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Tax Treaty Treatment of Dividend Related Payments under Share Loan Agreements

The article analyses some of the qualification and allocation challenges that dividend related payments under share loan agreements give rise to for tax treaty purposes. The analysis is based on constructed scenarios illustrating how inconsistent domestic allocation of the dividend related payments give rise to qualification and allocation conflicts for tax treaty purposes in cross-border situations. The main challenges concern to what extent dividend related payments may be covered by the term "dividends" in article 10 of the OECD double tax convention and to what extent the lender in a share loan agreement fulfils the beneficial ownership requirement.

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1. Introduction

A share loan is generally characterized as a loan of listed shares, according to which one party lends its shares to another party for a specified period. During this period the borrower has disposal over the shares. There are various reasons why one would enter into share loan agreements, such as to hinder disturbance situations in stock trading, to bring additional return to the lender's share investment, for the borrower to benefit from changes in market value or to grant additional voting rights to the borrower during the loan period.[1]

A share loan agreement is an agreement of lent (restricted) ownership rights, which can entail that the right to sell the shares and the right to receive distributed dividends on the

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1. For these and other non-tax reasons for the use of share loan agreements; *see* P.H. Blessing, *Domestic and Treaty Anti-Abuse Rules as Applied to Dividends* in *Taxation of Intercompany Dividends under Tax Treaties and EU Law* (G. Maisto (ed.), IBFD 2012), EC and International Tax Law Series, Vol. 8, p. 100, Online Books IBFD; R. Cordner, *Growth of Securities Lending Depends on Regulations, Securities Lending, the Taxation of International Stock Lending*, International Tax Review Supplement, 1992, pp. 2-4; M.C. Faulkner in F.J. Fabozzi & S.V. Mann (eds.), *Securities Finance – Securities Lending and Repurchase Agreements*, John Wiley & Sons, Inc., 2005, p. 21 et seq.; M. Gaffney, *Cross-Border Securities Lending and Qualified Securities Lending Regime*, Tax Notes International, 2011, p. 975 et seq.; M. Helminen, *The International Tax Law Concept of Dividend*, Wolters Kluwer, 2010, p. 108; and O.S. Penn, *Withholding Tax Issues in Cross-Border Equity Swaps: The Dividend Problem*, Tax Notes International, 1993, p. 927.

lent shares might not belong to the same party. Consequently, the design of share loan agreements may give rise to several challenges for tax law purposes.

The domestic tax treatment of the payments under share loan agreements varies between jurisdiction. In cross-border situations, these inconsistent domestic tax treatments may give rise to qualification and allocation conflicts for tax treaty purposes, which may impose a risk of double taxation and consequently double non-taxation.

The purpose of this article is to identify and analyse some of the qualification and allocation challenges that the dividend related payments under share loan agreements give rise to for tax treaty purposes.[2] First, the general content of share loan agreements is introduced. This is followed by a brief overview of the relevant considerations for domestic tax purposes. Thirdly, the qualification of the dividend related payments for treaty purposes is analysed. For the purpose of simplification; this analysis is made under the assumption that the involved states apply the same allocation principles. Finally, on the basis of the qualification of the dividend related payments the allocation challenges, that may occur, are identified and analysed. These potential allocation conflicts are identified on the basis of three constructed scenarios.

2. The Content of Share Loan Agreements

According to a share loan agreement one party (the borrower) borrows (listed) shares from another party (the lender) often against the transfer of collateral.[3] Share loan agreements are often based on master agreements such as the Global Master Securities Lending Agreement produced by the International Securities Lending Association (ISLA). Two intermediaries, one on each of the parties' behalf may undertake the share loan agreements. These intermediaries arrange, manage and report on the lending activity and are often custodians, investment managers, third-party agents, brokers, investment banks, etc.[4]

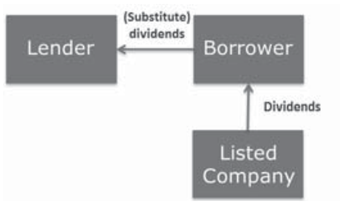
Generally, share loan agreements stipulate that the borrower is entitled to obtain ownership rights of the shares and by termination of the agreement, the borrower is obliged to transfer the borrowed shares or shares of the same sort; quality as well as quantity to the lender. Under share loan agreements the borrower pays for the right to lend the shares. This remuneration for lending out shares may be a fixed amount or a variable amount such as a percentage of the market value of the lent shares over the duration of the agreement. Additionally, it may be agreed that the borrower obtains ownership rights of the shares, including voting rights on annual meetings and the right to sell the shares to a third party.[5]

It is often agreed that the lender remains entitled to the dividends paid on the shares, either by a reimbursement of the gross dividends paid on the shares or an amount equal to the

2. Therefore, issues concerning relief of withholding taxes in practice, the proof of beneficial ownership, etc. are not dealt with in this article. However, these issues are of great importance in practice.
3. *See*, for example, article 1.2 of the ISLA Global Master Securities Lending Agreement (2010).
4. *See*, for example, Faulkner, *supra* n. 1, at p. 12 et seq.
5. *See*, for example, Cordner, *supra* n. 1, at pp. 2-4; Faulkner, *supra* n. 1, at p. 4; E. Flink et al., *Securities Lending*, International Tax Review, 1994, pp. 51-54; Gaffney, *supra* n. 1, at p. 975 et seq.; M. Helminen, *supra* n. 1, at p. 170; and R. Avi-Yonah & L. Swartz, *US International Tax Treatment of Financial Derivatives*, Tax Notes International, 1997, pp. 787-800.

net dividends distributed during the term of the loan.[6] Based on the ISLA Global Master Securities Lending Agreement, the lender will usually expect to receive a substitute payment of the same amount as the dividend to which the lender would normally be entitled and thus, the borrower would therefore have to pay a substitute payment that exceeds the net dividend that it receives if withholding taxes are levied.[7] Accordingly, depending on the specific terms agreed, it might be argued that the payment constitutes a dividend in the hands of the lender, as the lender has maintained the ownership right to the distributed dividends and the borrower has merely passed on dividends. Figure 1 shows a simplified illustration of the cash flow stream of the dividend related payments.[8]

Figure 1: Dividend related payments under share loan agreements



3. Domestic Tax Considerations

The design of share loan agreements may give rise to several challenges for tax law purposes. In some countries, a share loan agreement is considered a sale of the lent shares for tax purposes, i.e. tax on realized gain/loss may be imposed. In other countries, a share loan agreement is classified as a loan in kind for tax purposes, i.e. the share loan agreement is not considered a sale as the lender is still recognized as the owner of the shares.

As an example, for US tax purposes, the income tax consequences of the share loan agreement itself were addressed in Rev. Rul. 57-451, according to which the loan of shares was not considered a sale. In 1978 the Congress enacted section 1058 of the Internal Revenue Code, which provides that when a taxpayer transfers securities pursuant to an agreement which meets specified requirements, no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an obligation under such agreement, or on the exchange

6. This payment is generally referred to as a "substitute dividend" or as "in lieu of payments" or as "a manufactured dividend", *see,* for example, M. Gaffney, *supra* n. 1, at p. 977; Helminen, *supra* n. 1, at p. 170; and Penn, *supra* n. 1, at p. 927.

7. It follows from article 6.21 of the ISLA Global Master Securities Lending Agreement (2010) that where income is paid in relation to any Loaned Securities:

> Borrower shall, on the date of such Income is paid by the issuer … pay or deliver to Lender such sum of money ... equivalent to (and in the same currency as) the type and amount of such Income that would be received by Lender in respect of such Loaned Securities assuming such Securities were not loaned to Borrower and were retained by Lender in the Income Record Date.

See also, article 3(ii) of the ISLA Global Master Securities Lending Agreement, UK Tax Addendum according to which:

> any Income comprising a payment, the amount (the "Manufactured Dividend") payable by Borrower shall be made without any deduction or withholding for or on account of any Tax, provided that Lender has supplied Appropriate Tax documentation.

8. Figure 1 is based on the assumption that the borrower has not resold the borrowed shares.

of rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer.[9]

The Canadian Income Tax Act has specific provisions dealing with share loan agreements. Provided that certain requirements are met; a transfer of securities under a share loan agreement is not deemed to be at disposition by the lender for Canadian income tax purposes.[10] Specific anti-avoidance rules may apply in order to deny this qualification.

In Denmark the tax treatment of share loan agreements are not governed by law but follows from administrative case law, as the question has not yet been dealt with by the courts. According to administrative case law, the lender of the shares is regarded as the owner of the shares if certain requirements are met.[11] Thus, also for Danish tax purposes; the loan of shares is generally not considered a sale.

For domestic tax law purposes, allocation of dividends typically follows from a general principle of attribution based on either legal or economic entitlement.[12] Therefore, the allocation of dividends does not necessarily follow the legal ownership of the shares but depends on the applicable principle of attribution.[13] In some jurisdictions such as Germany, Italy, New Zealand and Norway, it follows from general propositions that income (including dividend payments) cannot be alienated independently of its source, whereas the alienation of income generally is tax-effective in Argentina, Austria, Switzerland and the United Kingdom.[14] In

9. For these rules *see,* for example, Avi-Yonah & Swartz, *supra* n. 5, at p. 790 et seq., W. Chip, *Are Repos Really Loans?*, Tax Notes International, Special Report, 2002, pp. 1057-1063; Flink et al., *supra* n. 5, at p. 52; Penn, *supra* n. 1, at p. 927 et seq.; and R.J. Shapiro in F.J. Fabozzi & S.V. Mann (eds.), *Securities Finance – Securities Lending and Repurchase Agreements*, John Wiley & Sons, Inc., 2005, p. 182 et seq. For case law, *see Calloway v. Commissioner* where the court found that the transaction was considered as a sale for tax purposes as the transaction was not analogous to the securities lending agreement in Rev. Rul. 57-451 and *Anschutz Co. v. Commissioner* where the court found that the transaction eliminated the risk of loss with regard to the lent shares and thus violated the requirements of section 1058(b)(3) according to which a share-lending agreement must not limit a security lender's risk of loss or opportunity for gain. For more on these cases, *see* V. Hammer, *Update on US Taxation Issues*, 12 Derivs. & Fin. Instrums. 5, pp. 142-144 (2010), Journals IBFD.
10. Cf. subsec. 260(2). For more information on Canadian tax treatment of payments under domestic and cross-border transactions, *see* C. Steeves, *Securities Lending and REPO Transactions: Canadian Income Tax Considerations*, 15 Derivs. & Fin. Instrums. 3, pp. 96-100 (2013), Journals IBFD.
11. For Danish administrative practices, *see* K. Dyppel, *Beskatning af aktielån og REPO'er*, SR-Skat, 2013, p. 53 et seq.
12. Such allocation principles often follow from specific rules or case law. The branch reporters to the IFA Congress in 2007 (Kyoto) were asked whether their country attributed income, as a general rule, on the basis of legal or economic entitlement, where legal entitlement was the basis was reported in 20 countries and economic entitlement in 8 countries, cf. J. Wheeler, *The General Report on Conflicts in the attribution of income to a person*, Cahiers de droit fiscal international, 2007, volume 92b, p. 20. Wheeler states, that: '*of course a simple choice between legal and economic entitlement as a basis for attribution cannot do justice to the many nuances and qualifications explained by the branch reporters*', and gives examples of different nuances.
13. This is especially essential if the ownership is changed for tax avoidance reasons. For considerations on classification of proceeds from the transfer of dividend rights as part of a dividend-stripping arrangement *see* M. Helminen, *supra* n. 1, at pp. 99-106.
14. Cf. J. Wheeler, *supra* n. 12, at p. 26. Concerning Germany *see* A. Born, *Impact of Tax Reform 2001 on Stock Lending Transactions*, 5 Derivs. & Fin. Instrums. 1, pp. 27-28 (2003), Journals IBFD; and H. Häuselmann, *Tax Treatment of Domestic Cross-Border Securities Lending Transactions*, 3 Derivs. & Fin. Instrums. 2, pp. 73-74 (2001), Journals IBFD; concerning Italy *see* R. Russo, *Tax Treatment of Stock Lending Agreements*, 8 Derivs. & Fin. Instrums. 1, p. 20 (2006) Journals IBFD; concerning New Zealand *see* A. Smith, *Tax Treatment of Domestic and Cross-Border Securities Lending Transactions*, 3 Derivs. & Fin. Instrums. 2, p. 87 (2001) Journals IBFD; and concerning Switzerland *see* J. Salom, *The Attribution of Income in Swiss and International Tax Law*, 65 Bull. Intl. Taxn. 7, p. 394 et seq. (2011), Journals IBFD.

almost all countries dividends are generally allocated to the shareholder, i.e. the owner of the shares.[15] However, deviations exist such as in the Netherlands and Sweden, where dividends are attributed to the person who is entitled to them and in Australia, where dividends are attributed to the person who has the voting power on matters regarding distribution on dividends.[16]

In some countries the allocation and tax treatment of dividends and/or substitute dividend payments under share loan agreements may follow from domestic substance over form or anti-avoidance rules.[17] Such anti-avoidance rules may be applied for the purpose of determining the ownership of the shares and/or the allocation of the dividends or merely for the purpose of imposing withholding taxes.

The US dividend stripping rules are an example of enacted anti-avoidance rules for the purpose of imposing withholding taxes on payments of a "dividend equivalent" or "substitute dividend payments".[18] A substitute dividend payment is a payment made to the transferor of a security in a securities lending transaction or a repo of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction.[19]

For UK tax purposes, short-term ownership of shares is ignored and therefore the dividends paid under share loan agreements are generally allocated to the lender as the long-term owner.[20]

For Danish tax purposes a reimbursement of distributed dividends on the lent shares is taxed as dividends in the hand of the lender if the dividends themselves are merely paid on by the borrower to the lender. Thus, the dividends are also allocated to the lender for Danish tax law purposes. Contrary, in other countries such as Finland, France, Germany, Italy, Ireland, Korea, the Netherlands, Norway and Switzerland the dividends paid under a share loan agreement are generally allocated to the borrower.[21]

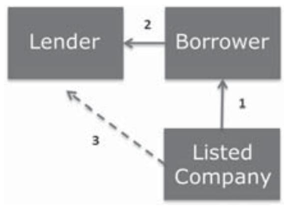
15. Cf. Helminen, *supra* n. 1, at p. 109; and Wheeler, *supra* n. 12, at p. 31.
16. Cf. Wheeler, *supra* n. 12, at p. 31, where also other exceptions are outlined.
17. Id. at p. 32.
18. Cf. section 871(m) in section 541 of the HIRE Act (dividend equivalent) and Treas. Reg. section 1.861-3(a)(6) (substitute dividend payments). For these rules *see,* for example, Blessing, *supra* n. 1, at p. 126 et seq.; P. Carman, *US Dividend Equivalents: Repos and Swaps Subject to Dividend Tax*, 14 Derivs. & Fin. Instrums. 2, pp. 74-80 (2012), Journals IBFD; Flink et al., *supra* n. 5, at p. 52 et seq., Gaffney, *supra* n. 1, at p. 985 et seq., Penn, *supra* n. 1, at pp. 917-933; Shapiro, *supra* n. 9, at p. 188 et seq.; and L.A. Sheppard, *How to Fix Withholding on Securities Loans and Swaps*, Tax Notes International, 2009, pp. 633-636. For a regulatory framework effective as of 1 January 2012 to reduce the possibility of cascading taxes (announced as Notice 2010-46) *see* Gaffney, *supra* n. 1, at p. 986 et seq.
19. Cf. Treas. Reg. sec. 1.861-3(a)(6). For earlier case law in this regard, *see* Chip, *supra* n. 9, at p. 1061 et seq.
20. *See* J. Lindsay, *Tax Treatment of Domestic and Cross-Border Securities Lending Transactions*, 3 Derivs. & Fin. Instrums. 1, p. 41 (2001), Journals IBFD; and Wheeler, *supra* n. 12, at p. 32.
21. Cf. J. Wheeler, *The General Report on Conflicts in the attribution of income to a person*, Cahiers de droit fiscal international, 2007, volume 92b, p. 32. The Netherlands makes an exception under its treaty with the United States and for that purpose regards the lender as the beneficial owner of a dividend, cf. id. Concerning Germany *see* Born, *supra* n. 14, at pp. 27-28; and Häuselmann, *supra* n. 14, at pp. 73-74; concerning Italy *see* Russo, *supra* n. 14, at pp. 19-24; concerning Ireland *see* J. O'Leary, *Tax Treatment of Domestic and Cross-Border Securities Lending Transactions*, 3 Derivs. & Fin. Instrums. 1, pp. 25-30 (2001), Journals IBFD; concerning the Netherlands *see* B. Baldewsing et al., *The Tax Treatment of Stock Lending and REPO Transactions*, 2 Derivs. & Fin. Instrums. 1, pp. 16-19 (2000), Journals IBFD; and J. Smits, *Tax Treatment of Domestic and Cross-Border Stock Lending Transactions*, 9 Derivs. & Fin. Instrums. 6, pp. 203-209 (2007), Journals IBFD.

As briefly illustrated, the allocation of dividends under share loan agreements differs from state to state and depends not only on whether the share loan agreement entails a transfer of ownership but also on the applicable principle of allocation. It follows from the general report to the IFA Congress in 2007 (Kyoto) that all the branch reporters were of the opinion that domestic allocation of outbound income is made without taking allocation principles in other countries into consideration.[22] This may impose a risk of double taxation and double non-taxation if the involved states apply different allocation principles.

4. Qualification of Dividend Related Payments According to the OECD Model

It follows from the above that qualification and allocation according to domestic tax law may differ from state to state. Further, it follows, for the purpose of analysing the tax treatment of the dividend related payments under cross-border share loan agreements, that three income streams are relevant. Compared to Figure 1 illustrating the real cash flows (cash flow 1 and 2), a third cash flow occurs. This cash flow illustrates the relevant income stream if the dividend payment is allocated to the lender. Consequently, the three cash flows illustrated in Figure 2 occur due to different allocation principles under domestic law, i.e. in some jurisdictions cash flow 1 and 2 (the real payments) are relevant, whereas cash flow 3 is relevant in jurisdictions where the dividends are allocated to the lender for tax purposes.

Figure 2: Dividend related payments under share loan agreements for tax purposes



In the following the qualification of the related dividend payments are analysed for treaty purposes. The purpose is to outline the tax treatment of the cash flows under the different allocation principles. As the tax treaty qualification may depend on the domestic allocation of the income, the analyses are made under the simplified assumption that the relevant states allocate the given cash flow to the same taxable person for domestic tax law purposes. Unless otherwise stated the analyses are based on the 2010 version of OECD Model Tax Convention on Income and on Capital (OECD Model).

4.1. Qualification of cash flow 1

Cash flow 1 is relevant if the dividend payments are allocated to the borrower and constitutes the dividends distributed to the borrower from the listed company, whose shares are subject to the share loan agreement. Firstly, it is relevant to ascertain whether cash flow 1 qualifies as a dividend payment for treaty purposes. If so, it is analysed whether the borrower is the beneficial owner of the dividends in the meaning of the treaty. This question is of relevance as the borrower is obliged to pass the dividends on to the lender under the share loan agreement.

22. Cf. Wheeler, *supra* n. 12, at pp. 48-50, in which some exceptions are also mentioned.

Article 10 of the OECD Model covers dividends paid by a company.[23] The term; "dividends" is defined in article 10(3) on the basis of examples. According to article 10 (3), "dividends" means:

(1) Income from shares (…) or
(2) [Income from] other rights not being debt-claims (…)
(3) As well as income from other corporate rights which is subject to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

The definition in the OECD Model consists of three parts, whereas the first two parts define the term autonomously.[24] The term is not fully and exhaustively defined and it follows from the third part of the definition, that the term must be interpreted in accordance with the laws of the source state. However, if an income fits under the autonomous parts of the dividend definition, domestic law does not affect the classification, as the reference to domestic law under the third part of the definition must be secondary, with respect to the conditions in the first and second part of the definition.[25] This follows from the interrelation of the three parts of the definition observed by Vogel, according to which:[26]

> The three parts of the definition are not set side by side in a way that would make them independent of one another. The word 'other' used in the second and third parts of the definition constitute a reference to the preceding part or parts, a reference that must not be ignored when reading the definition.

It follows from paragraph 1 in the preliminary remarks of the Commentary on Article 10 of the OECD Model, that "by 'dividends' is generally meant the distribution of profits to shareholders by companies limited by shares". Accordingly, a distribution from a listed company to a shareholder is covered by the term "dividends" for treaty purposes. Therefore – under the given assumptions – the qualification of cash flow 1 should not give rise to any doubt in this regard, i.e. a distribution from the listed company to the borrower (as shareholder) is qualified as dividends for treaty purposes.

According to the OECD Model, the principle of taxation of dividends is not an exclusive right to tax by either of the states. Instead, the right to tax is divided between the contracting states. Thus, the source state may only levy a reduced withholding tax, if the beneficial owner of the dividends is a resident of the other contracting state, whereas the tax so charged depends on whether the participation exemption is met by the beneficial owner, compare article 10(2). Consequently, if the borrower is the beneficial owner of the distributed divi-

23. For a historical evolution of the definition, *see* J.F. Avery Jones et al., *The Definition of Dividends and Interest in the OECD Model: Something Lost in Translation?*, 1 World Tax J. 1, p. 1 (2009), Journals IBFD; J. Hattingh, *South Africa: The* Volkswagen *Case and the Secondary Tax on Companies: Part 2 – The Effect on the Taxation of Dividends with Emphasis on Deemed (Constructive) Dividends*, 63 Bull. Intl. Taxn. 10, pp. 509-533 (2009), Journals IBFD; H. Pijl, *Interest from Hybrid Debts in Tax Treaties*, 65 Bull. Intl. Taxn. 9, pp. 496-502 (2011) Journals IBFD; and J. Sasseville, *The Definition of "Dividends" in the OECD Model Tax Convention* in *Taxation of Intercompany Dividends under Tax Treaties and EU Law* (G. Maisto (ed.) IBFD 2012), EC and International Tax Law Series, Vol. 8, p. 70 et seq., Online Books IBFD.
24. These parts must be interpreted according to the general rule of article 3(2) of the OECD Model, cf. Hattingh, *supra* n. 23, at p. 518; Helminen, *supra* n. 1, at p. 63; Sasseville, *supra* n. 23, at p. 69; and Vogel et al., *Klaus Vogel on Double Taxation Conventions. Kluwer Law International*, 1997, p. 649.
25. *See* Avery Jones et al., *supra* n. 23, at sec. 3.3.; *see* Hattingh *supra* n. 23, at p. 516; and Helminen, *supra* n. 1, at p. 65.
26. Cf. Vogel et al., *supra* n. 24, at p. 649. *See also* Pijl, *supra* n. 23, at p. 490 et seq.

dends, the state, in which the distributing company is resident, may only levy a reduced withholding tax. On the other hand, if the borrower is not considered to be the beneficial owner, the source state is not obliged to give up taxing rights over the dividend income, i.e. withholding tax may be levied (without limitations).

In recent years the beneficial owner requirement has been frequently analysed in the literature and subject to case law, as numerous revenue authorities have relied on the concept to challenge, otherwise tax effective, arrangements involving holding companies and other intermediaries.[27] In respect of the beneficial owner requirement in article 10, the question at hand often concerns whether a company, that redistributes a dividend payment to its parent company, is the beneficial owner of the dividends received.

Unlike the traditional cases, the relevant parties (the borrower, the distributing company and the lender) under a share loan agreement may not be connected as a group for tax purposes. Thus, the borrower does not redistribute the dividends to its parent company in a traditional sense. However, if the borrower as the immediate recipient of the dividends is obliged to pass the dividends on to the lender under the share loan agreement, it raises the question whether the borrower is the beneficial owner of the dividends in the meaning of the treaty.

The requirement of beneficial ownership was introduced in articles 10, 11 and 12. The term was added to clarify the meaning of the words "*paid…to a resident*" and thus to make clear that the source state is not obliged to give up taxing rights over dividend income merely because that income was immediately received by a resident of a state with which the source state had concluded a double tax convention.[28]

It has been widely discussed whether the term beneficial owner should be interpreted autonomously or whether the term has to be determined from domestic law of the contracting state (lex fori) in accordance with article 3(2) of the OECD Model. However, distinguished scholars agree that the term has an "*international fiscal meaning*" and is not dependent upon the domestic law in either of the contracting states.[29] According to P. Baker, there are several reasons for the use of an international fiscal meaning:

> in many countries there is no domestic meaning of the term; where there is such a meaning, it is now clear from the OECD Commentary that a technical meaning is not to be applied; the term is essentially one that has come into tax treaty usage from international tax practice and not from the domestic tax systems of the countries concerned.[30]

27. For some recent contributions, *see* P. Baker, *The Meaning of "Beneficial Ownership" as Applied to Dividends under the OECD Model Tax Convention* in*Taxation of Intercompany Dividends under Tax Treaties and EU Law* (G. Maisto (ed.) IBFD 2012), EC and International Tax Law Series, Vol. 8, chapter 6, Online Books IBFD; M. Lang et al. (eds.), *Beneficial Ownership: Recent Trends*, (IBFD 2013), Online Books IBFD; and J. Wheeler in *The Missing Keystone of Income Tax Treaties*, 3 World Tax J. 2, p. 257 et seq. (2011), Journals IBFD; and in *The Attribution of Income to a Person for Tax Treaty Purposes*, 59 Bull. Intl. Taxn. 11, pp. 478-488 (2005), Journals IBFD. For an overview of the pending Danish cases on beneficial ownership *see* H.S. Hansen et al., *Danish "Beneficial Owner" Cases – A Status Report*, 67 Bull. Intl. Taxn. 4/5, pp. 192-200 (2013), Journals IBFD; for an Canadian view *see* G. Watson & S. Baum, *International Tax Planning: Beneficial Ownership as a Treaty Anti-Avoidance Tool?*, Canadian Tax Journal, 2012, pp. 149-168; and for a French view *see* B. Gouthière, *Benefical Ownership and Tax Treaties: A French View*, 65 Bull. Intl. Taxn. 4/5, pp. 217-222 (2011), Journals IBFD.
28. Cf. paragraph 12 of the Commentary on Article 10(2) of the OECD Model.
29. Cf. Baker, *supra* n. 27, at p. 100; C.P. du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* p. 171 et seq. (IBFD 1999), Online Books IBFD; K. Vogel et al., *supra* n. 24, at p. 562; and Wheeler, *supra* n. 27, at p. 481.
30. Cf. Baker, *supra* n. 27, at p. 100.

However, C.P. du Toit states that if the term forms part of domestic law; there is room to argue that article 3(2) can be applied for the purpose of interpreting the meaning of beneficial ownership itself, i.e. it does not allow recourse to other domestic legal principles, such as domestic anti-abuse law.[31]

It follows from the proposed revised comments to paragraph 12.1 to article 10 of the OECD Model that the term "beneficial owner" should have an autonomous meaning.[32] Further, it is stated that this revised comment should not be viewed as an amendment but as a specification of the existing comment. This remark is based on the guidance in the existing paragraph12 and the majority of the comments received on the issue supporting the conclusion that the term beneficial owner should have an autonomous treaty meaning.[33] Accordingly, this also indicates that the term should be interpreted autonomously.

According to the Commentary on Article 10 of the OECD Model, the term "beneficial owner" should not be used in a narrow, technical sense. Rather, the term should be understood in its context and in light of the object and purpose of the double tax convention.[34] The term is defined in paragraph 12 of the Commentary on Article 10(2) of the OECD Model and it follows from paragraph 12.2 that the borrower is not considered a beneficial owner if he is acting in the capacity of an agent or nominee or is simply acting as a conduit for the lender.[35]

In this regard, it is specified that:

> For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation conventions and the Use of Conduit Companies" concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties

Thus, if the immediate recipient has very narrow power in relation to the income concerned and therefore acts as a conduit company; the immediate recipient cannot be regarded as the beneficial owner. Under a share loan agreement, the borrower is obliged to pass on received dividends to the lender and therefore has no power in regard to the income, as the share loan agreement does not attributes the borrower disposal over the distributed dividends. Based on this, it seems that the borrower cannot be regarded as the beneficial owner.

31. Cf. du Toit, *supra* n. 29, at p. 177 et seq. This reference to domestic law has been taken further by the Netherlands State Secretary for Finance, who has argued that domestic dividend stripping rules also applies in the tax treaty context, irrespective of whether the relevant tax treaty itself limits the benefits of (the dividend article of) the treaty to the beneficial owner. This means that only a person that qualifies as the beneficial owner for dividend stripping purposes is eligible for the benefits of (the dividend article of) the applicable tax treaty, cf. the Netherlands Parliament, Upper Chamber, 2001-2002, 27896-28246, No. 117b, pp. 4-8 and Netherlands Parliament, Lower Chamber, 2000-2001, 27896, No. 3, pp. 2-3 commented by Smits, *supra* n. 21, at p. 207 (2007). According to J. Smits this has been widely criticized in Netherlands tax literature. *See also* the Canadian cases *Prévost* and *Velcro Canada Inc. v. The Queen*, according to which the domestic definition of "beneficial owner" is appropriate when interpreting Canada's tax treaties. These cases are e.g. commented by Watson & Baum, *see supra* n. 27, at pp.149-168.
32. Cf. OECD's public discussion draft of the revised proposals concerning the meaning of beneficial owner in articles 10, 11 and 12 of the OECD Model as of 19 October 2012 to 15 December 2012.
33. Cf. paragraphs 2-4 of OECD's public discussion draft of the revised proposals concerning the meaning of beneficial owner in articles 10, 11 and 12 of the OECD Model as of 19 October 2012 to 15 December 2012.
34. Cf. paragraph 12 of the Commentary on Article 10(2) of the OECD Model.
35. It follows from OECD's public discussion draft of the revised proposals concerning the meaning of beneficial owner in articles 10, 11 and 12 of the OECD Model as of 19 October 2012 to 15 December 2012, that the expression in paragraph 12 "received by" is amended to "paid direct to" and the expression "immediate" is amended to "direct", i.e. "immediate received by" is amended to "paid direct to".

In October 2012, the OECD released a revised discussion draft on suggested changes to the commentary relating to the meaning of the term "beneficial owner".[36] The proposed paragraph 12.4 is perhaps the most significant attempt to clarify the meaning of the term "beneficial owner", as it clarifies that anything less than a binding obligation to pay the actual payment to another person does not deprive the recipient of beneficial ownership.[37] The revised proposal explains that any obligation to pass the payment received to another person "must be related to the payment received" and "would therefore not include contractual or legal obligations unrelated to the payment received even if those obligations could effectively result in the recipient using the payment received to satisfy those obligations".[38] Accordingly, the mere fact that the immediate recipient passes on received dividends to fulfill contractual or legal obligations does not solely preclude that the immediate recipient is considered the beneficial owner, as the obligation to pass on the received dividends must be related to the dividends received. The proposed commentaries laid down in the revised discussion draft therefore suggest a narrow scope of the beneficial ownership requirement in order to prevent that a number of legitimate situations do not fulfil the beneficial ownership requirement and thus, are not be covered by the reduced withholding taxes on dividends.

As the borrower's obligation under a share loan agreement is a legal obligation to pay the actual payment to the lender and this obligation is in fact related to the dividends received, an adoption of the amended commentaries outlined in the revised discussion draft does not change the initial conclusion. Thus, under the given assumptions, the borrower may not be regarded as beneficial owner of the distributed dividends illustrated as cash flow 1, as the borrower has a binding obligation to pass on the received dividends to the lender.

Consequently, the real payment made from the listed company, whose shares are subject to the share loan agreement, to the borrower (cash flow 1) qualifies as a dividend payment covered by article 10 of the OECD Model. However, if the borrower is obliged to pass on the received dividends to the lender under the share loan agreement, the borrower (as shareholder) may not qualify as the beneficial owner of the dividends in the meaning of the treaty. Whether the lender (as beneficial owner) is granted treaty benefits (i.e. reduced withholding tax on dividends) may depend on the applicable principle of allocation in the residence states of the parties and whether these states have entered into a double tax treaty. This is further analysed in regard to Scenario 2 and 3 in sections 5.2. and 5.3. of this article.

4.2. Qualification of cash flow 2

Cash flow 2 is relevant if the dividends are allocated to the borrower and constitutes the actual payment from the borrower to the lender under a share loan agreement. The payment from the borrower to the lender constitutes a reimbursement of the gross dividends paid on the shares or an amount equal to the net dividends distributed during the term of the loan. In either case, the payment constitutes a substitute dividend payment. As the payment mirrors an actual dividend payment, it raises the question of whether the income may

36. Cf. OECD Model: Revised Proposal Concerning the Meaning of "Beneficial Owner" in Articles 10, 11 and 12, 19 October 2012 to 15 December 2012.
37. Cf. Baker, *supra* n. 27, at p. 93. *See also* M. Lang et al. (eds.), *supra* n. 27, at p. 3.
38. Cf. Revised proposed Commentary on Article 10, paragraph 12.4 in OECD Model: Revised Proposal Concerning the Meaning of "Beneficial Owner" in Articles 10, 11 and 12, 19 October 2012 to 15 December 2012, *see* http://www.oecd.org/ctp/treaties/Beneficialownership.pdf.

arise from a corporate right and thus, be covered by the term "dividend" in article 10 of the OECD Model.

From the wording "*income from other corporate rights which is subject to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident*" in Article 10(3), it can be drawn that for treaty purposes only such items of income can be considered "dividends" that arise from corporate rights.[39] The requirement of a corporate right must be interpreted autonomously and therefore the fact that the source state taxes the distribution as dividends under domestic law does not qualify the income as a dividend for treaty purposes.[40]

The term *corporate rights* is not expressly defined in the OECD Model and the term is primarily used to distinguish dividend constituting equity investments from other kinds of investments in a company.[41] In this regard Vogel and Lehner have argued that the context of the treaty indicates that corporate rights must entitle the owner, not only to a share in the current profit, but also, at least, to a share in the liquidation proceeds of the company.[42] Helminen argues that income from a corporate right is income that is received because of a person's position as a shareholder or because of a comparable relationship to a company.[43] Thus, she does not consider access to liquidation proceeds as a dividend requirement. Hattingh argues that the absence of a right to a share in future liquidation proceeds would not preclude a person from holding the necessary corporate right, as he generally considers the content of a corporate right as being the yield of capital risked as an investment in a company.[44] Pijl argues that there is no convincing support for the requirement that the instrument should be entitled to unfettered profit rights, nor that the instrument should be based on company law.[45] Regardless of the delimitation of the substance of the term "corporate right", it seems clear that the income must originate from a corporate right. Further, there also seems to be a general consensus that corporate rights refer to rights under an instrument issued by or at least agreed to by the corporation itself and not a third-party contract in reference to shares of the corporation.[46]

The lender's entitlement to get reimbursed for distributed dividends for the duration of a share loan agreement derives from the specific terms of the share loan agreement entered into between the lender and the borrower. Therefore, even though the substitute payment is based on the amount of the distributed dividends on the transferred shares, the substitute

39. Cf. Vogel et al., *supra* n. 24, at p. 649. *See also* Hattingh *supra* n. 23, at p. 518; and Helminen, *supra* n. 1, at pp. 64-65.
40. Cf. Vogel et al., *supra* n. 24, at p. 650. *See also* S. Bärsch, *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in and International and Cross-Border Context*, Springer, 2012, p. 99 et seq.; Hattingh *supra* n. 23, at p. 518; Helminen, *supra* n. 1, at pp. 102 and 175; and Pijl, *supra* n. 23,at p. 489 et seq.
41. *See*, for example, J.F. Avery Jones et al., *supra* n. 23, at p. 1 et seq.; J. Bundgaard, *Perpetual and Super-Maturity Debt Instruments in International Tax Law*, 10 Derivs. & Fin. Instrums. 4, p. 139 et seq. (2008), Journals IBFD; J. Bundgaard & K. Dyppel, *Profit Participation Loans in International Tax Law*, Intertax, 2010, p. 657 et seq.; Helminen, *supra* n. 1, at p. 80; Pijl, *supra* n. 23, at pp. 482-502; and Vogel et al., *supra* n. 24, at p. 650.
42. Cf. K.Vogel et al., *supra* n. 24, at p. 651.
43. Cf. M. Helminen, *supra* n. 1, at p. 96.
44. Cf. Hattingh, *supra* n. 23, at p. 519.
45. Cf. Pijl, *supra* n. 23, at p. 489.
46. Cf. Blessing, *supra* n. 1, at p. 128; Avery Jones et al., *supra* n. 23, at sec. 3.2.; and Pijl, *supra*. n. 23, at p. 493.

payment, in and of itself, is not income from corporate rights.[47] In other words, the fact that the substitute payment mirrors the dividends paid by the listed company to the borrower does not make the lender's rights under a share loan agreement into corporate rights. Consequently, the entitlement to the substitute dividend payment does not derive from corporate rights. Instead, the right is based on a lending agreement. Therefore the payment does not qualify as dividends under the OECD Model, even though the payment might be taxed as a dividend in the source state.[48]

It follows from the methodology of the OECD Model that unless income is subject to one of the specific provisions outlined in articles 6 to 20 of the treaty, the income is considered "other income" covered by article 21. It seems reasonable to conclude, that cash flow 2 qualifies as other income under article 21 of the OECD Model unless the lender trades securities in the course of its regular business, i.e. then the payment may qualify as business profits under article 7 of the OECD Model.[49]

4.3. Qualification of cash flow 3

Cash flow 3 in Figure 2 illustrates the relevant cash flow, in the case where the dividend payments are allocated to the lender for tax purposes. Thus, for domestic tax purposes, the payment constitutes a dividend payment from the listed company to the lender, as the lender in this scenario is considered the shareholder and/or the rightful recipient of the dividend income. This raises the question of whether cash flow 3 can constitute *income from shares* covered by the term "dividend" in article 10(1) of the OECD Model and consequently be classified as a dividend payment for treaty purposes when the real payments made are cash flow 1 and 2.

As briefly mentioned above, in some jurisdictions share loan agreements are classified as a loan in kind, i.e. the lender is still the legal owner of the shares and in other jurisdictions the share loan agreement is considered a sale of the transferred shares. The allocation of the dividend payment to the lender may follow from general domestic principles of attribution or anti-avoidance legislation. Accordingly, the dividend payment can be allocated to the lender as shareholder of the transferred shares or due to a principle of economic entitlement.

According to paragraph 3 of the Commentary on Article 10 of the OECD Model, the term "dividends" generally means distribution of profits to its shareholders as return on the

47. *See also* Helminen, *supra* n. 1, at p. 113.
48. Id. at pp. 111-112; Smits, *supra* n. 21, at p. 208; and Blessing, *supra* n. 1, at p. 128. Substitute payment may qualify as a dividend under tax treaties, if the substitute payments are treated as a dividend under the domestic law of the payer or if the wording of the dividend definition does not require a dividend to be income from corporate rights, e.g. treaties that follow the US Model or treaties with similar wording. Under the US Model, any income that is taxed the same way as a dividend in the source state qualifies as a dividend. Thus, if the state of residence of the paying company treats the distribution as dividend under domestic law, the income also qualifies as a dividend under the US Model. Another deviation from the OECD Model is the Nordic multilateral treaty according to which any income paid by a company treated in the source state as dividend also qualifies as a dividend for treaty purposes, cf. paragraphs 1 and 6 of article 10 of the treaty. *See*, for these and other specific treaties, M. Helminen, *supra* n. 1, at p. 102 and Blessing, *supra* n. 1, at p. 128.
49. *See also* Helminen, *supra* n. 1, at pp. 110-111. However, if the lender is considered the beneficial owner of the dividends distributed as cash flow 1, cash flow 2 may constitute a dividend payment for treaty purposes. Thus, the lender may claim the treaty benefits under article 10 of the OECD Model and would thus be eligible for the relief or exemption under article 10 of the OECD Model. *See also* Blessing, *supra* n. 1, at p. 129 et seq., This is further discussed in section 5.2.

capital which has been made available to a company by its shareholders. The wording of the commentaries indicates that income based on a dividend right, but paid to a person other than the shareholder, does not qualify as a dividend within the meaning of the definition. As the OECD Model does not explicitly require that a dividend is received by a shareholder, it may be argued that income received by another person than a shareholder may qualify as a dividend payment for treaty purposes. However, the individual parts of article 10(3) of the OECD Model must be interpreted with respect to the whole definition, as the wording "other" used in the second and third parts of the definition constitute a reference to the preceding part or parts.[50] Thus, the wording "as well as income from *other* corporate rights" in the third part of the definition indicates that "*income from shares*" in the first part also must originate from a "*corporate right*".[51] Based on this, income qualifying as "*income from shares*" must be paid to a shareholder, as a corporate right to income from shares generally follows from shareholding. Accordingly, scholars have argued that dividend treatment requires that the income recipient be a shareholder at least at a certain point prior to the distribution so that the distribution may be said to be made by virtue of a shareholding.[52] However, others have argued that a shareholder requirement is not decisive for an income to qualify as a dividend covered by article 10 of the OECD Model.[53]

For the purposes of qualifying cash flow 3 under the share loan agreement for tax treaty purposes; a "shareholder requirement" gives rise to a distinction between situations in which the income is allocated to the lender as shareholder of the transferred shares and situations in which the allocation is based on other principles; such as economic entitlement or anti-avoidance legislation, i.e. situations in which the lender is not considered shareholder of the transferred shares.[54]

If the source state considers the lender as shareholder for domestic tax purposes, the income is considered a payment made by the distributing company to a shareholder and must, consequently, be qualified as a dividend for treaty purposes. Based on the same arguments as presented in section 4.1., the lender must be considered the beneficial owner of the dividends in this scenario.

On the other hand; if the source state considers the borrower as shareholder but allocates the income to the lender, based on principles such as economic entitlement, substance-over-form or (other) anti-avoidance principles, the shareholder requirement is not met. In other words, if the wording "income from shares" is strictly interpreted and a shareholder requirement is upheld, a substitute dividend payment allocated to another recipient than the shareholder is not considered "income from shares". Further, based on the same arguments as presented in section 4.2., the income cannot be considered income from corporate rights, if the entitlement to the dividend payment follows from a share loan agreement entered into between other parties than the distributing company. Consequently, if the source state con-

50. Cf. Vogel et al., *supra* n. 24, at p. 649. *See also* Avery Jones et al., *supra* n. 23, at sec. 3.3.; and Hattingh, *supra* n. 23, at p. 517 et seq.
51. *See also* Pijl, *supra* n. 23, at p. 490 et seq. For similar considerations and summaries of case law concerning deemed or constructive dividends or hidden profit distributions *see* Hattingh, *supra* n. 23, p. 521 et seq., at p. 532.
52. *See* Helminen, *supra* n. 1, at p. 101 and Vogel et al., *supra* n. 24, at p. 653.
53. *See*, for example, Pijl, *supra* n. 23, at p. 493.
54. If the ownership of the shares is determined under an anti-avoidance rule, the dividends are still considered as allocated to the lender as shareholder of the transferred shares.

siders the borrower as shareholder but allocates the income to the lender based on economic entitlement of the income – substance-over-form or (other) anti-avoidance principles – cash flow 3 may not be considered a dividend covered by article 10 of the OECD Model.

The Commentary on Article 10(3) of the OECD Model seems to have no legal basis themselves to import a substance-based notion of the concept of a dividend into the treat definition[55] Therefore, to apply domestic substance-over-form or anti-avoidance principles for treaty purposes and, thus, (re)classify the income as dividend, it seems to require that such domestic substance-over-form or anti-avoidance principles are respected for tax treaty purposes.[56]

Generally, it follows from the commentaries to the OECD Model that domestic anti-abuse rules do not conflict with treaties.[57] However, the commentaries do not clearly make a distinction between general and specific anti-abuse rules and it is not obvious that domestic anti-abuse rules should be respected for treaty purposes regardless of whether the anti-abuse rule is applied for the purpose of (re)classifying income on a general basis or only to hinder abuse.[58] In any event the effect of domestic (re)characterizations for treaty purposes seems to depend on whether the relevant term is defined in the treaty.[59]

Consequently, the tax treaty qualification of cash flow 3 may depend on whether the domestic allocation to the lender is based on the lender's ownership of the transferred shares or principles such as economic entitlement, substance-over-form or (other) anti-avoidance, i.e. situations where the lender is not considered a shareholder of the transferred shares.

If the source state considers the lender as shareholder for domestic tax purposes, cash flow 3 qualifies as a dividend for treaty purposes. If the source state considers the borrower as shareholder for domestic tax purposes and (re) allocates the income to the lender based on anti-avoidance principles, it seems fair to conclude that the income cannot be considered a dividend covered by article 10 of the OECD Model, as the income cannot qualify as a *corporate right*. As a result, the income must be qualified as other income under article 21 of the OECD Model and is therefore subject to the same tax treatment as cash flow 2 analysed in section 4.2. above.

55. Cf. Hattingh, *supra* n. 23, at p. 520. *See also* S. van Weeghel in *The General Report* in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, 2010, volume 95a, p. 33 et seq.
56. The approach should be allowed at least with respect to treaties expressly allowing the use of domestic anti-avoidance provisions, cf. Helminen, *supra* n. 1, at p. 112. For variations of the third part of the definition, *see* Avery Jones et al. *supra* n. 23, at sec. 3.4.
57. Cf. paragraph 22 of the Commentary on Article 1 of the OECD Model.
58. For the relationship between the domestic anti-avoidance provisions and tax treaties *see* paragraphs 9(1) and 22 of the Commentary on Article 1 of the OECD Model. The commentaries concludes that domestic anti-abuse rules do not conflict with treaties, without clearly making a distinction between general and specific anti-abuse rules. *See also* the reports to the IFA Congress in 2010 (Rome) on *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, 2010, volume 95a.
59. Cf. van Weeghel, *supra* n. 55, at p. 33 et seq.

5. Allocation Conflicts

The qualification and tax treatment of the three cash flows illustrated in Figure 2 have been analysed for tax treaty purposes. These analyses are made under the assumption that the involved states have allocated the payment to the same person for tax purposes.

However, the allocation of dividend- related payments under share loan agreements differs from state to state and depends not only on whether the share loan agreement entails a transfer of ownership but also on the applicable principle of allocation. In general, income is allocated to a taxable person for domestic tax law purposes before the relevant treaty is applied, as the treaty generally does not deal with allocation of income.[60]

Some argue that this initial domestic allocation results from the absence of an explicit allocation concept in the treaty whereas others argue that the treaty is not applicable until the income is allocated in accordance with domestic law.[61] Regardless of the argument, this may, obviously, give rise to allocation conflicts in cross border transactions, if the domestic allocation in the relevant states differs and the treaty does not deal with the allocation of the income.[62]

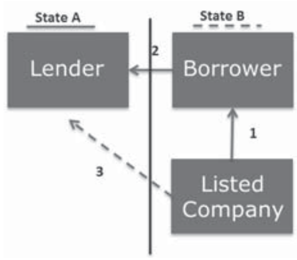
In this section the tax implications of allocation conflicts occurring in respect to dividend-related payments under share loan agreements are analysed on the basis of constructed scenarios. In the constructed scenarios it is assumed that the income is allocated to the rightful income recipient based on the ownership of the shares, i.e. the substitute dividends payment is allocated to the shareholder.[63]

5.1. Scenario 1: Different domestic allocation results in a qualification conflict

The first constructed allocation conflict is Scenario 1 as illustrated in Figure 3. In this scenario State A allocates the dividend payment under a share loan agreement to the borrower and, thus; in State A the real payment, i.e. cash flow 2 is the relevant income for treaty purposes. On the other hand, State B allocates the dividend payment to the lender and, thus; in State B cash flow 3 is relevant for treaty purposes.

60. Cf. D. Kleist, *Methods for Elimination of Double Taxation under Double Tax Treaties – with Particular Reference to the Application of Double Tax Treaties in Sweden*, Iustus Förlag, 2012, p. 126; Salom, *supra* n. 14., at p. 399; and Wheeler, *supra* n. 27, at pp. 478-488. It follows from the general report to the IFA Congress in 2007 (Kyoto) that also in practice most of the countries apply domestic allocation principles for treaty purposes; cf. Wheeler, *supra* n. 12, at p. 49. However, exemptions are mentioned including Italy, Luxembourg and Portugal who applies the same allocation principles as the resident states for treaty purposes, id. at p. 49.
61. *See*, for example, Wheeler *supra* n. 27.
62. As noted by Wheeler, it might have been expected that more attention would have been paid to this issue, cf. Wheeler, *The Attribution of Income to a Person for Tax Treaty Purposes*, 59 Bull. Intl. Taxn. 11, p. 478 et seq. (2005), Journals IBFD.
63. In this case it makes no difference whether the ownership of the shares follows specific legislation, a general principle of law or anti-avoidance rules.

Figure 3: Scenario 1



Accordingly, both State A and B consider the lender as the rightful recipient of the relevant income for treaty purposes, whereas State A considers the borrower as the payer and State B considers the listed company as the payer. Based on the analysis carried out in section 4. of this article, State A may qualify the relevant income as other income under article 21 of the OECD Model whereas State B may qualify the relevant income as dividends under article 10 of the OECD Model. Consequently, a reduced withholding tax may be levied by State B. In this scenario the tax consequences of a qualification conflict occurring as a spill-over effect of the different domestic allocations of the payments (by State A and State B) is analysed.

The scope and reference to the domestic laws of the contracting states in article 3(2) is widely discussed.[64] However, since the OECD changed the Commentary on Article 23 of the OECD Model in 2000, the residence state must grant relief where the provisions of the convention, as interpreted and applied by the source state in accordance with article 3(2) of the OECD Model, authorizes taxation of an item of income by the source state, irrespective of how the income is characterized according to domestic law of the residence state.[65] Article 23 should not be used as a toll for conflicts of qualification in the first place as such conflicts primarily should be solved by the autonomous interpretation in accordance with the provisions of the convention. Further, article 23 can only solve conflicts that are based on different provisions of domestic law and not conflicts of qualification (that are) based on a different interpretation of facts or a different interpretation of the provisions of the convention.[66] Consequently, if and only if – in accordance with article 3(2) and article 10 – the income is characterized

64. For this discussion *see* for example J.F. Avery Jones et al., *Credit and Exemption under Tax Treaties in Cases of Differing Income Characterization*, 36 Eur. Taxn. 4, p. 133 et seq. (1996), Journals IBFD; L. De Broe, *International Tax Planning and Prevention of Abuse*, Doctoral Series, volume 14, p. 262 et seq. (IBFD 2008), Online Books IBFD; F. Engelen, *Interpretation of Tax Treaties under International Law*, Doctoral Series, volume 7, chapter 10.10 (IBFD 2004), Online Books IBFD; A.R. Huerta in E. Burgstaller & K. Haslinger (eds.), *Conflicts of Qualification in Tax Treaty Law*, Linde, 2007, pp. 19-38; J.F. Avery Jones, *The Interaction between Tax Treaty Provisions and Domestic Law* in *Tax Treaties and Domestic Law* (G. Maisto (ed.) IBFD 2006), paragraph 6.2, Online Books IBFD; J. Schwarz, *Schwarz on Tax Treaties*, CCH, Wolters Kluwer, 2011, second edition, p. 90 et seq.; and N. Shelton, *Interpretation and Application of Tax Treaties*, Tottel publishing, 2004, p. 196 et seq. For this discussion with specific regards to the definition of dividends *see*, for example J.F. Avery Jones et al., *Whether the Definition of Dividend Limited to the Dividend Article Applies to the Double Taxation Relief Article Granting Underlying Credit*, 53 Bull. Intl. Taxn. 3, pp. 103-108 (1999), Journals IBFD.

65. Cf. paragraphs 32.1 and 32.2 of the Commentary on Article 23A and 23B of the OECD Model. *See also* Engelen, *supra* n. 64, at sec. 10.10; Huerta, *supra* n. 64, at p. 29 et seq., Avery Jones, *supra* n. 64, at para. 6.2; S. Kienberger in E. Burgstaller & K. Haslinger (eds.), *Conflicts of Qualification in Tax Treaty Law*, Linde, 2007, pp. 309-332; P. Martin, *Interaction between Tax Treaties and Domestic Law*, 65 Bull. Intl. Taxn. 4/5, pp. 205-210 (2011), Journals IBFD; and Sasseville, *supra* n. 23, at p. 70.

66. Cf. paragraphs 32.4 and 32.5 of the Commentary on Articles 23A and 23B of the OECD Model.

as dividends in State B (the source state), State A (the domicile state) must grant relief for withheld taxes. Based on this it should be considered whether State B has characterized the substitute dividend payment as dividends in accordance with article 3(2) and article 10 under this constructed scenario.

In this constructed scenario it is assumed that State B allocates the substitute dividend payment to the lender as the rightful income recipient based on the ownership of the shares, i.e. the lender is considered shareholder according to domestic law in State B. As concluded in section 4.3.; if the source state considers the lender as shareholder for domestic tax purposes, the income is considered a payment made by the listed company to its shareholder and, thus; the income must qualify as a dividend covered by article 10 of the OECD Model for treaty purposes. As article 21 of the OECD Model only applies to items of income not dealt with in the foregoing articles, State A (the resident state) must grant relief as State B (the source state) has levied withholding tax in accordance with articles 3(2) and 10 of the OECD Model.

If, on the other hand, State B (the source state) considers the borrower as shareholder for domestic tax purposes and (re) allocates the income to the lender based on economic entitlement, substance-over-form or (other) anti-avoidance principles the income may not be considered a dividend covered by article 10 of the OECD Model.[67] As a result, the income may qualify as other income under article 21 of the OECD Model, i.e. State B is not given the right to levy any withholding taxes.

As concluded in section 4.3., the tax treaty qualification of cash flow 3 may depend on whether the domestic allocation in the source state is based on ownership of the shares or economic entitlement of the income, substance-over-form or (other) domestic anti-avoidance provisions and whether the contracting states accepts domestic anti-avoidance provisions for treaty purposes. Consequently, if State B – in accordance with articles 3(2) and 10 – considers the income as dividends in State B (the source state), State A (the domicile state) must grant relief for withheld taxes, compare article 23 of the OECD Model. If, on the other hand, the domestic allocation in State B (the source state) is based on domestic anti-avoidance provisions not accepted for treaty purposes, State A (the domicile state) may not be obliged to grant relief for withheld taxes, compare article 23 of the OECD Model.

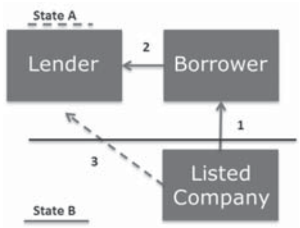
The distinction between the different situations may not always be clear and therefore, in practice, the qualification conflict may be based on different interpretations of facts or different interpretations of the provisions of the convention, which are conflicts that cannot be solved by applying article 23 of the OECD Model. As a result, in this scenario the income received by the lender may be subject to double taxation and consequently double non-taxation.[68]

67. *See* section 4.3.
68. In order to avoid double taxation based on classification conflicts, Helminen suggests not to tax substitute dividend payments as a dividend under tax treaties, which follows the wording of the OECD Model and proposes that, if contracting states wish to treat a substitute dividend as a dividend for tax treaty purposes, such treatment should expressly be mentioned in the tax treaty, cf. Helminen, *supra* n. 1, at p. 112. The treaty entered into between the Netherlands and the United States includes a special article on share loan agreements. According to Netherlands domestic tax law, substitute dividend payments are not treated as dividends and consequently no domestic credit is granted for withheld foreign taxes. However, according to the treaty entered into with the United States, the payments are treated as dividends paid directly by the distributing company to the lender and are subject to the applicable withholding tax rate under the treaty, thus, domestic credit is granted. This provision is analysed in Smits, *supra* n. 21, at p. 203. *See also* Avi-Yonah & Swartz, *supra* n. 5, at p. 798.

5.2. Scenario 2: Different domestic allocation results in two relevant tax subjects

In the second constructed scenario, the border and the allocation according to domestic tax law has been amended as illustrated in Figure 4. Under this scenario State A allocates the dividend payment to the lender and consequently; in State A cash flow 3 is the relevant income for treaty purposes. On the other hand, State B allocates the dividend payment to the borrower and, thus, in State B the real distribution, i.e. cash flow 1 is the relevant income for treaty purposes.

Figure 4: Scenario 2



In this scenario the different domestic allocation principles, applied in State A and State B, result in a situation in which both states consider State B as the source state, whereas State A considers the lender as the rightful income recipient and State B considers the borrower as the rightful income recipient.

Based on the analysis carried out in section 4. of this article, State A will presumably qualify the substitute dividend payment as dividends under article 10 of the OECD Model received by the lender. Therefore, a relief for withheld tax may be granted.[69] As the lender is considered the beneficial owner for treaty purposes; State A may only grant limited credit for withheld tax, as State A considers the source state (State B) subject to the limitation of tax according to article 10 of the OECD Model.

Based on the analysis carried out in section 4. of this article, State B may also qualify the payment as a dividend payment covered by article 10 of the OECD Model, but instead, the borrower is considered the rightful income recipient. However, the lender – and not the borrower – is considered the beneficial owner of the distributed dividends for treaty purposes.

Accordingly, State A and State B have applied different domestic allocation principles but it is assumed that both states consider the lender as the beneficial owner of the dividend payment. In this scenario it is analysed whether treaty benefits may be granted, i.e. whether the beneficial owner requirement in article 10(2) may solve the risk of double taxation that occurs due to this allocation conflict. This imposed risk of double taxation occurs if State B levies withholding taxes without limitations (i.e. if the condition for the limitation of tax in the source state is not considered fulfilled) and State A only grants a limited relief.

The general scope of the comprehension of the beneficial owner provision is that the provision is not an allocation rule.[70] It is argued that, before applying a treaty, the source state

69. *See* section 4.3.
70. *See,* for example, V.K. Gupta in E. Burgstaller & K. Haslinger (eds.), *Conflicts of Qualification in Tax Treaty Law*, Linde, 2007, p. 56.

should first ascertain whether or not the income is paid to a person resident in the other contracting state.[71] Only then, does the source state verify whether the person, to whom the income is allocated to, is the beneficial owner. Therefore, the beneficial owner requirement cannot be applied as an allocation principle for the purpose of reducing the risk of double taxation.

If the borrower is not the beneficial owner and therefore cannot claim treaty benefits in respect of the dividend income under article 10 of the OECD Model, it raises the question; can the beneficial owner, i.e. the lender can claim treaty benefits and thus be eligible for the relief or exemption under article 10 of the OECD Model.[72] If so, this may solve the risk of double taxation occurring due to the allocation conflict.

In the constructed Scenario 2 the lender and the borrower are both resident in State A which has entered into a treaty with the resident state of the listed company (State B). Therefore, the limitation of tax in State B remains available, as it follows from the wording of article 10(2) of the OECD Model that:

> …if the beneficial owner of the dividends is a resident of the other Contracting State [than the Contracting State of which the company paying the dividends is a resident], the tax so charged shall not exceed….

The wording of this paragraph was amended on 21 September 1995 by replacing the words "*if the recipient is the beneficial owner the dividends*" with "*if the beneficial owner of the dividends is a resident of the Contracting State*". It follows from the amended wording that it is no longer a requirement that the immediate recipient is the beneficial owner but only a requirement that the beneficial owner is a resident of the contracting state.[73] Thus, as both the lender and the borrower are resident in State A, the listed company is obliged to levy reduced withholding taxes as the lender (as beneficial owner) is granted treaty benefits.

In this regard it should not be decisive that the lender may not be considered the owner of the shares for domestic tax purposes in State B (the source state), as the beneficial ownership requirement in article 10 of the OECD Model, presumably, must be concerned with the right to the income flow and not the right to the shares.[74] In other words, the qualification of the income as dividends covered by article 10 of the OECD Model should not be influenced by the fact that the lender as beneficial owner is not considered owner of the shares according to which the dividends are distributed. This seems to follow from the nature of the beneficial ownership requirement. This also follows from the *Royal Dutch* case[75] according to which it is possible to be the beneficial owner of dividends, even though the recipients do not own the shares themselves. Consequently, in this situation, the income can be considered a dividend payment received by the lender as beneficial owner.

71. *See* Salom, *supra* n. 14, at p. 400. *See also* J. Wheeler, *The Missing Keystone of Income Tax Treaties*, 3 World Tax J. 2, p. 257 et seq. (2011), Journals IBFD, who states that it is not clear, whether the beneficial ownership requirement is a substantive attribution rule or an anti-avoidance rule.
72. This question is also raised by Wheeler, *see supra* n. 12, at p. 41.
73. This also follows from paragraph 12.2 of the Commentary on Article 10(2) of the OECD Model.
74. Cf. Baker, *supra* n. 27, at p. 95. *See also* J. Wheeler, *The Attribution of Income to a Person for Tax Treaty Purposes*, 59 Bull. Intl. Taxn. 11, p. 479 et seq. (2005), Journals IBFD, for an outline of the different arguments.
75. Cf. BNB 1994/217 also referred to as the "*Market Marker*" case.

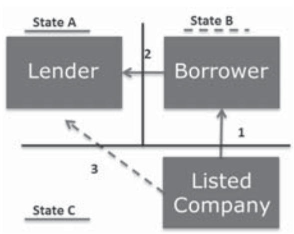
It follows from paragraph 12.2 of the Commentary on Article 10(2), that the amended wording in 1995 was to clarify what was already the consistent position of all member countries. However, even though this amendment, presumably, was merely a clarification, it is not obvious that all OECD Member States will grant relief or exemption under article 10, when the immediate recipient is not the beneficial owner, if the wording of the treaty follows an earlier version of the model. Thus, the current wording and the clarifying comments may reduce the risk of double taxation but the risk of double taxation remains in practice.[76]

In this scenario, State A and State B have applied different domestic allocation principles – allocating the distributed dividends to the lender and the borrower respectively. Based on the assumption that both states consider the lender as beneficial owner of the dividend payment, the imposed risk of double taxation occurring due to this allocation conflict, should be eliminated under treaties following the wording of the 1995 version of the OECD double tax convention, as treaty benefits should be granted "*if the beneficial owner of the dividends is a resident of the Contracting State*". However, it is not obvious that all OECD Member States will grant relief or exemption under article 10, when the immediate recipient is not the beneficial owner, if the wording of the treaty follows an earlier version of the model, i.e. a risk of double taxation remains in practice.

5.3. Scenario 3: Different domestic allocation results in multiple applicable treaties

In the final and third constructed scenario, State C is added. State A and B allocate the income as in Scenario 1. Therefore, in Scenario 3 State A allocates the dividend payment to the borrower making the real payment, i.e. cash flow 2 relevant for treaty purposes. State B allocates the dividend payment to the lender and thus, the payment is not relevant for neither domestic nor treaty purposes, as State B considers the payment made between the listed company resident in State C and the lender resident in State A. State C allocates the income to the borrower, therefore, cash flow 1 is relevant for treaty purposes in State C. Scenario 3 is illustrated in Figure 5.

Figure 5: Scenario 3



Based on the analysis carried out in section 4. of this article, State A may qualify the dividend payment under as other income under article 21 of the OECD Model and therefore the payment is not eligible for relief in State A according to the treaty. As the income is not relevant for tax purposes in State B, no withholding tax is levied on cash flow 2 and the borrower is not granted any relief for withholding taxes levied by State C on cash flow 1. Based on the analysis carried out in section 4. of this article, State C may qualify the payment as dividend

76. *See* under Scenario 3 for an example of a double tax risk.

paid to the borrower covered by article 10 of the OECD Model. As the lender – and not the borrower – is considered the beneficial owner of the distributed dividends for treaty purposes, the condition for the limitation of tax in State C is not fulfilled. Thus, according to the treaty entered into between State B and State C, State C may not be restricted to withhold tax.

Accordingly, in this scenario the different domestic allocation principles applied in State A, B and C may result in a situation where State C levies withholding taxes on the dividends paid immediately to the borrower, whereas neither State A nor B grant any relief for the paid tax. In Scenario 2 it is analysed whether treaty benefits may be granted, i.e. whether the beneficial owner requirement in article 10(2) may solve the risk of double taxation that occurs due to this allocation conflict. Unlike in Scenario 2 this scenario is based on a share loan agreement involving three treaty states.

It follows from paragraph 12.2 of the Commentary on Article 10(2) of the OECD Model that:

> subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State....

Accordingly, the beneficial owner can claim treaty benefits in respect of the dividend income under article 10 of the OECD Model and thus be eligible for the relief or exemption under article 10 of the OECD Model, if the resident state of the beneficial owner and the original source state have entered into a treaty – even though the intermediate company is resident in a third state.

As mentioned under Scenario 2 in section 5.2., the wording of article 10 was amended in 1995 to clarify what was already the consistent position of all member countries. However, even though this amended wording should also apply when interpreting the consequences of the beneficial owner requirement in treaties following the wording of a version of the OECD Model older than 1995, it is not obvious that all OECD Member States will grant relief or exemption under article 10, when the immediate recipient is not the beneficial owner. Also situations in which the original source state acknowledges that the beneficial owner should be granted treaty benefits, it is not clear under what circumstances these benefits are granted. As an example, withholding taxes on dividends paid from Denmark as the original source state are, presumably, only reduced if:[77]

– The income received by the beneficial owner is identical to the value of the income paid from the original source state to the intermediate company.
– The income received by the beneficial owner has the same character as the income paid by the original source state to the intermediate company, i.e. the income must not change character (e.g. be repaid to the beneficial owner as interests) as the income should be subject to the same tax treatment in the resident country of the beneficial owner as if the income was paid directly from the original source state to the beneficial owner.
– The income is received by the beneficial owner and taxed in the same taxable income year as the payment to the intermediate company is made.

77. Cf. SKM 2011.441 SR (Administrative case).

However, in one case the Danish tax authorities have decided on the applicability of treaties in respect to share loan agreements and decided that the applicable treaty is the one entered into between the resident state of the distributing company and the resident state of the lender.[78]

It should be noted, that these requirements follow from administrative case law concerning a traditional beneficial ownership issue and is therefore merely included for the purpose of illustrating the issues and some of the practical uncertainties that still exist even though the wording of article 10 of the OECD Model was amended (and clarified) in 1995. The tax implications in respect to beneficial ownership seem to differ from state to state, which is also illustrated in the general report to the IFA Congress in 2007 (Kyoto).[79]

This scenario may result in a situation in which the resident state of the lender (State A) acknowledges the immediate allocation of income to the borrower and, therefore, the lender may not be granted relief for withholding taxes levied by the original source state (State C); but only for withholding taxes imposed by the intermediate state (State B). If neither the beneficial owner nor the intermediate company is granted relief for tax withheld by the original source state, a double tax situation occurs. Accordingly, in this scenario the different domestic allocation principles applied in State A, B and C may result in a situation where State C levies withholding taxes on the dividends paid immediately to the borrower, whereas neither State A nor B grant any relief for the paid tax.

Based on the assumption that all states consider the lender as beneficial owner of the dividend payment, the imposed risk of double taxation occurring due to this allocation conflict, should be reduced under treaties following the wording of the 1995 version of the OECD double tax convention, if the resident state of the beneficial owner and the original source state have entered into a treaty – even though the intermediate company is resident in a third state. However, from a source state perspective, it may still be subject to uncertainty under what circumstances the beneficial owner in practice can claim treaty benefits, when the immediate recipient is not the beneficial owner and, from a resident state perspective, it may still be subject to uncertainty under what circumstances the intermediate company and/or the beneficial owner in practice is granted relief for withholding taxes.

6. Conclusion

The purpose of this article is to identify and analyse some of the qualification and allocation challenges that the dividend related payments under share loan agreements give rise to for tax treaty purposes. It has been shown that different domestic allocations of dividends under share loan agreements may impose a risk of double taxation and double non-taxation, as the allocation of outbound income generally is made without taking allocation principles in other countries into consideration.

None of the articles in the OECD Model deals specifically with qualification of payments made under share loan agreements. Further, the OECD Model generally does not deal with allocation of income. Thus, on the basis of three constructed scenarios, it is illustrated how the different domestic allocations of the dividends under share loan agreements can result in

78. Cf. TfS 2010.454 SR.
79. Cf. Wheeler, *supra* n. 12, at p. 36 et seq.

a qualification conflict for treaty purposes; a situation in which two tax subjects are relevant for the treaty purposes and a situation in which multiple treaties may apply.

The main challenges identified in this article concern the questions: to what extent payments made under a share loan agreement may be covered by the term “dividends” in article 10 of the OECD double tax convention and to what extent the lender in a share loan agreement fulfil the beneficial ownership requirement and thus, is granted treaty benefits. The answers to these questions seem to depend on whether the income is allocated to the (legal or economic) owner of the transferred shares for domestic tax purposes of whether the income is allocated to another person than the shareholder of the transferred shares based on economic entitlement, substance-over-form or (other) anti-avoidance principles.

Based on the analysis carried out in this article it can be concluded, that treaties following the wording of the 1995 version of article 10 of the OECD double tax convention may grant the beneficial owner treaty benefits and thereby eliminating any risk of double taxation. Further, if a qualification conflict occurs as a spill-over effect of the different domestic allocations of the payments article 23 of the OECD Model can eliminate the risk of double taxation if, and only if, in accordance with article 3(2) and article 10 – the income is characterized as dividends in the source state. However, for many reasons it is not obvious that all OECD Member States will grant relief or exemption under articles 10 and 23. The risk of double taxation and double non-taxation cannot be eliminated by applying the ordinary articles in the OECD Model. Thus, unless the treaty deals specifically with the qualification of payments made under share loan agreements or allocation conflicts, this risk remains.