Chapter 3

The Concept of Beneficial Ownership under Canadian Tax Treaties

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3.1. Introduction

In 2007, in the *MIL (Investments)* case, the Federal Court of Appeal decided summarily that the Canadian general anti-avoidance rule (GAAR) did not apply to a blatant case of treaty shopping.[1] The taxpayer company had continued from the Cayman Islands to Luxembourg before selling the shares of a Canadian corporation and claiming the protection of Article 13 of the Canada-Luxembourg tax treaty (1999). The Federal Court of Appeal found that the disposition of the shares was within the plain words of the treaty and could not be considered to be a misuse or an abuse of the provisions of the Canadian Income Tax Act or the treaty.

Before the *MIL (Investments)* case, the Canadian tax authorities had reason to be confident about their ability to deal with the problem of treaty shopping. The Supreme Court's negative statements about treaty shopping in the *Crown Forest* case[2] were often referred to in this regard. Then, in 2004, the GAAR was amended retroactively to make it explicitly applicable to transactions that misuse or abuse the provisions of tax treaties.

After losing the *MIL (Investments)* case, apparently the Canadian tax authorities decided to change their strategy and challenge treaty shopping arrangements – at least those involving dividends, interest and royalties – by arguing that the recipient of the amount (usually an intermediary company)

1. CA: FCA/CAF, 13 June 2007, *Canada v. MIL (Investments) SA,* Tax Treaty Case Law IBFD.
2. CA: SCC, 22 June 1995, *Crown Forest Industries Ltd. v. Canada,* Tax Treaty Case Law IBFD: "It seems to me that both Norsk and the respondent are seeking to minimize their tax liability by picking and choosing the international tax regimes most immediately beneficial to them. Although there is nothing improper with such behaviour, I certainly believe that it is not to be encouraged or promoted by judicial interpretation of existing agreements. ... 'Treaty shopping' might be encouraged in which enterprises could route their income through particular states in order to avail themselves of benefits that were designed to be given only to residents of the contracting states. This result would be patently contrary to the basis on which Canada ceded its jurisdiction to tax as the source country, namely that the U.S. as the residence country would tax the income."

was not the beneficial owner of the amount. This argument was first made in 2008 in the *Prévost Car* case[3] dealing with the receipt of dividends by a Netherlands holding company, and again in 2012 in the *Velcro* case[4] dealing with royalties received by a Netherlands company in an artificial conduit arrangement. The *Prévost Car* and *Velcro* cases are discussed in detail below.

3.2. *Prévost Car*

3.2.1. Facts

Prévost Car was a Canadian company engaged in manufacturing buses. In the years 1996-99 and 2001 it paid dividends to its parent, a Netherlands holding company. The shares of the Netherlands holding company were owned as to 51% by Volvo Bus Corporation, a Swedish resident company, and as to 49% by Henlys Group, a UK resident company. Volvo acquired all of the shares of Prévost Car in 1995 and transferred them to the Netherlands holding company; Volvo then transferred 49% of the shares of the Netherlands holding company to Henlys. Prévost Car withheld tax on the dividends paid to the Netherlands holding company at the rate of 5%, as provided in Article 10(2) of the Canada-Netherlands tax treaty.[5] The Canada Revenue Agency (CRA) assessed Prévost Car on the basis that Article 10(2) of the Canada-Netherlands tax treaty did not apply because the Netherlands holding company was not the beneficial owner of the dividends. According to the CRA, Volvo and Henlys were the beneficial owners of the dividends and therefore the applicable rates of withholding tax were 10% and 15% (the applicable rates under Canada's tax treaties with Sweden[6] and the United Kingdom)[7] as to Volvo and Henlys, respectively.

3. CA: FCA/CAF, 26 Feb. 2009, *Canada v. Prévost Car Inc.*, Tax Treaty Case Law IBFD affirming CA: TaxCC/CCI, 22 Apr. 2008, *Prévost Car Inc. v. Canada,* Tax Treaty Case Law IBFD.

4. CA: TaxCC/CCI, 24 Feb. 2012, *Velcro Canada Inc. v. Canada,* Tax Treaty Case Law IBFD.

5. *Convention between the Government of Canada and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* art. 10(2) (27 May 1986), Treaties IBFD.

6. *Convention between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains* (8 Sept. 1978), Treaties IBFD.

7. *Convention between the Government of Canada and the Government of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (27 Aug. 1996), Treaties IBFD.

The shareholders' agreement between Volvo and Henlys (the Netherlands holding company was not a party to this agreement) provided that at least 80% of the profits of Prévost Car and the Netherlands holding company were to be distributed to Velcro and Henlys. The Netherlands holding company had no employees and no assets other than the shares of Prévost Car. Its registered office in the Netherlands was in the office of a management company affiliated with its bank.

3.2.2. Decision

The Tax Court of Canada heard the case initially and decided that the Netherlands holding company was the beneficial owner of the dividends for purposes of Article 10(2) of the Canada-Netherlands tax treaty. As a result, the dividends were subject to Canadian withholding tax at the treaty rate of 5%.

The Tax Court judge (Gerald Rip, now the Chief Justice) considered the meaning of the term "beneficial owner" under Canadian law as required by Article 3(2) of the Canada-Netherlands tax treaty, under the Commentary on Article 10 of the OECD Model (2010), under Netherlands law, and in the *Indofood* case.[8] He concluded that the beneficial owner of dividends is "the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received".

With respect to corporations, Justice Rip held that the corporation itself, not its shareholders, is the beneficial owner of its assets and income. However, he held that this general principle is subject to a caveat with respect to conduit companies:

> When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and *has absolutely no discretion as to the use or application of funds* put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it. [Emphasis added]

On the facts of the case, the Netherlands holding company was not a conduit because there was "no predetermined or automatic flow of funds" to its shareholders. The shareholders' agreement between Volvo and Henlys did not impose any legal obligation on the Netherlands holding company and could not do so because it was not a party to the agreement.

8. UK: EWCA, 22 Mar. 2006, *Indofood International Finance Ltd. v. JP Morgan Chase Bank NA London,* Tax Treaty Case Law IBFD.

The government appealed the decision on the basis that the term "beneficial owner" should "mean the person who can, in fact, ultimately benefit from the dividend". The Federal Court of Appeal rejected this test because there was no support for it in the OECD documents, namely, the 1977 and 2003 OECD Commentaries on Article 10 and the OECD Conduit Companies Report.[9] The Court of Appeal endorsed the test of beneficial ownership adopted by the Tax Court of Canada and noted that the Tax Court had considered the ordinary meaning, technical meaning and the meaning under the common law, civil law, Netherlands law and international law of the term "beneficial owner". The Court also approved the Tax Court's application of the test to the facts in the case. In particular, the Court of Appeal noted that there was no predetermined or automatic flow of funds from the Netherlands holding company to Volvo and Henlys.

3.2.3. Comments on the decision

The *Prévost Car* case provides a valuable clarification of the circumstances in which a corporation can be considered to be a conduit and not the beneficial owner of dividends, interest and royalties received by it. The OECD Commentary is rather vague in this regard. Paragraph 12.1 of the Commentary on Article 10 of the OECD Model (2010) provides 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.[10]

The *Prévost Car* case makes it clear that, under Canadian treaties, a non-resident holding company receiving dividends will be considered to be the beneficial owner unless it has absolutely no discretion as to the use of the funds received.

Although the Tax Court considered the meaning of beneficial owner under Netherlands law (the residence country) and under international tax law, it appears that its decision was fundamentally based on the meaning under Canadian law. The application of domestic law in this regard is not surprising given that domestic courts are more familiar with domestic law, although

9. Organisation for Economic Co-operation and Development, *Conduit Companies Report* (OECD 1986).
10. *See*, similarly, *OECD Model Tax Convention on Income and on Capital: Commentary on Articles 11 and 12* paras. 10 and 4.1 (15 July 2005), Models IBFD, respectively.

some commentators argue that the term "beneficial owner" has an international fiscal meaning.

In my view, the decision in the *Prévost Car* case also makes sense in policy and practical terms. Canada entered into treaties with the Netherlands, Sweden and the United Kingdom with different rates of withholding tax on dividends. The treaty with Sweden was entered into in 1983 and provided for a 10% tax rate on direct dividends.[11] The treaty with the United Kingdom was entered into in 1978 and provided for a 15% tax on direct dividends.[12] The 1993 Second Protocol to the Canada-Netherlands tax treaty reduced the rate of tax on direct dividends from 10% to 5%.[13] When the Canadian government entered into this 1993 Protocol, it knew or should have known that the lower rate of tax on dividends under the Netherlands treaty compared to Canada's treaties with other European countries would make Netherlands holding companies attractive as vehicles for holding investments in Canadian companies. Moreover, the Canadian treaty negotiators must have been aware that the Netherlands provided a preferential tax regime for holding companies and that Netherlands holding companies were widely used for international tax planning. Nevertheless, Canada did not insist on the inclusion of any limitation-on-benefits provision or other protection against treaty shopping through the use of Netherlands holding companies. Accordingly, in my opinion, the result in the *Prévost Car* case is consistent with Canada's tax treaty policy at the time that the treaty with the Netherlands was amended to reduce the withholding tax on direct dividends to 5%. Canada should have expected that residents of other countries would use Netherlands holding companies to hold investments in Canadian companies, and its later complaints when Canadian tax was reduced through the use of such Netherlands holding companies ring hollow.

11. *Supra* n. 6. The current treaty, entered into in 1996, provides for a 5% rate on direct dividends.
12. *Supra* n. 7. This rate was reduced to 5% pursuant to the third protocol, 7 May 2003, to the treaty.
13. Protocol, Done at The Hague, 4 Mar. 1993, art. 1(6). The rate was reduced from 10% by 1 percentage point per year over 5 years. The first year in which the 5% rate was applicable was 1997.

3.3. *Velcro Canada*

3.3.1. Facts

The *Velcro* case[14] involves the use of a Netherlands intermediary company to funnel royalties from a Canadian company to a Netherlands Antilles company. All three companies were part of the Velcro group.

In 1987, Velcro Industries (VIBV), a company resident in the Netherlands at that time, entered into a licensing agreement with Velcro Canada, a Canadian resident company engaged in manufacturing fastening products for the automobile industry. In consideration for the use of the Velcro intellectual property, Velcro Canada paid royalties to VIBV. The royalties were subject to Canadian withholding tax of 25%, which was reduced to 10% under Article 12(2) of the Canada-Netherlands tax treaty.[15]

In 1995, VIBV moved its residence from the Netherlands to the Netherlands Antilles. Immediately following its change of residence, VIBV assigned its rights under the licensing agreement with Velcro Canada to Velcro Holdings (VHBV), another member of the Velcro group resident in the Netherlands. The obvious reason for the assignment was that there was no treaty between Canada and the Netherlands Antilles. Under the assignment agreement, VIBV retained ownership of the intellectual property. In effect, VHBV had only the right to receive the royalty payments and the obligation to pay what the Tax Court described as “an arm’s length percentage of the net sales of the licensed products within 30 days of receiving royalty payments from VCI [Velcro Canada]”. This arm’s length royalty was whatever the Netherlands tax authorities would allow.

VHBV’s board of directors met as necessary without any scheduled meetings and no minutes were kept. Its management was provided by an arm’s length management company. In addition to the royalties, VHBV held shares of subsidiaries and loaned funds to subsidiaries. The royalties were the largest revenue and expense items of VHBV but no amounts are provided in the case. It seems unlikely that VHBV had an office or any employees, but the decision is silent on these points.

14. CA: TaxCC/CCI, 24 Feb. 2012, *Velcro Canada Inc. v. Canada,* Tax Treaty Case Law IBFD.
15. *Supra* n. 5.

The facts concerning the flow of payments from Velcro Canada to VHBV and then to VIBV are also skimpy. VHBV received royalty payments from Velcro Canada in Canadian dollars, less the 10% Canadian tax withheld. The amounts received were commingled with VHBV's other funds and were converted to US dollars, and occasionally to Netherlands currency. The commingled funds were used to pay "investment loans, operational expenses and professional fees", as well as the payments to VIBV. Apparently, these funds earned interest, although, once again, no amounts are provided.[16]

One additional significant point about the Tax Court's description of the facts should be noted. The Court pointed out more than once that the amount paid by VHBV to VIBV was different from the amount received by VHBV from Velcro Canada. This point is discussed further below.

The issue was whether the royalties paid by Velcro Canada to VHBV were subject to Canadian withholding tax at the statutory rate of 25% or the reduced rate of 10% provided in Article 12(2) of the Canada-Netherlands tax treaty. The applicable rate depended solely on whether the Netherlands recipient of the royalties (VHBV) was the beneficial owner of the royalties. The government argued that VIBV and not VHBV was the beneficial owner of the royalties, and that VHBV was simply an agent or conduit acting on behalf of VIBV.

3.3.2. Decision

The Tax Court (Associate Chief Justice Rossiter) held that VHBV was the beneficial owner of the royalties and not an agent, nominee or conduit; therefore, the Canadian withholding tax was reduced to 10% pursuant to the Canada-Netherlands tax treaty. The Court's holding was based on the application of the test of beneficial ownership adopted initially by Chief Justice Rip of the Tax Court in the *Prévost Car* case and affirmed by the Federal Court of Appeal.

The Tax Court referred to the 1977 and 2003 Commentary on the OECD Model, and also to the 1986 OECD Conduit Companies Report, without analysing them in detail or drawing any firm conclusions. For example, the Court quotes paragraph 7 of the Commentary on Article 12 of the OECD

16. I suspect that the amounts expended for operational expenses and professional fees for a corporation like VHBV would have been immaterial. Similarly, the amount of interest earned on the royalties received from Velcro Canada could not have been significant because approximately the same amount was paid to VIBV within 30 days.

Model (2010), which raises the issue of whether countries may want to include special provisions to deny the exemption for royalties where the beneficial owner is a company that is subject to preferential tax treatment and whose shares are owned by non-residents. But this paragraph assumes that the company is the beneficial owner of the royalties, so its relevance for the *Velcro* case is doubtful. Also, the statement from the Conduit Companies Report incorporated into the Commentary[17] – that a conduit company cannot be considered to be the beneficial owner if it has very narrow powers – is quoted but not analysed.

Consequently, the case depended largely on the application of the beneficial-owner test in the *Prévost Car* case. Both parties agreed that the *Prévost Car* case provided the appropriate test of beneficial ownership. According to that test, the beneficial owner of dividends, interest or royalties is "the person who receives the dividends [interest, or royalties] for his or her own use or enjoyment and assumes the risk and control of the dividends [interest, or royalty] he or she received". Further, with respect to a corporate recipient:

> ... one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it.

Applying this test to the facts of the *Velcro* case, the government argued that VHBV's contractual obligation to pay 90% of the royalties received to VIBV within 30 days distinguished the *Velcro* case from the *Prévost Car* case. The Tax Court held, however, that there was "no automatic flow of funds" in the *Velcro* case. The Tax Court analysed the facts to determine if VHBV had the attributes of a beneficial owner: possession, use, control and risk. It concluded that VHBV had all of these attributes of ownership on the basis of two factors. First, the royalties received by VHBV were commingled with other funds in one bank account; and second, the amount paid by VHBV to VIBV was different from the amount received by VHBV from Velcro Canada.

3.3.3. Comments on the decision

The Court's reasons are not convincing. First, it is difficult to assess the issue of beneficial ownership in the absence of complete disclosure of the facts.

17. *OECD Model: Commentary on Article 12* para. 4.1 (2010), Models IBFD.

Second, from the Tax Court's reasons, all that is necessary to ensure that a person is the beneficial owner of dividends, interest or royalties is that the funds are commingled with other amounts. This renders the concept of beneficial owner essentially meaningless because the commingling of the amounts is completely within the control of the recipient. This is not consistent with what the Commentary on the OECD Model (2010) says about a conduit company not being 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".[18] On the facts, VHBV was contractually obligated to pay to VIBV the amount of the royalties received from Velcro Canada (net of Canadian withholding tax) within 30 days. VHBV had the discretionary use, control and risk of the royalties received for 30 days, subject to the obligation to pay the same amount to VIBV. Therefore, there appears to be a strong argument that VHBV had "very narrow powers" with respect to the royalties received.

Third, the Tax Court relied on the fact that the amount received by VHBV was different from the amount paid to VIBV:

> It is not 100% of the royalties amount that are paid to VIBV but only approximately 90%. The other 10% is subject to the discretionary use, enjoyment and control of VHBV.

This conclusion appears to reflect a misunderstanding of the facts. Given that 10% tax was withheld from the royalty amount considered to be received by VHBV, only 90% of the royalty is available to be paid on to VIBV. VHBV did not have discretionary use of the other 10%, as the Tax Court thought. If VHBV paid to VIBV the amount of the royalty received from Velcro Canada (subject to currency fluctuations), less the 10% Canadian withholding tax, the arrangement looks like an artificial conduit arrangement.

The Tax Court held that VHBV was not an agent or nominee for VIBV. In substance, however, VHBV was little more than VIBV's agent or nominee although the assignment agreement explicitly denied any agency relationship between them. VHBV did not obtain a licence from VIBV and did not sublicense Velcro Canada; it simply collected the royalties on behalf of VIBV. The real issue was whether VHBV was merely a conduit for the funnelling of the royalty payments from Velcro Canada to VIBV. On the conduit issue, the Court applied the test in *Prévost Car* that only if a corporate recipient had "absolutely no discretion" with respect to the funds received could it

18. Id.

be considered to be a conduit and not the beneficial owner. On the facts, the Court concluded that VHBV had some limited discretion and therefore was not a conduit. Although VIBV was a third-party beneficiary to the agreement assigning the royalties to VHBV and entitled to enforce VHBV's rights to the royalties, that did not mean that VHBV was obligated to automatically pass the royalties to VIBV without any discretion on the part of VHBV.

Although the decision is clearly wrong in my opinion, the government did not appeal.

3.4. Conclusion

It is unclear why the government did not argue that the Canadian GAAR applied to the insertion of the Netherlands holding company in *Prévost Car* or to the assignment of the royalties in *Velcro*. The GAAR applies to transactions carried out primarily for the purpose of getting a tax benefit if the transactions misuse the provisions of the Income Tax Act or a treaty, or abuse the provisions of the Act or a treaty read as a whole. The insertion of the Netherlands holding company and the assignment of the royalties by VIBV to VHBV were clearly done for the primary purpose of getting the benefits of the reduced rate of withholding tax under Articles 10 and 12 of the Canada-Netherlands tax treaty. The crucial question would have been whether those transactions were abusive – not an easy question to answer.

Perhaps the government did not argue the GAAR because of the retroactive aspects of its application. The GAAR was amended in 2004 retroactive to 1988 to make it applicable to any misuse or abuse of a tax treaty. Although the retroactive application of the GAAR to tax treaties is clear and intentional, it may be that the government wanted to avoid the issue of retroactivity.

Although in both the *Prévost Car* and *Velcro* cases the Tax Court did not deal explicitly with the question of which country's meaning of beneficial owner should apply, the Court clearly applied the meaning under Canadian law. This approach is consistent with that in the United States Model Income Tax Convention.[19] However, the application of the domestic-law meaning of the country in which the payer is resident is not self-evident. Arguably, the reason for the beneficial-owner requirement is to ensure that the recipient

19. *United States Model Income Tax Convention* art. 10 (15 Nov. 2006), Models IBFD: "The term 'beneficial owner' is not defined in the Convention and is therefore defined as under the internal law of the country imposing tax i.e., the source country."

of the amount is subject to tax on the amount in its country of residence. In addition, the recent OECD proposals to revise the Commentary dealing with beneficial ownership suggest that the term "beneficial owner" should have an autonomous treaty meaning rather than a domestic law meaning.[20]

The *Velcro* and *Prévost Car* cases, viewed together, establish a very low threshold for beneficial ownership for the purposes of Canadian tax treaties. The only persons who will *not* be considered to be beneficial owners will be agents, nominees and conduit companies with absolutely no discretion over the amounts received. In effect, it seems likely that, at least with respect to corporations, Canadian treaties would be interpreted and applied in the same way as if the articles dealing with dividends, interest and royalties did not contain the words "beneficial owner".

It is interesting to note that the result in the *Velcro* case might be different in the future if the Commentary on the OECD Model is revised as the OECD has proposed. The OECD has proposed to revise the Commentary on Articles 10, 11 and 12 of the OECD Model (2010) to define a beneficial owner as the person who "has the right to use and enjoy the dividend [interest, or royalty] unconstrained by a contractual or legal obligation to pass the payment received to another person".[21]

The combined effect of the *MIL (Investments)* case and the *Prévost Car* and *Velcro* cases is that the Canadian tax system is relatively defenceless against blatant treaty shopping. Only the treaty with the United States has a comprehensive limitation-on-benefits provision. This situation is unacceptable. However, it is difficult to see any effective way for the Canadian government to correct the situation. It would take decades to renegotiate all of Canada's tax treaties to include a limitation-on-benefits provision, although such a provision should be included in any new or renegotiated treaties. The real problem is the *MIL (Investments)* case.[22] In that case, the courts did not adequately confront the issue of the treaty shopping. The Canadian tax authorities should pursue other cases of treaty shopping through the application of the GAAR in order to effectively overturn *MIL (Investments)* or limit its authority.

20. OECD Model Tax Convention: Revised Proposals Concerning the Meaning of "Beneficial Owner" in Articles 10, 11 and 12, 19 Oct. 2012, at p. 3, available at www.oecd.org.
21. Id., *Draft Commentary on Articles 10, 11 and 12* paras. 4.3, 12.4 and 10.2 (2005), respectively.
22. As an example of the questionable reasoning in the case, the Tax Court found as a fact that a primary purpose of moving the residence of the company from the Cayman Islands to Luxembourg was to better manage mining operations in Africa.