Conduit Companies, Beneficial Ownership, and the Test of Dominion in Claims for Relief under Double Tax Treaties

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I. PREFACE AND CONTEXT

A Double taxation

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4 Sections I.A, I.B and I.D are, with minor edits, adopted from an earlier article in the series of which this present article is a part: Saurabh Jain, John Prebble and Kristina Bunting “Conduit Companies, Beneficial Ownership, and the Test of Substantive Business Activity in Claims for Relief under Double Tax Treaties” (forthcoming).
Most countries tax income on the basis of both residence and source. As a result, cross-border transactions risk being taxed twice, both in the source country and in the country of residence. This consequence is known as double taxation. One response is for states that have trading or investment relationships to enter treaties, known as “double tax treaties”, whereby the states that are parties to the treaty each agree to restrict their substantive tax law to ensure that income is not taxed twice. Double tax treaties are also known as “double tax conventions” or “agreements”. Most double tax agreements hew broadly to the form of the model tax convention on income and on capital promulgated by the Organisation for Economic Cooperation and Development, known as the OECD Model Convention. This model, and most treaties, contain articles that address the taxation of dividends, interest and royalties, collectively known as “passive income”.

Where passive income flows from a source in one treaty partner to a resident of another treaty partner double tax treaties usually partially or fully exempt the income from withholding tax imposed by the state of source. For example, subject to Articles 10(3) and 10(4), Article 10(2) of the Convention between New Zealand and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1982 (Convention between New Zealand and the United States of America) updated by protocols in 1983 and 2010.

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

An example is the Convention between New Zealand and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1982 (Convention between New Zealand and the United States of America) updated by protocols in 1983 and 2010.


For example, Articles 10, 11 and 12 of the Convention between New Zealand and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1982 address the taxation of dividends, interest and royalties respectively.
States of America limits the tax that contracting states may levy on dividends paid by companies that are resident within their jurisdiction where the dividends are beneficially owned by residents of the other contracting state. The intention of the contracting states is that only their own residents will obtain treaty benefits. Sometimes, residents of a non-contracting state try to obtain the benefits of a tax treaty by interposing a company in a contracting state, a company that subsequently forwards passive income to the residents of the non-contracting state. This scheme subverts the intention of the contracting states to confine benefits to their own residents. Companies interposed in this manner are sometimes called “conduit companies”. Conduit company cases usually turn on whether the company in question should be characterised as the beneficial owner of passive income that it receives, or as a conduit that merely forwards passive income to persons who are not residents of one of the states that are parties to the treaty in question.

B Conduit companies, beneficial ownership and corporate personality

Conduit companies are able to obtain treaty benefits by dint of two factors. First, people establishing companies destined to serve as conduit companies contrive to ensure that the conduit qualifies as resident in the jurisdiction of a treaty partner pursuant to the residence rules of the treaty partner. Ordinarily, this objective can be achieved by incorporating the company in the state in question. Take, for instance, the Mauritius Income Tax Act 1995. Section 73 of that Act provides that a company that is “resident” in

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Mauritius means a company incorporated in Mauritius. The second factor is that as far as companies are concerned treaties operate on a formal, legalistic basis rather than on a substantive basis.\textsuperscript{10}

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

The OECD Model Convention, and treaties that are drafted in accordance with it, attempt to frustrate this strategy by anti-avoidance rules that limit relevant treaty benefits to a resident who derives income as the “beneficial owner”\textsuperscript{11} of that income. Treaties sometimes use terms such as “beneficially entitled”,\textsuperscript{12} and “beneficially owned”\textsuperscript{13} in order to achieve the same result. Thus, Articles 10(2), 11(2) and 12(2) of the Model Convention respectively limit treaty benefits to a recipient who is the “beneficial owner” of the dividends, interest, or royalties in question. As the following paragraphs of this article will argue, the problem is that, as a matter of linguistic logic, of company law, and of economic

\textsuperscript{10} See OECD Committee on Fiscal Affairs “Commentary on Article 1 concerning the Persons Covered by the Convention” in OECD Committee on Fiscal Affairs Model Tax Convention on Income and on Capital (OECD, Paris, 2010) 100 at para 1 “Under the laws of the OECD member countries, such joint stock companies are legal entities with a separate juridical personality distinct from all their shareholders.”

\textsuperscript{11} For example Convention for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, the Netherlands–Indonesia (29 January 2002, entered into force 30 December 2003), art 10(2).

\textsuperscript{12} For example Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Canada–Australia (21 May 1980), art 10(1).

\textsuperscript{13} For example Convention for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, the United Kingdom–the Netherlands (7 November 1980), art 10(1).
analysis, the expression “beneficial owner” is not capable of fulfilling the anti-avoidance role that treaties assign to it.

From an economic perspective, companies are not capable of owning income beneficially. The object of a company is to make profits for the benefit of its shareholders. It is merely a vehicle through which shareholders derive income. As Thuronyi has pointed out, in substance a company is no more capable of beneficially owning anything than it is capable of having a blood group.\(^\text{14}\) Thus, a conduit company is not beneficially entitled to treaty benefits. Rather, it is the shareholders, residents of a non-contracting state, who substantially enjoy the benefit of passive income. It follows that in order to ensure that a resident of a contracting state who claims treaty benefits is entitled to those benefits in substance, double tax agreements should be interpreted in a substantive economic sense.

Nevertheless, the traditional and formal legal view is that companies have separate legal personality, and are therefore not only the legal but also the beneficial owners of their income. The observations of Justice Pitney in the case of *Eisner v Macomber*\(^\text{15}\) reflect this view. Although *Eisner v Macomber* did not concern the issue of companies’ beneficial ownership of assets, Justice Pitney observed that companies hold both legal and beneficial title to their assets:\(^\text{16}\)

\[
\text{… [T]he interest of the stockholder is a capital interest,} \\
\text{and his certificates of stock are but the evidence of it …} \\
\text{Short of liquidation, or until dividend declared, he has}
\]

\(^\text{15}\) *Eisner v Macomber* 252 US 189 (1920) at 193.
\(^\text{16}\) At 206, emphasis added.
no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole.

The Commentary on the OECD Model Convention followed this approach. The Commentary explains that double tax agreements recognise the legal personality of companies.\(^\text{17}\) From the perspective of legal analysis and of the meaning of the word “ownership”, it follows that legally speaking conduit companies are the beneficial owners of income that they derive and are entitled to treaty benefits.

**C Definition of “conduit”**

Bearing in mind the matters discussed in I.B, above, it is convenient at this point to explain more precisely how this article uses the term “conduit”. The authors use “conduit” to refer to an entity that has three characteristics. First, a conduit is an entity that is an intermediary between a source of income and the destination of that income. Secondly, this intermediary acts in its own right as the legal owner of the income that it receives and that it passes on. Nevertheless, the fact that the intermediate entity owns income from a legal perspective begs the question of whether it owns the income beneficially in the sense that “beneficially” is used in double tax treaties. This question goes to the core of the issues addressed in this article. The third characteristic of a conduit is perhaps more correctly described as a conclusion, namely that, on the facts of the

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\(^{17}\) OECD Committee on Fiscal Affairs “Commentary on Article 1 concerning the Persons Covered by the Convention” in OECD Committee on Fiscal Affairs *Model Tax Convention on Income and on Capital* (OECD, Paris, 2010).
case, when the role of the intermediary in question is taken into account, the intermediary should be denied treaty benefits according to the policy of double tax treaties because it does not satisfy the requirement of being the beneficial owner of the income at issue.

Having defined what they mean by “conduit”, the authors should also explain what they do not mean by the term. A conduit is not a nominee or agent. As will be explained in section II.D, the reason is that persons acting as nominees and agents do not own the income that they receive. They are therefore obliged in property law to pass that income on to principals. In contrast, because a conduit is the legal owner of the income that it receives, a conduit is not obliged in property law to pass the income on (although it may be obliged to do so by contract).

D Surrogate tests of beneficial ownership

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

This article, the second in a series, focuses on the surrogate test of dominion. An earlier article, the first in the series, concerns the substantive business activity test.¹⁸

II. INTRODUCTION

A The test of dominion in conduit company cases

As explained in section I.D, the test of dominion is a surrogate form of reasoning that courts have used to apply the beneficial ownership test in conduit company cases. The word “dominion” is not a term of art. This article uses the word “dominion” to represent an incident that exhibits ownership. Salmond describes rights and liberties that belong to this incident of ownership as follows:¹⁹

[T]he owner normally has the right to use and enjoy the thing owned: the right to manage it, i.e., the right to decide how it shall be used; and the right to the income from it. …, these rights are in fact liberties: the owner has a liberty to use it, in contrast with others who are under a duty not to use or interfere with it.

That is, in essence “dominion” is a property right.²⁰

The OECD report on double tax conventions and conduit companies²¹ uses the absence of dominion over

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²¹ OECD Committee on Fiscal Affairs “Double Taxation Conventions and the Use of Conduit Companies” in OECD Committee on Fiscal Affairs International Tax Avoidance and Evasion: Four Related
passive income that it receives as a criterion for determining that a recipient company is not the beneficial owner of the income in question. The report adopts the dominion test from cases in which a tax authority argues that a recipient company acts in the capacity of a nominee or agent. As will be explained in section II.D, a reason for the report to adopt this approach is a reference in the report to the official commentary on Articles 10, 11 and 12 of the OECD Model Convention of 1977, which presented a nominee or agent as an example of a conduit. The role of a nominee or agent is to pass income on to a principal. One result of this arrangement is that the nominee or agent does not have dominion over the income that it passes on. For this reason, the OECD model convention regards a nominee or agent as not being the beneficial owner of income that it must pass on to the owner.

It does not make sense, however, to decide conduit company cases on the basis of the criterion of dominion. This is because companies are, by definition, the owners of their income. A nominee or agent is under an obligation in property law to pass income on to a principal, whereas a conduit company may pass passive income on to a third party because of a contractual obligation. It can also occur that the terms of a particular structure are such that a company passes passive income on without a contractual obligation to do so. For instance, a conduit company may distribute passive income that it receives to shareholders as dividends, or the conduit company may deal with the


income in some other manner that eventually benefits residents of another jurisdiction.

This article argues that the official commentary’s use of a nominee or agent as an example of a conduit is misleading. The use of a nominee or agent as an example of a conduit implies that the absence of dominion is a defining characteristic of conduit companies. As will be explained in section IV.A, this factor has been turned around and interpreted to mean that the presence of dominion justifies considering a recipient of passive income to be the beneficial owner of that income and not a mere conduit. But it is a mistake to assume that the presence of dominion is conclusive for solving conduit company cases. Instead, the focus in conduit company cases should be on whether the arrangement at issue is consistent with the object and purpose of the relevant double tax agreement.

B Paragraph 14(b) of the Conduit Companies Report

Paragraph 14(b) of the OECD’s Conduit Companies Report discusses the application of the beneficial ownership test to conduit companies under Articles 10(2), 11(2) and 12(1) of the OECD Model Convention. It states:

Articles 10 to 12 of the OECD Model deny the limitation of tax in the State of source on dividends, interest and royalties if the conduit company is not its “beneficial owner”. Thus the limitation is not available when, economically, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the

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24 Ibid.
income … . The Commentaries mention the case of a nominee or agent. The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has a similar function to those of a nominee or an agent. Thus a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company). In practice, however, it will usually be difficult for the country of source to show that the conduit company is not the beneficial owner. The fact that its main function is to hold assets or rights is not itself sufficient to categorise it as mere intermediary, although this may indicate that further examination is necessary.

The significance of this paragraph is evident from the fact that the official commentary on Articles 10, 11 and 12 of the OECD Model Convention has incorporated this drafting since the Model Convention was amended in 2003.  

Further, when applying the dominion test in conduit company cases as a surrogate test for the test of beneficial ownership, some courts have relied on this paragraph. 

For this reason, it is necessary to begin with an analysis of the paragraph.

C Conceptual and linguistic confusions

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26 For example Prévost Car Inc v Her Majesty the Queen (2008) TCC 231.
The paragraph is based on an illogical assumption. It assumes that the notion of beneficial ownership is capable of being applied as a test to determine whether a company is acting as a conduit company. The report states:27

… a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company).

The use of the word “normally” leaves open the possibility that a conduit company could be regarded as the beneficial owner of the passive income that it receives. That is, the report assumes that in at least some circumstances conduit companies can be considered to be the beneficial owners of passive income.

As explained in section I.B, from a substantive economic point of view a company that acts as a conduit cannot be considered to be the beneficial owner of income. Further, in the first sentence of paragraph 14(b), the phrase “if the conduit company is not its “beneficial owner””28 creates a linguistic confusion. The phrase implies that a conduit company is different from a company that is not the beneficial owner of its income.

Paragraph 14(b) seems to use the term “conduit company” to mean a company that receives passive income but that does not operate as a nominee or agent.


Because it does not necessarily follow that a company in this position always operates as a mere conduit, the present authors use the term “recipient company” to refer to such a company in order to avoid confusion.

D  “Narrow powers”: the absence of dominion

The problem with paragraph 14(b) is its reference to the official commentary on Articles 10, 11 and 12 of the OECD Model Convention of 1977. The official commentary used a nominee or agent as an example of a conduit company. The official commentary on Articles 10 and 11 stated:29

Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State.

The official commentary on Article 12 was similar:30

Under paragraph 1, the exemption from tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State.

In 2003, the official commentary on Articles 10, 11 and 12 was amended to include:31

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Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence.

In 2003, the amended commentary clarified the point that because nominees or agents by definition do not own income, no potential double taxation arises. For this reason, it is not necessary to ask the question whether a nominee or agent is the beneficial owner of passive income. They are clearly not.

This amendment is not a significant improvement. The clarification as to whether a nominee or agent can qualify for treaty benefits, while helpful, is not necessary. The commentary as it stood in 1977 did not imply that nominees and agents could be the beneficial owners of income and so qualify for treaty benefits in any circumstances. The problem with the commentary as it stood in 1977 was that the commentary implied that a nominee or agent was an example of a conduit. Neither the 2003 amendment nor any amendments that followed addressed this problem and the official commentary as it

Fiscal Affairs “Commentary on Article 11 concerning the Taxation of Interest” (OECD, Paris, 2003) in OECD Committee on Fiscal Affairs Model Tax Convention on Income and on Capital (OECD, Paris, 2003) 162 at para 8.1. OECD Committee on Fiscal Affairs “Commentary on Article 12 concerning the Taxation of Royalties” (OECD, Paris, 2003) in OECD Committee on Fiscal Affairs Model Tax Convention on Income and on Capital (OECD, Paris, 2003) 173 at para 4.1; The commentary was amended again in 2008 and 2010. However, these amendments made no material changes to the commentary that are relevant to the purposes of this article.
stands in 2013 still implies that a nominee or agent is an example of a conduit. It is this implication that misled the writers of paragraph 14(b) of the Conduit Companies Report.

Paragraph 14(b) notes that the official commentary as it stood in 1977 used a nominee or agent as an example of a conduit company.

An agent passes income on to his or her principal that belongs to the principal, which the agent received for the principal’s use. Similarly, a nominee passes income on to his or her mandator. For this reason, a nominee or agent does not qualify as the beneficial owner of income that is received on behalf of a principal or mandator.

Agents and nominees pass income on to the person on whose behalf they work because property rights to the income are vested in that person. Agents and nominees do not, therefore, have the freedom to decide how to use the income. That is, they lack dominion over the income. For this reason, in order to determine whether a relationship between two parties is an agency relationship, courts occasionally consider the question of whether the alleged agent has dominion over its business and over the income that is derived from the business. In such cases courts have referred to the criterion of dominion as “control”.


34 For example South Sydney District Rugby League Football Club Ltd v News Ltd and Others (2000) 177 ALR 611 and Royal Securities Corp
Just as agents and nominees pass income on to a principal or mandator, so too do conduit companies pass income on to a resident of a third state. This apparent similarity could be why paragraph 14(b) draws an analogy between the function of a conduit company and the role of a nominee or agent. The paragraph regards a conduit as a person who “enters into contracts or takes over obligations under which he has a similar function to those of a nominee or agent”. By employing this analogy, the Conduit Companies Report transposes the dominion test from cases concerning agents or nominees to cases concerning conduit companies. The reader infers that the phrase “narrow powers” in paragraph 14(b) means the absence of the freedom to decide how to use income. That is, in using the phrase “narrow powers” paragraph 14(b) refers to the absence of the power that this article calls “dominion”. To put the matter positively, paragraph 14(b) (perhaps unconsciously) invokes the concept of dominion as a test of whether a company acts as a mere conduit.

It is illogical, however, to transpose the dominion test from cases concerning nominees or agents to conduit company cases in general simply because both conduit companies and nominees or agents pass income on to third parties. Reasons for conduit companies to pass income on differ from the reason for which nominees or agents pass income on. While nominees and agents are obliged in property law to pass income on to the person on whose behalf they work, conduit companies are under no

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obligation in property law to pass passive income on to a third party. A conduit company may be under a contractual obligation to do so; however, in such a case contract law, not property law, creates the obligation. The following sections discuss and contrast obligations to pass on passive income in property law and in contract law.

III. THE ABSENCE OF AN OBLIGATION TO PASS ON PASSIVE INCOME IN PROPERTY LAW OR CONTRACT LAW IS INCONCLUSIVE

A The obligation to pass on passive income in property law

As indicated in section II.D, in cases where a nominee or agent receives property the owner of the property is the person to whom the nominee or agent is responsible. For this reason, in property law a nominee or agent must pass passive income on to the person on whose behalf the nominee or agent receives it.\(^{36}\)

By contrast, in cases where the recipient of passive income is alleged to act as a conduit the passive income originates as the property of the recipient company. That is, where the recipient company passes the income on to the resident of a third state the recipient transacts as owner of the income. Thus, property law does not require a recipient company that acts as owner and not as a nominee or agent to pass passive income on to the resident of a third state or to anyone else. This is so even if the recipient company has been interposed as a conduit company. For example, taxpayers often build conduit structures by interposing a subsidiary as an immediate recipient of

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passive income. In such cases the subsidiary passes passive income on in the form of dividends to its shareholders, but it is not required to do so by property law. Similar considerations obtain where the interposed company acts as a borrower and then as a lender, paying and receiving interest in respect of back-to-back loans.\textsuperscript{37}

The very essence of company law is that companies are independent and able to control their property. It follows that conduit companies are, by definition, the owners of passive income that they receive. That is, conduit companies have dominion over the passive income that they receive, simply by virtue of being corporations.

It is therefore illogical to apply the dominion test to determine beneficial ownership of passive income. If conduit company cases are decided by the criterion of dominion, a recipient company will always qualify for treaty benefits, regardless of whether the tax planning arrangement at issue is consistent with the object and purpose of the double tax agreement in question. The opinion of the Government Commissioner, M François Séners, in Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland \textsuperscript{38} supports this argument.

\textbf{B The Bank of Scotland Case}\textsuperscript{39}

\begin{itemize}
  \item \textsuperscript{37} See, for example, Northern Indiana Public Service Company v Commissioner of Internal Revenue 105 TC 341 (1995). Northern Indiana Public Service Company v Commissioner of Internal Revenue 115 F 3d 506 (7th Cir 1997).
  \item \textsuperscript{38} Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland (2006) 9 ITLR 683.
  \item \textsuperscript{39} The facts of this case are recounted in the first article of this series, Saurabh Jain, John Prebble and Kristina Bunting “Conduit Companies, Beneficial Ownership, and the Test of Substantive Business Activity in Claims for Relief under Double Tax Treaties” (forthcoming), and have been reproduced here with minor changes.
\end{itemize}
In the *Bank of Scotland* case, Pharmaceuticals Inc, a resident of the United States, held all the shares in Marion SA, a French company. In 1992 Pharmaceuticals Inc entered into a three-year usufruct contract with the Bank of Scotland, a company resident in the United Kingdom, under which the bank acquired dividend coupons attached to some shares of Marion SA. The Bank of Scotland acquired the usufruct in consideration for a single payment to Pharmaceuticals Inc. Under the contract, the bank was entitled to receive a predetermined dividend from Marion SA in each of the three years of the usufruct. Pharmaceuticals Inc guaranteed the payment of dividends.

By French law, dividends that Marion SA paid to foreign recipients were subject to a 25 per cent withholding tax. Article 9(6)\(^{40}\) of the France-United Kingdom double tax treaty of 22 May 1968 reduced French withholding tax to 15 per cent on dividends distributed to a company resident in the United Kingdom. The France-United States double tax treaty of 28 July 1967 contained a similar provision. But Article 9(7)\(^{41}\) of

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\(^{40}\) Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, France–the United Kingdom (22 May 1968, entered into force 27 October 1969), art 9(6). It provided: “Dividends paid by a company which is a resident of France to a resident of the United Kingdom may be taxed in the United Kingdom. Such dividends may also be taxed in France but where such dividends are beneficially owned by a resident of the United Kingdom the tax so charged shall not exceed:

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

(b) in all other cases 15 per cent of the gross amount of the dividends.”

\(^{41}\) The Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, France–the United Kingdom (22 May 1968, entered into force 27 October 1969), art 9(7). The relevant part of Article 9(7) provided “A resident of the United Kingdom who receives from a company which is a resident of France dividends which, if received by a resident of France, would entitle such resident to a fiscal credit (avoir fiscal), shall be entitled to a payment from the French Treasury equal to such
the France-United Kingdom treaty also provided for a refund of the *avoir fiscal* after the deduction of withholding tax.\(^{42}\)

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

If Pharmaceuticals Inc had received dividends directly from Marion SA it would have paid 15 per cent French withholding tax under the France-United States double tax treaty but would not have qualified for a refund of the *avoir fiscal*\(^{43}\).

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\(^{42}\) The previous footnote explains the operation of *avoir fiscal*.

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

Figure III.1: The Bank of Scotland case
The French tax administration denied the request on the grounds that the Bank of Scotland was not the beneficial owner of the dividends. The French tax administration characterised the transactions as a loan made by the bank to Pharmaceuticals Inc which was repaid by the dividends from Marion SA. The case went to the Supreme Administrative Court, which ruled in favour of the French tax administration. Section III.C of this article explains and analyses the reasoning of the court.

C Bank of Scotland: the absence of an obligation in property law is inconclusive

The court was advised by the Government Commissioner, who agreed with the tax administration. He analysed several definitions of the term “beneficial owner”, all of which excluded nominees or agents, or a person who received income for the account of another person, from the description of a beneficial owner. He concluded:\footnote{Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland (2006) 9 ITLR 683 at 711-712 (emphasis added).}

The doctrinal analyses are united [in] the fact that the direct recipient of income is not entitled to obtain the advantages granted by international tax treaties if he is not the ultimate recipient of this income and if he has only received it in the status of intermediary for another person to whom the income is destined to be transferred in one form or another.

This analysis does not completely resolve the question in the present case which is more complex since, as the Bank of Scotland contends, it has truly received, for its own account and as the ultimate recipient, the dividends distributed by [Marion SA]. This could lead you to conclude that despite the triangular arrangement operated with the companies in the … group, [the Bank of Scotland] was the beneficial owner of the dividends paid. The fact that [the bank] could be regarded in this...
matter as a lender with respect to [Pharmaceuticals Inc] did not however prevent the latter from freeing itself from this debt by the grant of a real right that it held with regard to [Marion SA].

I think nevertheless that this case reveals that the notion of beneficial ownership cannot be reduced to cases of transfer of intended benefits and that, by its nature, it encompasses situations of fraud on the law …

If you are with me on this conceptual territory, it remains only to judge whether, in this particular case, there was an abusive arrangement …

The observation that “the notion of beneficial ownership … by its nature … encompasses situations of fraud on the law” shows that the Government Commissioner regarded the beneficial ownership test as an anti-avoidance test, and not a test of ownership. He applied the beneficial ownership test in the manner of the general anti-avoidance doctrine of abuse of law, which is essentially the approach of the predication test in another guise.

The “predication test” refers to the approach adopted by Lord Denning in L.J. Newton v Federal Commissioner of Taxation. The Newton case concerned the interpretation and application of section 260 of the Income Tax and Social Services Contribution Assessment Act 1936-1950, which was the former Australian general anti-avoidance rule. Although the case dealt with a domestic

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46 The Income Tax and Social Services Contribution Assessment Act 1936-1950 (Australia), s 260. The relevant part of s. 260 provided:

“Every contract, agreement, or arrangement made or entered into, orally or in writing …, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—(a) altering the incidence of any income tax; (b) relieving any person from liability to pay income tax or make any return; (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or (d) preventing the operation of this Act in any respect, be absolutely void ….”
dividend stripping scheme the reasoning of the court is relevant in the present context. Lord Denning did not concretise the law by basing his decision on the absence or presence of a specific criterion. He examined overt acts of the parties in order to predicate whether the arrangement at issue was consistent with the overall purpose of the Act. That is, he examined whether the arrangement resulted in tax avoidance.47

In the Bank of Scotland case, adopting a method similar to that of Lord Denning, the Government Commissioner generalised the application of the beneficial ownership test. Thus, he did not concretise the law by basing his decision on the presence or absence of a specific criterion, in this case that of dominion. His analysis shows that he regarded the presence of dominion as an insufficient basis on which to determine whether the Bank of Scotland was the beneficial owner. His opinion, essentially, was that although the bank had dominion over the dividends, the arrangement as a whole was inconsistent with the object and purpose of the France-United Kingdom double tax treaty. Accordingly, he advised the court to apply the abuse of law doctrine.

The Supreme Administrative Court followed this approach. The court accorded no significance to the presence of dominion. It examined the arrangement and found that the usufruct contract concealed a loan agreement between the bank and Pharmaceuticals Inc. On analysis of the usufruct agreement, the court concluded that the beneficial owner of the dividend payments was Pharmaceuticals Inc, and that Pharmaceuticals Inc

47 A full analysis of Lord Denning’s reasoning in the Newton case will appear in a later article in this series of articles. This later article will also discuss the parallel between the predication test and the beneficial ownership test as it should be interpreted for the purposes of double tax treaties.
delegated the repayment of the loan to Marion SA. It was therefore evident that the usufruct agreement was motivated solely by the purpose of reducing tax, with the aim of benefiting from the reimbursement of the *avoir fiscal* tax credit available under the France-United Kingdom double tax agreement.\(^{48}\) Thus, the court based its decision on the substance of the usufruct agreement.

The *Bank of Scotland* case illustrates that a recipient company may act as a conduit notwithstanding that it has dominion over passive income that it receives. The focus in conduit company cases should, therefore, be on whether the arrangement is consistent with the object and purpose of the double tax agreement.

\(D\) **Obligation to pass on passive income in contract law**

A recipient company that has dominion over the passive income that it receives and is therefore under no obligation in property law to pass that income on to a third party may nonetheless be bound by contract to do so. As discussed in section II.D, paragraph 14(b) of the Conduit Companies Report describes such a company as having narrow powers in respect of the passive income that it receives, meaning that the recipient company does not have freedom to decide how to use that income.

The existence of only narrow powers, however, is in such a case the result of a contractual obligation and not the result of an obligation in property law. The recipient company still has dominion over the passive income that it receives, and it can choose not to pass that income on to a third party. Choosing not to pass the income on may breach the recipient company’s contractual obligations,

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but this situation will be governed by contract law rather than by property law.

The absence of an obligation in contract law to pass passive income on is, like the absence of an obligation in property law, inconclusive when determining whether a recipient company acts as a conduit. The absence of a contractual obligation does not answer the question of whether the arrangement is consistent with the object and purpose of the double tax treaty.

The Bank of Scotland case, discussed in section III.C, demonstrates this point. Not only did the recipient company, the Bank of Scotland, have no obligation in property law to pass the passive income that it received on to Pharmaceuticals Inc, the bank also had no contractual obligation to do so. The bank contended, and the Government Commissioner agreed, that the bank received the dividends at issue for its own account and as the ultimate recipient. The reason was that the bank had legally paid for the dividends by the lump sum that it transferred to Pharmaceuticals Inc at the start of the scheme. In substance, as the court held, this payment was a loan that the dividends steadily repaid, serving as both principal and interest. This fact did not, however, prevent the court from finding that Pharmaceuticals Inc, and not the Bank of Scotland, was the beneficial owner of the dividends.

While the absence of a contractual obligation to pass passive income on does not show that a recipient company is the beneficial owner of that income, the converse may be true. That is, the presence of such a contractual obligation suggests that a recipient company is not the

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beneficial owner of passive income that it receives. This is because the presence of such a contractual obligation is strong evidence that the impugned arrangement is not consistent with the object and purpose of the treaty in question. In other words, a contractual obligation on a recipient company to pass passive income that it receives on to a third party suggests that treaty benefits are being enjoyed by residents of non-contracting states.

This point is illustrated by the next two cases to be discussed, Aiken Industries Inc v Commissioner of Internal Revenue\textsuperscript{50} and Indofood International Finance Ltd v JP Morgan Chase Bank NA, London Branch.\textsuperscript{51}

\textit{E \ The Aiken Industries case}

Ecuadorean Corp Ltd, a resident of the Bahamas, wholly owned Aiken Industries, a United States resident corporation. Aiken Industries took over the ownership, as well as the relevant rights and obligations, of Mechanical Products Inc, another United States resident corporation. Mechanical Inc was initially a principal in the disputed transaction. Aiken Industries assumed Mechanical Inc’s role as a consequence of its takeover of Mechanical. Ecuadorean Ltd also held all the shares of CCN, a resident of Ecuador. CCN wholly owned Industrias, a Honduran corporation.

\textsuperscript{50} Aiken Industries Inc v Commissioner of Internal Revenue 56 TC 925 (1971).

Ecuadorian Ltd made a loan to Mechanical Inc in return for a promissory note. The transaction numbers 1 and 2 on the diagram of the case indicate this loan and promissory note. As there was no double tax treaty between the United States and the Bahamas, Mechanical Inc would have had to deduct United States withholding tax on interest payments to Ecuadorian Ltd. At this point, it seems that someone advising Mechanical Inc saw the shortcomings of the structure from a tax point of view. One possibility might have been to unwind the loan and promissory note and to start again, planning to take advantage of a convenient treaty. Instead, the parties modified the structure, using the existing promissory note. Ecuadorian Ltd interposed Industrias, a Honduran
company. Ecuadorian transferred Mechanical Inc’s promissory note to Industrias in consideration for a debt from Industrias to Ecuadorian Ltd. The result was that (ignoring the transactions numbered 1 and 2) Industrias borrowed from Ecuadorian Ltd and lent to Mechanical Inc by a back-to-back loan. Thus, the interest flowed from the United States to the Bahamas through Honduras.

The transaction was designed to take advantage of a United States withholding tax exemption under Article IX of the United States-Honduras double tax treaty of 26 June 1956. Accordingly, Mechanical Inc did not withhold tax from the interest payments. The Commissioner of Internal Revenue determined deficiencies in withholding tax.

The Commissioner submitted to the United States Tax Court that, for tax purposes, the existence of Industrias as a corporation should be disregarded because Ecuadorian Ltd was the true owner and the recipient of the interest paid by Mechanical Inc. Aiken Industries responded that Industrias could not be disregarded because it complied with the definition of a corporation under Article II of the treaty. Aiken Industries contended that Industrias received the income as a “Honduran enterprise” and that therefore the interest payments should be exempt from withholding tax under the treaty.

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53 Convention for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, the United States–Honduras (25 June 1956, entered into force 6 February 1957), Article II. Article II(g) stated: The term “Honduran enterprise” means an industrial or commercial or agricultural enterprise or undertaking carried on by a resident of Honduras (including an individual in his individual capacity or as a member of a partnership) or a fiduciary of Honduras or by a Honduran corporation or other entity; the term “Honduran corporation or other entity” means a corporation or other entity formed or organized in Honduras or under the laws of Honduras.
The United States Tax Court held that “Industrias had no actual beneficial interest in the interest payments it received”. 54 At the time when the court decided the case neither Article IX of the United States-Honduras double tax treaty nor Article 11 of the OECD Model Convention used the term “beneficial owner”. The relevant part of Article IX of the United States-Honduras double tax treaty stated:55

Interest on … notes … from sources within one of the contracting States received by a resident, corporation or other entity of the other contracting State not having a permanent establishment … shall be exempt from tax by such former State.

The court interpreted the words “received by” in Article IX in accordance with the language and context of the treaty, and observed:56

As [utilised] in the context of article IX, we interpret the terms “received by” to mean interest received by a corporation of either of the contracting States as its own and not with the obligation to transmit it to another. The words “received by” refer not merely to the obtaining of physical possession on a temporary basis of funds representing interest payments from a corporation of a contracting State, but contemplate complete dominion and control over the funds.

The words “received by a resident … of the other contracting State” in the United States-Honduras double

54 Aiken Industries Inc v Commissioner of Internal Revenue 56 TC 925 (1971) at 934.

55 Convention for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, the United States–Honduras (25 June 1956, entered into force 6 February 1957), Article IX.

56 Aiken Industries Inc v Commissioner of Internal Revenue 56 TC 925 (1971) at 933 (emphasis added).
tax treaty and “paid … to a resident of a Contracting State” in the OECD Model Convention point to the same person, who is the immediate recipient of the passive income at issue. In this context, the foregoing interpretation of the United States Tax Court becomes relevant to the approach that, according to the official commentary, the term “beneficial owner” was introduced to clarify. Indeed, the foregoing observation of the court illuminates that approach. The court essentially upheld the object and purpose of the treaty to limit the treaty benefits to residents of the contracting states.

The court used the phrase “complete dominion and control”. Thus, the above observation of the court implies that in order for a recipient of passive income to qualify for a reduction of withholding tax under the treaty, that recipient should be a person who owns the passive income in question in a substantive economic sense. The court observed: 

The convention requires more than a mere exchange of paper between related corporations to come within the protection of the exemption from taxation granted by article IX of the convention, and on the record as a whole, [Aiken Industries] has failed to demonstrate that

57 See also Stef van Weeghel The Improper Use of Tax Treaties: with Particular Reference to the Netherlands and the United States (Kluwer, London, 1998) at 89.


59 Aiken Industries Inc v Commissioner of Internal Revenue 56 TC 925 (1971) at 933 (emphasis added).
In considering whether Industrias had “received” the interest payments in a substantive economic sense, the court accorded significance to Industrias’s contractual obligation to pay the interest that it received to Ecuadorian Ltd, indicating a recognition by the court that because of this contractual obligation Industrias lacked “complete dominion and control” over the interest payments. That is, Industrias had only narrow powers in respect of those payments.

The court did not end its inquiry at this point, but went on to note that the transaction occurred between related parties and resulted in equal inflows and outflows of funds to and from Industrias. There was therefore no financial benefit to Industrias for its participation in the transaction. On the basis of these facts the court observed “… we cannot find that this transaction had any valid economic or business purpose”. The court’s analysis of the facts shows that the words “this transaction” refer to the arrangement as a whole. The court held that Industrias could not be regarded as having “received” the interest within the meaning of Article IX of the United States-Honduras double tax treaty. Essentially, the court investigated whether the effect of the arrangement entailed improper use of the treaty.

The approach of the United States Tax Court implies that while the presence of a contractual obligation to pass passive income on to a third party should not be the sole basis for resolving a conduit company case, such an obligation strongly suggests that allowing the recipient

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60 Aiken Industries Inc v Commissioner of Internal Revenue 56 TC 925 (1971) at 934.
61 Ibid.
company to enjoy treaty benefits would be contrary to the object and purpose of the double tax treaty in question. This in turn leads to a conclusion that the recipient company cannot be the beneficial owner of the passive income at issue. The England and Wales Court of Appeal adopted this reasoning explicitly in *Indofood International Finance Ltd v JP Morgan Chase Bank NA, London Branch.*

G The Indofood case

In 2002 Indofood, an Indonesian corporation, planned to raise funds by issuing loan notes on the international market. If Indofood issued loan notes, however, it would have to withhold 20 per cent tax on interest payments to note holders whose country of residence did not have a double tax agreement with Indonesia.

The Indonesia-Mauritius double tax treaty of 10 December 1996 was in effect in 2002. Article 10(2) of the treaty limited Indonesian withholding tax on interest payments to 10 per cent. In order to take advantage of the treaty, Indofood incorporated a Mauritian subsidiary, which will be referred to as Finance. Finance borrowed money from the international bond market on five-year loan notes guaranteed by Indofood and on-lent the proceeds to Indofood.

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The loan notes required Indofood to pay interest to Finance. In turn, Finance was obliged to transfer the interest to JP Morgan, a bank in the United Kingdom, which acted as the trustee and principal paying agent for the note holders. The conditions allowed Finance to redeem the loan notes at par if a change in the law of Indonesia obliged Indofood to deduct more than 10 per cent withholding tax. However, Finance was required to take “reasonable measures” before redeeming the notes.64

Following the first interest payment to Finance, Indofood made all subsequent interest payments directly to JP Morgan. In 2004, Indonesia gave notice to terminate

the Indonesia-Mauritius double tax treaty. As Indofood would have had to withhold tax at 20 per cent following the termination of the treaty, it decided to redeem the loan notes.

JP Morgan contended that the loan notes required Indofood to take “reasonable measures”. It proposed that, as a reasonable measure, Indofood should incorporate a Dutch subsidiary, which will be referred to as Dutch BV, to which Finance would assign ownership of Indofood’s debt to Finance. This proposal presupposed that Dutch BV would be entitled to a reduction of Indonesian withholding tax under Article 10(2) of the Indonesia-Netherlands double tax treaty of 29 January 2002.65

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Indofood sought the advice of the Director General of Taxes in Indonesia on the issue of whether Dutch BV would be recognised under the Indonesia-Netherlands double tax treaty as the beneficial owner of the interest payments from Indofood. The Director General replied in the negative. Subsequently, he defined “beneficial owner” in a circular as follows:66

“Beneficial owner” refers to the actual owner of income such as Dividend, Interest, and or Royalty [being] either [an] individual taxpayer or business entity taxpayer that has the full privilege to directly benefit from the income.

As a result of the Director General’s advice a dispute arose between Indofood and JP Morgan as to what constituted a “reasonable measure”. The matter reached the Court of Appeal of England and Wales. In order to determine whether establishing Dutch BV was a “reasonable measure” the court investigated whether Dutch BV would be considered to be the beneficial owner of the interest payments from Indofood under the Indonesia-Netherlands double tax treaty. The court held that Indonesian law would not regard Dutch BV as the beneficial owner of the interest payments and that therefore the option of establishing Dutch BV was not a “reasonable measure”.

H Indofood: a substantive interpretation of beneficial ownership

Evaluating the facts in the light of the definition accorded to “beneficial owner” by the Director General, the court was of the opinion that “the legal, commercial and practical structure behind the loan notes” was inconsistent with the concept that Finance or Dutch BV could enjoy the full privilege to benefit directly from the income.

In reaching this conclusion, the court drew a distinction between the meaning of “beneficial owner” for formal legal purposes on the one hand, and for the purposes of double tax agreements on the other. For the purposes of double tax agreements, a substantive interpretation of “beneficial owner” was required.

Nonetheless, the court began with a formal legal analysis, examining the legal structure and finding that

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68 Ibid, at para 42.
69 Ibid, at para 44.
Finance was bound to pay the interest payments from Indofood to JP Morgan. 70 This was because the conditions of the loan notes precluded Finance from funding the money from any other source. Dutch BV would probably be bound by the same conditions. This analysis implies that the contractual obligation in this case was so strict that Finance may not have been the beneficial owner even from a purely legalistic point of view.

The court did not make this point explicitly, because it considered that such a formal legalistic approach was inappropriate in the context of double tax treaties. The court said: 71

… the meaning to be given to the phrase “beneficial owner” is plainly not to be limited by so technical and legal an approach. Regard is to be had to the substance of the matter.

For this reason, the court went on to investigate the commercial and practical structure behind the loan notes.

The court noted that, following Indofood’s first interest payment to Finance, Indofood had been paying interest directly to JP Morgan. In the court’s opinion, Indofood was bound to ensure that the payments to JP Morgan continued lest Indofood be required to pay the interest again under the guarantee to the note holders. 72 Further, in practical terms neither Finance nor Dutch BV could have used the interest payments for any purpose other than funding the liability to JP Morgan. 73

The court did not consider that the ability of Finance or Dutch BV to use the interest payments to fund the

71 Ibid at para 44.
72 Ibid.
73 Ibid.
liability to JP Morgan constituted the “full privilege” needed to qualify as the beneficial owner of the payments from Indofood.\textsuperscript{74} The court therefore equated the position of Finance and Dutch \textit{BV} to that of an “administrator of the income”.\textsuperscript{75} This conclusion was found to be consistent with the object and purpose of the Indonesian double tax agreements with Mauritius and the Netherlands.\textsuperscript{76}

The point that emerges is that the court seemed to consider that the unusually strict nature of Finance’s contractual obligation showed that the arrangement at issue was inconsistent even with the technical legal meaning of beneficial owner, and thus certainly inconsistent with the meaning of beneficial owner for treaty purposes. Nevertheless, the court chose not to base its decision on this factor alone, and examined the substance of the arrangement as a whole.

When determining whether Finance was, and Dutch \textit{BV} would be, the beneficial owner of the interest payments for the purposes of the double tax treaties the court examined the substance of the arrangement in the light of the object and purpose of the treaties.

\textit{I Official commentary: origin of the false analogy between nominees and agents and conduit companies?}

The approach of courts in the \textit{Bank of Scotland} case, the \textit{Aiken Industries} case and the \textit{Indofood} case shows that the main issue in conduit company cases is whether the contested arrangement is consistent with the object and purpose of a double tax agreement. Resolving this issue requires a substantive economic approach. The question

\begin{footnotesize}
\textsuperscript{74} \textit{Indofood International Finance Ltd v JP Morgan Chase Bank NA, London Branch} [2006] EWCA Civ 158.

\textsuperscript{75} Ibid.

\textsuperscript{76} Ibid, at para 45.
\end{footnotesize}
cannot be resolved solely on the basis of the absence of an obligation to pass passive income on to a third party, whether the obligation is in property law or in contract law.

In spite of these considerations, paragraph 14(b) of the Conduit Companies Report implies that the main issue in a conduit company case is whether a recipient company is obliged to pass on passive income, particularly under property law. If there is such an obligation, says paragraph 14(b), then the recipient company cannot be said to have dominion over the income and is therefore not the beneficial owner. But what if a recipient company is not obliged to pass on income that it receives? Paragraph 14(b) appears by implication to take it for granted that if there is no obligation to pass income on it follows that the recipient company does have dominion over the income and is therefore the beneficial owner. In short, paragraph 14(b) treats the presence or absence of dominion as a sufficient criterion for deciding the issue of beneficial ownership in conduit company cases. As explained in section II.D, a reason for paragraph 14(b) to adopt this approach appears to be the reference in the paragraph to the official commentary on Articles 10, 11 and 12 of the

77 The relevant part of paragraph 14(b) of the Conduit Companies Report, OECD Committee on Fiscal Affairs “Double Taxation Conventions and the Use of Conduit Companies” in OECD Committee on Fiscal Affairs International Tax Avoidance and Evasion: Four Related Studies, Issues in International Taxation No 1 (OECD, Paris, 1987) 87, states: “Thus a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company).” Section II.B of this article contains the full context of this passage.

78 For example, the court in Prévost Car Inc v Her Majesty the Queen (2008) TCC 231 relied on paragraph 14(b) when the court treated the presence of dominion as an indicator of beneficial ownership, see section V.B of this article.
OECD Model Convention of 1977, which presented a “nominee or agent” as an example of a conduit.

Although the official commentary misled the writers of paragraph 14(b), it did not mislead courts in Bank of Scotland, Aiken Industries and Indofood. However, there were cases in which the courts were misled by the official commentary, namely the Royal Dutch Shell case and Prévost Car Inc v Her Majesty the Queen. The following sections examine the reasoning in these cases.

IV. ROYAL DUTCH SHELL: AN EXAMPLE OF REASONING BY FALSE ANALOGY

A  The example of a “nominee or agent” as a conduit: a fallacy

Because the official commentary as it stood in 1977 used a “nominee or agent” as an example of a conduit, courts have misinterpreted the official commentary on Articles 10, 11 and 12 of the OECD Model Convention of 1977 to suggest that the presence of dominion justifies treating passive income as being held by someone who is beneficially entitled to that income for treaty purposes as well as for legal purposes. That is, courts have regarded an immediate recipient that exercises dominion over passive income as necessarily qualifying for treaty benefits. In other words, where an immediate recipient does not act as a nominee or agent, courts have considered that recipient necessarily to qualify for treaty benefits.

A decision of the Hoge Raad of 6 April 1994 known as the Royal Dutch Shell case is an example of such a misinterpretation. This case concerned the application of

79 Royal Dutch Shell (6 April 1994) Case no 28 638, BNB 1994/217 (the Hoge Raad, the Netherlands).
80 Prévost Car Inc v Her Majesty the Queen (2008) TCC 231.
Article 10(2) of the Netherlands-United Kingdom double tax treaty of 7 November 1980.\textsuperscript{81} Although the Hoge Raad did not refer to the official commentary on Article 10(2) of the \textit{OECD} Model Convention of 1977 the Attorney General, who agreed with the court, relied on it. Further, Article 10(2) of the Netherlands-United Kingdom double tax treaty was the same as Article 10(2) of the \textit{OECD} Model Convention of 1977.\textsuperscript{82} For these reasons, the case is relevant in the present context.

\textbf{B The Royal Dutch Shell case}

Luxembourg SA, a holding company resident in Luxembourg, owned some shares of Royal Dutch Shell, a Dutch corporation. Royal Dutch Shell declared dividends. Soon after the dividends were declared, but before they were made payable, X Ltd, a stockbroker company resident in the United Kingdom, bought coupons from Luxembourg SA that entitled the owner of the coupons to dividends on the shares of Royal Dutch Shell.

\textsuperscript{81} Convention for the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains, the Netherlands–the United Kingdom (07 November 1980), art 10(2).

\textsuperscript{82} “Conclusie Advocaat-Generaal mr. Van Soest” in \textit{Royal Dutch Shell} (6 April 1994) Case no 28 638, BNB 1994/217 (the Hoge Raad, the Netherlands) at para 4.5.
The purpose of the arrangement was to obtain a 10 per cent withholding tax reduction under Article 10(2) of the double tax treaty between the Netherlands and the United Kingdom. The Netherlands-Luxembourg double tax treaty of 1968 provided for a withholding tax reduction at the same rate, but that treaty did not apply to holding

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83 Convention for the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains, the Netherlands–the United Kingdom (07 November 1980), article 10(2). The relevant part of art 10(2) provides, “… dividends may be taxed in the State of which the company paying the dividends is a resident, and according to the law of that State, but where such dividends are beneficially owned by a resident of the other State the tax so charged shall not exceed:

[...]

(b) … 15 per cent of the gross amount of the dividends.”
companies. Since Luxembourg SA was a holding company within the meaning of the Luxembourg holding company law of 1929 it was not entitled to a withholding tax reduction under the Netherlands-Luxembourg treaty and was therefore subject to Dutch withholding tax at the rate of 25 per cent.

When the dividend was made payable X Ltd cashed the coupons. The paying agent of the dividend withheld Dutch withholding tax at the rate of 25 per cent. X Ltd applied for a partial refund of the withholding tax on the basis of Article 10 of the Netherlands-United Kingdom double tax treaty. The Dutch tax inspector denied the refund, arguing that X Ltd was not the beneficial owner of the dividend.

The Hoge Raad held that X Ltd was the beneficial owner of the dividend. Explaining its reasons for considering X Ltd to be the beneficial owner, the court observed (S. Jain’s translation):

[X Ltd] became [the] owner of the dividend coupons as a result of purchase thereof. [It] can further be assumed that subsequent to the purchase [X Ltd] could freely avail itself of those coupons and, subsequent to the cashing, could freely avail itself of the distribution, and

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85 Loi du juillet 1929 sus le regime fiscal des sociétés de participations financiers 1929 (Luxembourg).

86 Convention for the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains, the Netherlands–the United Kingdom (07 November 1980), art 27(6).

87 “Beoordeling van de middelen van cassatie” in Royal Dutch Shell (6 April 1994) Case no 28 638, BNB 1994/217 (the Hoge Raad, the Netherlands) at para 3.2 (emphasis added). See also Stef van Weeghel The Improper Use of Tax Treaties: with Particular Reference to the Netherlands and the United States (Kluwer, London, 1998) at 76 (emphasis added).
in cashing the coupons [X Ltd] did not act as a voluntary agent of or for the account of the principal.

Under these circumstances the taxpayer is the beneficial owner of the dividend.

The freedom to avail oneself of property corresponds to the liberty to use property. The liberty to use property constitutes dominion over property, as discussed in section II.A. Dominion is a characteristic of ownership. The Hoge Raad evidently assumes that X Ltd could “freely avail itself” of the distribution after cashing the dividend coupons because X Ltd did not act as a nominee or agent when cashing them. X Ltd did not act in the capacity of a nominee or agent because it was the legal owner of the coupons by virtue of buying them. Effectively, the court treated the freedom to avail oneself of property as an incident of ownership. In speaking in terms of “freedom to avail” the court was referring to the concept that, for consistency of expression, this article calls “dominion”. For purposes of the present discussion, therefore, the freedom to avail oneself of property can be equated with dominion.

In the passage quoted above, the court showed that it regarded the presence of dominion as an indicator of beneficial ownership. In essence, the Hoge Raad’s reasoning was as follows: because X Ltd had ownership of the coupons it had dominion over them and therefore X Ltd did not act as a nominee or agent in relation to the coupons or, subsequent to cashing the coupons, as a nominee or agent in relation to the dividend; because X Ltd was not a nominee or agent, it was the beneficial owner of the dividend. Thus the court treated the presence of dominion as showing that the recipient was not a mere nominee or agent and thus the presence of dominion was a
sufficient basis on which to determine whether X Ltd was the beneficial owner of the dividend.

The court can be seen to commit an error of logic known as “denying the antecedent” or “inverse error”.88 If a person acts in the capacity of a nominee or agent in relation to passive income, he or she is not the beneficial owner of that income for the purpose of double tax treaties. However, it does not follow that a person who is not acting in the capacity of a nominee or agent necessarily qualifies as the beneficial owner of passive income for the purpose of double tax treaties. The approach of Chadwick LJ in the Indofood case supports this argument. As discussed in section III.G, the court in that case was concerned with the issue of whether the proposed Dutch corporation, Dutch BV, would be regarded as the beneficial owner of interest payments from Indofood under the double tax treaty between Indonesia and the Netherlands. Chadwick LJ observed:89

The fact that neither [Finance] nor [Dutch BV] was or would be a trustee, agent or nominee for the noteholders or anyone else in relation to the interest receivable from Indofood is by no means conclusive.

The foregoing analysis illustrates how the use of a “nominee or agent” in the official commentary on the OECD Model Convention of 1977 as an example of a conduit has misled courts and caused them to apply the dominion test to conduit company cases.

88 The Oxford Dictionary of Philosophy defines the phrase “denying the antecedent” as follows: To argue invalidly that given that if p then q, and given not-p, we can infer not-q. ‘If she is in Barbados she is in the Caribbean; she is not in Barbados, so she is not in the Caribbean.’ Simon Blackburn The Oxford Dictionary of Philosophy (2nd rev ed, Oxford University Press, Oxford, 2008).

C  Role of X Ltd in the structure

Because a person who acts as a nominee or agent in relation to passive income does not have dominion over that income, a mandator or principal receives the income in the form in which it arises. The Hoge Raad decided *Royal Dutch Shell* on the basis of the dominion test and so seems to have accorded undue significance to the fact that Luxembourg SA received a price paid for the dividend and not the dividend itself. But this difference in the character of the income was purely formal. Instead of applying the dominion test the court should have analysed the facts from a substantive economic perspective and considered the role of X Ltd in the structure.

Because Luxembourg SA was a holding company that had been established under the Luxembourg legislation of 1929, it was liable to pay the Netherlands withholding tax at 25 per cent on the dividend payment it would have received from Royal Dutch Shell. That is, had Luxembourg SA received dividends directly from Royal Dutch Shell, it would have received 75 per cent of the gross dividends. The price at which Luxembourg SA sold dividend coupons to X Ltd was 80 per cent of the gross dividends. In effect, Luxembourg SA avoided five per cent of the Netherlands withholding tax. Subsequently, when X Ltd received a 15 per cent withholding tax reduction under the Netherlands-United Kingdom double tax treaty, X Ltd gained a profit of five per cent.

From the available facts we are forced to conclude that Luxembourg SA had no reason to interpose X Ltd in the chain of companies other than to enable Luxembourg SA to obtain a tax reduction by taking advantage of the Netherlands-United Kingdom double tax treaty. X Ltd’s only role was tax-related. That role was to function as a
conduit that earned five per cent profit in the process of passing dividends on from Royal Dutch Shell to Luxembourg S.A. To the Hoge Raad, X Ltd did not look like a conduit because rather than functioning, as it were, as a pipe down which dividends flowed, it simply bought the dividends. But the economic effect was the same.

The arrangement at issue in the Royal Dutch Shell case resembles that in the Bank of Scotland case. In both cases the recipient company, when it derived passive income, was neither contractually bound nor obliged in property law to pass the income on to a company resident in a third state. Further, the recipient company was unrelated to the other two companies involved in the transaction. In spite of these similarities between the cases, the courts came to opposite conclusions because their approach differed. While the court in the Bank of Scotland case evaluated the effect of the arrangement, the court in the Royal Dutch Shell case based its decision on the presence of dominion and the misleading corollary that the recipient company did not act as an agent.

The Royal Dutch Shell case shows that the application of the dominion test leads a court to analyse facts from a company law perspective rather than from a substantive economic perspective. As a consequence, the court focused on a criterion that a recipient company possesses by definition and ignores factors that could help the court to determine whether the arrangement at issue is consistent with the object and purpose of a double tax agreement. While this point emerges as an implication of the Hoge Raad’s reasoning in the Royal Dutch Shell case, it is

90 See also Herman Born “Beneficial Ownership: Decision of the Netherlands Supreme Court of 6 April 1994” (1994) ET 469, at 472.
illustrated directly by the reasoning of the Tax Court of Canada in *Prévost Car Inc. v Her Majesty the Queen*. 92

V. PREVOST CAR: A SECOND EXAMPLE OF REASONING BY FALSE ANALOGY

A *The Prévost Car case*

The *Prévost Car* case involved Volvo, a Swedish company, and Henlys, a company resident in the United Kingdom. The two companies entered into a “shareholders’ and subscription” agreement under which they incorporated Dutch BV in the Netherlands. Dutch BV acquired shares in Prévost, a Canadian company. Dutch BV was not a party to the agreement. Volvo owned the majority of shares in Dutch BV.

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92 *Prévost Car Inc v Her Majesty the Queen* (2008) TCC 231.
Dutch BV had no physical office or employees and had the same directors as Prévost. Presumably because it had no employees but had to operate somehow, Dutch BV executed a power of attorney in favour of a Dutch management company, TIM, to carry out business transactions and to pay interim dividends on behalf of Dutch BV to Volvo and Henlys.

According to the shareholders’ and subscription agreement, at least 80 per cent of the profits of Prévost and Dutch BV were to be distributed to Volvo and Henlys. The agreement provided that the board of directors of Dutch BV would take reasonable steps to procure dividends and other payments from Prévost to enable Dutch BV to pay dividends to Volvo and Henlys.

Prévost paid dividends to Dutch BV and Dutch BV distributed them to Volvo and Henlys. Prévost deducted five per cent withholding tax from dividend payments in accordance with Article 10(2) of the Canada-Netherlands double tax treaty of 4 March 1993. The Canadian Minister of National Revenue issued assessment notices with respect to the payments on the basis that Volvo and Henlys were the beneficial owners of the payments.

The Tax Court of Canada held that Dutch BV was the beneficial owner of the dividend payments from Prévost. The Federal Court of Appeal confirmed this decision.

B Prévost Car: dominion an indicator of beneficial ownership

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94 Her Majesty the Queen v Prévost Car Inc 2009 FCA 57 (Federal Court Of Appeal, Canada).
The Tax Court of Canada referred to the official commentary on Article 10(2) of the OECD Model Convention of 1977.\textsuperscript{95} The court acknowledged that the official commentary was amended in 2003 but did not mention the change in the commentary with respect to nominees and agents.\textsuperscript{96} Further, the court referred to paragraph 14(b) of the Conduit Companies Report.\textsuperscript{97} As discussed in section II.C, the Conduit Companies Report itself relied on the official commentary on the relevant provisions of the OECD Model Convention of 1977 for transposing the dominion test from cases involving nominees or agents to conduit company cases. It is possible that the court referred to paragraph 14(b) because the OECD Committee on Fiscal Affairs incorporated the paragraph in the official commentary in 2003.

Thus, when discussing the meaning of the term “beneficial owner” the Tax Court was influenced by the official commentary on Article 10(2) of the OECD Model Convention of 1977, which used a “nominee or agent” as an example of a conduit. The court observed:\textsuperscript{98}

\textit{… the ‘beneficial owner’ of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is [the] beneficial owner of the dividend is the person who enjoys and assumes \textit{all the attributes of ownership}. In short the dividend is for the owner’s own benefit and this person is \textit{not accountable to anyone for how he or she deals with the dividend income} … It is the true owner of property who is the beneficial owner of the} \footnote{\textit{Prévost Car Inc v Her Majesty the Queen} (2008) TCC 231 at para 31.}

\textsuperscript{95}

\textsuperscript{96} Ibid, at para 32. The present authors discuss that change at section II.D of this article.

\textsuperscript{97} Ibid.

\textsuperscript{98} Ibid, at para 100 (emphasis added).
property. Where an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatory is acting or for whom the nominee has lent his or her name. When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as [a] conduit, or has agreed to act on someone else’s behalf pursuant to that person’s instructions without any right to do other than what that person instructs it ...

The court considered the characteristic of not being accountable to anyone for dealing with income to be an attribute of ownership. This characteristic of not being accountable is the same characteristic as the attribute of ownership that is the subject of this article, that is, dominion. In short, the attribute of ownership that the court discusses is the attribute embodied in the term “dominion”. The court’s observation shows that the court regarded the presence of dominion as an indicator of beneficial ownership. Two points emerge.

First, the case involved an alleged conduit company scheme. Nevertheless, the dominion test was applied because the court equated the function of conduit companies with the role of nominees and agents.

Second, as a result of applying the dominion test the court compared the beneficial ownership test to the doctrine of piercing the corporate veil and so analysed the facts from a company law perspective.

The following two sections will discuss these points separately.

C Prévost Car: analogy between nominees and agents, and conduit companies
As did paragraph 14(b) of the Conduit Companies Report, the court drew an analogy between nominees and agents on the one hand, and conduit companies on the other. The two categories were apparently compared on the basis that companies in these categories “act on someone else’s behalf pursuant to that person’s instructions”\(^99\) and therefore have “no discretion as to the use or application of funds”.\(^100\) Thus, the court transposed the dominion test from cases concerning nominees and agents to the case before it, which was a conduit company case. In doing so, the court observed:\(^101\)

> However, there is no evidence that the dividends from Prévost were \textit{ab initio destined} [to go to] Volvo and Henlys with [Dutch BV] as a funnel of flowing dividends from Prévost ... There was no predetermined or automatic flow of funds to Volvo and Henlys ...

The use of the phrases “\textit{ab initio destined}” and “predetermined or automatic flow” shows that the court examined the facts on the basis of a criterion that exists in cases concerning a nominee or agent. That is, the court applied the reasoning of a case of a nominee or agent to a conduit company case.

As discussed in section II.D, where a nominee or agent receives passive income that income is the property of the person on whose behalf the nominee or agent receives it: the income is \textit{ab initio} destined to reach the mandator or principal in the form in which it arises. In conduit company cases, by contrast, passive income originates as the property of the interposed recipient company. When the recipient company passes the income on to a company


\(^{100}\) Ibid.

\(^{101}\) Ibid, at para 102 (emphasis added).
that is resident in a third state the recipient company is transacting as the legal owner of the income. As the legal owner of the income the recipient company, unlike a nominee or agent, has dominion over that income and is not obliged in property law to pass it on (though the recipient company does in fact pass the income on). That is, as a strict matter of law the recipient company may opt not to pay the passive income that it receives to a resident of a third state. The point is that although from a substantive economic point of view a conduit company passes the income that it receives on to a resident of a third state, in a formal legalistic sense the income cannot be regarded as *ab initio* destined to reach that person. This significant distinction between a nominee or agent and a conduit company makes it illogical to assume that where a company acts as a conduit the passive income that it receives will be *ab initio* destined to reach a resident of a third state, as would be the case if the income had been received by a nominee or agent.

The foregoing discussion shows that because the court in *Prevost Car* mistakenly equated conduit companies with companies that act as nominees or agents, the case accorded undue significance to a factor that would have been relevant if the case had concerned a nominee or agent, but was not so in the context of a conduit company case.

*D* Prévost Car: analogy between the beneficial ownership test and piercing the corporate veil

As explained in section I.B, the word “beneficial” is hard to apply in any substantive sense to a corporation because a corporation is a creation of the law. A similar problem may seem to arise in cases where the issue is whether the court should pierce the corporate veil; that is, in cases in
which the question before the court is whether a company should be treated as a wholly independent legal person or whether the court should look through the veil of incorporation and determine the economic substance of the company or its transactions. While this issue prima facie resembles the question of whether a company is the beneficial owner of passive income that it receives, the issue of whether to pierce the corporate veil is essentially a different question.

When applying the doctrine of piercing the corporate veil courts analyse facts from the perspective of an approach that has been developed as a technical doctrine of company law. By contrast, the application of the beneficial ownership test requires courts to investigate facts for purposes of determining entitlement to benefits under double tax treaties. Nevertheless, courts have proceeded on the basis that tests appropriate to determine when the law can pierce the corporate veil can logically be applied also to determine whether a company is the beneficial owner of the passive income that the company receives. The Prévost Car case is a good example.

Because the court in the Prévost Car case applied the dominion test to Dutch BV, the court resolved the issue of whether Dutch BV was the legal owner of the passive income at issue, as opposed to determining whether Dutch BV was the substantive economic owner. That is, the court applied the beneficial ownership test from a legal perspective. The court’s reasoning suggests that, as a result of misdirecting itself in this manner, the court mistook a decision to disregard a separate entity for tax purposes for a decision to lift the corporate veil.

The court analysed the facts of the case from a company law perspective and therefore focused on the fact that Dutch BV was a separate entity that exercised
dominion over the passive income that it received, observing that: 102

[Dutch BV] was a statutory entity carrying on business operations and corporate activity in accordance with the Dutch law under which it was constituted …

…

[Dutch BV] was the registered owner of Prévost shares. It paid for the shares. It owned the shares for itself. When dividends are received by [Dutch BV] in respect of shares it owns, the dividends are the property of [Dutch BV]. Until such time as the management board declares an interim dividend and the dividend is approved by the shareholders, the monies represented by the dividend continue to be property of, and [are] owned solely by, [Dutch BV]. The dividends are an asset of [Dutch BV] and are available to its creditors, if any. No other person other than [Dutch BV] has an interest in the dividends received from Prévost. [Dutch BV] can use the dividends as it wishes and is not accountable to its shareholders except by virtue of the laws of the Netherlands.

This observation shows that the court tested Dutch BV against a quality that Dutch BV possessed simply by virtue of being a company, that quality being the enjoyment of dominion over dividends that the company received. On this basis, the court found Dutch BV to be the beneficial owner of the income at issue. However, the court asked the wrong question. As discussed in section III.C in the context of the Bank of Scotland case, the main issue in conduit company cases should be whether the impugned arrangement is consistent with the object and purpose of a double tax agreement. In order to determine this issue, courts should analyse the facts with the objective of

102 Prévost Car Inc v Her Majesty the Queen (2008) TCC 231 at para 103 & 105.
discovering the function of the alleged conduit company in the investment structure. The paragraphs that follow therefore examine the facts of the investment structure in general and the role of Dutch BV in particular. The objective is to predicate the substantive purpose and object of the structure, objectively ascertained.

E Role of Dutch BV in the structure

The court found that the dividends were not "ab initio destined" for Volvo and Henlys. The court also found that no person other than Dutch BV had an interest in the dividends. As a matter of economic substance, these findings are questionable. On an analysis of the arrangement in the light of the object and purpose of double tax treaties, it is hard to conclude that there were reasons for Dutch BV’s presence in the investment structure other than to pass dividends from Prévost to Volvo and Henlys, or that Dutch BV had any other role.

As explained in section V.A, under the shareholders’ and subscription agreement Volvo and Henlys, between them were entitled to a minimum of 80 per cent of the profits of both Prévost and Dutch BV. The agreement provided that the directors of Dutch BV, who were also the directors of Prévost, would ensure that Prévost would declare dividends, which would enable Dutch BV to pay dividends to Volvo and Henlys. The inevitable inference is that Dutch BV had the simple function of receiving income from Prévost and passing the income on to Volvo and Henlys.

In support of this inference it may be recalled from section V.A that Dutch BV had no office or employees.

103 Prévost Car Inc v Her Majesty the Queen (2008) TCC 231 at para 102.

104 Ibid, at para 103.
and that it appears that the company’s only activity was making dividend payments to Volvo and Henlys—an activity for which Dutch BV had mandated a management company.

Considered together, these facts show that Dutch BV acted as a conduit and that therefore the arrangement at issue was inconsistent with the object and purpose of the Canada-Netherlands double tax treaty.

Nevertheless, the court accorded no significance to these facts, but observed:105

There is no evidence that [Dutch BV] was a conduit for Volvo and Henlys. It is true that [Dutch BV] had no physical office or employees in the Netherlands or elsewhere. It also mandated to TIM the transaction of its business as well for TIM to pay interim dividends on its behalf to Volvo and Henlys…

… [Dutch BV] was not party to the shareholders’ agreement; neither Henlys nor Volvo could take action against [Dutch BV] for failure to follow the dividend policy described in the shareholders’ agreement ….

… I cannot find any obligation in law requiring [Dutch BV] to pay dividends to its shareholders on a basis determined by the shareholders’ agreement. When [Dutch BV] decides to pay dividends it must pay the dividends in accordance with Dutch law.

This observation shows that the court examined the shareholders’ and subscription agreement in order to determine whether Dutch BV was contractually obliged to pass on dividends received from Prévost. As discussed in section III.D, the presence or absence of an obligation in contract law to pass passive income on to a third party should logically be inconclusive in conduit company cases. The fact that a recipient company is not under a

105 Prévost Car Inc v Her Majesty the Queen (2008) TCC 231 at para 102.
legal obligation to pass dividends on cannot logically lead to a conclusion that the company is not a conduit.

This analysis of the *Prévost Car* case shows that because the court applied the dominion test, the court ignored facts that would have helped to answer the question of whether the arrangement at issue was consistent with the object and purpose of the Canada-Netherlands double tax agreement and focused on facts that were not conclusive on the issue of whether Dutch BV acted as a conduit.

VI. Conclusion

The test of dominion may help to resolve cases concerning nominees and agents. However, since dominion is a concept that is used in a formal legalistic sense it cannot logically determine an issue that, under the policy of double tax agreements, is a matter of substance. As a result, courts that have applied the dominion test to conduit company cases have evaluated facts from a formal legalistic point of view, rather than adopt a substantive economic approach.

The reasoning of courts in *Royal Dutch Shell* and *Prévost Car* illustrate that when applying the dominion test courts effectively ask the question of whether a recipient company is a nominee or agent. If a recipient company does not act as a nominee or agent in respect of the passive income at issue, courts conclude that that company is not a conduit. This reasoning does not make sense. A company that sits between the source of income and the destination of income, through which that income flows, can in substance be a conduit without being a nominee or agent of either the source company or the destination company, or of anyone else.
The absence of dominion shows that an intermediary transacts as a nominee or agent and is therefore not entitled to treaty benefits. Such cases do not, however, involve an issue of beneficial ownership. In such cases, an intermediary possesses no ownership rights at all. For this reason, it is misleading to present a nominee or agent as being an example of a conduit in order to demonstrate the role of a conduit company.

Conduit companies are the legal owners of the passive income that they receive. Conduit companies exploit their status as the legal owners of passive income to disguise their role, which is in effect no more than to pass income on to a third party. That is why double tax agreements require courts to differentiate legal ownership from substantive economic ownership. Because the presence of dominion establishes no more than legal ownership, where the test of dominion establishes only that an intermediate company has legal dominion over income that it receives, this outcome cannot be conclusive by itself in deciding conduit company cases.
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