International taxation of cross-border leasing income
Mehta, A.S.
CHAPTER 7

TAX TREATY ASPECTS OF TAXATION OF CROSS-BORDER LEASING INCOME IN THE SOURCE STATE

7.1. Introduction

This chapter begins with an analysis of significantly differing provisions of tax treaties relevant for cross-border leasing, and discusses how it could motivate lessors to exploit these differences. As the next step, it is examined whether an interposed leasing entity carrying on substantive leasing business activities should qualify for the benefits under a tax treaty of its residence state. Finally, the chapter ends with the conclusion that a typical “Limitation on benefits” article in a tax treaty should not affect the applicability of the tax treaty to the leasing income of an “interposed” leasing entity carrying on substantive business activities in its residence state.

7.2. Differing provisions in bilateral tax treaties

As pointed out in 7.2.1. to 7.2.3., a review of the 64 tax treaties selected for the purpose of this research reveals significant differences that may provide tax arbitrage opportunities in respect of cross-border leasing transactions.

7.2.1. Differing provisions concerning royalties

7.2.1.1. Right to tax royalty income and treaty definition of “royalties”

Out of 64 tax treaties reviewed for the purposes of the research, only 16 tax treaties reserve the right to tax royalty income in favour of the residence state, and 44 tax treaties include (whereas 19 tax treaties exclude) in the “royalties” definition consideration for the use of or the right to use ICS equipment, and one tax treaty does not specifically deal with royalty income.

338. See Appendix 3 for the list of tax treaties examined.
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7.2.1.2. Withholding tax: rate differences

In the case of the tax treaties that include in the “royalties” definition consideration for the use of or the right to use ICS equipment, the rate at which the source state is permitted to withhold tax on royalties ranges from 2% to 25% of the gross amount of the royalties. For instance, the United Kingdom–Korea and Germany–Korea tax treaties provide for 2% withholding tax, whereas the Netherlands–Korea tax treaty provides for 10% withholding tax. At the other end of the spectrum, the United Kingdom–Philippines tax treaty provides for withholding tax at the rate of 25% (whereas the Germany–Philippines tax treaty provides for withholding tax at the rate of 10%).

7.2.1.3. “Beneficial ownership” requirement

Under most of the tax treaties examined, the concessional withholding tax rate is applicable only if the recipient (i.e. resident in the residence state) is the beneficial owner of the royalty. However, 19 tax treaties do not stipulate this requirement.

7.2.2. Differing provisions concerning “interest” income

7.2.2.1. Taxing right and rate differences

Out of the 64 tax treaties reviewed, 12 tax treaties reserve the right to tax interest income exclusively in favour of the residence state. In the case of the tax treaties permitting the source state to levy a withholding tax on interest income, the rate ranges from 5% to 25%. As compared to a higher withholding tax rate under the domestic tax law of the source state. Netherlands–Switzerland, United Kingdom–Venezuela, Germany–Venezuela and Netherlands–Venezuela tax treaties.

Germany–Thailand tax treaty. Under the United Kingdom–Thailand and Netherlands–Thailand tax treaties, instead of the general withholding tax rate of 25%, a concessional rate of 10% applies in respect of interest derived by banks and other financial institutions.
7.2.2.2. "Beneficial ownership" requirement

Out of the 64 tax treaties examined, 20 tax treaties do not stipulate the "beneficial ownership" condition for exclusive taxation of interest by the residence state or for applicability of the concessional source state withholding tax (as compared to a higher withholding tax rate under the domestic tax law of the source state).

7.2.3. Differing provisions concerning taxation of capital gains

In most of the tax treaties examined for the purposes of the research, capital gains from the alienation of movable assets not forming part of a permanent establishment in the source state are taxable only in the residence state. However, the India–United Kingdom tax treaty (but not the India–Germany and the India–Netherlands tax treaties) is an exception under which the source country is permitted to tax the capital gains from the alienation of movable assets even if the assets are not part of a permanent establishment in the source state.

7.2.4. Implications of differing provisions in bilateral tax treaties

The above-discussed differing bilateral tax treaty provisions could have a significant impact (favourable or adverse) on the tax consequences of cross-border leasing transactions. With a view to obtain the tax benefits under a particular tax treaty, the lessors from third-country jurisdictions might incorporate a leasing entity in one contracting state for leasing assets to lessees in the other contracting state, as highlighted in the following case studies:

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342. Not being shares of a company.
343. For instance, to escape "royalties" treatment of lease rentals in the source state in accordance with a tax treaty that excludes consideration for the use of or right to use ICS equipment from the definition of royalties, or to escape interest withholding tax, where a source state treats certain sale-and-leaseback transactions as financing arrangements, in accordance with a tax treaty that precludes the source state from taxing interest income.
344. At this stage, the case studies are used to highlight the way in which the tax treaty network may be exploited in practice. The case studies are revisited at a later stage (after dealing with the notion of "beneficial owner") in this chapter to examine the tax treaty implications of back-to-back leasing transactions.
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Case study 1

A UK bank ("UK bank") has a wholly owned leasing subsidiary in Sweden ("SW Leasing"). A Singapore company (the lessee) is interested in obtaining an operating lease certain scientific equipment. SW Leasing enters into a contract with the lessee on its own account under which SW Leasing agrees to sublease the equipment to the lessee. For this purpose, SW Leasing enters into a back-to-back arrangement with the UK bank, whereby the UK bank would acquire the equipment from the vendor, lease it to SW Leasing, and SW Leasing would sublease the equipment to the lessee.

If the lessee would have entered into the lease arrangement directly with the UK bank, then under the Singapore–United Kingdom tax treaty, the consideration for the use of or the right to use ICS equipment is included in the "royalties" definition, and subject to 10% withholding tax in Singapore. However, under the Singapore–Sweden tax treaty, royalties are taxable only in the residence state, if the beneficial owner of the royalties is resident in one of the contracting states. Under the Sweden–United Kingdom tax treaty, the royalties derived and beneficially owned by a resident in the United Kingdom are taxable only in the United Kingdom.

Case study 2

A Seoul-based consumer electronics company ("lessee") requires a robotic system ("equipment") for its manufacturing plant. A Hong Kong-based financial institution is willing to enter into a leasing arrangement with the lessee. For this purpose, it uses its 100% Dutch subsidiary ("sublessor"). As per the arrangement, the Hong Kong-based financial institution will lease the equipment to the sublessor, and the sublessor will sublease the equipment to the lessee. The lessee is required to pay the lease rentals to the sublessor, calculated at a certain percentage of the gross sales of the products manufactured at its plant in Korea. As rentals for the headlease, the sublessor is required to pay to the Hong Kong-based financial institution 98% of the net lease rentals received by it from the lessee.

There is no tax treaty between Hong Kong and the Republic of Korea. As per the tax treaty between the Republic of Korea and the Netherlands, royalty payments are subject to a 10% withholding tax in the source state. The

345. As compared to 15% withholding tax under the domestic tax law of Singapore.
346. On an operating leasing basis.
347. I.e. lease from the Hong Kong-based financial institution to the sublessor.
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said tax treaty does not include a “beneficial ownership” requirement for applicability of the 10% withholding tax.

7.3. Entitlement to treaty benefits in case of improper use of tax treaties (by third-country residents)

7.3.1. Relevance of the issue in cross-border leasing transactions

Due to differing provisions in various tax treaties, as well as for various commercial (non-tax) reasons, the banks, financial institutions and other companies engaged in the leasing business may be inclined to set up leasing entities in jurisdictions having favourable tax treaty networks. Valid commercial reasons for setting up a leasing entity in a jurisdiction other than the residence state of the parent entity could include:
- enhanced possibilities of obtaining bank loans in a particular jurisdiction;
- liberal (or absence of) exchange control regulations;
- existence of investment protection treaties between the jurisdiction and the potential lessee jurisdictions; or
- a particular jurisdiction may be regarded as a leading international financial market as compared to the jurisdictions in which the equity investors in the lessor entity may be resident.

It is submitted that where a leasing entity is established in a jurisdiction outside the residence state of the parent entity for a valid commercial reason, the issue of treaty abuse does not arise. However, if a parent company establishes a leasing entity in a jurisdiction other than its residence country predominantly for exploiting a favourable tax treaty network of that jurisdiction, such a manoeuvre may amount to “improper use” of tax treaties (treaty shopping). In such cases, it is relevant to examine as to whether the interposed leasing entity can claim the benefits under a tax treaty of the country of its residence.

As the issue of applicability of a tax treaty in the case of “improper” use by residents of a third country\(^{348}\) could be a subject matter of a doctoral research by itself, it is not examined in detail for the purposes of the present study. However, in view of the fact that often the equity capital of a lessor

\(^{348}\) I.e. other than the two contracting states.
in a cross-border leasing transaction may be owned by the investors resident in third countries, it is necessary to take into account the current position on the issue. The focus of the analysis is on the interposed leasing entities actively carrying on substantive business activities in their residence state, rather than mere "paper companies".

7.3.2. Entitlement in case of improper use of tax treaties: contemporary position

It appears that even in the case of interposition of a conduit leasing company with a view to access the favourable tax treaty network of a jurisdiction, especially if the said leasing company actively carries on substantive business activities (and hence it is not a mere "paper entity"), the treaty application must not be denied in the absence of anti-avoidance provisions (such as a "beneficial owner" clause or "Limitation on benefits" article) in the relevant tax treaty. This finding is based on the following observations.

7.3.2.1. The OECD view

7.3.2.1.1. The 1977 and 1992 OECD MC Commentaries

The 1977 and 1992 versions of the OECD MC Commentary stated that, for preventing treaty shopping, the contracting states may adopt necessary anti-avoidance provisions in their domestic tax laws, and may seek to preserve the application of such provisions in their tax treaties. Thus, as per the 1977 and 1992 versions of the OECD MC Commentary, anti-abuse rules under the domestic law could not be applied in tax treaty situations, unless the relevant tax treaty contained the provisions permitting application of such rules.

7.3.2.1.2. The OECD Conduit Companies Report

In its 1987 Report, "Double Taxation Conventions and the Use of Conduit Companies", at paragraph 43, the Committee on Fiscal Affairs opined that where tax treaties do not contain clauses with the safeguards against improper use of their provisions, treaty benefits must be granted under the

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principle of *pacta sunt servanda*, even if considered improper. The OECD MC Commentary 2003 version makes a note of the said Report, and states that with a view to prevent the use of conduit companies to obtain the treaty benefits not intended by the contracting states in their bilateral negotiations, a number of OECD Member countries have implemented treaty provisions (both general and specific) for countering treaty abuse and for preserving the application of anti-avoidance domestic legislation in treaty situations.

7.3.2.1.3. *The 2003 version of the OECD MC Commentary*

In its 2003 version, the OECD MC Commentary drastically moves away from its earlier position, and reaches a diagonally opposite conclusion. In its 2003 version, the OECD Commentary states that “... it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.” Further, the said Commentary provides that the benefits of a tax treaty should not be available where the main purpose of entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining an advantage in such a manner that would be contrary to the object and the purpose of the relevant provision. In an earlier paragraph, the said Commentary notes that some states prefer to view certain abuses as abuses of the convention itself as opposed to abuses of domestic law, and such states consider that a proper construction of tax conventions allows them to disregard abusive transactions. The Commentary endorses such a view by stating that this interpretation results from the object and the purpose of tax conventions as well as the obligation to interpret them in good faith as per Art. 31 of the Vienna Convention on Law of Treaties 1969 (VCLT). However, it is rather surprising that the OECD formed this “new view” on the basis of the same “good faith” principle under the VCLT, on the basis of which it had reached the diagonally opposite conclusion in its 1987 Conduit Company Report. Moreover, in the 2003 version of the OECD MC Commentary, it is not only that the OECD Committee on Fiscal Affairs does not make an attempt to substantiate the reversal of its earlier position, but it does not even mention the fact that it has now moved away from its earlier position, that it had adopted for over 25 years (from 1977 onwards). For that reason, it is not surprising that some of the Member countries entered observations

350. See paragraph 9.4, Commentary on Art. 1.
351. See paragraph 9.5, Commentary on Art. 1.
352. See paragraph 9.3, Commentary on Art. 1.
353. Belgium, Ireland, Luxembourg, the Netherlands, Portugal and Switzerland.
against the position now adopted by the OECD. As regards the object and the context of the relevant provision, it is submitted that the object and the context of a distributive rule (such as the royalties article) in a tax treaty would be the same as the larger object and context of the tax treaty itself, i.e. avoidance of international juridical double taxation. In its introduction part, the 2003 version of the OECD MC Commentary notes the generally recognized position that international juridical double taxation harms international exchange of goods and services as well as movement of capital and technology. The Commentary states that the main purpose of the OECD MC is to eliminate such obstacles. Accordingly, it is submitted that, unlike the approach adopted in the 2003 version of the OECD MC, an interposed leasing company may be denied the treaty benefits if and only if it is a “paper company”, i.e. if it does not carry out substantive business activities. If an interposed leasing company undertaking substantive leasing business activities is denied access to the treaty network of its residence state, then such a denial may rather obstruct the exchange of goods and services, and the movement of capital and technology and, as a consequence, undermine the very object and the context of a tax treaty.

Therefore, for the above-stated reasons, it is submitted that the new approach adopted in the 2003 version of the OECD MC is too broad and not in harmony with the fundamental object and context of the OECD MC and the tax treaties. It is not a mere coincidence that, time and again, courts have confirmed the treaty entitlements of the interposed entities carrying on substantive business activities and the anti-abuse rules of even the most stringent jurisdictions exempt from its scope interposed entities that carry on active trade or business.

Also, automatic application of the domestic anti-abuse laws to tax treaty situations (unless the treaty itself authorizes such a treatment) could pro-

354. I.e. denial of a tax treaty benefit where the main purpose of entering into certain transactions or arrangements is to secure a more favourable tax position as compared to the tax position if the parent entity would have operated directly from its residence state without interposing an entity in one of the contracting states.

355. Indeed, as discussed at 7.3.2.3., in a few cases, the courts have even confirmed treaty entitlements of interposed entities not carrying on any economic activities.

356. For instance, the US Conduit Financing Arrangement Regulations issued under Sec. 7701 of the US Internal Revenue Code (IRC) do not apply to a financing transaction in the nature of a lease or licence, if the interposed entity derives the lease rentals from the active conduct of a trade or business. Similarly, Sec. 50d Abs. 1a of the German EStG, which was introduced with effect from 1 January 1994 with a view to combat tax treaty abuse by foreign entities, does not apply to interposed entities carrying on economic activities of its own.
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remote cases of “treaty override”, which may not only conflict with the tax treaty provisions but may even undermine the very object of the tax treaties. For instance, the Conduit Financing Arrangement Regulations issued under Sec. 7701 of the US IRC allow the IRS to disregard the participation of one or more intermediate entities in a financing arrangement if the intermediate entities are conduits.\textsuperscript{357} For this purpose, the term “financing arrangement” means a series of transactions whereby one person (the financing entity) advances money or other property, or grants rights to use property, and another person (financed entity) receives such money, other property or the right to use the property through one or more persons (intermediate entities), and there are financing transactions linking the financing entity, the intermediate entities and the financed entity.\textsuperscript{358} As per the regulations, a “financing transaction” includes a debt instrument, lease, or licence.\textsuperscript{359} The Regulations provide that where the participation of a conduit entity in a conduit financing arrangement is disregarded, it is disregarded for all purposes of Sec. 881, including for the purposes of applying any relevant income tax treaties. Accordingly, the conduit entity is precluded from the benefits of the tax treaty between its country of residence and the United States. The preamble to the Regulations states that the Regulations are intended to provide anti-abuse rules that supplement, but do not conflict with, the “Limitation on benefits” articles in the US tax treaties. It is submitted that if and once an intermediate entity fulfils the conditions relating to the “beneficial ownership” requirement and “limitation on benefits” under a tax treaty, then denial of favourable withholding tax treatment to such an entity by virtue of the Regulations would amount to treaty override.

7.3.2.2. Views expressed by commentators

Vogel, in his treatise on double taxation conventions, opines that in case of treaty shopping, if a national court were to apply domestic law rather than treaty law without being authorized to do so either by the tax treaty in question or by a general rule of international law, it would be violating an international obligation. Further, Vogel categorically concludes that domestic

\textsuperscript{357} An intermediate entity is regarded as a “conduit” only if its participation in the financing arrangement reduces the US withholding tax under IRC Sec. 881 pursuant to a tax avoidance plan.

\textsuperscript{358} See Reg. 1.881-3(a)(2)(i)(A).

\textsuperscript{359} Reg. 1.881-3(a)(2)(ii)(A). However, the Regulations do not apply to a financing transaction in the nature of a lease or licence, if the intermediate entity derives the rental or royalty income from the active conduct of a trade or business (Reg. 1.881-3(b)(3)(ii)(A)).
anti-avoidance rules may not be applied to tax treaties unless non-application (or modified application) of the tax treaty rules can be justified not only domestically, but even from the viewpoint of international law.\footnote{360}

Also, as per Ward, though tax authorities and legislatures may be inclined to apply domestic anti-abuse principles to abusive tax treaty structures, the courts may be reluctant to uphold such a treatment.\footnote{361}

7.3.2.3. Court decisions on treaty entitlement of interposed entities

7.3.2.3.1. Court decisions in the United States

Aiken Industries\textit{ case}\footnote{362} 

In Aiken Industries, the US Tax Court recognized the identity of an interposed Honduran corporation and did not deny the applicability of the Honduras–United States tax treaty to the Honduran entity.\footnote{363}

Perry R. Bass\textit{ case}\footnote{364} 

In this case, an individual (citizen and resident of the United States) owning a stake in an oil and gas lease in Texas incorporated a Swiss corporation and transferred 25\% of the said stake to the Swiss corporation. The Swiss corporation actually engaged itself in the business of oil and gas production, participated in the drilling and development of its properties, and sold the production therefrom. The IRS took the view that the sole purpose behind incorporation of the Swiss corporation was to avoid taxes and hence its existence must be ignored. However, in view of the fact that the Swiss corporation acted as a viable business entity engaged in substantive business activity, the Tax Court respected its existence and held that the Switzerland–United States tax treaty was applicable to the Swiss corporation.

\footnote{360}{See Vogel, K., \textit{Klaus Vogel on Double Taxation Conventions}, 3rd Edition, pp. 121-122 (Kluwer Law International).}


\footnote{363}{Though, based on the domestic law, the Tax Court reached a finding that the interest income, which was the subject matter of the dispute, was not received by the Honduran corporation, but rather by its Bahamian parent company.}

\footnote{364}{Perry R. Bass and Nancy Lee Bass v. Commissioner, 50 T.C. 595 (1968).}
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Northern Indiana case

In this case, a US corporation incorporated a Netherlands Antilles company ("the finance company") for raising finance for funding the business of the US corporation. The finance company issued notes in the Eurobond market in the amount of USD 70 million, at the interest rate of 17.25%. On the same date, the US corporation issued USD 70 million notes at the interest rate of 18.25%, so in effect the finance company passed on the proceeds of the Euronotes to the US corporation for a 1% spread. A few years later, repayment from the US corporation was used by the finance company to repay its Euronotes. Soon after that, the finance company was liquidated. The IRS took the view that the finance company must be ignored and hence the Netherlands–United States treaty (as extended to the Netherlands Antilles) must not be applied, and interest payment by US corporation must be treated as payment to Euronote holders subject to the US withholding tax. The Tax Court opined that, normally, a choice to transact business in corporate form will be recognized for tax purposes so long as there is a business purpose or the corporation engages itself in business activity; since the finance company was engaged in the business activity of borrowing and lending money at profit, it had to be recognized as recipient of interest income on its own behalf, rather than as an agent of the US corporation. Accordingly, the Tax Court respected the existence of the finance company and held that the finance company was entitled to apply the Netherlands–United States tax treaty.

Ingemar Johansson case

This case involved Ingemar Johansson, a Swedish citizen and a heavyweight boxer, who fought heavyweight world championship on three occasions in the United States. Johansson used a Swiss company that received income for Johansson’s participation in the world championship and related activities. Johansson had entered into an employment contract with the Swiss corporation, as per the terms of which he was entitled to receive remuneration equal to 70% of the gross revenue of the Swiss company. He was the only employee and the only source of revenue for the Swiss company, and he conducted his affairs independent of the Swiss company. The district court found that the Swiss company had no legitimate business pur-

366. Accordingly, the Tax Court held that the interest payment by the US corporation to the finance company was not subject to the US withholding tax.
pose, and was merely a device used by Johansson as a conduit to escape the US tax on his personal income. On the basis of this finding, the district court disregarded the Swiss company, and held that Johansson was liable for the US tax in respect of the income earned from the United States. The Court of Appeals affirmed the decision of the district court.

Apparently, this is a rare case where a court in the United States has disregarded an interposed entity. It seems that the absence of a legitimate business purpose and lack of any substantive activity by the Swiss company formed the basis for it being disregarded by the Court. On the other hand, based on the precedents in Parry R. Bass and Northern Indiana cases, the courts in the United States are likely to recognize the existence of an interposed leasing entity carrying on substantive leasing activities, and confirm its entitlement to treaty benefits.

7.3.2.3.2. Court decisions in the Netherlands

Hoge Raad decision BNB 1994/253

In this case, two individuals, A (a resident of Switzerland) and B (a resident of Belgium), held shares in a Dutch entity (C BV). A incorporated a company (D NV) in the Netherlands Antilles as the sole shareholder. Subsequently, A transferred his shares in C BV to D NV as capital contribution, and B sold his shares in C BV to D NV against profit-sharing rights. Upon the dividend distribution by C BV to D NV, D NV claimed that the said dividend income received by D NV was not taxable in the Netherlands in accordance with Art. 11(3) of the Tax Arrangement of the Kingdom. The tax inspector took the view that D NV was a mere “paper company” incorporated with the purpose of avoiding the Dutch withholding tax on dividends, that must be disregarded.

In spite of the fact that D NV was a company interposed in a low-tax jurisdiction and without any economic activity, the Hoge Raad recognized its existence and confirmed its entitlement to be exempt from the Dutch withholding tax on dividends distributed by C BV.

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369. Prior to its revision in 1986.
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Hoge Raad decision BNB 1994/259\(^\text{370}\)

This case involved a so-called "cash box" structure. An individual (A), a resident of the United States, held shares in a Dutch company (A BV), which in turn held shares in another Dutch company (B BV). A acquired interest in a third Dutch company (C BV), to which A BV transferred shares of B BV. As a result, A BV became a cash box company (owning substantial amounts of cash). Subsequently, A sold shares in A BV to a bank. Under the Netherlands tax law, based on the principle of *fraus legis*, the gains realized by A from such sale were subject to recharacterization as income from capital (in the form of notional dividends). Under the Netherlands–United States tax treaty, capital gains were taxable only in the residence state (i.e. the United States in the present case). However, the tax inspector sought to extend the domestic law recharacterization provision to the treaty situation by holding that gain made by A amounted to dividends under the applicable Netherlands–United States tax treaty.

The *Hoge Raad* disallowed the action of the tax inspector, holding that the income recharacterization rule of the domestic tax law (based on the principle of *fraus legis*) could not be applied to a tax treaty unless the tax treaty itself permitted such recharacterization.\(^\text{371}\)

7.3.2.3.3. Court decisions in Germany

Bundesfinanzhof decision in BStBl. 1973 II p. 57 (dated 13 September 1972)\(^\text{372}\)

This case involved a so-called "quintet" structure, where a Dutch company (A BV) held 23.5% shares of a German company (C GmbH). A BV’s Dutch parent company (B BV) owned 24% shares in C GmbH. In the Netherlands, A BV and B BV were consolidated in a fiscal unity. As per the tax treaty between Germany and the Netherlands, dividends distributed by a German company were subject to a higher withholding tax rate if the recipient shareholder owned more than 25% voting shares of the German company. The German tax authorities took the view that A BV and B BV, together, should be regarded as one entity and hence the dividend distribution by C

\(^{370}\) See, also, Van Weeghel, Stef, *The Improper Use of Tax Treaties*, p. 172.
\(^{371}\) Subsequently, in BNB 1995/150 (see Tax Notes International, 26 June 1995), the *Hoge Raad* once again rejected the attempt of the Dutch tax authorities to recharacterize the gains from sale of shares as dividends by applying the domestic anti-abuse provisions to a situation under Belgium–Netherlands tax treaty.
GmbH should be subject to a higher withholding tax. Before the Court, in addition to the said view, the German tax authorities argued that the split-shareholding structure (i.e. A BV and B BV separately holding shares of C GmbH) amounted to abuse of law. However, the Bundesfinanzhof rejected the arguments of the tax authorities.

Bundesfinanzhof decision in BStBl. 1982 II p. 150 (dated 29 October 1981)\textsuperscript{373}

In this case, a resident of Monaco owned shares in a German company. As there was no tax treaty between Germany and Monaco, he incorporated a company in Switzerland and transferred the said shareholding in the German company to the Swiss company. Art. 6(3) of Germany–Switzerland tax treaty restricted the German withholding tax on dividends to 15%. The German tax authorities viewed the interposition of the Swiss company as treaty abuse and sought to deny the treaty benefit in respect of the withholding tax on dividend distribution by the German company. However, the Bundesfinanzhof recognized the existence of the Swiss company and confirmed its entitlement under the Germany–Switzerland tax treaty.

7.3.2.4. Conclusion

Based on the above analysis, it may be appropriate to conclude that in a case where a leasing entity is interposed by a parent entity in a jurisdiction other than the residence state of the parent entity, and if the leasing entity actively carries on substantive business activities (as opposed to being a mere “paper company”), the leasing entity should be entitled to claim benefits under the tax treaties of its residence state. As the courts in some jurisdictions (e.g. the Netherlands and Germany) have allowed treaty benefits even in the case of holding companies interposed solely for the purpose of securing a benefit under a tax treaty, if an interposed leasing entity has a business purpose and if it conducts the actual leasing business in its residence state, then it is even more arguable that such entity is eligible for the benefits under the treaties of its state of residence.

\textsuperscript{373} See, also, Van Weeghel, Stef, \textit{The Improper Use of Tax Treaties}, p. 189.
7.4. Anti-abuse tax treaty provisions relevant for cross-border leasing transactions

7.4.1. Beneficial ownership

7.4.1.1. The “beneficial owner” requirement

In its 1977 MC, the OECD introduced the “beneficial ownership” requirement for taxation of royalties exclusively in the residence state. The notion of beneficial ownership was subsequently introduced in the UN and the US MCs. Also, the majority (but not all) of contemporary tax treaties require the beneficial owner of royalties and interest to be a resident of one of the contracting states for favourable\textsuperscript{374} treaty treatment of royalties and interest.

7.4.1.2. Purpose of the “beneficial owner” requirement

The “beneficial ownership” requirement is stipulated in the OECD MC and the tax treaties with the aim to prevent third-country\textsuperscript{375} residents from obtaining the benefit of source-country tax exemption or concession under the treaty by interposing an agent or a conduit in one of the contracting states.\textsuperscript{376}

The following extract from the 2003 version of the OECD MC Commentary on Art. 1 is relevant in this regard:

9.6. The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy. ...

10. For instance, some forms of tax avoidance have already been expressly dealt with in the Convention, e.g. by the introduction of the concept of “beneficial owner” (in Articles 10, 11, and 12)....

Thus, the extracts from the OECD MC Commentary given above (especially paragraph 10) indicate that the concept of “beneficial owner” was intro-

\textsuperscript{374} As compared to the treatment under domestic tax law of the source state.

\textsuperscript{375} I.e. a country other than the two contracting states.

duced in the OECD MC as an anti-abuse measure to combat the improper use of tax treaties.

7.4.1.3. Definition of the term “beneficial owner”

While a majority of the tax treaties include the “beneficial ownership” requirement for applicability of exemption or concessional tax treatment of royalties in the source country, most of such tax treaties as well as the OECD MC do not define “beneficial owner”.

As per Art. 3(2) of the OECD MC as well as under most tax treaties, an undefined treaty term must be interpreted in accordance with its meaning under the domestic law of the state applying the tax treaty, unless the treaty context requires otherwise.

A review of the literature reveals that, as regards interpretation of the term “beneficial owner”, a number of commentators are in favour of autonomous treaty interpretation, rather than interpretation in accordance with the meaning under the domestic law of the contracting state applying the tax treaty.377 In his doctoral thesis “Beneficial ownership of royalties in bilateral tax treaties”, Charl P. du Toit convincingly concludes that “beneficial owner” is one of the terms falling in the category of “international tax language” (i.e. warranting autonomous interpretation of the tax treaty term, rather than interpretation in accordance with the meaning under the domestic law of the contracting state applying the tax treaty).378 This opinion is also duly reflected in the 2003 version of the OECD MC Commentary on Arts. 10, 11 and 12, which states that the term “beneficial owner” is not used in a narrow technical sense; rather, it should be understood in its context and in light of the object and purposes of the Convention, including

378. See Du Toit, Charl, Beneficial Ownership of Royalties in Bilateral Tax Treaties (IBFD).
avoidance of double taxation and the prevention of fiscal evasion and avoidance.\textsuperscript{379}

Accordingly, it is submitted that the term “beneficial owner” should be given an international tax language meaning (i.e. interpreted autonomously, rather than in accordance with its meaning, if any, under the domestic law of the contracting state applying the tax treaty).

7.4.1.4. OECD Commentary on the term “beneficial owner”

The 2003 version of the OECD MC Commentary states that the “beneficial ownership” requirement was introduced in paragraph 1 of Art. 12 (and paragraph 2 of Arts. 10 and 11) of the MC to clarify how the article applies in relation to payments made to intermediaries. Further, the said OECD MC Commentary provides that where a recipient of interest or royalties is acting merely in the capacity of agent or nominee, he is not to be regarded as the beneficial owner of such income. Similarly, the said OECD MC Commentary indicates that an entity, though not acting as an agent or a nominee, but merely acting as a conduit for another entity, should not be regarded as “beneficial owner” of the income.

Except for the above-discussed clues, neither the OECD MC Commentary nor any other international source provides any indication as to whether the term “beneficial owner” excludes any person other than the persons acting as mere agents, nominees or conduits for other persons.

As the concept of beneficial ownership is derived from the OECD MC,\textsuperscript{380} it can be inferred that the OECD Member States intend to interpret the term “beneficial owner” in the same manner as understood in the OECD MC. This view is endorsed by Vogel in the following words:

[W]here OECD member States conclude tax treaties following the text of the MC, it is presumed that those states want the treaty provisions to convey the

\textsuperscript{379} It must be mentioned that the present study seeks to examine the consequences of absence of the “beneficial ownership” requirement in a tax treaty, rather than exploring the meaning of the term “beneficial owner”.

\textsuperscript{380} See Du Toit, Charl, \textit{Beneficial Ownership of Royalties in Bilateral Tax Treaties} (IBFD), p.145.
meaning intended by the MC and its Commentary ... – as long as no particular circumstances indicate to the contrary.\textsuperscript{381}

On the basis of the same principle, since the UN MC has subsequently adopted the "beneficial owner" requirement from the OECD MC, it may be appropriate to infer that the term appearing in the tax treaties based on the UN MC should be viewed in the same manner as understood in the OECD MC.

7.4.1.5. International tax language meaning of "beneficial owner"

In his doctoral thesis "Beneficial ownership of royalties in bilateral tax treaties", Charl P. du Toit, inter alia, summarizes the following attributes of beneficial ownership:

- beneficial ownership can either be with legal ownership or divided therefrom, but mere legal title without the right to deal with the income as one's own does not constitute beneficial ownership;
- the right of beneficial ownership must be recognized by law and should be enforceable by the courts;
- where something is acquired subject to the obligation to transfer it to others, such acquisition is not regarded as beneficial ownership.

After extensively investigating various aspects relevant for ascertaining the meaning of the term "beneficial owner", Charl P. du Toit concludes the following international tax language meaning of the term:

The beneficial owner is the person whose ownership attributes outweigh that of any other person.

Thus, as long as the income is received by the recipient as his own, rather than as an agent, nominee or a mere conduit, such income should be regarded as beneficially owned by him.

\textsuperscript{381} See Vogel, K., \textit{Klaus Vogel on Double Taxation Conventions} (3rd Edition), marginal note 80, page 44. See also Ault, Hugh, "The Role of the OECD Commentaries in the Interpretation of Tax Treaties", \textit{Intertax} 1994/4, pp. 146-147.
7.4.1.6. Beneficial ownership of income rather than the income-producing asset

It is important to note that the OECD MC, the UN MC and the tax treaties (that were examined for the purpose of the research) that include the “beneficial ownership” requirement stipulate such requirement in respect of the royalty income, rather than the asset giving rise to the income. Thus, for the source country exemption or concessional tax treatment of rentals from a sublease (treated as royalty income under a tax treaty), it is sufficient if the rentals are beneficially owned by a resident of the residence state, though the leased asset may be owned by a third-country resident.

7.4.1.7. Implications of the absence of “beneficial ownership” requirement in a tax treaty

OECD 1977 and 1992 MCs and Commentaries

The “beneficial ownership” requirement was first introduced in the OECD 1977 MC. As regards the “beneficial owner” requirement, the Commentary to the OECD 1977 MC explained that the exemption from tax in the source state is not available when an intermediary is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other contracting state. As noted earlier, the “beneficial owner” requirement is an anti-abuse provision that was introduced in the 1977 OECD MC to prevent improper use of tax treaties.

The OECD 1992 MC and the Commentary did not alter this position.

OECD 2003 MC and Commentary

While the OECD MC 2003 version does not alter the “beneficial ownership” requirement in any manner, the 2003 version of the Commentary to the OECD MC provides as follows:

The requirement of beneficial ownership was introduced in paragraph 1 of Article 12 to clarify how the Article applies in relation to payments made to intermediaries. It makes plain that the State of source is not obliged to give up taxing rights over royalty income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term “beneficial owner” is not used in a narrow technical

382. For instance, an agent or a nominee.
Chapte rr  7  -  Ta x  treat y  aspect s  o f  taxatio n  o f  cross-borde r  leasin g  incom e  i n  th e  
sourc ee  stat e

sense, rather, it should be understood in its context and in light of the object and 
purposes of the Convention, including avoiding double taxation and the pre-
vention of fiscal evasion and avoidance. [emphasis added]

From the portion of the 2003 version of the OECD MC Commentary repro-
duced above (particularly the words highlighted), one gets the impression 
that the role of the words “beneficial owner” included in the OECD MC and 
tax treaties based on that MC is mere clarificatory, so that even in the ab-
sence of the said words, the royalties exemption would apply only if the 
royalties were received by the beneficial owner being resident of one of the 
contracting states. It is submitted, however, that this is not the case for the 
following reasons:

- Generally, in the case of a tax treaty not containing a “beneficial own-
ership” condition, it is provided that the royalties arising in a contract-
ing state (the source state) and paid to a resident of the other contracting 
state (the residence state) would be taxable only in the residence state. 
Thus, as per the text of such tax treaty, the only condition for the roy-
alties to be tax exempt in the source state is that the royalties must have 
been paid to a resident of the residence state. The term “resident” is, 
normally, defined in Art. 4 of the tax treaty.

- A tax treaty must be interpreted in accordance with the principles con-
tained in the VCLT. As per Art. 31(1) of the VCLT, a treaty is required 
to be interpreted in good faith in accordance with the ordinary meaning 
to be given to the terms of the treaty in their context and in the light of 
its object and purpose.

- As per Art. 31(2) of the VCLT, the context for the purpose of the inter-
pretation of a treaty shall comprise, in addition to the text (including its 
preamble and annexes) (a) any agreement relating to the treaty that was 
made between all the parties in connection with the conclusion of the 
treaty, and (b) any instrument that was made by one or more parties in 
connection with the conclusion of the treaty and accepted by the other 
parties as an instrument related to the treaty. As per Art. 31(3) of the 
VCLT, any subsequent agreement between the parties regarding inter-
pretation of the treaty or application of its provisions must be taken into 
account. However, it is submitted that the OECD MC Commentary can 
be regarded as neither “context” nor an agreement (between the con-
tracting states) concerning “interpretation of tax treaty or application of 
tax treaty provisions”, as the introduction to the OECD MC 2003 ver-
sion itself clarifies that the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, and that the OECD MC is not a legally binding international instrument.

As per the official explanation to the VCLT, the parties are presumed to have the interpretation which appears from the ordinary meaning of the terms used by them. Thus, as per Art. 31 of the VCLT, the “textual approach” must be adopted for interpreting a treaty. In this regard, reference to the following extract from an Advisory Opinion of the International Court of Justice is relevant:

The court considers it necessary to say that the first duty of a tribunal, which is called upon to interpret and apply the provisions of a treaty, is to endeavor to give effect to them in their natural and ordinary meaning in the context in which they occur. If the relevant words in their natural and ordinary meaning make sense in their context, that is an end of the matter.

Also, the International Court of Justice has held that it is not the function of interpretation to read into the treaties what they do not, expressly or by implication, contain. Accordingly, in the case of a tax treaty that exempts royalties from being taxed in the source state if the recipient is resident of the residence state, an interpretation that such recipient should also be the beneficial owner of the royalties would not be tenable in the absence of the tax treaty expressly stipulating such a prerequisite (as in the case of OECD 1977 MC and onwards).

The remarks in the Commentary to the OECD MC 2003 version, that the requirement of the beneficial ownership was introduced to clarify how Art. 12 applies in relation to the payments made to the intermediaries, do not reconcile with the OECD 1977 MC Commentary, as that Commentary did not state that the “beneficial ownership” requirement was stipulated as a mere clarification. Rather, the OECD 1977 MC Commentary (as well as the subsequent Commentaries) specifically indicated that the “beneficial ownership” requirement was introduced as

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a measure to combat treaty shopping. In other words, the “beneficial ownership” condition was included in the OECD 1977 MC (and subsequent MCs) to plug a loophole in the 1963 Draft, since in absence of such a condition, potential treaty shopping could not be prevented. The OECD Report entitled “Double Taxation Conventions and the Use of Conduit Companies” confirms this aspect. As per paragraph 13 of the Report, under the OECD MC, the conduit company is regarded as a person resident in the state of conduit, and therefore entitled to claim the treaty benefits in its own name. Paragraph 14 notes that the OECD has incorporated in its 1977 MC provisions (such as “beneficial owner” condition) precluding (rather than providing mere clarifications) in certain cases persons not entitled to a treaty from obtaining its benefits through a conduit company. Further, as noted earlier, paragraph 43 of the Report categorically states that the existing conventions may have clauses with safeguards against the improper use of their provisions; where no such provisions exist, treaty benefits will have to be granted under the principle of pacta sunt servanda even if considered to be improper.

Finally, as stated earlier, the introduction to the 2003 version of the OECD MC Commentary itself admits its limitation by stating that the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries that, unlike the OECD MC, are legally binding international instruments.387 Further, as pointed out by Ault,388 given the framework of the VCLT and its thrust on the strict textual interpretation, it is difficult to visualize how the Commentaries can play a conclusive role in tax treaty interpretation. In any case, under the textual approach of treaty interpretation, it is doubtful as to whether the OECD Commentary could have even a persuasive (leave aside the binding) effect where the tax treaty provisions are clear enough and do not involve interpretation of an undefined term.389

387. It is relevant to note, however, that in one particular case (see BNB 1992/379) the Dutch Supreme Court considered the OECD Commentaries to be of significant importance. In this respect, see Smit, Pieter, “Taxation of Dividends Distributed by a Dual Resident Company”, European Taxation January 1993, p.36.
389. As in the case of Art. 12 of a tax treaty providing for tax exemption or limited taxation of royalties in the source state if the recipient of the royalties is resident in the residence state; the term “resident” would normally be defined in Art. 4 of a tax treaty based on OECD MC.
In the light of the above, it is submitted that the “beneficial owner” provision in the OECD MC and the tax treaties is a substantive anti-treaty shopping measure rather than a mere clarificatory provision; and in a case where the royalties article in a tax treaty provides for tax exemption or limited taxation of royalties in the source state (if the recipient is resident of the residence state) without stipulating the “beneficial owner” condition, then even an intermediate recipient must qualify for such favourable treatment.  

7.4.1.8. The two sublease case studies vis-à-vis the “beneficial ownership” requirement

Case study 1

In Case study 1, the sublessor enters into the sublease contract with the lessee on its own account, and not as agent of the headlessor. The headlease is rather a matter of buy/lease decision for the sublessor, in the same manner as an end user of an asset may consider to obtain an asset on lease instead of purchasing it. If the headlease arrangement is entered into on an arm’s length basis, the mere fact that the headlessor is the parent entity of the sublessor is, per se, irrelevant and should not have implications different from a hypothetical situation of the sublessor obtaining the headlease from an unrelated party. Though the sublessor does not “own” the asset giving rise to the rental income from the sublease, it may be the absolute (legal as well as economic) owner of such income, rather than a mere conduit for the headlessor; and its obligations in respect of the headlease rentals could be regarded as “detached” from the lease rental income from the sublease. For instance, even in case of an eventual default in respect of rental payments by the lessee or in case of insolvency of the lessee, the sublessor may still be liable to pay the headlease rentals to the headlessor. Accordingly, it is submitted that in such cases the lease rentals paid by the lessee must be respected as the income beneficially owned by the

390. It is relevant to note that in a case concerning the 1942 Canada–United States tax treaty, which did not contain the “beneficial ownership” requirement, the Canadian Tax Review Board held that the concessional withholding tax rate under the tax treaty applied even if the income recipient (resident in United States) was not a beneficial owner of the income (MacMillian Bloedel Ltd. v. MNR, 79 DTC 297 (TRB)).
391. See 7.2.4. for a background description.
392. I.e. SW Leasing.
393. I.e. the UK Bank.
394. If the headlease is not entered into on an arm’s length basis, a transfer pricing adjustment may apply under the “Associated enterprises” article of the applicable tax treaty.
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sublessor, and the sublessor must be regarded as entitled to the favourable tax treaty provisions. 395

Case study 2

In this case, the relationship between the Hong Kong-based financial institution and the sublessor 396 appears to be that of an agency. As stated earlier, the beneficial owner of income is the person whose ownership attributes outweigh that of any other person. 397 Since, as per the contract between the sublessor and the Hong Kong-based financial institution, the latter is obliged to pass on 98% of the net lease rentals to the former, the “income” receivable by the sublessor is not detached from the headlease payment to be made by the sublessor to the Hong Kong-based financial institution. Rather, 98% of the said net lease rental income could be viewed as owned by the Hong Kong-based financial institution, whereas only 2% of the said net lease rental income could be viewed as owned by the sublessor. Accordingly, the ownership attributes of the Hong Kong-based financial institution completely outweigh the ownership attributes of the sublessor. As a result, the sublessor cannot be regarded as beneficial owner of the lease rental income.

In spite of the fact that the sublessor is not the beneficial owner of the lease rentals payable by the lessee, for the reasons discussed at 7.4.1.7., it is submitted that the tax treatment (in the Republic of Korea) of the lease rentals payable by the lessee must be governed by the tax treaty between the Republic of Korea and the Netherlands, i.e. subject to the Korean withholding tax at the rate of 10% of the gross amount of the royalty.

7.4.2. “Limitation on benefits” article

Typically, the contemporary US tax treaties include a “Limitation on benefits” article, as per which a resident of a contracting state qualifies for the tax treaty benefits only if such person satisfies at least one of the tests provided for in the said article. While the analysis of the detailed and complex nature of the various tests in a typical “Limitation on benefits” article is well beyond the scope of this study, with respect to cross-border leasing

395 I.e. exemption from Singapore withholding tax.
396 I.e. the wholly owned Dutch subsidiary of the Hong Kong-based financial institution.
397 See 7.3.1.5.
Anti-abuse tax treaty provisions relevant for cross-border leasing transactions

structures, it appears necessary to pay attention to one of the tests, i.e. “income connected with or incidental to active trade or business”.

"Income connected with or incidental to active trade or business" test

As per this test, even if a resident of a contracting state satisfies none of the other tests under the “Limitation on benefits” article, such person would be entitled to the tax treaty benefits in respect of an item of income, profit or gain derived from the other contracting state, inter alia, if:

- such person is engaged in the active conduct of a trade or business in the residence state; and
- the income, profit or gain is derived from the source state in connection with, or incidental to, such active trade or business.

Meaning of "active trade or business"

Generally, the term “trade or business” is not defined in a tax treaty. Accordingly, such a term would be required to be interpreted in accordance with its meaning under domestic law of the contracting state applying the tax treaty. As per the regulations issued under Sec. 367(a)(3) of the IRC, the term “trade or business” means a specific unified group of activities that constitute or could constitute an independent economic enterprise for profit. One can expect a comparable meaning of the term “trade or business” under domestic laws of other countries.

Significance of the test in the case of cross-border leasing transactions

In the case of cross-border leasing transactions, it is possible that the lessor is a resident of a tax treaty partner of the United States, but meets none of the tests (except “active trade or business” test) under the “Limitation on benefits” article of the tax treaty, and its entitlement to the tax treaty between its state of residence and the United States may depend entirely on the “active trade or business” test. If the lessor entity actively conducts activities of its leasing business from its residence state, including employing in the residence state the managers and other officers for funding, negotiating and executing the transactions in the residence state and if the key business decisions are taken by such managers and officers (rather than by the parent entity in a third country), then the income from leasing transactions

398. For this purpose, “making or managing investments” is not regarded as active conduct of a trade or business, unless the activity is a banking, insurance or securities activity conducted by a bank, insurance company or registered securities dealer.

399. Art. 3(2) of the OECD MC/its equivalent article in the relevant tax treaty.
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should be regarded as “connected with active trade or business” carried on in the residence state. In such a case, the lessor’s income from the leasing transactions should qualify for the tax treatment in accordance with the tax treaty between the lessor’s state of residence and the United States.