New Zealand includes a provision in most of its treaties that deems the trustee to be the beneficial owner of income that is taxable in the hands of the trustee.

It is of course true that the application of treaties to trusts has to be capable of accommodating all the different domestic systems and their complexities, but stating the problem this way creates an unfortunate suggestion that first a treaty structure has to be created and subsequently all the various domestic approaches to trust taxation have to be made to fit into the chosen treaty structure. The preferable approach, however, is to start from the choices made by the domestic law of states and to allow the treaty consequences to flow from those choices. So if a domestic policy choice is made to treat trust income as if it flows directly to a beneficiary, the treaty should follow suit and look to the beneficiary as the potential treaty claimant. The different routes set out in this subsection for determining the application of treaties to trusts under the new approach are, in other words, an inevitable part of a system in which treaties build on the foundation of domestic law, and should not be regarded as a systemic flaw.

5.4.2.1. Representative liability

Although the systems discussed in the following three subsections are the main tax systems for taxing trusts in the major common-law countries, there are also situations in these countries in which trustees are taxable on trust income as the representative of a beneficiary. This is the case in the United Kingdom, for example, if a trustee holds property on a bare trust for a minor or incapacitated individual³⁴⁸ and, if the appropriate election is made, in respect of certain trusts for vulnerable beneficiaries.³⁴⁹ It is also the case in Australia if the trustee holds property for a beneficiary under a legal disability or if the beneficiary is deemed to be presently entitled to the trust income.³⁵⁰

347. Baker, P., "An Approach to the Application of Double Taxation Conventions to Trusts", in: Cadesky and Pease, note 341.

348. Sec. 72 Taxes Management Act 1970.

349. Secs. 23-45 Finance Act 2005.

350. Sec. 98 Income Tax Assessment Act 1936. The concept of a beneficiary being presently entitled to trust income is the key concept in determining whether it is the

In these cases, the tax liability is imposed on the trustee, but the amount of the tax charge is computed by reference to the personal circumstances of the beneficiary. In the current treaty framework there is a question as to whether the trustee or the beneficiary is the correct person to claim treaty benefits. Under the new approach, this situation is a clear example of fragmented tax liability, as discussed in 4.3.3. The beneficiary is the treaty-entitled person, as it is the beneficiary's personal circumstances that determine the amount of the tax liability. In the cases in which this system is applied, the beneficiary's claim to treaty protection would usually find sufficient support in the beneficiary's equitable entitlement to the income.

5.4.2.2. Initial choice system

The basic system of some states, notably Australia and New Zealand, is to make a choice as trust income arises as to whether to tax the beneficiary or the trustee.³⁵¹ In broad terms, the income is attributable to a beneficiary if the beneficiary is entitled to the income as it arises or if it is actually distributed to the beneficiary within the tax year or a short period after the end of the tax year. As it is the trust income itself that is attributed to the beneficiary, it keeps its characterization for tax purposes. If the income is not directly attributed to the beneficiary, the trustee is taxable in respect of the income, and no further tax charge is imposed if the income is later actually distributed to a beneficiary. Ireland and the United Kingdom also in practice often tax the beneficiary directly and do not tax the trustee if the beneficiary is entitled to the trust income as it arises and it is paid directly to the beneficiary.

The application of the new approach to a domestic system such as these is relatively easy. The choice between the trustee and the beneficiary determines which person is potentially entitled to treaty benefits. If the beneficiary is the taxable person, that claim to treaty entitlement is easily supported by the beneficiary's equitable ownership of the income.

If the trustee is the taxable person, the claim to treaty benefits may be supported by the trustee's ownership of the income, as the new approach does

trustee or the beneficiary who is taxable in respect of trust income. A beneficiary has present entitlement if he is legally able to claim the trust income as it arises. The legislation (Sec. 95A(2) Income Tax Assessment Act 1936) also deems a beneficiary to have present entitlement in certain circumstances, for example if the beneficiary has a vested interest but the income cannot be distributed until the beneficiary reaches a certain age. 351. In Australia, Div. 6, Income Tax Assessment Act 1936; in New Zealand, Subpart HC Income tax Act 2007.

not necessarily require the person claiming treaty benefits to benefit personally from the income. All it requires is that the trustee's liability to tax on trust income is acceptable to the source state as a basis for treaty benefits. In these systems, trust income is not attributable to trustees if their only duty is to collect the income and hand it over to the beneficiary; the attribution to the trustee implies, in other words, that the trustee has at least some control over the application of the income, and that control should be sufficient for treaty purposes.³⁵² If the source state has difficulty accepting the tax liability on the trustee as basis for treaty entitlement, it might alternatively view this situation as an example of fragmented treaty entitlement and allow the trustee to claim the benefit of the treaty using the equitable ownership of the beneficiaries to support the treaty claim. The issue of treaty entitlement for trustees is discussed further in 5.4.3.

5.4.2.3. Credit system

The basic system of Ireland and the United Kingdom is to tax both the trustees on trust income and the beneficiaries on distributions, but to grant a credit to the beneficiary for tax paid by the trustee,³⁵³ although both countries sometimes tax the beneficiary directly if the beneficiary is entitled to the trust income as it arises and the income is paid directly to the beneficiary. If the beneficiary is entitled to the income as it arises, the distribution often has the same characterization as the trust income, but if the distribution is made at the discretion of the trustee it may have a different character. Australia also applies a credit system in some cases, in order to prevent the use of trusts to achieve income splitting; if an individual subject to a legal disability derives income from more than one trust, the beneficiary is liable to tax on the whole income derived in this way and may credit the tax payable by the trustees.³⁵⁴

Under the new approach, to the extent that the trust income is distributed to a beneficiary, it would be preferable to regard the beneficiary as the person entitled to treaty benefits as it is the beneficiary's circumstances that determine the definitive amount of tax on the income. Even if the income changes its character as it passes through the trust, the credit system implies

352. See also Appendix II, Section 5.4.5.2., which argues that the control of trustees over the application of income can be comparable with economic entitlement to income.

353. There is no legislation in the United Kingdom that provides this credit, although in practice it is clear that it is available; Gordon, Montes Manzano and Tiley, note 169, Sec. 14.15. As regards Ireland, see: McAvoy and Associates, note 181.

354. Sec. 100 Income Tax Assessment Act 1936. In this case the trustee of each trust is liable to tax as the representative of the beneficiary.

that the receipt of trust income and the distribution to the beneficiary are regarded as one flow of income. The tax liability on the trustee would be disregarded as a basis for treaty protection because it is only a temporary liability, as discussed in 4.3.2.

The problem with this solution is that it is not always possible to determine which trust income is distributed to which beneficiary. Sometimes there is a close correlation between the trust income received by the trustees and the distributions to beneficiaries, for example because the beneficiary is entitled to the income as it arises or because the trustee exercises his discretion to distribute specific income, and in these cases there is no difficulty with the claim to treaty protection emanating from the beneficiary. It is also possible that, even if under trust law it is not clear which income is distributed to which beneficiary, a solution can be found in the domestic tax law of the state where the trust is situated which allocates specific items of trust income to specific beneficiaries.

But if no correlation can be made between the income received by the trustee and a distribution made to a beneficiary, it is not possible in practical terms to regard the beneficiaries as the treaty claimants. This could be the case if, for example, the distributions are made at the discretion of the trustee and they are not clearly made out of a specific source of income. It is also possible that the income is not distributed at all, but instead accumulated in the trust; in this case the tax liability on the trustee is not temporary and could not be disregarded on that ground. The timing problem discussed above also plays a role here, as it might simply not be known for a time whether the income will be distributed or accumulated.

In these cases, the only practical solution is to grant treaty protection to the trustees, although the basis for doing so may vary. If it is clear that the income will be accumulated, the same considerations apply as in respect of the treaty entitlement of trustees as discussed in 5.4.2.2. In other cases, the trustees may have a sufficient ownership connection with trust income, due to their control over the way in which it is applied. Alternatively, some states may wish to look to the equitable entitlement of the beneficiaries in order to apply the concept of a fragmented treaty entitlement. In the latter two cases, the tax liability of the trustees would still often be temporary, even though it might not lead to a beneficiary credit for a very long time, but this temporary liability would be aggregated with the future permanent liability of the beneficiaries to form a complete entitlement to treaty protection. If the beneficiaries are not all resident in the same state as the trust/trustees, the use of the fragmented treaty entitlement notion could lead

to some very complex determinations. For practical reasons, therefore, in non-abusive situations states might be willing to use some approximations of the supporting tax liability and equitable ownership of the beneficiaries.

5.4.2.4. Deduction system

The final system for taxing trust income that has to be considered is that of Canada and the United States, which tax both the trust on trust income and beneficiaries on distributions, but which allow the trust a deduction for distributions out of current income to beneficiaries.³⁵⁵ Both countries allow this deduction in respect of income to which a beneficiary is entitled as it arises to the trust and distributions that are actually made within a certain period after the income arises.³⁵⁶ In the United States a trust is regarded as a conduit to the extent that it distributes income to its beneficiaries, and domestic law specifies how the characterization of the trust income is to be carried through to the beneficiaries. In Canada, by contrast, the general rule is that distributions take on a new character, although the trustees may elect for distributions to retain the character of the trust income.

A deduction system carries less of an implication than a credit system that it is the same income flow that is taxed in the hands of both the trust and the beneficiary. Nevertheless, to the extent that this system pursues the same policy goal of taxing trust income in the hands of a beneficiary, it should again be the beneficiary that is the treaty-entitled person. If it is clear that a specific item of trust income flows through to a specific beneficiary, this result is easily achieved. The tax liability of the trust on the trust income would be disregarded, because the deduction allowed for the distribution reduces its liability to zero and that tax liability is therefore not sufficient to give entitlement to treaty benefits. The beneficiary, on the other hand, would have both the tax liability and the equitable ownership of the income that gives entitlement to treaty benefits.

The problem with this solution is that it may be difficult to combine with the domestic systems of Canada and the United States. There would be no

355. In respect of the application of treaties to trusts from a Canadian and a United States perspective in the current treaty framework, see: Ward, note 345; and Goldberg, S.H., "US Taxation of Trusts under Income Tax Conventions", in: Cadesky and Pease, note 341, pp. 164-74.

356. The United States also allows a deduction to foreign trusts for distributions made out of accumulated income, but this aspect is not considered further here as it does not introduce any other considerations of principle. For a further explanation see: Kozusko and Vetter, note 346 sec. 4.3.2., (accessed 21 April 2011).

problem in Canada if the trustees do indeed elect for distributions to retain the character of the trust income, as in this case it would be clear how the trust's income correlates with its distributions. In the United States, the problem is that domestic law characterizes distributions to beneficiaries in proportion to the income received by the trust, which may make the correlation between income and distributions complex.

If the correlation cannot be made in a satisfactory manner for treaty purposes, the answer, as with the credit system, is to regard the trust as the treaty-entitled person. Similar considerations apply in this respect as in respect of the credit system: if it is clear that the trust income will be accumulated, the trustees are the only persons who could claim treaty protection in respect of the income. In cases in which the problem is the difficulty of correlating the trust income to distributions, the notion of a fragmented treaty entitlement would apply, with the same problems and practical solutions.

5.4.3. Treaty entitlement of trustees

The previous subsection already touched briefly on the possibility that the beneficiaries of a trust are not resident in the state where the trust is situated. This possibility raises the interesting issue of whether treaty benefits should be granted in respect of trust income if the trust's only connection with a state is the residence of the trustees/trust there. Should it be possible, in other words, for trustees to be able to claim treaty benefits in respect of trust income in their own right? This question is the treaty equivalent of a domestic jurisdictional issue, namely whether the residence of the trustees/trust in a state is sufficient, on its own, to bring the trust income into the state's tax net.

This jurisdictional question arose in the United Kingdom in an old House of Lords case, *Williams v. Singer*,³⁵⁷ which concerned UK resident trustees who held foreign-situs assets for a non-resident beneficiary. The only jurisdictional connection of the trust with the United Kingdom was therefore the residence of the trustees. The legislation imposed income tax on the persons "receiving or entitled unto" income, but the trustees did not receive the income because the beneficiary was entitled to the trust income as it arose and the trustees mandated payment directly to her.

357. *A W Williams (Surveyor of Taxes) v. W M G Singer* 7 TC 387.

The issue before the House of Lords was whether the trustees were taxable in the United Kingdom. In holding that they were not taxable, the judges reasoned that the beneficiary would not have been liable to tax in the United Kingdom if she were entitled to the income directly, and therefore the trustees were not liable. Viscount Cave, delivering the leading judgment, said that “a decision that in the case of trust property the trustee alone is to be looked to would lead to strange results” and mentioned some of the anomalies that could arise if the taxation of trust income depended on the trustee. This decision has been criticized by Tiley,³⁵⁸ who argues that it muddles the liability of the trustee with the liability of the beneficiary and that, if this exception to the liability of trustees is correct, it is a very limited one.

The interesting issue in the context of the discussion in this thesis, however, is not whether the decision was correct as matter of UK law, but the question that the case raises about the justification for taxing trustees and, consequently, the justification for granting treaty benefits to trustees. It provides a crystal-clear example of the issue. The beneficiary had absolute entitlement to the income as it arose, so the trustees had no choice about what to do with it. For the trustees to collect the income in order to hand it over to the beneficiary would have been nothing more than an inconvenient detour, so they authorized the source to pay it directly into the beneficiary’s bank account. One could argue that in these circumstances the residence state of the trustees has no business in taxing the income, and it is submitted that this is, in colloquial terms, what the House of Lord did in fact decide. But if Tiley’s criticism is correct, and the trustees should have been taxable as matter of domestic law, should they also have been entitled to treaty benefits in respect of that income?

Prebble has argued that trustees should not be entitled to the application of a treaty in their own right. During a seminar at the 2010 Congress of the International Fiscal Association, Prebble argued that³⁵⁹ that taxing a trustee is only a proxy for taxing the beneficiaries, and therefore a source state should not be required to grant treaty benefits to a trustee if the beneficiaries are not resident in the same state as the trustee. The starting point of Prebble’s argument is that taxation is essentially concerned with human beings. The taxation of trustees (and companies) is only an economic proxy for taxing humans, albeit one that is necessary in order to reconcile the essential aim of taxation with the economic reality of funds being held by

358. Tiley, J. assisted by Loutzenhiser, G., *Revenue Law*, 6th ed. (Oxford and Portland, Oregon: Hart Publishing, 2008), Sec. 29.2.2.

359. The PowerPoint presentation used during this seminar is available to IFA members; see note 238.

these intermediaries. Treaties, like the imposition of taxation in the first place, are concerned ultimately with the human beings who receive the benefit of income. The application of a treaty to trustees should therefore be limited to trustees who are acting as a proxy in the right state, which is the residence state of the beneficiaries; to do otherwise would be to grant treaty benefits inappropriately.

One practical objection to this line of reasoning is that it is difficult to apply if some beneficiaries are resident in the same state as the trustee and some in other states, particularly if the beneficial interests are still indeterminate. The more fundamental objection is that Prebble concedes that domestic tax systems have to impose tax liability on trustees for pragmatic reasons, and it is not clear why that same pragmatism should not be carried through to treaties. In other words, if one accepts the taxation of trustees as economic proxies, as many countries do, then why would one not also accept the application of tax treaties to trustees as economic proxies?

Indeed, an early case from the US Supreme Court, the *Maximov* case,³⁶⁰ held that a trustee resident in the United States came squarely within the scope of the United Kingdom–United States treaty, and that it was quite irrelevant that all the beneficiaries were resident in the United Kingdom. This case concerned a capital gain derived by the trustee, which he was obliged to accumulate in the trust. The trustee had argued that the real burden of the US tax charge fell on the beneficiaries and therefore the treaty should be read as though it applied to the beneficiaries who, as residents of the United Kingdom, could have claimed treaty protection against the US tax charge. This argument was roundly rejected by reference to both the plain words of the treaty and its underlying intent. The result was that the treaty did not prevent the United States from taxing the trustee.

The controversy surrounding the application of treaties to trustees touches the core of the argument in this thesis, namely what it is that causes treaty protection to be available in respect of a specific item of income. The function of treaties, to prevent the overlapping of tax liability by limiting the application of domestic law, implies that one should take the overlapping tax claims as the starting point. On the other hand, in an equal exercise of their taxing sovereignty, states should not be obliged to grant treaty benefits in respect of overlaps that they consider should not have happened in the first place. For this reason, a number of conditions may be attached to the granting of treaty benefits. If a source state considers that another state has

360. *Andre Maximov, Trustee, Petitioner v. U.S.*, 373 U.S. 49; United States: SC, 29 April 1963, Tax Treaty Case Law IBFD.

no business imposing a tax liability on trustees, it can draft the conditions for treaty entitlement accordingly. But if the trustee is the only person who is liable to tax in respect of trust income as such, for example because the income is accumulated and capitalized in the trust, it would be excessively harsh to deny treaty benefits altogether if the beneficiaries happen to be resident in a different state.

The essential point here is not simply that the trustees are trustees, but rather that income may be taxable in the hands of trustees for a variety of reasons. In *Williams v. Singer* the court declined to attribute income to trustees for tax purposes on the strength of their simple legal entitlement to it. Their connection with the income was simply too thin. Similarly, treaty benefits should be denied to trustees if their connection with the trust income is too thin. But if trustees have a more substantial connection with the income, they should not be denied treaty benefits just because they are trustees. In the *Maximov* case the connection of the trustee with the gain was considerably more substantial, as he was obliged to add it to the capital of the trust and to continue to administer the money received for a number of years. This issue highlights, in other words, the major argument of this thesis, that the reason for which income is taxed in the hands of a specific person is an important element in the application of treaties.

5.4.4. Settlor taxation

In most of the major common-law jurisdictions it is also possible that trust income is attributable to someone other than the trustees/trust or the beneficiaries. One of the simplest, and most common, examples is the attribution of trust income to the settlor if the settlor is able to revoke the trust. As discussed in 3.3.3., in the current treaty framework a claim to treaty benefits on the part of the settlor would generally run into the problem that the income is not “paid to” or “derived by” the settlor.³⁶¹ Nor is the settlor the owner of the income in anything but a very indirect way, so it would be rather difficult to argue that he is the beneficial owner of passive income. On the other hand, if the revocability of the trust means that the trustees are not taxable at all on the trust income, there may be a problem in establishing their liability to tax for the purposes of the residence definition.

The new approach, by contrast, would pay attention to the imposition of the tax liability on the settlor. Two possibilities arise. One is that the attribution

361. The United States forms an exception to this general approach, as mentioned in 3.3.2.

of the income to the settlor excludes the attribution of the income to any other person; this is likely to be the case if the settlor, trustees and beneficiaries are all resident in the same state. This is an example of a fragmented treaty entitlement, with all the fragments being found in the same state as discussed in 4.8.2. The liability of the settlor on the income could be supported by the ownership connection of the trustees/trust or the beneficiaries with the income in order to form a full claim to treaty benefits.

The second possibility is that the taxation of the income in the hands of the settlor is in addition to taxation in the hands of the trustees/trust or a beneficiary. This possibility is most likely to be the case if the settlor is resident in a different state from the other parties, with the settlor's residence state attributing the income to the settlor and the residence state of the other party attributing the income to the other party. If the source state accepts both attributions, this is a clear example of a double attribution, which would have to be resolved as discussed in 4.7. As a preliminary issue, however, the source state would have to consider whether it accepts the attribution to the settlor for treaty purposes, and it may find that the ownership connection of the settlor with the income is too remote. Again, this issue highlights the importance for treaty purposes of the reason for attributing income to a person.

If a source state does refuse treaty benefits for a settlor who is taxable on trust income under anti-avoidance legislation, one might expect the settlor's residence state, as the state imposing the problematic attribution, to seek a solution. Of course, this state may take a conscious policy decision not to do so, in order to preserve the deterrent effect of its legislation. But it should not automatically be assumed that a treaty prevents double taxation if the double taxation is caused by a tax charge found by the rest of the international tax community to be unacceptably extreme.

Chapter 6

Conclusion

6.1. The problems with the current approach

Many of the problems of the current treaty framework can be traced back to the excessive importance it places on the person who is entitled to treaty benefits. The current route to determining whether a person is entitled to treaty protection is also not satisfactory because it takes no account of the factor that is most relevant for treaty purposes, namely a liability to tax on the item of income for which treaty protection is sought, although it does place a great deal of importance on a factor that is not relevant to the core function of treaties, namely a person's liability to tax on other items of income. This route also makes an illogical jump, by looking first at the general liability to tax of the person claiming treaty protection and then testing the quality of that person's ownership of the income. The result is that there are gaps in the chain of tests for treaty entitlement, which create a need for states to include limitation-on-benefits provisions, subject-to-tax tests, switchover clauses and back-to-back provisions in their treaties.

Because the current route to claiming treaty benefits makes the wrong connections, the courts have sometimes had to distort the wording of treaties in order to achieve the right policy result. In the *TD Securities* case,³⁶² for example, the court held that treaty benefits were available, even though the wording of the treaty should have led to the opposite conclusion.³⁶³ And

362. Note 121.

363. In the *TD Securities* case the Court, in Para. 46 of the judgment, even noted in respect of the amendment to the treaty that was concluded after the facts of the case arose that "A perhaps surprising and relevant aspect of the Fifth Protocol Amendments is that they are not drafted in a manner that, applied literally, would resolve the problem faced by TD LLC or other US LLCs in later years to which the Fifth Protocol Amendments apply and this is acknowledged in the Technical Explanation. Under the Canadian Act, TD LLC is the legal entity that is the taxpayer required to prepare and file a Canadian income tax return in respect of its Canadian branch profits. The Fifth Protocol Amendments are clearly intended to ensure the LLC's income enjoys the benefits of the US Treaty. Yet, the Fifth Protocol Amendments do not provide that the LLC will be treated as a resident. To that extent TD LLC and other US LLCs will still not be able to get treaty relief if one seeks to apply the text of the treaty literally." The Court then went on to explain that treaty relief was achieved by, in essence, distorting the words of the treaty and the protocol. In Para. 49 of the decision the Court said "as the two countries are turning their minds to the wording of new provisions being drafted contemporaneously with the administrative provisions, they are content relying upon a sensible approach to

in the Netherlands case BNB 1990/45³⁶⁴ the court used a form of derivative benefits reasoning to reach its answer that was derived entirely from policy considerations, rather than anything in the treaty itself. One of the most striking aspects of the discussion in 5. of decided cases is how often the courts came to a conclusion that was in accordance with the new approach, even though they had to struggle with the wording of the current treaty framework to do so.

The current wording of treaties has also led to courts applying treaty provisions to situations for which they were not written. The double tax relief article, for example, is designed to oblige a residence state to give relief in respect of tax levied by the source state, but in the UK *Bayfine* case³⁶⁵ the court had to apply it to a case in which there were two residence states. Similarly, the capital gains article is designed to regulate overlapping tax claims of a situs state and a residence state on the same person, but much of the argument in the UK *Smallwood* case³⁶⁶ was about the application of this article to a situation in which the same gain was attributed by the two contracting states to different persons.

6.2. The new approach

6.2.1. The essence of the new approach

The proposed approach avoids the problems of the current treaty framework by mapping out a logical and coherent route through the various elements of entitlement to treaty benefits. It starts from the problem that the distributive rules of treaties are designed to solve, namely the overlapping tax claims of the contracting states. It then sets out the conditions that have to be fulfilled in order to substantiate a claim to treaty benefits. These conditions test the acceptability of the tax claim as a basis for treaty benefits, by looking both at the liability itself and at the circumstances that connect the income with the taxing state.

By starting from the tax liability, rather than a person, the new approach is rather more objective than the current treaty framework. It acknowledges that the fundamental point is a concurrent tax liability on one item of in-

the application and interpretation of the words and not the strict meaning or result of the words chosen for the treaty.”

364. Note 333.

365. Note 253.

366. Note 147.

come in the two contracting states to a treaty and the complex of factors that connects the income with the states wishing to tax it. The attribution of income to a person is necessary in order to make the link between income and a residence state, but the person should not be the focal point. For treaty purposes the important question is why a state imposes a tax liability in respect of income and whether another state finds that tax liability an acceptable basis on which to grant treaty benefits. The person on whom the liability is imposed is only one part of that determination, and a sufficient connection could also be established by aggregating the attributes of more than one person.

The explanation of the new approach given here has assumed that a liability to tax in respect of the income would be the usual starting point for treaty entitlement, but that in exceptional cases a state might be prepared to grant treaty benefits in the absence of a tax liability in the other state. States could also make a conscious policy decision to turn this exceptional case into a general rule, by looking directly at the connecting factors. Taking this as the standard approach would, however, require decisions about which connections are generally acceptable as a basis for granting treaty benefits and would, in effect, require states to define some international norm for the imposition of a tax liability. Some of the cases discussed in 2.3.4. suggest that this might already be a tendency in the current treaty framework.

One of the attractions of the new approach, by contrast, is that it respects the sovereignty of states by taking as its starting point what they actually do in their domestic law. It also respects their sovereignty by not requiring an unquestioning acceptance of the domestic law of another state as a basis for granting treaty benefits. States should undertake this determination bearing in mind the aim and spirit of treaties, and therefore should not limit their acceptance to tax liabilities that are an exact match of their own domestic law. If a state does find the tax liability of another state unacceptable, the result might be that the double taxation is not relieved. But at least this result stems from the correct problem, namely the disagreement between the states as to the justification for the tax liability, rather than an inability to deal with an inappropriately worded treaty.³⁶⁷

367. States that find themselves unable to obtain treaty benefits in respect of certain types of tax liability could pursue the solution adopted by the United States in respect of its citizenship taxation and seek a treaty provision allowing the imposition of this liability but subject to the granting of double tax relief in respect of the tax charge in the treaty partner state, thus giving the contentious tax liability the lowest priority.

By requiring that some attention be paid to the substantive grounds on which an attribution of income is made, the new approach also makes it possible to resolve conflicts in this respect. The current treaty framework has the residence tiebreaker rules to deal with situations in which two states claim a residence connection with one taxpayer. It also has some provisions which deal implicitly with the source of income, although problems may still arise if two states disagree, for example, as to where royalties arise. But the current framework pays no attention at all to the possibility that states may attribute income to a person on the basis of different factors, or different interpretations of the same factor. Yet it is the attribution of income to a person that creates the link between two states and thereby determines which treaty applies, if any. For this reason alone, it is high time that some explicit thought is given to this issue.

The new approach possibly puts even more pressure than the current treaty framework on a pressing issue in respect of treaties, namely the different acceptance levels of domestic law and treaty law of tax liabilities imposed on a formal basis. The clearest example is the taxation of the worldwide income of companies on the basis of their incorporation in a state, even in the absence of any activity there. Many states impose tax on this basis under their domestic law, but are reluctant to grant treaty benefits to such a company incorporated in a treaty partner state. This discrepancy even calls into question one of the assumptions behind the new approach, that if it is justifiable to impose tax on an item of income it is also justifiable to grant treaty protection in respect of the income. Maybe the solution is simply to accept that the reach of a state's treaties is not necessarily coexistent with the reach of its domestic tax system, and to word the conditions for entitlement to treaty benefits accordingly.

6.2.2. Issues with the new approach

The new approach requires explicit answers to a number of policy choices, some of which arise only implicitly in the current treaty framework. One of the most obvious choices is the acceptability of the various connecting factors that have been named in this discussion, both in respect of the connection between income and a person and between a person and a state. Another policy issue is whether a double attribution under domestic law should give rise to two treaty entitlements, or whether the treaty system should aim to find one treaty attribution only in respect of any given item of income.

It is not the purpose of this paper to answer all these questions, but only to highlight the choices that would have to be made. States, treaty negotiators, the OECD and the UN would have to consider these questions and come to, preferably, consistent answers. There are many decisions to be made, but one of the advantages of the new approach is that it raises the right questions.

Although the new approach offers many advantages over the current treaty framework, it would not create a tax treaty utopia. The main problem is that it puts pressure on the identification of the item or stream of income on which a liability to tax is imposed. This pressure is, however, one that is already there. Furthermore, the difficulty of defining an income stream is “only” a difficult problem of drawing a dividing line between one flow of income and two different items of income. However difficult the line is to draw, this is a qualitatively different problem from the fundamental flaw in the current OECD Model. It is the same difference as that between using a tool which requires skill in its handling and using a tool which is broken.

One problem that the new approach of course cannot solve is that the treaty network consists of bilateral agreements to prevent double taxation in an increasingly multilateral world. Just as in the current treaty framework, there would be plenty of scope for mismatches among the treaties that apply in a multilateral situation. The only solution for this problem is to press for consistency through bodies such as the OECD and the UN. Similarly, the new approach does not solve the problem noted in 5.4.2. in respect of trusts, that there is a general expectation that treaties can be applied immediately, whereas the facts on which their application is based are maybe not known for some years. Nor can it solve problems like those noted in 5.2.2.3. in connection with the *Russell* case, that a mismatch of attributions may lead to other, consequential mismatches between the domestic law of the two states.

6.3. The way forward

The new approach could not be introduced on the basis of the existing text of the OECD Model, as it simply does not fit with the current wording. A new version of the Model would therefore be necessary and Appendix I makes a suggestion in this respect. In drafting this text the wording of the current Model was retained as far as possible, but this exercise demonstrates that a rigorous introduction of the new approach necessarily leads to a radical re-structuring of the Model.

The practical problems of redrafting the OECD Model in this way are, of course, enormous. Not only would it require the development of a substantial new body of law in respect of the new approach, but it would also raise questions about a possible *a contrario* interpretation of the thousands of treaties that have already been concluded using the current structure.

But the new approach suggested here is not intended to be immediately adopted in practice. It is, rather, offered in order to contribute to the debate about entitlement to treaty benefits and to provide a sharper focus on the problems that beset the current treaty structure in this respect. The new approach cannot do away with the need to draw difficult dividing lines, and doubtless many questions can be asked about its detail and many practical difficulties discovered in respect of its application. But these problems are insignificant by comparison with the fundamental flaw of the current treaty structure, which is missing its keystone and can therefore never be entirely stable.

Appendix I

Draft Treaty Text and Commentary³⁶⁸

The following text is offered as an experimental model for implementing the new approach suggested in this thesis; the operative parts of the new approach are found in Arts. 1, 3, 4, 5A to 5D and 23. Commentaries have also been written in respect of these articles which include both references back to the chapters of the book which explain the background to the specific treaty provision and notes on points which would require some further explanation in order to explain the nuances of the new approach.

This text also includes Arts. 6 to 21, which are subject to some comparatively minor amendments and which do not have any commentary. The substance of Arts. 6, 7 to 16 and 18 to 21 has not been changed; these articles have only been reworded to make the attribution terminology consistent so that they all refer to income “derived by” a resident of a contracting state and, in Arts. 10 to 12, to remove the beneficial ownership requirement. Some of these provisions remain completely unchanged, but they are included for the sake of completeness or ease of reading and are marked as unchanged. The two paragraphs of Art. 8 grant the exclusive taxing right to the residence state rather than to the state in which the place of effective management of the enterprise is situated; this change is a natural consequence of adopting material criteria in the definition of “residence” in Art. 5C. The two paragraphs of Art. 17 have been forged together into a single provision which is more in keeping with the new approach.

The text suggested here covers only the basic framework of the new approach; much more detail would be required, either in the treaty text itself or in a commentary, to capture all its nuances. The main operative articles for the new approach have been written on the basis that treaty entitlement follows only from a liability to tax in one or both Contracting States. If the policy decision was made to extend treaty protection in the absence of a tax liability, as discussed in 4.5, it would be necessary either to amend these articles or to add extra articles to the treaty. Further, the text is written as if the treaty does not apply to the taxation of capital and as if

368. The author wishes to express her gratitude to Dan Berman (Boston University School of Law), Jacques Sasseville (OECD) and Wim Wijnen (IBFD) for their comments on earlier drafts of this treaty text and commentary. The text and commentary presented here remain, however, the sole responsibility of the author.

neither contracting state makes any distinction between income and capital gains; adaptations would be required if these assumptions were not correct.

Chapter I – Scope of the Convention

Article 1 – Income covered

This Convention shall apply to income derived by persons who are residents of one or both of the Contracting States.

Commentary

This article makes the fundamental change from the OECD Model that is required by the new approach; it states that the Convention applies to income rather than to persons. Nevertheless, the article does refer to persons, as the connection between income and a residence state that has to be made in order to determine whether or not the Convention applies is made through a person. In this respect, the new approach follows the OECD Model, in that it does not apply to resolve a conflict between two states which both wish to tax income on the sole basis that the source of the income is in the state. As mentioned briefly in 4.3.1., there seems to be no compelling conceptual reason that prevents treaties from being extended to resolve such source conflicts, but no attempt to extend the treaty text in that way has been made here.

This article introduces a number of concepts which are essential to the new approach and which are defined in later articles. A new definition of “person” is included in Art. 3, the term “derived by” is defined in Art. 5A and an adapted definition of “resident” is given in Art. 5C.

Chapter II – Definitions

Article 3 – General definitions

1. For the purposes of this Convention, unless the context otherwise requires:
 - a) the term “person” means an individual, legal person or arrangement which, under the law of one or both Contracting States, may be assessed to tax. If such a person may be assessed to tax in two or more separate capacities then, for the purposes of this Convention, the person shall be regarded as a separate person in respect of each such capacity. A permanent establishment shall also be regarded as a person separate from the person which carries on the enterprise of which it is a part.

Commentary

As discussed in 4.2.1., the current treaty focus on a person as such leads to problems if it is possible for one person to bear different tax liabilities in different capacities. The classic example is a professional trustee, which may have hundreds of different tax liabilities in respect of the various trusts it administers. Rather than changing the wording of the entire model, and in order to preserve the readability of the text, this provision makes clear that the treaty applies separately to each taxable capacity of a person. The inclusion of the term “arrangement” is necessary because a tax liability can also be imposed on something that is, strictly speaking, not a person. For example, Canada and the United States treat a trust as a fictitious person, so the convention should apply to income derived by the trust as such.

As discussed in 4.2.2., there are strong arguments for treating a permanent establishment as a separate treaty-entitled person, certainly if the permanent establishment is a substantial one. This part of the definition may need to be refined if a distinction is made in this respect between permanent establishments that pass a high-threshold definition and those that pass only a lower-threshold definition. There is a structural problem with this element of the new approach, namely the perennial problem of applying bilateral treaties to multilateral situations. The main aim of this provision is to allow the permanent establishment to claim the benefit of a treaty between its situs state and a third state in which income has its source and the definition of a permanent establishment that should be used in this context is therefore the definition in the treaty between the residence state of the whole enterprise and the situs state of the permanent establishment. An internationally consistent application of treaties would require the source state to accept that this definition can work through to its treaty with the situs state of the permanent establishment in this way.

Article 4 – Permanent establishment

Art. 5 of the current OECD Model would be renumbered as Art. 4. This article might also be adapted to create a distinction between high-threshold and low-threshold permanent establishments, as discussed in 4.2.2.

Chapter III – Entitlement to Treaty Benefits

One of the most important features of the new approach is that it aims to set out a clear, consistent path to the granting of treaty benefits. In accordance with that aim, a new chapter would be added to the model which would prescribe the steps to be taken along that path.

Art. 5A starts with the fundamental issue that engages the treaty, namely the imposition of a liability to tax on the income. Arts. 5B and 5C look at different aspects of the connection between the income and the state imposing the tax as residence state in order to determine whether that tax liability is one that should lead to the granting of treaty protection. Art. 5D applies the notion of a fragmented treaty entitlement and allows the required connection to be established by aggregating the connecting features of different persons.

It is also possible that the required residence connections can be established in both contracting states. This could happen either if both states attribute the income to a person resident in the state, or if both states attribute the income to the same person and both regard that person as resident. In these cases it is necessary to establish a priority between the two residence states in order to resolve their competing tax claims. The solution for both situations is given in Art. 5E, which has been placed at the beginning of the next chapter of the treaty as it provides the more general rules for the allocation of taxing rights and forms a backdrop for the specific allocation rules of Arts. 6 to 21.

Article 5A – Liability to tax

1. For the purposes of this Convention, income is derived by a person if the person is liable to tax in respect of the income in a Contracting State in which the person is resident.
2. [Optional] The benefits of this Convention shall apply only if a sufficient liability to tax is imposed on the income in a Contracting State in which the person who derives the income is resident. A liability to tax is not sufficient for this purpose if: ...

Commentary

Art. 5A(1) sets out the basic entry requirement for the treaty, that the income is taxable in a contracting state as residence state. The consistent use of the term “derived by” in this provision and the remainder of the treaty ensures that the same basic threshold applies throughout. In some exceptional cases, discussed in 4.3.3., a liability to tax may be fragmented between two persons, in that the amount of tax is computed by reference to the characteristics and circumstances of one person but the tax liability is imposed on a different person. Such a fragmentation is likely to occur only between two persons resident in the same state, however, and Art. 5D would allow these fragments to be aggregated for the purpose of determining treaty entitlement.

The essential point of this article is that the basic entry requirement for the treaty consists of liability to tax in respect of a specific item of income. The same distinction would be made in this respect as is often made in the current treaty framework between being “liable to tax” and being “subject to tax”. So an individual, for example, would be liable to tax in respect of an item of income even though the individual’s income all falls within his nil rate band and he is therefore not required to pay a positive amount of tax. Similarly, a company would be liable to tax in respect of an item of income even though the company makes an overall loss in the year concerned and for that reason does not pay a positive amount of tax. In focussing on liability to tax in respect of a single item of income the new approach is, however, substantially different from the current treaty framework, which looks for the liability to tax of a person as such in its definition of residence. As discussed in 4.3.1., the advantage of this aspect of the new approach is that there is generally a clear yes/no answer to the question whether an item of income is included in the taxable base in a state.

In the context of the current treaty framework there is a debate, discussed in 2.3.4., as to whether a potential liability to tax of a person in a state is a sufficient connection between the person and the state to make that person a resident of that state for treaty purposes. The treaty text suggested here is designed to prevent a similar debate from arising in connection with the liability to tax requirement of Art. 5A(1). By providing material criteria with which to test both the connection between the income and the person, and the connection between the person and the claimed residence state, this text removes any issues of “potentiality” in these respects. The only remaining issue of “potentiality” is the imposition of a tax liability in respect of the item of income. As this is a much clearer issue than the residence test in the current treaty framework, it is hoped that the “potentiality” argument would not be raised in this respect. The Commentary on this article should, in any event, make clear that the entry requirement for the treaty is the actual imposition of a tax liability. As discussed in 4.5., states that wish to give treaty protection to income in the absence of a liability to tax in respect of that income have the option of including an explicit provision in the treaty to that effect.

Art. 5A(2) is included to cater for the concerns that states may have as to the adequacy of the tax liability that forms the basic entry threshold into the treaty. This paragraph would be necessary only if the contracting states wished to set out specific conditions in respect of the tax liability imposed by the other state and its precise formulation would depend very much on the concerns and tax systems of the specific states concerned. Factors

that may be addressed in this paragraph include special tax regimes, which would probably be named in the treaty, and very low rates of tax levied under more general regimes. The contracting states could also conclude an exchange of notes or a mutual agreement specifying which tax liabilities would, in any event, be regarded as sufficient for treaty purposes or which persons would in any event qualify.

This is the provision that could also be used to deal with the concerns about conduit structures and base erosion that are discussed in 4.9. This part of the provision would focus on the relationship between the payment for which treaty protection is claimed and payments made by the recipient of that first payment. It may, for example, deny treaty benefits if the payment for which treaty benefits is claimed essentially passes through the recipient by being paid out as a deductible expense. Alternatively, it may deny treaty benefits to the extent that the recipient's taxable base is eroded by deductible payments of non-business expenses. In both cases, the notion of a fragmented treaty entitlement, which is introduced in Art. 5D, would allow the application of a derivative benefits approach if the offending payments by the recipient of the income are made to persons who would be entitled to treaty benefits if they received the original payment directly. Clearly, Art. 5A(2) would have to be formulated particularly carefully in order to ensure that it hits only the intended targets.

Article 5B – Attribution of income

The benefits of this Convention shall be available in respect of an item of income only if the person who derives the income has at least one of the following connections with the income:

- a) the person is an individual who derives the income from an employment carried out by that individual or the exercise of personal activities by that individual;
- b) the income is a business receipt of an enterprise carried on by the person;
- c) the person has the full ownership of the income;
- d) the person is economically entitled to/enjoys the income; or
- e) the person exercises control over the application of the income.

Commentary

This article introduces one of the most novel features of the new approach, namely a consideration of the reasons for which a state imposes tax on a given item of income. The introduction of this article follows from the basic premise of the new approach that states are entitled to determine whether the basis on which a tax liability is imposed in another state justifies the granting of treaty benefits. This article would be particularly important in

respect of anti-avoidance legislation, such as that discussed in 4.3.1., which may be found by other states to be too extreme in attributing income to individuals who have only an indirect connection with the income.

In order to ensure consistency throughout the Model, the terminology of Para. a) is taken as far as possible from Arts. 15 and 17 OECD Model, and the wording of Para. b) is taken as far as possible from Arts. 3 and 7. But although the scope of Art. 17 is limited to remuneration from one specific category of personal activities, the application of Para. a) would not be limited in the same way. Paras. c) to e), in particular, would depend on the domestic law of the contracting states, although the elements listed in this draft are likely to be rather common. If the contracting states agree, this article might also include paragraphs to allow a person who is liable to tax on income under anti-avoidance legislation to claim treaty benefits in respect of the income. This could be done either by naming specific legislative regimes in the contracting states, or by including the attribution grounds used in such regimes, and could lead to the addition of one of the following paragraphs:

- f) the person is able to obtain/benefit indirectly from the income.
- f) the income is taxable in the hands of that person under Sec XX of the XXX Act.

The list of criteria in Art. 5B also forms a hierarchy which is used by Art. 5E(1) to resolve double attributions in the two states. It would therefore be necessary for the two contracting states to the specific treaty to have a mutual understanding of what is meant by the criteria used and how the terminology in the treaty relates to their domestic law in this respect. There is a difficult balance to be achieved here between catering to the needs of specific treaties and developing a treaty terminology that is widely accepted and understood.

The “beneficial ownership” terminology has been deliberately avoided in this article, although it would be appropriate to use the concept if it were used in the domestic law of one or both contracting states. As discussed in 4.9., conduit structures would be addressed, not by this article, but by two other elements of the new approach. One element is Art. 5C, which adopts a substantive test of residence and therefore would prevent shell companies from claiming treaty benefits. The other element is Art. 5A, which provides states the opportunity to stipulate conditions about the sufficiency of the tax liability in the residence state. As argued in 4.9., the essential issue with conduit structures is the mismatch of tax liabilities between the resi-

dence state, which taxes on the net income, and the source state, which is expected to grant treaty benefits on the gross income. The more appropriate way to combat such structures is therefore on the basis of this mismatch of tax liabilities, rather than on the basis of the ownership of the income.

Article 5C – Residence

For the purposes of this Convention, the term “resident of a Contracting State” means a person who has at least one of the following connections with that State:

- a) the person is the government of the State;
- b) if the person is an individual:
 - i) the individual resides permanently in the State;
 - ii) the individual has a permanent home in the State;
 - iii) the individual has his centre of vital interests in the State; or
 - iv) the individual has his place of habitual abode in the State;
- c) if the person is neither the government of a Contracting State nor an individual:
 - i) the person carries on an active business in the State; or
 - ii) the management and control of the person is carried out in the State.

Commentary

This article defines the second limb of the connection between income and a state that justifies the imposition of a tax liability by the state and the granting of treaty benefits. The clauses included in the suggested text in respect of individuals are based on the text of Art. 4(2) of the current OECD Model but, as with Art. 5B, the precise formulation of this article would depend on the domestic law of the two states. Another similarity with Art. 5B is that the criteria listed in Art. 5C form a hierarchy that is used by Art. 5E in order to resolve the dual residence of a person for treaty purposes.

The clauses in respect of companies reflect the management test used in many states and the active business test that was discussed briefly in 4.4.2. The “place of effective management” test in Art. 4(3) OECD Model has deliberately not been used, to emphasize the point that these tests should reflect domestic law rather than the current tiebreaker rule, but it would be appropriate to use this test if a state used it in its domestic law.

There is an acute policy question in respect of companies, as to whether the place of incorporation is a sufficient connection for this purpose, highlighting the policy clash between domestic law and treaties in this respect. The place of incorporation could easily be added to the list of criteria in Para. c) if that was the decision made in this respect.

Using a material definition of residence means that it is possible for a person to be resident in a state for treaty purposes even though the person is not taxable in that state. This possibility does not upset the system of the new approach, as the basic entry threshold for the treaty is not the liability to tax of a person as such but rather the imposition of a liability to tax on the item of income for which treaty protection is claimed. Nor does this possibility upset other features of the treaty, such as the implied source rules in Art. 10 and 11 and the resident employer test in Art. 15(2). Indeed, these rules arguably work better with a material test of residence than in the current treaty framework, as a material test avoids any technical issues with wholly or partly exempt bodies which pay such income.

The new definition of residence would have an impact on the scope of Arts. 24(3)-(5) and 25, but an impact that is consistent with the overall structure of the new approach. Arts. 26 and 27 would continue to state that they apply notwithstanding Art. 1; although the text suggested here would change the stated scope of the treaty, there would be no change in the need to extend the scope of these two articles.

Article 5D – Fragmented treaty entitlement

Notwithstanding Articles 5A and 5B, if a person resident in a Contracting State derives income but does not satisfy the conditions specified in those Articles in respect of the income, the benefits of this Convention shall nevertheless be granted in respect of the income if those conditions are satisfied in respect of the income by the person who derives the income together with one or more other persons resident in the same State.

Commentary

One of the major differences between the new approach and the current OECD Model is that the new approach grants entitlement to treaty benefits on a more objective basis, and places less focus on the person as such. If a treaty following the new approach were to be drafted from a blank page, it may have a different structure altogether. In the text suggested here, however, the distributive articles of the current OECD Model are incorporated as far as possible and those articles retain their focus on the person who is liable to tax in respect of income. In order to introduce the more objective element of the new approach, it is therefore necessary to provide that the various elements that are required for entitlement to treaty benefits may be aggregated for treaty purposes if they are divided among different persons under domestic law.

This article deals with the notion of a fragmented treaty entitlement within one state, as discussed in 4.8.2. This is the provision that would deal primarily with situations in which one person is liable to tax in respect of income that is owned in legal terms by a different person, although it could also apply to other types of fragmentation. This paragraph would cover the income of transparent entities, trust income in certain situations and income attributed to a person other than the legal owner by anti-avoidance legislation. No attempt has been made here to deal with a fragmented treaty entitlement of this kind across borders, such as that achieved in the Netherlands in case BNB 1990/45, discussed in 5.3.2.1., as this situation is likely to be rather rare in practice.

If a treaty includes a provision in Art. 5A denying treaty benefits in a conduit structure or a situation where the treaty claimant's tax liability is subject to base erosion, the contracting states may also wish to include in Art. 5D a second paragraph which applies the notion of a fragmented treaty entitlement in these situations. Such a provision would allow treaty benefits to income which does not qualify for protection under Art. 5A but which would attract treaty benefits if it flowed directly to the ultimate recipient of the income. The wording of this provision would, preferably, be clearly designed as a complement to Art. 5A, and would trace the offending payments referred to in that article to their ultimate recipient in order to determine whether the attributes of the immediate and the ultimate recipients can be aggregated in order to form one complete entitlement to treaty benefits. If the ultimate recipient is resident in a third state, treaty benefits would be available only if there is a treaty between the source state and the third state, and subject to the maximum granted under that treaty; it is therefore the lesser benefit that should be available if entitlements under two treaties have to be aggregated.

Chapter IV – Taxation of Income

Article 5E – General priority rules

1. For the purposes of Articles 6 to 21 of this Convention, if income is derived in one Contracting State by a person resident in that State and the same income is also derived in the other Contracting State by a different person resident in the other State, the income may be taxed in the State in which the person is resident who has the stronger connection with the income. The connection of a person with an item of income is stronger than the connection of another person if the connection of the first-mentioned person is listed in Article 5B before the connection of the latter person.

2. For the purposes of Articles 6 to 23 of this Convention, if a person is a resident of both Contracting States by reason of the provisions of Article 5C,

then the person shall be regarded as a resident only of the State with which the person has a connection that is listed in Article 5C before the connection of the person with the other State.

Commentary

Art. 5E deals with two different mismatches between the domestic law of the contracting states which can lead to a double of taxation of income. Para. 1 deals with double attributions of income and Para. 2 deals with dual residence. This article has been placed before Arts. 6 to 21, which deal with specific cases of source/residence conflicts, as its provisions are of a more general nature. It may, however, be found preferable to place it at the end of this chapter of the Convention, as it deals with situations that are less common than those covered by Arts. 6 to 21.

Although both paragraphs of this article deal with mismatches which could be considered to result from comparable causes, the solutions chosen are different. The resolution of an attribution conflict leads to the granting of a primary taxing right to the state with the stronger taxing claim, whereas a conflict of residence leads to the granting of an exclusive taxing right to the state with the stronger taxing claim. This difference is not a necessary consequence of the new approach, but has been chosen because these solutions seem to accord best with the current policy of states in this respect. Para. 1 is a new element which would be added by the new approach and which follows from the attention paid by the new approach to the grounds on which a tax liability is imposed on income by states. A double attribution of income can arise because states have different basic rules in this respect or because the anti-avoidance legislation of a state seeks to impose tax on a person who has only a remote connection with the income in legal terms. It has been assumed that most states would not be willing to give up the reach of such anti-avoidance legislation, and therefore the solution has been chosen of granting a primary taxing right to the state with the stronger connection. This paragraph therefore needs Art. 23 to resolve the double taxation.

Some states may also wish to include a further provision if there is any doubt as to whether all cases of a double attribution can be resolved through the hierarchy given in Art. 5B, which might read as follows:

If the two persons have the same qualitative connection with the income, the connection that is more direct is stronger than the connection that is less direct.

Such a provision may be necessary to deal with cases such as the *Bay-fine* case, discussed in 5.2.5. It may also be found necessary in respect of

a permanent establishment, if both the permanent establishment and the enterprise as a whole would be regarded as carrying on the business of the permanent establishment. The alternative approach to this case, which would not require this extra provision, would regard the enterprise as a whole as having only an ownership connection with the income or profit of the permanent establishment, so that its connection would be lower in the hierarchy than that of the permanent establishment.

Of course states would remain free to grant an exclusive taxing right to the state with the stronger taxing right in the case of an attribution conflict if they wish to do so. This could not be done, however, simply by replacing the words “may be taxed” in paragraph 1 with the words “shall be taxable only”, as this latter wording would also prevent the state that loses in this tiebreaker from taxing on a source basis. Such a provision would, therefore, have to be carefully worded in order to ensure that it excludes the residence-based taxing right of the state which has the weaker connection with the income through its resident person, but without excluding the right of either state to tax on a source basis in appropriate cases.

Para. 2 resolves the dual residence of a person, and follows the current OECD Model in granting an exclusive taxing right on a residence basis to the state with which the person has the stronger connection. For this reason, and by contrast with Para. 1, this provision is also expressed to apply for the purposes of Art. 23. This policy decision can be questioned, as there is no conceptual or structural reason which requires the loser state to give up its taxing claim on a residence basis completely. It would be possible, for example, to allow the loser state to tax the person, subject to the obligation to grant double tax relief in respect of the tax levied in the winner state. The result would be rather similar to the current system in respect of US citizens who are resident outside the United States, with the tax claim of the loser state taking the place of the US tax levied on the basis of citizenship. On the other hand, states generally seem to be quite content to concede this residual possibility of taxation in the current treaty framework, and maintaining this position would certainly prevent the introduction of unwelcome complications.

Article 6 – Income from immovable property

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State. [No change from the current text.]

Article 7 – Business profits

1. Profits derived by a resident of a Contracting State from an enterprise shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

Article 8 – Shipping, inland waterways transport and air transport

1. Profits derived by a resident of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

2. Profits derived by a resident of a Contracting State from the operation of boats engaged in inland waterways transport shall be taxable only in that State.

Article 10 – Dividends

1. Dividends derived by a resident of one Contracting State from a company resident in the other Contracting State may be taxed in the first-mentioned State.

2. However, such dividends may also be taxed in the other Contracting State, but the tax so charged shall not exceed:

a) 5 per cent of the gross amount of the dividends if the person who derives the dividends is a company (other than a partnership) which holds ...

4. The provisions of paragraphs 1 and 2 shall not apply if the person who derives the dividends carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

Article 11 – Interest

1. Interest arising in a Contracting State and derived by a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but the tax so charged shall not exceed 10 per cent of the gross amount of the interest. ...

4. The provisions of paragraphs 1 and 2 shall not apply if the person who derives the interest carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

Article 12 – Royalties

1. Royalties arising in a Contracting State and derived by a resident of the other Contracting State shall be taxable only in that other State.
3. The provisions of paragraph 1 shall not apply if the person who derives the royalties carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

Article 13 – Capital gains

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State. [No change from the current text.]
2. Gains derived by a resident of a Contracting State from the alienation of movable property forming part of the business property of a permanent establishment which that person has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.
3. Gains derived by a resident of a Contracting State from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
4. Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State. [No change from the current text.]
5. Gains derived by a resident of a Contracting State from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which that person is a resident.

Article 15 – Income from employment

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State. [No change from the current text.]

Article 16 – Directors' fees

Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which

is a resident of the other Contracting State may be taxed in that other State. [No change from the current text.]

Article 17 – Artistes and sportsmen

Notwithstanding the provisions of Articles 7 and 15, income derived by a resident of a Contracting State from the personal activities of an individual as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsman, exercised in the other Contracting State, may be taxed in that other State, whether the income is derived by the individual who performs those activities or by another person.

Article 18 – Pensions

Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration derived by a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

Article 19 – Government service

- 1.a) Salaries, wages and other similar remuneration derived by an individual in respect of services rendered to that State or a political subdivision or a local authority thereof and paid by that Contracting State or subdivision or authority shall be taxable only in that State.
- b) [No change from the current text.]
- 2.a) Notwithstanding the provisions of paragraph 1, pensions and other similar remuneration derived by an individual in respect of services rendered to that Contracting State or a political subdivision or a local authority thereof and paid by, or out of funds created by that State or subdivision or authority shall be taxable only in that State.
- b) [No change from the current text.]

Article 20 – Students

Payments derived by a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

Article 21 – Other income

1. Items of income derived by a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.
2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the person that derives the income carries on business in the other Contracting State in

which the income arises through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

Chapter VI – Methods for Elimination of Double taxation

Article 23A – Exemption method

1. Where a resident of a Contracting State derives income which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income from tax.

Article 23B – Credit method

1. Where a resident of a Contracting State derives income which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow, as a deduction from the tax on the income, an amount equal to the income tax paid in that other State. Such deduction shall not, however, exceed that part of the income tax, as computed before the deduction is given, which is attributable to the income which may be taxed in the other State.

Commentary

Very little has to change in the wording of Art. 23 in order to accommodate the new approach. The references to capital taxation have been removed here, but no further changes have been made to Art. 23A. The only other change that has been made to Art. 23B is to remove the second reference to the resident, in order to remove the risk that this provision is interpreted as requiring subject identity.

Subject to the latter change, the current wording of both versions of Art. 23 is capable of applying to the situation contemplated by Art. 5E(1), the double attribution of income, as well as to the situations contemplated by the specific distributive rules. If it were considered desirable, however, a paragraph could be added specifically to deal with double attributions, as follows:

[23A(5)]

5. Where a resident of a Contracting State derives income which, in accordance with Article 5E, paragraph 1 of this Convention, may be taxed in the hands of a different person in the other Contracting State, the first-mentioned State shall exempt such income from tax but may nevertheless, in calculating the amount of tax on the remaining income of such resident, take into account the exempted income.

[23B(3)]

3. Where a resident of a Contracting State derives income which, in accordance with Article 5E, paragraph 1 of this Convention, may be taxed in the hands of a different person in the other Contracting State, the first-mentioned State shall allow, as a deduction from the tax on the income, an amount equal to the income tax paid in that other State.

These paragraphs make the more objective nature of the new approach explicit by referring specifically to the tax being levied in the winner state in the hands of a different person. If this additional paragraph were not used, an explicit statement in the Commentary would be necessary that the treaty allows one person to claim double tax relief in respect of tax levied in the name of a different person, provided that both tax liabilities are imposed in respect of the same item or stream of income.

As a permanent establishment would be regarded as a separate taxable capacity, and therefore a person for treaty purposes, it would be entitled to the benefit of Art. 23 in the treaty between its situs state and a third state that is the source state of income that is effectively connected with the permanent establishment. In order to achieve an internationally coherent application of treaties, however, the definition of a permanent establishment used for this purpose would have to be the definition in the treaty between the residence state of the whole enterprise and the situs state of the permanent establishment, as it is this definition that determines the taxing rights of the situs state of the permanent establishment.

Appendix II

Domestic Law of the Netherlands and the United Kingdom in Respect of the Attribution of Income to a Person

Abbreviations

A-G	Advocate-General
CIR	Commissioners of Inland Revenue
CTA	Corporation Tax Act 2009, as amended
FA	Finance Act
HMRC	Her Majesty's Revenue and Customs
HR	Hoge Raad
ICTA	Income and Corporation Taxes Act
IRC	Inland Revenue Commissioners
ITA	Income Tax Act 2007, as amended
ITEPA	Income Tax (Earnings and Pensions) Act 2003, as amended
ITTOIA	Income Tax (Trading and Other Income Act) 2005, as amended
TCGA	Taxation of Chargeable Gains Act 1992, as amended
Wet IB	Wet inkomstenbelasting (individual income tax law)
Wet VpB	Wet vennootschapsbelasting (corporate profit tax law) 1969
Wet DB	Wet dividendbelasting (dividend tax law) 1965

1. Introduction

1.1. The aim of this study

The original aim of this study was to search for principles on the attribution of income to a person which could be used for treaty purposes, either as a substantive definition of the term “beneficial owner” or as principles of general application throughout a treaty. The study is based on the premise that treaty law cannot be studied in isolation from domestic law, and follows the preparatory work for the 2007 congress of the International Fiscal Association³⁶⁹ which revealed that the attribution of income to a person is one of those very basic issues that have not been explored in detail in many

369. International Fiscal Association, note 1.

countries.³⁷⁰ It undertakes a detailed analysis of the domestic law of two countries – one in the civil law tradition and the other in the common law tradition – to investigate how they attribute income to a person for taxation purposes.

It soon became clear that this study was taking on a life of its own and that there was a great deal to be said on this issue. The results of this investigation are therefore presented here in a separate appendix. In addition to providing the groundwork for the thesis which it supports and which forms the main part of this book, this study aims to provide a conceptual framework for the attribution issue and to shed some light on the underlying policy considerations. Its conclusion highlights the complexities of attributing income to a person for tax purposes and the difficulty of isolating a single determinative factor in this respect.

The focus of the study is on when, and why, a particular item of income is attributed to a particular person. These questions can arise if there is more than one potential candidate for taxation, but sometimes there is also an issue as to whether income can be attributed to anyone at all. These questions can also arise both in respect of the imposition of a tax liability and in respect of the granting of a credit for tax withheld from the income.

The two countries through which this study travels are the Netherlands and the United Kingdom, and the countryside that it will travel through is the domestic law that determines which income belongs to which person for tax purposes. As the journey progresses the study compares and contrasts the law of the two countries in order to discover their similarities and differences. This journey goes through some areas in which the landscape is relatively open and clear, but there are also some thickets in the undergrowth and swamps to contest with. The ultimate goal is to end up on a hill with a good view of the surrounding countryside, but with an understanding of the nature of the thickets and swamps awaiting those who descend back down into the detail.

370. A recent exception is Salom., J., “L’attribution de revenue en droit fiscal Suisse et international”, in: Danon, R., Chenux, J.-L., and Tissot, N. (eds.), *Centre de droit commercial, fiscal et de l’innovation*, Vol. 3 (Geneva: Schulthess Éditions Romandes, 2010). The 32 branch reports in International Fiscal Association, note 1, provide an excellent introduction to many countries.

1.2. The scope of the study

This study covers taxes on both income and capital gains.³⁷¹ The focus is on the general principles as expressed in the legislation and what could be termed a search for the “natural” principles developed by case law; it does not, therefore, deal with facultative rules in the legislation, such as the Netherlands rules on the fiscal unity and the taxation of special vehicles such as collective investment vehicles. It also does not focus on situations in which the identity of the potential taxpayer is clear, but there is a question as to whether a payment or other benefit constitutes taxable income,³⁷² although it does touch this issue incidentally as the answer to this question may help to clarify how a choice is made to attribute income to one specific person. Tax avoidance is not covered as such, although a common avoidance strategy is to change the attribution of income to a person in a more favourable tax position, and therefore tax avoidance situations are inevitably part of the discussion. The collection of tax is also not covered, as this is a question of the collection mechanism rather than establishing the tax liability and the amount of the liability.

Further, the study does not cover partnerships and the entity classification issue. A minor reason for this exclusion is that a great deal has already been written in this respect. The major reason is that entity classification is not germane to the enquiry undertaken here. What this study will investigate is why a particular item of income is attributed to a particular person. How are the attribution rules expressed in the legislation? What are the policy reasons behind these rules? How do the courts approach the matter? Which factors determine the attribution of income to a person and what is the relative weight of those factors?

The entity classification issue, on the other hand, presents a different set of questions, directed towards identifying the unit that may potentially be subject to a tax liability. So whereas the entity classification issue is concerned with what the taxable unit should be, the attribution issue takes the potentially taxable units or persons as a given and is concerned with situations in which there are qualitatively different relationships with the income. This

371. Although the United Kingdom makes a clear distinction between income and capital gains for tax purposes, the term “income” will, for the sake of convenience, be used throughout this study to denote both income and capital gains, unless the subject matter requires a distinction to be made between the two.

372. So it does not, for example deal with cases such as HR 27 April 1955, No. 12 269, BNB 1955/211, in which there was an issue as to whether an individual could be taxed on a pension that he had not received because he had not provided evidence that he was still alive.

study therefore proceeds on the basis that the taxable unit has already been determined and assumes that the world is populated only by individuals, companies and trustees.

Much of the discussion concerns individual taxation, particularly in respect of the United Kingdom. In the Netherlands, the corporation tax law uses the same attribution criterion as the individual income tax law, and there is a great deal of uniformity between the two. In the United Kingdom, by contrast, there is a substantial difference, as the taxation of corporate profit in the United Kingdom is heavily based on accounting principles. In addition, the legislation on corporate loan relationships (discussed in 3.2.3.2.) overlays the accounting principles with a set of notional payments designed to reflect economic reality. The withholding of tax from actual payments is, however, governed by the income tax legislation. In seeking to determine the attribution of specific payments of income in legal terms, therefore, one is thrown back on the basic principles as developed in respect of, mainly, individuals.

A complication in respect of the Netherlands is the introduction in 2001 of a method of taxing individuals in respect of passive income that is known as the “Box 3” system. The Box 3 system taxes individuals in respect of a deemed return on the value of the assets they own,³⁷³ rather than on the actual income derived from the assets. Many arguments have been put forward³⁷⁴ in support of the proposition that the Box 3 tax is not an income tax at all, but rather a wealth tax. In the context of this study, the author would like to add a further argument, which does not seem to have been put forward elsewhere, that, if an asset is subject to a usufruct, the Box 3 charge also applies to the bare owner,³⁷⁵ who – by definition – has no entitlement to the income produced by the asset. Although the Box 3 system now applies under domestic law, it is still often necessary to attribute specific payments of income to an individual in a cross-border context. Given the comparative nature of this study, it therefore looks primarily at the pre-2001 law in this respect.³⁷⁶

373. Arts. 5.1 to 5.3 Wet IB 2001 note 56.

374. An overview of these arguments, with references to the relevant literature, is given in Sillevius, L.W. and van Kempen, M.L.M., *Cursus Belastingrecht (Inkomstenbelasting)* (Deventer, the Netherlands: Gouda Quint, loose-leaf), Sec. 5.0.6.A.d (March 2010).

375. Art. 5.22 Wet IB 2001 (note 56) provides that the value of a bare ownership for the purposes of the Box 3 charge is the difference between the full value of the asset and the value of the usufruct to which it is subject.

376. As regards the timing provision in the 2001 law (Art. 3.146 Wet IB 2001, note 56, which is the article that gives the most substantive indication of what is meant by the main attribution criterion of “enjoyment”), van Dijk and van Vijfeijken assume that

1.3. Structure of the study

The following four parts analyse the law of the two countries in different ways. Part 2. provides a general introduction to the law of each country; this is a general description of the lie of the land. Parts 3. and 4. deal with the law applicable to passive and active income, respectively; these two parts describe in detail the thickets and swamps down on the ground in respect of selected types of income. Part 5. examines the role of various factors in the attribution of income; this part looks at the material presented in Parts 3. and 4. from a different angle, and looks for patterns in the landscape. At this stage we are climbing up the hill at the end of the journey. In Part 6. we are almost at the top, and starting to look at the system as a whole again; this part focuses on the taxpayer as such. In the conclusions in Part 7. the journey is completed; the summit has been reached, we have an overview of both domestic systems, and we know what the navigational hazards below us are.

2. Basic principles in the Netherlands and the United Kingdom

2.1. Introduction

The attribution of income to a person has a fundamental importance because most domestic tax systems have many features which require one to take account of the personal characteristics and circumstances of the taxpayer. These features may determine the rate of tax that applies, for example, or the availability of reliefs. In a business context it is important to attribute profit to the right person in connection with the set-off of losses. Many countries impose creditable withholding taxes in a domestic context, and the correct attribution of the income is necessary in order to ensure that the credit is granted to the correct person. In a cross-border situation it is important to ensure that the correct person is granted double taxation relief in respect of a given item of foreign-source income.

Given this fundamental importance of the attribution issue, one might expect any country to deal with the basic principles in detail in the legis-

the old case law is still relevant: van Dijck, J.E.A.M., and van Vijfeijken, I.J.F.A., “Het kas-stelsel in de wet IB 2001” (2nd edn.), Sec. 1.2.6.1, p. 13, in: *FED Fiscale Brochures* (Deventer, the Netherlands: Kluwer, 2006). The importance of this provision is discussed in Appendix II, 2.2.

lation. That is not true, however, of either the Netherlands or the United Kingdom.³⁷⁷ The legislation of both countries gives a brief statement of the basic attribution principles, and to a large extent it has been left to the judges to work out how those principles apply. The avoidance aspects, by contrast, receive a great deal more legislative attention, certainly in the United Kingdom.

Anyone researching this issue cannot help but notice a striking disparity in the way that this topic is handled in the domestic law literature of the two countries. In the Netherlands there is plenty of literature to be found that addresses attribution as a topic in its own right,³⁷⁸ even though much of that literature is directed more towards the relationship of attribution with other aspects of the system such as the timing and characterization of income, rather than the specific topic discussed here. Contrast this with the United Kingdom, where one of the leading textbooks makes the following telling statement: “The tax system thus has to set the rates of tax, [...], to define what is meant by income, to define when it arises and, because of international rules, where it arises and on occasion to whom it arises.”³⁷⁹ Further research into the United Kingdom does reveal plenty of material on the attribution issue, but it has to be gleaned from the discussion of a variety of topics.

This difference can easily be explained by reference to the history of the tax system in the two countries and consequently the way in which the legislation has been formulated. The Netherlands has traditionally had a more subjective system, whereas the United Kingdom has developed from what was basically an objective system.

The essence of a subjective system of taxation is that it focuses on the tax subject, the taxpayer, whereas the essence of an objective system is that the tax liability is established without reference to a tax subject, or person. A subjective system of income taxation approaches the liability to tax by looking at the specific taxpayer; the event that triggers the imposition of in-

377. Nor is it true of many other countries: Wheeler, note 1, Sec. 1.1.1, p. 20.

378. In respect of the pre-2001 law, see van Dijck, J.E.A.M., “Wie Geniet het inkomen?”, in: *Smeetsbundel, Opstellen aangeboden aan Prof. Dr. M.J.H. Smeets* (Deventer, the Netherlands: Kluwer, 1967), pp. 159-89; Ganzeveld, J., “Vervreemding van inkomsten in de Wet op de inkomstenbelasting 1964”, in: *Fiscale monografieën* (Deventer, the Netherlands: Kluwer, 1994); and Van Dijck, J.E.A.M., “Het genieten van inkomsten” (4th edn.), in: *FED Fiscale Brochures* (Deventer, the Netherlands: Kluwer, 1998). In respect of the law since 2001, see van Dijck and van Vijfeijken, note 376.

379. Gordon, K.M., Montes-Manzano, X., and Tiley, J. (eds.), *Tiley and Collison's UK Tax Guide 2009-10* (27th edn.) (United Kingdom: LexisNexis, 2009), Chap. 5, p. 265.

come tax is an increase of that person's wealth due to a payment that constitutes taxable income for that person. In its most extreme form, a subjective system would define all the features of taxable income by reference to the taxpayer's viewpoint, such as the timing of the income, the characterization of the income, and even whether a payment constitutes taxable income at all. Restrictions on the taxpayer on the way in which the income may be applied would reduce its value for tax purposes.

Such an extreme form is not at all practical, however, as what constitutes a valuable benefit would vary from one taxpayer's perception to another. For this reason even the most subjective domestic systems step away from the taxpayer's viewpoint in some respects, for example by determining the timing of income in a more objective way in order to prevent taxpayers from deferring taxation through arrangements to delay the benefit of income.

An objective system of taxation determines the features of the tax liability by reference to the income only; this system is found in many countries in the form of flat-rate withholding taxes on passive income. In this case the characterization of the income, for example, has to be determined at the outset when the income is paid and it is irrelevant whether or not the taxpayer actually receives the income as a receipt of an active business. Similarly, the amount of the income has to be determined at the outset, so expenses incurred by a specific taxpayer in order to derive the income cannot be taken into account. This latter aspect means that an objective system cannot be used to levy tax on business profits and capital gains. Or maybe one should say, rather, that any attempt to do so would result in a tax that could no longer be properly described as an income tax, as the tax base would be much closer to the gross payment than to the net income. Nor can an objective system be used in conjunction with progressive rates of tax, as an objective system does not require the identification of a person whereas the application of progressive rates makes it necessary to identify a person in order to identify the total income to which the progressive rates apply.

The Netherlands has for a long time stated in its legislation the basic principle that income is attributable to the person who enjoys it. This statement of principle raises the question of what is meant by the notion of "enjoyment", which has led to plenty of case law and attention for this issue in professional and academic literature. In the UK system, by contrast, the collection of tax was traditionally the paramount issue. Until very recently, the legislation did not contain a general attribution principle, although a number of specific provisions did attribute income to the person who received or was entitled to it; this wording was adopted in a major rewrite

of the UK legislation in 2003 and 2005 as, in effect, the general attribution principle. These apparently alternative attribution criteria reflect the objective origins of the system and the preoccupation with the collection of tax.

So whereas the Netherlands system is concerned to find *the* person on whom to impose tax, the UK system was traditionally concerned to find *a* person from whom to collect tax. As the UK system became more subjective at the beginning of the last century with the introduction of higher rates, anti-avoidance legislation was quickly introduced to prevent taxpayers from manipulating the attribution of income in order to gain a tax advantage. Much of the case law in the United Kingdom, therefore, has been about the interpretation of the anti-avoidance legislation, rather than about basic principles.

2.2. The Netherlands

The Netherlands imposes three taxes that are important for the purposes of this study: the individual income tax, the corporate profit tax and the dividend tax. The dividend tax is withheld from dividends distributed by companies resident in the Netherlands, and is generally creditable by shareholders resident in the Netherlands. The corporate profit tax is charged on all elements of corporate profit, whether they have the character of recurrent income or of a capital gain. The individual income tax before 2001, on the other hand, was charged only on limited categories of capital gain derived by individuals, so inviting attempts to convert taxable income into non-taxable gains. The Box 3 system introduced in the 2001 individual income law³⁸⁰ has taken away the importance of this distinction. The Netherlands also imposes a wage tax, but this tax does not feature any further in this study as its principal function is to serve as a prepayment of the individual employee's liability to income tax on his salary or pension.

The Netherlands has for a long time had an explicit rule in its legislation, that income is taxed in the hands of the person who enjoys it. This criterion is found in the individual income tax law³⁸¹ and the corporate tax law.³⁸² The law on the dividend tax uses a different term; this tax is levied on the person who is entitled to the dividend.³⁸³

380. See Appendix II, 1.2.

381. Art. 2.1 Wet IB 2001, note 56.

382. Arts. 7(2) and 17(2) Wet vennootschapsbelasting 1969, Stb. 1969, nr. 445.

383. Art. 1(1) Wet dividendbelasting 1965, Stb. 1965, nr. 621.

Given that the dividend tax is withheld at source, it is maybe not surprising that it is levied according to the more formal criterion of entitlement. The company paying a dividend is required to withhold the tax at the moment of payment; it may not be in a position to determine who has the enjoyment of the dividend, but it should be able to determine who is legally entitled to it.³⁸⁴ On the other hand, given that the dividend tax is a flat-rate withholding tax, it is rather surprising to find that the law defines the tax as being imposed on a person at all, rather than simply on the dividend as such. This difference in wording does not seem to have attracted a great deal of comment in the literature. In BNB 1958/329,³⁸⁵ however, the lower court did say explicitly that the credit is granted to the person who is entitled to the dividend, and that that person is the person who receives the dividend voucher.³⁸⁶

In the more general attribution rule that is used in the rest of the legislation, the Dutch verb used is “*genieten*”. The dictionary translation into English of the term “*genieten*” usually gives the verb “to enjoy” as a first translation, with the verb “to receive” as an alternative. The Dutch term is clearly not used in a highly subjective sense, to require something that brings a smile to the face of the person in receipt of the income. Indeed, van Dijck has written³⁸⁷ that “*ontvangen*”, which translates directly into English as the verb “to receive”, is a synonym for “*genieten*” in this context. The two terms also appear to have been used interchangeably by the legislator in the 2001 income tax law, albeit inadvertently.³⁸⁸

The legislation does not define what it means by the term “enjoyment”, but it does include a timing rule³⁸⁹ which specifies the moments at which a person is taxable in respect of an item of income and, in so doing, provides some indication of what is understood by the term. The first event listed is the receipt of income. The other four are the moment that: the income is credited; the income is made available; the income starts to carry inter-

384. Arends, A.J.M. et al., “Wegwijs in de Inkomstenbelasting” (8th edn.), Sec. 13.5, pp. 337-8, in: van Arendonk, H.P.A.M (ed.), *Wegwijsserie* (Amersfoort, the Netherlands: Sdu, 2009).

385. Hof Amsterdam 3 April 1958, No. 36 957, BNB 1958/329.

386. The tax inspector in the case had argued that the shareholder should have treated the dividend as normal profit and the dividend tax as a deductible cost, because he had bought the shares after the date on which the dividend was declared.

387. Van Dijck, “Wie Geniet het inkomen?”, note 378, at p. 162.

388. See van Dijck and van Vijfeijken, note 376, Sec. 4.1 at p. 57, where the authors point out that the term “*ontvangen*”/receipt is used in Part 3.5 of the 2001 law where the term “*genieten*”/enjoyment should have been used.

389. Art. 3.146 Wet IB 2001, note 56. In the current law, this provision applies only to income that falls outside the Box 3 system.

est; and the claim to the income becomes legally enforceable. The common feature of all five events is that the amount of the payment is in some way made available by the debtor, and in that sense increases the available wealth of another person. Interestingly, the timing provision in the 1964 individual income tax law³⁹⁰ listed the same five events as the current law, but the third event was specifically that the income was made available to the person who enjoyed it. This difference in wording probably does not constitute a change from the 1964 law to the 2001 law, but rather confirms the general purport of this provision.

What this provision does not tell you is how to choose between potential taxpayers if, for example, one person's wealth is increased on a purely formal basis, while the real benefit of the payment goes to a different person. This provision says nothing, in other words, about the quality of the increase in wealth that leads to the imposition of tax, although the use of the term "enjoyment" does denote that some real benefit is required before a person can be taxed in respect of a particular payment. The required quality of the increase in wealth has been determined primarily by case law, and this is what is explored in the remainder of this study.

Curiously, the legislation has gradually dropped any mention of the criteria to be used in deciding which person enjoys a given item of income.³⁹¹ So whereas the 1941 individual income tax law³⁹² specified the link between income and the person for each type of income, and the 1964 law³⁹³ specified this link for business profit, the current 2001 law does not include any comparable provisions. The corporate tax law does not contain attribution criteria of its own, but it does provide³⁹⁴ that profit is to be computed as prescribed in the individual income tax law, and it is generally accepted that this provision also imports the attribution principles of the individual income tax law.

The explanatory memoranda to the individual income tax laws of 1964³⁹⁵ and 2001³⁹⁶ state that income is attributable to a person if it flows to that

390. Art. 33(1) *Wet inkomstenbelasting 1964*, Stb. 1964, nr. 519.

391. For the differences between the laws of 1941 and 1964, see van Dijck, "Wie geniet het inkomen?", note 378, pp. 159-89.

392. *Besluit inkomstenbelasting 1941*, *Verordeningsblad* 105/1941.

393. Art. 6 *Wet IB 1964*, note 390.

394. Art. 8 *Wet VpB*, note 382.

395. *Memorie van Toelichting Wet op de inkomstenbelasting 1958*, *Kamerstukken II* 1958/59, 5380, No. 3.

396. *Memorie van Toelichting Wet inkomstenbelasting 2001 (Belastingherziening 2001)*, *Kamerstukken II* 1998/99, 26 727, No. 3.

person or arises to that person. These statements echo a decision of the Hoge Raad, which stated in 1950³⁹⁷ that a person enjoys income if it flows to him directly. Whether that is the case depends, according to the Hoge Raad, on the facts and circumstances, including the applicable civil law and public law relationships. The leading writers also point to both the civil law relationships and the factual situation. Hofstra and Stevens, for example, consider civil law relationships to be important, but not determinative;³⁹⁸ if there is a difference between the civil law position and the factual situation, it is the factual situation that is more important.

Van Dijk, in his book on the enjoyment of income written on the basis of the pre-2001 law, also states as a general principle that income is enjoyed by the person who is originally entitled to it.³⁹⁹ On the other hand, he also uses many phrases which suggest that the important point is that the person who is to be taxed obtains some economic benefit from the income, or that he is able to decide how it is to be applied.⁴⁰⁰ Similarly, in BNB 1958/187⁴⁰¹ the Hoge Raad decided that a person could be taxable on income only if he was able to dispose of the income. The question in this case was whether a particular payment constituted taxable income at all, and many of van Dijk's comments are made in the same context. They may, therefore, not be entirely appropriate to cases in which the issue is a choice between two potential taxpayers, but they do suggest that the ability to dispose of the income is an important factor in making that choice.

That the principles for the attribution of income are not all clear was amply illustrated by BNB 2007/15,⁴⁰² a case decided in 2006, but under the 1964 income tax law (and explained further in 3.1.). This case concerned spouses who were married with a community-of-property regime, separated but not yet divorced and taxable separately from each other. Both spouses were

397. HR 15 November 1950, BNB B 8888.

398. Hofstra, H.J., and Stevens, L.G.M., *Inkomstenbelasting* (5th edn.) (Deventer, the Netherlands: Kluwer, 1998), Secs. II.1 and 2, pp. 93 and 95.

399. Van Dijk, "Het genieten van inkomsten", note 378, Sec. 4.1.1, p. 67.

400. *Ibid.*, Sec. 4.1.1, p. 67, "the taxpayer benefits from the payment"; Sec. 4.2, p. 42, "whether the amount paid has come within the control of the creditor"; Sec. 4.1.2.8, p. 71, "The taxpayer enjoys income if it is received for his account and at his risk"; Sec. 4.1.4, p. 74, there is no taxation if "the (factual) spending power of the taxpayer has not yet increased"; Sec. 5.4.3, p. 104, "Taxable income can be recognized if spending power has increased"; Sec. 5.4.4.3, p. 109, "the central question is whether the creditor's spending power has increased"; Sec. 8.4, p. 159, "the taxpayer enjoys income at the moment that he can do something with the money" (translations by the author).

401. HR 23 April 1958, No. 13 524, BNB 1958/187.

402. HR 10 March 2006, No. 38 044, BNB 2007/15 (with conclusion by A-G Overgaauw and comment by Heithuis).

legally entitled to the income in question, due to their marital community of property, but the income was received by the husband in his name and only he was factually able to dispose of it. There resulting clash between the legal entitlement to the income and the factual control over its application revealed a conceptual gap in the law, which had to be filled by the Hoge Raad from first principles. The difficulty of the issue was amply illustrated by the different opinions held at different levels of the judicial apparatus. There were two questions in the case: one as to the attribution of a capital gain and one as to the attribution of interest; the lower court answered both questions in favour of the tax inspector, the Advocate-General answered both in favour of the taxpayer, and the Hoge Raad answered one in favour of the inspector and one in favour of the taxpayer.

2.3. The United Kingdom

2.3.1. Background

In order to understand the UK law on the attribution of income it is necessary first to appreciate two important features of the tax system generally. One of those features is a traditional preoccupation with the practicability of collecting tax. This concern led to a system of income taxation that originally relied heavily on the withholding of tax at source⁴⁰³ – so heavily that it was not even found necessary to attribute income to a person. The legislation simply assumed that, if the person who received income was not the appropriate person to bear the tax, the burden would be passed on to the appropriate person.⁴⁰⁴ This system took, essentially, an objective approach to the taxation of income that is still visible in the current legislation.

This feature of the income tax system has also been noted judicially. In 1927, in *Archer-Shee v. Baker*,⁴⁰⁵ for example, Viscount Sumner said: “The fact appears to be that it has all along been the policy of the legislature in regard to Income Tax to keep aloof as far as possible from questions of title and to confine itself as far as possible to questions of administration.” And

403. For a full discussion of the origins of this system, see Soos, P., *The Origins of Taxation at Source in England* (Amsterdam: IBFD Publications, 1997). For a more general history of taxation in the United Kingdom, see Murgatroyd, R.C., “The history of taxation”, *Simon’s Taxes*, Division A1.5, available at <http://www.lexisnexis.com/uk/legal/results/pubTreeViewDoc.do?nodeId=TAACAABAAF&pubTreeWidth=23%25>.

404. 28th Report C. 4474 (1885) p. 30, cited in Gordon, Montes-Manzano and Tiley, note 379, Sec. 5.04, p. 270.

405. *Archer-Shee v. Baker* (*HM Inspector of Taxes*) 11 TC 749; see Appendix II, 3.2.1.3.

in 1915, in *Drummond v. Collins*,⁴⁰⁶ Lord Wrenbury explained the approach of the law when he said: “My Lords, upon this appeal there are two questions for decision – first, whether the remittances made to this country are income subject to income tax, and secondly, whether if they are, the Appellant is a person proper to be assessed.” Even when, in *Paget v. IRC*,⁴⁰⁷ it was held in 1938 that the attribution of interest could be changed by selling interest coupons, part of the legislative response was to strengthen the collection of tax from paying agents.⁴⁰⁸ A comprehensive legislative scheme to deal with the sale of income was not introduced until 2009.⁴⁰⁹

The original mechanism of collection of tax at source existed until 2007, although its scope had been gradually restricted, and the vestiges of this system can still be found in the legislation. This mechanism was often described in the United Kingdom as one that changed the attribution of income from the payor to the payee, although it will be argued in 5.5.3.2. that this is not an accurate view. As discussed in 2.1., an objective approach to income taxation cannot be used in conjunction with progressive rates, and indeed the system of collection at the source applied only for the purposes of the basic rate of income tax.

When the introduction of graduated rates of income tax was considered at the beginning of the last century, there seems to have been no realization of the importance that this change would bring to the attribution issue. A parliamentary committee was appointed to investigate this proposal; in the committee’s final report in 1906⁴¹⁰ there was no discussion of the attribution issue, and the discussion focused instead on the problems of moving away from the practical convenience of collection at source. What did exercise the committee was whether taxpayers could be persuaded to report their total income in order to be subject to higher rates of tax, or whether it would be preferable to collect at the source at the highest rates and allow taxpayers to report their income in order to claim lower rates. The latter option could, in effect, allow taxpayers to decide for themselves how to attribute income, but this also did not seem to cause concern.⁴¹¹ Evidence

406. *Drummond v. Collins (Surveyor of Taxes)* 6 TC 525.

407. *Paget v. IRC* [1938] 2 KB 25, 21 TC 677; see Appendix II, 3.5.2.2.

408. The provisions that became Secs. 118A-118K ICTA 1988 before their repeal.

409. See Appendix II, 3.5.2.2.

410. *Report from the Select Committee on Income Tax; together with the proceedings of the Committee, minutes of evidence and an appendix*, 20 November 1906, HC 365.

411. The system did already apply to a limited measure of progression, under which lower-income taxpayers could claim “abatements” of the tax collected at source by reporting their total income, but there was no discussion of the attribution issue in this context either.

had been collected from other countries, in which graduated rates were already levied and taxpayers were required to report their total income, to the effect that this system did not seem to lead to any particular problems, and this evidence seemed to satisfy the committee as to the practicability of the system.

The other feature that is essential for a good understanding of the UK system is the importance of the distinction between income and capital, which also traces its origins a long way back in history.⁴¹² The current UK system now imposes three taxes that are relevant to this study: income tax, which applies to individuals and trustees; corporation tax, which applies to companies; and capital gains tax. Each tax is governed by a separate, and substantial, quantity of legislation. The capital gains tax legislation provides the substantive rules for the computation of taxable capital gains, although it is corporation tax that is levied on capital gains realized by companies. The practical importance of the distinction between income and capital gains depends to a large extent on the relationship between the rates at which the taxes are levied – a relationship that has varied over time, but it is generally true to say that for the taxpayer the classification of a benefit as a capital gain is more favourable than classification as income. The dividing line between the two has, therefore, attracted much attention. The United Kingdom has no separate withholding taxes comparable with the dividend tax of the Netherlands, but there are requirements for the withholding of income tax in many situations, including various payments to companies. Income tax withheld in this way is generally creditable by UK resident taxpayers.

2.3.2. Attribution criteria

The income tax legislation still does not state explicitly that income tax is levied on the income of a person, although it does now state who is to be liable in respect of any given category of income. These provisions were added as a general feature in a major rewrite of the income tax legislation that culminated in the two major acts of 2003⁴¹³ and 2005.⁴¹⁴ Before these acts, the legislation had provided in respect of a number of categories of income that it was taxable in the hands of the person who received, or was entitled to, the income. With the enactment of these two acts, this provision

412. See Harris, P., *Income tax in common law jurisdictions: from the origins to 1820* (Cambridge University Press, 2006), pp. 125-7 and 397-9.

413. Income Tax (Earnings and Pensions) Act 2003 (ITEPA).

414. Income Tax (Trading and Other Income) Act 2005 (ITTOIA).

is now repeated in respect of most categories. The most important exceptions⁴¹⁵ are employment income, for which the legislation⁴¹⁶ now provides that it is taxable in the hands of the person to whose employment the earnings relate, and dividends, which are attributed⁴¹⁷ to the person to whom the distribution is made or is treated as made or the person receiving or entitled to the distribution.

The explanatory notes to the provisions applying what is now the general attribution rule⁴¹⁸ observe that “[t]he phrase ‘receiving or entitled to’ has been considered at length by the courts, although no clear definition of it has emerged.” Nevertheless, the notes continue “[a]s the phrase is well established in case law, it is retained in the rewritten legislation. It is not, however, considered appropriate to include any further explanation of the phrase because of its wide interpretation by the courts.” The explanatory note to the attribution rule for dividends⁴¹⁹ has rather more difficulty in justifying the attribution rule now embodied in the legislation, and draws the different possibilities embodied in the attribution rule from a number of different places in the previous legislation without referring to case law.

The rewrite of the legislation was not intended to change the law, except for some minor tidying-up,⁴²⁰ but it has been argued that, contrary to the stated aim of the rewrite, the introduction of an attribution rule on the basis of receipt or entitlement does change the law for the categories of income for which it did not appear previously,⁴²¹ although it is not clear in what way the law has been changed. What is clear, however, is that, especially given the aim of the rewrite, the old case law remains relevant. Interestingly, some of those cases used the term “enjoyment” in deciding whether

415. There are also various other provisions that deviate from the general rule, but these other provisions deal with rather specific situations.

416. Sec. 13(2) ITEPA.

417. Sec. 385 ITTOIA.

418. For example, the explanatory note to Sec. 371 ITTOIA, which is the provision specifying the person liable to tax in respect of interest. Available at <http://www.legislation.gov.uk/ukpga/2005/5/notes/division/5/4/6/2?type=en>.

419. Explanatory note to Sec. 385 ITTOIA, available at <http://www.legislation.gov.uk/ukpga/2005/5/notes/division/5/4/6/13/4?type=en>.

420. Both Acts start with the preamble “*An Act to restate, with minor changes, certain enactments relating to income tax on*” [the relevant types of income].

421. Curtis, R., “Alice’s Restaurant”, 164 *Taxation Magazine* 4220 (2009), p. 235 et seq.; Curtis, R., “Pieces of property pie”, 156 *Taxation Magazine* 4039 (2006), p. 330 et seq.

an individual was taxable,⁴²² although the issue under consideration was sometimes a related issue rather than a direct question of attribution.

In addition to the legislation on the basic liability to income taxation, the income tax legislation contains a large number of anti-avoidance regimes which impinge on the attribution issue. Indeed, much of the discussion about the attribution of income in the textbooks is to be found under the heading of anti-avoidance. These anti-avoidance schemes add a variety of further attribution rules, as each scheme has its own rule designed to fit in with the scheme of which it is a part. One major scheme, known as the settlements code,⁴²³ attributes income from assets to an individual who enters into an arrangement in respect of the assets but who retains any interest in the property transferred. Another major regime is the “transfer of assets abroad” regime,⁴²⁴ which attributes income from assets to an individual who transfers the assets but who retains a power to enjoy the income; the legislation provides an extensive list of circumstances in which that is regarded as being the case. Yet another regime, on transactions in land,⁴²⁵ provides as a general rule that the tax charge is imposed on the person who realizes the gain.

The legislation on the other two taxes that are relevant to this study employs different terms to deal with attribution.⁴²⁶ Corporation tax is charged simply “on the profits of companies”⁴²⁷ and the capital gains tax legislation provides that tax is chargeable on capital gains “accruing to” a person.⁴²⁸ It is perhaps not surprising that these attribution rules are so different from those in respect of income tax. These two taxes were not introduced until 1965,⁴²⁹ and they formed a clear departure from the traditional income tax system; neither tax, therefore, has to carry the burden of history that sometimes besets the income tax.

422. For example: *Dewar v. IRC* 19 TC 561, discussed in Appendix II, 5.3.2.1.; *Smyth (Surveyor of Taxes) v. Stretton* 5 TC 36, discussed in Appendix II, 5.3.2.3.; *Yuill v. Wilson (Inspector of Taxes)* [1980] STC 460, discussed in Appendix II, 3.4.2.1.

423. See Appendix II, 3.5.1.2.

424. See Appendix II, 3.4.2.2.

425. See Appendix I, 3.4.2.1.

426. Corporation tax is levied on the profits of companies. Capital gains are subject to capital gains tax in the hands of individuals and trustees, and to corporation tax in the hands of companies, although the computation of a capital gain is determined primarily by the provisions of the capital gains tax legislation.

427. Sec. 2 CTA.

428. Secs. 1 and 2 TCGA.

429. Until 1965 income tax was also levied on companies.

As we will see in 3.1.1., capital gains taxation is based primarily on beneficial entitlement rather than legal title. Corporation tax is levied on the profits of companies computed on the basis of generally accepted accounting practice.⁴³⁰ There are also a number of legislative schemes which apply specifically to companies. The most notable of these is the loan relationships legislation,⁴³¹ which seeks to tax companies on their economic profit. This legislation, which has a scope that extends well beyond traditional loans, was introduced in 1996 and removed the distinction between income and capital gains for the relationships that come within its scope. An example of the workings of this legislation, and its effect on the attribution of income, is the *DCC* case⁴³² discussed in 3.2.3.2. Both taxes also have their own complement of anti-avoidance rules, although their original design means that the anti-avoidance aspect is a less fundamental part of the system, at least with respect to the attribution issue, than it is for income tax.

3. Income from assets

Let us now turn to specific types of income in order to compare the way in which the Netherlands and the United Kingdom attribute income in specific situations. Perhaps the most obvious place to start is income from assets, as in a straightforward case the ownership of the asset gives a clear and simple indication of who should be taxable in respect of the income. Section 3.1. therefore starts by considering the importance of ownership of the asset as a general matter. On the other hand, ownership itself is not always a clear-cut issue, as discussed in 3.2. It is also easy to think of situations in which there are good reasons for paying more attention to other factors; these situations are discussed in 3.3. to 3.5.

In taking the ownership of the asset as a starting point, one has to recognize the differences between the property law of the two countries. So in the Netherlands, for example, the possibility for spouses of being married with a community-of-property regime has proved a rich source of law about the importance (or otherwise) of the legal ownership of an asset. The property law of England and Wales⁴³³ does not have any specific property regimes

430. Sec. 46 CTA.

431. Part 5 CTA.

432. *DCC Holdings (UK) Ltd v. Revenue and Customs Commissioners* [2011] STC 326.

433. The United Kingdom is a union of three jurisdictions: England and Wales; Scotland; and Northern Ireland. Some of the greatest differences among these jurisdictions are found in the law of property. The tax legislation applies to all three jurisdictions, with

specifically for married couples, so that source of law is cut off at the outset. On the other hand, it does encompass the trust concept, and that has proved to be a rich source of law about the importance of various facets of ownership in the United Kingdom, as discussed in 3.2.

3.1. The importance of ownership

Most countries make some distinction between the income derived from holding an asset and a gain (or loss) realized on its alienation; the Netherlands and the United Kingdom are no exception, although both countries have taken steps to reduce the importance of the distinction. In the Netherlands the distinction never was important for the taxation of business profit, as the income and gains from a business enterprise are taxable in one general category of profit. Its main importance was in respect of individuals, as the pre-2001 individual income law imposed tax only on certain specific types of capital gain. The introduction of the Box 3 system for the taxation of the passive income of individuals⁴³⁴ is now based on a deemed return from assets and the distinction between recurrent income and capital gains has, accordingly, lost most of its importance.⁴³⁵

In the United Kingdom, by contrast, the distinction between recurrent income and capital gains has traditionally been one of fundamental importance;⁴³⁶ until 1965 the only tax levied that is relevant to this study was income tax, which applied to individuals, trustees and companies but only in respect of recurrent income.⁴³⁷ In 1965 both the corporation tax and the capital gains tax were introduced. The introduction of tax on capital gains softened the sharpest edges of the distinction between capital gains and recurrent income, but the differences in rates and computation meant that it remained important. For companies, the loan relationships legislation⁴³⁸ has now removed the distinction for all assets within its (wide) scope,

minor variations in respect of Scotland and Northern Ireland. For a brief discussion of the consequences of these differences for tax purposes see Gordon, Montes-Manzano and Tiley, note 379, Sec. 1.28, pp. 61-2. When this study discusses property law in the United Kingdom, it refers to the law of England and Wales.

434. See Appendix II, 1.2.

435. It remains important in certain specific cases, for example in respect of a substantial shareholding held by an individual.

436. For an account of how this distinction developed, and its importance in the UK tax system, see Harris, note 412.

437. Although certain short-term capital gains were treated as income and taxed as such for a few years prior to the introduction of capital gains tax.

438. See Appendix II, 3.2.3.2.

by treating such assets as qualifying corporate bonds, which in turn means that gains and losses on their disposal are treated as recurrent income.⁴³⁹ The distinction remains important for individuals and trustees.

3.1.1. Gains from the disposal of an asset

The different approach of the Netherlands and the United Kingdom to the taxation of capital gains is reflected in the basic attribution principles applying to capital gains. Whereas the Netherlands has always treated capital gains, when they are taxable, as a category of income or profit, the United Kingdom has traditionally regarded them as a separate type of taxable benefit. Accordingly, the basic rule in the Netherlands, which attributes income on the basis of enjoyment, also applies to capital gains, whereas the United Kingdom has separate legislation for capital gains with a separate attribution rule.

The UK legislation provides that capital gains tax or corporation tax on a capital gain is payable by a person in respect of gains “accruing to” that person.⁴⁴⁰ This deceptively simple rule breaks down into a number of attribution rules, which can be combined into two major groups. One group is based on persons who are beneficially entitled to assets; this group includes the full owner of an asset. It also includes a person who is not the legal owner, but who is absolutely entitled to the asset as against the legal owner. In that case the person with absolute entitlement is subject to capital gains taxation as if he owned the assets directly,⁴⁴¹ and the legal owner is not taxable; this is often referred to as nominee property.⁴⁴² The other major group, which is based on the legal ownership of assets, consists of trustees if there is no beneficiary with absolute entitlement to the asset, and personal representatives. The taxation of trustees is discussed further in 3.2.1.

In *Booth v. Ellard*⁴⁴³ the court interpreted the provision on nominee property to include a rather more substantive, or economic, approach than it

439. Secs. 115(1) and 117(A1) TCGA and Secs. 295-300 CTA.

440. Secs. 1 and 2 TCGA and Sec. 2 CTA.

441. Sec. 60 TCGA.

442. In *Smart v. Lowndes (HM Inspector of Taxes)* 52 TC 436, for example, a husband and wife owned property jointly, but the wife was found on the facts to be acting as a nominee for the husband and so the gain realized on the sale of the property was taxable entirely in the husband’s hands.

443. *Booth v. Ellard (Inspector of Taxes)* [1980] STC 555. This case was followed in *Jenkins (Inspector of Taxes) v. Brown* [1989] STC 577, which concerned a similar pooling arrangement for family farms to ensure that the family retained control.

might appear to contain at first sight. The case concerned 12 family members, who transferred their shares in a family company to trustees to hold the shares for the individuals in proportion to their original shareholdings, with default powers to deal with the shares if they did not receive instructions from each individual. The court found that this was simply a pooling arrangement, to ensure that the family retained control over a company that was about to go to the stock exchange, and that all the individuals did was to transfer some powers and discretions to the trustees. The measure of their entitlements remained the same and, as their beneficial interests were concurrent (rather than successive) and qualitatively similar, the provision on nominee property applied. The court concluded, in effect, that the ownership of the shares remained with the individuals for capital gains tax purposes, and there was, therefore, no chargeable disposal when the individuals transferred their shares to the trustees.

This case was followed in *Anders v. Lovisa*,⁴⁴⁴ in which two companies settled a claim for damages by agreeing that the defendant company was to sell an asset it owned, and that the proceeds of sale were to be split between the two companies according to a formula agreed between them. The judge found that this agreement created a trust for sale of the asset. He went on to hold that the provision about nominee property applied so that, on the sale, each company made a disposal of its own interest to the purchaser and was taxable accordingly. The argument that the provision on nominee property could not apply, because the interests of the companies were not concurrent and qualitatively similar, he dismissed as “altogether too technical and refined”, and went on to declare himself “happy to reach a conclusion that seems to me to accord with common sense and commercial reality”.

The general attribution principle in the Netherlands on the basis of enjoyment also has a strong economic element, and the attribution of capital gains is no exception. In the attribution between spouses of gains realized on jointly owned assets it has been shown, for example, that reliance on the legal ownership of the asset does not always give a good answer about the attribution of a gain realized on its disposal.⁴⁴⁵

444. *Anders Utkilens Rederi A/S v. O/Y Lovisa Stevedoring Co A/B and Keller Bryant Transport Co Ltd* [1985] STC 301.

445. Roemers, S.M. and Spek, R.F.C., “Toerekening vermogensinkomsten bij duurzaam gescheiden leven; van scheiding, via echtscheiding tot boedelverdeling”, 129 *Weekblad Fiscaal Recht* 6403 (2000), p. 1424 et seq.

On the other hand, in BNB 2007/15,⁴⁴⁶ the Hoge Raad felt itself constrained to take a legal approach, due to a specific provision of the legislation. The case concerned two spouses who were separated, but not yet divorced, and who had a marital community-of-property regime. The husband lived in Belgium, the wife in the Netherlands, and they were therefore taxed separately on their individual income. The husband sold a substantial shareholding which he held in his own name. The wife had no influence on the husband's dealings with the shareholding and did not receive any of the proceeds. The Hoge Raad held that she was taxable on half of the gain nevertheless. The income tax law made no specific provision about the attribution of income or gains between a husband and wife in this situation, but the shares constituted a substantial shareholding⁴⁴⁷ and the definition of a substantial shareholding⁴⁴⁸ was based on the legal ownership of shares. The Hoge Raad therefore felt bound to take a legal approach, despite the advice of the Advocate-General to follow the usual economic approach to the attribution of income.

3.1.2. Income from an asset

One might expect the attribution of income from assets to follow the same principles as the attribution of a gain realized on the asset, but this is not always the case. The Netherlands is more consistent in this respect, as the general principle of enjoyment applies to all types of income, subject to the exception just noted in respect of substantial shareholdings. In the United Kingdom, whereas the capital gains tax legislation uses "accruing to" as its basic attribution principle, the individual income tax legislation generally refers to the person receiving or entitled to the income and the corporation tax legislation simply refers to the profits "of" companies.

So while the UK legislation refers specifically to receipt as factor in the attribution of income, in the Netherlands the receipt of income from an asset does not, of itself, lead to taxation in the hands of the recipient.⁴⁴⁹ Rather, the basic principle means that income is taxed in the hands of the person who has the actual enjoyment of the income. In looking for the per-

446. Note 402.

447. "*Aanmerkelijk belang*" in Dutch.

448. Art. 39 Wet IB 1964 (note 390), now in Art. 4.6 Wet IB 2001, note 56.

449. "Het louter ontvangen van de vrucht leidt niet tot belastingheffing bij de ontvanger" (The simple receipt of the income does not lead to the taxation of the recipient; author's translation): Roemers and Spek, note 445.

son who has the actual enjoyment, the case law has generally looked for the person who is able to control or deal with income.⁴⁵⁰

3.1.2.1. *The Netherlands*

In BNB 2007/15⁴⁵¹ (the facts of which were explained at the end of 3.1.1.) there was a second question before the Hoge Raad about the attribution of interest. The husband had sold the shares in the company in exchange for interest-bearing loans, held in his name alone, and the attribution of the interest from those loans was also in dispute. There was no specific provision in the law that provided any guidance in respect of the interest, so this question had to be answered through the application of general principles. The entire amount of the interest was attributed to the husband, because he had factual control over it and was also the one who received it. The Hoge Raad stated that the shared legal entitlement of the spouses to the interest had no bearing on the issue of which spouse enjoyed this income; the determining factor was, rather, which spouse had factual control over the income. The Advocate-General had come to the same conclusion in respect of the interest, although he also stated that control is a factual question which is not always easy to answer and which maybe does not always give the most desirable answer.

The Hoge Raad further indicated that control over the income produced by an asset usually follows control over the asset itself, so that the income is usually attributable to the person in whose name an asset is held. In BNB 2010/100⁴⁵² the Secretary of State objected to this approach, arguing that it invited avoidance by married couples by allowing them to manipulate the attribution of income by choosing in which spouse's name an asset is held. Nevertheless, the Hoge Raad confirmed that it is factual control that determines the attribution of income, stating again that the income is usually attributed to the person in whose name an asset is held and that, if an asset is held in the name of one spouse, the marital community-of-property regime does not mean that the income flows directly to both spouses for tax purposes.

In a number of earlier cases the Hoge Raad had also attributed income to the person with factual control over the income, in preference to the per-

450. The Dutch word that is usually used in this context is “*beschikkingsmacht*”.

451. Note 402.

452. HR 15 January 2010, No. 08/03923, BNB 2010/100 (with conclusion by A-G Niessen and comment by Heithuis).

son with legal entitlement. In BNB 1963/100,⁴⁵³ for example, one of two company director/shareholders extracted money from the company without the knowledge of the other. When this was discovered he came to a settlement with the other director/shareholder instead of paying the money back, which caused the amount he had extracted to be treated as a deemed dividend. The Hoge Raad held that the deemed dividend was attributable in its entirety to the shareholder who had taken the money, because he had enjoyed the benefit.

Similarly, BNB 1987/57⁴⁵⁴ concerned spouses who were married with a community-of-property regime, but who were separated. The wife had the exclusive use of the matrimonial home. The question before the Hoge Raad was whether the deemed income from the house should be attributed in its entirety to her, or whether half of it should be regarded as alimony from her husband; it was attributed to her, because she had the exclusive control and use of the house. In this case the Hoge Raad stated explicitly that the legal entitlement of both spouses was not relevant.

In BNB 1997/295⁴⁵⁵ two brothers each held 50% of the shares in a BV. One of them caused the BV to sell immovable property to his wife for a price below its market value, which caused a deemed dividend to have been paid by the BV. He argued that he was taxable on only half the dividend, as he owned only half the shares. The Hoge Raad rejected this argument with a very brief statement that it was not supported by the law, and (unfortunately) gave no further explanation.⁴⁵⁶ Clearly, however, the legal ownership of the shares was not the decisive factor.

What does not emerge from these cases is exactly how far, or for which reasons, control over the income has to be shifted in order to change the attribution away from the legal owner of the asset, but in BNB 1965/112⁴⁵⁷ the Hoge Raad may well have gone too far in this respect. This case again con-

453. HR 6 February 1963, No. 14 893, BNB 1963/100 (with comment by van Soest).

454. HR 3 December 1983, No. 23 874, BNB 1987/57 (with conclusion by A-G van Soest).

455. HR 8 July 1997, No. 32 050, BNB 1997/295 (with comment by Juch).

456. In his comment on the case, Juch states that he has difficulty with this conclusion, although he also takes a substantive, or economic approach. Juch's argument is that the brother (whose role was not discussed in the case at all), as the other shareholder, also shared in the provision of the benefit to the wife. The correct interpretation, therefore, could have been that the brothers each received half of the deemed dividend and each gave their share to the wife. In other words, the court jumped to its conclusion a little too hastily.

457. HR 17 February 1965, No. 15 261, BNB 1965/112 (with comment by Hellema).

cerned two spouses who were married in community of property. The wife was incurably mentally ill, and lived permanently in a nursing home, so the couple was treated as living apart and each was taxable on his/her own income. The Hoge Raad, in a very brief statement, attributed all the passive income of the couple to the husband, because he had control of it. Hellema, in his note to the case, states that he is unable to understand the decision; in his opinion the husband was correct in arguing that simply being able to control the income, in the sense that he decided how it was spent, did not necessarily mean that he also had the enjoyment of the income.

In accordance with the more formal nature of the dividend tax, the dividend tax credit forms an exception to the general approach of the case law, at least if a decision of the Secretary of State⁴⁵⁸ in this respect is correct. The law now allows spouses to divide their Box 3 income between themselves as they see fit,⁴⁵⁹ but this decision states that, strictly speaking, the dividend tax can be credited only by the spouse in whose name the shares are held. As a concession, however, the decision allows the allocation of the credit in the proportion chosen by the spouses for the attribution of the dividend.

3.1.2.2. *The United Kingdom*

The United Kingdom is able to tax a legal owner of an asset who has no personal right to enjoy any of the income, although one has to be careful in making comparisons due to the difference in property law between the two countries. The crucial difference in this respect is that in the United Kingdom it is possible that no one has any beneficial entitlement to the income.⁴⁶⁰ In *ex p Dr Barnado's Homes*,⁴⁶¹ for example, income was attributed to the executors of a deceased's estate, to the exclusion of the persons who inherited under the will. One of those persons was a charity which, as a tax-exempt body, claimed a refund of the tax withheld from its share of the dividends and interest received by the executors. The House of Lords held unanimously that the refund should be refused. Until the administration of the estate had been completed and the amount of the residue established, there was no property to which the charity could lay any claim. Therefore

458. Decision of the Secretary of State, 12 December 2007, No. CPP2007/2793M, Stcrt. 2008, 1, BNB 2008/63, question and answer 2.15.

459. Art. 2.17 Wet IB 2001, note 56.

460. This possibility is discussed in Appendix II, 3.2.1. in connection with trusts which, in this respect, are very similar to the estate of a deceased individual while it is still in administration.

461. *R v. IT Special Purposes Commrs, ex p Dr Barnado's Homes National Incorporated Association* [1920] 1 KB 26, 7 TC 646.

it was the executors, and they alone, who were the recipients of the income during the administration period.⁴⁶² A similar answer was given in *Corbett v. CIR*,⁴⁶³ even though in this case some of the income had actually been paid to the beneficiary under the will during the administration period, as an advance of her anticipated entitlement.

In these two cases the executors had both the legal ownership of the assets and income, and control over the income. Of course their control was limited by the function in which they received the income but, unless one argues that the deceased was still controlling the income from his grave, there was no other person who had control. That cannot be said of the trustees in question in *Perry v. Astor*,⁴⁶⁴ which concerned an individual resident in the United Kingdom who settled property on trustees in New York. He had no entitlement to any specific assets or payments of income under the trust, but he did retain a large degree of control over the way in which the trust assets and income were used; the trustees were required to pay or apply the income to him, or for his benefit, as and when he directed, and on his death they were to pay the capital to such persons as he should direct. He also reserved power to revoke or change the trust in any way.

The crux of the discussion in the case was whether or not an anti-avoidance provision in the income tax law of the time applied, under which income could be attributed to an individual if he was able “to obtain for himself the beneficial enjoyment” of the income. On a plain reading of those words it would seem that the individual clearly fell within the scope of that provision, yet four out of five law lords held that he was not taxable in respect of the trust income. Their reasoning was not based on the meaning of those words, however, but on the effect that this provision had on the reach of the UK taxing jurisdiction. In the case before them it had the effect of bringing income into the UK tax net, but in a mirror image case it would take income outside the UK tax net. Their Lordships considered that this result must have been unintended, and therefore held that the provision did not apply to attribute the trust income to the individual in the case before them. For the purposes of this study, however, the most interesting aspect of this case is the need for a specific legislative provision to attribute income to an individual who could have the income paid to him as and when he wanted.

462. What the charity received when the administration of the estate was completed was therefore capital.

463. *Corbett v. CIR* 21 TC 448.

464. *Perry v. Astor* [1935] AC 398, 19 TC 255.

Although *Perry v. Astor* is an old case, and the current anti-avoidance legislation would now give a different result,⁴⁶⁵ legal ownership still resonates as an important factor. In *Butler v. Wildin*,⁴⁶⁶ decided in 1988, two brothers set up a company to carry on their business, and all the shares were owned by their infant children. The judge deciding the case described the facts as “artificial and unreal”, but still the case was argued by the Revenue on the basis of anti-avoidance legislation,⁴⁶⁷ rather than on any basic principles. Indeed, the anti-avoidance legislation in question did not apply to a small number of the shares, because certain conditions for its application were not fulfilled, and in respect of those shares the dividends were attributed to the children.

3.1.3. Contractual arrangements

Where the Netherlands and the United Kingdom do agree is that, as a general principle, ownership is a more important factor than contractual arrangements.⁴⁶⁸ BNB 1982/179,⁴⁶⁹ for example, concerned a life insurance company which sold products under which participants made regular deposits, the deposits were invested in the name of the insurance company, and the insurance company paid the entire amount of the dividends it received to the participants. The issue before the court was the company’s claim to credit the withholding tax on the dividends. The court allowed the claim because it was the company, as the owner of the shares, that enjoyed the dividends; the participants were not the shareholders and therefore did not enjoy the dividends. Similarly, in the United Kingdom, an individual holding a unit-linked life policy does not own the investments on which his policy is based, even though his contractual entitlement to benefits depends on the performance of identified investments. It is therefore the insurance company that is taxable on the income from the investments.⁴⁷⁰

Both the Netherlands and the UK courts have also found that a contractual agreement about sharing income is not enough to displace the attribution of income on the basis of the ownership of the asset. In BNB 1995/280⁴⁷¹ a father and daughter owned a house in one-third and two-thirds shares, and

465. The legislation on transfers of assets abroad, explained in Appendix II, 3.4.2.2.

466. *Butler (Inspector of Taxes) v. Wildin* [1989] STC 22; see also Appendix II, 4.2.4.

467. The settlements code, discussed in Appendix II, 3.5.1.2.

468. But see the discussion in Appendix II, 3.2.3. on economic ownership.

469. Hof Amsterdam, 24 June 1981, No. 1107/99, BNB 1982/179.

470. Fraser, R., “‘Entity Classification’ – a Commentary and Critique”, *The Tax Journal* 491 (1999), p. 13 et seq. See also *IRC V. Willoughby* [1997] STC 995.

471. HR 28 June 1995, No. 30 388, BNB 1995/280.

rented it out, but the daughter took a larger proportion of the rent than two thirds. The Hoge Raad nevertheless attributed the rent in the same proportion as their ownership shares, holding that the difference in the amounts of rent actually taken were simply a payment from the father to the daughter after each had enjoyed his/her share.

In the United Kingdom, a similar result was reached in *Burca v. Parkinson*,⁴⁷² although this case concerned capital gains tax. An individual needed money for his business, which he borrowed from his parents on the security of shares that he owned, agreeing with them that if he sold the shares within two years they would receive 60% of the net proceeds of sale. He did indeed sell the shares within two years, and duly paid the agreed amount to his parents. He argued that the payment to his parents should have been deducted from the sale price in computing his gain, but the judge disagreed, holding that the sale proceeds belonged to him as a matter of property law and therefore the entire gain was attributable to him.

The difference between property law and contractual obligations on the attribution of income was a specific point of discussion in the Netherlands in BNB 2010/98.⁴⁷³ This case again concerned a married couple, but this time married without a marital community-of-property regime. The spouses had, however, entered into a prenuptial agreement to equal out their income year by year, although they had never actually made any payments to each other in accordance with that agreement. The Hoge Raad held that the prenuptial agreement was a contractual obligation, not a matter of property law, and therefore it could not change the attribution of loan interest to the spouse in whose name the loan was made. The UK court in *Anders v. Lovisa*, discussed in 3.1.1., used comparable reasoning, but in the opposite direction. In this case the judge found that the contract between the parties had created a trust, or in other words a property law relationship, and accordingly it did change the attribution of the gain in question.

3.2. Divided ownership

One of the obvious problems with attributing income on the basis of ownership of the asset that produces the income is that ownership has many

472. *Burca v. Parkinson (Inspector of Taxes)* [2001] STC 1298.

473. HR 18 December 2009, No. 08/00669, BNB 2010/98 (with conclusion by A-G Niessen and comment by Heithuis). A similar decision was handed down in HR 18 December 2009, No. 08/02994, BNB 2010/99 (with conclusion by A-G Niessen and comment by Heithuis).

aspects, which can be divided between two or more persons, leaving one with the question as to which part of the ownership attracts the income.⁴⁷⁴ This section deals with the major types of divided ownership in common law and civil law systems of property law, namely trusts⁴⁷⁵ and usufructs. It concludes by looking at the concept of economic ownership.

3.2.1. Trusts

3.2.1.1. *The trust concept*⁴⁷⁶

The trust is the classic form of divided ownership of, generally, assets. Or maybe it is better described as a legal figure that creates two concurrent ownerships of the trust assets and income, which is why it is such a difficult figure to handle for tax purposes. The two ownerships are the legal ownership of the trustees, and the equitable, or beneficial, ownership of the beneficiaries.⁴⁷⁷ The trustees hold the assets and bear all the burdens of ownership; they are responsible for maintaining and managing the assets, collecting the income produced by those assets and enforcing payment if necessary. The beneficiaries, collectively, enjoy all the benefits of the trust assets and income, although the entitlement to assets or income of any specific beneficiary depends on the terms of the trust. The interests of trust beneficiaries are often referred to as beneficial ownership, but that term is also used in the United Kingdom to denote other concepts; some examples are discussed in 3.2.3.3. In order to keep the distinction clear, therefore, the remainder of this study will use the term “equitable ownership” to denote the interests of trust beneficiaries.

474. This section does not deal with joint ownership in which the joint owners have interests that are qualitatively similar.

475. The reader is reminded of the warning given in note 433, which is especially pertinent to this subsection, that the property law referred to in this study in respect of the United Kingdom is the property law of England and Wales only.

476. A second warning is appropriate here, namely that the following paragraphs describe the nature of a trust in very broad terms, and each of these statements could be made subject to a myriad of qualifications. Trusts can be used for many purposes, including the carrying-on of an active business, the securitization of assets and as collective investment vehicles. In order to keep this study to manageable proportions, the discussion here is confined to use of trusts as vehicles for the private management and administration of investment assets.

477. In many jurisdictions it is also possible to create a purpose trust, which often takes the form of as a charitable trust. Charitable trusts are generally subject to many specific rules which are not discussed in this study. Given the lack of any named beneficiaries or class of beneficiaries, it is also rather obvious that the income of a purpose trust is attributable to the trustees.

A trust can be drafted to give rights to specific beneficiaries at any point along a very wide scale of possibilities. At one end of the scale, a specific beneficiary is entitled to specific assets or income. At the opposite end, the trustees have a discretion to decide which beneficiaries out of a prescribed class are to receive a benefit from the trust; no beneficiary has a specific claim to any specific asset or income, and all that can be said of specific beneficiaries is that they probably hope to find themselves favoured by the exercise of the trustees' discretion. The extent to which a beneficiary has a specific claim over any asset or income of the trust is always a matter of interpretation of the terms of the trust.⁴⁷⁸

When a beneficiary does become entitled to a distribution of income from the trust, however, that entitlement is legally enforceable, whether it arises from the terms of the trust or from the exercise of the trustees' discretion. In other words, a distinction has to be made between a beneficiary's equitable entitlement to the trust assets or income, and a beneficiary's legally enforceable entitlement to a trust distribution. An equitable entitlement can be highly specific, for example an entitlement to the income derived from a specific asset. In that case the beneficiary's equitable entitlement matches his legal entitlement to a distribution. An equitable entitlement can also be highly indeterminate, if the trust terms give the trustee a wide margin of discretion. In that case the beneficiary has no legally enforceable entitlement unless and until the trustees exercise their discretion to give him entitlement to a distribution. In some trusts it is possible for the trustees to accumulate the trust income and distribute it to beneficiaries as capital. In that case the beneficiaries collectively are equitably entitled to the income, but no specific person ever has an equitable entitlement to any specific item of the trust income.

3.2.1.2. *Taxation in the United Kingdom – basic principles*

Given the significance of the trust concept to the English legal system, one might expect the basic rules for the taxation of trust income to have been firmly anchored in the legislation and/or case law ever since the inception of the income tax. Yet, as we will see below, some of the fundamental issues raised by trusts have either not yet been resolved, or have been resolved but without any clear legal basis. On the other hand, the very

478. These terms are usually found in the trust deed. If the trust deed lacks certain details, legislation often steps in to complete them. It is also possible for a trust to be found by judicial intervention (see for example the case of *Anders v. Lovisa*, discussed in Appendix II, 3.1.1.), and in that case the terms of the trust have to be gleaned from the relevant court order, supplemented if necessary by legislation.

broad purport of the system is clear. In some specific cases the legislation provides that the trustee is taxable, in effect, on the trust income as agent for the beneficiary;⁴⁷⁹ this treatment can apply in the case of bare trusts for a minor or other beneficiary under an incapacity⁴⁸⁰ and trusts with a vulnerable beneficiary.⁴⁸¹ Outside these specific situations, there can be no doubt that a distribution of income to a beneficiary is taxable in the hands of the beneficiary.

For the purposes of this study, however, the vital issue is the attribution of the income from trust assets. Does that depend on whether or not the income is distributed to a beneficiary? In other words, is trust income always attributable to the trustee, who is the only party able to enforce payment,⁴⁸² or can it also be attributed to a beneficiary as soon as the income arises? And if it can be attributed to a beneficiary as soon as it arises, is it attributed only to the beneficiary, thus bypassing the trustee altogether, or is it attributable to both of them?

The legislation does not address these questions directly, but simply applies the attribution rules of the individual income tax legislation,⁴⁸³ as described in 2.3.2. In other words, trust income is generally taxable in the hands of the person who receives, or is entitled to, the income. If using two alternative criteria carries a risk of attribution problems anyway, that risk would seem to be squared in the context of a system that recognizes concurrent ownerships of property. Nevertheless, the attribution of trust income has generally been approached in the United Kingdom as two distinct questions, relating separately to the taxability of the trustee and the beneficiary, rather than as a choice between the two of them. Such is the nature of litigation that the courts have also generally been asked about the taxability of only one of the parties, although in answering this question they have, for obvious reasons, sometimes also considered the taxability of the other party.

479. In some cases an election has to be made for this treatment to apply.

480. Sec. 73 Taxes Management Act 1970.

481. Secs. 23-45 FA 2005.

482. Even if a beneficiary is entitled to the trust income as it arises, the trustee is still the only party that is able to enforce payment by the source of the income. If the trustees neglect this duty, the beneficiary's remedy is against the trustees, not against the source of the income.

483. Both individuals and companies can be trustees, but trustees are taxable in their capacity as trustees (separately for each trust) and this liability is quite separate from any tax liability they may have in their non-trustee capacity. Trustees are persons subject to the individual income tax; the taxing provisions are generally the same for both trustees and individuals, except that some provisions apply to individuals only.

In many cases the trustee and the beneficiary are indeed both taxable under general principles on what is economically the same income; the trustee when it arises to the trust and the beneficiary when he receives or becomes entitled to a distribution of the income. Both are, after all, receiving income to which they are legally entitled. There is no legislative provision to deal with the resulting double taxation, but in practice the beneficiary grosses up the distribution with the tax paid by the trustee on the trust income, and may credit that tax against his liability on the distribution, obtaining a refund if appropriate. “While this is clear the underlying theory is not.”⁴⁸⁴ In some cases HMRC, in practice, assesses only the beneficiary, for example in the case of a bare trust for an adult beneficiary of full capacity.⁴⁸⁵

This description of the taxation of trust income is, however, oversimplified, as the current law is the result of some meanderings on the part of the courts, particularly in the cases from the early part of the 20th century. The previous paragraph suggests that trustees are always taxable in respect of trust income as it arises, HMRC choosing to assess only the beneficiary in some cases as a matter of administrative convenience. That picture is not complete, however, as the case law has not always held that trustees are taxable in respect of trust income. The previous paragraph also suggests that a distribution of trust income is always a different item of income from the income arising to the trust, but in fact the courts have sometimes held that what the beneficiary receives is the trust income, rather than a distribution with a different character. It is, therefore, necessary to look further into the case law and the reasons for these decisions.

3.2.1.3. *Taxation in the United Kingdom – further consideration*

The grounds on which trust income can be attributed directly to a beneficiary are relatively clear. If it is beyond doubt that the beneficiary will receive the income of the trust, then it is attributable to the beneficiary; although the tax may be collected from the trustees, they pay it on behalf of the beneficiary. *Hamilton Russell’s Executors v. CIR*⁴⁸⁶ concerned an accumulating trust with a sole beneficiary. The accumulating nature of the trust was, however, unenforceable and the beneficiary had the right to end the trust and call for the trust property. It was held that the beneficiary was taxable on the trust income, and that the trustee took the trust income as the beneficiary’s income.

484. Gordon, Montes-Manzano and Tiley, note 379, Sec. 13.15, p. 844.

485. *Ibid.*, Sec. 13.03, p. 831.

486. *Hamilton-Russell’s Executors v. CIR* (1943) 25 TC 200.

In two other cases, by contrast, there was no certainty that the trust income would go to the beneficiary, either as it arose or at a later date, and therefore the income was not attributed to the beneficiary. In *CIR v. Blackwell Minor's Trustee*⁴⁸⁷ the beneficiary's interest was only a contingent one; the trust property was to vest in him absolutely when he reached the age of 21, but at the time in issue he was younger.⁴⁸⁸ In *Stanley v. IRC*⁴⁸⁹ the beneficiary had a vested life interest under the trust deed, but the trustees accumulated the income during his minority. If the beneficiary died before reaching majority, the legislation provided that the accumulated income must be added to capital. The court found, therefore, no certainty that the beneficiary would receive the income, and it could not be attributed to him as it arose. It could also not be attributed to him when he did reach his majority, because by that time it had been converted into capital.

Far more difficult is the issue of when trustees are taxable in respect of trust income. There is no doubt that trustees are legally entitled to the trust income as it arises, and they would seem to fall squarely within the general attribution rule for that reason alone. Nevertheless, some early cases have held or suggested that trust income is not always properly attributable to a trustee. The earliest of these cases is *Williams v. Singer*.⁴⁹⁰ The case concerned UK resident trustees, who held foreign-situs assets for a non-resident beneficiary who was entitled to the income as it arose. The trustees mandated payment of the trust income directly to the beneficiary, so that they never received it themselves. It was held that the trustees were not taxable; the beneficiary would not have been liable to UK tax if she had received the income directly, and the trustees could not have a wider liability to tax than the beneficiary.

It is notable that, as the case proceeded through the judicial hierarchy, every judge in every court regarded the income as belonging to the beneficiary, and the liability of the trustees as simply a mechanism for collecting the tax. In the House of Lords Viscount Cave, in a much-quoted part of his judgment, stated that: "... the person charged with tax is neither the trustee nor the beneficiary as such, but the person in actual receipt and control of the income which it is sought to reach. The object of the [taxing] Acts is to

487. *CIR v. Blackwell Minor's Trustee* 10 TC 235.

488. The judge did, however, say that the trust income would have been attributable to him if the only reason that it was accumulated was because he was a minor and therefore unable to give a good receipt even though, in that case, he would not have been able to touch any of the income until he attained his majority.

489. *Stanley v. CIR* 26 TC 12.

490. *A.W. Williams (Surveyor of Taxes) v. W.M.G. Singer* 7 TC 387.

secure for the State a proportion of the profits chargeable, and this end is attained (speaking generally) by the simple and effective expedient of taxing the profits where they are found. If the beneficiary receives them, he is liable to be assessed upon them. If the trustee receives and controls them, he is primarily so liable. ... in cases where a trustee or agent is made chargeable with tax, the statute recognizes the fact that he is a trustee or agent for others, and he is taxed on behalf of and as representing his beneficiaries or principals.” In the same vein Lord Wrenbury stated: “These Sections point to the conclusion that the person to be taxed is the beneficiary, not the trustee, and none the less because under certain conditions the beneficiary is to be reached through the trustee.”

Tiley doubts the correctness of this decision, saying that “[i]f the exception [to the taxability of trustees in respect of trust income] is sound, it is very limited, applying only where the income is not liable to income tax in the hands of the beneficiary (as where he is non-resident), and not applying where the income is liable to tax but no income tax will be due (e.g. by reason of personal allowances due to the beneficiary).”⁴⁹¹ He dislikes it because it “blurs the nature of the trustees’ liability with that of the beneficiary”,⁴⁹² but the case has nevertheless been accepted as part of the UK landscape for a long time. Perhaps a better explanation of the decision is that it was not founded on the attribution issue at all, but on concern about the extent of the United Kingdom’s taxing jurisdiction. In essence, the House of Lords was asked to decide whether the legal entitlement of UK resident trustees was enough to bring the income within the UK tax net; they decided that it was not, but in doing so they introduced an anomaly into the law on the attribution of income.

In *Archer-Shee v. Baker*⁴⁹³ a UK resident was the only life tenant of a trust set up under the law of New York with trustees resident in the United States. The trust fund consisted entirely of non-UK-situs property, and the income was paid by the trustees to the beneficiary’s order at a New York bank. The question before the court was the characterization of the income paid to the beneficiary; did it retain the characterization it had in the hands of the trustees, or did it acquire a new characterization by being passed through the trust?⁴⁹⁴ The answer switched from one side to the other as the case made its way up through the judicial hierarchy, and the final answer from a

491. Tiley assisted by Loutzenhiser, note 358, Sec. 29.2.2.

492. Ibid.

493. Note 405.

494. This question was important because, if the income changed its characterization, it fell into an income category for which the remittance basis applied. If the income re-

3:2 majority in the House of Lords was supported by only four of the nine judges who dealt with the case. The outcome was that the income did retain its original characterization, but the question is whether this decision can be taken as implying anything about the liability of the trustees.

That question was to a large extent answered in *Reid's Trustees v. CIR*.⁴⁹⁵ Put in a simplified form, the trustees held government bonds for three beneficiaries in equal shares. The trust was a testamentary trust, and the settlor had died on the last day on which the bonds were traded cum div; the interest payment for the period that included the settlor's death therefore became part of the trust capital. The trustees refuted any tax liability over the interest on their part by pointing out that, as it became trust capital, the beneficiaries would not have been liable to tax on it if they had received it directly. They then relied on the earlier cases to argue that they could not have a wider liability than the beneficiaries, but this argument was rejected by the court. The legislation at the time taxed this type of income in the hands of the person "receiving or entitled to" the income, and the court found the trustees liable as the persons who received it.

A number of the judges observed that, if the trustees were not taxable on the interest, there would be no one who was, and they obviously felt compelled to avoid that result. Lord Morison repeated what was said in *Williams v. Singer*,⁴⁹⁶ that the taxable person is not the trustee as such, but simply the person in respect of the income; in this case the trustees happened to be those persons. The court did pay attention to some dicta in the earlier cases, which suggested that trustees were mere conduits, but held that the earlier judges had not intended such a wide statement and that these comments had to be placed within the narrow context within which they were made. If these trustees were taxable, then a fortiori the trustees of a discretionary trust are taxable in respect of the trust income, as in that case there would be no beneficiary who could claim the income as it arises.⁴⁹⁷

tained its original characterization, it fell into a category for which the full amount was taxable in the United Kingdom, regardless of whether it was remitted.

495. *Reid's Trustees v. CIR*, *CIR v. Reid's Trustees*, (1929) 14 TC 512. The case was decided by the First Division of the Court of Session, the equivalent in Scotland of the Court of Appeal, but it is also good law in England and Wales. See Cleave, B., "Appeals in Tax Cases in the United Kingdom", 49 *European Taxation* 6 (2009), pp. 315-25.

496. Note 490.

497. One of the most curious aspects of the taxation of trusts in the United Kingdom is that there is still no definitive answer as to the characterization of a distribution of income received by a beneficiary of a discretionary trust; does it retain the characterization that it had in the hands of the trustees, or does it necessarily acquire a new character because the trust income cannot reach a beneficiary until the trustees have made a decision to that effect? HMRC regards the distribution as acquiring a new characteriza-

The most interesting aspect of these cases for the purposes of this study is the basis on which trustees are liable to tax. One approach is not to focus on the liability of trustees as such, but to see their liability as a proxy for the liability of the beneficiaries. This approach can explain *Williams v. Singer*, but not *Reid's Trustees*. Two different reasons for the liability of trustees can be extracted from *Reid's Trustees*: the receipt of the income by trustees; and the need to find a person to tax in order to avoid the result that no one is taxable. The legal entitlement of the trustees to trust income does not receive much attention in the cases discussed above or, for that matter, in most other cases on the liability of trustees.

The much more recent case of *Dawson v. IRC*,⁴⁹⁸ however, did consider the quality of legal entitlement of trustees as the basis of a tax charge. This case concerned a discretionary trust; most of the trust assets were situated outside the United Kingdom, the trust was administered outside the United Kingdom and the principal beneficiaries were resident outside the United Kingdom. There were three trustees and the trust income arose to the three trustees jointly, not jointly and severally. One of the trustees was resident in the United Kingdom; he was able to veto the exercise of the trustees' discretions but was not able to exercise any of them on his own. The Revenue sought to assess the one resident trustee on the trust income.

The relevant legislation provided that income tax was chargeable on the persons receiving or entitled to the income,⁴⁹⁹ but it also stated that tax was chargeable on "profits or gains arising or accruing ... to any person residing in the United Kingdom".⁵⁰⁰ The Revenue accepted that none of the trustees individually was legally entitled to any particular share of the income, but argued that the income arose to all three jointly and it was irrelevant that two of them were resident outside the United Kingdom. The House

tion, but a concession is granted (Concession B18, available at <http://www.hmrc.gov.uk/manuals/intmanual/INTM367820.htm>) under which HMRC treats distributions from a discretionary trust as taking their characterization in proportion to the various items of trust income, so that the beneficiary can claim the same relief as if he received the income directly. In Statement of Practice 3/86 (available at <http://www.lexisnexis.com/uk/legal/results/pubTreeViewDoc.do?nodeId=TAEEAAEAACADBAAD&pubTreeView=23%25>), HMRC changed this practice in respect of resident trusts if: the beneficiary is resident in a treaty country; under the relevant treaty the trust distribution falls under the "other income" article; and that article gives the exclusive taxing right to the residence state. In these cases, HMRC goes back to regarding the distribution as acquiring a new characterization, in order to increase the treaty relief available to the beneficiary. The answer to this question is not, however, directly relevant to the attribution issue and is not pursued further in this study.

498. *Dawson v. IRC* [1989] STC 473.

499. Sec. 108 ICTA 1970.

500. Sec. 114(1) ICTA 1970.

of Lords, in a unanimous judgment, disagreed, holding that the resident trustee was not taxable, “because the income does not arise or accrue to him personally. He has no right of control over the income. ... Similarly ... the persons receiving or entitled to the income are the three trustees jointly. ... [T]he taxpayer as an individual cannot properly be described as *the* person receiving or entitled to the income.”⁵⁰¹ The House of Lords, in other words, was looking for something more than the trustee’s simple legal entitlement to the income, and added the element of control as a necessary ingredient. This issue is discussed further in 5.3.3.2. and 5.4.5.3.

3.2.1.4. *Taxation in the Netherlands*⁵⁰²

Of course the one factor that cannot cause trust income to be attributable to a trustee is that the trustee is able to benefit from it personally. In the Netherlands the Secretary of State has stated that trustees cannot be taxable in respect of trust income because they do not enjoy that income;⁵⁰³ the implication is that a person can enjoy income only if he is able to apply it for his own personal benefit, but it is questionable whether that is an appropriate criterion to apply to a trustee. The powers exercised by many trustees come very close to what the cases and literature have explained to be the essence of enjoyment, namely that a person is able to decide on the application of income. In respect of income derived by discretionary trustees, those powers are the maximum control that any person can have over that income; that the trustee cannot apply the income for his own personal benefit seems irrelevant if his tax liability as trustee also does not affect his own personal wealth. It will indeed be argued in 5.4.5.3. that the Secretary of State is asking the wrong question in this respect.

Nevertheless, the attribution of trust income poses two other problems for the Netherlands. One is the difficulty under the Netherlands civil law of recognizing the different ownership capacities of a trustee, namely ownership of the trustee’s personal assets on the one hand and ownership of the trust assets on the other.⁵⁰⁴ This issue has, however, been overshadowed for

501. The case was subsequently reversed by legislation which makes it possible to attribute income to one of a number of trustees: Sec. 151(1) FA 1989.

502. For an English-language explanation of the law in the Netherlands in this respect, see Auerbach, note 175.

503. *Memorie van Toelichting Wet Conflictenrecht Trusts*, Kamerstukken II 1992/1993, 23 017, No. 3, at p. 12.

504. Although it has been disputed in the literature that the Netherlands is unable to recognize these different ownership capacities. See, for example, Koppenol-Laforce, M.E., “Inbreng van Nederlandse goederen in een trust”, 128 *WPNR* 6281 (1997), pp. 545-51.

tax purposes by the second problem: the distrust evidenced by the Secretary of State about the use of trusts.

In decisions of 2000 and 2005⁵⁰⁵ the Secretary of State expressed his view that “floating wealth” did not fit into the tax system of the Netherlands⁵⁰⁶ and that, given the flexibility of the trust concept, it was necessary to decide for each case individually how the law should be applied. A practice was developed of coming to an agreement with taxpayers who had connections with a trust in which all the tax issues raised by the trust were agreed in advance. These agreements were not made public, but it is understood that they strove as far as possible to impose tax as if the trust were transparent. The decisions of the Secretary of State also suggested transparent treatment, explaining that this meant imposing tax as if the trust did not exist and that therefore the trust assets and income would have to be attributed to an individual or legal entity. They stated that it is not possible to apply this treatment to a fully discretionary trust, implying that if a beneficiary had an entitlement under the trust the assets and income would be attributed to that beneficiary; yet both decisions also stated that, if transparent treatment was applied, the settlor would be required to provide a yearly summary of the trustee’s financial report, implying that the settlor would retain at least a certain amount of responsibility for the trust.

The assumption that the settlor retains a role was made explicit in the explanatory memorandum to an amendment of the income tax law⁵⁰⁷ which governs the taxation of many trusts as of January 2010. This explanatory

505. Besluit van 10 februari 2000, No. DB99/4199M, BNB 2000/154 (adapted to the Wet IB 2001 in Besluit van 8 december 2000, No. CPP2000/2818) and Besluit van 15 december 2005, No. CPP2005/2528M, BNB 2006/139.

506. This view was based by the Secretary of State on four cases decided by the HR in 1998; three of these decisions have been published as HR 18 November 1998, Nos. 31 756-31 759, BNB 1999/35-38 (all with conclusion by A-G Moltmaker and comment by J.W. Zwemmer). In these cases, the HR decided that the system of the gift and inheritance tax law did not allow an individual resident in the Netherlands to give away assets without triggering a charge to gift or inheritance tax, and that therefore a trust could be regarded as a “purpose fund” and as a donee for this purpose. A-G Moltmaker expressed in his conclusion his agreement with the argument of the Secretary of State that floating wealth did not fit into the system of the gift and inheritance tax, although he also stated that such a possibility may have to be accepted if the trust concept were to be recognized for the purposes of the tax law of the Netherlands (Paras. 3.5.5 and 3.5.6 of his general conclusions on these cases).

507. Art. 2.14a Wet IB 2001 (note 56), introduced by Wet van 17 december 2009, Stb. 2009, 564. A comparable amendment was also made to the law on gift and inheritance tax, the Successiewet 1956.

memorandum⁵⁰⁸ states that in practice the settlor retains control in many different ways over such a trust fund. Accordingly, the amended income tax law now attributes all the income⁵⁰⁹ of an irrevocable discretionary trust to the person who provided the assets, generally the settlor.⁵¹⁰ After the death of the settlor, the income is attributed to the settlor's heirs in proportion to their entitlements in the settlor's estate, regardless of the actual entitlements to the trust income. On the death of the heirs the attribution is made proportionally to their heirs, and so on.⁵¹¹ There is no exception in respect of trust income that is actually distributed to a beneficiary,⁵¹² nor does the law provide any possibility for the settlor or his heirs to demonstrate that the settlor did not retain any control. Although this amendment was adopted primarily in order to deal with irrevocable discretionary trusts, it applies to all funds that fall within the definition of a "separate private fund".⁵¹³

508. Memorie van Toelichting Wijziging van de Successiewet 1956 en enige andere belastingwetten (vereenvoudiging bedrijfsopvolgingsregeling en herziening tariefstructuur in de Successiewet 1956, alsmede introductie van een regeling voor afgezonderd particulier vermogen in de Wet inkomstenbelasting 2001 en de Successiewet 1956), Kamerstukken II 2008/09, 31 930, No. 3, Artikelsgewijze toelichting, Artikel II, onderdeel A (artikel 2.14a Wet IB 2001).

509. And the assets, debts and expenses of the fund.

510. Unless the trust carries on a business and is subject to a tax on its net profit of at least 10%.

511. This rule does not apply, however, in respect of an heir if the heir or his/her spouse is not, and cannot become, a beneficiary of the trust; in that case the attribution is made to the remaining heirs. There is also an exception if the choice of heirs in the settlor's will is made principally in order to manipulate the application of this rule.

512. The only exception in this respect is that the income can be attributed to a beneficiary if the settlor or the settlor's spouse or heirs cannot be identified, which is a rather unlikely circumstance unless the trust is a charitable one that receives donations from the public.

513. Author's translation; the term in Dutch is "*afgezonderd particulier vermogen*". A separate fund is "private" for this purpose if: it has a private aim that is more than incidental; the separation of the fund is not carried out in exchange for the issue of any shares, profit shares, membership rights, shared entitlement or comparable rights; and the separation of the fund does not give any shared economic entitlements. The separation of assets into such a fund is defined as: separating assets in such a fund for no consideration or on abnormal conditions; or transferring assets to such a fund that has a private aim that is more than incidental and that is a private aim of the transferor or defined family members of the transferor. The definition, therefore, also includes many foundations. Although it is clear that this amendment applies to irrevocable discretionary trusts, its further scope is disputed in the literature: Boer, J.P., and Freudenthal, R.M., "'De identiteitscrisis van de Anglo-Amerikaanse trust': afgezonderd of niet?", 140 *WPNR* 6802 (2009), pp. 507-11; and Verstijnen, W., "Afgezonderde particuliere vermogens", 79 *MBB* 5 (2010), pp. 189-94.

The anti-avoidance character of this amendment is clear,⁵¹⁴ reflecting the finding reported in the explanatory memorandum to the amending law⁵¹⁵ that, since the ratification by the Netherlands of the Hague Convention on the Recognition of Trusts,⁵¹⁶ there had been widespread use of trusts in order to avoid taxation. What is also clear is the amendment's potential for attributing income to a person who does not enjoy the benefit of the income in any way.⁵¹⁷ Case law before the 2010 amendment⁵¹⁸ had also found control over the application of trust income important, but had looked at factual control. In choosing the presumed control of the settlor as the determining factor for the attribution of trust income, the law now imposes an attribution rule that may be far removed from reality, and creates a distortion far greater than the distortion that would have been caused by attributing the income to the trustee.

3.2.2. Usufruct

The usufruct is the answer of countries with a civil law tradition to the trust figure and, like the trust, the usufruct is a figure of property law. Whereas a trust splits the burdens of ownership from the benefits, placing the burdens on the trustee and giving the benefits to the beneficiaries, a usufruct divides them by putting the burdens and benefits of the asset itself in the hands of the bare owner, and the burdens and benefits of the income in the hands of the usufructer.⁵¹⁹

514. See the letter of the State Secretary for Finance in this respect: Brief van de staatssecretaris van Financiën van 24 oktober 2008, No. DB/2008/607U.

515. Note 508, Sec. 5.1.

516. Hague Conference on private international law, *Convention on the law applicable to trusts and on their recognition* (The Hague: Permanent Bureau of the Conference, 1984), available at http://www.hcch.net/index_en.php?act=conventions.text&cid=59.

517. This aspect of the law has been widely criticized in the literature. See for example Auerbach, X.G.R., "Doelvermogens verdienen evenwichtige wetgeving", 138 *WFR* 6707 (2009), p. 122 et seq.; Boer and Freudenthal, note 513; van Vijfeijken, I.J.F.A., "Wetsvoorstel 31 930: Gebrek aan visie", 138 *WFR* 6829 (2009), p. 1231 et seq., at p. 1234; Verstijnen, note 513; and Auerbach, X.G.R., "Afgezonderd Particulier Vermogen: constructiefouten", 139 *WFR* 6874 (2010), p. 1172 et seq.

518. Hof 's-Hertogenbosch, 24 April 1964, No. 196/1963, BNB 1964/265. See also Verstijnen, note 513, who concludes from the case law in respect of the Box 3 tax charge (admittedly a slightly different issue; see Appendix II, 1.2.) that factual control was the determining factor.

519. This simple contrast is complicated by the possibility of creating a usufruct over payments of income, but the case law has focused on usufruct over assets, and so will the discussion here.

The way in which a usufruct divides ownership is generally less problematic for the application of a tax on income than the way in which a trust divides ownership, as under a usufruct there is only one person who is entitled to the income at any given time. Nevertheless, the taxation of usufructs in the Netherlands contains a similar sort of surprise as the taxation of trusts in the United Kingdom, namely that the application of the tax law to all the important aspects of a usufruct was not definitively settled long ago. Some important aspects were not settled until relatively recently, and have now possibly been overturned by the developments in respect of economic ownership discussed in 3.2.3.1.

The classic case in the Netherlands, often called “the usufruct case”, is BNB 1955/50,⁵²⁰ which held that a usufructer is not entitled to the participation exemption. The Hoge Raad stated that the participation exemption is intended for persons who have a specific type of relationship with the company and that only the bare owner has that relationship; the usufructer’s relationship is with the bare owner, not the company, and he could not therefore be regarded as a shareholder. This conclusion was contested by Hellema in his note to the case, who argued that the purpose of the participation exemption – to prevent the economic double taxation of corporate profits – should have led to exactly the opposite conclusion. Interestingly, Hellema found the simple possession of the share certificates important,⁵²¹ reasoning that if the usufructer had them there would have been virtually no difference between him and a full owner for this purpose. The Hoge Raad, however, confirmed its approach in BNB 1998/130.⁵²²

These cases were not directly concerned with the attribution of income from assets subject to a usufruct, but in BNB 1983/175⁵²³ the attribution issue did arise in a direct form. In this case a company bought back its own shares; the excess of the purchase price over the nominal value was regarded as a dividend for tax purposes and was therefore subject to the dividend withholding tax. The question before the Hoge Raad was whether the bare owner of the shares could take a credit for the dividend tax (and, in this case, obtain a refund because it was a tax-exempt person). The essence

520. HR 29 December 1954, No. 12 040, BNB 1955/50 (with comment by Hellema).

521. It was not clear from the facts which party had the share certificates in his possession.

522. HR 11 February 1998, No. 31 601 BNB 1998/130 (with comment by van Vijf-eijken). A usufructer of shares (which were represented by certificates) sold her usufruct and the bare owners sold their interest to the same person at the same time. The HR held that the usufructer did not sell in the capacity of shareholder. As the usufructer was an individual, the profit she realized was therefore a non-taxable capital gain.

523. HR 2 March 1983, No. 21 136 BNB 1983/175 (with comment by van Dijk).

of the question was how to resolve the clash between two aspects of the situation: on the one hand the bare owner, as the only owner of the shares, was entitled to the whole repurchase price paid by the company;⁵²⁴ on the other hand the tax legislation labelled the gain realized by the bare owner as a dividend and subjected it to dividend tax as if it were regular income.

The bare owner argued that, as it was entitled to the whole amount regarded as a dividend, it should also be able to credit the whole amount of the dividend tax. According to the established case law, however, the gain in a case such as this was attributable for tax purposes to the bare owner and the usufructer in proportion to the respective values of their interests. If the dividend tax was attributed in the same proportions, the usufruct portion of the credit would be “lost”, because the usufructer was not taxable on any part of the gain. Advocate-General van Soest observed in his conclusion that this result was the effect of the established case law, but he did so without any enthusiasm. He also repeated his opinion in an earlier case⁵²⁵ that the absence of any taxation on the usufructer was comparable with a tax exemption and that therefore the usufructer should be able to credit the usufruct portion of the dividend tax. Van Dijck, in his note on the case, also disliked the outcome of the established case law, but he argued that the entire gain should have been attributed to the bare owner, who would then have been able to credit the entire amount of the dividend tax. The Hoge Raad followed the established case law, however, holding that the bare owner was entitled to credit only a portion of the dividend tax.

3.2.3. Economic ownership

3.2.3.1. *The Netherlands*

Trusts and usufructs are figures of property law, and one would therefore expect them to have an impact on the attribution of income from assets, but both the Netherlands and the United Kingdom also have case law that develops a concept of ownership outside the law of property. In the Netherlands this concept is called economic ownership, and it came under the spotlights when the Hoge Raad, in BNB 1986/118,⁵²⁶ decided that the full economic ownership of shares fell within the participation exemption. The

524. Although the price received by the bare owner would have been subject to the same usufruct as the shares it replaced.

525. HR 25 June 1975, No. 17 572, BNB 1975/213 (with comment by Nooteboom), discussed in Appendix II, 3.5.2.1.

526. HR 16 October 1985, No. 23 033, BNB 1986/118 (with conclusion by A-G van Soest and comment by Bartel).

case concerned an individual who had entered into an arrangement with a company to hold shares in his own name because, for commercial reasons, the company did not want the “true” ownership of the shares to be public knowledge. The company lent money to the individual to buy the shares, and the two parties signed contracts which gave all the economic benefits and burdens of ownership to the company and entitled the company to call for the shares at any moment. The company claimed depreciation on the loan to the individual, but the Hoge Raad disallowed the claim because the participation exemption applied. Given the purpose of the participation exemption (to prevent corporate profits from being taxed in the hands of two companies), the Hoge Raad found that it extended to a company that held the entire economic interest in shares, even though it did not own them legally. The logical conclusion must be that the benefits from the shareholding did not affect the taxation of the individual in any way, although the Hoge Raad did not say so explicitly.

One’s immediate reaction to this decision could be to see the individual as simply a front man⁵²⁷ for the company, but this possibility was explicitly dismissed by Advocate-General van Soest,⁵²⁸ who stated that, if the individual had been simply a front man, the company would have been both the legal and the economic owner of the shares. Van Soest also distinguished this case from the usufruct case⁵²⁹ discussed in 3.2.2., because a usufructer is not an economic owner. The point here was that the company, by taking all the economic benefits and burdens of the shares, was entitled to something so close to ownership that it had to be treated in the same way as a full owner. By contrast, the essence of a usufruct is to leave the ownership of the asset in the hands of the bare owner and to put only the benefits and burdens of the income in the hands of the usufructer.

The concept of economic ownership has since been developed by the courts in a number of directions. It also applies, for example, to an asset which is legally owned by one person but used in the business of another. A recent example is a case⁵³⁰ in which a building was attributed to an individual as his business asset, even though the building belonged to his wife.⁵³¹ The couple lived in the upper floors of the building, and the husband used the

527. “*Stroman*” in Dutch, which translates literally into English as “man of straw”.

528. The term “*stroman*” was used by the lower court, but A-G van Soest found this rather a loose use of the term.

529. BNB 1955/50, note 520.

530. Rechtbank ’s-Gravenhage 7 September 2009, No. AWB 07/3245, *Vakstudie-nieuws* 30 September 2009, No. 2009/206.

531. The couple was not married with a community-of-property regime, so the wife retained sole ownership in legal terms.

ground floor for his shop. The building was included in his balance sheet, and the costs associated with the building, including depreciation, were deducted in his profit and loss account. The court concluded that he bore all the risks of changes in the value of the building, that he therefore was the economic owner and, as such, was taxable in respect of the latent gain in the building when he ended his business. Here again, the logical conclusion must be that the gain was not taxable in the hands of any other person.

The reach of BNB 1986/118 was broadened considerably, and rather unexpectedly, in BNB 2003/34⁵³² (known as the Falcons case), in which the Hoge Raad extended the participation exemption to payments received for the granting of call options over shares.⁵³³ The Hoge Raad reasoned that the purpose of the participation exemption is to prevent the economic double taxation of business profit and that, if an interest in shares is split, the aim of the exemption is achieved only if it applies to both parts of the split interest. In this case it found that the options had the effect of splitting the interest in the shares, and therefore all the benefits from the shares, including the payment for granting the option, fell within the exemption. The surprise element of this decision was the finding that the participation exemption can be claimed by two persons in respect of the same shareholding.

The Falcons case led to a number of further cases exploring the concept of economic ownership,⁵³⁴ and to a lively debate in the literature⁵³⁵ about the exact contours of the concept. Much of this debate focuses on what is

532. HR 22 November 2002 No. 36 272 BNB 2003/34 (with conclusion by A-G Wattel and comment by de Vries).

533. The particular options granted were called “falcons”, hence the common name of the case.

534. For example HR 8 October 2004, No. 40 158, BNB 2004/437; HR 22 April 2005, No. 40 562, BNB 2005/254 (with comment by Juch); HR 14 October 2005, No. 41 275, BNB 2006/7 (with conclusion by A-G Wattel and comment by de Vries).

535. See for example van der Stok, E.B., “De economische eigendom van aandelen”, 129 *WFR* 6408 (2000), p. 1571 et seq.; de Gunst, H., “Hoge Raad introduceert nieuw fiscaal eigendomsbegrip?”, 129 *WFR* 6406 (2000), p. 1523 et seq.; de Gunst, H., “Nogmaals de economische eigendom (van aandelen); een reactie op het artikel van mr. E.B. van der Stok?”, 130 *WFR* 6420 (2001), p. 154 et seq.; the comment by R.J. de Vries on BNB 2003/34, note 532; Janssen, J.J.M., “Het uitdijende FALCONS-universum”, 135 *WFR* 6664 (2006), p. 344 et seq.; Eijkenduijn, A.A., and Rozendal, A., “Een nieuwe invulling van het begrip ‘economische eigendom’? Het begrip ‘economische eigendom’ na HR 8 oktober 2004, BNB 2004/437”, 134 *WFR* 6630 (2005), p. 917 et seq.; Janssen, S.M.H., and Rozendal, A., “Is het vruchtgebruikarrest achterhaald?”, 138 *WFR* 6816 (2009), p. 779 et seq.; Rozendal, A., “BNB 2006/7: (on)gewenste uitbreiding van het ‘gesplitste-aandelenbelangconcept’?”, 138 *WFR* 6838 (2009), p. 1520 et seq.; Hiemstra, H., “De Falcons-doctrine: het gesplitste belang bij de voordelen uit hoofde van een deelneming”, 139 *WFR* 6863 (2010), p. 6863 et seq.

necessary to create a split interest in shares such that both parties qualify for the participation exemption, and whether the Falcons case overturned the usufruct case.⁵³⁶ That debate has not yet reached a definite conclusion, and is not pursued here as it is not directly relevant to the attribution issue.

What is more interesting in respect of the attribution issue is BNB 2006/7,⁵³⁷ which appears to take the economic ownership concept a stage further. This case concerned a contractual right in connection with shares that was rather small; it was held by the original owner of shares, who had sold the shares, and consisted of a right to receive part of the resale price if the purchaser of the shares sold them on to a third party. The purchaser did resell the shares and duly paid some of the resale price to the original shareholder. The Hoge Raad referred to the Falcons case and held⁵³⁸ that the reasoning in that case also required that the original shareholder in this case was entitled to the participation exemption for the portion of the resale price that it received. On the other hand, the Hoge Raad also held that the entire resale price was attributable to the purchaser. So whereas in BNB 1968/118 the full economic ownership of an asset displaced its legal ownership as the guiding principle for determining the enjoyment of the income, in BNB 2006/7 splitting off a small portion of the economic ownership did not affect the attribution of the income. What is not clear is how much of the economic ownership has to be split off in order to change the attribution of the income, but what is required in this respect is clearly different from what is required in order to fragment the participation exemption.

The cases discussed in this section so far concerned the general attribution rule, which is based on the enjoyment of income, but a similar issue arises in respect of the dividend tax, which is imposed on the more formal, legal basis of entitlement to the dividend. When the law on the dividend tax was still a proposal, the explanatory memorandum that accompanied it stated⁵³⁹ that only the legal owner of shares⁵⁴⁰ could be regarded as the person entitled to dividends. An economic owner of shares would therefore seem to be squarely excluded. That document was written in 1960, however, when the concept of economic ownership was still in its infancy. In 2007 the Secretary of State seemed to move away from this position in a

536. BNB 1955/50; see Appendix II, 3.2.2. and note 520.

537. Note 534; see also Appendix II, 5.5.3.1.

538. Contrary to the advice of the A-G.

539. *Memorie van Toelichting Wet op de dividendbelasting 1960, Kamerstukken II 1959/60, 6 000, No. 5, pp. 2-3.*

540. Or a certificate holder; see Appendix II, 3.4.1.1.

decision⁵⁴¹ about structures used by quoted companies to repurchase their own shares. Often the shares are purchased on the stock exchange by an intermediary company, which then sells them to the company carrying out the repurchase programme. According to the Secretary of State the intermediary company is not the person entitled to a dividend paid during its short period of ownership, and therefore not entitled to credit the dividend tax, because its interest is in the commission it receives for this activity, rather than any shareholder's interest. In other words, it is possible that the concept of economic ownership could also find its way into the application of the dividend tax.

3.2.3.2. *The United Kingdom*

By contrast with the Netherlands, the United Kingdom has not explicitly adopted a notion of economic ownership, but that is not to say that the notion does not play any role in the UK tax system. Quite the contrary, in fact; the loan relationships legislation for companies that took effect in 1996⁵⁴² is heavily based on the notion of economic ownership. This legislation introduced a complex scheme for the computation of corporate profit resulting from all aspects of loan relationships, and it has since been extended to cover other relationships and structures that imitate loan relationships. Its scope extends to foreign-exchange movements, repos, stock lending and shareholdings that are economically equivalent to a loan. The basic tax treatment of these relationships follows the accounting treatment adopted by the company, provided the company's accounts follow generally accepted accounting practice.⁵⁴³ The legislation then overlays the accounting treatment with the loan relationships scheme, which provides that the profits and deficits arising to a company from its loan relationships are to be calculated using the credits and debits prescribed by the legislation;⁵⁴⁴ actual payments are taken into account only if they correspond with what is prescribed. The scheme also creates payments between companies when necessary to achieve the required economic effect.

One of the best ways of illustrating the scheme is to look at the *DCC* case,⁵⁴⁵ which concerned the application of the legislation to a repo trans-

541. Besluit van 11 mei 2007, No. CPP2007/9983M, BNB 2007/173; see further Appendix II, 3.3.2.

542. Now found primarily in Parts 5 and 6 CTA.

543. Sec. 46 CTA.

544. Sec. 296 CTA.

545. Note 432.

action.⁵⁴⁶ The facts were rather simple. Ulster Bank, which was not resident in the United Kingdom, borrowed money from DCC on the security of gilts owned by the bank. The simplified and stylized facts discussed in court were that gilts were sold to DCC for GBP 812 million, and shortly afterwards the bank bought them back for GBP 785 million. During the period of DCC's ownership, interest of GBP 28.8 million became payable on the gilts and that amount was collected by DCC. DCC did not pay any of the interest to the bank. There was no dispute that the loan relationships legislation applied; the sale and resale prices were fixed in advance, the bank was the economic owner of the gilts, and the essence of the arrangement was that the bank took a loan from DCC. DCC therefore accounted for the arrangement in its books as a loan, recording a profit of GBP 1.8 million⁵⁴⁷ in its profit and loss account. The loan relationships legislation treated the difference between the sale and resale prices as interest paid by the bank to DCC. It also treated DCC as having paid loan interest of GBP 28.8 million to the bank, even though it did not actually pay any of that sum to the bank and even though the real loan was in the other direction. If DCC had entered the GBP 28.8 million in its books as a credit, the picture would have been complete and the tax treatment would have reflected economic reality. The problem was that there was a gap in the legislation at the time, as there was no provision that specifically required DCC to take the GBP 28.8 million as a credit.

Instead, DCC claimed that it should credit only GBP 2.9 million, as this was the amount of interest on the gilts that was attributable to its period of ownership according to an accepted accruals method of accounting.⁵⁴⁸ The Supreme Court dismissed DCC's argument on the basis that the legislation prevented such an asymmetrical result, and held that both the debit and the credit should be GBP 2.9 million, on a time-apportioned basis.

What is interesting about this case from the attribution perspective is that it is a misleading question to ask to which party the GBP 28.8 million of actual interest paid should be attributed. In the overall scheme of the loan relationships legislation, that sum was simply a payment to DCC which

546. The author wishes to express her gratitude to Roger Muray of Ernst & Young, London, for helping her to understand this case and the legislation behind it.

547. $\text{GBP } 785 \text{ million} + \text{GBP } 28.8 \text{ million} - \text{GBP } 812 \text{ million} = \text{GBP } 1.8 \text{ million}.$

548. This amount is different from the GBP 1.8 million recorded by DCC in its profit and loss account, because the two amounts were based on different relationships: the GBP 1.8 million was the interest due from the bank to DCC; and the GBP 2.9 million was a portion of the interest due from the government to the holder of the gilts, payable at a different rate of interest because the loan represented by the gilts was taken out at a different time.

formed one element of the whole loan arrangement with the bank. The legislation has, in effect, created a notional world that exists alongside the accounting world. In that notional world, the only interest payments were the notional ones from the bank to DCC and from DCC to the bank, and the GBP 28.8 million did not exist as interest paid by the government to DCC; it served, rather, to repay some of the debt back from the bank and to pay the interest due from the bank to DCC.

Economic ownership also plays a role in the attribution of capital gains, as discussed in 3.1.1., although to a lesser extent than in the loan relationships legislation.

3.2.3.3. *Beneficial ownership in the United Kingdom*

One other notion of economic ownership should also be explained here, as it is sometimes a source of confusion, and that it is the concept of “beneficial owner”. This term is often used in the UK legislation in connection with the ownership of assets for various purposes such as liability to stamp duty and the shareholding required for group relief; the latter was the issue in *J. Sainsbury v. O’Connor*.⁵⁴⁹ Much of the case law about beneficial ownership in these contexts concerns contractual arrangements, not figures of property law. As regards the relationship between beneficial ownership in these contexts and the equitable ownership of a beneficiary, the author can do no better than to cite a leading UK textbook, which states: “The courts have struggled to disentangle the notion of beneficial ownership from that of legal or equitable ownership but their comments have not always been helpful.”⁵⁵⁰

One of the more disturbing aspects of beneficial ownership in this context is its habit of disappearing from time to time.⁵⁵¹ One situation in which this can occur is on the conclusion of a contract for sale of an asset, when the beneficial ownership of the asset would seem to leave the vendor on the conclusion of the contract, but not arrive at the purchaser until the asset is transferred to him.⁵⁵² The alternative view is that the beneficial owner-

549. *J. Sainsbury plc v. O’Connor (Inspector of Taxes)* [1991] STC 318.

550. Gordon, Montes-Manzano and Tiley, note 379, Sec. 28.01, p. 1276, referring to *J. Sainsbury plc v. O’Connor*, note 549.

551. Rowland, A., “Beneficial Ownership in a Corporate Context: What is it? When is it Lost? Where Does it Go?”, *British Tax Review* 3 (1997), pp. 178-87.

552. J.G.M., “Beneficial Owner”, *British Tax Review* (1962), pp. 343-4, at p. 343: “It is clear that once the beneficial owner of property has entered into an unconditional

ship in such a case is divided between the vendor and purchaser.⁵⁵³ Another situation in which beneficial ownership can disappear temporarily is on the liquidation of a company.⁵⁵⁴

This rather unexpected behaviour of beneficial ownership does not, however, affect the attribution of income or gains. In respect of capital gains, it is clear that the gain realized on a sale of an asset is attributed to the vendor, or the person who is treated as the vendor in the case of nominee property, whatever the effect of the sale contract on the beneficial ownership in the period between the completion of the sale contract and the transfer of the asset.⁵⁵⁵ And in respect of regular income, the beneficial ownership of an asset is not generally a concept that is used in connection with the attribution of the income from the asset.⁵⁵⁶ There is an issue as to the extent of the economic interest that a person has to have in income in order to be taxable in respect of the income but, as will be seen in 5.2.3.2., the answer to that question is not found by looking at the beneficial ownership of the asset that produces the income.

3.3. Short-term ownership of shares

Another problem with an attribution principle based on the ownership of assets is the possibility that it offers for manipulating the attribution of the income by manipulating the ownership of the assets. This problem usually manifests itself in the transfer of the asset for a short period, and is particularly acute in respect of dividends, due to the difficulty of apportioning them on a time basis. In both the Netherlands and the United Kingdom the

contract to sell it, he has ceased to be the beneficial owner of it, though it is perhaps less certain that the purchaser immediately becomes the beneficial owner instead.”

553. See the judgment of Lord Walker in *Jerome v. Kelly (Inspector of Taxes)* [2004] STC 887, at Para. 32, where he stated “Neither the seller nor the buyer has unqualified beneficial ownership. Beneficial ownership of the land is in a sense split between the seller and buyer on the provisional assumptions that specific performance is available and that the contract will in due course be completed, if necessary by the court ordering specific performance.”

554. See Davis, A.C.R., *Taxation in Corporate Insolvency and Rescue* (6th edn.) (Haywards Heath, United Kingdom: Bloomsbury Publishing, 2009), in particular Secs. 4.7 to 4.21.

555. See the judgment of Lord Hoffmann in *Jerome v. Kelly*, note 553, at Para. 11, where he stated “[The legislation] assumes that the contract will not in itself count as a disposal and so deals with the academic arguments about the effect of the equitable interest which arises at the time of the contract.”

556. But see Appendix II, 6.3.2.4. in respect of income derived from property that is jointly held by a married couple.

courts have, however, accepted the attribution of dividends on the basis of the legal ownership of the shares, although the question has been put to them in different ways. Both countries have also responded to the planning opportunities with legislation, but the legislative responses have also been very different.

3.3.1. Case law responses

In the Netherlands, it is mainly the credit for the dividend tax that has given rise to the case law. The basic attribution principle for dividends was laid down in BNB 1957/226,⁵⁵⁷ in which the Hoge Raad held that the person who enjoys a dividend, and who may take a credit for the dividend tax, is the person who is entitled to the dividend on the day that it becomes payable. That person is usually the legal owner of the shares.⁵⁵⁸ BNB 1957/226 concerned a sale of shares cum div that was not intended to be short-term, but the attribution principle stated there was also applied in BNB 2001/196,⁵⁵⁹ which did concern a short-term transfer. This case, known as the Second Market Maker's case, concerned a company resident in the Netherlands⁵⁶⁰ that, on one day, bought both put options on shares and a corresponding number of the shares. On the following day a dividend was declared, and the company then exercised the options. The dividend was payable nine days later, to the company; it reported the dividend as part of its taxable profit and claimed a credit for the dividend tax. Both the lower court and the Hoge Raad held that it was entitled to the credit.

The lower court made a finding, which was accepted by the Hoge Raad, that the dividend was part of the company's taxable profit. As the dividend had been received subject to the withholding of dividend tax, it followed inevitably from the terms of the law that the company was entitled to credit the tax withheld. The lower court also held explicitly that the person claiming the credit does not have to have the economic ownership of either the dividend or the shares. The net result of these transactions was a substantial benefit for the company and, when it received the dividend, it had complete freedom to deal with the dividend as it saw fit. The Secretary

557. HR 12 June 1957, No. 13 142, BNB 1957/226.

558. Subject to what is discussed elsewhere in this study, for example Appendix II, 3.2.3.1. on economic ownership and Appendix II, 3.5.1.1. and 3.5.2.1. on the transfer of dividend coupons.

559. HR 21 February 2001, No. 35 415, BNB 2001/196 (with conclusion by A-G van den Berge and comment by Cornelisse).

560. A market maker on the Amsterdam option exchange, hence the common name of the case.

of State argued before the Hoge Raad that the company must have known that these transactions were part of a dividend-stripping scheme carried out by non-residents,⁵⁶¹ and that therefore the credit should be refused, but the Hoge Raad rejected this argument, stating that the tax avoidance motive of the other parties did not take away the substantial benefit received by the company from the scheme. It therefore maintained its legal approach to the attribution of the dividend and the credit.

The UK courts have also maintained a legal approach to the attribution of dividends, but they have not been asked to decide explicitly on the attribution issue. The question put to the UK courts has been, rather, the treatment of the short-term owner who buys shares, receives a dividend and sells the shares at a loss, in particular whether the loss on the shares is deductible and how the dividend is to be accounted for. The answers to these questions have in turn depended on whether the short-term owner was trading in shares.⁵⁶² What has not been discussed, and seems never to have been in doubt, is that the dividend paid is properly attributable to the short-term, legal owner of the shares.⁵⁶³

561. The company was one of a number of companies that had carried out these transactions in very large numbers, and the price agreed in the put options was far above the market value of the shares on the date the options were granted. The transactions were carried out through the Amsterdam exchange, so the company did not know the identity of its counter-parties, but the Secretary of State argued that the structure and circumstances of the transactions were such that the company could have had no doubt that the intention behind the transactions was for the company to take a credit for the dividend tax that could not have been claimed by the original non-resident shareholders.

562. In *J.P. Harrison (Watford) Ltd v. Griffiths* [1962] 1 All ER 909, 40 TC 281, it was held by the House of Lords that a simple transaction of buying shares, stripping out the dividend, and selling the shares again did constitute trading and that therefore the loss incurred on the shares was a deductible loss. That decision was subsequently narrowed down considerably by the subsequent decisions. *Finsbury Securities Ltd v. Bishop* [1966] 3 All ER 105 at 110; 43 TC 591 concerned a forward stripping transaction, and the claim to deduct the loss failed in the House of Lords. Some of the reasons given by their Lordships were that the scheme tied the purchaser of the shares in for a period of five years and restricted its ability to deal with the shares as it liked, and that the essence of the scheme was to safeguard the future interests of the vendors (per Lord Morris at p. 627). In *Lupton v. FA & FB Ltd* 47 TC 580, which concerned both backward and forward stripping, the House of Lords was even more explicit about the tax avoidance purpose of the scheme and again held that the losses were not deductible. Their Lordships pointed out that the price paid to the vendors of the shares depended on the success of the purchasers in making their claim for tax relief, and that the profit of the purchasers was not intended to be derived from the trade of buying and selling shares. For an explanation of the history of the legislation leading to these cases see T.D.S., “The Source of ‘Dividend Stripping’”, *British Tax Review* (1961), pp. 346-9.

563. For example, Lord Reid in *FS Securities Ltd v. CIR* 41 TC 666 stated at p. 693: “But then it cannot be denied that [the dividends] were income of the [legal owner]”.

3.3.2. Netherlands legislative response

As might be expected, the legislator in both the Netherlands and the United Kingdom has felt the need to respond to the case law. In the Netherlands this response was relatively limited and not adopted until 2001. It affects only the withholding tax credit, and denies the credit to a person that is not the beneficial owner of the dividend.⁵⁶⁴ The amendment that was originally proposed would have defined the beneficial ownership of shares by reference to the period for which the shares were held⁵⁶⁵ but, after criticism of this proposal from banks and the stock exchange, the legislation that was eventually adopted defines a lack of beneficial ownership in a more substantive way.

In the form in which it was finally adopted, this rule provides that a person is not the beneficial owner of a dividend it receives if (stated in broad terms): the recipient of the dividend has provided some consideration for the dividend; the dividend is received as part of a scheme under which some or all of the benefit of the dividend flows to a person who has a more limited right to credit the dividend tax than the dividend recipient; and the person to whom that benefit flows has a position as shareholder in the distributing company that is, in effect, maintained after the execution of the scheme. This rule has also been extended to the foreign tax credit, not only in respect of dividends, but also in respect of interest and royalties,⁵⁶⁶ although the explanatory memorandum to this decree admits that it is not clear whether a rule that was written for dividends will give the desired results in respect of interest and royalties, and states that therefore the practical effect of the rule in this respect will be monitored.⁵⁶⁷

When this proposal was discussed in the parliament, there was an explicit acknowledgement⁵⁶⁸ that it might have the effect of denying the credit for the dividend tax altogether, as the short-term shareholder might be pre-

564. Art. 9.2 Wet IB 2001, note 56, and Art. 25(2) Wet VpB 1969, note 382. The term used in the legislation is “*uiteindelijke gerechtigde*”. Literally translated, this means “the person who is ultimately entitled” to the dividend, but it is usually translated as “beneficial owner”.

565. More accurately, it provided that a person was not the beneficial owner of the dividend if it did not own the shares for at least ten days before the dividend declaration and at least three months after that date.

566. Art. 16 Besluit voorkoming dubbele belasting 2001, Stb. 2000, nr. 642.

567. Nota van Toelichting bij het Besluit voorkoming dubbele belasting 2001, Stb. 2000, 642, p. 42.

568. Advies Raad van State en Nader Rapport Wijziging van belastingwetten in verband met dividendstripping en het verlenen van opties aan werknemers, Kamerstukken II 1999/2000, 27 896, No. B.

vented from claiming a credit, and the long-term shareholder would not receive the dividend and would be unable to claim the credit for that reason, but this risk was accepted as part of the price of dealing effectively with avoidance schemes. The anti-avoidance nature of the rule was implicitly confirmed during the parliamentary discussion by the Secretary of State, who said that it would be reasonable not to apply it to a short-term owner who knows nothing of the dividend-stripping activity, for example because the short-term owner is dealing on the stock exchange.⁵⁶⁹ It seems, however, that the non-application of the rule in this situation is a discretionary matter, as there is no exception in the law that allows taxpayers to demonstrate the non-avoidance nature of their transactions.

The anti-avoidance nature of this provision has also been called into question by a decision of the Secretary of State in 2007⁵⁷⁰ dealing with forward purchase agreements. Forward purchase agreements are structures that facilitate a company wishing to reacquire its own shares on the stock exchange. The difference between the price paid and the paid-up capital on the shares is regarded as a dividend in such a situation and, if the purchasing company does not know the identity of the person selling the shares, it is required to gross up that amount with the dividend tax. In order to prevent this grossing-up, the company may arrange to buy the shares from a party that is identified, usually a financial institution. The financial institution buys the shares on the stock exchange, and sells them to the repurchasing company. In this decision the Secretary of State expresses his opinion that the financial institution would not qualify as the beneficial owner of the amount regarded as a dividend, and therefore would not be able to credit the dividend tax. What he does not explain is how the financial institution satisfies the second part of the negative definition, as there does not appear to be any shareholder involved that, in effect, maintains its position after the repurchase.⁵⁷¹

The decision also deals with alternative quotations of the shares that allow shareholders to be identified and sell directly to the company (a second trading line). If the second trading line is used by persons who acquire shares in order to sell them to the company in this way, the reasoning of the

569. Nota naar Aanleiding van het Verslag Wijziging van belastingwetten in verband met dividendstripping en het verlenen van opties aan werknemers, Kamerstukken II 2001/02, 27 896, No. 5.

570. BNB 2007/173, note 541.

571. Brandsma also disagrees, on slightly different grounds: Brandsma, R.P.C.W.M., *Cursus Belastingrecht (Dividendbelasting)* (Deventer, the Netherlands: Gouda Quint, loose-leaf), Sec. 2.2.0.B (October 2008).

decision is that these persons, like the financial institution, are interested in the purchase commission and therefore are also not the beneficial owner of the amount regarded as a dividend. On the other hand, for shareholders who use the second trading line and who owned the shares before the repurchase programme started, there is no problem with their credit for the dividend tax.⁵⁷² Maybe this decision is best interpreted as indicating a general concern of the tax administration about granting the dividend tax credit to shareholders who are not regarded as true investors, although this concern has not yet manifested itself in any other legislative measures.

3.3.3. UK legislative response

By contrast with the one legislative response in the Netherlands, the United Kingdom has, since the early dividend-stripping cases, adopted a plethora of legislation to deal with perceived problems that arise in connection with transfers of income-producing assets. These legislative responses have taken a variety of approaches; some introduce a specific attribution rule, but many others accept the attribution of income to the person with legal entitlement and address other issues such as the deduction of losses, or the characterization of a payment for the short-term transfer. The fundamental distinction made in the UK legislation between income and capital gains has always encouraged taxpayers to find ways of turning their income into a capital gain, and many anti-avoidance provisions have been concerned to recharacterize the resulting gain as income.

One of the earlier responses was, for example, legislation in 1937⁵⁷³ that applied if a higher-rate taxpayer sold securities to a lower-rate taxpayer with an agreement to buy them back, and which applied to attribute the income payable during that period to the higher-rate taxpayer. The legislative schemes that were added subsequently were many and varied, but the current legislation deals with many of the issues arising from the short-term ownership of shares and securities through two major schemes: the loan relationships legislation for companies; and the accrued income scheme for individuals. The loan relationships scheme covers both stock lending and repos, as illustrated by the *DCC* case⁵⁷⁴ discussed in 3.2.3.2. The accrued income scheme⁵⁷⁵ for individuals has a narrower scope. The essence of

572. This is so even if they subsequently rebuild their portfolio with shares in the same company, but the rebuilding of their portfolio would not usually be part of a scheme that included their sale to the company in the first place.

573. Sec. 12 FA 1937.

574. *DCC Holdings v. RCC*, note 432.

575. Part 12 ITA.

this scheme is that, on the transfer of a security, it apportions interest on a time basis between the transferor and transferee. Separate legislation deals with stock lending and repo transactions, which prevents individuals and trustees who are the short-term holder of shares from claiming a credit in respect of dividends paid to them if they pay a manufactured dividend to the long-term holder.⁵⁷⁶

Underneath all this legislation there remain the basic attribution rules but, in order to counter any avoidance scheme that might still otherwise work, a general anti-avoidance provision allows HMRC to undo the effect of transactions in securities for tax purposes by issuing a notice to that effect.⁵⁷⁷ This provision is widely worded, and its meaning is rather obscure. It applies in four prescribed sets of circumstances, which include, for example, the receipt of an abnormal dividend in connection with the purchase and sale of securities if the amount received is taken into account for an exemption from income tax or loss relief.⁵⁷⁸

3.4. Indirect ownership and ownership equivalents

The discussion so far on various aspects of ownership has assumed that there is a direct relationship between the asset and the owner. This section discusses how far the ownership concept can reach; can a person also be regarded as the owner of an asset for tax purposes if the relationship is an indirect one? Can it reach even further, to attribute income to a person who has one or more attributes of ownership without being the owner of the asset?

3.4.1. The Netherlands

3.4.1.1. *Certification of shares*

The form of indirect ownership that comes closest to full ownership in the two countries studied here, aside from a pure nominee arrangement, is probably the system of share certification, which is used in respect of many widely held companies incorporated in the Netherlands in order to concentrate the voting power. Under this system the legal title to shares is held by

576. Secs. 592 and 593 ITA.

577. Originally Sec. 32 FA 1951, now Chap. 1, Part 13 ITA for income tax and Chap. 1, Part XVII ICTA 1988 for corporation tax.

578. Secs. 684 and 686 ITA.

an administrative office, which issues certificates representing the shares to the investors. The terms of the certification agreement determine the powers of the administration office in respect of the shares and the rights of the investors, and matters such as when and how dividends received by the administrative office are paid to the investors and how bonus shares are to be dealt with. The indirect ownership of the investor is recognized explicitly in the dividend tax law, which provides that the tax is imposed on the person who is entitled to the dividend, whether directly or through certificates.⁵⁷⁹ It is also clear that the investor is the person who enjoys any income derived from the shares, although the timing of that income in the hands of the certificate holder is not entirely free from doubt.⁵⁸⁰

3.4.1.2. *Interposed companies*

Some case law has gone a stage further and, in effect, attributed income to a person who owns assets through an interposed company, although in BNB 2003/285 (discussed below) the Advocate-General found these cases exceptional. They generally concern shareholders of a company with large cash reserves, who extract the cash by interposing another company which they also own. The cash-rich company then distributes a dividend to the interposed company, which falls within the participation exemption, and the interposed company transfers the cash to the shareholders in a tax-free form. Often the price for the transfer of shares from the shareholder to the interposed company is left outstanding as a debt, and the interposed company uses the dividend to pay off the debt. In this way the shareholders receive the same monetary benefit as if they receive a dividend from the

579. Sec. 1 Wet DB, note 383.

580. In HR 19 March 1958, No. 13 506, BNB 1958/185 (with comment by Hollander), the HR held that certificate holders enjoyed a distribution in the form of new shares issued on a merger on the merger date, and not on the date on which the administration office replaced the certificates for the old shares with certificates for the new ones, which was several months later. Hollander, in his note, concluded that distributions are generally taxable in the hands of certificate holders on the date that they arise, unless there is something unusual in the certification agreement to the contrary. In a Resolution referring to this case, however, the Secretary of State, stated that regular dividends are not enjoyed by the investors on the date they are received by the administration office; presumably the investors do not enjoy the dividends in his view until they receive them from the administration office. He does regard distributions in kind as being enjoyed by the investors when they are received by the administration office if the administration office; Resolutie van 12 oktober 1994, No. DB94/2980M, BNB 1994/329

cash-rich company, but without incurring the income tax charge that would apply on the receipt of a dividend.⁵⁸¹

This line of case law originated in BNB 1968/80,⁵⁸² in which the tax inspector applied the “*richtige heffing*” principle⁵⁸³ to tax one of the shareholders as if he received the dividend directly from the cash-rich company. The assessment was upheld by the Hoge Raad, which agreed that it was correct to impose tax as if the shares in the cash-rich company had not been transferred to the interposed company. The Hoge Raad reasoned that the interposition of the holding company prevented the imposition of a charge to income tax on the dividend that would otherwise have been received by the shareholder, that preventing this tax charge was the main motive behind the interposition and that the taxpayer was one of a group of shareholders in the same position, who all retained virtually the same economic interest in the cash-rich company after the interposition. Neither the Hoge Raad nor the lower court specifically stated that the dividend from the cash-rich company was to be regarded as flowing directly to the shareholder, but this was the effect of the decision. Nor did either court state that the dividend was to be regarded as not having been enjoyed by the interposed company, but as the interposed company was entitled to the participation exemption it would have made no difference to that company’s tax position to do so.

BNB 1990/45⁵⁸⁴ did, however, explicitly address the issue of which person enjoyed the dividend. In this case the cash-rich company was resident in the Netherlands, the original shareholder was a company resident in Canada, and the interposed company was resident in the Netherlands Antilles. The Antilles company was interposed after the dividend had been declared but before it became payable, which meant that the dividend was paid to the Antilles company rather than the Canadian one. The Antilles company claimed the benefit of the *Belastingregeling voor het Koninkrijk*⁵⁸⁵ (BRK – the “treaty” between the European territory of the Netherlands and the Netherlands Antilles), which would have entitled it to a complete refund of

581. The case law has also developed in a different direction, concerned with the characterization of sums received for the transfer of the shares in the cash-rich company; this case law is not discussed here.

582. HR 27 December 1967, No. 15 722, BNB 1968/80 (with comment by Hofstra).

583. Principle of correct and just imposition of tax (author’s translation). This principle is enacted in Art. 31 Algemene wet inzake rijksbelastingen 1959, Stb. 1959, nr. 301.

584. BNB 1990/45, note 333.

585. The BRK is technically a domestic law adopted by the Kingdom of the Netherlands, but it has the same practical effect as a treaty between the European territory of the Netherlands and the dependencies. It is drafted during a process of negotiation between these separate jurisdictions and follows the same format as a regular tax treaty.

the dividend withholding tax. The lower court refused the refund, holding that the Antilles company had been inserted purely for tax reasons, in order to take advantage of the BRK.

On appeal to the Hoge Raad, one of the arguments of the Antilles company was that the lower court found that it did not enjoy the dividend but had failed to say which party did enjoy it. This argument was easily dismissed by the Hoge Raad, which found it implicit in the lower court's decision that the dividend was enjoyed by the Canadian parent. The Hoge Raad noted the finding of the lower court that the Canadian parent had the same interest in the dividend both before and after the interposition; this finding was sufficient to support the conclusion that the interposition was carried out purely for tax reasons and therefore the lower court was correct to refuse the full refund. Unlike the lower court, however, the Hoge Raad did grant a partial refund of the dividend withholding tax; it reasoned that, to the extent that the Canadian parent would have been able to claim a refund under the treaty with Canada, the BRK was not being used to avoid tax, and therefore there was no reason to refuse that part of the refund. The Hoge Raad did not, however, go so far as to state that the treaty with Canada applied, rather than the BRK.⁵⁸⁶

The limits of this line of case law were explored in BNB 1994/37.⁵⁸⁷ In this case the Hoge Raad did not apply BNB 1968/80, stating that it applies only to the extent that the dividend is paid by the cash-rich company out of reserves that it already had at the time of the restructuring, and only if the shareholder is able to get at those reserves and retains the same, or almost the same, interest in the transferred shares after the restructuring as he had before. This decision goes some way towards defining the limits of the case law, although in his annotation on the case van Dijk argues that the precise limits are still not at all clear. Nevertheless, the underlying philosophy of the Hoge Raad is clear: that a shareholder cannot avoid the attribution of a dividend from funds that were already available simply by interposing another entity between himself and the distributing company.

In BNB 2003/285⁵⁸⁸ the Hoge Raad again held that a dividend distributed by the cash-rich company could not be attributed to the ultimate share-

586. Maybe because the dividend was not "paid to" the Canadian parent, as required by Art. VII of the treaty of 2 April 1957, which was the applicable treaty at the time of the dividend payment.

587. HR 17 November 1993, No. 29 283, BNB 1994/37 (with comment by van Dijk).

588. HR 6 December 2002, No. 36 773, BNB 2003/285 (with conclusion by A-G Watlet and comment by van Weeghel).

holder as if there had been no interposition of the intermediate company, but now because the applicable treaty did not allow this interpretation. The ultimate shareholder was resident in Belgium and the Hoge Raad found that the treaty with Belgium did not allow the attribution of a dividend to the indirect owner, even if domestic law would have attributed it in that way (although the Hoge Raad did not make any pronouncement on the domestic law). Advocate-General Wattel, in his conclusion, found this case similar to BNB 1968/80, except that this one concerned the dividend tax and BNB 1968/80 concerned the final tax on the shareholder. He considered two possible solutions when a company is interposed for non-commercial reasons. One possibility is to ignore the transfer of shares to the interposed company and treat the dividends as being paid to the indirect owners until the profit reserves at the time of the interposition have been used up. The other possibility is to respect the structure once it is put in place, but to treat the price received for the sale of the shares as a dividend. The first solution, in other words, is to substitute a different taxpayer in respect of the dividends, and the second is to substitute a different type of income for the original shareholders.

BNB 1968/80 chose the first solution, but in his review of the cases Wattel found that since then the Hoge Raad had generally chosen the second solution. BNB 1990/45 was unusual, because the dividend had already been declared when the company was interposed. The attribution solution had also been chosen in BNB 1994/252 (discussed below), but the Advocate-General found that in that case the Hoge Raad did not give any theoretical underpinnings to its decision. Wattel also expressed his dislike of the attribution solution on theoretical grounds. One of the problems with attributing dividends to the indirect owner is that it can create a timing mismatch, as the payment of the dividend does not necessarily occur at the time that the indirect owner obtains any benefit. He preferred to deal with this situation at the moment that it is created, by treating the sale price for the shares in the cash-rich company as a dividend to the extent that the price reflects anticipated dividends, and imposing the dividend tax accordingly.

BNB 1994/252⁵⁸⁹ is one of a pair of cases heard at the same time, and concerning the same situation, in which the Hoge Raad accepted the attribution of income to an indirect owner in one case but not in the other. Both cases concerned a family company, with shareholders who wanted to concentrate the ownership of the company. The company was resident

⁵⁸⁹. HR 18 May 1994, No. 28 293, BNB 1994/252 (with conclusion by A-G Verburg and comment by Wattel included in HR 18 May 1994, No. 28 296, BNB 1994/253).

in the Netherlands, and its three individual shareholders were resident in Belgium, the Netherlands and Switzerland, respectively. These individuals sold their shares to an Antilles company, which was owned by the Belgian resident individual. The Netherlands company then bought back most of those shares from the Antilles company for a price that had been agreed in advance. The issue was whether the BRK applied.

BNB 1994/252 concerned the purchase by the Netherlands company of its own shares, which caused a deemed dividend of the excess of the sale price over the nominal value of the shares. The tax inspector treated the purchase as if it were made directly from the original shareholders, so that they received the deemed dividend. The lower court had found on the facts that the Antilles company was used for tax avoidance purposes and that the family members had never intended it to acquire the economic ownership of the shares. In a decision upheld by the Hoge Raad, it applied the reasoning of BNB 1990/45, and gave the relief that would have been available to the family members if they had sold their shares back to the Netherlands company directly.

BNB 1994/253⁵⁹⁰ concerned a dividend distributed by another company resident in the Netherlands, K BV, which was owned jointly by the Antilles company and the family member resident in the Netherlands. Some of the shares owned by the Antilles company had previously been acquired from the other two family members. The Antilles company claimed a refund of the dividend tax, which was refused by the tax inspector on the grounds that the Antilles company was just a “paper company” set up for treaty shopping purposes. The lower court had agreed with the tax inspector, supporting its decision by referring to its reasoning in BNB 1994/252. The Hoge Raad, however, agreed with the taxpayer that the two cases were so different that this was not an adequate form of reasoning; in this case there was no complex of transactions, agreed in advance, which entailed K BV buying back its own shares. The Hoge Raad also held that the lower tax burden in the Antilles, and the lack of any real commercial activity in the Antilles company, were not enough of themselves to prevent the application of the BRK.

Wattel, in his annotation on the two cases written in the capacity of commentator before his appointment as Advocate-General, argues that the crucial difference between them, which led the Hoge Raad to its different

590. HR 18 May 1994, No. 28 296, BNB 1994/253 (with conclusion by A-G Verburg and comment by Wattel).

conclusions, is that the first case, but not the second, concerned an overall scheme or complex of interdependent transactions which together led to the final result and which was agreed in advance. He also points out that an extra degree of artificiality is needed, beyond the simple interposition of a company resident in the Antilles, in order for the Hoge Raad to ignore the interposed company and attribute a dividend to the shareholders of the interposed company. That degree of artificiality was reached in BNB 1990/45, but not in BNB 1994/253.

3.4.1.3. *Foundations*

One of the more extreme forms of attribution on the basis of indirect ownership in the Netherlands is the case law that attributes the income of a foundation⁵⁹¹ to a person who is able to control the application of the foundation's assets and income. In BNB 1986/16,⁵⁹² for example, an individual established a foundation for the benefit of her descendants, who at that time were only her son and his two children. The foundation's statutes prescribed the circumstances in which payments could be made to, or for the benefit of, her descendants but otherwise gave the directors of the foundation absolute discretion to decide on making payments. The son was the only director of the foundation, and the foundation had never made any payments. The issue was whether the foundation's income was taxable in the hands of the son. Earlier case law⁵⁹³ had established that the income of a foundation is attributable to the founder, if the founder is factually able to deal with the foundation's assets and income as if they were his own. The son argued that this attribution rule should be limited to the founder. The Hoge Raad obviously disagreed, although it did not say so specifically, and remitted the case to the lower court to decide whether the son's control was such that he could be regarded as being able to deal with the assets and income as his own.

The previous case law had already been criticized by van Dijck,⁵⁹⁴ and his criticism swelled to severe proportions in his note on this case. He points out that the attribution criterion used here would be quite inadequate to achieve the same effect with a company's income, and sees no justification for the difference in treatment. Advocate-General Moltmaker, in his

591. In Dutch: *stichting*.

592. HR 30 October 1985, No. 22 715, BNB 1986/16 (with conclusion by A-G Moltmaker and comment by van Dijck).

593. For example HR 31 May 1978, No. 18 853, BNB 1978/297 (with comment by Scheltens); HR 22 July 1981, No. 20 657, BNB 1982/42 (with comment by van Dijck).

594. For example in his comment on BNB 1982/42; see note 593.

opinion, paid some attention to this issue. Although there is no conceptual difference in this respect between a company and a foundation, he argues that there is a difference in tax treatment; the assets of a company clearly remain within the tax system, but the assets of a foundation may end up beyond its reach. He finds it therefore justifiable to impose stricter conditions for recognizing a foundation as an independent taxable subject. Van Dijk's retort is that the answer is to reconsider the tax regime applicable to foundations, not to distort the principles for the attribution of income.

With the introduction of the Box 3 system in 2001⁵⁹⁵ this issue changed to the attribution of the assets of a foundation,⁵⁹⁶ and a lower court⁵⁹⁷ has indeed attributed the assets of a foundation to an individual for the purposes of Box 3 because the foundation's directors followed her instructions without question. As of January 2010, however, this case law has been rather overshadowed by the legislative amendment discussed in 3.2.1.4. and 5.4.5.3. that applies to separated private funds. If the foundation qualifies as such a fund, this legislation attributes its income and assets to the person who contributed assets to the foundation, regardless of any other benefit he may derive from the foundation, any control he may exercise or any other connection he has with the foundation.

3.4.2. The United Kingdom

Whereas much of the law in the Netherlands on indirect ownership is case law, in the United Kingdom most of the law is found in the legislation. The absence of case law is probably explained by the large quantity of the legislative anti-avoidance schemes, and their scope. As a result, much of the case law that does exist in this respect is concerned with the interpretation of the legislation, rather than with basic principles.

3.4.2.1. *Capital gains*

One case that does deal with basic principles is the now notorious case of *Furniss v. Dawson*,⁵⁹⁸ which provides a remarkably strong echo to the analysis by Wattel of BNB 1994/252 and BNB 1994/253, discussed in 3.4.1.2. Like those cases, *Furniss v. Dawson* concerned an interposed company but,

595. See Appendix II, 1.2.

596. Van Dijk and van Vijfeijken, note 376, Sec. 3.7, p. 56.

597. Rechtbank Haarlem 17 December 2009, Nos. AWB 09/1750, 09/1751, 09/1752 and 09/1753.

598. *Furniss (Inspector of Taxes) v. Dawson and related appeals* [1984] STC 153.

as so often happens, the issue was raised in the UK court in a different way. *Furniss v. Dawson* concerned individuals who had negotiated the sale of their shares in two family companies to an unrelated company. In order to defer their tax liability, they exchanged their shares in the family companies for shares in a company they set up in the Isle of Man, and the Manx company then sold the shares to the purchaser. The House of Lords held expressly that all the steps were genuine, Lord Brightman even calling this “a simple and honest scheme which merely seeks to defer payment of tax until the taxpayer has received into his hands the gain which he has made”. Nevertheless their Lordships held that for tax purposes the individuals had disposed of their shares in the family company to the purchaser and were taxable on the gain, even though the consideration was paid to the Manx company, and stayed there. This case has been described⁵⁹⁹ as “the furthest and most unruly extension of the *Ramsay* approach”, referring to *Ramsay v. IRC*,⁶⁰⁰ the case that marked a seminal change in the approach of the courts to tax avoidance. Later case law⁶⁰¹ has, however, found various reasons not to ignore the intermediate company, thus limiting the scope of the decision to schemes that are fully planned in advance and carried out as planned.

Furniss v. Dawson was applied, however, in *Magnavox Electronics Co Ltd v. Hall*,⁶⁰² to ignore the interposition of a company in rather different circumstances. A vendor agreed to sell property to A, but A defaulted, and the vendor found B who was willing to buy the property but at a lower price. A year later, the vendor acquired a company, S, which took an assignment from A of A’s rights as purchaser. The vendor then varied the original sale contract to reflect the lower price, and S made a new contract with B for the sale of the property. The court held, following *Furniss v. Dawson*, that the interposition of S should be ignored and that it was the original vendor who had sold the property to B.

As regards capital gains, in other words, the approach of the UK case law is similar to that in the case law of the Netherlands. A capital gain may be attributed to the indirect owner of an asset in anti-avoidance situations in

599. Gordon, Montes-Manzano and Tiley, note 379, Sec. 3.17, p. 220.

600. *W.T. Ramsay Ltd v. IRC; Eilbeck (Inspector of Taxes) v. Rawling* [1981] STC 174.

601. In *IRC v. Bowater Property Developments Ltd* the series of transactions was interrupted. In *Baylis (Inspector of Taxes) v. Gregory* the second sale occurred at a later date to a company that was not known to the parties when the first exchange took place, so this was an unformed plan. In *Craven (Inspector of Taxes) v. White* there was not enough certainty that the second sale would really happen. These three cases were considered together by the House of Lords in a judgment reported at [1988] STC 476.

602. *Magnavox Electronics Co Ltd (in liquidation) v. Hall (Inspector of Taxes)* [1986] STC 561.

which there is a complex of transactions and a certain level of artificiality. This similarity is not surprising, given that the attribution rule for capital gains taxation in the United Kingdom is similar to the Netherlands concept of enjoyment.

The United Kingdom also has legislation which attributes capital gains to indirect owners in various circumstances. One major example is the provision which attributes the capital gains of closely held non-resident companies to their UK resident shareholders, in proportion to their shareholdings, if they have a shareholding of at least 10%.⁶⁰³ The attribution is also made through any number of non-resident companies in a chain of shareholdings, provided they are all closely held companies as defined in the legislation. This provision can operate to make a shareholder taxable even though he has no possibility of getting his hands on the gain.⁶⁰⁴

Another provision⁶⁰⁵ attributes capital gains derived by a non-resident trust to the settlor if the settlor is domiciled and resident in the United Kingdom for any part of a tax year. This rule applies if the settlor, or certain defined family members of the settlor, enjoy any benefit from the trust or if the assets or income of the trust may become payable to the settlor or those family members in any circumstances whatsoever, although there is an exception if the family members can benefit from the trust only in certain specified circumstances that are beyond the control of the settlor, such as the bankruptcy or death of a beneficiary. The amount that is taxed in the hands of the settlor is the amount that would have been taxed in the hands of the trustees if they were resident in the United Kingdom. This provision can operate to impose a tax charge on a settlor who receives no benefit from the trust, but there is also a statutory provision giving the settlor a right to reimbursement of the tax charge from the trustees.

Yet another example is legislation applying to transactions in land in various widely defined sets of circumstances,⁶⁰⁶ which is called the scheme on artificial transactions in land, although its scope is not explicitly limited to artificial transactions. The main thrust of this legislation is to recharacterize certain gains as income but, if one person provides another person with

603. Sec. 13 TCGA.

604. A shareholder subject to this tax charge may credit a portion of the foreign tax paid by the non-resident company. If the non-resident company later distributes the realized gain, the shareholder may credit the tax charged under this provision against the tax liability on the distribution.

605. Sec. 86 and Sched. 5 TCGA.

606. Secs. 752-772 ITA for income tax; Secs. 776-778 ICTA 1988 for corporation tax.

an opportunity to realize the gain, the legislation also attributes the gain to the person who provides the opportunity. The wide reach of this legislation was illustrated by *Yuill v. Wilson*.⁶⁰⁷ The essential facts in this rather complex case were that land was sold to an intermediate company for its full undeveloped market price, the intermediate company was then sold to an independent party, planning permission for the land was obtained soon afterwards and then the intermediate company sold the land and realized a gain. The House of Lords held that the legislation operated in this case to attribute the gain to an individual who had a rather indirect interest in the intermediate company, even though that company had been sold to an independent party before it realized the gain. It was not clear from the facts how, or even whether, the individual received any benefit from this scheme, but Lord Russell said explicitly that it was irrelevant for the purpose of this charge whether the benefit of the gain would enure to the benefit of the taxpayer or his family.⁶⁰⁸

3.4.2.2. *Recurrent income – CFC regime and “transfer of assets abroad” scheme*

There are two major schemes of legislation that attribute recurrent income on the basis of indirect ownership, one of which is the controlled foreign company legislation.⁶⁰⁹ Strictly speaking this legislation does not attribute income to an indirect owner; in the *Bricom*⁶¹⁰ case the Court of Appeal held that the correct technical construction of the legislation is not that a portion of the subsidiary’s profit is attributed to the parent company, but that a separate, notional sum is added to the parent’s taxable profit. Nevertheless, the practical effect of the legislation is very similar to attribution to an indirect owner.

The other major piece of legislation is the scheme on transfers of assets abroad,⁶¹¹ which applies to individuals and which has a very wide scope. This scheme operates to attribute income from an asset to an individual who is ordinarily resident and who transfers the income-producing asset to a non-resident. It is triggered if income becomes payable to the non-resident as a result of the transfer and/or any connected operations, and the

607. Note 422.

608. The tax liability did not arise immediately, however, as the sale price was payable in instalments on the happening of certain contingencies, and the court held that the sale price was not taxable until it was effectively enjoyed.

609. Secs. 747-756 ICTA 1988.

610. *Bricom Holdings Ltd v. IRC*, note 116.

611. Secs. 714-751 ITA.

transferor or his/her spouse has the power to enjoy the income or receives a capital sum connected with the transfer.

The legislation prescribes five sets of circumstances in which an individual is regarded as having the power to enjoy income. Those circumstances include the individual being able to receive any benefit out of the income, and the receipt or accrual of the income operating to increase the value to the individual of any assets held by him or for his benefit. In *IRC v. Botmar*⁶¹² an individual set up a trust, and the trust terms excluded him from receiving any benefit under the trust. The trustees were, however, permitted to transfer capital to another trust, and the individual was a potential beneficiary under the second trust; he was held therefore to have the power to enjoy the income of the first trust. In *IRC v. Brackett*⁶¹³ a power to enjoy income was found to exist in the provision of a benefit in the form of liquidity. In this case an individual transferred his earning capacity under a contract of employment to a non-resident company and sold assets to the company that he could sell on the open market. Basing himself on the wide definitions of “transfer of an asset” and “power to enjoy income” in the legislation, the judge held that the receipt of income by the company increased the value of the individual’s rights by enabling the company to buy the assets, and that that was sufficient to trigger this legislation.

An individual is also regarded as having a power to enjoy income if he is able in any manner whatsoever to control the application of the income; it is not necessary that he is able to control it for his own benefit. In *Lee v. IRC*⁶¹⁴ an individual transferred shares to a Canadian company in exchange for shares in that company. He was found to have indirect control over the application of the income of the company, because he had the power to elect and remove its directors and he was able to veto any amendment of the company’s statutes and any allotment of transfer of shares. On the other hand, in *IRC v. Schroder*⁶¹⁵ the power to appoint members of a committee which could veto the decisions of trustees did not give the individual control over the trust income; trustees act in a fiduciary capacity, and the trustees therefore could not be compelled to act in accordance with the individual’s wishes, even though in the circumstances of the case it was likely that they would do so.

612. *IRC v. Botmar* [1999] STC 711.

613. *IRC v. Brackett* [1986] STC 521.

614. *Lee v. CIR* 24 TC 207.

615. *IRC v. Schroder* [1983] STC 480.

It is interesting to consider how the fact pattern of BNB 1986/16⁶¹⁶ would fare under this legislation if the facts were transposed to the United Kingdom. This scheme would not apply for the simple reason that the foundation was not resident abroad but, even if it had been resident abroad, the scheme still would not apply because the assets were transferred to it by one person and the control over the income was exercised by a different person.⁶¹⁷ This element of the case was used by the son in BNB 1986/16 to argue against the attribution of the income to him, but neither the Hoge Raad nor the Advocate-General paid any attention to it.

3.5. Separation of income from the asset

This section has, so far, discussed a number of issues that are all based on the ownership of an asset as the most important factor in the attribution of the income produced by the asset. The question remains as to when, or whether, it is possible to change the attribution of the income for tax purposes by detaching it from the asset and making it flow to a person who has no ownership rights over the asset. This section accordingly examines how the two countries under study deal with both gifts and sales of income in such cases. Section 5.5. considers the alienation of income more generally, in particular the extent to which it is possible to alienate income for tax purposes and how such an alienation is achieved.

As regards gifts and sales of income separately from the asset that produces it, there is a large difference between the approaches of the legislation in the Netherlands and the United Kingdom. The courts, on the other hand, have come to conclusions that are much more similar. The United Kingdom stepped in with legislation in this area sooner than the Netherlands and now has much more comprehensive legislation in this respect. The case law of the Netherlands is therefore richer in cases that deal with the basic principles, whereas the case law in the United Kingdom, particularly the more recent case law, is more concerned with the interpretation of the legislation.

616. See Appendix II, 3.4.1.3.

617. The other major anti-avoidance scheme in the United Kingdom in respect of individuals, the settlements code described in Appendix II, 3.5.1.2., would also not apply for the same reason.

3.5.1. Gift of income

3.5.1.1. *The Netherlands*

The earlier cases in the Netherlands on gifts of income were based on the law of 1941, which stated⁶¹⁸ that income from capital was enjoyed by a person who derived the income from a real or personal usufruct over an asset. Although this wording was not repeated in the 1964 law, it was generally accepted that it applied under that law too.⁶¹⁹ A real usufruct – the property law concept discussed in 3.2.2. – is a relatively clear concept. The concept of a personal usufruct,⁶²⁰ on the other hand, is less clear, and the limits of this concept therefore have had to be explored in the case law.

In a case decided under the 1941 law, in which one individual gave coupons to another individual for dividends that had not yet been declared,⁶²¹ the Hoge Raad found that ownership of the dividend coupon gave the right to claim the dividend directly from the company that distributed it. By transferring the entitlement to claim the dividend directly from the company the transferor had granted the right to enjoy the income to the transferee. This reasoning was implicitly confirmed in a later case⁶²² in which a father gave dividend coupons to his children; the tax inspector's appeal, and therefore the discussion in the case, was based on the father's motive and the application of the "*richtige heffing*"⁶²³ principle. There was no dispute, in other words, that the dividends were attributable to the children under basic principles.

This simple method of shifting income was prevented by an addition to the 1964 law,⁶²⁴ which attributed to the donor income payable on a coupon that was given away.⁶²⁵ The question that then arose was whether this attribu-

618. Art. 29 Besluit IB 1941, note 392.

619. Van Dijck, J.E.A.M., *Vervanging van inkomsten* (5th edn.), in FED fiscale brochures (Deventer, the Netherlands: Kluwer, 1996), Sec. 2.3.3.2, p. 37. A comparable provision is not necessary in the Wet IB 2001, because the Box 3 system is based solely on the ownership of assets; see Appendix II, 1.2.

620. A "*recht van vruchtgenot*" in Dutch. The word "*vrucht*" means "fruit" and the word "*genot*" has the same root as the verb "*genieten*", meaning "to enjoy".

621. HR 27 January 1954, No. 11 584, BNB 1954/101 (with comment by Hellema).

622. HR 8 March 1961, No. 14 368, BNB 1961/133 (with comment by van Soest).

623. The principle of the correct and just imposition of tax, note 583.

624. Art. 27(2) Wet IB 1964, note 390. For a discussion of the conceptual and practical problems created by this rule see van Dijck, note 619, Chap. 3.

625. This law also contained a rule for gifts of instalments of rent and interest, which apportioned the income according to the periods of ownership of the transferor and transferee; Art. 27(1) Wet IB 1964, note 390.

tion rule applied to the income only, or also to the credit for the dividend tax. During the parliamentary debate on this law the Secretary of State had stated⁶²⁶ that this rule was limited to the income, and that entitlement to the credit would remain with the person who receives the coupon, but in BNB 1971/40⁶²⁷ the court held that the rule also applied to the credit. In coming to this decision the court bore in mind that the attribution rule had been adopted to reflect the notion that the person who gives away a coupon actually enjoys the income himself by using it to make a gift. The aim of the rule was ensure that the income was taxable in the hands of the person who enjoyed it in that sense, not to impose a penalty by separating the credit from the income, which would lead to the credit being “lost”.

The alternative method of giving income away is to transfer the entitlement to a stream of income. In BNB 1964/206⁶²⁸ a father who owned interest-bearing bonds in his employer company, which he was not permitted to transfer, gave the interest for two years to his son under a notarial deed. The Hoge Raad found that the father had made a legally valid gift to his son of a personal usufruct; it was therefore the son who had a claim against the company in respect of the interest. In other words, the legal entitlement to the income had been successfully detached from the ownership of the assets and transferred to the son. Once that had been established, it was simply a question of applying the basic principle that income is enjoyed by the person who is legally entitled to it, and the attribution of the interest to the son for income tax purposes followed.

By contrast, in BNB 1974/3⁶²⁹ a father, in a notarial deed, granted to his children the right to the income in one year from various assets, including immovable property and shares. The sources of the income were not informed and they continued to pay the income to the father, who then paid the income to his children. Here the Hoge Raad found that the father had not granted a personal right of enjoyment to the children, but only the right to claim the income from him. The income was therefore attributable to the father.

626. Brief van de staatssecretaris van Financiën van 30 november 1962, Kamerstukken II 1962/63, 5390, No. 20.

627. Hof Arnhem 18 March 1970, No. 394/1969, BNB 1971/40.

628. HR 24 June 1964, No. 15 224, BNB 1964/206 (with comment by Hellema).

629. HR 21 November 1973, No. 17 188, BNB 1974/3 (with comment by Schuttevaer).

BNB 1981/27⁶³⁰ concerned a very different situation, but here again income was attributed to an individual who purported to have given it away, and for similar reasons. The individual had entered a religious order and, in order to satisfy her vow of poverty, had given the right to deal with her assets and enjoy the income they produced to the Congregation that she was about to enter. The lower court found that this document did not transfer the entitlement to the income to the congregation; it merely imposed on her a personal obligation to apply her income by giving it to the Congregation. Given that finding, the Hoge Raad found it very easy to decide that the income was still attributable to the individual.

Van Dijck⁶³¹ concludes from these cases that the crucial difference is the difference between giving a right that is enforceable against the source of the income, and giving a right that is enforceable only against the person making the gift.⁶³² The case law, in other words, is primarily concerned to find the person who is entitled to the income as it arises from the source, without being dependent on the owner of the asset to receive the income and pay it on. If that requirement is fulfilled, it is possible to separate income from an asset and give it to another person, subject to the specific anti-avoidance provisions on dividend coupons and instalments of rent and interest. Fulfilling that requirement, however, is not a simple matter of signing away the income. As Schuttevaer states in his comment on BNB 1974/3, “one really can’t operate in these areas without an elementary understanding of property law and the law of obligations.”⁶³³

3.5.1.2. *The United Kingdom*

By contrast with the Netherlands, the UK legislation has for a long time demonstrated concern about the separation of income from an asset in

630. HR 17 December 1980, No. 20 253, BNB 1981/27. This is only one of a number of similar cases.

631. Van Dijck, note 619, Sec. 2.3.3.2 at p. 38.

632. He also concludes that economic ownership of an asset gives the economic owner a personal usufruct, and thus changes the attribution of the income, whereas economic ownership of the income does not. This conclusion was written well before the expansion of the economic ownership concept in BNB 2003/34 (the Falcons case, note 532) and its further development in BNB 2006/7, note 534 (both cases are discussed in Appendix II, 3.2.3.1.). Both of these cases concerned commercial transactions, but they accept that economic ownership of an asset can be divided into parts. From the latter case it appears to be possible that the parts are rather small, but in that case the attribution of income from the asset did not follow the small part of the economic ownership that was split off. It remains to be seen how the developing law on economic ownership will relate to this conclusion drawn by van Dijck.

633. Author’s translation.

order to give the income away. One manifestation of this concern relates to the attribution of income from assets that are jointly held by married couples living together. This income is generally divided between the spouses in equal shares, regardless of their actual shares in the asset, but they may make a declaration that the income is to be split in different proportions – provided the proportions chosen in the declaration correspond to their shares in the asset.⁶³⁴

Another manifestation of this concern with a much wider import is the legislation known as the settlements code;⁶³⁵ this is a major scheme of anti-avoidance legislation with a very wide scope, which applies to gifts of both single items of income and streams of income. This legislative scheme was first introduced in 1938,⁶³⁶ which explains the lack of case law on basic principles in this respect. The name “settlement code” is a misnomer; it applies to trusts, as its name suggests, but it also applies to many other arrangements, including the use of a company,⁶³⁷ the disclaimer of an interest by a beneficiary⁶³⁸ and absolute and unconditional gifts.⁶³⁹ The one limiting factor in this respect is that the structure or arrangement has to have an element of “bounty”,⁶⁴⁰ or in other words the provision of a benefit by a person who is acting otherwise than at arm’s length.⁶⁴¹

The overall aim of the scheme has been explained by Lord Wilberforce in the House of Lords⁶⁴² as follows: these provisions “are designed to bring within the net of taxation dispositions of various kinds, in favour of a settlor’s spouse, or children, or of charities, cases, in popular terminology, in which a taxpayer gives away a portion of his income, or of his assets, to such persons, or for such periods, or subject to such conditions, that Parliament considers it right to continue to treat such income, or income of the assets, as still the settlor’s income.” The scheme recognizes that the income first arises to the settlement under basic principles, but then superimposes a rule that changes the attribution to the settlor, or in other words the person who provided the assets or income subject to the settlement. That person

634. Sec. 837 ITA.

635. Now contained in Chap. 5, Part 5 ITTOIA.

636. For the background to this legislation, see Stopforth, D., “The Legacy of the 1938 Attack on Settlements”, *British Tax Review* 4 (1997), pp. 276-91.

637. *IRC v. Mills* [1974] STC 130.

638. *IRC v. Buchanan* (1957) 37 TC 365.

639. *Thomas v. Marshall* [1953] 34 TC 178, [1953] AC 543.

640. *IRC v. Plummer* [1979] STC 793.

641. Per Lord Hoffmann in *Jones v. Garnett (Inspector of Taxes)* [2007] STC 1536. This case is explained below.

642. *IRC v. Plummer*; note 640, at pp. 800-1.

is generally entitled to recover the tax from any trustee or other person to whom income is payable in connection with the arrangement.

The legislation applies in various defined sets of circumstances. One set of circumstances covers situations in which the income is payable to, or for the benefit of, a child of the settlor. Another covers situations in which the settlor retains an interest in the property transferred, any related property, or the income from the property (except in certain narrowly defined cases). The original reasoning behind this part of the legislation was that, “if an individual had not parted with his wealth beyond recall, he should be treated as still owning it”,⁶⁴³ which meant that the income produced by that wealth would belong to the individual for tax purposes. The notion of retaining an interest in the property is interpreted extremely widely and includes the possibility that the property may revert to the settlor at some point in the future. The scheme also applies if the property may in any way revert to the settlor’s spouse.

The scheme does not apply to an outright gift of property from the settlor to his/her spouse, but this exclusion is itself subject to an exception if the gift serves to separate income from the asset that produces it. So a gift to a spouse is not subject to the code if it consists of an asset together with all the income produced by the asset. It is covered by the code if: either the gift is wholly or substantially a right to income from an asset; or the gift does not include the right to the whole of the income produced by the asset. Two cases with similar facts have served to delineate the contours of this exception rather sharply.

In *Young v. Pearce*,⁶⁴⁴ a company controlled by two husbands created a special class of preference shares which were allotted to their wives. The preference shares carried a preferential right to a dividend if the directors and ordinary shareholders (the husbands) decided to distribute the profits. The preference shares also carried a right to the return of their nominal value and the right to be heard at shareholders’ meetings, but no right to vote. The issue of the preference shares was found to be a settlement within the terms of the code, and to constitute a gift that was wholly or substantially a right to income. The judge stated that, in strict legal principle, the preference shares were assets that were distinct from the dividends, but in reality the value of the shares could not have been realized, and the income

643. Stopforth, note 636, at p. 278.

644. *Young (Inspector of Taxes) v. Pearce; Young (Inspector of Taxes) v. Scrutton* [1996] STC 743.

was dependent on the decision of the husbands to distribute profits. The preference dividends were therefore attributable to the two husbands.

In *Jones v. Garnett*,⁶⁴⁵ on the other hand, in a much-publicized battle that was taken to the House of Lords, the exception for outright gifts did apply. In this case a husband and wife each owned one ordinary share of a company. The company's income was derived primarily from the consultancy activities of the husband, and his wife did the administrative and financial work. The company paid them each a modest salary for their employment activities and a substantial dividend in their capacity as shareholder. As the case made its way through the judicial hierarchy, there were considerable differences of opinion among the judges as to the applicability of the various elements of the legislation.⁶⁴⁶ In the end, a majority of the House of Lords found that the arrangement was a settlement within the code, but that the exception for outright gifts between spouses applied. The ordinary share owned by the wife in this case was found to be different from the preference shares held by the wives in *Young v. Pearce* because it carried entitlement, not just to dividends, but also to participate in the distribution of assets on a winding-up and to vote. The vital difference between the two cases, in other words, was that the ordinary share in *Jones v. Garnett* represented a complete slice of the company's capital, with the accompanying income and the accompanying right to determine the company's policy. It was, therefore, not the equivalent of separating the income from the asset and transferring only the income.

Within 24 hours of this decision the government announced its intention to respond,⁶⁴⁷ and at the end of 2007 a consultation document⁶⁴⁸ was issued which stated "... it is now clear that the settlements legislation is not sufficient to address all cases of income shifting."⁶⁴⁹ The consultation document included draft legislation designed to apply to situations similar to that in *Jones v. Garnett*, which would attribute to the individual who carried

645. Note 641.

646. See Kerridge, R., "*Jones v Garnett* (Arctic Systems): another way of getting to the same result", *British Tax Review* 5 (2007), p. 591 et seq.; Gammie, M., "Reflections on *Jones v Garnett*", *British Tax Review* 6 (2007), p. 687 et seq.; and Loutzenheiser, G., "Income Splitting and Settlements: Further Observations on *Jones v Garnett*", *British Tax Review* 6 (2007), p. 693 et seq.

647. Statement of the Exchequer Secretary to the Treasury of 26 July 2007, available at <http://www.hmrc.gov.uk/practitioners/sba.htm>.

648. HM Treasury and HMRC, "Income shifting: a consultation on draft legislation", December 2007, available at http://www.hm-treasury.gov.uk/consult_income_shifting.htm.

649. *Ibid.* at Para. 1.13, p. 5.

out the main income-generating activity the amount of income that he/she could reasonably expect to receive for that activity. These proposals have now been deferred, but the government has stated that it will keep this area under review.⁶⁵⁰

The final manifestation of the UK concern with splitting income from the asset that produces it is legislation introduced in 2009, on transfers of income streams.⁶⁵¹ This is a comprehensive scheme of legislation to deal with both gifts and sales, and is explained in 3.5.2.2.

3.5.2. Sale of income

3.5.2.1. *The Netherlands*

Income can also be separated from the asset that produces it in a sale transaction, and in the Netherlands it is particularly sales of dividend coupons that have attracted attention. The specific provision in the 1964 Netherlands legislation on dividend coupons, described in 3.5.1.1., was limited to gifts, leaving sales for the courts to consider. In respect of sales, the main issue has been the attribution of the dividend tax credit. The basic attribution rule for dividend tax purposes follows the entitlement to the dividend, but how strong is that principle in the face of attempts to shift entitlement to the dividend and thereby also shift entitlement to the credit?

In BNB 1975/213⁶⁵² an individual resident in Switzerland owed a debt to his wholly owned company, which was resident in the Netherlands, and paid the debt by transferring Netherlands dividend coupons. The company collected the dividends and claimed a credit for the dividend tax withheld. There was no doubt in the mind of the Advocate-General that both the dividends and the credit were fully attributable to the company under basic principles. In his view the question came down to whether the *fraus legis* doctrine applied, due to the substitution of the company, which had a full right to the credit, for the individual, who had only a limited right to a refund of the dividend tax under the relevant treaty. The Hoge Raad found that the *fraus legis* doctrine did not apply, holding that the coupons gave the company legal entitlement to the dividends, that the dividends formed part of the company's gross profit and that therefore it was entitled to credit the entire amount of the dividend tax.

650. 2008 pre-budget report, available at <http://www.hmrc.gov.uk/pbr2008/pn03.pdf>.

651. Sec. 49 and Sched. 25 FA 2009.

652. Note 525.

This strong reliance on the legal entitlement to the dividend was confirmed in BNB 1994/217,⁶⁵³ known as the First Market Maker's Case, in which a non-resident company that was not entitled to treaty benefits sold dividend coupons to a company resident in the United Kingdom (the market maker). The market maker was held by the Hoge Raad to be entitled to the benefit of the treaty with the United Kingdom in respect of the dividends, and it was therefore entitled to a refund of the dividend tax in excess of the treaty rate. This case was about treaty entitlement, not domestic law, but in his opinion Advocate-General van Soest stated that under the domestic law of the Netherlands it is the purchaser of a dividend coupon to whom the dividend is attributable. One of the issues discussed in the case was whether it was necessary for the market maker to be owner of the shares in order to claim treaty benefits. The Hoge Raad stated that this condition was not imposed by the treaty, and refused to imply it.

Both cases, in other words, accepted that a sale of the dividend coupon separately from the share could change the attribution of the dividend for tax purposes. The First Market Maker's Case was answered by the legislation on beneficial ownership explained in 3.3.2. As well as dealing with the short-term ownership of shares, the negative definition of beneficial ownership also ensures that a person who buys a dividend coupon is not entitled to credit the dividend tax.

3.5.2.2. *The United Kingdom*

The UK law in respect of sales of income has developed in a very different way from that of the Netherlands, but from a similar starting point. *Paget v. IRC*,⁶⁵⁴ decided in 1938, concerned the sale of coupons; the question put to the court was different from the question put to the courts in the Netherlands, but the answer was the same. An individual owned various interest-bearing securities, but the debtors were unable to meet their obligations and offered an alternative to the owners of the securities. The alternative offered was of no interest to the individual, so she sold her interest coupons to a coupons dealer. The issue before the court was whether the price she received for the coupons was income in her hands, and the Court of Appeal answered very clearly that it was not income, but capital. The court also added that the interest payable on the coupons was attributable to the owner

653. HR 6 April 1994, No. 28 638, BNB 1994/217 (with conclusion by A-G van Soest and comment by van Brunschot).

654. Note 407.

of the coupons, and that there was no problem with the transfer of income in this way.

In 1997 the House of Lords again had to consider the sale of a single payment, this time a dividend, in *IRC v. McGuckian*.⁶⁵⁵ In this case the right to the dividend was sold as part of a scheme that was openly admitted by the taxpayers to be an avoidance scheme. The right to the dividend was sold by trustees, for a sum equalling 99% of the dividend, to a company associated with the tax consultant that appears to have been involved solely for the purpose of carrying out the scheme. One of the arguments of the taxpayers was that the sale price received by the trustees was capital, not income. The *Paget* case was not even mentioned in any of the judgments, but in between the two cases the House of Lords had decided *Ramsay v. IRC*,⁶⁵⁶ which had brought about a considerable change in the judicial approach to the interpretation of taxing statutes. The *Ramsay* principle requires that artificial steps inserted into a scheme simply for the purpose of obtaining a tax advantage are to be ignored. In *McGuckian* the House of Lords applied this principle to the sale of the dividend, and held that 99% of the dividend was attributable to the trustees for tax purposes.

These two cases highlight one of the major concerns of the United Kingdom, namely tax avoidance by converting income into a capital gain. After *Paget*, the United Kingdom introduced legislation⁶⁵⁷ which applied to the sale of a right to receive income payable in respect of securities without selling the securities themselves, and which deemed the income to belong to the vendor. This provision went through various re-enactments⁶⁵⁸ until it was repealed in 2009, on the introduction of a comprehensive scheme which replaces not only this rule, but also a number of other schemes that had been added separately to the legislation over the years.

Although the 2009 legislation is headed “transfers of income streams”, it applies to the transfer of any income, so it also covers the transfer of a single payment. It applies to both sales and gifts, regardless of any avoidance motive, and to both companies⁶⁵⁹ and individuals.⁶⁶⁰ Transfers of assets with their accompanying income are explicitly excluded. The

655. *IRC v. McGuckian* [1997] STC 908.

656. Note 600.

657. Sec. 24 FA 1938.

658. It finally became Sec. 730 ICTA 1988 as amended by Sch. 7, Para. 2 F(No. 2)A 2005, before it was repealed.

659. Sec. 49 and Sched. 25 FA 2009.

660. Secs. 809AZA-AZG ITA.

scheme applies only if a payment received by the transferor for the transfer would not otherwise be taxable as income, and it operates by placing that payment in the same category as the income transferred. Its main thrust, therefore, is to prevent the conversion of income into a capital gain. If the transfer is a gift, or if the sum received is less than the market value of the income transferred, the transferor is treated as having received a sum equal to that market value. Corporate transferees are taxable on their accounting profit from the income stream, which is generally the difference between the cost of the income stream and the amount of income they actually receive. Individual transferees, however, are taxable on the full amount of the income they receive.

This legislation, in other words, adopts a characterization solution, rather than an attribution solution. The *Paget* and *McGuckian* cases remain good law, so that transferring the entitlement to a payment of income or a stream of income is still effective for tax reposes, provided the transfer is not part of an avoidance scheme with artificial steps that should be ignored. The 2009 legislation discourages such transfers by ensuring that the transfer is not also effective to reduce the tax liability of the transferor.

4. Active income

This section examines the two main types of active income: employment income and business profit. Active income, like passive income, has an instinctively obvious basis on which to base its attribution, namely the person who carries out the activity. Nevertheless, as with passive income, the issue is not that simple, especially in respect of business profit. Whereas passive income raises questions as to what exactly counts as ownership for tax purposes, so business profit raises questions as to exactly which person is carrying on the business activity. It is generally rather obvious who is carrying out an employment activity, but the highly personal nature of employment raises other issues about the extent to which employment income can be attributed to someone other than the employee.

4.1. Employment income

Employment income is a special type of income in respect of attribution, because the source of the income – the activity of the employee – cannot be separated from the individual who carries it out. This feature of employment income is recognized in the current UK legislation; by contrast with

the general attribution rule, employment income is expressed to be taxable in the hands of the person to whose employment it relates.⁶⁶¹ The Netherlands legislation, on the other hand, simply applies the general attribution rule on the basis of enjoyment,⁶⁶² without making any specific provision as to how that person is to be found in respect of employment income.⁶⁶³

The personal nature of employment income would also seem to dictate the attribution of employment income to the individual exercising the employment, and in the vast majority of cases this simple rule is enough. Nevertheless, there are situations in which this rule may not be adequate; this section discusses three such situations. One is when a benefit generated by the employment is granted to a person other than the employee. The second situation is when an employee assigns his right to his salary to another person, and the third is the “incorporated employee”, or in other words an individual who formally carries on his activity through a company which he owns.

4.1.1. Payment to a person other than the employee

An employment relationship can give rise to many types of payment or benefit in addition to the employee’s salary. One set of benefits are the fringe benefits commonly provided by employers in addition to salary, such as the use of a car. Nowadays no one would doubt that the benefit is attributable to the employee for tax purposes, even though the actual payment is made to a person other than the employee, for example a car lease company. Another set of benefits are pensions provided to family members of an employee if the employee dies. In this case no one would doubt that the pension is attributable to the individual who is entitled to it, if only because it is no longer possible to tax the employee. But who is the taxable person in respect of benefits, such as a study grant for an employee’s child, that are paid during the period of employment? The benefit is provided because of the employment, but the primary benefit is received by the child; any benefit received by the employee is an indirect one.

661. Sec. 13(2) ITEPA.

662. Art. 2.3 Wet IB 2001, note 56.

663. Neither the 2001 law nor the 1964 law provides a specific rule for the attribution of employment income, unlike the 1914 legislation.

4.1.1.1. *The Netherlands*

The legislation of the Netherlands appears, at first sight, to it make possible to attribute anything not paid directly to the employee away from the employee. Employment remuneration is subject to wage tax (which is withheld by the employer and creditable against the income tax) and the income tax law relies on the wage tax law for many definitions. The wage tax law defines employment income as income from an employment relationship,⁶⁶⁴ and also defines employees to include both individuals who enjoy employment income from their own employment relationship and individuals who enjoy employment income from the employment relationship of a different individual.⁶⁶⁵ Taken together, these provisions seem to make it possible to manipulate the attribution of employment income by choosing who to pay it to. In the parliamentary discussion on this law,⁶⁶⁶ however, it was stated that this is not its intended effect. In respect of income from a current employment,⁶⁶⁷ it was stated these provisions are intended to attribute employment income to a non-employee only if that person is the only person entitled to the income.

Although this interpretation is not unequivocally founded in the wording of the legislation, it has been borne out by case law. In BNB 1969/221⁶⁶⁸ an employer paid the premiums on life insurance policies taken out for the benefit of an employee's children and in their name. The employee argued that, according to the definitions just described, the premiums were salary of the children and that therefore he should not be taxable on them. The Hoge Raad dismissed this argument, stating that the payments were made under the employment contract, that the employee had consented to the way in which this money was spent and that the premiums were therefore a benefit enjoyed as a result of his employment contract and attributable to him.

A different answer was given in two cases⁶⁶⁹ concerning social security payments paid to the wife of an employee. In both cases a husband or ex-husband worked in Belgium, but both he and his wife (or ex-wife) lived in

664. Art. 10(1) Wet loonbelasting 1964, Stb. 1964, nr. 521.

665. Art. 2(1) Wet LB 1964, note 664.

666. Memorie van Antwoord Wet op de loonbelasting 1960, Kamerstukken II 1962/63, 5380, nr. 23, p. 5-6 (MvA).

667. In respect of past employment, these provisions are necessary to make it possible to withhold wage tax from widows' and orphans' pensions.

668. HR 18 June 1969, No. 16 095, BNB 1969/221 (with comment by van Soest).

669. HR 16 July 1984, No. 22 327, V-N 1984/1578 and Hof 's-Gravenhage 7 September 1994, No. 92/1834, V-N 1995.

the Netherlands. The Belgian social security system paid a child allowance to the wife, and the issue before the courts was whether the allowance was taxable in the hands of the husband as his employment income. In both cases the answer was that it was not, even though, in one case, it had been paid into the husband's bank account at the request of the wife. One of the reasons given for this conclusion in the first of these cases is that the husband would not have been able to prevent the payment of the allowance to his wife. In the second case it was found as a fact that the allowance had to be claimed by the husband, but even this did not change the decision. The crucial factor that distinguishes these cases from BNB 1969/221 is that the wife was the only person entitled to the social security payment; this point was emphasized in both cases, confirming the interpretation of the law given during the parliamentary discussion.

4.1.1.2. *The United Kingdom*

There is an interesting comparison to be made between these two cases from the Netherlands and the UK case of *Barclays Bank v. Naylor*,⁶⁷⁰ which was decided in 1960, before the legislation contained any provision on the attribution of employment income. An employer set up a discretionary trust to help with the education of the children of employees posted abroad. The trustees paid 75% of the school fees into a bank account in the name of an employee's child, the employee added the remaining 25%, and the bank then paid the school fees out of the account. The High Court held that the sums paid by the trustees were income of the child, not of the employee. The arrangement was described by the judge as one in which "the employer contributed to the education expenses ... not by paying the school bills, or part of the school bills, out of its own money, but by providing the child with an income out of which the bills or part of them could be met." It did not matter that the money was used to pay a bill for which the father was legally liable, the judge saying that he did not see why that use of the money should suddenly make the income belong to the parent rather than to the child.

What is particularly interesting is the different approach of the judges to these cases. The Netherlands courts started their enquiry from the open question of the individual to whom the income should be attributed. The UK judge, on the other hand, assumed that the income belonged to the child for tax purposes, and found no reason to attribute it to the employee instead. He gave no explicit reasons for the initial attribution of the income

670. *Barclays Bank Ltd v. Naylor (Inspector of Taxes)* 39 TC 256.

to the child, but presumably did so on the basis that the distribution from the trust was received by the child.

The UK legislation, in addition to a number of provisions on specific types of fringe benefit, now also contains a residual provision⁶⁷¹ which taxes an employee on benefits provided for members of the employee's family or household if the benefit is provided "by reason of the employment". This legislation would catch the situation in the *Barclays* case, but presumably the conclusion in the *Barclays* case would still apply to benefits provided to a person outside the employee's family or household, although this would be a rather unusual case.

On the face of it, the UK legislation appears to attribute all payments to an employee if the payments are derived from the employment, regardless of whether the employee is entitled to the payments in any way. On the other hand, payments such as the Belgian social security payments received in the two Netherlands cases discussed above would also be taxable in the hands of the person who is entitled to them, and presumably that tax liability would take priority. The legislation also makes no exception for situations in which the employee does not know about the benefit, or disagrees with the provision of the benefit. This point has been addressed very briefly in the UK House of Lords, in *Rendell v. Went*,⁶⁷² by Lord Reid who expressly declined to give an opinion on the taxability of a benefit in the hands of an employee who did not consent to it. This remark was, however, obiter, because the case concerned an employee who did consent to the benefit.

4.1.2. Alienation of employment income

The question that the previous section does not answer is whether an employee can avoid being taxed on salary by transferring his entitlement to the salary to someone else. There seems to be very little authority on this question in the United Kingdom, but that is probably explained by the one case that is relevant, *Reade v. Brearley*,⁶⁷³ decided in 1933. An individual who was a member of a religious congregation was appointed by that congregation as headmaster of a school. He had a legal entitlement against the school for his salary but, in accordance with his vow of poverty, allowed his salary to flow to the congregation. In fact the judge decided that the

671. Sec. 201 ITEPA is the general, residual provision on employment benefits. Secs. 211 et seq. ITEPA deal specifically with scholarships.

672. In *Rendell v. Went* (*HM Inspector of Taxes*) 41 TC 641.

673. *Reade v. Brearley* (*HM Inspector of Taxes*) 17 TC 687.

individual was not taxable on the salary, but he was at great pains to point out that his decision was based on the highly specific facts of the case. He also stated very clearly that the general principle is that an employee who voluntarily foregoes salary is still taxable on the salary, and that foregoing salary is an application of the income, not a transfer of it.

In the Netherlands the Hoge Raad has consistently come to the same conclusion, although developments since 2003 suggest that a different answer might be possible in some limited cases. In BNB 1969/115,⁶⁷⁴ for example, a member of a religious order was appointed as rector of a church parish. This appointment carried a salary, but the individual concerned had taken a vow of poverty, under which his income became the income of the religious order, and the salary was paid directly to the religious order. The Hoge Raad held that the salary was taxable in the hands of the individual; the true construction of the situation was that the salary was payable to the individual, and the individual had obliged himself to give it to the religious order. That obligation was not sufficient to change the attribution of the income.⁶⁷⁵

Similarly in BNB 1968/133,⁶⁷⁶ an employee donated his annual holiday pay to a benevolent organization. He did this before the date on which the holiday pay became taxable, and arranged for his employer to pay the money directly. The Hoge Raad found it clear from its history that the intention of the legislation was not to treat payments made out of salary directly to a third party as income of the donee. The donated holiday pay was therefore salary of the employee even though, by the time it became due, the donee was the only person who had the legal right to claim it. In BNB 1980/227 the Hoge Raad reached the same conclusion in respect of an employee who transferred the right to his salary to a company in exchange for a right to periodic payments. Both decisions have been criticized by van Dijck and van Vijfeijken,⁶⁷⁷ who do not find any reasons in the decisions for deviating from the general rule that attribution follows the entitlement to income under civil law.

674. HR 16 April 1969, No. 16 098, BNB 1969/115.

675. The same issue arises currently in respect of the members of parliament for the Socialist Party (SP). It is a condition of standing for election for the SP that the individual agrees in advance, if elected, to give his salary to the SP and receive a more modest income from the SP in return; information from Wikipedia on 24 January 2011, available at [http://nl.wikipedia.org/wiki/Socialistische_Partij_\(Nederland\)](http://nl.wikipedia.org/wiki/Socialistische_Partij_(Nederland)). Unfortunately, however, it is not possible to find out how this situation is treated for tax purposes as the tax inspectorate is not permitted to provide information about individual cases to the general public.

676. HR 3 April 1968, No. 15 845, BNB 1968/133 (with comment by Hellema).

677. Van Dijck and van Vijfeijken, note 376, Sec. 4.2.2.1, p. 59.

These cases seemed to settle the issue, but in 2003 the discussion arose again, as a result of a lower court decision⁶⁷⁸ on a scheme under which employees donated their salary for the last hour of the year 2000 to a benevolent organization. The court found that the employees had made an agreement in addition to their employment agreement, that the donation was carried out correctly in advance, and that therefore the employees did not enjoy the salary that they donated. Unfortunately the court did not state explicitly what the difference was between this case and the earlier decisions. It did emphasize, however, that the employees had unconditionally and definitively given away the entitlement to that part of their salary. The court also stated that the only right the employees retained over that amount was to demand that the employer carried out the agreement to make the donation.⁶⁷⁹

In 2005, when the discussion arose yet again in connection with similar schemes to aid the tsunami victims of 2004, the State Secretary for Finance issued a letter⁶⁸⁰ stating that an employee enjoys salary if he agrees to waive holiday days in return for the employer paying the relevant salary to a benevolent organization. This is, however, a different situation from an employee who actually does the work and gives away the legal entitlement to that part of his salary in advance, as in “cashing in” a day’s holiday the employee is, in effect, taking the income before it is donated. It seems, therefore, that in the Netherlands it might still be possible to alienate employment income, although the circumstances in which this can be done are rather limited.

4.1.3. Personal companies (disguised employment)

Alienating their salary is something that most employees would only wish to do in very specific circumstances, and then usually only in small amounts. But it may be an attractive proposition to divert salary by carrying out the employment activity through a personal holding or management company. This structure allows the remuneration to flow to a different person, but as business profit rather than salary. If the structure is accepted for tax purposes, it changes the characterization of the income, and the new

678. Hof Amsterdam 30 October 2003, No. 03/0246, *V-N* 2004/12.17.

679. The employees in this case did not escape taxation, as the court also held that the gift itself was taxable salary in their hands, and so was the amount that had been added by the employer to double the donation. The tax inspector lost the case, however, because he had issued the assessment for 2000, but the donated amounts had actually been paid in 2001, so the income became taxable in 2001.

680. Brief van 24 mei 2005, No. DGB2005/2966.

characterization brings with it a different attribution of the income. Both the Netherlands and the United Kingdom have seen this phenomenon, and their reactions have been very different.

4.1.3.1. *The Netherlands*

The Netherlands has not had to deal with this issue through legislation because, if the remuneration is paid for activity that is essentially employment activity, the basic principles of attribution do not allow any problem to arise. The Netherlands has consistent case law deciding that employment income is attributable to the individual in this situation. These decisions do not look at any other factors, but simply proceed on the basis of a factual finding that the income is from employment; if that is the case the income is attributable to the individual who carries out the employment activity.

In BNB 1992/145⁶⁸¹ and BNB 1995/116,⁶⁸² for example, the Hoge Raad relied on the findings of the lower court that the individual was in an employment relationship with the person to whom the services were provided. From this it followed that the income paid for those services was attributable to the individual, even though in both cases it was payable to a company under an agreement between the individual and the client. Similarly in BNB 1997/133,⁶⁸³ the Hoge Raad, basing itself on the findings of the lower court, observed that an individual had been appointed as a member of the board of supervisors⁶⁸⁴ of a BV solely on the basis of his personal qualities. He was therefore taxable as an employee; the attribution of the remuneration to the individual inevitably followed, even though he had an agreement with his BV that he was acting on behalf that BV and that the BV was therefore entitled to (and did) receive the remuneration.

Van Dijck and van Vijfeijken⁶⁸⁵ state that whether or not income of an “incorporated employee” is attributed to the management BV depends on whether or not the service agreement with the BV is recognized or whether the relationship between the individual and the client is, in fact, an employment relationship. They also dispute the reasoning of the Hoge Raad in BNB 1997/133, because it left open the possibility that remuneration paid to a member of the board of supervisors could be attributed to a management company. They argue that only an individual can be appointed to the

681. HR 18 December 1991, No. 27 171, BNB 1992/145 (with comment by Brunt).

682. HR 22 July 1994, No. 29 874, BNB 1995/116 (with comment by van Dijck).

683. HR 19 February 1997, No. 32 000, BNB 1997/133 (with comment by van Dijck).

684. In Dutch: “*commissaris*”.

685. Van Dijck and van Vijfeijken, note 376, Sec. 4.2.3.5, p. 62.

supervisory board, and for that reason alone the remuneration has to be attributed to the individual.

4.1.3.2. *The United Kingdom*

In the United Kingdom the issue of incorporated employees has been approached in quite a different way than in the Netherlands. The legal entitlement of the company that receives the payment does affect the attribution of the remuneration, to the extent that specific legislation has been found necessary to deal with these structures. The United Kingdom has a scheme that applies to intermediary companies generally,⁶⁸⁶ which was designed primarily for subcontractors in the construction industry. Broadly speaking, it imposes the PAYE (pay as you earn) requirements on the intermediary company in respect of 95% of the remuneration received from the client. The requirements of this scheme made it difficult, however, for the tax authority to apply it to a new and rapidly growing structure, in which something that was essentially an employment relationship was structured through a company owned by the individual but managed by professional managers which carried out all the administration and management work.⁶⁸⁷

In 2007, therefore, a special legislative regime for managed service companies was introduced.⁶⁸⁸ This scheme applies if the payments to the individual, which are usually received as dividends, bear less tax than they would if they were employment income. So the scheme does not apply an attribution rule; instead it accepts the attribution of the remuneration to the company, but deems the company to pay employment income to the individual worker.

What is especially interesting in the context of this study are the factors cited in the consultative document on the legislation⁶⁸⁹ as the indicators that the attribution of the remuneration to the company is “wrong” for tax purposes. This document refers repeatedly to the lack of involvement by the individual in the management of his individual company and his lack

686. Secs. 48-61 ITEPA.

687. The structures that are targeted by this legislation are described in detail in a consultation paper issued by HMRC. HM Treasury and HMRC, “Tackling Managed Service Companies”, December 2006, available at http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_026427.

688. Part 2, Chap. 9 ITEPA.

689. Note 687.

of control over that company, concluding⁶⁹⁰ that “[t]he key distinction here is about who exercises financial and management control.” It also draws a distinction⁶⁹¹ with structures in which the end client has a direct contractual relationship only with the company providing the service; by contrast, in the case of managed service companies, the end client also has a relationship with the individual carrying out the work. In essence, the message given by the consultative document was that the government would have liked to adopt the reasoning of the Netherlands courts, but felt unable to do so, and therefore had to find another solution.

4.2. Business profit

Business profit is the most complex category of income for many tax purposes, and the attribution of business profit, or loss, is no exception. Income from assets and employment income both arise due to one predominant factor, namely ownership of the asset or the exercise of employment activity, and the basic attribution rule in respect of each is instinctively obvious. Carrying on a business, on the other hand, has more ingredients. Most businesses require both activity and the use of assets. Risk is also generally regarded as an essential element of a business. Which of these aspects determines the attribution of the business profit? Or is it a combination, the precise weight of each factor depending on the type of business and the context in which the question is posed?

4.2.1. Basic approaches

Neither the Netherlands nor the UK legislation attempts to set out specific rules for the attribution of business profit, both applying the general attribution principles in this respect. So in the Netherlands the basic principle of attribution on the basis of enjoyment applies to business income derived by both individuals⁶⁹² and companies.⁶⁹³ The 1964 individual income tax law specified that business profit was enjoyed by the person for whose account the business was carried on.⁶⁹⁴ This explicit provision was not carried over into the 2001 law, but it can be deduced from related provisions that the

690. In Sec. 3.12.

691. In note 2 of the consultation paper, at p. 8.

692. Art. 2.3 Wet IB 2001, note 56.

693. Art. 7(2) Wet VpB, note 382.

694. Art. 6 Wet IB 1964, note 390.

same principle has been carried over to the 2001 law.⁶⁹⁵ The corporate tax law also does not state explicitly what “enjoyment” means in the case of a company, but it refers⁶⁹⁶ specifically to the definition of business profit in the individual income tax law and it is generally accepted that the concept of enjoyment is the same as under the individual income tax law. In the United Kingdom, the legislation similarly follows the basic rules for both individuals and companies. The income tax legislation states that the individual liable for tax in respect of the profits of a trade, profession or vocation is the person “receiving or entitled to” the profits⁶⁹⁷ and the corporation tax law simply states that tax is charged “on profits of companies”.⁶⁹⁸

If a question arises as to the attribution of business profit there may also be an issue as to the consequences if the profit is not properly attributable to the person who is legally entitled to it. The complex nature of business operations, and the structures in which businesses are carried on, do not always make it easy to determine what the correct tax treatment should be. Should the profit simply be attributed to its “true” owner, thus bypassing the legal owner altogether? Or should the legal structure be respected, so that the legal owner is taxable in respect of the profit, and some other remedy applied to ensure that the true owner also suffers an appropriate tax burden? And if the latter answer is chosen, does that mean that the profit is taxed twice?

The solution in some Netherlands cases (discussed in 4.2.5.1. and 4.2.6.1.) has been to characterize an amount of profit that was shifted for non-business reasons as a disguised dividend. If, for example, two companies are in common ownership and one transfers profit to another in order to absorb losses, the profit transferred may be a disguised dividend distribution of the first company. The case law has, however, not made clear what the further consequences are.⁶⁹⁹ Logic would dictate that, in order to distribute something as a dividend, the transferring company must first have received it as taxable profit, and therefore it cannot also be profit of the transferee company, but the case law has not drawn this conclusion in unequivocal terms.

695. The 2001 law defines business profit as the benefit derived from an enterprise (Art. 3.8 Wet IB 2001, note 56) and defines an entrepreneur as an individual for whose account an enterprise is carried on and who is directly liable for the obligations of the enterprise (Arts. 3.4 and 3.5(2) Wet IB 2001). The latter definition is mainly of importance in connection with the favourable provisions that are available only to entrepreneurs.

696. Art. 8(1) Wet VpB, note 382.

697. Sec. 8 ITTOIA.

698. Sec. 2 CTA.

699. See on this point further Lancée, L., “Overheveling van winst naar een geliëerde N.V.”, 45 *de Naamloze Vennootschap* 8 (1967), pp. 129, 134.

Indeed, the case law has left the picture rather incomplete, to the extent that some commentators have speculated on the risk that the transferred profit could be taxed three times in economic terms – in the hands of both companies and in the hands of the shareholder as a disguised dividend.⁷⁰⁰

The United Kingdom has not used a deemed-dividend solution, and there the question put to the courts has more often been the simple question of who the taxable person is in respect of business profit. Usually the question has been put in respect of only one person, rather than as a choice between two potential taxpayers, although one would expect the answer to the question that was posed also to provide the answer to the question that was not posed. Unlike the Netherlands courts, the UK judges have indeed taken both questions into account and considered the risk of the double attribution of income that could ensue if they gave the “wrong” answer.

4.2.2. The importance of carrying on the business

Although the legislation in neither country states explicitly that the identity of the person carrying on the business is important in attributing business profit, it is clear from the case law that in making the attribution the courts of both countries generally look for the person who carries on the business. This is so despite the seemingly different attribution criteria explained above.

In the Netherlands in *BNB B 8888*,⁷⁰¹ for example, the Hoge Raad held that business profit flows to the person who carries on the business activity. The case concerned a widower, who took equal shares in his deceased wife’s estate together with his children. The widower and his wife had been married in community of property, and the widower argued that after his wife’s death part of the business profit was therefore enjoyed by his children. The Hoge Raad disagreed and attributed all the business profit to the widower, because he was the one who carried on the business; the profit had to be taken into the community of property, but that did not mean that it was no longer attributable to the widower for tax purposes. In order to be taxable in respect of income from a given source, the income has to flow directly to

700. See for example the comment by H.J. Hellema on HR 26 June 1963, No. 14 939, *BNB* 1963/291. Hellema also notes the risk that there could be yet another tax charge if the profit were actually distributed to an individual shareholder (if the shareholder were a company the participation exemption would usually apply.)

701. Note 397.

that person. In this case the profit flowed directly to the widower, and from there indirectly to the children.

In the United Kingdom this point arose indirectly in *HMRC v. Anson*,⁷⁰² which concerned an individual resident in the United Kingdom who was a member of a Delaware LLC. The question before the court was whether the individual could claim a foreign tax credit for the United States tax paid by the LLC, and the answer turned on whether the distributions made by the LLC to the individual were the same as the profit of the LLC or a different item of income. In finding that they were a different item of income, the judge emphasized that it was the LLC that conducted the business, owned the business assets and incurred the business liabilities. The profit therefore belonged to the LLC for tax purposes, and the individual had nothing more than a contractual right to receive a payment equal to a share of the profit. This conclusion is backed up by plenty of case law to the effect that the executors of a deceased's estate and the liquidator of a company incur a liability to tax on profits realized if they are trading, but not if all they are doing is winding up the affairs of the individual or the company.⁷⁰³ Although this case law concerns primarily the characterization of the amounts received, the conclusion drawn consistently by the courts underlines the importance of carrying on a business if realized profits are to be subject to tax as such.⁷⁰⁴

The point has also arisen in respect of VAT, in a case which was later referred to in *Alongi*, an income tax case discussed in 4.2.3. In *Nasim v. C & E Commissioners*⁷⁰⁵ the taxpayer used to run a restaurant at premises that she had leased. She was no longer able to cope with the physical burden of the restaurant business, but the terms of the lease prevented her from simply assigning the lease to someone else. Instead Mr Matin, who had been the head waiter, took over the running of the restaurant and paid rent to Nasim. Nasim continued to deal with the landlord and provided some help with the paperwork. The issue before the court was whether Nasim was carrying on the business of the restaurant. The court found that she was

702. *The Commissioners for Her Majesty's Revenue and Customs v. George Anson*, FTR/39-2010. At the time of writing, no further reference was available. It also remains to be seen whether this case will be appealed.

703. In respect of the executors of an individual's estate, see for example *Cohan's Executors v. CIR* 12 TC 602; and *Newbarns Syndicate v. Hay (HM Inspector of Taxes)* 22 TC 461. In respect of a liquidator see *Wilson Box (Foreign Rights), Ltd (In Liquidation) v. Brice (HM Inspector of Taxes)* 20 TC 736.

704. Rather than becoming part of the capital of the deceased's estate or the company.

705. *Nasim and another (trading as Yasmine Restaurant) v. Customs and Excise Commissioners*, [1987] STC 387.

not, pointing out that the whole arrangement, both as drafted in the written agreements and as implemented in practice, was designed to transfer the business to Matin. He decided which food to buy and to sell, at which price, at which times, and whether he even opened the restaurant at all. In other words, he made all the decisions that affected the profit or loss. Nasim, therefore, was not running the business and therefore not liable for VAT.

One of the characteristics of carrying on a business is incurring business risk⁷⁰⁶ and sometimes this element of risk is singled out as a determinative factor. The Netherlands policy in respect of intermediary companies in international structures, for example, sees risk as the crucial element in the attribution of income to the intermediary company. Interest and royalties which flow from connected persons through a company resident in the Netherlands are included in the company's taxable base, and therefore attract a credit for source-state withholding tax, only if the company bears substantial risks, including market risk, in respect of the income flow.⁷⁰⁷ In the United Kingdom the element of business risk was specifically named as a factor in *Butler v. Wildin*,⁷⁰⁸ discussed in 4.2.4., in which the judge took into account which party really bore the business risk in coming to his decision.

The following subsections look at cases in which the attribution of business profit was an issue, dividing the cases into four groups with similar fact patterns. This division is inevitably a little arbitrary, given the complexity of the issue and the number of, sometimes overlapping, factors at play.

4.2.3. Enabling another person to make a business profit

A situation in which one person helps another to make a business profit is most likely to arise within family relationships, and can create a difficult dividing line between, on the one hand, helping another person to make a profit and, on the other, providing so much "help" that one actually makes the profit oneself. In BNB 1969/5,⁷⁰⁹ for example, an estate agent received a tip about a plot of land for sale, bought the land in the name of his father-in-law, and then sold it for his father-in-law at a profit; the lower court found

706. As opposed to bearing the risk of default on the part of the source of the income; see Appendix II, 5.2.2.2. in respect of the First Market Maker's case in the Netherlands.

707. Art. 8c Wet VpB, note 382. This article also prescribes the required amount of risk in monetary terms, and requires the company to demonstrate both that it has enough capital to cover the risk and that the capital will be depleted if the risks are realized.

708. Note 466.

709. HR 30 October 1968, No. 15 993, BNB 1969/5 (with comment by Lancée).

that the estate agent genuinely wanted to give his father-in-law an opportunity to make some money and that the benefit of the transaction did flow to the father-in-law. The tax inspector argued that the profit was attributable to the estate agent, as he was the one who had acted as a trader, but the Hoge Raad disagreed, reasoning that a person is taxable only on profit that he actually enjoys, not on profit that he could have enjoyed if he wanted.

The Hoge Raad also stated that there may be exceptional cases in which a profit that is realized by a person from an opportunity given to him by an entrepreneur is properly attributable to the entrepreneur, but it did not elucidate what those exceptional cases may be.⁷¹⁰ In this case it obviously found no reason to deviate from the legal construction, according to which it was the father-in-law who carried out the transactions. In this case, as in the *Nasim* case discussed in 4.2.2., there was a factual finding that the parties had intended only one person to benefit from the business and that that intention was properly reflected in the legal structure, making both cases relatively easy to decide.

The UK case of *Alongi v. IRC*⁷¹¹ was more complex. The taxpayer in this case had bought a restaurant business and premises from his brother, Tony, who was in financial trouble. Tony continued to run the restaurant, taking a lease of the premises from the taxpayer. On the other hand, he was formally employed by the taxpayer and there was a finding of fact that the lease was not a genuine business transaction. Payments, which were regarded by both parties as rent, were regularly paid from a bank account for the restaurant's business receipts to a bank account controlled by the taxpayer. The taxpayer had taken a loan to buy the restaurant and it was agreed that, when the loan plus interest had been paid off, the taxpayer would transfer the restaurant back to Tony for a nominal sum.

The General Commissioners had found on the facts that the restaurant was owned and controlled by the taxpayer, and therefore attributed the profit to him. The taxpayer appealed, arguing that he was not active in the business and all he did was assist or facilitate the carrying-on of the business by Tony. The Court of Session dismissed his appeal, reasoning that business profits are, *prima facie*, attributable to the owner of the business, and that ownership of a business usually carries with it the right to control the busi-

710. It is interesting to note here by way of comparison that the UK legislation on artificial transactions in land, described briefly in 3.4.2.1., specifically provides that if one person provides another person with an opportunity to realize a gain, the gain is attributable to the person who provided the opportunity.

711. *Alongi v. IRC* [1991] STC 517.

ness. The taxpayer could not convincingly displace this prima facie attribution rule unless he could demonstrate that the profits arose or accrued to someone else, and that he had been unable to do. He also failed to prove that he did not have overall control of the restaurant. The court placed much less weight on the issue of who actually took the benefit of the restaurant's profit. It pointed out the unlikelihood that the parties had intended the profit to belong to Tony, who was an undischarged bankrupt for part of the period concerned, and the lack of documentary evidence that Tony took anything except his wages, but these comments were made only to support the conclusion already reached.

In both the *Alongi* case and BNB 1969/5, in other words, the profit was attributed to the person who was legally entitled to it, rather than the person who carried out the day-to-day activity. Nevertheless, it is submitted that these cases confirm the basic principle stated above of attribution to the person who carries on the business activity. What happened in both cases was that the legal owner had delegated the activity, but it is irrelevant whether the business activity is carried on personally or by delegation. The identity of the person who does the "dirty work" is not the issue; the important point is which person has legal responsibility for the business risks.

4.2.4. Carrying on a business in order to benefit another person

This section discusses two cases, one from each country, in which individuals attempted to transfer business profit to family members by channelling the profit through an artificial arrangement. In both cases the benefit received by the family members was funded by the business profit, although it reached them in a different form.

BNB 1968/112⁷¹² concerned an individual X who owned an estate agency, which developed and rented out shopping centres, and interests in a number of related businesses. In 1955 X started to buy and sell immovable property, and in 1955 he bought all the shares in Company A, which had accumulated losses. His wife, with whom he had no marital community-of-property regime, used NLG 16,000 of her own money to buy a claim against Company A with a nominal value of NLG 139,000. X became a director of Company A, and carried on a profitable trade in houses on its behalf, which meant that his wife's claim increased in value. The tax inspector added the increase in the value of her claim to X's taxable income as his business profit. The lower court found that all the activities of X, includ-

712. HR 27 March 1968, No. 15 859, BNB 1968/112 (with comment by Hofstra).

ing the dealings with Company A, formed a single business and that X had arranged for his wife to buy the claim against Company A for non-business reasons. From this the court concluded that the advantage she derived, of her claim against Company A increasing in value, was a benefit extracted by X from his business. The taxpayer appealed to the Hoge Raad, arguing that the lower court had, in effect, ignored the separate legal personality of Company A, but the Hoge Raad upheld the assessment.

The Hoge Raad understood the lower court to have found that X carried on his own business in addition to the business of company A. It agreed that the benefit received by X's wife had been extracted from X's business, and that that sum must, therefore, first have been part of X's business profit. The Hoge Raad put some emphasis on the possibility that X could have obtained for himself both the benefit of the increase in value of the claim and the profit from the trade in houses that he carried on for Company A. By itself, this possibility was not enough to support the attribution of the benefit to X, but it was enough when seen in combination with the other facts of the case. In his comment on the case, Hofstra is very wary about this argument, arguing that being able to obtain a benefit has never been a basis for taxation, but only actually obtaining the benefit. He would therefore have preferred to see the case decided on the basis that X's wife made a profit in the "other income" category.⁷¹³

In this case the Hoge Raad came to its conclusion on the basis of first principles regarding the attribution of income, but that was not so in *Butler v. Wildin*,⁷¹⁴ a UK case about parents and children and a more extreme structure to channel the benefit of the profit to the children. Two brothers set up a company and had the shares issued to themselves and their infant children, the shares issued to the children being paid for by their grandparents. The fathers organized and directed the company's business venture of buying, developing and letting out land and effectively bore all the company's risk by giving personal guarantees. When more children were born, shares were transferred from the fathers and the older children to the younger ones to keep the children's shareholdings roughly equal; in the end the entire share capital of the company was held only by the children, who were all still very young. The question before the court was whether the dividends paid by the company were taxable in the hands of the two fathers.

713. This profit would have been taxable in X's hands under the law in force at the time.

714. Note 466.

The High Court judge found the “facts ... artificial and unreal.” He continued that “[t]here must be a real doubt whether the infant children were genuinely shareholders and if they were whether they were the beneficial owners of the shares which from time to time stood in their names ... The children contributed nothing except the trifling sums which I must assume were paid on the allotment of the shares. They were exposed to no risk.” Nevertheless, the Revenue argued the case not on any basic principles, but on the basis of the settlement code.⁷¹⁵ The judge found that the settlement code did apply to most of the structure and therefore most of the dividends were attributable to the two fathers. Some of the dividends were attributable to the children, however, as some of the share transfers from the older children to the younger ones did not satisfy all the conditions for the application of the settlement code.

So whereas in BNB 1968/112 the profit was attributed to the person carrying on the business activity as a deemed profit extraction on the basis of general principles, in *Butler v. Wildin* it was attributed as a real dividend on the basis of anti-avoidance legislation. But in both cases the activity or risk of the person creating the profit weighed more heavily than the formal legal ownership of the person who received the benefit. In both cases the lack of business purpose was important, but in the Netherlands case it led to the conclusion that the taxpayer had extracted profit from his own business, whereas in the UK case it demonstrated the element of bounty that was a necessary condition for the application of the settlement code.

4.2.5. Shifting business profit

This section discusses various cases in which profit was shifted from one person to another. By contrast with the cases discussed in the previous section, in the cases discussed here the shifting was achieved by transferring the profit-making opportunity, so that the transferee formally realized the profit and the amounts shifted retained their character of business profit.

4.2.5.1. *The Netherlands*

In BNB 2010/93, a case decided by the Hoge Raad in 1969,⁷¹⁶ a company resident in the Netherlands placed patents with its Antilles subsidiary, which received large amounts of royalties in respect of them. The lower

715. See Appendix II, 3.5.1.2.

716. HR 25 June 1969, No. 16 016. BNB 2010/93 (with comment by Langereis).

court found that the patents had been transferred for tax avoidance reasons, as the Antilles company had no business of its own and no capacity to exploit the patents. Furthermore, all its policy decisions were made by its directors in the Netherlands, although there was always someone physically present in the Antilles to take care of administrative matters. The tax inspector argued that the parent had shifted its profit to the subsidiary and tried to attribute the royalties to the Netherlands parent company on an ongoing basis, but the Hoge Raad found that this went too far. No payment had been made by the subsidiary for the patents, and the Hoge Raad held that only an arm's length price for the transfer of the patents was attributable to the parent.

A similar issue arose in BNB 1998/385,⁷¹⁷ in which a construction company transferred each potential new project for a small sum to a separate subsidiary which had no staff and no assets except the minimum required capital. The transfer always occurred at an extremely early stage of the project, even before it was known whether the project would go ahead. If the project did go ahead all the work was carried out by the parent, with the subsidiary paying a cost-plus fee to the parent, and on completion of the project either the subsidiary or the building was sold. The Hoge Raad again used a transfer pricing solution, confirming the lower court's finding that the subsidiary's reward should be limited to 2% of certain costs, which amounted on average to 15% of the profit on each project. In effect, therefore, this decision did split the remuneration between the parent and each subsidiary on an ongoing basis, the Hoge Raad stating that an arm's length solution entailed the parent reserving most of the profit for itself. Presumably the remuneration was attributable directly to the companies in their prescribed shares, rather than being attributed entirely to one with a deduction for a payment to the other, although the Hoge Raad was not explicit in this respect.

In a number of other cases the tax inspector approached the issue a different way, by treating the profit shifted from one company to another as a disguised dividend. As explained in 4.2.1., a transfer of profit between companies in common ownership can constitute a disguised dividend by the transferor company if, for example, as a result of the transfer, the value of the shares of the transferee company increases, or the transferee company is in a better position to meet its obligations to the common shareholder. A number of these cases arose at a time when there was no legislative provi-

717. HR 17 August 1998, No 32 997, BNB 1998/385 (with conclusion by Deputy Procurator-General van Soest and comment by Hoogendoorn).

sion⁷¹⁸ to prevent the carry-forward of losses by a company on a change of ownership.⁷¹⁹ The tax inspector therefore used the “disguised dividend” concept to combat the purchase of loss companies and the subsequent arrangements made by the purchaser to divert profit to the newly acquired loss company.

One such case is BNB 1967/167.⁷²⁰ Company X, together with one of its directors, bought Company A, which had debts and accumulated losses but no business activity. The director and his brother each owned half the shares of Company X. The director also bought all the claims against Company A for 10% of their nominal value. In an arrangement found by the lower court to have been set up for non-commercial reasons, Company X rented its production equipment to Company A, made its personnel available to Company A, and placed production orders with Company A. In the year following the purchase of Company A, the tax inspector attributed Company A’s profit to Company X. This assessment was confirmed by the Hoge Raad; the structure allowed Company X to shift profit to Company A, which in turn benefited the director whose debt claims against Company A substantially increased in value. The profit realized by Company A should therefore be regarded as a dividend distributed by Company X to its shareholders, which was then transferred by them to Company A. The Hoge Raad did not have to consider the liability of Company A, but there is no suggestion in its decision that the tax liability of Company A was reduced by the profit attributed to Company X.

Similarly, in BNB 1999/326,⁷²¹ the decision of the Hoge Raad did not disturb the tax liability of the transferee company, but it did have a different effect on the transferor company. The case concerned another Company X, which was owned by an individual and his wife, and Company B, which was owned by the same individual and which had accumulated losses. Company X transferred its business to Company B for a period of six months; during that period Company B carried on the business in its own name, using the premises and the trade name of Company X. The profit it realized during that period was sufficient to absorb its losses. The

718. Such a provision was introduced originally in Art. 20(5), Wet VpB, note 382. In 2001 this provision was redrafted and moved to Art. 20a Wet VpB.

719. Lancée points out that many of the cases about the transfer of profit have arisen in connection with loss companies, but that this is not the only situation in which the issue arises. The tax authority now has a specific means of preventing the use of losses, but the old law still applies to other cases; Lancée L., “De N.V. met gestaakte onderneming en haar verlies compensatie”, 47 *de Naamloze Vennootschap* 11 (1970), pp. 173-8.

720. HR 12 April 1967, No. 15 661, BNB 1967/167 (with comment by Vinke).

721. HR 14 April 1999, No. 34 137, BNB 1999/326 (with comment by Aardema).

lower court found that Company X, by shifting profit to Company B, had paid a disguised dividend and increased Company X's profit by the amount of profit realized by Company B. The Hoge Raad agreed with this general approach, but disagreed about the amount of the disguised dividend. Unlike the previous case, the profit realized by Company B was the wrong measure; the correct measure was the price that would have been paid by an unconnected third party for the six-month transfer. In other words, the Hoge Raad accepted, albeit implicitly, that the profit derived by Company B was properly attributable to B and, importantly, not to Company X.

The distinction that seems to be drawn by these cases, although it is not very clearly articulated, is the difference between, on the one hand, transferring an entire branch of business together with its profit potential and, on the other hand, transferring only the profits. If an entire business venture is transferred, the Hoge Raad accepts that the subsequent profit is attributable to the transferee and the only issue is the price for the business venture. The same conclusion also applies when assets are transferred on their own, such as the patents in the first case described above.

It is the transfer of the profits alone that raises questions about attribution.⁷²² BNB 1967/167 concerned one specific year, but the reasoning of the Hoge Raad implies that the profits should have been attributed to the transferor company on an ongoing basis, at least until the claims against Company A bought by the director returned to their full value. Presumably the crucial difference between this case and BNB 1999/326 is that in BNB 1967/167 the transferor company kept a finger in the business pie, whereas in BNB 1999/326 the business was transferred in its entirety, albeit for a very short time. In BNB 1998/385 the Hoge Raad seems to have considered that it was a slice of the business that was transferred, together with its profit potential, rather than a slice of the profit.

4.2.5.2. *The United Kingdom*

The United Kingdom has much less case law on profit shifting in this way, which has two obvious explanations. One is that the United Kingdom has had legislation since 1969 to prevent the carry-forward of losses on a change of company ownership.⁷²³ The other is that trading profit was one

722. It is interesting to note here an echo of the UK concern with the separation of income from the asset that produces it, as discussed in Appendix II, 3.5.1.2., but now applied to business profit.

723. Now Part 14 Corporation Tax Act 2010.

of the income categories which the legislation, before the rewrite, already attributed on the basis of receipt or entitlement, so making the attribution issue considerably less acute. The one case in which the issue arose in this form led to the introduction of anti-avoidance legislation – the scheme on artificial transactions in land.⁷²⁴

The one case is *Ransom v. Higgs*,⁷²⁵ which concerned an individual, Higgs, who consented to a complex avoidance scheme which he did not really understand. Stated briefly, land owned by companies owned by Higgs and his wife was sold via a circuitous route to a development company, which was also owned by Higgs and his wife. The profit realized from developing and selling the land followed another circuitous route, ending up in the hands of the trustees of a discretionary trust for the benefit of the Higgs family.⁷²⁶ The question before the House of Lords was whether Higgs had carried on a trade by consenting to the scheme. This question arose because the facts happened before the introduction of capital gains tax, so tax could be levied only if the profit derived was trading income.⁷²⁷ Higgs had been assessed to tax, as the person entitled to the profit, and so had the trustees, as the persons in receipt of the profit from Higgs' trade. In the House of Lords, the Revenue chose to defend only the assessment on the trustees.

The House of Lords held unanimously for Higgs; each of the five judges gave a speech with slightly different reasons, but they all agreed that Higgs was not trading. Some of the judges found that he could not have been trading because all the actions that were necessary for the scheme had been carried out by the companies and Higgs had no dealings with any persons.

724. Now in Secs. 776-778 ICTA 1988 for corporation tax and Secs. 752-772 ITA for income tax. The main thrust of this legislation is to tax the person behind such schemes, treating capital gains as income. These provisions also make a person taxable if he provides an opportunity to another person to realize a gain. In that case, however, the person that provides the opportunity has a right of indemnity for the tax against the person who realizes the gain.

725. *Ransom (Inspector of Taxes) v. Higgs* [1974] STC 539, [1974] 3 All ER 949.

726. The scheme was described as a "stock stripping scheme" by Lord Wilberforce. In more detail, Mrs Higgs formed a partnership with two subsidiaries of the advisory company that arranged the scheme, and gave her partnership interest to the trustees of the family trust. The trustees then sold the partnership interest to the advisory company for GBP 170,000. The Higgs companies that owned the land sold it to the partnership, and the partnership sold it to the advisory company, both sales for a price of GBP 87,000. There were some more sales of the land through companies connected with the advisory company, until it was sold to the Higgs development company which developed and sold it to third parties; the price for all these sales was roughly GBP 287,000. It was the GBP 170,000 paid by the advisory company to the trustees that was at issue in the case.

727. The facts also occurred before the introduction of corporation tax, so the liability of any of the companies involved would have been to income tax.

What he had been doing, according to all five judges, was “procuring other persons to trade”.⁷²⁸

Most of the judges stated explicitly that they saw the undesirability of allowing Higgs to “get away with it”, but what seems to have hampered them in preventing that outcome was their concern about the risk of double taxation if they found that he had been trading. Lord Reid put it this way: “I do not understand the basis of [the Revenue’s] argument. Is it to be said that whenever A persuades B to do some trading which yields a profit, A as well as B is liable to pay tax on that profit? That would be ridiculous.” Lord Wilberforce was similarly concerned about the risk of a double attribution (“once in the hands of the actual trader, again in the hands of the procurer”), and concluded that “... these acts of trading were done by the companies, or just possibly by the trustees. Their attribution to these entities, which is indisputable, makes it impossible to attribute them to Mr Higgs.”

In other words, the judges felt themselves constrained to find in favour of Higgs because the various sales and purchases in the scheme were also capable of creating taxable profit in the hands of the companies. The court was not able to remove the potential tax liability of the companies and therefore declined to affirm the tax liability of Higgs, demonstrating a concern which, if it is shared by the Hoge Raad, has not been explicitly addressed by it. It would be interesting to know what the decision would have been if the issue had been presented to the court in a way similar to that in the Netherlands cases, as the initial sales of the land by the Higgs companies had been made below market value and the deficit in the sale price could have been regarded as a disguised dividend distributed to Higgs. That line of reasoning is, however, not one that ever seems to have been pursued by the Revenue in the United Kingdom.

4.2.6. Integrated businesses

Finally, two cases, one from each country, about companies with integrated businesses, provide an interesting comparison. Both cases concerned the use of one company in a group as the sales arm of the group and whether profit realized was correctly attributed to the sales arm. Although the back-

728. In a critical article published shortly after the decision, Twitley argues that the scheme was a trade carried on by Higgs, but gives a slightly different explanation of the decision. He considers that the House of Lords came to its conclusion because it focused on the person rather than the trade, and the judges were unable to accept the possibility of transactions being trading transactions of more than one trade concurrently: Twitley, G., “A Matter of Form”, *British Tax Review* (1974) 6, pp. 335-9.

grounds to the two cases are very different, they both illustrate the importance of determining which person is carrying on a business.

4.2.6.1. *The Netherlands*

The Netherlands case led to two decisions from the Hoge Raad,⁷²⁹ with the case being referred back to the lower court in between. Two individuals, X and Y, owned Company A, which in turn owned Companies B1 and B2. X and Y, together with Z (an employee of Companies B1 and B2), bought all the shares of Company C together with a loan made to Company C by its previous owner. Company C was more or less a shell at the time of the purchase, but it had accumulated losses. A business that had been carried on by Companies B1 and B2 was transferred to Company C. There were demonstrable commercial reasons for this transfer, and the business grew rapidly in the hands of Company C. When Company C needed bank credits to finance its expansion, these credits were secured on the shares owned by X and Y in Company A and Company A guaranteed the credits. The tax inspector asserted that profit had been shifted from Company A, as the owner of Companies B1 and B2, to Company C, and assessed tax on X, Y and Z as if they had received a disguised dividend from Company A. When the case first reached the Hoge Raad, it agreed that the increase in the value of the shares held by X, Y and Z could constitute a disguised dividend, and referred the case to another lower court to determine the relevant facts.

The second lower court found it entirely plausible that a separate company (C) had been used as the sales arm of the whole concern, but found nevertheless that the commercial nature of the structure had not been adequately demonstrated. Why, for example, did Company C not pay Companies B1 and B2 for its acquisition of the sales function? And why did Company A take the risk of Company C's sales, especially as Company C started off with accumulated losses? There was no other explanation than that the common ownership of the two companies had caused Company A to allow Company C to realize the profit. The court found that this profit shift constituted a disguised dividend paid to the individuals and fixed the dividend at 80% of Company C's profit, leaving 20% as remuneration for Company C's activities.

This decision was appealed to the Hoge Raad by one of the individuals, partly on the basis that the lower court had confused a transfer of profit and

729. HR 21 March 1962, No. 14 642, BNB 1962/139 (with comment by Hellema) and HR 26 June 1963, No. 14 939, BNB 1969/291 (with comment by Hellema).

a transfer of a profit-making branch of activity. The lack of any payment by Company C for its acquisition of the activity was, he argued, not the right basis on which to decide the case, as after the transfer it was only Company C that was entitled to the profit. The Hoge Raad did not agree that the lower court had been confused; to the contrary, it had found that there had been no transfer of a profit-making branch of activity, but rather that Company C had been engaged only to realize the sales. Company C was therefore not the only person entitled to the profit. The remuneration for the sales activity was a factual question, and the lower court's decision in this respect was reasonable. The Hoge Raad therefore confirmed the disguised dividend in the hands of X, Y and Z.

Neither the lower court nor the Hoge Raad stated explicitly the further consequences of this finding. If 80% of the profit legally derived by Company C was indeed a disguised profit distribution by Company A, then logically that amount of profit should have been taxable in the hands of Company A and, importantly, not in the hands of Company C. Both courts, however, stopped short of drawing this conclusion.

4.2.6.2. *The United Kingdom*

The UK *Firestone* case⁷³⁰ provides an interesting comparison. This case concerned a UK company, called Brentford in the case (after the town where it was located), that belonged to a multinational group of companies. The group was headed by a US resident company, which owned all the shares of Brentford and which was called Akron in the case (also after the town where it was located). Brentford manufactured tyres, which it sold to distributors outside the United Kingdom. The sales contracts were governed by UK law, but their terms had all been determined by Akron and the sales were made only to distributors approved by Akron. Akron also had master agreements with the distributors setting out the terms of their distributorship. Brentford had a contractual obligation to fulfil orders obtained by Akron, but in practice it received its orders directly from the distributors. Payments received by Brentford were credited to Akron in Brentford's books, subject to a deduction of Brentford's costs plus 5%.

The issue before the House of Lords was the assessment on Brentford as the UK agent of Akron and the underlying question of whether it was Akron or Brentford that carried on the trade of selling tyres. The Court of Appeal had decided that it was Akron, because Akron determined the

730. *Firestone Tyre and Rubber Co Ltd v. Lewellin* [1957] 1 All ER 561, 37 TC 139.

prices and policy and owned the intangibles. The House of Lords came to the same conclusion, by relying specifically on the factual findings of the Special Commissioners that, for example, the tyres manufactured in the United Kingdom were at the disposal of Akron, even though they were owned by Brentford. The Special Commissioners had also found that the customers were Akron's customers and that Brentford sold the tyres to the distributors on behalf of Akron, according to the arrangements set up by Akron and subject to the terms imposed by Akron. Taking the facts as a whole, there were two possible interpretations: either Brentford was selling the tyres on its own behalf; or it was selling them as agent for Akron. The Special Commissioners had decided that the trade belonged to Akron, and the House of Lords saw no reason to overturn that finding.

4.2.6.3. *Comparison*

The courts in these two cases clearly took quite different approaches. The decision in the Netherlands case turned on the commercial justifications for the transfer of the sale function to Company C, and the influence of the common ownership of Companies A and C. The conclusive element was that the dealings between the companies were not at arm's length, due to their common ownership. In the UK case, by contrast, the decision turned on the contractual arrangements surrounding the sales, and Akron's role in choosing the distributors to whom the sales were made and generally determining the way in which the trade was carried on. Whether or not the companies acted at arm's length was raised very briefly and in rather an indirect way in the Court of Appeal by Birkett L.J., who described Akron as "the over-riding master company" and pointed out that Brentford was part of Akron's worldwide organization. In the House of Lords, however, this point was not even considered.

These different approaches can be explained by the different fact patterns and background of the cases. In the Netherlands case, for example, the company used as a sales arm was acquired when it had virtually no activity itself and accumulated losses, whereas in the UK case the situation had grown organically. On the other hand, in the Netherlands case it was accepted that there were good commercial reasons for using the acquired company as a sales arm. The question in the Netherlands case was whether there had been a shifting of profit in order to benefit the individuals who owned both companies, whereas the question in the UK case was whether a non-resident company (Akron) was taxable in the United Kingdom. And finally the interests of the taxpayers were different. In the Netherlands case

the taxpayers wanted the profit to be attributed to the sales arm, or at least not attributed to Company A. In the UK case the taxpayers argued that the trade was carried on by the US parent, Akron, but that it was not carried on through Brentford as agent.

Despite the differences in their background, however, in both cases the issue came down to the question of which company was carrying on the business. The outcomes were also largely similar; the sales arm did not have the sales profit attributed to it, but only a small remuneration for its activities. The important difference between the two outcomes is that the House of Lords endorsed the decision of the Special Commissioners as to which party could, and which party could not, have the profit attributed to it. The Hoge Raad, on the other hand, confined itself to attributing the profit to Company A, without drawing the conclusion that the profit was not attributable to Company C.⁷³¹

5. Factors in the attribution of income

Having looked at the way in which income is attributed to a person in different situations, this part of the study looks at the issue from a different angle. It discusses much of the same material that was discussed in Parts 3. and 4., but here the focus is on the various factors that play a role in the attribution of income.

One factor can be dismissed relatively easily as a general principle, namely whether or not the person who pays the income is able to deduct the payment for tax purposes. The deductibility of a payment may be linked in policy terms to the taxability of the payment in the hands of the recipient,⁷³² but that link is a different issue from the question of whether the income payment has been correctly attributed. The only relevance to the attribution issue is that the deductibility of a payment implies that the person who makes the payment does so out of his own pocket, which in turn implies that any income received by that person is properly attributable to him even if he uses it to fund the deductible payment. Nevertheless, the deductibility of certain payments is sometimes described in the United Kingdom as a

731. In his note on this case, Hellema points specifically to the risk that the profit was attributable to both Companies A and C.

732. That this link is a policy choice of the legislator, and not an automatic one, is illustrated by HR 12 October 2007, No. 43 643, BNB 2008/6 (with comment by Lubbers) and the judgment of Viscount Radcliffe in *CIR v. Freere* 42 TC 125 at pp. 25-6.

mechanism which changes the attribution of income; this aspect of the law is discussed in 5.5.3.2.

5.1. Legal entitlement

5.1.1. Introduction

Legal entitlement is used here to denote the person to whom income belongs in legal terms, or in other words the person who has the right to claim the income from its source. Two questions arise immediately in respect of legal entitlement as an attribution factor: whether it is a necessary ingredient for the imposition of a tax liability; and the extent to which it is a sufficient ingredient.

The first question is easily answered, as legal entitlement is not a necessary factor in either the Netherlands or the United Kingdom. The most extreme example of income to which a person is not legally entitled is income that is illegally obtained, and both countries are able to tax income in the hands of a person who obtains it illegally.⁷³³ There may be an issue as to whether the legal obligation to pay the income back has an effect on the amount of taxable income, but that issue does not negate the existence of the tax liability as such. Another, very different, case in which legal entitlement is not a necessary ingredient is within family relationships in the Netherlands. The legislation of the Netherlands regulates the attribution of the income of minor children in such a way, for example, that one textbook describes any similarity between the attribution of the income of a minor child and the law relating to parental usufruct as entirely coincidental.⁷³⁴

The reverse question – whether legal entitlement is a sufficient factor – has two aspects. One is the issue as to whether there is income at all. Can a person be taxed on the basis of legal entitlement if, for example, the payment of the income is prevented by foreign exchange controls?⁷³⁵ That question is not discussed here, as it does not raise any issue as to the identity of the

733. As regards the Netherlands, see Pijl, H., Netherlands, in: International Fiscal Association, note 1, pp. 447-67 at p. 448, citing HR 4 July 1961, No. 14 559, BNB 1961/284 (with comment by A.J. van Soest). As regards the United Kingdom, see Gordon, Montes-Manzano and Tiley, note 379, Sec. 8.09, citing *Forbes v. Director of the Assets Recovery Agency* [2007] STC (SCD) 1.

734. Sillevs and van Kempen, note 374, Sec. 2.4.3.B (February 2010).

735. Interestingly, the 1914 individual income tax law of the Netherlands did tax individuals on income to which they were legally entitled even if they did not actually receive the income. Consequently the only individual to whom income was attributable

potential taxpayer. The following subsections look, rather, at the extent to which the legal entitlement to income can determine the attribution of the income to one or other person.

In respect of business profit, it is arguable that the concept of legal entitlement is something of a nonsense, because profit is only an arithmetical difference which is not capable of being subject to any form of entitlement. But the payments that go into the computation of profit can be the subject of a legal entitlement or a legal obligation, and in that sense one can speak of the legal entitlement to the resulting profit.

5.1.2. The Netherlands

5.1.2.1. *Dividend tax*

In the Netherlands a distinction has to be made between the dividend tax on one hand, and the individual income tax, wage tax and corporate income tax on the other. As explained in 2.2. and 3.1.2.1., legal entitlement is the primary attribution factor in respect of the dividend tax,⁷³⁶ in keeping with the more objective nature of this tax. That person is also generally the person entitled to credit the tax, and in a number of cases the Hoge Raad has confirmed this rule despite the economic interest of a different person in the dividend.

In BNB 1975/213,⁷³⁷ for example, a company's sole shareholder transferred dividend coupons to the company in satisfaction of a debt he owed the company. The shareholder was non-resident, and would therefore not have been entitled to a credit if he had received the dividends himself, but the company was entitled to credit the dividend tax, even though its entitlement to the dividend in effect constituted the repayment of the debt from the shareholder. Similarly, in BNB 1958/329⁷³⁸ the lower court held that the dividend tax is imposed on the income arising from shares and that that concept is to be interpreted in a "technical" fashion. It held that the tax was creditable by the person with legal entitlement to the dividends, even though there appeared to be some rather suspicious dealings in respect of the shares at the time of the dividend declaration.

was the individual who was entitled to it. See van Dijk, "Wie Geniet het inkomen?", note 378, at p. 170.

736. Art. 1(1) Wet DB, note 383.

737. Note 525.

738. Note 385.

This strict legal approach has also been maintained by the Hoge Raad in more recent cases. In both the First Market Maker's case (BNB 1994/217,⁷³⁹ concerning the sale of a dividend coupon) and the Second Market Maker's case (BNB 2001/196,⁷⁴⁰ concerning a short-term transfer of shares) the Hoge Raad held that the dividend tax was attributable for the purposes of the dividend tax to the person with legal entitlement to the dividend; in neither case did the court consider whether that person was the economic owner of the dividend.⁷⁴¹

There appears to be no case law in which a court has refused to attribute a dividend to a person with legal entitlement to a dividend on the basis of that person's lack of economic entitlement. As a general rule, in other words, legal entitlement to a dividend is, if not the determinative factor in the attribution of the dividend, at least a very strong factor. The relatively recent introduction of the beneficial ownership requirement in respect of the dividend tax credit (discussed in 3.3.2.) has, however, added an economic element to the requirements for claiming a credit for the dividend tax. Where this requirement applies, legal entitlement is no longer a sufficient factor for claiming the credit. It remains a necessary factor, however, as the person with economic entitlement to the dividend is also not able to claim the credit.

5.1.2.2. *Employment income*

In respect of the individual and corporate income taxes, which are imposed on the person who enjoys income, the role of legal entitlement is different. Here the primary attribution principle is that income is taxed in the hands of the person who enjoys the income. Legal entitlement according to the civil law relationship that gives rise to the income provides the initial indication of the taxable person, but if a different person has the economic entitlement to the income, the income is attributed to the person with economic entitlement.⁷⁴² Legal entitlement, in other words, is only the basis of an assumption. The person with legal entitlement to the income has to be identified, but the assumption that that person enjoys the income may be displaced.⁷⁴³

739. Note 653.

740. Note 559.

741. Brandsma, note 571, Sec. 2.2.0.B.a2 (October 2008). In the Second Market Maker's case the Hoge Raad did, however, point to the substantial benefit that was received by the company claiming the credit.

742. Van Dijk and van Vijfeijken, note 376, Sec. 4.2.1, p. 57.

743. *Ibid.*, Sec. 4.2.2.1, p. 59.

In respect of income from individual activity, this assumption can be displaced because the determinative factor is generally the identity of the individual who carries on the activity, rather than the formal entitlement to the income; this is so whether the income is derived from employment or from other types of individual activity. This displacement depends on the finding that the income is derived directly from the activities of the individual. So in respect of management companies, or the “incorporated employee”, the important issue is whether or not the court recognizes the agreement with the company as being effective to change a personal employment relationship into an impersonal business one; if the relationship remains employment, the income is attributable to the individual.⁷⁴⁴

In the rare cases in which income from employment was attributed to a person other than the individual employee, it was important that the legal entitlement to the income had been completely taken away from the employee. In the two cases in which Belgian-source social security payments were attributed to the wife of the employee,⁷⁴⁵ for example, the courts specifically found that the wife was the only person who had legal entitlement to the payments. And in respect of the donation of salary to a benevolent organization, the only case in which the employee did successfully change the attribution of his salary was a lower court decision⁷⁴⁶ in which the court found that the legal entitlement to the salary had been properly transferred before the salary arose.

The difference between these cases and the general principle, although nowhere expressed by the courts, seems to be that in these cases the court found that the employee did not even indirectly benefit from the income, whereas there is a general presumption that an employee does benefit from his salary even if it is paid to someone else. In respect of income from employment, in other words, legal entitlement can be determinative, but only if a person other than the employee has both the legal entitlement to, and the real benefit of, the income.

5.1.2.3. *Other categories of income*

Income from assets and business profit have a much less personal character than income from individual activity, and in respect of these types of income the assumption that legal entitlement to income carries with it

744. See Appendix II, 4.1.3.1.

745. See Appendix II, 4.1.1.1.

746. Hof Amsterdam 30 October 2003, note 678; see Appendix II, 4.1.2.

the enjoyment of the income is a stronger starting point, although it can still be displaced relatively easily. In BNB 1986/118,⁷⁴⁷ for example, the company's economic ownership of shares was not founded in the law of property but was constituted by contractual agreements. Nevertheless, the company's economic ownership overrode the legal ownership of the individual. Similarly in BNB 2007/15,⁷⁴⁸ which concerned spouses who were separated but still married with a marital community-of-property regime, interest was attributed to the husband on the basis of a factual finding that he received it and could decide how it was applied. In this case there were not even any contractual arrangements in respect of the income; it was sufficient that in practice the wife had no say over the income.

On the other hand, legal entitlement is not so easily displaced as to attribute income to a person who has only an indirect ownership interest in assets, unless the indirect ownership is part of a complex of facts amounting to a tax avoidance scheme.⁷⁴⁹ The cases attributing the income of a *stichting* to a person who is able to control the application of the income as if it were his own⁷⁵⁰ are an exception. Case law has come to this conclusion only in respect of individuals, and the literature generally agrees that an attribution of this sort cannot be made to a company.⁷⁵¹

Nor is the legal entitlement to income from assets generally displaced as an attribution factor when the legal entitlement to the income changes. A short-term transfer of shares is generally effective to change the attribution of dividends, for example.⁷⁵² And, as discussed in 3.5.1.1., the effectiveness of a gift of income without the underlying asset depends on whether the person receiving the gift acquires the right to claim the income from its source. The exception in this respect is the beneficial ownership requirement adopted by the legislation in respect of the credit for the dividend tax.⁷⁵³ This provision does not, however, change the attribution of the dividend in any way; it simply prevents a person with legal entitlement to a dividend from claiming the credit if that person does not also have a sufficient economic interest in the dividend.

747. Note 526.

748. Note 402.

749. See Appendix II, 3.4.1.2.

750. See Appendix II, 3.4.1.3.

751. Strik, S.A.W.J. and de Vries, N.H., *Cursus Belastingrecht (Vennootschapsbelasting)* (Deventer, the Netherlands: Gouda Quint, loose-leaf), Sec. 1.0.3.I.f (April 2010).

752. See Appendix II, 3.3.1.

753. See Appendix II, 3.3.2.

As regards business profits, legal entitlement is the basic indication of which person is carrying on the business and therefore the basic indication as to the attribution of the profit. So in BNB 1969/5,⁷⁵⁴ for example, in which an estate agent carried out a profitable transaction in the name of his father-in-law, the legal entitlement of the father-in-law to the transaction determined the attribution of the profit. On the other hand, in BNB B 8888,⁷⁵⁵ the legal entitlement to profit was overridden as an attribution factor because the individuals with legal entitlement were not the ones who carried on the business. The legal entitlement to business profit is also not determinative if it is manipulated in order to place profits in a company selected for tax avoidance purposes. In these cases the courts have paid regard to the economic aspect of the structure by looking at transfer pricing issues or by treating the profit that is shifted in this way as a disguised dividend. As discussed in 4.2.1., however, when a disguised dividend has been found, which implies that the profit is attributable to the company with economic entitlement to the profit, it is often not at all clear whether the attribution of profit to the company with legal entitlement to the profit has been removed.

The one case in which legal entitlement is not relevant is when it does not carry with it any possibility of personal benefit for the person who has the legal entitlement, or in other words when it is paid to a trustee.⁷⁵⁶ So although legal entitlement is an important factor, this is because it is assumed to encompass the enjoyment of income. If it can be shown that a person other than the person with legal entitlement has the enjoyment of income, even on a factual basis, the income is attributed to that other person, provided that that person has a direct connection with the income or a connection that is close enough to be considered a direct one.

5.1.3. The United Kingdom

5.1.3.1. *Capital gains tax and corporation tax*

Capital gains tax and corporation tax were both introduced in 1965 and, unlike the income tax, both are attributed on the basis of a single criterion. In both cases the single criterion places more emphasis on economic than legal entitlement, although this result is achieved in rather different ways.

754. Note 709.

755. Note 397.

756. See Appendix II, 3.2.1.4.

In the case of capital gains tax, the legislation determines the attribution of gains, if possible, on the basis of the beneficial entitlement to the asset. Although the legislation is worded in terms that are most appropriate to fiduciary relationships, such as trusts, the case law discussed in 3.1.1. has taken a wider, more economic view than the legislative wording might suggest. But this approach is based on an economic view of what constitutes ownership of property, so legal entitlement remains important to that extent. In *Burca v. Parkinson*,⁷⁵⁷ for example, a contractual obligation to pay part of the sale price to a third party was not enough to displace the attribution of the whole sale price to the vendor as a matter of property law. In *Anders v. Lovisa*,⁷⁵⁸ on the other hand, an agreement to pay part of the sale price to a third party did change the attribution of the gain, but this decision was founded on the law of property because the judge found that the agreement had created a trust.

If a gain is realized by the trustees of a trust in which no beneficiary has a clearly definable interest, the gain is attributed to the trustees.⁷⁵⁹ As the capital gains tax legislation provides only one criterion for attribution, it may seem that it is the legal entitlement of the trustees in this case that is the determining factor. Yet the legal ownership of the trustees in such a case carries with it a degree of control that is not comparable with a person who is able only to sue for payment; the trustee has to exercise at least a minimum amount of discretion in making the sale, by finding a purchaser and concluding the sale contract. It is therefore not accurate to isolate the legal entitlement of the trustees as a sufficient basis for attribution.

In respect of corporation tax, there is a basic presumption that income is attributable to a company which is legally entitled to the income. So, for example, special legislation is necessary in respect of “incorporated employee” companies⁷⁶⁰ because the legal entitlement of the company is sufficient to cause the attribution of the fee income to the company. Nevertheless, the requirement to compute profit according to generally accepted accounting practice,⁷⁶¹ coupled with the loan relationships legislation,⁷⁶² means that the computation of a company’s taxable profit is based on an economic approach. Indeed, the loan relationships legislation sometimes

757. Note 472.

758. Note 444.

759. Sec. 65(2) TCGA; and see the analysis of Lord Hoffmann in *Jerome v. Kelly*, note 553.

760. See Appendix II, 4.1.3.2.

761. Sec. 46 CTA.

762. Part 5 CTA; see 3.2.3.2.

imposes tax on the basis of notional payments that are constructed purely according to the economic view of the relationship in question.⁷⁶³

5.1.3.2. *Income tax*

The UK income tax legislation now, as a general rule, attributes income to the person who is entitled to, or who receives, the income. Two questions arise immediately in the context of this section: what type of entitlement is meant? And does the apparent use of two alternative criteria have any implications for entitlement as an attribution factor?

That legal entitlement, on its own, is not necessarily sufficient as the basis for attribution is clear from the case law on trusts. Indeed, in *Williams v. Singer*,⁷⁶⁴ the House of Lords expressly declined to attribute income to a trustee on the basis of his legal entitlement. And in the cases in which trustees have been found taxable on trust income there has always been some additional factor which was named by the courts in preference to legal entitlement.⁷⁶⁵

Outside the trust context the United Kingdom, like the Netherlands, seems to assume that the legal entitlement to income carries with it the economic entitlement and therefore legal entitlement provides an initial indication as to the taxable person. The United Kingdom, however, has such a thick overlay of anti-avoidance provisions that it is difficult to give any guidance as to the importance of legal entitlement in general terms. The anti-avoidance legislation and the existence of two alternative grounds for attribution have also meant that the case law has not thoroughly explored what exactly is meant by “entitlement” in this context.

Some of the anti-avoidance legislation adopts an attribution solution, and attributes income away from the person with legal entitlement to a person who derives some indirect personal benefit from the income. Some examples are the legislation attributing the gains of non-resident companies to their shareholders,⁷⁶⁶ the settlements code⁷⁶⁷ and the legislation on transfers of assets abroad.⁷⁶⁸ Other schemes adopt different solutions; the recently

763. See, for example, the *DCC* case discussed in Appendix II, 3.2.3.2.

764. Note 490.

765. See Appendix II, 3.2.1.2. and 3.2.1.3.

766. See Appendix II, 3.4.2.1.

767. See Appendix II, 3.5.1.2.

768. See Appendix II, 3.4.2.2.

adopted legislation on sales of income streams,⁷⁶⁹ for example, accepts the attribution of the income to the new legal owner and deals with the perceived problem by recharacterizing the consideration received for the sale.

Case law has also stepped in to limit the effectiveness of legal entitlement as a means of changing the attribution of income in situations perceived to be abusive. So, for example, in the *McGuckian*⁷⁷⁰ case income was found to be taxable in the hands of a person who did not have any legal entitlement to it. The principle of the *Ramsay*⁷⁷¹ case was applied to ignore intermediate steps inserted into a scheme for no purpose other than tax avoidance, and one of those steps was the transfer of legal entitlement to the asset or income.

The United Kingdom does not have any separate withholding taxes, but does require the withholding of income tax in many cases.⁷⁷² In respect of the withholding of tax, one might expect the legal entitlement to income to play a more important role than in the rest of the system, as is the case in the Netherlands, but in the United Kingdom this is not so. Tax is withheld from bank interest, for example, if it is paid in respect of what is termed a “relevant investment”, and in determining what is a “relevant investment” the legislation looks primarily at the beneficial entitlement to the interest.⁷⁷³

One interesting issue did arise as to what is meant by “entitlement” in *Way v. Underdown*.⁷⁷⁴ An agent for an insurance company wished to pay to the client the commission he received from the insurance company on the premiums he collected. Instead of collecting and paying over the full premium and then receiving the commission and giving it to the client, however, he simply collected from the client an amount equal to the premium less the commission and paid that amount over to the company. It was held that he was not taxable on the amount of the commission; in other words, the concept of entitlement could not create a tax liability when the agent waived income, even though he would have been taxable had he accepted it and then given it to the client.

769. See Appendix II, 3.5.2.2.

770. Note 655.

771. Note 600.

772. In the United Kingdom it is income tax that is withheld, even if the payment is made to a company, although in appropriate cases the tax withheld is creditable against any corporation tax due from the company. The main withholding obligations are governed by Part 15 ITA.

773. Secs. 856-861 ITA.

774. *Way v. Underdown (Inspector of Taxes) (No. 2)* [1974] STC 293.

5.2. Economic entitlement

5.2.1. Introduction

Economic entitlement is used here to denote the person who is legally entitled to benefit from the income. This is not necessarily the same as the person who in fact benefits from the income; where the factual benefit of the income rests is an enquiry that is fraught with differences of perception that should not be relevant to a taxing system. If the person who is entitled to the benefit of income voluntarily uses the income to bestow a benefit on a second person, does that mean that the benefit has passed to the second person? Or does the first person have the benefit, which consists of being able to use the income in that fashion? Or do both benefit from the same income, but in different ways? This study will assume that the ability to make the gift is an indication of economic entitlement on the part of the person receiving the income, and that the recipient of the gift has no entitlement to the income used to fund the gift. If the gift consists of the income itself, there is of course an issue as to whether the economic entitlement to the income has been transferred; this issue is discussed in 5.5.3.

The other side of the coin is that the person with economic entitlement to the income may not receive any factual benefit from it. A person who buys shares cum div, for example, may get no real benefit from the dividend when it is paid, because the amount of the dividend was reflected in the purchase price of the shares.⁷⁷⁵ Nevertheless, it is arguable that the purchaser is economically entitled to the dividend, in the sense that, when he receives it, he is able to spend it, even though he has, in effect, already done so by buying the share cum div. The ability to spend the dividend is, in this view, an indication that the purchaser has the economic entitlement to it.

This view of economic entitlement has been specifically confirmed in the Netherlands by Advocate-General van Soest in the First Market Maker's case,⁷⁷⁶ which concerned the sale of a dividend coupon. Although the issue in the case was beneficial ownership for treaty purposes, van Soest also

⁷⁷⁵. This issue is explored in Sillevius and van Kempen, note 374, Sec. 4.4.1.B (March 2010) in respect of the Netherlands in the context of income from a substantial shareholding. The Ministry of Finance has also confirmed that the dividend tax is creditable by a corporate purchaser of shares, even if the dividend is deductible from the base cost of the shares because it was reflected in their purchase price; Mededeling van het Ministerie van Financiën, 12 juni 1990, No. DB90/3221, Infobulletin 90/434.

⁷⁷⁶. BNB 1994/217, note 653.

considered domestic law,⁷⁷⁷ and concluded that the domestic law of the Netherlands regards the purchaser of the coupon as enjoying the dividend. In the United Kingdom a similar statement was made in the *Pager*⁷⁷⁸ case, although the issue before the court was the characterization of the sale price of coupons in the hands of the vendor. In *McGuckian*,⁷⁷⁹ however, a dividend was attributed to the vendor of the right to the dividend, but this case concerned an avoidance scheme, and the court made this attribution by ignoring the artificial steps of the scheme that were inserted purely in order to obtain a tax advantage. None of the judgments of the House of Lords explicitly considered the position of the purchaser, but the general tenor of their judgments was that the dividend was attributable only to the vendor.

That it is no simple matter to determine in general terms where the economic entitlement to income lies is demonstrated by Parts 3. and 4. of this study. This section does not attempt to summarize the findings of those parts, but offers some general thoughts relating to the nature and importance of economic entitlement. The following sections, particularly 5.3. and 5.4., consider some specific features of the payment of income which are closely related to economic entitlement.

5.2.2. The Netherlands

5.2.2.1. *Dividend tax*

As discussed in 2.2. and 3.1.2.1., dividend tax is levied primarily on the basis of the legal entitlement of the shareholder to the dividend. The legislation does not state explicitly the basis on which the credit for the tax is granted,⁷⁸⁰ but the case law⁷⁸¹ has also granted the credit for the tax on the grounds of legal entitlement as a basic principle.

Nevertheless, the approach to granting the credit for the tax has taken on more of an economic colour with the introduction of the beneficial ownership requirement.⁷⁸² Indeed, the beneficial ownership requirement goes beyond the concept of economic entitlement explained above, as it looks at whether the benefit of the dividend flows to another person, and whether

777. In Paras. 7.1 to 7.9 of his conclusion.

778. Note 407.

779. Note 655.

780. Art. 25(1) Wet VpB 1969 (note 382) and Art. 9.2 Wet IB 2001 (note 56) simply denote the dividend tax a payment in advance of the corporate or individual income tax.

781. See Appendix II, 3.3.1. and 3.5.2.1.

782. See Appendix II, 3.3.2.

that other person is in the same shareholder relationship with the distributing company before and after the scheme.⁷⁸³ In this case, therefore, the factual benefit of the income does become relevant, and the legislation does look at whether the person claiming the credit has already applied the income. The decision of the Secretary of State on second trading lines,⁷⁸⁴ arguably, goes even one stage further, by attempting to limit the dividend tax credit to persons who are regarded as true long-term investors in a company.

5.2.2.2. *General principle*

Most of the case law of the Netherlands discussed so far has been devoted to considering what it means for a person to “enjoy” income according to the basic attribution rule. Aside from all the specific situations discussed in previous sections, the essence of this concept still deserves consideration. The literature on the concept generally points to the increased availability of funds to a person as a result of the payment.⁷⁸⁵ And in BNB 1958/187⁷⁸⁶ the Hoge Raad decided that the taxpayer has to be able to do something with income before he can be taxed on it.⁷⁸⁷ In other words, the taxpayer has to be able to apply, or spend, the income.

Whether or not a person has the enjoyment of income is sometimes described in the literature as question of fact. Hofstra and Stevens state, for example, that the factual situation is decisive either if it differs from the civil law situation or, especially, if the civil law situation is not clear.⁷⁸⁸ There has indeed been a lower court decision of 1992⁷⁸⁹ in which the concept of enjoyment was extended beyond the legal right to take the ben-

783. Brandsma, note 571, Sec. 2.2.0.D.i (January 2008) explains that the condition that the person avoiding tax should be in the same shareholder position before and after the transactions refers to the economic entitlement of that person.

784. BNB 2007/173; note 541.

785. Van Dijck, “Het genieten van inkomsten”, note 378, p. 42, “whether the amount paid has come within the control of the creditor”; 4.1.1, p. 67, “[if] the taxpayer benefits from the payment. He can be taxed over the amount received”; p. 74, 4.1.4, there is no taxation if “the (factual) spending power of the taxpayer has not yet increased”; p. 98, “the general concept of Art. 33... namely the increase of spending power”; p. 104, “Taxable income can be recognized if spending power has increased”; p. 109, “The central question is whether the creditor’s spending power has increased” (translations by the author).

786. Note 401.

787. “Er moet een bestedingsmogelijkheid zijn” – it has to be possible to apply the income (author’s translation).

788. Hofstra and Stevens, note 398, Sec. 11.2, p. 95.

789. Hof ’s-Gravenhage 28 February 1992, No. 90/0226, V-N 1992/1812.

efit of income, to encompass a factual benefit. One individual held a bank account in his own name, but asserted that he held the account on behalf of a second individual and that the interest was therefore attributable to the second individual. There was no legal relationship between the individuals to support this claim, but the court accepted the factual evidence of the individuals and attributed the interest to the second individual, adding that the burden of proof in such a case is on the account holder. Van Dijck and van Vijfeijken comment that this burden would be a heavy one.⁷⁹⁰ They also add their opinion that such an arrangement should be respected by the law only if it is known to the economic agents involved, in this case the bank.

It is, however, not at all clear to the current author why such an arrangement should be respected at all if there is absolutely no legal backing to it. As explained above, the factual benefit of income is a concept that is subject to too many subjective differences of perception to serve as the basis for the imposition of a legal liability, such as the liability to pay tax. It is also not clear why it should make a difference that the bank knows about the arrangement; even if the bank is fully aware of the way in which the individuals concerned regard the account, it would have no justification for treating anyone other than the account holder as the person entitled to the interest. Of course the situation could change if the account holder issues some sort of instruction to the bank in connection with the arrangement, but in that case there may be some legal basis to support the arrangement.

It is submitted that this case should be regarded as an aberration, and that the concept of enjoyment should be interpreted in the same way as the concept of economic entitlement explained above. In other words, there should be some feature with legal effect that determines the attribution of the income, rather than just the perception of the parties involved. And in all the other cases discussed so far there has indeed been such a legal feature, whether it was the ownership of an asset or the contractual relations among the parties. Family relationships may also be a factor with legal effect in this sense, as the law takes cognizance of family relationships between individuals.

The enjoyment of income also has a reverse side, and the risks associated with the income are also part of the “enjoyment”. So bearing those risks is sometimes singled out as a factor governing the attribution of income.⁷⁹¹

790. Van Dijck and van Vijfeijken, note 376, Sec. 4.2.4, p. 66.

791. For example van Dijck, “Het genieten van inkomsten”, note 378, Sec. 4.1.2.7, p. 71 states that a person enjoys income if the income is received for the account of and at the risk of that person (“indien deze voor zijn rekening en risico wordt ontvangen.”)

The most obvious risk in this respect is the risk of non-payment, or debtor default. There may, however, also be other risks embedded in the payment, such as the risk that currency fluctuations reduce the value of the payment received. This aspect was relied on by Advocate-General van Soest in the First Market Maker's Case as an indication that the purchaser of dividend coupons, without the underlying shares, was the person who enjoyed the dividends paid on the coupons.⁷⁹²

5.2.2.3. *Whose benefit?*

It is inherent to the concept of enjoyment that the availability of funds has to be for the personal benefit of the person regarded as having enjoyment; this is clear from the impossibility of attributing trust income to trustees, as discussed in 3.2.1.4. In some cases, however, an individual is treated as enjoying income that is paid to a family member even though there is no legal arrangement for the benefit to flow to the individual.

These situations arise particularly in connection with employment or a substantial shareholding. As regards substantial shareholders, an advantage provided by the company to a family member of a substantial shareholder is regarded as a distribution for tax purposes to the shareholder followed by a gift to the family member.⁷⁹³ In respect of employment income, payments to a family member of an employee in current employment⁷⁹⁴ are usually attributed to the employee. In these situations the law takes cognizance of the family relationship and regards the income as flowing via the employee or shareholder. There is an implicit assumption that the payment to the other person is made at the behest of the individual whose relationship causes the payment, and the individual's enjoyment of the income consists of providing spending power for another person. A different result was reached in the cases discussed in 4.1.1.1., in which Belgian social security payments were paid in respect of the husband's employment but the wife was the only person who had any entitlement to them. In these cases the husband had no contractual relationship with the source of the income and

792. BNB 1994/217; note 653.

793. Strik and de Vries, note 751, Sec. 2.0.5.E.f (April 2010) discuss various cases in this respect. See also HR 25 November 1992, No. 27 519, BNB 1993/41 (with conclusion by A-G Verburg and comment by Bartel); HR 26 March 1997, No. 31 995, BNB 1997/219 (with comment by Wattel); Hof 's-Hertogenbosch 15 November 2001, No. 98/2189, *V-N* 2002.8/25.

794. Pensions paid to the widow/widower or children of previous employees are generally attributed to the widow/widower or child.

so could not be treated as if he had agreed that part of his salary would be paid to his wife.

There is now a clear exception to the attribution of income on the basis of personal enjoyment, namely the new law on the taxation of separated private funds discussed in 3.2.1.4. This legislation attributes the income of such a fund to a person who provides assets to the fund, regardless of whether that person derives any personal benefit from the fund. In doing so, it goes a considerable step further than the case law discussed in 3.4.1.3., which attributed the assets of a foundation to an individual who could control the foundation's assets and income as his own, as it was an important factor in that case law that the individual was able to take the benefit of the income, even if he did not actually do so.

5.2.3. The United Kingdom

5.2.3.1. *Capital gains tax and corporation tax*

Economic entitlement is the primary attribution factor in respect of both capital gains taxation and corporation tax in the United Kingdom, although the economic aspect is not explicit in either of the basic attribution rules in the legislation. In respect of capital gains tax, the reliance on the economic approach is derived from the rules applicable to trusts, which attribute capital gains realized in respect of trust assets to a beneficiary who is absolutely entitled to the asset.⁷⁹⁵ The legislation also carries this approach through in other ways, for example by allowing a beneficiary who becomes absolutely entitled to property to carry forward losses incurred by the trustees in respect of the property,⁷⁹⁶ and by granting the exemption for a principal residence to trustees in respect of property which is the principal residence of a beneficiary allowed to occupy the property under the terms of the trust.⁷⁹⁷

As discussed in 3.1.1., this economic basis has been extended by case law to pooling arrangements in two cases⁷⁹⁸ in which the court took a substantive approach to the issue, rather than approaching it as a matter of strict trust law. But the courts apply an economic approach only if they

795. Sec. 60 TCGA.

796. Sec. 71(2) TCGA. This provision does, however, cause difficulty in respect of discretionary trusts, as the legislation does not prescribe how losses are to be apportioned for this purpose.

797. Sec. 225 TCGA.

798. *Booth v. Ellard*; *Jenkins v. Brown*, both note 443.

see a clear entitlement of a specific person to specific property. In *Prest v. Bettinson*,⁷⁹⁹ for example, trustees held property on trust to pay a number of annuities and to divide the residue among five organizations, four of which were charitable. The trustees were held to be unable to claim the charitable exemption for four fifths of the gain they realized on a sale of property, because the residuary beneficiaries had no specific entitlement to any specific property and were therefore not in a position to direct the trustees in how to deal with the property.

In the corporation tax legislation, the reliance on economic entitlement is derived from the requirement of the legislation to follow generally accepted accounting principles in the computation of profit.⁸⁰⁰ In addition, the loan relationships regime⁸⁰¹ is designed to reflect economic reality even more closely than a taxing system based on actual payments. This legislation creates a system of notional payments, so that in respect of relationships falling within the ambit of this legislation it is even misleading to talk about economic entitlement to a particular payment. Actual payments determine the economic reality of a loan relationship, but they are not necessarily the items that go into the computation of profit.

5.2.3.2. *Income tax*

The most problematic issue in respect of economic entitlement in the United Kingdom is its importance in respect of income tax. The problem here is to ascertain what is meant by “entitlement” in the general attribution rule that attributes income on the basis of entitlement or receipt.⁸⁰² As discussed in 5.1.3.2., simple legal entitlement to income, on its own, appears not to be a sufficient basis on which to attribute income to a person, but it is not clear how much more is needed.⁸⁰³ On the other hand, it was held in *IRC v. Wemyss*⁸⁰⁴ that receiving an economic benefit from income was also not sufficient to make an individual taxable. In this case an individual transferred to trustees for his wife and children securities that were burdened with a debt for which the individual was personally liable. Some of the

799. *Prest (Inspector of Taxes) v. Bettinson* [1980] STC 6.

800. Sec. 46 CTA.

801. Part 5 CTA; see Appendix II, 3.2.3.2.

802. See Appendix II, 2.3.2.

803. Tiley also asks whether the term “entitlement” in the legislation means entitlement to receive income or entitlement to retain it, and answers that the prevailing view is that this provision imposes a tax charge on anyone in whose hands a payment has the quality of income; Tiley, J., “More on receivability and receipt”, *British Tax Review* 3 (1986), pp. 152-75.

804. *CIR v. Wemyss* 8 TC 551.

trust income was to be used to pay off those debts, but the individual was held not to be taxable on the trust income that was used for that purpose. Although the individual derived a financial advantage because his debts were paid off, the court found that the trust income belonged to the trustees and could not be attributed to the individual.⁸⁰⁵

That the courts have not explicitly explored the importance of economic entitlement to the attribution of income for the purposes of income tax has two explanations. One is that the legislation uses the term “entitlement”, without any qualification, as a ground for the attribution of income, and also uses it as one of two alternative grounds. The case law has accordingly considered questions such as whether there is any priority between receipt and entitlement,⁸⁰⁶ but the case law is rather unclear as to exactly what is meant by the term “entitlement”.

The second explanation is the quantity, and the scope, of anti-avoidance legislation that deals with the economic aspect of the income tax.⁸⁰⁷ This feature has effectively prevented any detailed consideration of the role of economic entitlement in the general principles that might otherwise have emerged, but it has generated plenty of discussion about the interpretation of the anti-avoidance legislation instead.

Even in 1935, in *Perry v. Astor*,⁸⁰⁸ the issue was already the interpretation of anti-avoidance legislation which attributed income to a person if he was able “to obtain for himself the beneficial enjoyment” of the income.⁸⁰⁹ The House of Lords held that it did not apply to attribute trust income to an individual settlor, even though the trust was fully revocable and the trust deed required the trustees to pay the income from the shares to the settlor, or apply it for his benefit, in such amounts and at such times as he may direct. As discussed in 3.1.2.2., the real problem in this case was that the legislation had not been drafted tightly enough and the House of Lords was worried that applying the legislation in this case would have undesirable effects in other cases. As a result, the judgments focus on the undesirable effects rather than on the concept of beneficial enjoyment. Subsequent anti-

805. Under the current legislation the income would have been attributable to the individual under the settlements code; see Appendix II, 3.5.1.2.

806. This question is discussed in Appendix II, 6.3.2.3.

807. See for example the legislative schemes described in Appendix II, 3.4.2.2. and 3.5.1.2.

808. Note 464.

809. Sec. 20(1) FA 1922.

avoidance legislation has generally been more carefully drafted in order to prevent these problems.⁸¹⁰

The various legislative schemes which currently apply and which adopt an attribution solution do not use a common concept of economic entitlement or enjoyment. Rather, each scheme uses different terminology, creating an array of specific connections with income that makes it difficult to extract one general approach.⁸¹¹ There is a common core of being able to obtain the benefit of income for oneself, but the various legislative schemes can reach out to some rather remote connections between income and a person and there is no common theme to the outer reaches of the various schemes. One of the most extreme examples of the application of anti-avoidance legislation concerned the legislation on artificial transactions in land,⁸¹² and a case⁸¹³ in which the House of Lords held that the legislation attributed a payment to an individual even though it was not at all clear from the facts before the court whether he or his family could actually derive any benefit from it.

5.2.3.3. *Whose benefit?*

It is clear that in the United Kingdom a person does not have to be able to benefit personally from income in order to be taxable on it. The obvious example of this phenomenon is the taxation of trust income and gains in the hands of trustees⁸¹⁴ and persons in other fiduciary positions, such as the personal representatives of a deceased individual. On the other hand, the basic attribution rule for income tax is less well equipped than that of the Netherlands to attribute income to a person who takes the benefit of the income by allowing it to flow to someone else. Where this is the case, therefore, the attribution of the income to the person who benefits in this way has to be achieved by legislation.

One example of the latter phenomenon is the attribution of benefits provided by an employer to family members of an employee. In *Barclays Bank v. Naylor*,⁸¹⁵ for example, money provided for the education of an employee's child was attributed to the child, seemingly simply because it was paid into a bank account set up for the child and therefore the child

810. But see the discussion in Appendix II, 6.3.2.2. for some of the exceptions.

811. See Appendix II, 3.4.2.2. and 3.5.1.2 for the major anti-avoidance schemes.

812. See Appendix II, 3.4.2.1.

813. *Yuill v. Wilson*, note 422.

814. See Appendix II, 3.2.1.2. and 3.2.1.3.

815. Note 670.

received it. The legislation now provides that benefits provided by the employer to members of the employee's family or household are taxable in the hands of the employee.⁸¹⁶

A similar development can be observed in respect of the major schemes of anti-avoidance law relating to individuals. As discussed above, the basic attribution factors of receipt and entitlement do not invite consideration of where the true economic entitlement to income lies and, if both receipt and legal entitlement are shifted to another person, these terms throw up a considerable barrier to the attribution of income from an asset to a person who originally owned the asset and who has transferred it in such a way as to benefit, for example, a family member.

Both the settlement code⁸¹⁷ and the "transfer of assets abroad" regime⁸¹⁸ deal with this issue. The settlement code, in very broad terms, treats an arrangement falling within its scope as a temporary diversion of the settlor's income, even though the diversion may well last for the settlor's lifetime. The regime for transfers of assets abroad, in very broad terms, regards an individual falling within the scheme as applying income which in some way still belongs to him. Their broad scope means that both regimes often attribute income to one individual even though a different person in fact takes the benefit of the income. On the other hand they have in common that, as a general rule, they apply only to attribute income to the individual who originally owned the asset concerned.⁸¹⁹ This limitation is built into the wording of the settlement code, and in respect of the legislation on transfers of assets abroad it was added judicially by the *Vestey* case.⁸²⁰ One can see a premise behind this limitation that it is justifiable to treat income as belonging to an individual only if he was the person originally entitled to it and can therefore be regarded as in some way spending his own money by setting up the arrangement.⁸²¹ This premise forms quite a contrast with the

816. Sec. 201 ITEPA; see Appendix II, 4.1.1.2. If the individual who receives the benefit is not a member of the employee's family or household, then the general attribution rule on the basis of entitlement or receipt would apply.

817. See Appendix II, 3.5.1.2.

818. See Appendix II, 3.4.2.2.

819. In respect of the settlement code there are, however, difficult issues connected with the identification of the settlor if two or more persons have transferred assets to the same settlement; see the discussion in Gordon, Montes-Manzano and Tiley, note 379, Sec. 15.08, pp. 873-4.

820. See Appendix II, 6.3.2.2. Subsequent legislation has, however, extended the scheme to impose tax on a person who receives a benefit as a result of a transfer made by someone else, if the benefit would not otherwise be chargeable to income tax (because, for example, it is a payment of capital); Sec. 732 ITA.

821. See also note 643 and the accompanying text.

case law of the Netherlands,⁸²² which has attributed the income of a foundation to one individual even though the foundation's assets were provided by a different individual.

5.3. Receipt

5.3.1. Introduction

The receipt of income can play an important role in respect of the attribution of income, despite one's initial reaction that receipt is nothing more than a formality. Its importance in the United Kingdom is obvious in respect of income tax, as receipt is one of the two grounds for attribution named in the legislation. In respect of the Netherlands, receipt may at first sight seem irrelevant to a general attribution rule based on the enjoyment of income. But this initial view is misleading, as the general rule is not as subjective as the term "enjoyment" may suggest. As discussed in 2.2., the term "*genieten*" is used in a more objective sense that is maybe better translated as receipt than as enjoyment.

In both countries, however, there is an issue as to the quality of the receipt that is required before a person can be taxed in respect of the payment received. If income is paid into a bank account, for example, the bank could be said to have received the income, but one would not expect receipt of this kind to be enough to make the bank taxable over the income. What more is required? There are also issues as to whether one person can be regarded as receiving income that is formally paid to a different person. This section therefore first explores what is meant by the concept of receipt, and then goes on to explore the importance of receipt as a factor in the attribution of income.

5.3.2. What is receipt?

5.3.2.1. *What is a payment?*

In order for income to be received, there first has to be a payment of the income, so the first question is what constitutes a payment. For example, does the receipt of a cheque constitute the receipt of a payment, or is the payment not received until the cheque has been cleared? Does the crediting

822. See Appendix II, 3.4.1.3.

of interest to a bank account of the bank constitute a receipt of the interest by a taxpayer if the interest benefits the taxpayer?⁸²³ These questions concern the manner in which money is made available to a person and are not pursued further here. This section is, rather, concerned with the quality of the connection between the payment and the person to whom it is made available.

Nevertheless, the use of the word “receipt” in the income tax legislation of the United Kingdom has led to some case law on the quality of a payment that is necessary in order to create a tax liability. In *Dewar v. IRC*⁸²⁴ it was held that an individual who is entitled to claim interest on his legacy under a will, but does not do so, is not taxable in respect of the interest that he does not claim. Similarly in *Way v. Underdown*,⁸²⁵ an insurance agent was held not to have received any payment when, instead of collecting the full insurance premium from clients and then giving them back his commission, he simply collected a smaller amount from the clients to start with. And in *Hillsdown Holdings*⁸²⁶ a payment out of a trust that was found to have been made in breach of trust was held not to be a payment for tax purposes at all; because the payment was made in breach of trust it had to be repaid and had therefore not transferred any real value to the payee.

5.3.2.2. *Indirect receipt*

One obvious case in which the concept of receipt should be extended beyond its literal meaning is to include the indirect receipt of a payment through an agent, and in straightforward cases both the Netherlands and the United Kingdom do regard receipt by an agent as receipt by the principal, even if the agent has not handed the payment over to the principal.⁸²⁷ But how far does this principle extend outside straightforward cases? In the UK case *Paget v. IRC*⁸²⁸ it was held that there was no indirect receipt in the absence of an agency or comparable relationship. An individual held

823. These questions are discussed in some detail in respect of the United Kingdom in Tiley, J., “Receivability and receipt: the problem of timing under income tax legislation”, *British Tax Review* 1 (1982), pp. 23-35; and Tiley, note 803. In respect of the Netherlands, see van Dijck and van Vijfeijken, note 376, Sec. 4.4, pp. 73-4.

824. Note 422.

825. Note 774.

826. *Hillsdown Holdings plc and another v. IRC* [1999] STC 561.

827. As regards the Netherlands, see HR 14 October 1931, B 5056; HR 28 February 1934, B 5584; and van Dijck and van Vijfeijken, note 376, Sec. 4.2.3.1, p. 60. As regards the United Kingdom, see *IRC v. Lebus' Executors* (1946) 27 TC 136 at 147; and Gordon, Montes-Manzano and Tiley, note 379, Sec. 5.15, p. 276.

828. Note 407.

Hungarian bonds which carried the right to interest payable in sterling in London, but the Hungarian legislation changed the terms of the bonds, so that the interest was payable through the Hungarian National Bank in London. It was held in the High Court (and this point was not even argued in the Court of Appeal) that the individual did not receive the interest, even though it was held on deposit for her benefit, because the bank was in no sense acting as her agent.

By contrast, an indirect receipt has been found in a lower court case in the Netherlands in 1992⁸²⁹ in the absence of any representative arrangement. In this case, the court attributed bank account interest to one individual, even though the account was held in the name of a different individual and there was no legal structure in place to create any sort of representative agreement, but only factual evidence that both individuals regarded the account holder as a nominal owner. This decision has, however, been criticized by van Dijck and van Vijfeijken who, like the UK court, argue that there can be an indirect receipt of income only if income is explicitly received in a representative capacity.⁸³⁰

Van Dijck and van Vijfeijken also go one step further, and argue that the relationship between the direct recipient of the income and the person for whom it is received should be a public one so that, for example, income received in a bank account held in the name of one person can be attributed to a different person only if the bank knows about the arrangement. The basis of their argument is that income is attributable to the person who is entitled to it in commercial terms,⁸³¹ rather than as part of a moral or social arrangement. As argued in 5.2.2.2., the current author agrees that there should be some legal basis on which to support the attribution of the income but, if the legal basis is there, the extra requirement of publicity seems an unnecessary limitation.

An extra element of receipt that was added by a lower court in another case,⁸³² that the agent has to have enough money to pay the principal, is also disputed by van Dijck and van Vijfeijken.⁸³³ This criticism is quite justified; if the payment received already belongs to the principal, the financial situation of the agent should be quite irrelevant.

829. Hof 's-Gravenhage 28 February 1992, note 789.

830. Van Dijck and van Vijfeijken, note 376, Sec. 4.2.4, pp. 65-6; see also Sec. 4.2.3.3 at p. 61.

831. Author's translation. In Dutch the term is "*in het economische verkeer*".

832. Hof 's-Gravenhage, 30 June 1989, No. 748/89, *V-N* 1989, p. 3621.

833. Van Dijck and van Vijfeijken, note 376, Sec. 4.2.3.1, p. 60.

5.3.2.3. *Constructive receipt*

A different situation in which one person is usually regarded as receiving income paid to another person is constructive receipt. This is the situation in which income is paid, for example, to a third party on the instructions of the person who is entitled to the income in order to satisfy a debt owed by that person to the third party. In this case neither the Netherlands nor the United Kingdom has any difficulty in “uncollapsing” the structure to find receipt of the payment by the person entitled to the income, followed by a payment from that person to the third party.⁸³⁴

Of course there is a question as to when a payment directly to a third party can be “uncollapsed” in this way. In the Netherlands, it has been held that this can be done only if there is a conscious act on the part of the person who is entitled to the income that constitutes the application of the income by that person. The *Stichting Atletenfondsarrest*,⁸³⁵ for example, concerned an athlete who, in order to preserve his amateur status, had to allow the prize money he won to be paid to a foundation which invested it for him until he ended his athletics career. The Hoge Raad decided that he was not taxable until he received the prize money from the foundation. The Hoge Raad’s reasoning was that the athlete had not made any decision of his own to invest the prize money; he had not come to any agreement with the organizers of the athletics events, nor had he come to any agreement with the athletics association of which he was a member and which selected him to participate. The whole payment structure had been devised by the organizations that governed the sport, and all the athlete did was to slot into that structure. A constructive receipt of income, in other words, could be found only if the athlete had made a choice in respect of that particular item of income; the other options open to the athlete, such as accepting professional status so that he could take the prize money immediately, were extraneous to these specific items of income and therefore not relevant.

Compare this with the UK case *Smyth v. Stretton*,⁸³⁶ in which an employee was granted an increase in salary but the increase was compulsorily paid into a provident fund which would pay a lump sum to the employee when he retired or resigned. The court held that the employee was taxable in

834. In respect of the Netherlands, see van Dijck and van Vijfeijken, note 376, Sec. 4.2.3.6, pp. 62-3. In respect of the United Kingdom, see *Salter v. Minister of National Revenue* (1947) 2 DTC 918; and *Dewar v. IRC*, note 422.

835. HR 15 November 1995, No. 29 138, BNB 1996/38 (with conclusion by A-G van den Berge and comment by van Dijck).

836. Note 422.

respect of the salary increase in the year in which it was paid into the provident fund, the judge saying that the increase “is not the less added to the salary because there has been a binding obligation created between the [employees and the employer] that they should apply it in a particular way.” It is possible to see a closer connection between the payment and the individual in this case than in the Netherlands case, as in this case the compulsory application of the payment was part of the terms under which the specific payment was made, rather than part of a whole remuneration structure relating to the exercise of a sport in which the payment was earned. Nevertheless, it is notable that the UK judge did not spend any time considering the issues that formed the basis of the Hoge Raad decision. He saw instead primarily a timing issue, namely whether the payment was intended to be current salary or whether it was intended to provide a bonus when the individual left employment.

5.3.3. Receipt as an attribution factor

The concepts of indirect receipt and constructive receipt illustrate that a person can be regarded as having received income without actually taking possession of the income. But the more interesting, and more fundamental, question in respect of the attribution issue is how substantive a receipt of income has to be in order to affect the attribution of the income. As stated above, a payment made into a bank account can be said to have been received by the bank, yet one would not expect the bank to be taxable in respect of payments made into client accounts. What, in other words, is the quality of receipt that is required as the basis of a tax liability?

5.3.3.1. *The Netherlands*

This question is easier to answer in respect of the Netherlands than in respect of the United Kingdom. In the Netherlands the receipt of income is not a ground for attribution of itself, but rather a timing issue. As explained in 2.2., the legislation does not define the term “enjoyment”, but it does include a timing rule⁸³⁷ which specifies the moments at which a person is taxable in respect of an item of income. The first event listed is the receipt of income. But before the timing of the tax charge can be considered, the income first has to be attributed to the correct person and that attribution is made on the basis of enjoyment.

837. Art. 3.146 Wet IB 2001, note 56.

In other words, the receipt of income is not, of itself, a basis on which to found a tax liability, even though the receipt of income has sometimes been named in the case law as a factor in the attribution of income. In BNB 2007/15,⁸³⁸ for example, one of the factors named by the Hoge Raad in attributing the interest to the husband was that he was the one who received it. In this case, however, the husband's receipt of the interest was one of the facts that gave him control over the application of the interest. It was, therefore, simply an additional indication of his enjoyment of the interest.

In respect of the dividend tax, receipt has a more prominent role, as the primary basis of attribution is the receipt of the dividend that follows from having the legal entitlement to it.⁸³⁹ In respect of the credit for the dividend tax, however, the beneficial ownership condition⁸⁴⁰ now adds a substantial economic element that looks well beyond the receipt of the dividend.

5.3.3.2. *The United Kingdom*

In the United Kingdom the required quality of a receipt is a more difficult issue, certainly in respect of the income tax legislation, which names the receipt of income as a self-standing basis of attribution.⁸⁴¹ In fact two questions arise in this respect; the first is the quality of the receipt that is required as a basis for the attribution of income; and the second is the importance of a finding that a person has a receipt of income with the required quality, given that receipt is only one of the two alternative bases named in the legislation. This section focuses on the first question, and 6.3.2. focuses on the second.

As regards the quality of receipt that is required as basis for attribution, it seems hardly conceivable that a purely formal receipt could be a sufficient basis on which to found a tax liability. That conclusion was indeed drawn in two lower court cases, in both of which a husband attempted to change the attribution of his pension through the simple expedient of arranging for his wife to receive it. As the United Kingdom has no marital community-of-property regime, the wife would not have been entitled to the pension in any way. In *Meredith-Hardy v. McLellan*⁸⁴² the husband simply gave instructions for his pension to be paid into his wife's bank account; the

838. Note 402.

839. Brandsma, Note 571, Sec. 1.1.1.A (October 2008).

840. “*Uiteindelijk gerechtigde*” in Dutch; see Appendix II, 3.3.2.

841. See Appendix II, 2.3.2.

842. *Meredith-Hardy v. McLellan (Inspector of Taxes)* [1995] STC (SCD) 270.

Special Commissioner needed only an extremely short decision to dismiss his claim that he was not the taxable person.

This case was decided in 1995, under the pre-rewrite legislation which did not include an attribution rule for pensions, but *Rockcliff v. HMRC*⁸⁴³ arose after the rewrite. In this case the husband's pension was paid into a joint account of himself and his wife, and he claimed to be taxable on only half of it. By now the legislation provided that pensions were taxable in the hands of the person receiving or entitled to the pension. The husband argued that this change in the legislation had to have some significance, but this argument was dismissed by the judge, who found him taxable on the entire amount as the only person entitled to the pension. No doubt these decisions were influenced by the circumstance that in each case the wife was in a lower tax bracket than the husband, but they make it clear that simply changing the receipt of income is not enough to change its attribution.

On the other hand, it is also clear that the receipt of income need not be for the personal benefit of the recipient, otherwise it would not be possible to tax trustees in respect of trust income. What, then, is the quality of receipt that is required as the basis of a tax liability? This issue has not been discussed explicitly in the case law, although it has been addressed indirectly.

Income is sometimes attributed to a person on the basis of receipt if it is necessary to do so simply in order to find a taxable person. This was one of the main considerations of the court in *Reid's Trustees v. IRC*,⁸⁴⁴ in which trustees were held to be subject to income tax on a payment that immediately became part of the trust capital, even though the payment would not have been income in the hands of the beneficiaries if they received it directly. In *Aplin v. White*⁸⁴⁵ an estate agent collected rent on behalf of clients, which he deposited in a bank account held in his firm's name. The account paid interest, but the estate agent did not apportion the interest among the clients as it would have been too complicated to do so. The court held that he was taxable on the interest as the person who received it, even though he was not beneficially entitled to it.⁸⁴⁶ The judge did not explicitly note the risk of not being able to find any taxable person at all, but this point must have been at the back of his mind.

843. Decision TC00124: *Trevor Rockcliff*, Case SC/3094/2008, [2009] UKFTT 162(TC); see also Appendix II, 6.3.2.3.

844. Note 495.

845. *Aplin v. White (Inspector of Taxes)* [1973] STC 322.

846. But see further Appendix II, 6.3.2.4. as to the importance of this case in respect of higher rates of tax.

The reverse issue, whether a lack of receipt prevents the attribution of income, was considered in *Williams v. Singer*.⁸⁴⁷ In this case trustees were held not to be taxable on trust income that was paid directly from the source to the beneficiary entitled to the income. The reason given for this decision was that the trustees did not have receipt and control of the income. The important point, in other words, was not their simple lack of receipt, but that the lack of receipt meant they had no control over the income.

Tiley, writing in 1982,⁸⁴⁸ also considers this issue, and concludes that “[w]hat amounts to receipt must depend on the degree of economic benefit to or control by the taxpayer which the law will require.” Writing on this issue again in 2008 he concludes,⁸⁴⁹ rather tentatively, that “personal entitlement [to the income] matters when one is being taxed as an individual but not when as a trustee.”

It is submitted that the correct criterion is that receipt has the necessary quality to trigger a tax liability at the point at which it gives a person enough control over the income that he may use it to pay the tax liability. The famous dictum of Viscount Cave in *Williams v. Singer*⁸⁵⁰ expressed it in this way: “The object of the Acts is to secure for the State a proportion of the profits chargeable, and this end is obtained (speaking generally) by the simple expedient of taxing the profits where they are found.” This conclusion also follows from the objective nature of the UK system, in which historically income was attributed to a person primarily in order to be able to collect the tax on it. As Tiley and Collison put it, “... this approach of taxing the person in receipt is fully consistent with the original notion of income tax as a flat rate tax largely deducted at source.”⁸⁵¹ So the receipt of income for the purpose of safekeeping, such as the receipt by a bank of money deposited in client accounts, is not sufficient. But the receipt of income by a person who has no economic entitlement, but who does take the benefit of the income, such as the estate agent in *Aplin v. White*, is sufficient.

On the other hand, the receipt of income is only one of the two alternative grounds for attribution,⁸⁵² and it is clear that receipt is not a necessary ingredient for a tax liability. This is so, not only under the general attribution

847. Note 490.

848. Tiley, note 823, at p. 30.

849. Tiley assisted by Loutzenhiser, note 358, Sec. 7.3.3 at p. 150.

850. Note 490, at p. 411.

851. Gordon, Montes-Manzano and Tiley, note 379, Sec. 13.08, p. 833.

852. In Appendix II, 6.3.2.3. and 6.3.2.4. the relationship between receipt and entitlement is discussed.

rule, but also under many anti-avoidance measures. Under the “transfer of assets abroad” regime,⁸⁵³ for example, it has been explicitly held that it is not necessary for an individual to receive the income in order to be taxed on it.⁸⁵⁴ Similarly, the legislation on the attribution of capital gains realized by a non-resident company⁸⁵⁵ “carries the very real risk that a taxpayer will be liable to CGT without being able to secure the payment or get his hands on any of the gain.”⁸⁵⁶

5.4. Control

5.4.1. Introduction

Control is often cited as a factor in the attribution of income, both as a positive factor leading to the attribution of income to a person who has control and as a negative factor preventing the attribution of income to a person who has no control. The concept is also used frequently in the Netherlands and the United Kingdom, even though it is not immediately obvious that control of any variety should have a role to play in the application of rules based on enjoyment, receipt or entitlement.

In the Netherlands the essence of the concept of enjoyment is sometimes described as having control over the income.⁸⁵⁷ The case law has also repeatedly looked at “control” or “factual control” over income in deciding which person enjoys the income. Similarly, in the United Kingdom, control has often been cited as an attribution factor in the case law, although it is not mentioned anywhere in the legislation. Control has also been named as a factor in consultative documents published by HMRC; the consultative document on income shifting between individuals, for example, included draft legislation which looked at control over the amount of income and the arrangements by which the income shifting was achieved.⁸⁵⁸ And the

853. See Appendix II, 3.4.2.2.

854. Carswell L.J. in the Court of Appeal in *IRC v. McGuckian* [1994] STC 888, CA (NI) at 916. This point was conceded by taxpayer’s counsel in the subsequent hearing in the House of Lords, note 655.

855. See Appendix II, 3.4.2.1.

856. Gordon, Montes-Manzano and Tiley, note 379, Sec. 35.53, p. 1532.

857. In Dutch: “*beschikkingsmacht*”. This term is used in connection with the timing rule of the income tax law in Sillevs and van Kempen, note 374, Sec. 3.12.1.A (November 2008), and in van Dijk and van Vijfeijken, note 376, for example Sec. 2.2 at p. 21, Sec. 4.2.3.4 at p. 62, Sec. 4.2.5 at p. 67 and Sec. 6.5.4 at p. 105.

858. See Appendix II, 3.5.1.2. and note 648.

consultative document on managed service companies,⁸⁵⁹ or “incorporated employees”, emphasized the lack of control by the individual over the management company.

Although not the focus of this study, it is also interesting to note that control is sometimes cited as a factor in connection with entitlement to treaty benefits. Vogel, for example, considers the beneficial owner of passive income to be the person who has the power to decide whether assets should be used by, or made available to, others and/or the power to decide how the yield from the asset should be used.⁸⁶⁰ Danon also focuses on control, but he defines the beneficial owner as the person who has power to control the attribution of the income.⁸⁶¹ And the 2010 Commentary to the OECD Model Convention⁸⁶² relies on discretionary power to manage assets as the indicator of the beneficial ownership of income of collective investment vehicles.

Even from this short introduction it is clear that control is not a closely defined concept with a single purport. This section therefore considers various types of control that could have an impact on the attribution of income, as follows:

- control over the creation of income;
- control over the selection of beneficiaries;
- control over assets; and
- control over the application of income.

5.4.2. Control over the creation of income

One type of control seems to be capable of being dismissed immediately as a factor in the attribution of income, namely the decision of whether to create income in the first place. One would not expect the attribution of a dividend, for example, to be affected by the power of a company to decide whether or not to distribute the dividend. On the other hand, the same instinctive reaction does not arise in respect of the decision to realize a gain by selling an asset; it seems obvious that the gain should be attributed to the asset owner who makes the decision to sell. The contradiction here is, however, more apparent than real. A decision to sell an asset is not necessarily made by the owner of the asset; an owner may be forced to sell,

859. See Appendix II, 4.1.3.2. and note 687.

860. Vogel et al., note 29, Preface to Arts. 10-12, Sec. II 1 b), at p. 561.

861. Danon, note 155, Sec. 3.IV.B.2.f, p. 340.

862. OECD Commentary on Art. 1, Para. 6.14.

for example, as a result of a compulsory acquisition order. In this case, one would still attribute the gain to the owner of the asset, even though the decision to realize the gain was not his.⁸⁶³

This example highlights the problem of looking at the decision to create the income, that in many cases that decision-making power is intertwined with other factors. Investment income other than dividends, for example, generally arises automatically once the investment has been made. The amount of income, and the timing of the payments, may depend on other factors, but the decision to bring the income stream into existence is made by the investor through the act of making the investment and owning the investment assets. In respect of active income, the decision to bring the income into existence is embedded in the activity; an employee creates salary by taking employment and carrying out his employment duties, and business profit is created by the person who carries on the business activity.

It is difficult, in other words, to find situations in which control over the creation of income is isolated from other connections with the income. One clear example, however, is found in the two cases decided in the Netherlands on the attribution of Belgian social security payments⁸⁶⁴ which could be claimed only by the employee/husband, but which were payable only to the wife. The decision to create the flow of income was, in other words, completely separated from any entitlement to the income. The courts found that the payments were attributable to the wife; the power of the husband to decide whether there would be income at all was found to be irrelevant.

In respect of dividends, there is a complicating factor in that the decision to distribute a dividend is made by the shareholders, who are also the persons entitled to the dividend. In a widely held company this connection is usually more theoretical than real, but in the case of a closely held company the merging of interests can be very real. It is for that reason that control over the source of a dividend is sometimes taken into account as an attribution factor, because the shareholder is able to manipulate the entitlement to the dividend as it comes into existence. This feature is particularly evident if the dividend is distributed in a disguised form, such as the provision of a benefit to a family member of an individual shareholder. Like most modern

863. Although some relief from taxation might be available due to the compulsory nature of the disposal.

864. See Appendix II, 4.1.1.1.

tax systems, both the Netherlands and the United Kingdom have law to deal with this situation and attribute a disguised dividend to the shareholder.⁸⁶⁵

Outside these situations, however, control over the decision to distribute a dividend is not relevant as an attribution factor. A bare owner of shares in the Netherlands, for example, usually exercises the voting rights in respect of the shares and is therefore able to influence the decision to distribute of a dividend, but that does not prevent the attribution of the dividend to the usufructer.⁸⁶⁶

5.4.3. Control over the selection of beneficiaries

Another type of control that can be dismissed immediately is the power to select the beneficiary of income. This type of control is particularly relevant to discretionary trusts, although it is also exercised by anyone who gives away income. One way in which such a power could be exercised is by adding beneficiaries to, or removing them from, a class of discretionary trust beneficiaries. The exercise of this power has no effect on either the structure of the trust or on any actual distributions from the trust, and for that reason alone is generally inadequate as a factor to determine the attribution of either the trust income or the distributions actually made.

A different type of control over the selection of beneficiaries is the granting of a specific equitable interest, such as a life interest, to a specific beneficiary. This exercise of a power does change the structure of the trust, as it gives the beneficiary an entitlement to distributions and to that extent abrogates the discretion of the trustees. In essence, this type of control is a subset of the power to create income discussed under the previous heading; it should therefore not affect the attribution of the distributions, except to the extent that the beneficiary's entitlement to the distributions is determined by the granting of the equitable interest.

In other words, the identity of the person holding or exercising either type of power should not, of itself, affect the attribution of either the trust income or the distributions. And indeed, in the United Kingdom, the power to appoint beneficiaries is not generally a factor that causes attribution of

865. In respect of the Netherlands see, for example, Hoge Raad, 9 January 1935, No. 5784. In respect of the United Kingdom, see Secs. 1064-1069, Part 23, Chap. 4 Corporation Tax Act 2010. The application of the settlement code to a gift of dividends also depends on whether the gift includes the right to control the source of the dividend; see Appendix II, 3.5.1.2.

866. Janssen and Rozendal, note 535.

trust income to the settlor under the settlement code;⁸⁶⁷ he can even do this in the capacity of trustee without triggering the application of the code.⁸⁶⁸ It has also been held that the power to appoint beneficiaries does not generally trigger the application of the “transfer of assets abroad” regime.⁸⁶⁹ The important exception in both cases is a power of the transferor or settlor to appoint himself, or certain connected persons, as a beneficiary. But of course the power to appoint oneself adds another element, namely the power to take the benefit of the trust income.

The final type of control over the selection of beneficiaries is the control exercised by the trustees of a discretionary trust in making distributions to beneficiaries within the existing class of beneficiaries. In this case the power to select beneficiaries is relevant, but only to the attribution of the trust income. In other words, this power indicates that the trustees are exercising control over the application of trust income and it is this aspect, rather than the choice of beneficiaries, that is important, as discussed in 5.4.5.2.

5.4.4. Control over assets

The power to control the way in which an asset is used, and whether to sell it, is usually exercised by the owner of the asset. As discussed in 3.1., the ownership of an asset generally gives a first indication as to the attribution of income derived from the asset, and control over the asset sometimes features as an element of this general principle. So in the Netherlands, for example, in BNB 2007/15⁸⁷⁰ the Hoge Raad held that, as a general rule, the enjoyment of income denoted the factual control over income and this factual control was usually derived from a person’s control over the assets. In other words, the control over the assets was important, not as an attribution factor in its own right, but as a *prima facie* indicator of who had control over the income derived from the assets.

The case law discussed in 3.4.1.3., which attributes the income of a foundation to a person who is able to control the assets and income of the foundation, takes in essence the same approach. In these cases the Hoge Raad has assimilated the ability to exercise this type of control with full ownership

867. Although it may have consequences for inheritance tax purposes.

868. Gordon, Montes-Manzano and Tiley, note 379, Sec. 15.01, p. 868.

869. *Vestey’s Executors v. IRC* [1949] 1 All ER 1108, 31 TC 1; *IRC v. Schroder*, note 615.

870. Note 402.

of the assets, and then attributed the income from the assets to the person exercising control on the basis of that “ownership”. It was an essential part of the decision in BNB 1986/16,⁸⁷¹ however, that the individual exercising this control was able to direct the payment of any amounts out of the foundation’s assets or income to himself or to his children. In other words, the control over the assets was not, of itself, the determining factor; if the individual had not been able to exercise this power for his own benefit the conclusion would probably have been different.

In the United Kingdom, control over assets plays a central role in the accounting standards that largely govern the computation of profit for corporation tax purposes. The financial reporting principles developed by the Accounting Standards Board (ASB) describe assets as “rights or other access to future economic benefits controlled by an entity as a result of past transactions or events”⁸⁷² and an entity as having control if it “has the ability both to obtain for itself any economic benefits that will arise and to prevent or limit the access of others to those benefits.”⁸⁷³ Although the control may be exercised through a legal structure such as ownership, it is not necessary that the control be legally enforceable.⁸⁷⁴ Factual control of an asset, therefore, usually causes attribution of the income from the asset to the company. But again, the control over the assets is not a factor as such, but rather a factor indicating ownership of the assets for tax purposes and, as a consequence, attribution of the income from the assets to the person with control.

In respect of income tax, it was held specifically in *Drummond v. Collins*⁸⁷⁵ that control over the assets that produce income is not a necessary ingredient of a tax liability. The case concerned payments of income from a discretionary trust to a mother for her minor children and the issue was whether the income was taxable in the hands of the mother as guardian of the children. One of the arguments used in an attempt to refute her tax liability was that she had no control over the trust assets. Although this

871. Note 592.

872. Accounting Standards Board, *Statement of Principles for Financial Reporting*, October 1999, available at <http://www.frc.org.uk/documents/pagemanager/asb/Statement%20-%20Statement%20of%20Principles%20for%20Financial%20Reporting.pdf>, Para. 4.6. The concept of assets for this purpose is, therefore, an accounting concept rather than a legal one.

873. *Ibid.*, Para. 4.17.

874. *Ibid.*, Para. 4.18; “... weight can be given to economic and social sanctions when these are effective in inducing entities to fulfil promises or to comply with widely accepted business practices or customs.”

875. Note 406.

argument was based on the specific wording of the relevant legislation, the House of Lords found the mother's lack of control over the trust assets quite irrelevant to the question of tax liability over the income.

The subordinate role of control over assets as a factor in its own right is clearly seen if this type of control is completely isolated from the ownership of the assets, for example if the assets are used as security for the debts of the asset owner. In both countries the income from the asset remains attributable to the owner, even though the person taking the security may be able to sell the asset against the will of the owner.⁸⁷⁶ In other words, just as the exercise of control over assets does not, of itself, determine the attribution of the income from the assets, so a lack of control over the assets does not prevent the attribution of income from the assets to their owner.

One area in which one might expect control over assets to play a role is in the anti-avoidance legislation, but neither of the two major anti-avoidance schemes in the UK income tax legislation, the settlement code and the "transfer of assets abroad" regime,⁸⁷⁷ is triggered by the power to control assets or investments. The regime on transfers of assets abroad does not look at the power to control assets at all. The settlement code does attribute income to the settlor if the assets may at some point revert to the settlor, but it does not matter whether that happens due to the actions of the settlor or the actions of another person.⁸⁷⁸

It is only in respect of the taxation of capital gains in the United Kingdom that control over assets appears as an attribution factor in its own right. As explained in 3.1.1., capital gains realized by the trustees of a bare trust are attributed to the beneficiary. The legislation specifically provides⁸⁷⁹ that a trust is regarded as a bare trust for any person who has the exclusive right, subject only to satisfying any outstanding charge, lien or other right, to direct how a trust asset is to be dealt with. This rule is rather strange when considered in the light of trust law, as even a beneficiary with absolute entitlement to the trust assets has no power to direct the trustee how to deal with those assets.⁸⁸⁰ Like the Netherlands foundation cases, it seems to be

876. Although in the Netherlands there has been some discussion as to whether granting a "*pandrecht*" over shares means that the holder of the "*pandrecht*" is also regarded as a shareholder for the purposes of the participation exemption; Strik and de Vries, note 751, Sec. 2.4.1.C.b6 (April 2009).

877. See Appendix II, 3.5.1.2. and 3.4.2.2., respectively.

878. Gordon, Montes-Manzano and Tiley, note 379, Sec. 15.11, p. 876.

879. Sec. 60 TCGA.

880. Although the beneficiary of a bare trust has the right to end the trust and require the trustee to transfer the trust assets to him. In respect of a trust that is not a bare trust,

based on the notion that this type of control is equivalent to full ownership of the assets but, unlike the foundation cases, it does not require that the control can be exercised for the benefit of the person who exercises it, at least not explicitly.

In conclusion, the ability to control assets may be an indication of the ownership of assets that gives the primary indication as to the attribution of the income they produce, but neither the Netherlands nor the United Kingdom regards this type of control as a factor in its own right in the attribution of income, except for the one strange exception just noted in the United Kingdom. In the Netherlands the control over assets has, however, acquired a new importance with the introduction of the Box 3 system in the Netherlands in 2001⁸⁸¹ but, as argued in 1.2., the Box 3 tax is a wealth tax rather than an income tax.

5.4.5. Control over the application of income

If there is any variety of control that should have an effect on the attribution of income, it is control over the application of the income that is the most likely candidate. The most obvious way of being able to benefit from income is being able to spend it, although various qualifications have to be added to that statement. The following two subsections consider the basic concept of being able to apply or spend income, and the two subsequent subsections consider the qualifications.

5.4.5.1. *Whether there is taxable income*

Control over the application of income can affect the attribution of the income in two respects. One issue is whether there is taxable income at all, and the other is the person to whom income should be attributed. Although neither the Netherlands nor the United Kingdom has an extreme form of the subjective and objective systems discussed in 2.1., their different approaches to these issues neatly illustrate the fundamental difference between the two countries.

the rule in *Saunders v. Vautier* allows the beneficiaries collectively to end the trust provided they are all *sui juris* and are unanimous in this respect.

881. See for example Rechtbank Haarlem 19 January 2009, Nos. AWB 08/02773 and 08/02774, *FED* 2009/37; and Rechtbank 's-Gravenhage 16 December 2009, No. AWB 09/2177, *V-N* 2010/40.

The question as to whether there is taxable income at all arises when a person has some entitlement to a payment but is unable to get his hands on the money. This could happen, for example, because the income has its source in another country and the payment is blocked by foreign exchange controls in that country. The general principle in the Netherlands in this respect is that a person is not taxable on income until he has control⁸⁸² of it, in the sense that he is able to get his hands on the money. In a case in 2008,⁸⁸³ for example, the Hoge Raad held that income was taxable when the taxpayer's right to it became unconditional. In the same vein, a lower court has held⁸⁸⁴ that alimony plus accumulated interest that was paid to a notary by one spouse, to be paid to the other spouse when their divorce was registered, was not taxable until the moment at which it was paid to the other spouse.

This general principle is, however, modified by the timing rule,⁸⁸⁵ which lists the events that bring income close enough to a person for that person to become taxable in respect of it. One of those events is indeed that the income is made available,⁸⁸⁶ but the other four events give the person considerably less control over the income; the most remote connection is that the income starts to bear interest. So, for example, income was found to be taxable when it was paid into a blocked bank account simply because the account bore interest.⁸⁸⁷ In BNB 1958/344, on the other hand, income was held not to be taxable because it was blocked in a foreign bank account which did not bear interest, the income could not be moved to the Netherlands and the person entitled to it was not able to spend it in the foreign country.

The UK income tax system, by contrast, pays very little attention to control over the application of income in respect of this issue. The system does not attribute income to a person until the existence of the income has already been ascertained and, once that is the case, the income is taxable in the hands of a person who receives it or who is entitled to it. A blockage that prevents a person obtaining control over the income does not take away that person's entitlement to it. There is, however, statutory relief⁸⁸⁸ for foreign-source income if it is blocked in a foreign country because of local laws or government action, and the income cannot be converted into a currency

882. The Dutch word usually used in this context is "*beschikkingsmacht*".

883. HR 28 April 2008, No. 07/11951, *V-N* 2008/29.14 (with conclusion by A-G van Ballegooien).

884. Hof Amsterdam 20 February 1991, No. 19/90, *FED* 1991/661.

885. Art. 3.146 Wet IB 2001, note 56; see Appendix II, 2.2.

886. In Dutch, the moment at which income is "*ter beschikking gesteld*".

887. Hof Arnhem 20 July 2001, No. 99/01908, *NFTR* 2001/1135.

888. Secs. 841-844 ITTOIA.

which can be remitted to the United Kingdom. Curiously, this relief seems to apply even if the person is able to spend the money in the country where it is blocked,⁸⁸⁹ maybe in reflection of the requirement to pay UK tax in UK currency.

5.4.5.2. *Control over application as an attribution factor*

In the context of this study, however, the more interesting question is the role of control over income in selecting the correct taxpayer in respect of the income, and in both the Netherlands and the United Kingdom control over the application of income has been cited as a factor. An example in the Netherlands is BNB 2007/15,⁸⁹⁰ in which the Hoge Raad attributed interest to the spouse who had factual control over the income rather than to the spouse who was legally entitled to it.⁸⁹¹ Similarly, in the two Market Maker's cases⁸⁹² the Hoge Raad reasoned that a dividend was attributable to a company because the company was able to apply the dividend as it liked. The control can also be exercised rather more remotely. BNB 1999/173⁸⁹³ concerned a professional footballer who was not a shareholder or director of the company that managed his image rights, but who was found to exercise such a degree of factual control over the company that the company acted entirely for the account of, and at the risk of, the footballer. A transfer fee that was paid to the company was therefore attributable to the footballer.⁸⁹⁴

In the United Kingdom control over the application of income has also sometimes determined the attribution of the income. In *Spens v. CIR*,⁸⁹⁵ for example, income received by the trustee of a life interest trust was attributed to the life tenant as soon as it was received by the trustee because it was immediately under the control of the life tenant. And in *Drummond v. Collins*,⁸⁹⁶ it was the mother's control over the application of the income that was the decisive factor. As Lord Loreburn put it, "[t]he lady had control of the sums which are sought to be charged with the tax."

889. Gordon, Montes-Manzano and Tiley, note 379, Sec. 35.24, p. 1210.

890. Note 402. See also the other cases discussed in Appendix II, 3.1.2.1.

891. Although in respect of a capital gain on shares the attribution was made on the basis of legal entitlement due to a specific provision in the law.

892. BNB 1994/217, note 653, and BNB 2001/196, note 559.

893. HR 10 February 1999, No. 33 948, BNB 1999/173 (with comment by Kavelaars).

894. This type of control was also important in a similar case concerning another professional footballer: HR 24 July 2001, No. 36 208, BNB 2001/357 (with comment by Essers).

895. *Spens v. CIR* 46 TC 276.

896. Note 406.

In all these cases, however, the person exercising control over the application of the income also took the benefit of the income, either directly or indirectly. Control over income that is isolated from the benefit of the income and, in respect of passive income, is also isolated from the ownership of the asset that produces the income, does not lead to taxation of the person exercising control.

This situation occurs in the Netherlands, for example, if a person is subject to a “*bewind*”,⁸⁹⁷ and it is clear that the “*bewindvoerder*”, the person who exercises control over the assets and income, is not taxable in a personal capacity in respect of the income. It is for a comparable reason that in 3.1.2.1. it was asserted that the Hoge Raad in BNB 1965/112⁸⁹⁸ went too far in attributing income on the basis of control. In this case all the income of a married couple was attributed to the husband who exercised control over the income because his wife was incurably mentally ill. Although he was not a “*bewindvoerder*”, his control over the income was derived from a comparable situation and equally did not give him any personal enjoyment of his wife’s share of the income. Similarly, a lower court⁸⁹⁹ has attributed rent from two immovable properties to a father even though he had assigned the rent to his children, because the rent was received in the father’s bank account and there was no evidence that the bank account was under the control of any other person. Van Dijck and van Vijfeijken see no reason for setting aside the assignment to the children so easily,⁹⁰⁰ and it is indeed not immediately obvious that the control over the bank account gave the father enjoyment of the income.

The United Kingdom does not have a legal figure that is directly comparable with a “*bewind*”,⁹⁰¹ but it is possible to find a different legal figure that isolates control over the application of income. In respect of a trust, a power of appointment over the trust income may be granted to a person for whom this is the only connection with the trust income. Such a person has the power to apply the trust income by deciding, for example, that a specific amount of it is to be distributed to a specific beneficiary. This power of control does not, of itself, lead to tax liability over the trust income; the

897. A “*bewind*” is a form of a guardianship; it does not change the ownership of assets, but it subjects the owner to the control of another person when dealing with the assets and the income they produce. A “*bewind*” is used, for example, to provide for an individual who is mentally incapacitated.

898. Note 457.

899. Hof ’s-Hertogenbosch 5 December 2002, No. 99/0618, V-N 2003/4.2.3.

900. Van Dijck and van Vijfeijken, note 376, Sec. 4.2.3.7, pp. 64-5.

901. In the United Kingdom the same aim is achieved by placing assets in trust, but this is quite a different legal figure as the trustee is the legal owner of the assets.

person who exercises the power is not a trustee and is therefore not legally entitled to the income, nor does he receive the income.

But if control over the application of income does not or should not of itself determine the application of the income in straightforward cases, it is an important factor in the anti-avoidance law of both countries. Control that allows a person to take the benefit of income himself is the obvious candidate for this treatment, but the anti-avoidance law of both countries goes further and attributes income on the basis of control that does not give any personal benefit – unless one regards the ability to direct income to other persons as an indirect personal benefit.

One early example of anti-avoidance law based on control was in issue in *Perry v. Astor*.⁹⁰² The legislation under discussion in that case attributed income to a person who was able “to obtain for himself the beneficial enjoyment” of the income. As discussed in 3.1.2.2., the decision of the House of Lords not to apply it to a person who could compel trustees to make distributions to him as and when he chose had more to do with the feared side effects of the legislation than with the meaning of those words.

In the Netherlands control over the application of income lies at the root of the case law discussed in 3.4.1.3., which attributes the income of a foundation to a person who exercises the control. This case law has been severely criticized in the literature for going too far with the notion that control is a form of enjoyment, even though it was an important feature that the person exercising control was able to deal with income as if it were his own and take the benefit himself. As of 2010, however, the law on irrevocable discretionary trusts and other separated private funds described in 3.2.1.4. takes control as an attribution factor very much further, and attributes the income of the fund to the settlor or his heirs on the basis of the presumed control of the settlor,⁹⁰³ regardless of whether those persons receive any personal benefit. This law does not even contain any provision allowing for the rebuttal of that presumption of control.

In the United Kingdom, the ability to control the application of income is one of the factors that can trigger the application of the legislation on transfers of assets abroad⁹⁰⁴ and cause the attribution of the income to the person who has that control, even if he is not able to exercise it for his own benefit. In this sense this scheme goes further than the Netherlands case law on

902. Note 464.

903. Note 508.

904. See Appendix II, 3.4.2.2.

foundations. The UK legislation also goes further as regards the immediacy of the control; whereas the Netherlands case law has been applied only to a person who has direct control over the assets and wealth of the foundation, the UK legislation can apply if the control can be exercised more remotely. In *Lee v. IRC*,⁹⁰⁵ for example, it was held that a person has the required control if he can control a company, and thereby control the company's directors. On the other hand, the UK legislation applies only to the person who provided the assets,⁹⁰⁶ whereas the Netherlands case law on foundations is not limited this way. The Netherlands legislation on separated private funds is a mixture in this respect, as it attributes the income to the person who provided the assets if he is still alive, but after that the income is attributed to the heirs.

5.4.5.3. *Structural limits on control over the application of income*

Clearly control over the application of income is a factor of some importance in the attribution of income but, as we saw in the previous subsection, control can be limited by references to the persons who can benefit from its exercise. Two more limits over this type of control also require consideration; this subsection considers constraints derived from the nature of the person who receives income, and the next subsection considers constraints that are attached to the income itself.

A constraint on a person's control over the application of income is inherent to the function of some persons who receive income. The most obvious examples are trustees and foundations, both of which can apply their income only for defined purposes. But companies are also subject to a comparable "institutional" constraint, although the scope of their discretion is usually wider. The question for this study is whether such a constraint on the application of the income has any effect on the attribution of the income. As a general rule, the answer is clearly that it does not; there are no "institutional" problems with the taxation of companies in either country or with the taxation of foundations in the Netherlands.

Nevertheless both countries have had to contend with this issue. In the United Kingdom it was raised in the *Mersey Docks* case⁹⁰⁷ in the 19th century. The Mersey Docks Corporation was incorporated by a statute which

905. *Lee v. IRC*, note 614.

906. Although it does include provisions taxing a different person who actually receives income.

907. *Mersey Docks and Harbour Board v. Lucas* 2 TC 25.

permitted it to charge fees for the use of the Mersey Docks harbour, but which also obliged it to maintain the harbour, pay off the debt that had been incurred in order to build the harbour and in the meantime pay interest on that debt. The corporation argued that it was not taxable on the excess of the fees it collected over the cost of running the harbour, because the obligation to pay off the debt and pay interest meant that it had no control over this profit. This argument was rejected by the House of Lords, which found that the repayment of the debt and interest were the application of the corporation's profit and that the profit was no less taxable because the corporation was required to apply it in a particular way.

The closest case in the Netherlands, BNB 1998/2,⁹⁰⁸ is from a much later date. A pension fund invested assets for employees and was required to pay to the employer any surplus over the amounts needed to meet its obligations to the employees. The issue was whether the fund could take a credit for the foreign withholding tax it suffered on the return from its investments, given that its obligations towards the employees and employer reduced its taxable profit to zero. There was no doubt, however, that the return was properly attributable to the pension fund, and this point was stated explicitly by the lower court.

Both countries have also had to consider the question of control in connection with trustees. In the Netherlands, as discussed in 3.2.1.4., the institutional constraints on trustees were considered by the Secretary of State to prevent the attribution of trust income to them. The introduction of the law on separated private funds has prompted some writers, however, to argue that a better solution would have been to attribute trust income to trustees.⁹⁰⁹ The current author agrees that the Secretary of State was asking the wrong question in this respect. In respect of persons subject to an institutional constraint, the concept of "personal benefit" can only mean the ability to apply the income within the range of action allowed by the institutional constraints.

The issue, in other words, is not whether trustees are able to use trust income for the personal benefit of the person who happens to fulfil the function of trustee, but whether they have control over the application of the income within the inherent limits of their function. The trustees of a discretionary trust have all the control that exists in respect of the trust income;

908. HR 27 August 1997, No. 31 652, BNB 1998/2 (with conclusion by Deputy Procurator-General van Soest and comment by Wattel).

909. See for example Auerbach, "Doelvermogens verdienen evenwichtige wetgeving", note 517; and Boer and Freudenthal, note 513.

why would this control not count as the enjoyment of the trust income, in the same way that the discretion of a company to deal with its income also counts as enjoyment? On the other hand, if there is a beneficiary who is entitled to the trust income as it arises, it is arguable that trustees do not have sufficient control over the income to count as enjoyment of that income.

In the United Kingdom the inability of trustees to take a personal benefit from trust income clearly does not prevent the taxation of trust income in their hands, but nevertheless there has been an issue as to the nature of the control required in order for a trustee to be taxable in respect of trust income. In *Dawson v. IRC*⁹¹⁰ the issue was whether tax could be assessed on one trustee resident in the United Kingdom who had two non-resident co-trustees. The House of Lords held that the one resident trustee was not taxable, because he did not have enough control over the trust income; he was able to veto decisions made by the other two trustees, but he could not decide on the application of the trust income on his own.

The level of control required by this decision accords with the conclusion drawn in 5.3.3.2., that the quality of receipt that is necessary as the basis of a tax liability is the point at which a person has enough control over the income that he may use it to pay the tax liability. Although the House of Lords in this case did not express its decision in these terms, the one resident trustee would not have been able on his own to use the trust income in order to pay the income tax. This aspect could explain why in some other trust cases, such as *Williams v. Singer*,⁹¹¹ the courts have talked about trustee receipt and control of the trust income as if they were a single attribution factor.

5.4.5.4. *Obligations attached to income*

The second way in which a person's control over income can be limited is when the income is received subject to an obligation to apply it in a certain way. This type of obligation affects the specific item of income, rather than the person, and the case law and literature of both the Netherlands and the United Kingdom provide many examples.

There is, of course, no attribution issue if the obligation operates merely to postpone the benefit to the person who receives the income, or obliges him to receive the benefit in a particular form, although in this case other issues

910. Note 498.

911. Note 490.

may arise. In the Netherlands, for example, some obligations to apply income in a particular way have been held to affect the quantification of the income and/or the timing of the tax charge. In BNB 1958/187,⁹¹² income that the taxpayer was obliged to pay into a blocked account (without interest) was not taxable at that moment, but when the balance on the account became available to buy bonds, the taxpayer became taxable on the value of the bonds in the Netherlands.⁹¹³ The United Kingdom is stricter in this respect; in *Smyth v. Stretton*⁹¹⁴ the full amount of a salary increase was added to the employee's salary even though it had to be placed in a provident fund and the employee would not receive any benefit until he left the employment.

If the limit on control over the application of income serves to secure a claim of another person, there is usually also little difficulty in attributing the income to the person who is entitled to it, despite his lack of factual control. For example, in the Netherlands income is taxable in the hands of the person entitled to it even if it is subject to a seizure order.⁹¹⁵ And in the United Kingdom a person who deposits money with a bank to secure a debt to the bank is taxable in respect of the interest on the deposit, even though the bank's claim means that he has very little factual control over the interest.⁹¹⁶

In all these cases the forced application of the income was for the ultimate benefit of the person subject to the obligation. The more interesting issue in the context of this study, however, is obligations attached to income which operate to benefit some other person, and whether an obligation of this kind is sufficient to change the attribution of the income. This issue is considered in detail in 5.5.3.

912. Note 401.

913. See further Hofstra and Stevens, note 398, Para. 95, pp. 93-5. See also the *Stichting Atletenfondsarrest*, explained in Appendix II, 5.3.2.3., in which the Hoge Raad held that the forced application of income can be regarded as the enjoyment of the income by the person subject to the obligation only if that person can be regarded as having made a conscious decision to apply the income in that way.

914. Note 422.

915. Author's translation; in Dutch a "*beslag*". See van Dijk, "Het genieten van inkomsten", note 378, Sec. 4.1.1, p. 67.

916. *Dunmore v. McGowan (Inspector of Taxes)* [1978] STC 217 and *Peracha v. Miley (Inspector of Taxes)* [1990] STC 512. A different result was reached in *Macpherson v. Bond (Inspector of Taxes)* [1985] STC 678, however, on the basis of the specific facts of that case. See also *Girvan (Inspector of Taxes) v. Orange Personal Communications Services Ltd* [1998] STC 567. For a discussion of the first of these cases, see Tiley, note 823.

5.5. Alienation of income

The possibility of changing the attribution of income by some act of alienation is often a fraught issue due to the tax planning possibilities that it offers. Assuming that income cannot be made to disappear altogether for tax purposes, the next best alternative is often to make it flow to a different person. It is not surprising, therefore, that both the Netherlands and the United Kingdom have plenty of law in this respect.

This section considers first the extent to which it is possible to alienate income at all, as some types of income are easier to alienate than others. In respect of those types of income that can be alienated, it goes on to consider what is required in order to achieve a formal alienation. Finally, it considers an issue of considerable practical importance, namely the extent to which an obligation on a taxpayer to pay income to another person can amount to an alienation for tax purposes.

5.5.1. Which types of income can be alienated?

Even before the effectiveness of a possible alienation for tax purposes is considered, there is a preliminary issue as to whether the income in question can be alienated under the civil law. And indeed, in both the Netherlands and the United Kingdom some highly personal types of income, such as alimony, are inalienable.⁹¹⁷ In respect of these types of income there is, therefore no question as to alienation for tax purposes.

If the civil law does allow alienation, the question remains whether the alienation is recognized for tax purposes. Here again the personal nature of income plays a role; the more personal the nature of the income, the less likely it is that an alienation is effective for tax purposes. One of the most personal types of income is employment income and, as discussed in 4.1.2., it is extremely difficult to change the attribution of employment income, although it seems that this may be possible in both countries in some highly specific circumstances.⁹¹⁸

917. Van Dijck, note 619, states in Sec. 2.3.4 at p. 51 that alimony is inalienable due to its highly personal nature. In the United Kingdom alimony and maintenance payments granted by a court and certain specific types of salary and pension are also inalienable; Hayton, D., Matthews, P. and Mitchell, C., *Underhill and Hayton: Law of Trusts and Trustees*, 17th.ed., (UK: LexisNexis Butterworths, 2006), pp. 235-7.

918. In respect of the Netherlands Ganzeveld, in an extensive study of the alienation of income, came to the conclusion that income from individual labour cannot be alienated,

Pensions have a slightly less personal character, as the source of the income is one step removed from the personal service that gives rise to it. In BNB 2001/49,⁹¹⁹ however, the Hoge Raad cited from the parliamentary history of the income tax legislation to demonstrate that the legislation was intended to treat pensions as personal income. It held accordingly that a pension was attributable to the pensioner even though the legal entitlement to the pension, and the control over it, had been transferred to his wife. There seems to be no directly equivalent authority in the United Kingdom, although it is clear from *Meredith-Hardy v. McLellan*⁹²⁰ and *Rockcliff v. HMRC*,⁹²¹ discussed in 5.3.3.2., that the attribution of a pension cannot be changed by simply having it paid to a different person.

It is maybe easier to change the attribution of remuneration for individual services outside an employment relationship, although there seems to be little authority in either country on this point. As regards the Netherlands, Ganzeveld, writing in 1994, concluded that there is no clear answer to this question.⁹²² Tiley, writing even earlier in respect of the United Kingdom, also states that it is not clear how far a right to payment for services to be rendered can be assigned.⁹²³ The United Kingdom does, however, have a number of anti-avoidance provisions which apply to arrangements that change the legal structure around the rendering of personal services, implying that income from rendering personal services is not necessarily attributed to the individual. There is legislation on the sale of income from a personal occupation,⁹²⁴ which applies to structures designed to convert income from personal services into a capital gain and operates by treating capital sums received by the individual concerned as income. The diversion of income from rendering personal services can also be caught by the settlement code⁹²⁵ or by the legislation on transfers of assets abroad.⁹²⁶

but this was written in 1994, before the most recent developments discussed in 4.1.2.; Ganzeveld, note 378, p. 480.

919. HR 22 November 2000, No. 34 542, BNB 2001/49 (with conclusion by A-G van den Berge and comment by Spek).

920. Note 842.

921. Note 843.

922. Ganzeveld, note 378, Sec. IV.2.2.B, pp. 170-3.

923. Tiley, note 823, at p. 28.

924. Chap. 4, Part 13 ITA 2007.

925. In *IRC v. Mills*, note 637, the child actress Hayley Mills was formally employed by a company which provided her services to the film industry, and the shares of the employer company were held in trust for her and others. It was held that she indirectly provided dividends to the trust and therefore the settlement code applied to attribute to her the dividends paid by the employer company. For the settlement code, see Appendix II, 3.5.1.2.

926. In *IRC v. Brackett*, note 613, a consultant set up a non-resident trust which in turn set up a non-resident company. The consultant referred clients to the company and

Business profit is not normally alienated by realizing the profit and then transferring it to a different person – in such an arrangement it is obvious that the profit arises to the person who carries out the profitable transactions – but rather by transferring the opportunity to carry out the profitable transactions. As discussed in 4.2.5.1., the Netherlands case law has drawn a distinction between on the one hand transferring a complete business, or slice of a business, together with its profit potential and on the other hand transferring just the opportunity to make a profit. Only the transfer of a profit-making opportunity causes the profit to be attributed back to the transferor. The case law is not clear, however, as to whether this attribution back to the transferor also negates the attribution to the transferee, so it is not clear whether the attempted alienation simply fails for tax purposes or whether it creates a double liability.

In the United Kingdom the alienation of business profit has been less of an issue, probably because legislation was introduced to prevent the use of loss companies much earlier than in the Netherlands legislation. In the one case in which the transfer of a business opportunity did arise, *Ransom v. Higgs*,⁹²⁷ the House of Lords did not attribute the profit back to the transferor, precisely because they were concerned about creating a double attribution. Anti-avoidance legislation was subsequently introduced to deal with the result of this case.

As regards income from assets, the most impersonal category of income, both countries accept as a general principle that it is possible to alienate the income for tax purposes. That this is so can be deduced from various legislative provisions which either accept impliedly that income can be transferred, or adopt specific measures to prevent an alienation from being effective for tax purposes.

The current income tax law of the Netherlands,⁹²⁸ for example, deals with the sale price of periodic payments, thereby accepting the possibility that the periodic payments can be sold. The Box 3 system⁹²⁹ of the 2001 law means that the alienation of income from privately held assets is no longer

provided his services to the company for no salary, although he was formally employed by the company, but he did receive other benefits indirectly from the company. It was held that the rights under the employment contract were assets for the purposes of the legislation, that the consultant had power to enjoy the income from those assets and that therefore the legislation operated to attribute the company's income to the consultant. For the legislation on transfer of assets abroad, see Appendix II, 3.4.2.2.

927. Note 725.

928. Art. 3.102 Wet IB 2001, note 56.

929. See Appendix II, 1.2.

an issue under domestic law, but the pre-2001 law accepted the possibility that income from assets could be alienated. One provision of this law⁹³⁰ dealt with gifts of dividend coupons and the allocation of regular income, such as interest and rent, on the transfer of the asset that produced the income. Another provision⁹³¹ dealt with payments received as a substitute for income.

The UK legislation makes the same implicit acceptance in much of its anti-avoidance legislation. In this context the most important scheme is now the 2009 legislation on transfers of income streams,⁹³² which accepts the sale of the income and solves the perceived problem by characterizing the sale price as income, rather than a capital gain.

5.5.2. When is alienation effective for tax purposes?

5.5.2.1. *General requirements*

In order to succeed for tax purposes, a formal alienation of income has to comply with certain conditions. One of the most obvious is that the relevant formalities of civil law have to be observed. So in BNB B 9224⁹³³ in the Netherlands, an author purported to assign her copyright royalties, but failed to observe the civil law requirements for making the assignment, and therefore the royalties were attributed to her.⁹³⁴ Similarly in *Meredith-Hardy v. McLellan*⁹³⁵ in the United Kingdom, a husband purported to assign his state retirement pension to his wife by directing the government agency to pay it into his wife's bank account, but this direction was not a valid disclaimer of the pension and therefore the pension was still attributable to him.

A second condition is that the alienation has to be made on time; once the income has been attributed to the alienator it is too late to change the attribution for tax purposes. In the Netherlands this means that the income

930. Art. 27 Wet IB 1964, note 390. For a full discussion of the issues raised by this provision, see van Dijck, note 619, Chap. 3, pp. 59-82; and Ganzeveld, note 378, Chap. 4, pp. 152-327.

931. Art. 31(1) Wet IB 1964, note 390. For a full discussion of the issues raised by this provision, see van Dijck, note 619, Chap. 4, pp. 85-120.

932. See Appendix II, 3.5.2.2.

933. HR 14 May 1952, BNB B 9224.

934. See also Ganzeveld, note 378, Sec. IV.3.1.C.c, pp. 191-2.

935. Note 842; see also 6.3.2.3.

has to be alienated before the occurrence of one of the timing moments⁹³⁶ listed in the law.⁹³⁷ This principle applies even when the law specifically allows taxpayers to change the attribution of income; on the incorporation of a company, for example, the founders of the company may agree that the pre-incorporation profits will be attributed to the company when it comes into existence,⁹³⁸ but this option cannot be extended to profit made before the date of that agreement, as that profit will already have been attributed to the founders.⁹³⁹

As regards the United Kingdom, the general principle is the same, although the timing moments are not spelled out in the legislation in the same way. Tiley, for example, states: “What is clear is that once income has arisen as income of the assignor it is too late for him to assign it if he wishes to divert it for tax purposes”.⁹⁴⁰ He can use all the income to pay deductible expenses, so that he does not actually pay any tax on it, but he can no longer prevent the original income from entering into his tax liability.

A further condition is that the alienation achieves a connection between the income and the transferee that is strong enough to displace, or to take priority over, the connection between the income and the transferor. This condition has quite a different impact in the two countries, reflecting the difference in their basic law on attribution. In the Netherlands the issue is whether the enjoyment of the income has moved from the transferor to the transferee. In respect of the income tax in the United Kingdom, on the other hand, the alternative bases of receipt and entitlement mean that the issue is often not a choice between one person and another. This double basis of attribution makes it easier to manipulate the attribution of income, and the result of a “failed” alienation would often mean that the transferor is entitled to the income and the transferee receives it. There is accordingly very little literature or case law in the United Kingdom on this specific point, certainly by comparison with the Netherlands. Instead, the United Kingdom has all the anti-avoidance legislation described throughout this study to prevent taxpayers from manipulating the attribution of income.

936. See Appendix II, 2.2.

937. Van Dijck, note 619, Sec. 2.1, p. 29.

938. Besluit van 12 juli 2001, No. CPP2001/1951M, BNB 2001/409, Deel 12.

939. Bartel, J.C.K.W., Cornelisse, R.P.C., and van Weeghel, S., *Mr. A.J. van Soest: Belastingen* (23rd edn.) (Deventer, the Netherlands: Kluwer, 2007): “There can be little doubt that a profit that has already been realized cannot be turned into the profit of another person by entering into an agreement, however the agreement is drafted” (author’s translation). In practice, however, the tax authority does allow some backdating; BNB 2005/70.

940. Tiley, note 823, at p. 27.

In respect of the Netherlands, Ganzeveld concludes⁹⁴¹ that, as a general principle, income can be alienated for tax purposes only if the transferee becomes legally entitled to the income. Similarly, van Dijck and van Vijfeijken⁹⁴² state that the attribution issue does not arise until a person other than the transferor has a valid title to the income as against the debtor. It is not necessary that the transferee has a relationship with the source of the income, such as owning the asset that produces it, but only a relationship with the income itself.⁹⁴³

That it is relatively easy to alienate income is demonstrated by two lower court cases⁹⁴⁴ which found an alienation effective when the person originally entitled to the income requested the source to pay it to the transferee and all the parties were aware of, and agreed to, the arrangement. In one of these cases the alienation was voidable, but this was held not to stand in the way given that none of the parties had attempted to void the transaction.⁹⁴⁵ This possibility of changing the attribution seems to have led to some uneasiness on the part of the courts, which on occasion have attributed the income to the transferor in decisions criticized by van Dijck and van Vijfeijken for being based on unclear reasons.⁹⁴⁶

That it is just as easy to achieve an alienation in the United Kingdom is evidenced by *Mason v. Innes*.⁹⁴⁷ An author had assigned his royalty rights from a book by deed of gift, and the only issue in the case was whether he was taxable on the market value of the rights at the time of the gift; the alienation of the income was accepted without question.

5.5.2.2. *Sale of income – the relevance of the sale price*

If an alienation of income takes the form of a sale, one of the factors that may be relevant in determining whether the sale is effective to change the attribution of the income is the price paid for the sale, particularly in relationship to the amount of income sold. In neither country, however, does this connection prove to be a factor of general importance, although

941. Ganzeveld, note 378, p. 480.

942. Van Dijck and van Vijfeijken, note 376, Sec. 4.2.1, p. 58.

943. Van Dijck, "Wie Geniet het inkomen?", note 378, at p. 183.

944. Hof 's-Gravenhage 6 February 1963, No. 106/1962, BNB 1963/227; Hof Amsterdam 17 May 1973, No. 584/72, BNB 1974/72.

945. Ganzeveld disagrees with the conclusion in the latter case: Ganzeveld, note 378, Sec. IV.3.1.C.c, p. 192.

946. Van Dijck and van Vijfeijken, note 376, Sec. 4.2.3.7, p. 64. See also Ganzeveld, note 378, Sec. IV.3.1.C, pp. 186-92.

947. *Mason (HM Inspector of Taxes) v. Innes* 44 TC 326.

it seems to have more significance in the Netherlands than in the United Kingdom.

In the Netherlands, consideration of the sale price for income has manifested itself in the cases discussed in 4.2.5.1. about the transfer of business profit. In this respect it has been held, impliedly if not explicitly, that a payment has to be of an arm's length amount in order for the sale to be recognized as the sale of a business activity that is effective to change the attribution of the profit, rather than a transfer of a profit-making opportunity which is not effective. The sale price is evaluated, however, by looking at the value of the business transferred rather than the amount of the potential profit transferred.

The amount of the sale price is also important in connection with the beneficial ownership condition introduced in respect of the credit for the dividend tax.⁹⁴⁸ This legislation disallows the credit on the sale of a dividend if the dividend directly or indirectly benefits a person who would have a lesser right to the credit than the person who actually claims it. In deciding whether or not this is the case, the relationship between the sale price and the amount of the dividend is one of the main factors to consider. A difference between the two that reflects the different tax positions of the transferor and transferee is a clear indication that the sale is part of a scheme to channel the credit to a person with a better ability to credit it than the transferor.

In the United Kingdom the price paid for a sale of income seems to have less significance, maybe because of the way in which the anti-avoidance legislation is framed in this respect. Over the years large numbers of taxpayers have attempted to convert their recurrent income into a capital gain and large amounts of legislation have been directed towards preventing them from doing so. For many years the legislation included a growing number of schemes, all targeted at specific situations, but since the Finance Act 2009 many of these schemes have been replaced by a general scheme on transfers of income streams.⁹⁴⁹ This legislation, like most of its predecessors, operates by providing that the sum received for the sale is taxed as income, rather than capital. In doing so it accepts that the income is properly attributable to the transferee and there is therefore no need to consider the sale price in order to determine the attribution of the income.

948. See Appendix II, 3.3.2.

949. See Appendix II, 3.5.2.2.

The *McGuckian* case did,⁹⁵⁰ however, make an explicit connection between income and the price for which it was sold. The case concerned the sale of a dividend, and whether that sale should be disregarded for tax purposes on the basis that it was an artificial step inserted into a composite transaction in order to obtain a tax advantage. In finding that it should be disregarded, one of the features that attracted the attention of the judges was that the sale price for the dividend was funded by the dividend itself, and that through the scheme 99% of the dividend still found its way to the original shareholder.

5.5.2.3. *Alienation of a stream of income or of a specific payment of income*

The final aspect to consider in respect of a “formal” alienation of income is whether there is a significant difference between the alienation of a stream of income and the alienation of one or more specific payments of income. The difference between the two has been considered in the Netherlands in connection with two provisions in the pre-2001 individual income tax legislation which dealt with the transfer of income by an individual.⁹⁵¹ These provisions were based on the notion that there was no practical difference between transferring a specific payment of income and transferring the same amount of money.⁹⁵² A distinction therefore had to be made between the alienation of specific payments of income, which was subject to these provisions, and the alienation of a stream of income. A similar distinction was also drawn by the Secretary of State on the introduction of the beneficial ownership condition for the dividend tax credit,⁹⁵³ who found that there is a difference between the sale of a single dividend coupon and the sale of coupons for a number of years.

In the United Kingdom, by contrast, the concern is quite a different one. Or, rather, the United Kingdom has two different concerns. One concern is the separation of income from the asset that produces it; this concern applies to

950. Note 655.

951. Art. 27(1) Wet IB 1964 (note 390) apportioned rent and interest between the transferor and the transferee according to the time periods for which they were entitled to the income; and Art. 27(2) Wet IB 1964 attributed to the donor the dividends paid on coupons that had been given away. These provisions are extensively discussed in van Dijck, note 619, Chap. 3, who describes them (at p. 81) as “complicated, obscure and based on a misconceived idea” (author’s translation). The details of these provisions are, however, not germane to this study.

952. Bartel, J.C.K.W. and van Brunschot, F.W.G.M., *Van Soest Belastingen* (19th edn.) (Deventer, the Netherlands: Gouda Quint, 1997), Sec. 1.3.50.6, p. 146.

953. Note 569, explained in Brandsma, note 571, Secs. 1.1.1.D and 2.2.0.D.1. and m.

gifts and is manifested primarily in the settlements code,⁹⁵⁴ which operates to attribute the income back to an individual settlor who retains any interest in the property that produces the income. The other concern, which applies to sales of income, is that the sale price is characterized as a capital payment rather than as income. This concern is now primarily manifested in the legislation on transfers of income streams,⁹⁵⁵ which operates to characterize a sale price as income if it would not be so characterized otherwise.⁹⁵⁶

In other words, in very broad terms, the Netherlands accepts that a stream of income can be diverted, as it leaves its source, to a person other than the person originally entitled to it, but does not accept an alienation that amounts to transferring a sum of money. The United Kingdom, on the other hand, does not draw the same distinction between alienating a stream of income and transferring what amounts to a sum of money. Instead, the United Kingdom prevents gifts of income separately from their source through the settlements code and, in respect of sales, accepts the alienation but deals with the sale price.

The Netherlands therefore has to deal with a dividing line that does not generally concern the United Kingdom in its domestic law,⁹⁵⁷ and the question is how to distinguish between the alienation of a stream of income and the alienation of specific payments. One possibility is that the dividing line falls at the point at which the amount of the alienated income is known, as this is the point at which the income that is alienated is the equivalent of a sum of money. The problem with this approach, however, is that some assets, such as interest-bearing bonds, can produce income that is fixed in advance for the entire life of the asset. Applying this reasoning would make it impossible ever to achieve an assignment of the income from such

954. See Appendix II, 3.5.1.2.

955. See Appendix II, 3.5.2.2.

956. In the Netherlands, Art. 31(1) Wet IB 1964 (note 390) similarly characterized the price received by an individual for the sale of income as taxable income rather than a non-taxable capital gain. The introduction of the Box 3 system has removed the need for this provision. No comparable provision is necessary in respect of companies, as all income and gains of companies are characterized as taxable profit.

957. There is one minor aspect of the UK law in which the distinction discussed here has been relevant, namely the law on charges on income described in Appendix II, 5.5.3.2., which has now been abolished. This scheme applied to annuities and annual payments and in *CIR v. Frere*, note 732 (and see Appendix II, 5.5.3.2.), in deciding whether or not the scheme applied, the court saw a qualitative difference between long interest and short interest. In *Paget v. CIR*, Note 407, on the other hand, Sir Wilfred Greene found no difference between the alienation of a stream of income and the alienation of a single payment.

a security, even if the owner assigned the right to the interest for a period of 20 years or more.

So should one then look at other factors, such as the risk of currency fluctuations and the reliability or solvability of the source? This approach was proposed by the Secretary of State⁹⁵⁸ on the introduction of the beneficial ownership condition for the dividend tax credit. His reason for distinguishing between the sale of a single dividend and a sale of dividend coupons for a number of years was the difference in the amount of economic risk assumed by the purchaser. In the First Market Maker's case⁹⁵⁹ (which, admittedly, was about the beneficial ownership concept for treaty purposes), the Advocate-General also looked⁹⁶⁰ at the risks borne by the purchaser of the dividend coupons, even though the case concerned a single item of income and even though the Advocate-General agreed that what the purchaser received was, subject to those short-term risks, the equivalent of a sum of money.

It is probably not possible to find one absolute guiding principle. Moreover, the two aspects discussed here do not exclude each other but are, rather, complementary to each other. The greater the risks assumed by the transferee, the less the alienated income resembles a sum of money. In the case of a gift, the only risk assumed by the transferee is that the amount of the gift is less than he had hoped, and it is easier to find that what has been alienated is the equivalent of money. In the case of a commercial transaction, the risks borne by the transferee take on a greater significance, which is maybe why the Advocate-General in the Market Maker's case found even the short-term risks incurred by the purchaser sufficient to confirm its beneficial ownership. On the alienation of the income from a fixed-interest security, the risks taken on by the transferee relate only to the reliability or solvability of the income source and possibly exchange rate risks. The point at which the alienated income is equivalent to a sum of money would be found on the alienation of income over a longer period than would be the case with, for example, dividends, the amount of which is often quite uncertain from one year to the next.

958. Note 569.

959. BNB 1994/217, note 653.

960. Para. 4.27 of his conclusion.

5.5.3. Does an obligation to pay income amount to alienation?

So far this section has discussed whether it is possible for a person to change the attribution of income by carrying out a “formal” act of alienation in respect of the income. But there is also an issue as to whether the same result can be reached informally if the person who is originally entitled to income is obliged to pay it to another person. To put the question another way, is it possible to alienate income for tax purposes by being subject to an obligation to pay it to someone else?

In respect of the United Kingdom, Tiley puts this issue as follows: “It is beyond doubt that an arrangement, to use a neutral word, entered into before income is received and which binds income on receipt, does not necessarily prevent income from being received for tax purposes and so as being taxable as income of the recipient. The distinction to be drawn is between the alienation of income, which is effective for this purpose, and the disposition or application of income, which is not; this distinction is well established.”⁹⁶¹ The difficulty, of course, is to distinguish between alienation and application. As Rowlatt J. put it in *Perkin’s Executor v. CIR*,⁹⁶² “[i]t is the particular case that causes the trouble every time, and I am bound to say it does occur to me that there may be cases where the line is very hard to draw between what is an alienation and what is a binding application.”

5.5.3.1. *The Netherlands*

The general attribution principle of the Netherlands, that income is attributable on the basis of enjoyment, means that an obligation to pay income on to another person changes the attribution of the income if the obligation shifts the enjoyment of the income. So if the person who receives the income has only the legal entitlement to the income, and is obliged to pay it to the person with economic entitlement, it is the person with economic entitlement who enjoys the income.⁹⁶³ In order to change the attribution in this way, however, and as discussed in 5.2.2.2., the obligation has to be one that is valid in commercial terms,⁹⁶⁴ rather than as part of a moral or social arrangement. In other words, economic entitlement in this sense has to be based on some structure that has a legal impact on the income in question.

961. Tiley, note 823, at p. 27.

962. *Perkins’ Executor v. CIR* 13 TC 851.

963. Van Dijck and van Vijfeijken, note 376, Sec. 4.2.1, p. 57.

964. Author’s translation. In Dutch the term is “*in het economische verkeer*”.

If, on the other hand, the obligation to pay on the income is a moral or social one, it does not change the attribution. BNB 1981/27,⁹⁶⁵ for example, concerned an individual who agreed to transfer all her income to the religious order that she was about to enter. The lower court found this to be a personal obligation, rather than an obligation with an impact in commercial terms, and the Hoge Raad held that this finding led to the attribution of the income to the individual. She was, in other words, applying her own income by giving it to the religious order. The same result was reached in BNB 1969/115,⁹⁶⁶ which concerned the individual's salary, in a decision in which the Hoge Raad focused on the ineffectiveness of the alienation rather than the personal nature of the income.

Case law has also established that a contractual obligation, as opposed to a property law obligation, does not generally change the attribution of income from property. This point was raised by van Brunschot in his note on the First Market Maker's case,⁹⁶⁷ in which he found the notion ridiculous that a contractual obligation to pass on income could negate beneficial ownership for treaty purposes. The treaty interpretation of beneficial ownership is of course a different issue, but it is only relatively recently that the domestic law on this point was resolved.

BNB 2006/7⁹⁶⁸ concerned a sale of shares in which the purchaser agreed that if it resold the shares within a certain period it would pay a portion of the resale price to the original vendor. The purchaser did indeed resell the shares and duly made a payment to the original vendor. The Hoge Raad held that the whole of the resale price was attributable to the purchaser, adopting the argument of the Advocate-General that the purchaser was the only person entitled to the resale price, and that a contractual obligation to pay part of that sum to the original vendor was not capable of changing its attribution.

A similar reasoning was applied in BNB 2010/98,⁹⁶⁹ which concerned spouses who had no community-of-property regime, but who had undertaken in a marriage contract to equal out their income each year. This obligation was found to be a contractual one, not a matter of property law, and the conclusion followed that it did not change the attribution of interest to

965. Note 630.

966. Note 674.

967. BNB 1994/217, note 653.

968. Note 534.

969. Note 473.

the spouse who provided the money for a loan and in whose name the loan was made.

Contractual obligations are, however, capable of changing the attribution of income from assets if they create full economic ownership in the hands of someone other than the legal owner of the asset. This was established in BNB 1986/118.⁹⁷⁰ What has not yet been established is whether something short of full economic ownership is capable of changing the attribution of income and, if so, how much economic ownership is required.

It is equally difficult to change the attribution of active income through a contractual obligation to pay it to another person. In the case of employment income this has led to problems in respect of individuals who, as part of their employment activity, take an employment function with another company; the most common example is an employee who sits on the supervisory board of a subsidiary company. In this case the remuneration paid for the “subsidiary” function remains attributable to the individual, even though he is obliged to hand it over to his principal employer and even though he would not have received it without at the same time incurring the obligation to hand it over. The problems caused by this situation for the operation of the wage tax have been resolved by a special rule,⁹⁷¹ but the theoretical attribution of the “subsidiary” remuneration to the individual remains unaffected.

As regards business profit, the Hoge Raad has suggested in one case that the attribution of the profit to a person could be negated by an obligation to pay it to a different person. BNB 1962/139⁹⁷² was one of the cases discussed above on the attribution of profit among companies carrying on an integrated business. In its decision the Hoge Raad contemplated the possibility that profit could be transferred from one company to another subject to an obligation to declare a dividend that would be strong enough to prevent the attribution of that profit to the recipient company. It also added, however, that this was a very unlikely situation, did not give any details as to how such an obligation would be constituted, and found that in any event this was not the situation in the case at hand. Since then there appears to have been no case in which such an obligation was indeed found to have the effect of changing the attribution of profit.

970. Note 526.

971. Now in Art. 32d Wet loonbelasting 1964, which allows the payment of the remuneration without the withholding of wage tax.

972. Note 729.

5.5.3.2. *The United Kingdom*

The United Kingdom seems to have less case law than the Netherlands on the effect of obligations to pay on income to another person. Various causes can be found for this difference: one is that the basic attribution principle for income tax places less importance on economic entitlement than the basic principle in the Netherlands; another is the large quantity of anti-avoidance legislation in the United Kingdom; and the third is the historical possibility explained below of shifting liability to basic-rate income tax to another person by making regular payments to that person.

One case that is directly on point is *Burca v. Parkinson*,⁹⁷³ which is the same in all material respects as BNB 2006/7⁹⁷⁴ discussed above. This case concerned an individual who borrowed money from his parents on the security of a 98% shareholding, and who agreed that if he sold the company within two years he would pay his parents 60% of the net sale proceeds, all of which duly happened. He argued that the amount due to his parents was not attributable to him, but the judge disagreed. Following reasoning that was remarkably similar to that of the Hoge Raad, he said “[the individual’s] obligations to [his parents] sounded in contract only. He discharged his obligations promptly and honourably, but in my view he was paying his contractual debts out of money which, as a matter of property law, belonged to him.”

A similar line of reasoning was adopted in *HMRC v. Anson*.⁹⁷⁵ This case concerned an individual who was resident in the United Kingdom and who was a member of a Delaware LLC. The judge held that the individual was not able to claim a foreign tax credit for the United States tax paid by the LLC on its profits against his income tax liability on the amounts he received from the LLC, because these were two different items of income. He found specifically that the individual did not have a proprietary interest in the LLC’s profit, but only a contractual right to be paid an amount equal to his share of the profit, stating⁹⁷⁶ “... the profits were LLC’s and the contractual obligation to credit and distribute did not make them the members’, at least for English tax purposes.”

973. Note 472.

974. Note 534.

975. Note 702.

976. In paragraph 53 of the judgment.

In *Perkin's Executor v. CIR*⁹⁷⁷ a contractual obligation was also held not to change the attribution of income even though the obligation was not accepted entirely voluntarily and even though the payments did not satisfy a debt of the individual who made them. This case concerned a widow whose husband, before his death, had borrowed money from the trustees of his marriage settlement on the security of shares that he owned. The husband later went bankrupt and the mortgaged shares, which at that time were practically valueless, were sold by the official receiver to the wife for a nominal amount. Still later, the shares became valuable again and the trustees asked for repayment of the debt. The widow was entitled to income from the marriage settlement, and a compromise was reached under which the trustees were entitled to retain certain sums out of the widow's income from the settlement in order to pay off the debt. The judges held that the sums retained by the trustees were an application of income rather than an alienation, and therefore they were attributable to the widow.

In respect of employment income, the United Kingdom appears to have no case law, although there is Irish case law⁹⁷⁸ on individuals who enter a religious order, which comes to the same conclusion as the Netherlands case law, namely that the income remains attributable to the individual even though the individual undertakes to pay it all to the religious order. There is also an HMRC manual⁹⁷⁹ dealing with members of a religious order who earn income, for example as a teacher, which states that such income is generally attributable to the individual who earns it.

Historically, however, the United Kingdom has embraced a concept of shifting liability to tax by making payments out of one's own income; this concept was generally referred to as the alienation of income, although, as argued below, it did not create a true alienation. The scope of application of this concept had also been gradually reduced until it was finally abolished in 2007. In very broad terms,⁹⁸⁰ the scheme applied to certain recurrent payments that were taxable income in the hands of the recipient. It operated by allowing⁹⁸¹ the payor to deduct tax at the basic rate from the payments and keep it, so compensating himself for his own tax liability on the income out

977. Note 962.

978. *Dolan v. K* [1944] IR 470.

979. HMRC employment income manual EIM69700, "Tax treatment of religious orders and similar bodies: members in employment". Available at <http://www.hmrc.gov.uk/manuals/eimanual/EIM69700.htm>.

980. And ignoring all the variations over the years that followed from changes to the income tax rate structure.

981. Or requiring in some cases.

of which the payments were made.⁹⁸² His own tax liability on the amount of the payments was limited to the basic rate, so that he bore no liability on the income used to make the payments. The recipient was fully taxable in respect of the payments, but could claim a credit for the tax withheld, or a refund if the withholding exceeded his own liability.

The payments to which the scheme applied were charges on income – a concept that was never defined by the legislation but which was defined in an HMRC manual⁹⁸³ as sums which a person was under a legal obligation to pay and in respect of which that person was required or permitted to deduct tax at source. The scheme of the law extended only to income that was “pure income profit” for the recipient; in other words, it applied only if the entire payment was taxable in the hands of the recipient without any deductions for expenses.⁹⁸⁴ This limitation has to be seen in context of the historical focus of the United Kingdom on the ease of collecting taxes; it was seen as the most efficient way of collecting tax from the person who ultimately received income, but if the payment went into a net profit computation the amount of tax collected would be incorrect and would need adjustment.

What the scheme really did was to allow a deduction for charges on income; it did not switch the attribution of income to the recipient that would otherwise be attributable to the payor. That this was so can be deduced from two aspects of the scheme. One was that the payment made as a charge on income did not necessarily have the same character as income derived by the payor.⁹⁸⁵ And the other was that a charge on income was not necessarily related to any specific income received by the payor but was, rather, a personal obligation of the payor.

982. Per Viscount Simonds in *CIR v. Whitworth Park Coal Co, Ltd (in liquidation)* 38 TC 531.

983. HMRC Relief Instructions Manual Re110, now repealed as being obsolete.

984. *Campbell and Another v. CIR* [1970] AC 77, 45 TC 427, [1968] 3 All ER 588. This case concerned trustees who received payments of profit from one company under a deed of covenant and who were obliged to use those sums to purchase the business of a different company. Some of the judges stated that the income did not belong to the trustees because of that obligation, but these statements have to be seen in the light of the whole case, in which a scheme had been set up to enable the trustees to buy the business and claim back the tax deducted at source from the covenanted payments (due to the exemption they could claim as trustees of a charitable trust). When read in context, these pronouncements serve only to limit the scope of the scheme of deduction at source, not to deal with the attribution of income in a more general sense.

985. *Ang v. Parrish (Inspector of Taxes)* [1980] STC 341.

Nevertheless, the scheme was often described as achieving an alienation of income.⁹⁸⁶ In *CIR v. Frere*,⁹⁸⁷ however, Viscount Radcliffe in the House of Lords, delivering a judgment with which the other four judges simply concurred, gave a more accurate explanation of the scheme. The crux of this case was the interpretation of a legislative provision that was not very clear, but in coming to their decision the courts all discussed whether an obligation to pay interest meant that the amount paid as interest never belonged to the payor for tax purposes. Viscount Radcliffe firmly rejected that idea as a general principle, saying that it follows from the general conception of income “that in principle it is irrelevant to the determination of a person’s taxable income that some part of it has been expended by him on what would normally be regarded as his own income account, in paying rent, wages, mortgage interest, rates, insurance, for example, or that the payments that he makes for such purposes will themselves constitute or contribute to assessable income in the recipient’s hands.” The only exception was the scheme for charges on income, which recognized that a true charge on income divided the entitlement to the income between the annuitant and the person entitled to the remainder. That scheme had also been extended to payments made under a personal obligation, such as a deed of covenant, thus treating those payments as dividing rights over income for tax purposes although they did no such thing under property law.

The current legislation still applies a scheme to certain annual payments and patent royalties paid by an individual which requires the individual to withhold tax from the payment at the basic rate and, instead of requiring the individual to hand that amount over to HMRC, allows him to retain it but adds the same amount to his own tax liability.⁹⁸⁸ The concept of an annual payment is not defined, but case law has held⁹⁸⁹ that there has to be an element of recurrence. So, like the Netherlands law on the “true” alienation of income, the mechanism does not apply to something that amounts to the transfer of a simple sum of money. This scheme is still described by one of the leading textbooks as one that treats the payment as an assignment of income.⁹⁹⁰

986. See for example Simon’s Taxes, Sec A4.431, available at http://www.lexisnexis.com/uk/legal/search/runRemoteLink.do?bct=A&risb=21_T9877915039&homeCsi=274725&A=0.6222751283014527&urlEnc=ISO-8859-1&&dpsi=02G4&remotekey1=RE FPTID&refpt=02G4_2_A4:HTCOMM-PART_431:HTCOMM-PARA&service=DOC-ID&origdpsi=02G4.

987. Note 732.

988. Secs. 448, 900 and 903 ITA 2007.

989. Gordon, Montes-Manzano and Tiley, note 379, Sec. 11.22, pp. 784-5.

990. *Ibid.*, Sec. 11.37, p. 796.

6. Taxable persons

6.1. Introduction

The discussion so far has focussed on when and why a specific item of income is attributed to a specific taxpayer, without paying much attention to the phenomenon of taxpayers as such. This section fills that gap by looking at the relationship between the attribution of income and taxpayers.

There is clearly a difference in this respect between an extremely subjective system and an extremely objective one. In a subjective system there can be only one taxpayer, but there must always be a taxpayer because there is no taxable income until a person has the benefit of a payment that is regarded as taxable income in his hands. An objective system, on the other hand, does not need a taxpayer in the sense of a person who benefits from income, but only a person from whom to collect the tax. That person could be the person who benefits from the income, the person who receives the income, the person who pays the income, or any other person on whom the legislation sees fit to impose the obligation to pay the tax. The legislation could also impose the obligation to pay on more than one person.

The difference between these two approaches is indeed reflected in the law of the Netherlands and the United Kingdom, although not in such an extreme form. In the Netherlands, with its more subjective system, both the general attribution rule and the rule for the dividend withholding tax are directed towards finding a single taxpayer. In the United Kingdom, the general attribution rule for income tax seems to carry an inherent risk of finding two possible taxpayers, although the attribution rules for corporation tax and capital gains tax seem to be seeking one single taxpayer. The relationship between attribution and taxpayers is, however, not that simple in either country.

The next subsection discusses the need to find a taxpayer, and the consequences of not being able to find one. The following subsection discusses the possibility of finding two potential taxpayers, and the consequences of that finding. Given the different nature of their income tax systems, it should come as no surprise that the first discussion is predominantly about the Netherlands, and the second predominantly about the United Kingdom.

6.2. No taxable person

6.2.1. The Netherlands

6.2.1.1. *General principle*

One of the issues that cause disagreement in the Netherlands is the extent of the subjectivity of the system and, in particular, whether it is possible to levy tax on a payment if no person can be found who enjoys the payment as taxable income. The choice that arises in this respect is usually between taxing one particular person and taxing no one at all. The issue, in other words, is whether there is taxable income, rather than the person to whom the income should be attributed. Nevertheless, this issue is considered here because a concern about payments going untaxed sometimes informs the choice of a taxable person.

Van Dijck and van Vijfeijken are proponents of a rather subjective approach in this respect; they argue⁹⁹¹ that, if there is no person who enjoys a payment as income, either the payment is not income or the income floats until someone does enjoy it. The Ministry of Finance, on the other hand, in its review of the 1964 income tax law in preparation for the 2001 law,⁹⁹² described the system for the taxation of passive income as an objective one, stating that passive income was taxable as soon as it emanated from its source, and that then the most appropriate taxpayer had to be found.

A subjective approach was embraced in a lower court decision of 2005,⁹⁹³ which concerned an insurance company that was not able to trace all the individuals who were entitled to a pension; it was a condition of their entitlement that they were still alive, but the company did not even know whether this was the case. The company had reserved money for their pension payments, but did not withhold wage tax⁹⁹⁴ from those sums. The court confirmed that the company was correct to do so, as it was not clear enough that the income would be enjoyed by anyone. Similarly, van Dijck and van Vijfeijken argue that, if a missing person is entitled to income, the income floats until the person returns or is presumed dead, even if the income is

991. Van Dijck and van Vijfeijken, note 376, Sec. 2.1.4, p. 21 and Sec. 4.2.5.1, pp. 67-8.

992. Nota Belastingen in de 21e eeuw: een verkenning, Kamerstukken II, 1997-1998, 25 810, No. 2.

993. Hof Leeuwarden 22 April 2005, No. 03/0211, *V-N* 2005/33.13.

994. In Dutch: “*loonbelasting*”.

received for him by a *bewindvoerder*.⁹⁹⁵ Other commentators⁹⁹⁶ suggest, however, that tax should be levied on a missing person through the *bewindvoerder* until there is a declaration of presumed death.

Van Dijck and van Vijfeijken take the subjectivity of the system even one stage further, and argue that there can be taxable income only if the taxable person knows about the income. In BNB 1987/10,⁹⁹⁷ for example, a lower court held that a minor child was taxable in respect of interest that was credited to a bank account that had been opened for her, even though she did not find out about the bank account until after she achieved her majority. Possibly this decision was motivated by a fear on the part of the court of creating an opportunity for income to float, but van Dijck and van Vijfeijken argue⁹⁹⁸ that the income should indeed have floated until the daughter found out about it.

The Ministry of Finance is clearly concerned to prevent the subjective element of the system from being so strong that it prevents taxation if no person can be found who enjoys income. One of the greatest worries of the Ministry in this respect is the prospect of “floating wealth”, and the corresponding “floating income”, which appears to be offered by the trust figure, due to the perceived difficulty of taxing trustees discussed in 3.2.1.4. This “attribution gap” has now been largely resolved, initially through the agreements concluded between the Ministry⁹⁹⁹ and persons involved with trusts and, since 2010, through the new law that governs the taxation of discretionary trusts.¹⁰⁰⁰ These solutions introduce an objective element into the attribution of trust income although, as argued in 5.4.5.3., a reconsideration of the concept of enjoyment as applied to trustees would have done much less damage to the subjective approach of the Netherlands.

A more objective approach has also been advanced as the justification for the tax on corporate profit,¹⁰⁰¹ based on the argument that there should be

995. Van Dijck and van Vijfeijken, note 376, Sec. 4.2.5.1, pp. 67-8. See also Sec. 4.2.3.4 for another case in which van Dijck and van Vijfeijken argue that income should float.

996. Sillevius and van Kempen, note 374, Sec. 2.1.0 (February 2010).

997. Hof 's-Gravenhage 15 March 1985, No. 95/84, BNB 1987/10.

998. Van Dijck and van Vijfeijken, note 376, Sec. 4.2.3.3, p. 61.

999. Although it has been argued that the agreements as envisaged by the Ministry are virtually impossible to carry out by the persons connected with a trust; Boer, J.P. and de Vries, R.J., “Anglo-Amerikaanse trusts en subjectieve vennootschapsbelastingplicht; Enkele noties aangaande fiscale transparantie”, 134 *WFR* 6631 (2005), p. 949 et seq.

1000. See Appendix II, 3.2.1.4. as to both.

1001. For example by Strik and de Vries, note 751, Sec. 2.0.2.A (April 2010).

some person that is taxable in respect of profit from an enterprise, even though the profit is not obtained for the account of, and at the risk of, an individual. The taxation of business profit in the hands of a company is now so embedded in the international tax order that it scarcely merits mention as a special attribution rule, but the need to find a taxable person in order to prevent income from going untaxed does clearly manifest itself when a company is in the process of being incorporated. If, during that period, the founders of the company already carry on the business, there is a profit (or loss) but no person to whom it can be attributed; the company does not exist yet and the profit cannot be attributed to the founders because the business is not carried on at their risk or on their account. The profit is therefore attributed to the company when it comes into existence; in other words, the company is taxable in respect of profits that were realized before it even existed.¹⁰⁰² It is only if there is an unreasonable delay in setting up the company that the profit can, instead, be attributed to the founders.¹⁰⁰³

The Hoge Raad has also introduced a comparable objective element in deciding whether income should be taxable in the hands of a company in order to prevent it escaping taxation. The case, decided in October 2009,¹⁰⁰⁴ concerned an individual who held a substantial shareholding in a company and who transferred his entitlement to a series of rent payments to the company. The issue was whether the rent should be taxed as income of the company, even though the company received it due to its relationship with the shareholder and not as a receipt of its business enterprise. The Hoge Raad stated that before 2001 it would have been necessary to tax the company, as the individual would not have been taxable under the 1964 income tax law. With the adoption of the 2001 income tax law, however, it was no longer necessary to tax the company, as the assets that produced the rent were part of an individual's taxable base in Box 3.¹⁰⁰⁵

6.2.1.2. *Dividend tax*

The possibility that there is no person to whom income can be attributed also arises in respect of the dividend withholding tax, but in a different context, namely the availability of the credit for the tax. Here the roles are usually reversed; the interest of taxpayers is to ensure that the dividend belongs to someone for tax purposes, whereas the interest of the tax administration

1002. Sillevius and van Kempen, note 374, Sec. 3.2.33.C.b1 (January 2010).

1003. Strik and de Vries, note 751, Sec. 2.0.8.D.a4 and 2.0.8.D.f2 (April 2007).

1004. HR 9 October 2009, No. 07/11868, BNB 2010/32 (with conclusion by A-G Wattel and comment by Heithuis).

1005. See Appendix II, 1.2. for an explanation of the Box 3 system.

is to ensure that the credit is not granted unjustifiably. The granting of the credit is the primary reason for including an attribution rule in the law,¹⁰⁰⁶ as the tax itself is levied on an objective basis. Whereas the individual and corporate tax laws impose tax on income enjoyed by the taxpayer, the dividend tax law imposes¹⁰⁰⁷ the tax on the income produced by shares.

In other words, it is not necessary to attribute the dividend to a person in order to levy the tax but it is necessary to do so in order to claim a credit for the tax. Two instances in which no credit can be claimed have already been discussed. One instance is when the person entitled to the yield from shares is not the beneficial owner of the dividend, in which case neither the recipient nor the person with true economic entitlement to the shares is able to claim the credit.¹⁰⁰⁸ This risk was accepted by the parliament as the price of preventing artificial avoidance structures. The other instance is the loss of a portion of the dividend tax credit when a company buys back shares which are subject to a usufruct.¹⁰⁰⁹

As a general rule, however, it is the intention of the law that the dividend tax is credited in full, and this assertion has been successfully used by taxpayers before the courts to support the argument that a dividend has to be attributed to someone. In BNB 1975/213¹⁰¹⁰ the sole shareholder of a company transferred dividend coupons to the company in satisfaction of a debt he owed to the company. The company argued that it should be able to claim a refund of the dividend tax, because there was no other person who could do so. The Hoge Raad held that the company was entitled to the refund, because the dividend tax was intended to be a prepayment of the (more subjective) corporate profit tax, not to impose a tax burden in its own right. Similarly, in BNB 1982/179¹⁰¹¹ an insurance company claimed a credit for the tax withheld from dividends which it received in respect of investments made on behalf of individual investors. The tax inspector had refused the credit, arguing that the dividends were received for the benefit of the investors, but the lower court agreed with the company; the investors did not receive the dividends and if the company could not take the credit there would be no one who could, which could not be a correct interpretation of the law.

1006. The other main reason is to allow the payment of dividends without the withholding of tax in certain cases – for example distributions that fall within the participation exemption; Art. 4 Wet DB, note 383.

1007. Art. 2 Wet DB.

1008. See Appendix II, 3.3.2.

1009. See Appendix II, 3.2.2.

1010. Note 525.

1011. Note 469.

The disparity between the basis for levying the dividend tax and the basis for levying the corporate profit tax leads to some interesting issues in certain situations when the law treats a gain realized on the sale of shares as a dividend. The problem arises in this situation that the “dividend” is subject to the dividend withholding tax, but no person can be found who has any obligation to make the withholding. This problem is, however, not germane to this study, as it is a problem of collection, rather than one of attribution.¹⁰¹²

6.2.2. The United Kingdom

The more objective nature of the UK individual income tax system means that the possibility of not being able to attribute income to anyone is less of a problem than it is in the Netherlands. In the original system of taxation at the source there was certainly no issue in this respect. The UK focus on the collection of tax was noted in 2.3.1.; this focus is still visible in the basic attribution rule of the current system and has shaped it in a manner designed to prevent the phenomenon that income cannot be attributed to any person. The underlying philosophy was epitomized by Viscount Cave in his famous dictum in *Williams v. Singer*,¹⁰¹³ in which he stated that the goal of taxing income was “attained (speaking generally) by the simple and effective expedient of taxing the profits where they are found.”

Nevertheless the possibility of income not being attributable to anyone has been considered in a small number of cases. In *Reid's Trustees*,¹⁰¹⁴ the judges clearly wanted to avoid the result that the income could not be attributed to anyone, as that would have led to the income in question escaping taxation altogether. The decision in *Aplin v. White*,¹⁰¹⁵ which attributed income to a person on the basis of receipt, may also have been motivated by a desire on the part of the judge to prevent that result, although he did not allude to this argument in his judgment.

In *Paget v. IRC*,¹⁰¹⁶ however, some of the judges explicitly stated that they were not troubled by the possibility that income may belong to no one at all. Lord Romer stated¹⁰¹⁷ that income frequently belongs to no one at all,

1012. For a discussion of this issue see Brandsma, note 571, Sec. 4.1.0.B (October 2008).

1013. Note 490.

1014. Note 495.

1015. Note 845.

1016. Note 407.

1017. At p. 697.

and gave the example of the income of an accumulating trust. And Sir Wilfred Greene MR stated that the risk of income escaping taxation is no argument for attributing the income to a person who cannot be brought within the attribution rules of the legislation.

Subject to these cases, there appears to be very little authority in the United Kingdom on the possibility that no taxpayer can be found in respect of a given item of income under the individual income tax legislation. In addition to the historical background of the system, one can also point to the large quantity of anti-avoidance legislation as an explanation.

The attribution rules in the capital gains tax and corporation tax legislation are quite different in this respect, as they both appear to seek one single taxpayer on a basis that is much more comparable with the Netherlands concept of enjoyment. There seems to be no authority on the possibility that no person can be found who is taxable in respect of these taxes, but this lack of authority is easily explained by the nature of these taxes. As discussed in 2.1., there is an inherently subjective element in the notion of a capital gain, so it is rather unlikely that a taxable gain would arise in the absence of any person who disposes of the relevant asset. And as regards corporation tax, the elements that have given rise to questions in the Netherlands, such as a person going missing or not being aware of the payment, are not likely to occur in connection with a company.

6.3. More than one taxable person

6.3.1. The Netherlands

Just as there is little discussion in the United Kingdom about the possibility of income being attributable to no one, in the Netherlands there is little discussion about the possibility of income being attributable to more than one person. The attribution criteria in the legislation are generally accepted to be seeking one taxable person only in respect of any given item of income. Van Dijck, for example, states that the enjoyment of income by one person excludes the possibility that the income can be enjoyed by a different person.¹⁰¹⁸

The case law also generally makes the assumption that a particular item of income can be attributed to only one person at a time without even dis-

1018. Van Dijck, “Wie Geniet het inkomen?”, note 378, at p. 162.

cussing the issue. In BNB 2007/15¹⁰¹⁹ Advocate-General Overgaauw did consider the possibility of a double attribution, but he did so by pointing out that the alternative solution to his conclusion would lead to a double attribution, a result which in his opinion was so obviously wrong that it was sufficient to dismiss the alternative solution.

Nevertheless, the literature mentions two cases in which it might be possible for income to be attributable to more than one person, although they are both the result of tax avoidance or another irregularity. One possibility is that a company is subject to corporate income taxation on its profit and that its individual shareholders are subject to individual income tax on the same profit.¹⁰²⁰ This can happen if the tax authority raises the voidability of a company towards the shareholders using the *fraus legis* doctrine. It can also happen if the company was not incorporated properly because the formalities for incorporation were not observed. The Ministry of Finance has made a commitment, however, to grant discretionary relief in such a case.¹⁰²¹

The other possibility is the conclusion that could be drawn from the case law on the attribution of profit among companies in common ownership. The Hoge Raad has never explicitly attributed the same profit to two persons in these cases but, as discussed in 4.2.1., in correcting what it perceives to be an artificial attribution of profit it has also not excluded that possibility.

The cases developing the concept of economic ownership in respect of shares, such as the Falcons case,¹⁰²² may also appear to attribute the same income to two persons at the same time, as they decided that two persons were entitled to the participation exemption in respect of one distribution. This is, however, not an accurate explanation of this case law. It is more accurate to say that when a distribution is split between two persons, the participation exemption is split in the same way. In other words, these were not situations in which the participation exemption was doubled, but situations in which it was shared. In developing this case law, the Hoge Raad may seem to have taken rather an objective view on attribution, reasoning that the aim of the participation exemption is to prevent the economic double taxation of intercorporate distributions and therefore attaching the

1019. Note 402.

1020. Bartel, Cornelisse and van Weeghel, note 939, pp. 486-7.

1021. Under Art. 63 Algemene wet inzake rijksbelastingen (note 583), the “*hardheidsclausule*” (hardship clause).

1022. BNB 2003/34, note 532.

exemption to all the portions of a dividend. On the other hand, one can only determine that a dividend is an intercorporate one by attributing it to a specific corporate shareholder.

6.3.2. The United Kingdom

6.3.2.1. *Introduction*

The United Kingdom knows a range of situations in which income could be attributed to more than one person at the same time, especially under the individual income tax legislation with its two alternative grounds for attribution. The capital gains tax and corporation tax legislation, by contrast, seem to preclude this possibility by providing only a single basis for attribution. Certainly, the case law on the risk of a double attribution has generally concerned the income tax. A potential double attribution does not usually mean that income is subject to double taxation, although in one exceptional case (the *Dimsey* case, discussed in 6.3.2.2.) the House of Lords held specifically that double taxation was indeed the result intended by the legislation.

As a general principle, however, the potential double attribution raises the issue of how it is to be resolved. One solution is that both persons are indeed taxable at the same time, and that a credit mechanism is used to relieve the double taxation; this mechanism is generally used in respect of trust income. The other possibility is that a choice is made between the two potential taxpayers; this is the more general solution. It has been left to the judiciary to make the choice between the potential taxpayers, as the legislation gives no indication of any priority between the two grounds of entitlement and receipt.

The next subsection considers anti-avoidance law that adopts an attribution solution. The following subsection considers the broader issue of the choice between potential taxpayers that sometimes has to be made in applying the basic attribution rule. The final subsection in this part looks at the distinction that is made between income tax levied at the basic rate and income tax levied at higher rates; in attributing income for the purposes of basic-rate tax, the system is considerably more objective than in attributing income for the purposes of higher rates.

6.3.2.2. *Anti-avoidance legislation*

Much of the anti-avoidance legislation imposes liability to tax on specific persons in respect of income that would not be attributable to them under the basic attribution rules. It also generally prevents a double charge to tax by providing that income attributed according to its special rule is not taxable in the hands of any other person. The *Dimsey* case,¹⁰²³ however, concerned the legislation on transfers of assets abroad, which did not include this latter provision and the House of Lords held specifically that under this scheme it was possible for the same income to be taxable in the hands of two persons at the same time. Admittedly, this case concerned an exceptional situation.¹⁰²⁴ Counsel for the Crown did state that the Revenue would allow the transferor of the assets a credit for tax paid on the same income by the transferee, or vice versa, but this credit would be granted by administrative discretion only.

The anti-avoidance legislation can also produce another strange result, due to its tendency to be framed in rather wide terms. The legislation on transfers of assets abroad,¹⁰²⁵ for example, does not provide any mechanism for apportioning the income of a discretionary trust that is affected by the scheme among the beneficiaries of the trust. In the *Vestey* case¹⁰²⁶ the Revenue argued that the legislation gave them discretion to attribute the trust income among the beneficiaries as they saw fit, the only limitation being that they could not attribute more income in this way than the taxable income of the trust in question. This assertion was roundly rejected by the House of Lords, which clearly deplored the idea that income could be attributed to a person on the basis of administrative discretion, and held that the trust income could not be attributed to any of the beneficiaries.

The legislation was then amended to impose a tax charge on any person to the extent that he/she receives a benefit that is not otherwise chargeable to

1023. *R v Dimsey* [2001] STC 1520. For an extensive discussion of this case, see Mullan, R., "Case Note", *British Tax Review* 5 (2002), pp. 149-60.

1024. This was a criminal case, and the appellant was a tax adviser accused of conspiracy to defraud and cheat the Inland Revenue by failing to make complete disclosure of the tax liabilities of three companies involved in an avoidance scheme. The conviction turned on whether the regime on transfers of assets abroad, which made the adviser's client liable to tax in respect of certain income, also removed the liability of the companies on the same income. The House of Lords held that it did not, because the legislation did not specifically exclude their liability.

1025. See Appendix II, 3.4.2.2.

1026. *Vestey v. IRC (Nos. 1 and 2)* [1980] STC 10.

tax.¹⁰²⁷ This added provision could result in tax being chargeable on two persons: the transferor of the asset; and a person who actually receives a benefit. The legislation therefore also provides¹⁰²⁸ that income cannot be taken into account more than once. If there is a choice of persons to whom the income could be attributed, the legislation explicitly grants HMRC a discretion in attributing the income – exactly what was rejected by the House of Lords in the *Vestey* case – although it does require that the attribution be made on a “just and reasonable” basis.

A similar problem could arise in respect of the settlements code.¹⁰²⁹ The breadth of the definitions in the code means that it is possible for one settlement to have two (or more) settlors. In that case the code applies to each settlor separately, which requires the income of the settlement to be apportioned among the settlors. The code does not, however, specify how that apportionment is to be made, so leaving the attribution of the settlement’s income to the discretion of HMRC¹⁰³⁰ – again, exactly what was rejected in the *Vestey* case.

In at least one case the legislation¹⁰³¹ deliberately creates a double attribution, and double taxation of income, but this is itself an anti-avoidance measure. This rule applies in respect of a loan if the interest on the loan is not deductible by the borrower. If, instead of paying interest, the borrower temporarily transfers income-producing assets to the lender, both the borrower and the lender are taxable in respect of the income produced by those assets. In this way the legislation prevents the borrower from indirectly obtaining what amounts to a deduction for the interest.

6.3.2.3. *General attribution rule*

Maybe the more interesting issue, however, is not the anti-avoidance legislation, but the double criteria that constitute the general attribution rule of the individual income tax legislation. The attribution provisions of the individual income tax legislation generally follow the same pattern, along the lines of “[t]he person liable for tax under this Chapter is the person

1027. Sec. 732 ITA 2007.

1028. Sec. 743 ITA 2007.

1029. See Appendix II, 3.5.1.2.

1030. See the discussion of the case law in Gordon, Montes-Manzano and Tiley, note 379, Sec. 15.08, pp. 873-4.

1031. Sec. 786 TA 1988.

receiving or entitled to the income”.¹⁰³² This phrase was taken over from various provisions in the earlier legislation, even though the explanatory notes on the rewritten legislation state that “no clear definition of it has emerged.”¹⁰³³ It was retained, however, because it was well established in case law and it was not “considered appropriate to include any further explanation of the phrase because of its wide interpretation by the courts.” But what exactly does this formulation tell us? Is this provision intended to express two alternative criteria, or is it intended to express two aspects of the same criterion? And in either case, how is it to be applied if one person receives income and another person is entitled to it?

What emerges from the case law is that entitlement and receipt are indeed two different grounds for attribution, both of which have been found sufficient on their own as basis for the attribution of income. In *Dewar v. IRC*¹⁰³⁴ Lord Hanworth considered these two grounds and suggested that nothing very much turns on the difference between the two, but that both of them are used simply in order to cover situations in which money is put at the disposal of a person as well as situations in which money has actually been paid.

And indeed, both entitlement and receipt have been found a sufficient factor on which to base a tax liability. In *Archer-Shee v. Baker*,¹⁰³⁵ for example, it was held that a beneficiary who was entitled to the income of a trust as it arose was taxable in respect of that income, whether or not she actually received it. And in *Re Blackwell Minor's trustee*¹⁰³⁶ it was held that income is attributable to a beneficiary if he is entitled to it but does not receive it because the trustees retain it until he is old enough to give a good receipt for it, even though that means that he is unable to get at it in the meantime.

Receipt is also a sufficient basis on which to found a tax liability, provided the recipient has enough control over the application of the income to be able to use it to pay the tax liability, as discussed in 5.3.3.2. In *Reid's Trustees*¹⁰³⁷ the trustees were found to be taxable due to their receipt of trust

1032. Secs. 572, 576, 579, 582, 592, 597, 600, 608, 614, 618, 622, 632, 636, 662 and 680 ITEPA and Secs. 8, 230, 245, 271, 332, 338, 348, 352, 360, 371, 385, 404, 425, 554, 581, 611, 616, 685 and 689 ITTOIA. The attribution provision relating to employment income is different; see Appendix II, 4.1.1.2.

1033. For example in Para. 66 of the rewrite notes on Sec. 371 ITTOIA (which deals with the taxation of interest), available at <http://www.opsi.gov.uk/acts/acts2005/en/05c5ENv2/05en05-a.htm>.

1034. Note 422.

1035. Note 405.

1036. Note 487.

1037. Note 495.

income. *Aplin v. White*¹⁰³⁸ illustrates the force of receipt even more forcibly; in this case an estate agent was found to be taxable in respect of income which he received but to which he had no beneficial entitlement. The Revenue's argument that the general attribution rule laid down two alternative grounds for liability was accepted by the court.

There is a question as to how these cases can be rhymed with *Williams v. Singer*,¹⁰³⁹ in which trustees were held not to be taxable in respect of trust income because they did not receive it; their legal entitlement to the trust income, in other words, was not enough on which to found a tax liability. As argued earlier,¹⁰⁴⁰ however, what this case really demonstrates is not a judicial disregard for the correct attribution of income, but rather a judicial reluctance to take the attribution rules to their full extent if the result is to change the reach of the United Kingdom's taxing jurisdiction in a way that is unacceptable to the court. A similar concern was expressed in *Perry v. Astor*,¹⁰⁴¹ although this case concerned a specific anti-avoidance rule, rather than the general principle. In this case, again, the House of Lords chose not to give the most obvious and literal interpretation to the legislation for the same reason. In the much later case of *Dawson v. IRC*,¹⁰⁴² however, Lord Keith dismissed comparable arguments as a guide to the correct attribution of income, saying that "[m]uch was made, on either side of the bar, of the anomalies which would arise if the competing argument was successful", but concluding that "[t]he issue cannot be resolved by a balancing of the anomalies which would arise on either view."

All the cases discussed so far in this subsection considered whether one specific person had a sufficient connection with an item of income to be taxable in respect of the income. In all of them there was only one candidate for taxation in respect of the income under consideration, an element which undoubtedly made the court's decision easier to reach in some of the cases. What none of them had to consider was how to choose the taxpayer if one person is entitled to income and a different person receives it.

The choice between receipt and entitlement has, however, been presented to the courts in a limited number of cases. In *Kings v. King*,¹⁰⁴³ a husband

1038. Note 845.

1039. Note 490.

1040. See Appendix II, 3.2.1.3.

1041. Note 464.

1042. Note 498.

1043. *Kings v. King (Inspector of Taxes)*; *Kings v. Barker (Inspector of Taxes)* [2004] STC (SCD) 186.

and wife¹⁰⁴⁴ jointly owned property which was rented out, but the rent was received by the husband. HMRC argued that income should be attributed to the wife on the basis of her entitlement to it, but the special commissioner attributed it to the husband on the basis that he received it and on the basis of his factual finding that the taxpayer's wife had surrendered her entitlement to the husband. He did, however, state explicitly that the legislation allowed taxation of either the person in receipt of the income or the person who was entitled to it, and that he did not see any priority in the legislation between these two grounds for attribution.

In the earlier case of *Ransom v. Higgs*,¹⁰⁴⁵ an individual, Higgs, had agreed to a complex avoidance scheme set up by his tax advisors which, it was conceded, he did not properly understand. Under the scheme, land owned by Higgs and his wife was developed and sold, and the major part of the resulting gain was received by trustees for the Higgs family. The trustees had not actively taken part in the chain of sales. The Revenue asserted that Higgs had been trading, and originally asserted that both Higgs and the trustees could be assessed – Higgs because he was entitled to the trading profit and the trustees because they received it. In the House of Lords, however, the Revenue chose to defend only the assessment on the trustees.

The House of Lords rejected this assessment, largely because of their finding that Higgs had not been trading,¹⁰⁴⁶ but their lordships also considered the attribution of the profit as such. They were clearly concerned that finding the trustees taxable would lead to a double attribution, once in the hands of Higgs or the trustees and once in the hands of the companies that formed part of the scheme and actually carried out the sales, and were clear in their opinion that income can be taxable only once. As regards the possible attribution of the profit to Higgs or the trustees, Lord Simon¹⁰⁴⁷ resolved any potential conflict by saying: “But it was common ground before your Lordships that, if any charge to tax arose at all, it was the trustees who were assessable as having *received* the profits or gains” (emphasis in the original). Although he gave no reason for this conclusion, the most obvious explanation is that the person in receipt of the profit is the person who is most likely to be able to pay the tax.

1044. Strictly speaking they were not husband and wife at the time, as they did not get married until after the facts of the case arose.

1045. Note 725.

1046. After this case, legislation was introduced that would have made Higgs himself taxable if the same facts were to arise again – the provisions on artificial transactions in land described briefly in Appendix II, 3.4.2.1.

1047. At p. 22.

On the other hand, giving absolute priority to receipt would be an invitation to manipulate the attribution of income. That the attribution of income cannot be manipulated in this way is clear from the two cases discussed in 5.3.3.2., in both of which a husband arranged for his wife to receive half of his pension but failed in his claim not to be taxable on that half.¹⁰⁴⁸ *Meredith-Hardy v. McLellan*¹⁰⁴⁹ concerned the legislation before the rewrite, which had no explicit attribution rule for pensions. The Special Commissioner's decision was very short, but he did say that "it would be strange if tax on the emoluments of an ... employment were to be chargeable on anyone but the holder of that ... employment; it would be equally strange if tax on a pension were not to be chargeable on the person who was entitled to that pension".

*Rockcliff v. HMRC*¹⁰⁵⁰ was decided on the basis of the legislation after the rewrite, which provided that a pension was taxable in the hands of the person receiving or entitled to it. The taxpayer's argument that this change in the legislation had to have some significance prompted a short discussion of this point in the judge's decision.¹⁰⁵¹ The judge found it plain from the legislation before the rewrite that, in the absence of a clear provision to the contrary, the tax was levied on the person entitled to income, but stated that the rewritten legislation on pensions appeared to add a liability on any person who merely received a pension. He found such a dramatic change in the scope of liability a highly improbable result for what was intended to be consolidating legislation, repeating, and apparently accepting, HMRC's position that there had been no change in liability. Curtis¹⁰⁵² argues, however, that the judge may have dismissed the taxpayer's claim a little too easily, and that the rewritten legislation may well have changed the attribution rule. Interestingly, the judge also paid attention to the collection of tax, describing the change in the legislation as adding an option for the recovery of tax, but concluded that this change had no effect on the attribution of the income as HMRC was still entitled to proceed solely against the husband.

A rather different instance of a double attribution is found in the case of trusts, in which both the trustee and a beneficiary may be taxable in respect of the same income. Two situations have to be distinguished here. One

1048. The United Kingdom has no marital community-of-property regime, so in neither case would the wife have had any legal entitlement to the income, either directly from the source or indirectly through her husband.

1049. Note 842.

1050. Note 843.

1051. The main thrust of the taxpayer's case was a non-discrimination argument based on the European Convention on Human Rights.

1052. Curtis, "Alice's Restaurant" and "Pieces of property pie", both Note 421.

situation is a true double attribution, when the same income is attributed to both the trustees and the beneficiary; this may occur if the beneficiary has an immediate entitlement to the trust income as it arises. The other situation is the case of a beneficiary who receives, for example, an annuity from the trust. In this case the income that the beneficiary receives is different from the trust income. In both cases the beneficiary is entitled to a credit for the tax paid by the trustees,¹⁰⁵³ but it is primarily the first situation that concerns us here.

When the same income is attributed to both the trustee and the beneficiary, there is obviously no need to make a choice between the two taxpayers.¹⁰⁵⁴ This description is not complete, however, as trustees and beneficiaries are subject to different rates of tax. The credit mechanism ensures that the final level of taxation is adjusted to the beneficiary's personal circumstances, but there is an important distinction between the liability of trustees and the liability of beneficiaries which has a bearing on the attribution issue. The distinction has a wider import than the taxation of trust income alone, and it is explored in the following subsection.

Capital gains tax and corporation tax do not raise the same issues in respect of attribution; both these taxes were introduced only in 1965, and in both cases the basic attribution rule appears to seek a single taxpayer on a basis that is closer to the concept of enjoyment used in the Netherlands.¹⁰⁵⁵ Nevertheless, in *Jerome v. Kelly*,¹⁰⁵⁶ an attribution issue arose in respect of capital gains tax that was in some ways comparable with that in *Ransom v. Higgs*.¹⁰⁵⁷ This case concerned an avoidance scheme for the sale of land,¹⁰⁵⁸ and the main issue in the case was the interpretation of the timing rule in the legislation,¹⁰⁵⁹ which provided that a gain was realized at the moment at which a sale contract was concluded. The problem in the case was that the benefit of the sale contract had been assigned by the vendors before the contract was completed, a complication that had obviously not been

1053. Gordon, Montes-Manzano and Tiley, note 379, Sec. 13.15, p. 844.

1054. If a beneficiary is entitled to the trust income as it arises, the income may also be paid directly to the beneficiary, and in that case often no assessment is raised on the trustees.

1055. See Appendix II, 2.3.2.

1056. Note 553.

1057. Note 725.

1058. Capital gains tax had been introduced between the facts of this case and those of *Ransom v. Higgs*. In *Jerome v. Kelly* it was therefore the application of the capital gains tax legislation that was important. If capital gains tax had applied at the time of *Ransom v. Higgs*, the issues in the case might have been very different.

1059. Now in Sec. 28 TCGA.

contemplated by the drafters of the timing rule. The Revenue asserted that the timing rule also served to attribute the gain to the original vendors, but the judge refused to attribute the gain to them, partly because they were unable to receive the sale price. He did not explain why this lack of receipt was important, but clearly the money from the sale was not in the hands of the original vendors.

6.3.2.4. *Basic rate and higher rates of income tax*

The previous subsection discussed the relationship between the two basic grounds for the attribution of income tax found in the legislation, receipt and entitlement, but, even disregarding the anti-avoidance legislation, these two factors are not the only ones to be used in connection with the attribution of income. As noted in 2.3.2. the case law has, on occasion, used the concept of enjoyment in cases related to attribution issues. Similarly the explanatory notes to the rewritten income tax legislation, referring to the case law on related issues, state that “[t]he most recent cases ... have hinged on whether or not any benefit has accrued to the taxpayer.”¹⁰⁶⁰ The concept of beneficial entitlement to income is also used occasionally in the legislation; in connection with the attribution of income from the jointly owned property of married couples, for example, the legislation¹⁰⁶¹ applies a rebuttable presumption that the individuals are beneficially entitled to the income in equal shares.

Tiley also suggests, rather tentatively, that personal entitlement to income matters when a person is being taxed as an individual but not when he is being taxed as a trustee.¹⁰⁶² This suggestion is made after the observation that the attribution of income is “muddied slightly by the fact that trustees are liable to income tax as trustees. ... [T]here may be a distinction between the trust situation, in which the trustee is entitled to the property as a matter of law but holds it for the beneficiary and that in which the taxpayer received property from X but X still owns it.” A comparable observation about the taxation of trust income was made by Vinelott J. in *IRC v. Crawley*¹⁰⁶³ when he said that “[t]he treatment of trustees in the Income Tax Acts is not altogether satisfactory. The legislation gives rise to serious problems as to the circumstances in which a trustee is liable for tax on income which

1060. For example, the explanatory note on Sec. 371 ITTOIA, note 418.

1061. Secs. 836 and 837 ITA 2007.

1062. Tiley assisted by Loutzenhiser, note 358, Sec. 7.3.3, at p. 150.

1063. *IRC v. Crawley and others* [1987] STC 147.

is not actually received by him or which belongs beneficially to a beneficiary and as to the manner in which trustees are to be assessed.”

As is so often the case in the United Kingdom, the root of these problems and apparent inconsistencies lies in history. As explained in 2.3.1., in its original form the UK income tax applied at a flat rate on a rather objective basis. The introduction of progressivity through the application of higher rates was first achieved, not by levying income tax at graduated rates, but by levying an additional tax, first called super-tax and then surtax, on individuals with higher incomes. The surtax was not integrated to form a progressive rate structure for income tax until 1973.

This differentiation between the basic rate¹⁰⁶⁴ and higher rates meant that it was possible for the application of the basic rate to retain a more objective approach to attribution than the application of higher rates. The distinction was visible, for example, in the mechanism for shifting tax liability to another person by making payments as a charge on income that was retained until 2007.¹⁰⁶⁵ The origin of this mechanism has been traced back to the English tax system of the 17th century,¹⁰⁶⁶ when the primary concern of the revenue authorities was very much the collection of tax. It embodied maybe the ultimate form of an objective system, as it imposed liability to pay tax on the most convenient and visible person, the source, and left that person to recoup the tax from the income payments made by him.¹⁰⁶⁷ On the introduction of super-tax the mechanism continued to apply, but only for the purposes of basic-rate tax; a similar mechanism of allowing the payor to withhold and retain basic-rate tax continues to apply to annuities and annual payments,¹⁰⁶⁸ so to that extent the original objectivity of the system has been retained.

But the same distinction between the application of the basic rate and higher rates of tax still has a wider importance. One of the best illustra-

1064. Before 1973 the flat rate of tax was called the standard rate. This subsection gives an extremely brief and general explanation of the history of the rate structure. For a more detailed account, see Tiley assisted by Loutzenhiser, note 358, Chap. 6, pp. 133-7.

1065. See Appendix II, 5.5.3.2.

1066. See generally Soos, note 403.

1067. *Ibid.*, Chap. 2 explains that this is a different mechanism from the usual form of a withholding tax. Whereas the usual withholding mechanism requires the payor to act as the agent of the payee, and to hand over to the government the tax withheld, this mechanism imposes tax on the payor but allows him to recoup it by retaining the tax withheld from the payment.

1068. See Appendix II, 5.5.3.2.

tions is *Aplin v. White*,¹⁰⁶⁹ the case in which an estate agent was found to be taxable in respect of interest on the basis that he received it, even though it was beneficially owned by his clients. His liability to tax was, however, limited to the standard rate, Megarry J. saying that the estate agent's lack of any beneficial entitlement did prevent him from being liable to surtax. Indeed, the Revenue had not attempted to charge surtax, and the judge agreed with the Revenue that the income subject to surtax was "necessarily beneficial income, and so sums received in a fiduciary capacity could not be included".

Finlay J. expressed this point even more clearly in *Rigden v. CIR*.¹⁰⁷⁰ The issue in this case was whether an individual who continued in a partnership after the retirement of two partners was liable to super-tax on a portion of a refund of excess profits tax, even though the continuing partners were contractually obliged to pay that portion to the retiring partners. In finding that the partner was not subject to super-tax on this portion, Finlay J. said: "Super-tax is a tax on income to which a man is beneficially entitled. Income tax may, broadly speaking, be exacted wherever you can find income liable to tax. It may come from a trustee, or it may come from a beneficiary. This matter is explained by Lord Cave in a well-known passage which I had occasion to read recently, and will not read again. The passage I mean is to be found in his speech in the case of *Williams v. Singer*.¹⁰⁷¹ ... A trustee may in some circumstances pay Income Tax on the income which he receives as trustee; but a man can never pay Super-tax on income of which he is only trustee. What he pays Super-tax on is the beneficial income, the income to which he is really entitled." The judge found that, by consent, an assessment had been made on the partner that was incorrect in form, and went on to say "For Income Tax I do not doubt for a moment that the assessment is final and conclusive. But when one comes to Super-tax one has got to ascertain, as I indicated a moment ago, what is the beneficial income."

The distinction drawn in this passage between income and beneficial income is a vital element in what are, essentially, two different systems for the attribution of income in the United Kingdom. In respect of the basic rate of income tax, the system is predominantly an objective one, tracing its roots back to the origins of the income tax. The primary concern of this system is the ease of collection and, as long as the tax can be collected

1069. Note 845.

1070. *Rigden v. Commissioners of Inland Revenue; Commissioners of Inland Revenue v. Urwicks Executors* 19 TC 542.

1071. Author's footnote: see Appendix II, 3.2.1.3. for the well-known passage to which this citation refers.

from someone, the system is not unduly concerned with the identity of that person. In respect of trust income, for example, the basic rate of tax can be collected from either the trustee or the beneficiary. Of course there are qualifications to be added to this statement; the relatively recent introduction of special rates of tax for trustees means that it is not always the basic rate that applies. There is now, for example, a special trust rate that applies to the income of discretionary and accumulation trusts.¹⁰⁷² But the essential point remains that the liability of trustees does not generally extend to higher rates of income tax (or previously super-tax or surtax).

In respect of the higher rates of tax, or previously super-tax or surtax, the system is a subjective one. In this case, income has to be attributed to the correct person in order to collect the correct amount of tax, and the identity of the person to whom income is attributed becomes important. In a number of trust cases,¹⁰⁷³ for example, the issue was whether trust income was attributable to a beneficiary; the importance of this question in each case was that income that was attributable to a beneficiary was part of the beneficiary's income for the purposes of the higher rates of tax. The subjective system does extend to trustees in specific cases in which they are taxable as the agents of the beneficiary,¹⁰⁷⁴ but the imposition of tax on trustees as such remains outside the subjective system.

The distinction between these two systems is what was troubling Vinelott J. in the citation given above from his judgment in *IRC v. Crawley*.¹⁰⁷⁵ But the problem that beset Vinelott J. is only part of a larger problem with the attribution of income in the United Kingdom, namely that the legislation attempts to capture both the objective system and the subjective system in one general formulation. The legislation attempts, in other words, to capture two irreconcilable systems in one phrase. This phrase has been carried through various incarnations of the income tax legislation for a long time and is, unsurprisingly, appropriate for an objective system.

It is, however, much less suitable for a subjective system. The emphasis it appears to give to an objective approach has created planning opportunities for taxpayers which, in turn, have prompted the adoption of the complex anti-avoidance legislation to preserve the subjective system. In respect of

1072. Sec. 479 ITA 2007.

1073. *CIR v. Blackwell Minor's Trustee*, note 487; *Hamilton-Russell's Executors v. CIR*, note 486; *Stanley v. CIR*, note 489; *Brotherton v. IRC* [1978] STC 201.

1074. For example, bare trusts for a minor or other beneficiary under an incapacity (Sec. 73, TMA 1970) and trusts with a vulnerable beneficiary (Secs. 23-45 FA 2005).

1075. Note 1063.

Jones v. Garnett,¹⁰⁷⁶ for example, Tiley and Collison¹⁰⁷⁷ state that the question at the heart of the case was whether, if a company activity is to exploit the skills of one spouse, the dividends paid by the company should all be attributed to the spouse with the skill. Yet the case was argued on the basis of the settlement code,¹⁰⁷⁸ rather than on the basis of the personal nature of the husband's activity that earned the income.

The case law generally reaches what most people would intuitively regard as the right answer and, in reading the decisions, one does sense that the judiciary has often taken an intuitive approach in order to strike a balance between the literal wording of the legislation and the demands of a subjective system, in particular. Nevertheless, the application of the legislation would be very much easier if it provided clear guidance on the basic attribution principles of both of the systems used in the United Kingdom.

7. Conclusion

7.1. Similarities and differences

Attempting to summarize the similarities and differences between the Netherlands and the United Kingdom reveals how many and diverse the differences are. The overall picture that emerges is precisely what one would have expected; both countries recognize the same broad principles, but the way in which those principles have been developed and fleshed out has led to substantial differences in many situations. The case law has often developed in different directions, although where the basic principles are similar the case law can also be similar. The UK attribution rule for capital gains, for example, is close to the Netherlands concept of enjoyment and, as discussed in 3.4.1.2. and 3.4.2.1., the two countries have developed similar case law in respect of indirect ownership in this context.

One large and obvious difference between the Netherlands and the United Kingdom is the approach towards a person such as a trustee¹⁰⁷⁹ who is legally entitled to income but who derives no personal benefit from the income. This difference of approach is derived from a fundamental differ-

1076. Note 641.

1077. Gordon, Montes-Manzano and Tiley, note 379, Sec. 15.30 at p. 890.

1078. See Appendix II, 3.5.1.2.

1079. Trustees are the principal category of person in this position, but other persons in a fiduciary position, such as the personal representatives of a deceased individual, are in a similar position in this respect.

ence in the underlying civil law; the other side of this civil law difference, which has not been discussed in detail in this study, is the ability of the United Kingdom to recognize two (or many more) taxpaying capacities in one person, such as a trustee.

But there are plenty of other points at which the two countries under study diverge, although they often take the same broad principle as a starting point. In the attribution of business profit, for example, both countries as a broad principle look for the person who carries on the business activity, although the factors used in the United Kingdom are more varied than in the Netherlands. Most of the Netherlands cases concerned structures set up for avoidance purposes, and the courts focused on whether the structure had a sufficient commercial justification and whether it was set up on arm's length terms. If the whole structure is itself defensible as a business arrangement, the attribution of the profit that it creates is accepted. If the structure is not sufficiently commercial, the courts are likely to remedy the situation by finding an extraction of profit by the person carrying on the business activity. The courts have, however, not clearly articulated the consequences of such a finding, leaving open the possibility that the profit could be attributed both to the person with legal entitlement and to the person who carried on the activity.

In the United Kingdom, the judicial approach to planning structures has also considered their commercial justification, although it is not necessarily the decisive factor. It was at its strongest as an attribution factor in *Butler v. Wildin*,¹⁰⁸⁰ which was decided on the basis of the settlements code rather than any basic principles, and in which the judge saw the lack of commercial justification as an indication that the arrangement had the element of bounty that is necessary for the application of the code. *Ransom v. Higgs*,¹⁰⁸¹ by contrast, was argued on the basic principle of attribution to the person in receipt of, or with entitlement to, the profit. The lack of commercial justification for the complex structure that had been created was clearly in the minds of the judges, who did not like the idea of allowing the scheme to succeed. They felt constrained to do so, however, because the profit was already attributable to the companies that had carried out the trading activity. In the UK cases which did not concern tax avoidance structures, the determining factor has been the exercise of control over the business. In *Alongi v. IRC*¹⁰⁸² the profit was attributed to the individual who was found to own and control the business, even though he took no active part in it.

1080. Note 466.

1081. Note 725.

1082. Note 711.

The UK *Firestone* case¹⁰⁸³ also, in effect, looked at which company controlled the business, by looking at which party determined the terms of the contractual arrangements that established the framework of the business.

In respect of income from individual activity, both countries start from a presumption that the income is attributable to the individual who carries out the activity, but this presumption is stronger in the Netherlands than in the United Kingdom. The Netherlands case law has, for example, consistently attributed income from what is essentially employment to the individual carrying out the employment activity, whereas the United Kingdom has had to deal with “incorporated employees” through anti-avoidance legislation, as discussed in 4.1.3.2. The picture is similar in respect of individual activity outside the context of employment, with the Hoge Raad attributing income to the individual on the basis of the general principle whereas the United Kingdom, as discussed in 5.5.1., again deals with this issue through anti-avoidance legislation.

As regards income from assets, again both countries take the same starting point, attributing the income to the owner of the asset, although the different types of asset ownership which are possible as a matter of civil law inevitably lead to different results in similar factual situations. These differences in civil law are not necessarily a problem in cross-border situations, if a country is able to accept the legal consequences of the civil law figure in another country for tax purposes. However, this is manifestly not the case with the Netherlands approach to trusts, as discussed in 3.2.1.4.

Both countries have also had to deal with various situations designed to manipulate the attribution of income from an asset, but the Netherlands has often responded through the interpretation of the enjoyment concept, whereas the United Kingdom has followed a more legal approach in its case law but has enacted anti-avoidance legislation. The Netherlands has developed some case law, for example, discussed in 3.4.1.2., which attributes income to an indirect owner of assets. The United Kingdom, on the other hand, has enacted many legislative schemes to attribute income to an indirect owner, including the “transfer of assets abroad” scheme, which applies to some extremely indirect forms of ownership; these schemes are discussed in 3.4.2.

In both countries the short-term transfer of an asset (discussed in 3.3.) has been held to be effective to change the attribution of the income derived

1083. Note 730.

during the period of short-term ownership, but both countries have enacted legislation to prevent the manipulation of income by this means. In the Netherlands this is the very specific legislation introducing the beneficial ownership requirement in respect of the dividend tax credit, whereas the United Kingdom has enacted many schemes of much wider import.

The law on the separation of the income from an asset (discussed in 3.5.) reveals a similar picture, with the case law in both countries holding that income can be attributed to a person other than the owner of the asset. The Netherlands adopted some specific provisions in the pre-2001 individual income tax law to deal with this issue but, subject to those provisions, the case law has generally continued to accept the separation of income from an asset for tax purposes. The United Kingdom, on the other hand, has dealt with this issue by adopting legislation with a wide scope; the settlements code applies an attribution solution to deal with gifts of income, but the legislation on transfers of income streams applies a characterization solution to deal with sales.

7.2. Attribution factors

An equally confusing picture emerges if the comparison is approached through the factors that determine the attribution. The clearest factor to use in this respect is the legal entitlement to income, but in both countries it serves primarily as a presumption only. In the Netherlands this presumption can be relatively easily displaced in looking for the enjoyment of income,¹⁰⁸⁴ although it is not as easily displaced in the application of the dividend tax.¹⁰⁸⁵ In the United Kingdom it can also be easily displaced in respect of the more subjective income tax system, although it has more force in respect of the more objective system.¹⁰⁸⁶ The coexistence of these two systems of taxation means, however, that the importance of legal entitlement has not been properly explored in the case law.¹⁰⁸⁷ Nor is legal entitlement a decisive factor in respect of corporation tax and tax on capital gains, as these taxes are levied primarily on an economic basis.¹⁰⁸⁸ The loan relationships legislation¹⁰⁸⁹ takes the economic basis of corporation tax even further, creating a world of notional payments in which legal

1084. See Appendix II, 5.1.2.2. and 5.1.2.3.

1085. See Appendix II, 5.1.2.1.

1086. See Appendix II, 6.3.2.4.

1087. See Appendix II, 5.1.3.2.

1088. See Appendix II, 5.1.3.1.

1089. See Appendix II, 3.2.3.2.

entitlement is clearly a subordinate factor in the domestic taxation of the real payments.

Economic entitlement is far more difficult to define than legal entitlement, as illustrated by the extensive case law of the Netherlands on the concept of enjoyment. The UK system, by contrast, is often more accepting of the legal structure as basic principle, although it then often applies anti-avoidance legislation to correct the disparity with the economic view of the situation. Some of this anti-avoidance legislation deals with the perceived problem through a solution other than an attribution solution, thus accepting the attribution of income to the person with legal entitlement.

The receipt of income plays a role in both countries but, as discussed in 5.3.3., primarily as a manifestation of some other factor. In the Netherlands receipt can be one manifestation of enjoyment, but it is the enjoyment of income that creates the attribution link, not the receipt. Receipt also plays a role in the attribution of a dividend for dividend tax purposes, but as an adjunct of the legal entitlement to the dividend rather than as a factor in its own right. In the United Kingdom, receipt can be an autonomous basis for the attribution of income for the purposes of income tax,¹⁰⁹⁰ provided the recipient has enough control over the income to pay the tax out of it. This is unacceptable as an attribution factor to the Netherlands, however, as evidenced by the approach of the Netherlands to the taxation of trustees.¹⁰⁹¹

As regards control, as discussed in 5.4., it is only control over the application of income that has any relevance, and when this type of control is examined further it appears not to be sufficient in either country in isolation. Both countries regard this type of control as an indication of the indirect ownership of assets in certain cases; in the Netherlands it can lead to the attribution of the income of a foundation to a person who is able to control the application of the foundation's income,¹⁰⁹² and in the United Kingdom this type of control is one of the factors that can trigger the application of the legislation on transfers of assets abroad.¹⁰⁹³ Generally, control over the application of income is important, not in its own right, but as the manifestation of the principal attribution factor, namely enjoyment in the Netherlands and the receipt of income in the United Kingdom.¹⁰⁹⁴

1090. See Appendix II, 5.3.3.2.

1091. See Appendix II, 3.2.1.4.

1092. See Appendix II, 3.4.1.3.

1093. See Appendix II, 3.4.2.2.

1094. See Appendix II, 5.4.5.2.

7.3. The difficulty of defining attribution principles

The difficulties that a country experiences with the attribution issue can have various causes. One possibility is simply that the legislation is not as precise or as well considered as it could be. In the United Kingdom, for example, as discussed in 6.3.2.4., the attempt of the legislation to capture two fundamentally different attribution systems in one phrase creates confusion, leading to Vinelott J.'s exclamation in *IRC v. Crawley*¹⁰⁹⁵ that the law on the attribution of income to trustees is “not altogether satisfactory”. The basic principle of the Netherlands is clearer, but specific aspects of the legislation can cause problems, for example the difficulty highlighted by the usufruct case¹⁰⁹⁶ and subsequent case law, which is discussed in 3.2.2. and which arose because the legislation deemed a capital gain to be a dividend for tax purposes but did not specify how this deemed treatment affected the attribution of the dividend tax credit.

In both countries the courts have also, in effect, supplemented the legislation and decided attribution cases on the basis of considerations other than the connecting factors between income and a person, so introducing elements that are extraneous to the attribution issue as such. The best examples of this phenomenon are the UK cases of *Williams v. Singer*¹⁰⁹⁷ and *Perry v. Astor*,¹⁰⁹⁸ in which the jurisdictional issues that would have arisen as a result of choosing the obvious interpretation of the legislative attribution rule led the House of Lords to choose instead a rather strained interpretation. And the courts of both countries have also, on occasion, attributed income to a person primarily in order to prevent the income from going untaxed, rather than on the basis of the factors connecting the income to a person.¹⁰⁹⁹

A second possible cause of difficulty is that different attribution principles may clash with each other. In the Netherlands, for example, it was for a long time not clear whether the legal entitlement to income or the factual control over income was the predominant factor in certain cases of income derived by a husband and wife. As discussed in 3.1.1. and 3.1.2.1., this question was not resolved until very recently, in BNB 2007/15¹¹⁰⁰ and BNB

1095. Note 1063.

1096. BNB 1995/50, note 520.

1097. Note 490.

1098. Note 464.

1099. See Appendix II, 6.2.1.1. and 6.2.2.

1100. Note 402.

2010/100,¹¹⁰¹ and it is still not clear as a general principle how far the control over income has to be shifted away from the person with legal entitlement in order to change the attribution of the income. Similarly, in the United Kingdom the problem of clashing attribution principles can arise in respect of income tax, with its dual basis of attribution; these difficulties are discussed in 6.3.2.3.

Finally, questions may arise simply because it is not clear how a particular basis for attribution should be interpreted or how far it should be taken. In the Netherlands the courts are not always willing to take the subjectivity of the concept of enjoyment as far as the literature has argued that it should be taken. This issue has arisen in respect of BNB 1987/10,¹¹⁰² in which income was attributed to an individual in circumstances in which van Dijck and van Vijfeijken argue that it should have floated. And, as noted in 5.5.2.1., the same authors have also criticized some cases in which income was attributed to a person who had alienated it, arguing that the basis for these decisions was not clear.

The United Kingdom has a comparable issue, namely how far to take entitlement as an attribution factor for income tax purposes and whether simple legal entitlement to income is sufficient. This question can be seen as the fundamental question underlying the decision in *Williams v. Singer*.¹¹⁰³ What really exercised the House of Lords in this case was whether the simple legal entitlement of a trustee to trust income was enough to bring the income into the UK tax net, when it would not have been subject to tax in the United Kingdom if the beneficiary had been entitled to it directly.¹¹⁰⁴ As concluded in 5.1.3.2., it is still not clear what precisely is meant by the term “entitlement”.

7.4. A final word on the international dimension

The study that has been undertaken here demonstrates, if nothing else, how difficult it is to identify in general terms what it is that makes income belong to a particular person for tax purposes. The very broad principles can be defined easily enough, but they have to be supplemented with a

1101. Note 452.

1102. Note 997.

1103. Note 490.

1104. Tiley is not even sure that the exception created by this case is sound, as trustees are clearly entitled to trust income; Tiley assisted by Loutzenhiser, note 358, Sec. 29.2.2, pp. 617-8.

great deal of detail in order to cope with situations other than the most straightforward ones. In any given case the answer might be relatively easy to find, but these answers tend to depend on the specific facts and the difficulty lies in defining in general terms how the various attribution factors relate to each other.

For this reason, although the very broad principles are similar in the two countries studied, they soon diverge in their development of the details. These differences are an inevitable result of the autonomy of countries in shaping their domestic law. There is no obligation on countries to align their domestic law in this respect and no compelling policy reason for expecting them to do so, but in cross-border situations these differences inevitably lead to attribution mismatches with the resultant problems of double taxation, double non-taxation and difficulties in granting double tax relief.

States may, of course, take it upon themselves to find mechanisms in their domestic law to deal with these mismatches. Certainly, if a state adopts an attribution rule based on a very indirect link between the income and the person, one might expect that state at the same time to deal with the mismatches it causes. This is not always the case, however, as demonstrated by some UK anti-avoidance regimes.¹¹⁰⁵ But although it is at the discretion of states whether and how to resolve cross-border mismatches in general, there is arguably an obligation on states to find a solution if they have concluded a tax treaty and the differing attribution rules of domestic law form a hindrance to a sensible application of the treaty.¹¹⁰⁶

A vital element in the application of a treaty is determining who the taxpayer is in respect of an item of income, as treaties are expressed to apply to persons¹¹⁰⁷ and the benefit of a treaty generally has to be claimed by the correct taxpayer. Yet the text of most tax treaties says very little about how income is to be attributed to a person for this purpose. The OECD

1105. For example, the legislation on transfer of assets abroad (see Appendix II, 3.4.2.2.) and the legislation on the capital gains of non-resident companies with resident shareholders (see Appendix II, 3.4.2.). This feature of the legislation has been highlighted in a paper written by the Society of Trust and Estate Practitioners (STEP) in response to a consultation of the EU Commission on double taxation conventions and the internal market; see note 256.

1106. Based on the Vienna Convention on the Law of Treaties, Art. 26, which obliges states to perform treaty obligations accepted by them in good faith.

1107. OECD Model Art. 1. See also Walser, J., "The Concept of Beneficial Ownership in Tax Treaties", at pp. 17-8 in: "The OECD Model Convention – 1998 and beyond; the concept of beneficial ownership in tax treaties", in: *International Fiscal Association Seminar Proceedings*, Vol. 23A (The Hague: Kluwer, 2000).

Model uses various terms in this respect, such as “derived by” and “paid to”. Maybe they are not quite used interchangeably, but the variety of terms used suggests that little thought was given to the attribution issue when the distributive articles of the treaty were first drafted.¹¹⁰⁸ The OECD has addressed specific aspects of this topic, for example in the context of its work on partnerships¹¹⁰⁹ and collective investment vehicles,¹¹¹⁰ but not yet the more general question.

It is especially the beneficial ownership concept that has received a great deal of attention in the case law and the literature of the past decade and a half, and many attempts have been made to formulate a definition of this term.¹¹¹¹ There is still a great deal of disagreement as to its meaning and even as to whether it is a substantive rule or an anti-avoidance rule.¹¹¹² But this focus on defining beneficial ownership masks the more fundamental issue, as these discussions do not generally answer the question of where one starts with attribution for treaty purposes; should we start from domestic law, or do treaties have autonomous attribution principles?

It is submitted, on the basis of the findings of this study that, regardless of one’s views on the function of the beneficial ownership concept, it is the wrong approach to seek to define a substantive attribution rule for inclusion in treaties. Treaties rest on the foundation of domestic law; their function is to smooth out the difficulties caused by the overlaps and mismatches of domestic law, not to create a new complex of overarching substantive rules.

Rather than attempting to express an autonomous attribution principle, therefore, treaties should take as their starting point the divergent attributions of domestic law. Of course states may not always be able to accept the attribution rules of other states, and so treaties should also provide some safeguards for states that are unable to accept the attribution rules of a treaty partner. As the attribution of income to a person is the link that determines which treaty should apply, if any, this issue should be the starting point of an investigation into the availability of treaty benefits, rather than one of the

1108. See further on this point Wheeler, note 58.

1109. OECD Committee on Fiscal Affairs, note 2.

1110. For the discussion on the substantive elements of this issue, see OECD Committee on Fiscal Affairs, note 13.

1111. Three doctoral theses addressing this issue are: van Weeghel, note 66; Danon, note 155; and de Broe, note 63. There have been far too many articles generated by this discussion to list in one footnote. Some of those found most useful by the author are: Walser, note 1107; Oliver, et al., note 63; Edge, note 63; Fraser and Oliver, note 63; Bernstein, note 63; Martín Jiménez, note 63, Li, note 65.

1112. Martín Jiménez, note 1111, Sec. 3.4, pp. 52-8; Li, note 1111, Sec. 3.2.4.

last issues, as is often the case at the moment. All these considerations lead to a fundamental rethinking of the way in which treaties are structured, and a suggestion as to how all of this might be achieved is made in the thesis which builds on the findings of this study and which forms the main part of this book.

Summary

This thesis makes a radical proposal for a redraft of the OECD Model Income Tax Convention, in order to correct a fundamental structural flaw in the current version of the Model which causes a large number of difficulties in determining which persons are entitled to treaty benefits.

The difficulty of making that determination in the current treaty structure is visible in many ways. The growth of treaty provisions such as limitation on benefit provisions and anti-conduit clauses evidences the need felt by states to protect their treaties against treaty shopping. The continuing discussion about the beneficial ownership requirement concerns, not only the meaning of the term, but also its very role in the treaty. It is still not clear what the “liable to tax” requirement in the residence definition entails. Difficulties sometimes arise because the Model starts by stating that it applies to persons, whereas the distributive articles are written as though they apply to income, regardless of the person who derives the income. It is not always self-evident which person is the correct person to claim benefits in respect of a given item of income. And even the reference to persons in the opening article is not always appropriate, because one person can have multiple taxable capacities.

The solutions that have been found or proposed for these problems generally consist of adding further treaty provisions or adopting a specific interpretation of the current provisions; these solutions, in other words, take the current wording of the OECD Model as their starting point. But solutions based on the current OECD Model will never be entirely satisfactory, because the problems stem from a fundamental structural flaw in the current Model, namely that two basic conditions for claiming entitlement to treaty benefits do not connect properly. Only by dealing with that structural flaw can a coherent path be defined for claiming entitlement to treaty benefits.

The fundamental disconnection in the current OECD Model is that the residence definition looks for a general liability to tax on a person, whereas the distributive rules are based on some form of ownership of income of the person. The problem is that ownership of an item of income and tax liability in respect of that item of income do not necessarily go hand in hand; they can be separated, for example, in a regime which taxes the profit of group companies in the hands of the top company in the group, or by anti-

avoidance regimes which tax income in the hands of a person who has only a remote connection to the income.

In the current OECD Model these two conditions, of bearing a general liability to tax and having ownership of the income, come together in the person who is entitled to treaty benefits; that person is the fulcrum on which the application of the treaty balances. There is, therefore, a great deal of pressure on a correct identification of the person and the interpretation of the treaty becomes strained when there is a disconnection between the person's liability to tax and the ownership of the income.

The main argument of this thesis is that this focus on the person is misplaced. The essential element leading to treaty entitlement should be, rather, liability to tax in respect of a specific item of income. This element is what is described as the missing keystone in the title of this thesis, as the current OECD Model pays no attention to it.

If all states agreed on the attribution of income to a person for treaty purposes, a less drastic solution could probably be found than the redrafting of the Model suggested here. It is, however, manifestly not the case that there is agreement in this respect. That much is evident from the study reproduced in Appendix II, which comprises an extensive analysis and comparison of the domestic law of the Netherlands and the United Kingdom in this respect.

Even this study limited to two countries reveals a wide range of differences in the way in which they attribute income to a person and the philosophies behind those differing attributions. The very broad principles in both countries are similar and predictable: legal entitlement to income generally provides an initial indication of the person to whom income should be attributed; and the person carrying on an income-producing activity is a strong indicator for the attribution of the income derived from the activity. But the countries start to diverge as soon as one starts to look at a more detailed level. Those divergences have various causes, such as the differing property law of the two countries, the differing basic attribution principles expressed in their tax legislation, the differing reaches of their anti-avoidance legislation and the differing imperfections in their tax legislation. It is hardly conceivable that a comparison of any other pair of countries would reveal differences that are substantially fewer in number or of a lesser importance, and indeed the case law discussed in the main body of this thesis does reveal similar differences among other countries.

The aim of this study was to investigate whether it was possible to identify substantive factors that could be used in shaping a treaty principle to deal with attribution conflicts between these two countries, but the study concludes that this is not a fruitful path to take. The basic factors used by domestic law in the attribution of income require a considerable degree of fleshing-out in order to be of any practical use, as is evident from the sheer size of the study. This issue is, in other words, far too complex to be captured in principles of a sufficient level of abstraction for inclusion in a treaty.

A better solution is to leave the attribution of income to a person to states to determine as part of their domestic system and to restructure treaties in the knowledge that states may have very different ideas in this respect. This philosophy is the basis of the new approach suggested by this thesis.

In contrast with the current treaty structure, the new approach takes the imposition of tax liability by a state in respect of a specific item of income as its starting point – a starting point which reflects the reason for including the distributive articles in treaties, namely to prevent double taxation. This starting point also gives the treaty a more objective nature, as it focuses in the first instance on the income. Nevertheless, it remains necessary to retain a subjective element and to look at the person too; given that states can have such different views on why a specific item of income is taxed in the hands of a specific person, the treaty should not oblige states to accept without question the attribution of another state as a basis for treaty entitlement. Therefore the treaty would allow states to test this tax liability in a number of ways.

In the majority of cases in which treaty benefits are claimed, it is the source state that is required to limit or forgo its taxing claim. In this situation, the first test applied by the source state would focus on the tax liability in the residence state and would allow the source state to refuse treaty benefits if that liability is not sufficient. The residence-state liability may be considered insufficient if, for example, the rate is extremely low or if the treaty claimant benefits from a very favourable incentive regime. Obviously the treaty would have to provide guidelines in this respect, and might also name specific tax regimes as imposing a sufficient or an insufficient liability.

The insufficiency of the tax liability in the residence state could also arise if base erosion in the residence state makes the formal tax liability on the income for which treaty protection is sought meaningless. The base erosion could affect the specific item of income for which treaty protection is

sought; this is the classic case of a conduit structure. Alternatively, the base erosion could affect the entire taxable base of the company seeking treaty protection; this is the main situation targeted by most limitation on benefits provisions. In the current treaty framework, claims to treaty benefits in conduit structures are generally combated on the basis of the company's ownership of the income, even though the problem arises precisely because the residence state taxation is founded on the company's legal ownership of the income. Limitation on benefit provisions, on the other hand, combat their target structures by looking primarily for substantive connections to back up the company's residence claim.

Neither response is entirely appropriate. Although both structures rely on artificial arrangements which place the ownership of income where it is needed for treaty shopping purposes, the true issue in both cases is that the residence state taxes the net income whereas the source state faces a claim for treaty benefits in respect of the gross payment. There is, in other words, a mismatch between the tax liabilities of the two states. The new approach allows source states to combat both phenomena by focussing on the true problem and determining that the tax liability in the residence state is not sufficient as a basis for granting treaty benefits.

The second test to be applied by the source state looks at the connection between the income and the person claiming treaty benefits, in order to determine whether it finds it acceptable to grant treaty benefits to that specific person in respect of that specific item of income. The treaty would probably include a list of connecting factors which are agreed between the two states to be acceptable for this purpose, such as the income being paid in respect of an activity carried on by the person, the person having the enjoyment of the income or the person having control over the application of the income. In making this determination states would be expected to allow a reasonable margin of discretion to their treaty partners; the issue here is not whether the law of the residence state is identical to the law of the source state, but only whether the source state finds the connection between the income and the person acceptable as a basis for imposing tax.

It is in connection with this test that source states would have to consider, in particular, situations in the residence state in which liability to tax in respect of an item of income is imposed on a person other than the legal owner of the income. Anti-avoidance law may be an issue in this respect; the comparative study in Annex II describes some examples in both the Netherlands and the United Kingdom of anti-avoidance law which attributes income to a person on the basis of a rather remote connection between the

person and the income. If treaty partner states find these connections unacceptably remote as a basis for imposing a tax liability, there is no reason to oblige them to grant treaty benefits on the basis of that liability.

On the other hand, the more objective character of the new approach offers the possibility of aggregating the attributes of two persons in order to form one complete entitlement to treaty benefits. So if, for example, domestic law taxes the income of a subsidiary in the hands of the parent company, the tax liability of the parent may be aggregated with the ownership of the subsidiary in order to claim treaty protection for the income. This possibility works best if both companies are resident in the same state, but the thesis also considers how it might work if they are resident in different states.

The third test applied by the source state looks at the connection between the person claiming treaty benefits and the state in which residence is claimed. As liability to tax in respect of the income is the starting point of the new approach this test, unlike the current treaty structure, would go straight to material tests of residence such as an individual having a permanent home in a state or a company having its management and control in a state. As with the second test, states would be expected to allow each other a reasonable margin of discretion in this respect.

By going directly to the material connection between the person claiming treaty benefits and the residence state, the new approach avoids the problems that arise in respect of the “liable to tax” criterion in the current residence definition. Many of those problems arise because, when applied to a person, the “liable to tax” test is not a binary test; there are many shades of grey between a person that is fully liable to tax and a person that is not liable. When applied to a single item of income, however, the test does have a binary quality; either the income is included in the taxable base or it is not.

The basic principles of the new approach would not grant treaty benefits in respect of either tax-exempt persons, such as pension funds and charitable organisations, or income that is exempt from tax in the residence state, such as dividends subject to a participation exemption. States would, however, remain free to include provisions in their treaties extending treaty benefits to these persons and income. This aspect of the new approach has the advantage of bringing some clarity to this issue, especially by comparison with the current situation in which the treaty entitlement of such persons sometimes relies on a rather strained interpretation of the treaty.

Summary

In respect of the residence state, the new approach follows a comparable route to the granting of double tax relief under the treaty. The issues for the residence state are whether there is an acceptable connection between the income and the state imposing tax on a source basis and, in some cases, on whether there is an acceptable connection between the income and the person on whom the tax is imposed. If the residence state uses the exemption method for active income, it would also be able to determine whether or not the source-state tax is sufficient to give entitlement to the exemption or whether it would switch to the credit method instead.

As the new approach sets out a logical and consistent path to claiming entitlement to treaty benefits, it is also capable of resolving a number of further current problems. One of those problems is that of identifying a “person” for treaty purposes. Although the thesis generally discusses treaty entitlement in terms of “persons”, it also considers the difficulties caused by persons who have multiple taxable capacities, such as trustees, and the imposition of a tax liability on something that is not a legal person, such as a partnership and certain types of collective investment fund. The new approach resolves these problems by granting treaty benefits to a taxable capacity, rather than to something that is strictly a person in legal terms. This aspect of the new approach follows logically from its starting point, namely the imposition of a tax liability in respect of a given item of income. The tax liability indicates which taxable capacity is implicated, and that is the taxable capacity that may be entitled to treaty benefits.

Although not a major part of the discussion, this element of the new approach is also capable of resolving the problem that permanent establishments are not treaty-entitled persons, whereas in certain situations the application of treaties would be much more logical if they were. By regarding a permanent establishment as a separate taxable capacity of the enterprise of which it is a part, the more logical application of treaties can be achieved.

A further issue that is solved by the new approach is whether the distributive rules of a treaty apply on a subjective basis or an objective basis. In other words, do they apply to the income, regardless of which person derives the income, or do they apply to a specific person in respect of the income? The starting point of the new approach is clearly an objective one; it is liability to tax on the specific item of income that forms the entry threshold into the treaty. A subjective element is introduced in order to substantiate the claim to treaty benefits by looking at the connections between the income and the person and between the person and the claimed residence state. In other

words, the new approach has a mix of objective and subjective elements but, unlike the current treaty structure it is clear which element plays a role at which point.

As the new approach, unlike the current treaty framework, pays specific attention to the reasons for which income is attributed to a person, it is capable of dealing with situations in which states disagree about the attribution of income. The solution suggested is to include a tiebreaker provision in the treaty which sets out a hierarchy of connections between the income and a person in order to determine which attribution takes priority. The thesis includes a substantial discussion as to how this tiebreaker provision would work in a number of two-state and three-state constellations.

Finally, the new approach also offers the possibility to resolve overlapping claims to source-state taxation in a treaty. As the entry threshold for claiming treaty benefits is the imposition of a tax liability on a specific item of income, the treaty could also incorporate a provision dealing with situations in which both states impose tax on a source basis. This possibility is, however, not explored extensively as it would extend the scope of thesis too far.

A substantial part of the thesis is devoted to testing the new approach in a variety of situations taken from decided cases. It is also tested in respect of the application of treaties to trusts, as the taxation of trusts under the domestic law of various countries raises almost every conceivable challenge for a theory on entitlement to treaty benefits. This part of the discussion focuses on the major common-law countries, as the taxation of trusts in civil-law countries is further complicated by the difficulties experienced in those countries in accommodating trusts in their civil law.

What emerges from this testing process is that the new approach is capable of providing solutions in all these situations. Whereas the courts in the cases discussed have usually arrived at the most appropriate answer from a policy point of view, they have often had to adopt a rather forced interpretation of the treaty in order to do so. The new approach avoids these problems, because the steps that it sets out for the determination of entitlement to treaty benefits all follow each other logically. The new approach also leaves room for states to determine their own policy on treaty entitlement. And because it deals with the elements of treaty entitlement one at a time, it raises each policy issue at the most appropriate stage in this process.

Two issues remain which cannot be resolved by the new approach. One is the perennial problem of drawing dividing lines. In the context of the new

approach, the most problematic dividing line is likely to be the distinction between on the one hand a person who receives an item of income and pays that same income to another person, and on the other hand a person who receives income and uses it to fund the payment of a different item of income to another person. This distinction is particularly important in deciding whether a person who is legally entitled to an item of income has a sufficient connection with the income to be granted treaty benefits in respect of it.

The second issue which cannot be resolved by the new approach is that treaties are generally bilateral instruments, whereas treaty questions also arise in triangular situations. Triangular situations are considered throughout the thesis and some suggestions are made as to how to apply the new approach, but the risk remains that differences among the applicable treaties will lead to inconsistencies and mismatches. Neither of these problems, however, is a particular feature of the new approach; they are both, rather, inherent to the nature of treaties as rather abstract documents which are generally concluded in bilateral relationships.

The discussion of the new approach concludes in Appendix I with a suggested text for a redrafted OECD Model. This text contains the basic provisions which would be necessary to introduce the new approach, with a brief commentary highlighting the differences from the current OECD Model and the most important policy choices that would have to be made. It follows the current OECD Model to the extent possible, but nevertheless contains a number of provisions which have no equivalent in the current model.

If the redrafted text were to be adopted in practice, it would be necessary to develop a large body of case law and practice to flesh out the details. But it is not the intention of this thesis to provide a solution for immediate adoption in practice. By proposing such an experimental solution, this thesis aims only to highlight the true problems with the current OECD Model and in that way to contribute to the discussion on entitlement to treaty benefits. The redrafted text of the OECD Model is offered in the knowledge that it can do no more than provide a focus for further discussion.

Samenvatting¹¹¹³

De Ontbrekende Sluitsteen van Inkomstenbelastingverdragen

Dit proefschrift mondt uit in een voorstel om het OESO-modelverdrag radicaal te herijken om een fundamentele structurele weeffout in het huidige model, die tot tal van problemen leidt bij het bepalen van de personen die gerechtigd zijn tot de verdragsvoordelen, te herstellen.

Deze problemen zijn op vele manieren zichtbaar in de huidige verdragsstructuur. De opkomst in de verdragen van bepalingen zoals “limitation on benefit” bepalingen en “anti-conduit” bepalingen maakt duidelijk dat staten zich genoodzaakt voelen om hun verdragen tegen “treaty shopping” te beschermen. De aanhoudende discussie over het “beneficial ownership” vereiste is niet alleen gericht op de betekenis van het concept, maar juist ook op zijn rol in het verdrag. Het is nog steeds niet duidelijk wat moet worden verstaan onder het onderworpenheidsvereiste (“liable to tax” vereiste) in de definitie van inwonerschap. De problemen ontstaan veelal doordat in de aanvang van het modelverdrag wordt bepaald dat het van toepassing is op personen, terwijl de toewijzingsartikelen vervolgens geschreven zijn alsof ze van toepassing zijn op inkomen ongeacht de persoon die het inkomen verwerft. Het is niet altijd zonder meer duidelijk wie met betrekking tot een bepaalde inkomensbetaling de persoon is die aanspraak kan maken op de verdragsvoordelen. Zelfs de verwijzing naar personen in het openingsartikel van het modelverdrag voldoet niet in alle omstandigheden, omdat een persoon zich in meerdere belastbare hoedanigheden kan manifesteren.

De oplossingen die voor deze problemen zijn gevonden of voorgesteld bestaan veelal uit het toevoegen van nieuwe bepalingen in de verdragen of het opnemen van een specifieke interpretatie van de bestaande bepalingen. Deze oplossingen nemen de huidige systematiek van het OESO-modelverdrag tot uitgangspunt. Oplossingen die berusten op het huidige OESO-modelverdrag zullen echter nooit helemaal bevredigend zijn, omdat de problemen hun oorzaak vinden in een fundamentele weeffout in het huidige model. Twee basisvoorwaarden voor de verdragsgerechtigdheid sluiten namelijk niet goed op elkaar aan. Alleen door deze weeffout te adres-

1113. Met dank aan Wim Wijnen voor alle moeite die hij heeft gedaan om van de originele vertaling mooi en correct Nederlands te maken.

seren kan een coherente route worden uitgezet voor gerechtigdheid tot de verdragsvoordelen.

Het fundamentele gebrek aan samenhang in het huidige OESO-modelverdrag is dat de definitie van inwonerschap is gebaseerd op de algemene belastingplicht van een persoon, terwijl de toewijzingsartikelen zijn gebaseerd op enige vorm van eigendom van het inkomen van de persoon. Het probleem is dat het eigendom van inkomen niet noodzakelijkerwijs samenvalt met de belastbaarheid van dat inkomen. Eigendom en belastbaarheid kunnen uiteenlopen, bijvoorbeeld in een fiscaal regime dat de vennootschapswinst van een dochtervennootschap bij de moeder belast, of door antimisbruikbepalingen die inkomen belasten bij een persoon die slechts op afstand in relatie staat tot het inkomen.

In het huidige OESO-modelverdrag vallen deze twee voorwaarden, t.w. de algemene belastingplicht en het eigendom van het inkomen, samen in de persoon die gerechtigd is tot de verdragsvoordelen; deze persoon is het scharnier waar het verdrag op draait. Het is daarom van groot belang om tot een juiste identificatie van deze persoon te komen. Bij de interpretatie van het verdrag ontstaat spanning indien de algemene belastingplicht van de persoon en het eigendom van het inkomen grootheden zijn die los van elkaar staan.

De hoofdstelling van dit proefschrift is dat deze allesoverheersende aandacht op de persoon misplaatst is. Het wezenlijke element dat recht geeft op verdragsvoordelen zou veeleer de onderworpenheid van het betreffende inkomensbestanddeel aan belasting moeten zijn. Het is dit element dat in de titel van dit proefschrift wordt aangeduid als de ontbrekende sluitsteen, aangezien daaraan in het huidige OESO-modelverdrag geen aandacht wordt besteed.

Indien alle staten dezelfde opvatting zouden hebben over de toewijzing van inkomen aan een persoon voor verdragsdoeleinden, zou er misschien een minder vergaande oplossing kunnen worden gevonden dan de herijking van het OESO-modelverdrag zoals hier wordt voorgesteld. Een dergelijke overeenstemming ontbreekt echter. Dit komt duidelijk naar voren in het onderzoek dat in Appendix II is opgenomen. Dit onderzoek omvat te dezer zake een uitgebreide analyse en een vergelijking van het nationale recht van Nederland en het Verenigd Koninkrijk.

Zelfs dit onderzoek, dat tot slechts twee landen is beperkt, legt al een breed scala aan verschillen bloot, zowel in de manier waarop inkomen aan een

persoon wordt toegewezen als met betrekking tot de achterliggende filosofieën. De algemene beginselen zijn in beide landen vergelijkbaar en voorspelbaar. Zo geeft de juridische gerechtigdheid tot inkomen in het algemeen een eerste aanwijzing voor de toewijzing van inkomen en vormt de persoon die een opbrengstgenererende activiteit verricht een sterke aanwijzing voor de toewijzing van het daarmee verkregen inkomen. Maar zodra deze algemene uitgangspunten aan een nader onderzoek worden onderworpen, blijkt dat de stelsels van deze landen naarmate men er gedetailleerder naar kijkt steeds verder uit elkaar gaan lopen. Dit heeft meerdere oorzaken. Zo verschilt het zakenrecht in beide landen, verschillen de beginselen die aan hun fiscale wetgeving ten grondslag liggen, loopt de reikwijdte van de antimisbruikwetgeving uiteen en vertonen ook de gebreken in hun fiscale wetgeving verschillen. Het is niet goed denkbaar dat een vergelijking van twee willekeurige andere landen substantieel minder, of minder belangrijke, verschillen zou opleveren. De jurisprudentie, die de revue passeert in het hoofddeel van dit proefschrift, laat inderdaad vergelijkbare verschillen zien tussen de landen die daarbij ter sprake komen.

Het doel van deze studie was om te onderzoeken of er materiële toewijzingsfactoren zijn te vinden die bruikbaar zijn voor de formulering van een verdragsbeginsel waardoor de toewijzingsconflicten tussen deze twee verdragslanden kunnen worden opgelost. De conclusie van deze studie is echter dat dit geen begaanbare weg is. Zoals uit de omvang van deze studie blijkt, dienen de grondbeginselen aanzienlijk te worden uitgewerkt om van praktisch nut te kunnen zijn in het nationale recht. Dit vraagstuk is, met andere woorden, veel te complex om zich te laten vangen in verdragsbeginselen van een passend niveau van abstractie.

Een betere oplossing is om de toewijzing van inkomen aan een persoon aan de verdragsstaten over te laten als onderdeel van hun nationale recht en om hun verdragen te herstructureren in de wetenschap dat staten in dit opzicht zeer uiteenlopende opvattingen kunnen hebben. Deze gedachte vormt de basis van de nieuwe benadering die in dit proefschrift wordt voorgesteld.

Anders dan in de huidige verdragsstructuur wordt in de nieuwe benadering de belastingplicht over een specifiek inkomensbestanddeel tot uitgangspunt genomen. Dit uitgangspunt strookt met de reden waarom in belastingverdragen toewijzingsartikelen zijn opgenomen, t.w. het voorkomen van dubbele belasting. Dit uitgangspunt verleent ook een meer objectief karakter aan het verdrag, omdat het zich in eerste aanleg op het inkomen richt. Toch blijft het noodzakelijk om een subjectief element te behouden en ook te kijken naar de persoon. Aangezien staten sterk uiteenlopende

visies kunnen hebben op de vraag waarom een specifiek inkomensbestanddeel bij een bepaalde persoon wordt belast, dient het verdrag aan staten geen verplichting op te leggen de toewijzing van een andere staat als basis voor gerechtigdheid tot de verdragsvoordelen klakkeloos te aanvaarden. Het verdrag dient staten toe te staan deze belastingplicht op een aantal aspecten te toetsen.

In de meerderheid van de gevallen waarin verdragsvoordelen worden geclaimd is het de bronstaat die zijn heffingsrecht moet verlagen of opgeven. De eerste toets van de bronstaat zou in deze situatie gericht moeten zijn op de belastingplicht in de woonstaat, hetgeen de bronstaat de mogelijkheid zou bieden om verdragstoepassing te weigeren, indien blijkt dat die belastingplicht onvoldoende is. De belastingplicht in de woonstaat zou als onvoldoende kunnen worden beschouwd als bijvoorbeeld het tarief extreem laag is of als degene die aanspraak maakt op verdragsvoordelen gebruik maakt van een zeer gunstig fiscaal stimuleringsregime. Het spreekt voor zich dat het verdrag in dit opzicht richtlijnen zou moeten bevatten. Het zou echter ook specifieke fiscale regimes met naam en toenaam kunnen noemen die in dit opzicht wel of niet voldoen.

De belastingplicht in de woonstaat zou ook als onvoldoende kunnen worden beschouwd, indien de belastbare grondslag van het inkomensbestanddeel waarvoor verdragsvoordelen worden geclaimd zodanig wordt uitgehouden dat er van de belastingplicht als zodanig vrijwel niets meer overblijft. Een dergelijke uitholling van de belastinggrondslag kan zich voordoen bij een specifiek inkomensbestanddeel waarvoor verdragsvoordelen worden geclaimd; dit is het klassieke voorbeeld van een doorstroomstructuur. Deze uitholling kan echter ook de hele belastbare grondslag van de vennootschap die aanspraak maakt op verdragsbescherming raken; dit is vooral de situatie waarop “limitation on benefit” bepalingen toezien. In de huidige verdragsstructuur wordt het claimen van verdragsvoordelen in doorstroomsituaties meestal bestreden op basis van het (gebrek aan) eigendom van het inkomen van de vennootschap, hoewel het probleem zich juist voordoet doordat de belastingplicht in de woonstaat berust op het juridische eigendom van het inkomen van de vennootschap. Anderzijds zijn “limitation on benefit” bepalingen er primair op gericht voor doorstroomstructuren een materieel verband te formuleren tussen de persoon en de woonstaat.

Geen van beide antwoorden is helemaal geschikt. Hoewel beide situaties berusten op kunstmatige structuren die het eigendom van inkomen daar situeren waar dat voor “treaty shopping” het beste uitkomt, is het wezenlijke probleem in beide situaties dat de woonstaat op nettobasis belasting

heft terwijl in de bronstaat aanspraak op verdragsvoordelen wordt gemaakt naar het bruto-inkomen. Anders gezegd: de belastingheffing in de beide staten sluit niet op elkaar aan. Deze tweezijdige problematiek wordt opgelost doordat de nieuwe benadering de bronstaat toestaat om te bepalen dat de belastingplicht in de woonstaat niet volstaat als basis voor de verlening van de verdragsvoordelen.

De tweede toets van de bronstaat richt zich op het verband tussen het inkomen en de persoon die aanspraak maakt op de verdragsvoordelen, zulks om te bepalen of het aanvaardbaar is om de verdragsvoordelen te verlenen aan deze persoon met betrekking tot dit inkomensbestanddeel. Hiervoor zou het verdrag wellicht een lijst met criteria moeten bevatten die een voor beide staten aanvaardbare band tussen persoon en inkomen formuleren. Hierbij kan worden gedacht aan bijvoorbeeld het geval dat het inkomen betaald wordt in verband met een door die persoon verrichte activiteit, dat de persoon het inkomen geniet of dat de persoon controle uitoefent over de besteding van het inkomen. De verdragsstaten zouden elkaar bij de vaststelling van de verdragsgerechtigdheid in dit verband een zekere discretionaire ruimte moeten laten. De vraag is hier niet of het recht van de woonstaat identiek is aan dat van de bronstaat, maar alleen of de bronstaat het verband tussen de persoon en het inkomen aanvaardbaar vindt bij de vaststelling van de belastingplicht.

Het is in verband met deze toets dat bronstaten in het bijzonder, aandacht zouden moeten besteden aan situaties in de woonstaat waarin een andere persoon aan belasting is onderworpen over een inkomensbestanddeel dan de juridische eigenaar van dat inkomen. Antimisbruikbepalingen kunnen vragen oproepen in dit verband; de vergelijkende studie in Appendix II beschrijft enige voorbeelden in zowel Nederland als het Verenigd Koninkrijk van antimisbruikwetgeving waarin inkomen wordt toegewezen aan een persoon die op nogal wat afstand staat in relatie tot het inkomen. Als een verdragspartner het onaanvaardbaar vindt om een belastingplicht te baseren op een minder directe relatie, is er geen reden om die staat te dwingen op basis daarvan verdragsvoordelen toe te kennen.

Aan de andere kant biedt het meer objectieve karakter van de nieuwe benadering de mogelijkheid om de kenmerkende factoren die de belastingplicht bepalen van twee personen samen te voegen tot één volle gerechtigdheid tot de verdragsvoordelen. Als bijvoorbeeld het nationale recht het inkomen van een dochtervennootschap belast bij de moedervennootschap, zouden voor de aanspraak op verdragsbescherming de kenmerkende factoren van de belastingplicht van de moedervennootschap kunnen worden samen-

gevoegd met de kenmerkende factoren van de dochtervennootschap. De toepassing van deze samenvoeging is het eenvoudigst, wanneer beide personen inwoner zijn van dezelfde staat. In deze studie wordt evenwel ook aandacht besteed aan situaties waarin de personen inwoner zijn van verschillende staten.

De derde toets die door de bronstaat wordt toegepast, richt zich op het verband tussen de persoon die aanspraak maakt op de verdragsvoordelen en de beweerde woonstaat van die persoon. Omdat anders dan in de huidige verdragsstructuur de belastingplicht het beginpunt is van het traject dat dient te worden afgelegd voor de vaststelling van de verdragsgerechtigdheid, richt deze toets zich rechtstreeks op de materiële woonplaatscriteria zoals bijvoorbeeld het duurzaam tehuis van een natuurlijk persoon of de uitoefening van leiding en toezicht (“management and control”) van een vennootschap. Evenals bij de tweede toets, zou er van staten moeten worden verwacht dat ze elkaar hierbij een redelijke discretionaire marge laten.

Doordat deze toets rechtstreeks aansluit bij het materiële verband tussen de persoon en de woonstaat, worden in deze nieuwe benadering de problemen vermeden, die ontstaan door het onderworpenheidsvereiste (“liable to tax” vereiste) in de huidige woonplaatsdefinitie. Veel van deze problemen ontstaan doordat deze toets, in zijn toepassing op een persoon, geen binair karakter heeft; tussen een volledig belastbare persoon en een niet-belastbare persoon bestaan vele schakeringen van grijs. Eenmaal toegepast op een specifiek inkomensbestanddeel is deze toets echter wel binair van aard; het betreffende inkomensbestanddeel is namelijk wel of niet opgenomen in de belastbare grondslag.

Tot het basisconcept van de nieuwe benadering behoort het beginsel dat geen verdragsvoordelen worden verleend aan vrijgestelde personen, zoals pensioenfondsen en charitatieve instellingen, noch ter zake van inkomen dat in de woonstaat is vrijgesteld, zoals dividenden die onder een deelnemingsvrijstelling vallen. Staten zijn volgens dit concept echter vrij om bepalingen in hun verdragen op te nemen waarin de verdragsvoordelen tot dergelijke personen en inkomensbestanddelen worden uitgebreid. Dit aspect van de nieuwe benadering heeft het voordeel dat het duidelijkheid verschaft, vooral in vergelijking met de huidige situatie, waarin de verdragsgerechtigdheid van deze personen soms van een tamelijk geforceerde interpretatie van het verdrag afhangt.

Wat de woonstaat betreft volgt de nieuwe benadering een vergelijkbare route bij het verlenen van voorkoming van dubbele belasting onder het

verdrag. Voor de woonstaat is de vraag of er een aanvaardbaar verband is tussen het inkomen en de staat waarin het inkomen aan de bron wordt belast, en in sommige gevallen of er een aanvaardbaar verband is tussen het inkomen en de persoon waarvan de belasting wordt geheven. Indien de woonstaat de vrijstellingsmethode toepast op actief inkomen, zou deze staat ook kunnen bepalen of de belasting in de bronstaat voldoende is voor aanspraak op de vrijstelling en, indien dit niet het geval is, bepalen dat in dat geval de verrekenmethode wordt toegepast.

Doordat de nieuwe benadering een logische en consistente route uitzet voor de aanspraak op verdragsvoordelen, worden gaandeweg ook een aantal andere lopende problemen opgelost. Één daarvan is de identificatie van een “persoon” voor verdragsdoeleinden. Hoewel in het proefschrift over het algemeen de verdragsgerechtigheid van “personen” aan de orde is, wordt ook aandacht besteed aan de problemen die worden veroorzaakt door personen die over meerdere belastbare hoedanigheden beschikken, zoals trustees, en ook de belastingplicht van een niet-juridische persoon, zoals een “partnership” en bepaalde gezamenlijke beleggingsfondsen. Deze problemen worden in de nieuwe benadering opgelost door de verdragsvoordelen toe te kennen aan een belastbare hoedanigheid in plaats van aan een persoon in strikt juridische zin. Dit aspect van de nieuwe benadering is een logisch gevolg van zijn uitgangspunt, t.w. de onderworpenheid aan belasting van het desbetreffende inkomensbestanddeel. De belastingplicht geeft aan om welke belastbare hoedanigheid het gaat. Het is deze belastbare hoedanigheid die aanspraak geeft op de verdragsvoordelen.

Hoewel het geen belangrijk onderdeel van de discussie vormt, biedt dit element van de nieuwe benadering ook de mogelijkheid om het probleem op te lossen dat vaste inrichtingen op zichzelf geen verdragsgerechtigde personen zijn, terwijl in bepaalde situaties het toepassen van verdragen veel logischer zou uitpakken als dat wel het geval zou zijn. Door een vaste inrichting te beschouwen als een aparte belastbare hoedanigheid van de onderneming waarvan het deel uit maakt, zou deze logischer toepassing van verdragen binnen bereik komen.

Een andere kwestie die door de nieuwe benadering wordt opgelost, is de vraag of de toewijzingsregels van een verdrag subjectief dan wel objectief zijn geïndiceerd. Met andere woorden: zijn deze regels van toepassing op het inkomen ongeacht de persoon, of zijn ze van toepassing op de persoon die dat inkomen heeft verworven? Het uitgangspunt van de nieuwe benadering is duidelijk gericht op het objectieve verband; de toegang tot het verdrag wordt bepaald door de belastbaarheid van het desbetreffende inko-

mensbestanddeel. Hieraan wordt een subjectief element toegevoegd om de aanspraak op verdragsvoordelen te onderbouwen door de toetsing van het verband tussen het inkomen en de persoon en het verband tussen de persoon en de woonstaat. De nieuwe benadering is, met andere woorden, een combinatie van objectieve en subjectieve elementen, maar anders dan in de huidige verdragsstructuur is het duidelijk welk element op welk moment een rol speelt.

Omdat in de nieuwe benadering anders dan de huidige verdragsstructuur aandacht wordt besteed aan de redenen om inkomen aan een persoon toe te wijzen, is deze in staat om een oplossing te bieden in situaties waarin staten het niet met elkaar eens zijn over de toewijzing van inkomen. De oplossing die wordt voorgesteld is een “tiebreaker” bepaling in het verdrag op te nemen waarin de diverse criteria die bepalend zijn voor de band tussen inkomen en persoon in een hiërarchische voorrangregeling zijn geformuleerd. Het proefschrift gaat uitgebreid in op de vraag hoe een dergelijke “tiebreaker” bepaling zou uitwerken in een aantal tweehoeks- en driehoekssituaties.

Ten slotte biedt de nieuwe benadering ook de mogelijkheid om in een verdrag overlappende belastingaanspraken bij heffing op bronbasis op te lossen. Doordat de belastingplicht van het desbetreffende inkomensbestanddeel bepalend is voor de toegang tot het verdrag, zou in het verdrag ook een bepaling kunnen worden opgenomen om situaties te regelen waarin beide staten op bronbasis belasten. Deze mogelijkheid is echter niet verder onderzocht, omdat het de reikwijdte van deze studie te zeer zou hebben overschreden.

Een belangrijk deel van het onderzoek is gewijd aan het toetsen van de nieuwe benadering aan de uiteenlopende situaties die zich in de jurisprudentie hebben voorgedaan. Deze benadering is ook getoetst aan de toepassing van verdragen op trusts, omdat de belastingheffing van trusts onder het nationale recht van nogal wat landen welhaast iedere uitdaging oproept die voor een theorie over gerechtigheid tot verdragsvoordelen denkbaar is. Dit deel van het onderzoek beperkt zich tot de grote common-law landen, omdat in civielrechtelijke landen de belastingheffing van trusts nog zoveel gecompliceerder is door de moeilijkheden die deze landen ondervinden bij de inpassing van de trustfiguur in hun civiele recht.

Uit deze toetsing blijkt dat de nieuwe benadering in staat is om een oplossing te bieden in al deze casusposities. Hoewel de gerechtshoven in de besproken gevallen vanuit beleidsmatig gezichtspunt meestal tot de meest

passende oplossingen zijn gekomen, hebben ze om dit resultaat te bereiken veelal hun toevlucht moeten nemen tot een tamelijk geforceerde interpretatie van het verdrag. In de nieuwe benadering worden deze problemen voorkomen, omdat de te nemen stappen voor de bepaling van de verdragsgerechtigdheid in een logische volgorde zijn geformuleerd. De nieuwe benadering laat ook ruimte aan staten om ter zake van het recht op verdragsvoordelen hun eigen beleid te bepalen. En omdat daarin de diverse elementen van de verdragsgerechtigdheid een voor een worden behandeld, worden de juiste vragen op het juiste moment gesteld.

Er blijven twee kwesties over die door de nieuwe benadering niet kunnen worden opgelost. De eerste is het eeuwige probleem van het trekken van scheidslijnen. In de context van de nieuwe benadering is de meest problematische scheidslijn waarschijnlijk het onderscheid tussen, aan de ene kant, een persoon die een inkomensbestanddeel ontvangt en die datzelfde inkomensbestanddeel vervolgens doorbetaalt aan een andere persoon en, aan de andere kant, een persoon die een inkomensbestanddeel ontvangt dat hij gebruikt om inkomen onder andere titel uit te keren aan een andere persoon. Dit onderscheid is vooral belangrijk bij de vaststelling of een persoon die juridisch gerechtigd is tot een inkomensbestanddeel daarmee een band heeft die sterk genoeg is om daarvoor verdragsvoordelen te verlenen.

De tweede kwestie die door de nieuwe benadering niet kan worden opgelost, is dat verdragen veelal bilaterale instrumenten zijn, terwijl de onderhavige verdragsvragen zich ook in driehoeksverhoudingen voordoen. Driehoeksverhoudingen komen in deze studie op verschillende plaatsen aan de orde. Voor de toepassing van de nieuwe benadering in dergelijke situaties worden weliswaar enige aanbevelingen gedaan, maar het risico blijft bestaan dat verschillen tussen de betrokken verdragen in dergelijke gevallen tot inconsistente en niet goed op elkaar afgestemde antwoorden leiden. Geen van beide problemen is echter een specifiek kenmerk van de nieuwe benadering; beide problemen vloeien voort uit het abstracte en over het algemeen bilaterale karakter van de verdragen.

De bespreking van de nieuwe benadering wordt in Appendix I afgesloten met een aanbeveling voor een herijking van het OESO-modelverdrag. Deze tekst bevat de basisbepalingen die nodig zijn om de nieuwe benadering te introduceren, en is voorzien van een kort commentaar waarin zowel de verschillen met het huidige OESO-modelverdrag als de beleidskeuzes die moeten worden gemaakt, worden aangeduid. Deze tekst volgt zoveel mogelijk het huidige OESO-modelverdrag, maar bevat desalniettemin een aantal bepalingen waarvoor geen equivalent bestaat in het huidige model.

Indien deze herijkte tekst werkelijk zou worden overgenomen, kan deze niet zonder een nadere uitwerking in praktijk en jurisprudentie. Het was echter niet de bedoeling om in dit stadium met een passende oplossing voor in de praktijk te komen. Met dit experimentele voorstel wordt slechts beoogd de aandacht te vestigen op een van de meest wezenlijke problemen van het huidige OESO-modelverdrag om op deze manier een bijdrage te leveren aan de discussie over verdragsgerechtigdheid. De herijkte tekst van het OESO-modelverdrag wordt hierbij aangeboden in de wetenschap dat het niet meer kan zijn dan een aanzet tot een verdere discussie.

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