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The concept of beneficial ownership in the OECD model tax convention 2014: A critical analysis – Part II

In Part I of his article on beneficial ownership, Dr Maxim Kotlyarov discussed the economic and social objectives of double taxation treaties, which are intended to contribute to wealth creation and social stability, focusing on the beneficial ownership concept in the context of the OECD Model. In Part II, he concludes his analysis of this concept drawing, in particular, on the meaning attributed to 'beneficial ownership' by courts in various jurisdictions and anticipating how the concept and meaning of 'beneficial ownership' may subsequently evolve.

Introduction

For complete understanding of the beneficial ownership concept it is important to examine how national courts of OECD member states apply it. Examples are drawn from Canada, Denmark, the UK, France, the Netherlands, Spain and Switzerland and are now examined. The criteria of cases' selection were the facts which led the courts to examine the basic elements of the beneficial ownership concept introduced in Part I of this article.

Case law practice and research of the OECD methodology enables a holistic picture of the current situation and of ways in which the beneficial ownership concept may develop. Elements of a proposed official OECD approach with regard to the beneficial ownership concept are introduced.

Application of the beneficial ownership concept in chosen OECD member states

Application of the beneficial ownership concept in various states may be assessed through examining the positions of tax authorities and courts. Academic publications are also helpful. However, there is no common approach. This applies not only to substantial issues but also to the general position. Common basic points relating to the concept definitely exist. Oliver and others have pointed out that the main debates have been about the legal or economic nature of the term 'beneficial ownership'.[46] Wheeler has argued that case law on beneficial ownership is not helpful. She cites Arnold and emphasises that case law:

> '…is growing and inconsistent. Some courts consider the term to have a domestic law meaning; others give it an international meaning. Some courts treat it as an anti-avoidance concept; others do not…'[47]

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IN THIS ISSUE

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Courts of almost all OECD member states where disputes regarding beneficial ownership have arisen tend to examine the issue using the following 'common points':

- recognising the beneficial ownership concept as a tax anti-avoidance technique or an instrument of income attribution;
- international and domestic meaning of the term;
- legal and economic essence of beneficial ownership concept.

The leading case law on beneficial ownership is the UK judgement in the *Indofood* case. It became the first case dealing with interpretation of the term after the new edition of the OECD Commentaries emerged in 2003 and determined that the term should be given an international broad fiscal meaning following the purpose of the agreement between contracting states.

The Indonesian company (Indofood) raised a 280m USD loan.[48] There was a rate of 20% of withholding tax if the interest had been paid directly to bondholders. The rate of withholding tax under the Indonesia-Mauritius tax treaty was only 10%. Indofood established a Mauritian subsidiary which borrowed money from lenders (acted through JP Morgan, which was an agent and trustee) and transferred it to Indofood. The agreement between Indofood and JP Morgan could have been terminated if the withholding tax rate was increased.

In 2005, the tax treaty was terminated[49] which meant that the rate of withholding tax would have increased. In order to avoid this, JP Morgan suggested that a Dutch subsidiary be interposed instead of the Mauritian one thereby preserving a favourable tax rate. The question arose of whether the Dutch subsidiary could be a beneficial owner of the interest it received from Indofood. A commercial dispute arose between Indofood and JP Morgan regarding the possibility of interposing the Dutch company as a beneficial owner of the interest. At first instance, it was held that the Dutch company was a beneficial owner of the interest as the Mauritian company had been.

The Court of Appeal overturned the ruling of the High Court and held that the term 'beneficial owner' should be given an international fiscal meaning[50] not taken from domestic law. Secondly, the term should be interpreted not technically and literally but economically within the substantive matter of the business relationship. The Court of Appeal used the construction that a beneficial owner should '…enjoy the full privilege to directly benefit from the income'[51] and compared this with mere administration of the income (formal ownership). The court relied on the Commentary to the OECD MTC and emphasised the importance of the object and purpose of the tax treaty (its tax anti-avoidance role) and acknowledged an economic 'substance-over-form' approach.[52]

The significance of *Indofood* is both in creating the above-named substantial properties of the beneficial ownership concept and in influencing further development of case law, tax administrations' practice and the official OECD approach set out in the Commentaries in 2010. Some authors, however, recognising the leading role of *Indofood*, demonstrated some anxiety that tax administrations would use the beneficial ownership concept as a '… broad anti-treaty shopping device which permits HMRC to attack any reduction of UK withholding taxes…'[53]

Canada is another country where the beneficial ownership concept has been explored because in *Prévost* a different approach to *Indofood* was adopted.[54] In this case, a Dutch company owned by Swedish and English shareholders (a Canadian company paid dividends to this Dutch company) was not considered by Canadian tax authorities to be a beneficial owner of dividends and, therefore, could not obtain benefits under the Canada-Netherlands tax treaty (ie in the form of reduced withholding tax). The Canadian tax authorities argued that the Canada-Netherlands tax treaty could not be applied because the Dutch holding company was not a beneficial owner of the dividends. The tax authorities had taken into account that there was an agreement between Swedish and English shareholders concerning the distribution of profits of the Dutch company and also the fact that this company had no personnel and assets[55] with the exception of the shares in the Canadian joint venture.

The Canadian Federal Court of Appeal in construing the term 'beneficial owner' applied a domestic and legal approach. First, the court rejected a broad international meaning of the term and reasoned that according to art 3(2) of the tax treaty a domestic interpretation should be applied.[56] In this respect, Li has underlined:

> '…because beneficial owner is undefined in the Canadian Income Tax Act, Rip, J. held that the ordinary meaning in private law has priority. After considering the meaning of this term under Canadian law, income tax law, the Civil Code of Quebec, and Dutch law, he concluded that "in both common law and civil law, the persons who ultimately receive the income are the owners of the income property".'[57]

In making this determination, the judge took into consideration such facts as receiving dividends for the purpose of the recipient and assuming the risk related to this dividend. He also noted that the Dutch company was not a part of any agreement between shareholders. He applied an 'insolvency test' and stated

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that the dividends paid to the Dutch company would be available to any of its creditors in the case of insolvency.[58] This 'insolvency test' was mentioned, however not developed in detail, in *Indofood*. Baker has summarised this test as follows:

> 'If the recipient entity went into liquidation, and it was a mere fiduciary, then any dividends etc., it had received could be claimed by the "real beneficial owner" and would not be available for general creditors in the liquidation….'[59]

Therefore, it was confirmed by the court that the Dutch company was not a conduit. In this respect, two criteria were applied: ability to dispose of dividends for the own benefit of the Dutch company and the rights of the directors of this company to make decisions concerning the received dividends.[60] After *Prévost* commentators came to the conclusion that Canada had rejected an economic or substance-over-form approach with the exception of cases where a tax treaty is used with the only purpose of avoiding taxation.[61]

In the Canadian context, commentators have also alluded to the *Velcro* case where a company-recipient of royalties was recognised by the court as the beneficial owner. This case involved the use of a Dutch company (*Velcro Netherlands*) set up for the purpose of channelling royalties from a Canadian company to the company registered in the Dutch Antilles.[62] The companies were parts of the Velcro group. *Velcro Canada* paid royalties, which were subject to a withholding tax of 10% under the Canada-Netherlands tax treaty,[63] to *Velcro Industries*. In 1995, *Velcro Industries* became a resident of the Dutch Antilles and transferred its rights to another member of the group – *Velcro Holdings*, because there was no tax treaty between Canada and the Dutch Antilles. Ownership of the intellectual property was transferred to *Velcro Industries* and *Velcro Netherlands* was obliged only to receive royalties from *Velcro Canada* and then to pay them to *Velcro Industries*.

It was held by the court that *Velcro Netherlands* had the possession, use, risk and control of the funds.

> 'It was contractually bound to pay an amount equal to 90% of the royalties to Velcro Antilles but entitled to deal with actual payments received from Velcro Canada as it saw fit…'[64]

It might be observed that the court in *Velcro* followed the decision in *Prévost*[65] in recognising a legal approach to beneficial ownership and rejected the tax administration assessment of *Velcro Netherlands* as an agent, nominee or conduit. Some commentators assessed critically the court's decision, arguing that *Velcro Netherlands* was contractually obliged to transfer the received royalties.[66] It is also worth noting that the court used some elements of an economic approach[67] when it assessed the risks which *Velcro Netherlands* had assumed.

So, generally, Canada reflects a mixed approach to the 'beneficial owner' concept. Though the courts have adopted domestic and legal approaches, tax administrations have examined the substance of the relationship (an economic approach).

France has a wide network of double taxation treaties (more than one hundred). However, the term 'beneficial owner' is not defined and there is no specific definition of beneficial ownership in French legislation. Therefore, some scholars have suggested that principles of international law should be applied. This has been done by the French Supreme Administrative Court[68] using the rules of treaty interpretation reflected in the Vienna Convention. The latter provides for the interpretation of tax treaties in good faith and in accordance with the ordinary meaning of the words used. This process of interpretation may also involve reliance upon preparatory work of negotiating parties and any supplementary materials.

Mostly because of the *Bank of Scotland* case, France is known as the country where a broad economic approach to the term 'beneficial ownership' has been applied. Before *Bank of Scotland* a formal legal approach was applied[69] (see,for example, *Diebold Courtage SA,* 1999*)*. In the *Bank of Scotland* case, the Royal Bank of Scotland (RBS) was not considered by the French tax authorities to be a beneficial owner of dividends paid from a French subsidiary of a US company. Before that payment, RBS had acquired rights (called 'usufruct rights') on preference shares from this US company.[70] The French tax authorities examined the economic nature of the relationship and concluded that, in substance, the payment for the usufruct rights was a loan to the US company, and this loan was repaid through the dividends. In addition, as Verdoner has pointed out, RBS '…would be entitled to a tax credit (*avoir fiscal*), following the deduction of the withholding tax. The result was that the amount of the dividends plus *avoir fiscal* was higher than the amount paid for the usufruct'.[71] It was held that the purpose of the transaction was to obtain tax treaty benefits (under the UK-France tax treaty). The court also took into consideration that RBS as a shareholder assumed almost no risk.[72]

Consequently, the beneficial ownership concept in France may be characterised as an anti-avoidance technique based on a broad economic examination of a transaction (French tax law also contains anti-avoidance provisions based on beneficial ownership concept). Some commentators have pointed out that the French Supreme Court has made the concept of beneficial ownership very wide, mostly because it has applied a substance-over-form approach.[73] Gutman has commented on the

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'over-extensive' meaning of the term 'beneficial owner' which was provided by the court:

> '…the main fault in the *Bank of Scotland* judgment consists in an inversion of the logical connection which should exist between beneficial ownership and abuse of law/fraud to the law… *The …Court distorted the meaning of the concept because its goal was to apply the French general anti-avoidance theory without formally departing from the treaty rule.*'[74] (Emphasis added.)

Denmark demonstrates a growing interest in the beneficial ownership concept. Some academics regard the number of cases on beneficial ownership as unprecedented and have noted that the reason lies in a fundamentally new understanding of the term 'beneficial owner' adopted by tax authorities, following the inclusion of the term in domestic law with effect from 1 January 2013.[75] Previously, under the Danish GAAR, two principles had been established in Denmark, namely the rule of 'rightful income recipient' and the 'substance-over-form doctrine'.

From the Danish cases[76] (some of them are pending) it may be inferred that the tax authorities are facing a new methodology, namely that there is a difference between 'beneficial owner' and 'rightful income recipient'. In all cases, the broad international meaning of the term is confirmed (referring to *Indofood*).[77] Denmark also follows the OECD approach concerning conduit companies and applies the beneficial ownership concept as an anti-treaty shopping instrument.

Though there was a tradition under Danish law to apply the legal ownership concept, the term 'beneficial owner', according to the National Tax Tribunal, now '…must be interpreted in the interest of a harmonised interpretation of the term. The assessment must then go beyond the legal ownership and also include other assessments, eg in relation to financial ownership…'[78]

Similarly, the Dutch courts have applied a variety of assessment methods combining legal and economic approaches. For example, the courts have taken into account the absence of any shareholders' agreement concerning obligations to pay dividends and have also applied the above-mentioned 'insolvency test'.[79]

Further, in the *Market Maker* case (1994) the Dutch Supreme Court decided in favour of the taxpayer and held that an ability to dispose freely of dividends constitutes beneficial ownership status and it is irrelevant for the purpose of the tax treaty who is the owner of the shares. Here, the Dutch approach resembles the reasoning in *Prévost*. However, earlier (long before 2003 and *Indofood*) the Dutch courts often followed a broad international meaning of the term and applied both economic and legal approach assessing risks of the dividends' recipient (currency and solvency risks were examined).

In Spain, *Real Madrid F.C.* is a leading case on beneficial ownership. It is noteworthy that in *Real Madrid F.C.* Spain changed its approach to the beneficial ownership concept for, as Jiménez has noted, the approach 'suffered mutation'.[80] Jiménez referred to the judgement of the *Tribunal Economico-Administrativo Central* (TEAC) in 2000 as the first case in which beneficial ownership was considered and pointed out that the TEAC introduced the concept as a means of establishing a nexus between the source of income and the recipient, but not as an anti-avoidance mechanism.[81]

In *Real Madrid F.C.,* the taxpayer, a Spanish football club, purchased rights to use image rights under a contract with a Hungarian party and claimed benefits under the Spain-Hungary tax treaty. The Hungarian party, however, transferred the sum in question to a Dutch company which was recognised by the tax authorities as the beneficial owner. The court upheld tax administration arguments and applied a broad international meaning of the term 'beneficial owner' coupled with an economic interpretation. The court carefully examined the OECD approach and pointed out its anti-treaty shopping function.

Switzerland is also a country which has developed the beneficial ownership concept as an anti-treaty shopping measure. This position follows from two cases – *V.SA* (2002) and *X Holding ApS* (2005), where the term 'beneficial owner' was given a broad anti-avoidance meaning.[82] In *V.SA* the term was interpreted by reference to the Vienna Convention and linguistic sources. As a result, the court emphasised two criteria of beneficial ownership. First, a beneficial owner is a person who has income received at his disposal. Secondly, a beneficial owner is not a conduit company.[83]

Developing an OECD approach to beneficial ownership

The beneficial ownership concept is currently facing significant challenges. The first one, introduced by Gutman, relates to the general approach to the concept.

> '…it may well be that in the future most of the controversy on the meaning of beneficial ownership will disappear due to the evolution of tax treaty policy between OECD Member States. Many recently concluded treaties already contain both beneficial ownership provisions and general anti-avoidance rules. If that proves to be a long term trend of tax treaty policy, the beneficial ownership concept will move from useless to obsolete.'[84]

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The second challenge concerns withholding tax regimes. Some academics argue that automatic information exchange will provide clearness and certainty while a withholding tax regime '…privileges the elite and undermines tax morale'.[85] It is widely considered that the withholding tax system helps the wealthiest taxpayers to avoid taxation while automatic information exchange closes such an opportunity.

Indirect confirmation that the beneficial ownership concept may be modified or even abandoned may be derived from the BEPS Action Plan. The term 'beneficial ownership' is not addressed directly in the Plan. It may be inferred, therefore, that the use of the concept is implied from provisions in the Action Plan devoted to hybrid mismatch arrangements, the prevention of treaty abuse or developing a mutual instrument.

The above-mentioned aspects suggest that the concept may be re-evaluated. However, it does not mean that the established elements of the concept will necessarily be rejected. Jain has stated:

> '…the term "beneficial owner" does not carry a meaning of its own. It simply reminds courts and tax authorities to adopt a substantive approach.'[86]

Taking into consideration the above-mentioned points, the following conclusions may be made:

- notwithstanding the prospects of existence of the term 'beneficial owner', its substantive application will be further developed;
- the OECD methodology lacks a substantive economic approach to beneficial ownership, therefore, gradual methodological improvement should be continued.

Some elements of a substantive approach to the term 'beneficial owner' have been identified in this article and may become a part of an authorised OECD approach.

The OECD Committee on Fiscal Affairs has developed several effective economic concepts which are germane to an AOA, for example, in a different sphere, the '*arm's length principle*' which was introduced in transfer pricing guidelines and later developed in the Report 'The attribution of profits to permanent establishments'.[87] Within the 'functionally separate entity approach' a concept of functional and factual analysis was developed which is considered to be a basic premise of the AOA in that context. Functional analysis identifies key functions performed by the entity. Thereafter, it is determined what assets are necessary in order to perform these functions and what risks are assumed while performing these functions and possessing the assets.

This approach is discussed here mainly because this OECD methodology applies an economic approach based on the principle of value creation (for example, when analysing allocation of taxing rights and identifying value creation chains in order to combat tax evasion) and mechanisms of attribution of income based on functions, assets and risks (FAR). FAR methodology may be helpful for the further development of an economic concept of beneficial ownership. Therefore, the following steps in developing a concept of 'beneficial ownership' as part of an OECD AOA (*proposed OECD AOA*) may be seen as material.

First, instead of introducing a perfect version of the term 'beneficial owner' it is reasonable to implement the elements of the beneficial ownership concept which have been considered in this article (namely, the anti-avoidance role of the concept, an international treaty meaning, legal and economic approaches in determining the fact of beneficial ownership). In the *proposed OECD AOA* 'beneficial ownership' inconsistencies would be part of a complex methodological issue in an OECD approach which mixes objective and subjective factors in the allocation of taxing rights. This may mean orientation of the OECD MTC methodology on 'income' rather than on a 'person' when allocating taxing rights between states and giving priority to the identification of a tax liability with respect to a particular item of income rather than on ownership or any other form of nexus with this income.

Secondly, it is crucial to continue developing the concept of beneficial ownership in the context of recent OECD initiatives in combatting harmful tax practices. In the *proposed OECD AOA* beneficial ownership methodology, which has been developed by the OECD since 1977 and developed in several landmark documents (eg the Report on Conduit Companies in 1986, and the amended Commentaries of 2003 and 2010), will be continued in the BEPS Action Plan and in other OECD initiatives aimed at combatting harmful tax practices, aggressive tax planning and the improper use of tax treaties. This may be particularly relevant to Action 15 which looks to 'develop a multilateral instrument' and requires an 'innovative approach to international tax matters'.[88]

Thirdly, it should be stressed in the *proposed OECD AOA* that there is no contradiction between legal and economic meaning of beneficial ownership. Both approaches may be used to establish beneficial ownership for the purpose of granting tax relief.

Fourthly, the substantial approach rather than formal definition of the term 'beneficial ownership' should be confirmed in the *proposed OECD AOA*. This suggests recognition of the substance-over-form approach and the use of economic techniques (eg 'the responsibility centres' and 'remaining economic

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risk') as part of an internationally accepted beneficial ownership test.

Fifthly, elements of a FAR analysis and value creation theory should be at the heart of the *proposed OECD AOA*. Tax is a cost and it is natural for an income recipient to endeavour to reduce this cost and, as a result, to increase value of an asset. The motivation of creating or increasing the value of an asset is a sign of a beneficial owner. Another sign is the acceptance of risk by an income recipient and this risk is connected or, more precisely, derives from the underlying asset (eg a share, loan or intellectual property).

Here, the following factors may be important:

1. The functions and motives of the passive income recipient (*the Recipient*) are to be examined.
2. An examination of functions will clarify whether the Recipient bears any risks[89] which are derived from the underlying asset. The fact of assuming such risks may lead to the conclusion that the recipient is a beneficial owner.
3. An Objectives' (or motives') examination will clarify whether the Recipient has an interest in underlying asset value creation. Presence of such an interest may lead to the conclusion that the Recipient is a beneficial owner.
4. Any investigation of insurance against all risks of devaluation or loss of an underlying asset or an assumption by third parties may be required. If, for example, the Recipient incurs no expenditure in securing the insurance, this may lead to the conclusion that the Recipient is not a beneficial owner.

Sixthly, the *proposed OECD AOA* should stress the legal meaning of beneficial ownership. As case law examined in this article shows, the following aspects of the legal meaning of the term may be relevant to the *proposed OECD AOA*:

- the fact of having an agency, nominee, administrator or conduit status;
- the presence of any kind of agreement between shareholders with regard to the income or any other forms of expressed obligation to pass the income to a third party;
- the ability to enjoy the full privilege to directly benefit from the income (to dispose of income for one's own benefit);
- the ability to use dividends freely (notwithstanding the legal ownership of the underlying asset);
- the application of an 'insolvency test' and assessment of whether funds are available to arm's length creditors;
- the availability of guarantees and insurances from third and related parties relating to sharing of risks.

Thoughts

Beneficial ownership as a tax treaty concept is currently facing both methodological difficulties and challenges of practical application. Latest trends in OECD discussions, academic publications and experts' commentaries suggest that the concept may be revised either radically (including its abandonment) or through gradual evolution. The way of gradual methodological and practical improvement was introduced in this article. This is based on previous OECD practice and case law in OECD member states.

The majority of OECD member states have experience of interpreting and applying the beneficial ownership concept. Though case law is not universal, it does contain common features. Three main issues have been addressed by courts and tax administrations in OECD member states:

- 'beneficial ownership' as an anti-avoidance rule or income attribution technique; and
- whether beneficial ownership should have an international or domestic meaning; and
- legal and economic criteria used in establishing beneficial ownership.

Generally, the term 'beneficial ownership' has been given a broad international treaty meaning. The concept is also developed by the courts as an anti-avoidance technique rather than an instrument of income attribution. The most problematic issue has been the selection; the courts have not developed clear and consistent guidelines. In the circumstances, it has been suggested that it would be reasonable to introduce an OECD AOA.

This proposed approach would be based on economic principles developed elsewhere by the OECD, namely – value creation and FAR analysis. The value creation principle is used in order to understand the nature of a particular transaction and to identify key functions performed by participants. Functions suggest the assumption of risks. The presence and assumption of risk leads to the conclusion that a person or an enterprise has an interest in utilising this asset or income and thus this person may be considered a beneficial owner. Such analysis would be supplemented by a legal examination in order to make sure that the person is not merely a conduit, administrator, agent or nominee, whose level of risk with regard to the asset or income is minimal.

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Further, the *proposed OECD AOA* should recognise that beneficial ownership is an international treaty concept, which is aimed at combatting treaty shopping. It is important to reflect that legal and economic approaches do not oppose but complement each other. It also should be clarified that the *proposed OECD AOA* reflects, particularly, the spirit of recent OECD initiatives that seek to combat tax avoidance that involves the improper use of tax treaties.

In view of the above, the *proposed OECD AOA* may settle key elements of the beneficial ownership concept, ie macro and microeconomic background; wealth and value creation; social, legal, economic and ethical aspects of tax avoidance and beneficial ownership in particular; risk assuming and economic nature of the concept; interaction with a legal approach, but it may be expected that aspects of this concept will continue to evolve. However, in time, the opinions of Gutman and others may prevail with the result that the concept will lose much of its current topicality.

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89. An agent receives remuneration for services, even if it is only a conduit or nominee. However, the difference between remuneration (even paid at arm's length), is that such compensation implies assuming of real risk. Analyses of the assumption of real risk assuming will always show whether this is compensation for assuming risks or an artificial compensation or fee for agency services.

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