SPECIAL REPORTS

Clarifying the Meaning of 'Beneficial Owner' in Tax Treaties

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Unless otherwise indicated as official, translations have been performed by the author.

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I. Introduction

A. 'Beneficial Owner' in Tax Treaties

''A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.''[1] No matter how eloquently the Vienna Convention on the Law of Treaties declares the general principles for the interpretation of treaty language, the interpretation of treaty language inevitably entails a degree of uncertainty, by its own nature as ''interpretation of language.'' Such uncertainty would be significant when there is no established consensus about the ''ordinary meaning to be given to the terms,'' the context of the terms, and the object and purpose of the treaty.

This is absolutely true regarding the term ''beneficial owner'' in the OECD's Model Convention on Income and Capital.[2] ''Beneficial owner'' was first incorporated in 1977 into articles 10 (dividends), 11 (interest), and 12 (royalties) of the OECD model as a requirement for a recipient of income to enjoy treaty benefits under a tax treaty.[3] For instance, article 10(2)[4] states:

> dividends may also be taxed in the Contracting State of which the company paying the dividends

[1]Vienna Convention on the Law of Treaties, article 31(1), May 23, 1969, 1155 U.N.T.S. 331.

[2]OECD Centre for Tax Policy and Administration (OECD CTPA), the 2010 Model Convention on Income and Capital, at M-3 (2010), *available at* http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-2010_9789264175181-en.

[3]*Id.* at M-28-M-29 (discussing history of article 10(2)), M-31 (discussing history of article 11(2)), M-34 (discussing history of article 12(1)).

[4]*Id.* at article 10(2).

> is a resident and according to the laws of that State, but *if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed*:
>
> a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
>
> b) 15 per cent of the gross amount of the dividends in all other cases. [Emphasis added.]

Under this provision, the dividends payable to a resident of the other contracting state (the residence state) will be subject to tax at a reduced rate of 5 percent (or 15 percent) in the contracting state where the paying company is a resident (the source state), if the recipient is the beneficial owner of the dividends. In other words, to qualify for a reduced tax rate, the recipient must be not only a resident of the residence state,[5] but also the beneficial owner of the dividends. Article 11(2) and article 12(1) stipulate equivalent effects regarding interest (reduced tax rate of 10 percent) and royalties (tax exemption), respectively.[6]

However, no definition was provided for the term beneficial owner, and, not only because of the inherent vagueness of the phrase as legal terminology,[7] but also because of the lack of consensus about the context of beneficial owner and the object and purpose of the OECD model, both of which should be taken into consideration in the interpretation of beneficial owner, no consensus has been established as to what exactly the term means. In particular, the 1977 version of the commentaries on the articles of the model (the OECD commentary)[8] did not specify an object and purpose of the OECD model that could be considered in the interpretation of beneficial owner.[9] Regarding the context, the 1977 version stated that ''the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State.''[10] However, as the 2003 version of the OECD commentary (to be discussed later) suggests, such agent and nominee are ''not treated as the owner of the income for tax purposes in the State of residence,''[11] and therefore, even without a beneficial owner requirement, such agent and nominee would not be able to enjoy treaty benefits. In this sense, the above-cited language of the 1977 OECD commentary was of little help in clarifying the context.

To be fair, the OECD has not been totally indifferent to this uncertainty. For instance, regarding the object and purpose of the OECD model to be considered in the interpretation of beneficial owner, the OECD in

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[5]In the OECD model, the term ''resident of a Contracting State'' is defined as ''any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.'' *Id.* at article 4(1). This definition of resident was introduced to deny treaty benefits to persons who are not subject to tax in a contracting state. However, as will be seen in the conduit transaction scheme below, this subject-to-tax requirement is only partially effective by itself for antiavoidance purposes.

[6]*Id.* at article 11(2) and article 12(1). To simplify explanations, I will explain or mention only those provisions and commentaries related to dividends unless I think it otherwise necessary or appropriate.

[7]*Black's Law Dictionary* defines beneficial owner accordingly:

> 1. One recognized in equity as the owner of something because use and title belong to that person, even though legal title may belong to someone else; esp., one for whom property is held in trust. — Also termed equitable owner. . . .
>
> 2. A corporate shareholder who has the power to buy or sell the shares, but who is not registered on the corporation's books as the owner. . . .
>
> 3. Intellectual property. A person or entity who is entitled to enjoy the rights in a patent, trademark, or copyright even though legal title is vested in someone else.

Black's Law Dictionary 1214 (9th ed. 2009). This only suggests a general idea that a beneficial owner is a person who has some sort of power over, or right to, a thing, the legal title to which does not belong to him, and provides no clue for interpretation of its precise scope.

Also, article 3(2) of the OECD model states:

(Footnote continued in next column.)

> any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Because of this provision, there have been differences in opinion as to whether ''beneficial owner'' is a concept of domestic law or tax treaty. *See, e.g.*, Joanna Wheeler, ''General Report,'' 92b *Cahiers de droit fiscal international* 17, 22-24 (2007).

Finally, the discussion drafts concerning the meaning of beneficial owner clearly state that the term:

> was intended to be interpreted in this context and not to refer to any technical meaning that it could have had under the domestic law of a specific country (in fact, when it was added to the paragraph, the term did not have a precise meaning in the law of many countries).

OECD CTPA, ''Clarification of the Meaning of 'Beneficial Owner' in the OECD Model Tax Convention: Discussion Draft,'' at 3 (2011), *available at* http://www.oecd.org/ctp/treaties/47643872.pdf (hereinafter first discussion draft); OECD CTPA, ''OECD Model Tax Convention: Revised Proposals Concerning the Meaning of 'Beneficial Owner' in Article 10, 11 and 12,'' at 2 (2012), *available at* http://www.oecd.org/ctp/treaties/Beneficialownership.pdf (hereinafter second discussion draft).

[8]OECD model, *supra* note 2, at C(1)-1.

[9]*Id.* at comment on article 10; *see also id.* at C(10)-25 to -65 (discussing history of comment on article 10).

[10]*Id.* at C(10)-31 (discussing history of comment 12.2 on article 10).

[11]*Id.* at comment 12.1 on article 10; *see also id.* at C(10)-30 (discussing history of comment 12.1 on article 10).

2003 inserted into the OECD commentary the following paragraph into articles 10, 11, and 12:

> The term ''beneficial owner'' is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.[12]

However, this additional paragraph explains nothing significantly more than what the Vienna Convention articulates.[13] Although it clarified that the object and purpose of the OECD model to be considered in the interpretation of beneficial owner includes ''avoiding double taxation and the prevention of fiscal evasion and avoidance,'' not only does this not explain how such clarified object and purpose affects the interpretation of beneficial owner, but also it is still unclear what other object and purpose can be considered, and how such other object and purpose affects the interpretation of beneficial owner. Therefore, this paragraph was not particularly helpful in clarifying the meaning of beneficial owner.

Regarding the context of beneficial owner, the 2003 OECD commentary states 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.''[14] Stating that a conduit company will not be regarded as the beneficial owner in some situations, even when it is the formal owner, reveals that the beneficial owner concept denies treaty benefits in some circumstances, including when the recipient is a conduit company, and this seems to have clarified the scope of beneficial owner to some extent. However, a conduit company is mentioned there as an example of when a recipient of income cannot be regarded as the beneficial owner of such income. Because the object and purpose to be taken into consideration in the interpretation of beneficial owner is still unclear, the precise delineation of beneficial owner remains uncertain.[15]

Finally, in 2011 the OECD started a discussion to clarify the meaning of beneficial owner by releasing public discussion drafts that proposed to set forth a definition of beneficial owner in the OECD commentary — ''Clarification of the Meaning of 'Beneficial Owner' in the OECD Model Tax Convention; Discussion Draft'' (the first discussion draft)[16] and ''OECD Model Tax Convention: Revised Proposals Concerning the Meaning of 'Beneficial Owner' in Article 10, 11 and 12'' (the second discussion draft; and collectively, the discussion drafts).[17]

Considering the uncertainty under the current OECD model and the OECD commentary, this action by the OECD should be welcomed, but the reactions to the discussion drafts have not been so. Many in the business community criticized the definitions in the discussion drafts as being vague and the scope of those definitions as unforeseeable.[18]

On one hand, the OECD employed a definitional approach to clarify the scope of the term ''beneficial owner.'' However, no matter how much effort the OECD makes and how much care it takes to define beneficial owner, it is not easy to set forth a clear definition, because the very nature of definition entails abstract and general language. Also, the discussion drafts do not clarify the context, object, and purpose to be considered in the interpretation of beneficial owner. Regarding the context, the drafts only explain that ''the term 'beneficial owner' was added to address potential difficulties arising from the use of the words 'paid to . . . a resident' in paragraph 1,''[19] but they leave unspoken exactly what those potential difficulties are; therefore, this additional explanation was not particularly helpful in defining beneficial owner. In this sense, the business community's criticisms are reasonable. In practice, contrary to the original intention, this action by the OECD might even have had the effect of increasing the risk of uncertainty in some countries

[12] *Id.* at comment 12 on article 10, comment 9 on article 11, comment 4 on article 12; *see also id.* at C(10)-30 (discussing history of comment 12 on article 10), C(11)-24 (discussing history of comment 9 on article 11), C(12)-25 (discussing history of comment 4 on article 12).

[13] *See supra* text accompanying note 1.

[14] OECD model, *supra* note 2, comment 12.1 on article 10, comment 10 on article 11, comment 4.1 on article 12.

[15] In 2010 the OECD commentary added paragraphs 6.8 through 6.34 to the commentary on article 1 (which relate to the treatment of collective investment vehicles); paragraph 6.14 stipulates about ''beneficial owner,'' but only in relation to collective investment vehicles. *Id.* comment 6.8-6.34 on article 1.

[16] First discussion draft, *supra* note 7. *See also* public comments on the first discussion draft (July 22, 2011), *available at* http://www.oecd.org/tax/taxtreaties/publiccommentsreceivedonthediscussiondraftonthemeaningofbeneficialownerintheoecdmodeltaxconvention.htm.

[17] Second discussion draft, *supra* note 7. *See also* public comments on the second discussion draft (Feb. 12, 2013), *available at* http://www.oecd.org/tax/publiccommentsreceivedontherevisedproposalsconcerningthemeaningofbeneficialownerinarticles1011and12oftheoecdmodeltaxconvention.htm.

[18] *See, e.g.*, public comment from Japan Foreign Trade Council, Inc. on the second discussion draft, at 1 (Dec. 14, 2012), *available at* http://www.oecd.org/ctp/treaties/BENOWNJapan_Foreign_Trade_Council.pdf; Public Comment from BIAC on the Second Discussion Draft, at 1 (Dec. 14, 2012), *available at* http://www.oecd.org/ctp/treaties/BENOWNBIAC.pdf.

[19] First discussion draft, *supra* note 7, at 3; second discussion draft, *supra* note 7, at 2.

where not much attention has been paid to the term ''beneficial owner,'' and hence it has just been ignored in practice.[20]

On the other hand, such criticisms often just request clarity and foreseeability for taxpayers and do not give sufficient consideration to the interests of the opposite side, including the necessity to handle tax avoidance. Some say that even if ''beneficial owner'' is a concept for anti-tax-avoidance purposes, now that many treaties or domestic laws have limitation on benefits clauses or anti-conduit rules, the OECD does not also need to allow tax authorities to make use of ''beneficial owner'' for that purpose, so the scope of beneficial owner should be defined in a much clearer and narrower way.[21] Although this might appear to be a valid argument at first glance, the critics do not provide any specific examination to support this line of argument. In this sense, their arguments sound naïve, and if we take a cynical view, they are trying to push ''beneficial owner'' back into a world where they can, in practice, just ignore it.[22]

B. Approach of This Article

1. Object and Purpose of the OECD Model

The foregoing is a brief description of the current situation regarding ''beneficial owner,'' and there is no consensus about where we should go. Even the OECD might be unsure, because it does not specifically articulate the context, object, and purpose to be considered in the interpretation of beneficial owner, and it hesitates to clarify the scope of beneficial owner beyond a certain point.[23] Without a precise consensus about both the context and the object and purpose, it is difficult to establish the scope of beneficial owner in a way that is clear and acceptable among differing interests. Conversely, once we have consensus about both the context and the object and purpose, it is likely that we will be able to agree on the scope of beneficial owner, based on that context, object, and purpose.

The discussion drafts explicitly admit that ''the concept of 'beneficial owner' deals with some forms of tax avoidance.''[24] Although this might appear to be just a reiteration of the current OECD commentary, which says the term ''beneficial owner'' should be interpreted in light of the object and purposes of the OECD model, including ''the prevention of fiscal evasion and avoidance,''[25] this reiteration nonetheless shows that the OECD is obviously focusing on anti-tax-avoidance as a function of beneficial owner.[26] Although the current OECD commentary implies that there could be other objects and purposes that are not enumerated,[27] given the OECD's focus on the anti-tax-avoidance

[20]*See, e.g.*, public comment from Taxand on the second discussion draft, at 1 (Dec. 15, 2012), *available at* http://www.oecd.org/ctp/treaties/BENOWNTaxand.pdf; public comment from Chartered Institute of Taxation on the second discussion draft, at 1 (Dec. 13, 2012), *available at* http://www.oecd.org/ctp/treaties/BENOWNChartered_Inst_tax.pdf; Gavin Helmer, ''Beneficial Ownership — A Looming Disaster?'' *available at* http://www.pwc.com/sg/en/tax/tax-issue 20120730.jhtml. In Japan, aside from agent or nominee cases, I am of the impression that practitioners started to worry about the beneficial owner requirement only after the first discussion draft was published. For a brief overview of the interpretation of beneficial owner in Japan, see Eiichiro Nakatani and Akira Tanaka, ''Host Country JAPAN,'' *Tax Mgm't Int'l Forum*, Dec. 2012.

[21]*See, e.g.*, Helmer, *supra* note 20; public comment from Capital Markets Tax Committee of Asia on the first discussion draft, at 8 (July 13, 2011), *available at* http://www.oecd.org/tax/treaties/48413629.pdf; public comment from Association for Financial Markets in Europe on the first discussion draft, at 4 (July 15, 2011), *available at* http://www.oecd.org/tax/treaties/48413772.pdf; public comment from Ernst & Young International Tax Services on the second discussion draft, at 2-3 (Dec. 14, 2012), *available at* http://www.oecd.org/ctp/treaties/BENOWNErnst&Young_LLP.pdf; public comment from New Zealand Institute of Chartered Accountants on the second discussion draft, at 4 (Dec. 15, 2012), *available at* http://www.oecd.org/ctp/treaties/BENOWNNew_Zealand_Institute_Chartered_Accountants.pdf.

[22]*See, e.g.*, Public Comment from Taxand on the Second Discussion Draft, *supra* note 20, at 1; Public Comment from PricewaterhouseCoopers LLP on the second discussion draft, at 1, *available at* http://www.oecd.org/ctp/treaties/BENOWNPwC.pdf.

[23]*See infra* note 88.

[24]First discussion draft, *supra* note 7, at 4; second discussion draft, *supra* note 7, at 10.

[25]OECD model, *supra* note 2 at comment 12 on article 10, comment 9 on article 11, comment 4 on article 12; *see also id.* at C(10)-30 (discussing history of comment 12 on article 10), C(11)-24 (discussing history of comment 9 on article 11), C(12)-25 (discussing history of comment 4 on article 12).

[26]John Avery Jones, Richard Vann, and Joanna Wheeler object to the OECD's focus on anti-tax-avoidance as a function of the beneficial owner by introducing the history of the concept of beneficial owner in the OECD model. Public Comment from John Avery Jones, Richard Vann, and Joanna Wheeler on the First Discussion Draft (July 15, 2011), *available at* http://www.oecd.org/tax/treaties/48420432.pdf. However, their argument is, at the same time, based on their view that ''other anti-avoidance principles are available to deal with treaty shopping situations,'' and that to interpret ''beneficial owner'' more broadly than originally intended brings ''confusion and disputation.'' *Id.* at 5. It is not clear what ''other anti-avoidance principles'' they have in mind, but as far as an LOB clause is concerned, I question their views. Although the history of legal concepts or measures is not something that we can just ignore, I believe that if there is a need to deal with a problem (here, tax avoidance), we should have the option to take advantage of preexisting legal concepts or measures (here, the concept of beneficial owner) rather than introduce new legal concepts or measures, even if that option might not be compatible with history.

[27]The OECD commentary stipulates that the principal purpose of income tax treaties ''is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion.'' OECD model, *supra* note 2, at comment 7 on article 1. However, it is

(Footnote continued on next page.)

function of beneficial owner, and no explicit mention about such other potential objects and purposes in the OECD commentary or the discussion drafts, it does not seem unreasonable to ignore such other potential objects and purposes, and I will do so for the purpose of the analysis of this article.

That said, the current OECD commentary explicitly includes, in addition to ''the prevention of fiscal evasion and avoidance,'' ''avoiding double taxation'' as another object and purpose. Since this is explicit, it would not be appropriate simply to ignore this language in the interpretation of beneficial owner. However, as we have seen from the beginning, ''beneficial owner'' is a concept to limit the application of treaty provisions that eliminate double taxation. Therefore, given the OECD's emphasis on anti-tax-avoidance, it would be appropriate to understand this other object and purpose as just intending that ''beneficial owner'' should not be interpreted more widely than necessary to prevent tax avoidance so that elimination of double taxation would not be impaired.[28] Hence, I will explore the scope of beneficial owner only to the extent necessary to prevent tax avoidance.

2. Context of Beneficial Owner

Having determined to focus on anti-tax-avoidance as an object and purpose of the OECD model to be considered in the interpretation of beneficial owner, this can also provide the answer to the next question: What is the context of beneficial owner? As shown above, I could not determine the term's context because the object and purpose to be considered is uncertain. The method of tax avoidance being considered in the tax treaty context, especially regarding ''beneficial owner,'' is, as shown in Section I.A of this article, ''conduit'' transactions. As another piece of evidence, the OECD commentary, when discussing the term ''beneficial owner,'' specifically cites[29] the report from the Committee on Fiscal Affairs entitled ''Double Taxation Conventions and the Use of Conduit Companies'' (the conduit report).[30] In contrast, there is no clue that would suggest what other methods of tax avoidance will be handled by way of using the term ''beneficial owner.'' Therefore, I assume that the context to be considered in the interpretation of beneficial owner is the conduit transactions as discussed in the OECD commentary and the conduit report.

Here, I briefly overview how such conduit transactions work and why they are considered to be tax avoidance. A state enters bilateral tax treaties on the condition that the other contracting state will give it the same treaty benefits as it gives to the other contracting state. In other words, a state is not willing to give up its revenues to other states that do not provide the same treaty benefits in return. However, sophisticated taxpayers are motivated to achieve tax benefits under tax treaties, regardless of their connection to the contracting states of such tax treaties. The conduit report describes the mechanism of how a third-state resident tries to take advantage of a tax treaty between other states, using typical methods of tax avoidance, such as direct conduits and steppingstone conduits.[31]

a. Direct Conduits. Figure 1 is an illustration of the following description of direct conduits. State A and State B correspond to the residence state and the source state, respectively:

> A company resident of State A receives dividends, interest or royalties from State B. Under the tax treaty between States A and B, the company claims that it is fully or partially exempted from the withholding taxes of State B. The company is wholly owned by a resident of a third state not entitled to the benefit of the treaty between States A and B. It

unclear how such promotion of ''exchanges of goods and services, and the movement of capital and persons'' can possibly relate to the meaning of ''beneficial owner.'' *But see* public comment from Avellum Partners on the second discussion draft, at 3 (Jan. 30, 2013), *available at* http://www.oecd.org/ctp/treaties/BENOWNAvellum_Partners.pdf (arguing that, since ''promotion of international trade and movement of capital'' is one of the ''object[s] and purpose[s]'' of the tax treaty, special purpose vehicles for financial transactions should be entitled to beneficial owner status).

[28]Regarding agent and nominee, the OECD commentary states:

> it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be *equally inconsistent* with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. [Emphasis added.]

OECD model, *supra* note 2 at comment 12.1 on article 10. This might suggest that a recipient will not be regarded as a beneficial owner when there is no potential double tax, and that another object and purpose — that of avoiding double taxation — will be considered in such a manner. However, although the OECD commentary states ''equally inconsistent with the object and purpose of the Convention,'' there is a stretch here between (a) an agent or nominee, and (b) a conduit. Unlike an agent or nominee, a ''conduit'' would be treated as the owner of the income for tax purposes in the residence state, and hence, at least theoretically, potential double taxation arises there. Therefore, this purpose would not be ''*equally*'' applicable to a conduit.

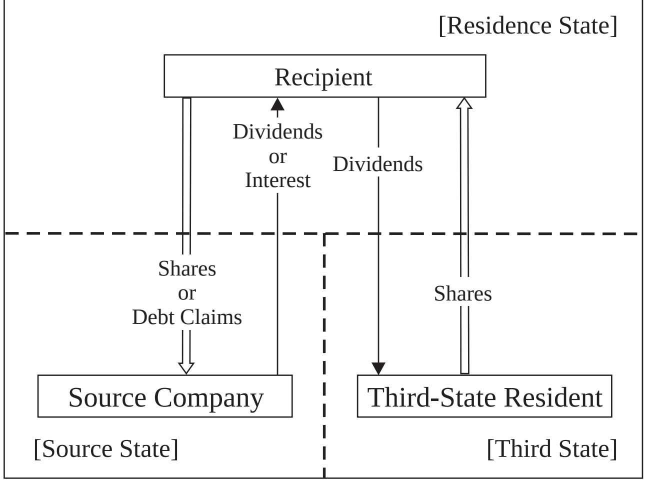
[29]*Id.* at comment 12.1 on article 10, comment 10 on article 11, comment 4.1 on article 12.

[30]*Id.* at R(6)-1.

[31]*Id.* at R(6)-2 to -3.

> has been created with a view to taking advantage of this treaty's benefits and for this purpose the assets and rights giving rise to the dividends, interest or royalties were transferred to it. The income is tax-exempt in State A, e.g. in the case of dividends, by virtue of a parent-subsidiary regime provided for under the domestic laws of State A, or in the convention between States A and B.[32]

Figure 1. 'Direct Conduits'

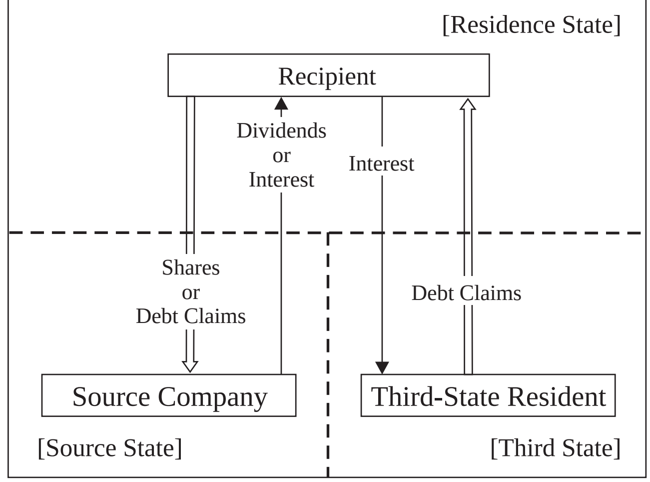


b. Steppingstone Conduits. Figure 2 is an illustration of the following description of steppingstone conduits. State A and State D correspond to the residence state and the third state, respectively:

> The situation is the same as in [the above example of direct conduits]. However, the company resident of State A is fully subject to tax in that country. It pays high interest, commissions, service fees and similar expenses to a second related ''conduit company'' set up in State D. These payments are deductible in State A and tax-exempt in State D where the company enjoys a special tax regime.[33]

If such attempt can be successfully made by a third-state resident, it would result in revenue loss of the source state without receiving anything in exchange, impair the principle of reciprocity that underlies tax treaties, and reduce incentives to conclude tax treaties.[34] Therefore, it is necessary for the contracting states of tax treaties to limit who can enjoy treaty benefits to those whose connection with the contracting states can be considered sufficient to entitle them to treaty benefits.

Figure 2. 'Steppingstone Conduits'



3. Assuming the Existence of an LOB Clause

In sections I.B.1 and I.B.2 of this article, I have assumed that beneficial owner is a concept to handle tax avoidance, especially regarding conduit transactions. However, as a measure to handle conduit transactions specifically, the OECD commentary proposes an LOB clause.[35] So, one question arises: How should we understand the relationship between beneficial owner and an LOB clause? If there are some similarities in the functions to be performed by beneficial owner and an LOB clause, respectively, to understand the difference in such functions would help to understand and clarify the scope of ''beneficial owner'' by assigning to it specific functions that it can and should appropriately handle. This approach also promises better acceptability among differing interests. The current approach of the discussion drafts is too focused on how to establish a general definition of beneficial owner without providing enough explanation about the rationale behind the definition, and this seems to be one of the biggest criticisms against it. If a sufficient rationale is provided, and that rationale is acceptable among differing interests since it is based on a functional analysis rather than a dogmatic definitional approach, it will be more easily accepted.[36]

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[32] *Id.* at R(6)-2.

[33] *Id.* at R(6)-3.

[34] *Id.* at R(6)-4 to -5. *See, e.g.*, Simone M. Haug, ''The United States Policy of Stringent Anti-Treaty-Shopping Provisions: A Comparative Analysis,'' 29 *Vand. J. Transnat'l L.* 191, 195-220 (1996).

[35] OECD model, *supra* note 2, at comment 13-20 on article 1.

[36] The assumption and approach of this article are different from those of previous discussions regarding the concept of beneficial owner, including judgments rendered in several jurisdictions; hence, I do not examine those discussions in this article. *See, e.g.*, Christiana HJI Panayi, in Peter HJ Essers et al., eds., *Double Taxation, Tax Treaties, Treaty-Shopping and the European Community* 44-50 (2007), for previous discussions.

Admittedly, not all tax treaties contain LOB clauses, so analyzing the scope of beneficial owner in consideration of an LOB clause might be criticized as being based on an unrealistic or unpractical assumption. However, as I will discuss later, the current trend shows that an increasing number of tax treaties contain LOB clauses, which provides considerable promise for the clarification of the scope of beneficial owner, as well as important implications about the current approach of the discussion drafts. Therefore, I believe it would be a meaningful approach to examine the scope of beneficial owner under this assumption. That said, the number of tax treaties containing LOB clauses is not small, and a comprehensive review is unrealistic and risks complicating the discussion. For the sake of simplicity and clarity, in this article I examine only the LOB clause in the Japan-U.S. income tax treaty,[37] as well as the general approaches to an LOB clause as proposed in the OECD commentary.[38]

In this article, I will examine the scope of beneficial owner in the following order:

- overview the approaches to an LOB clause as proposed in the OECD commentary and the LOB clause in the Japan-U.S. treaty, and the relationship between an LOB clause and the beneficial owner as a basis of functional analysis (Section II);
- examine the functions to be performed by an LOB clause and beneficial owner regarding conduit transactions, and the scope of beneficial owner (Section III.A through III.D);
- reconsider the relationship between an LOB clause and the beneficial owner (Section III.E); and
- review and comment on the discussion drafts, based on my analysis (Section IV).

II. LOB Clause and Beneficial Owner

A. LOB Clause

1. Approaches as Proposed in the OECD Commentary

Although the OECD model itself does not contain an LOB clause, the OECD commentary proposes possible approaches for a state to employ an LOB clause:[39]

a. The look-through approach.[40] Under this approach, a company will be denied treaty benefits if the company is owned or controlled, directly or through one or more other companies, by a third-state resident.

b. The subject-to-tax approach.[41] Under this approach, treaty benefits are granted only if the income received by a resident of the residence state is subject to tax in the residence state.

The OECD commentary specifically states that this approach ''does not offer adequate protection against . . . 'stepping-stone strategies.''’[42]

c. The channel approach.[43] Under this approach, when a third-state resident has a substantial interest in the recipient, or exercises the management of or has control over the recipient, if a certain percentage of the income of that recipient is used to satisfy the claim by such third-state resident, the recipient will be disallowed the treaty benefits regarding such income.

Unlike the subject-to-tax approach, the channel approach does not look at whether the income received by the recipient is subject to tax in the residence state; instead, this approach looks at the payment deductible in computing the taxable income of the recipient in the residence state. The OECD commentary states that the channel approach ''appears to be the only effective way of combating 'stepping-stone' devices.''[44]

d. Bona fide provisions.[45] If the provisions that reflect the above approaches are applied literally, there is a risk that it will lead to unreasonable results such as denying treaty benefits to bona fide business transactions, thereby discouraging legitimate business activities.[46] Therefore, the OECD commentary proposes to supplement them with bona fide provisions, such as:

- *General bona fide provision.*[47] Under this provision, a company can enjoy treaty benefits if the recipient's conduct of business and its acquisition or maintenance of the property from which income is derived are based on sound business reasons.
- *Activity provision.*[48] Under this provision, a company can enjoy treaty benefits if the recipient is engaged in substantive business operations in the residence state and the income is related to such operation.
- *Amount of tax provision.*[49] Under this provision, a company can enjoy treaty benefits if the reduction

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[37]Convention Between the Government of Japan and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Japan-U.S., Nov. 6, 2003, S. Treaty Doc. No. 108-14.

[38]OECD model, *supra* note 2, at comment 13-20 on article 1.

[39]*Id.* at comment 13-20 on article 1.

[40]*Id.* at comment 13-14 on article 1.

[41]*Id.* at comment 15-16 on article 1.

[42]*Id.* at comment 16 on article 1.

[43]*Id.* at comment 17-18 on article 1.

[44]*Id.* at comment 18 on article 1.

[45]*Id.* at comment 19 on article 1.

[46]*Id.*

[47]*Id.* at comment 19 on article 1, subpara. a).

[48]*Id.* at comment 19 on article 1, subpara. b).

[49]*Id.* at comment 19 on article 1, subpara. c).

of tax due to treaty benefits is not greater than the tax actually imposed on the recipient by the residence state.

- *Stock exchange provision.*[50] Under this provision, a company can enjoy treaty benefits if the principal class of its shares is listed on the stock exchange in the residence state, or the recipient is wholly owned — directly or through one or more companies each of which is a resident of the residence state — by a company whose principal class of shares is listed on the stock exchange in the residence state.
- *Alternative relief provision.*[51] Under this provision, a resident of a third state that has a tax treaty with the residence state will not be deemed to be treated as a nonresident of the residence state if it claims the treaty benefits under such treaty, and the treaty benefits under such treaty are not less than those under the treaty between the residence state and the source state.
- *Competent authority provision.*[52] Under this provision, a taxpayer can enjoy treaty benefits if a competent authority of the source state allows the treaty benefits by exercising the discretionary power given to it.

After proposing these approaches, the OECD commentary provides an example of an LOB clause.[53] Although I will not go into the details of this example in the OECD commentary in this article, note that even in the example in the OECD commentary, the aforementioned approaches are not necessarily being used separately from each other. In other words, some of them are often used in combination with other approaches to constitute an effective LOB clause, as can also be seen in the LOB clause of the Japan-U.S. treaty below.

2. The LOB Clause of the Japan-U.S. Treaty

The LOB clause in article 22 of the Japan-U.S. treaty can be summarized as follows regarding the treaty benefits eligibility of a company. A company resident can enjoy treaty benefits if it satisfies any one of the following four tests:

- *Article 22(1)(c).* A company in the residence state is eligible for treaty benefits (a) if its shares are publicly traded on a stock exchange in either contracting state, or (b) if at least 50 percent of each class of shares in the company is owned, directly or indirectly, by five or fewer companies in the residence state whose shares are publicly traded on a stock exchange in either contracting state. In the case of indirect ownership, each intermediate owner is required to satisfy the treaty benefits eligibility under article 22. This test corresponds to a combination of the look-through approach and the stock exchange provision in the OECD commentary.
- *Article 22(1)(f).* A company is eligible for treaty benefits (a) if at least 50 percent of each class of shares in the company is owned, directly or indirectly, by individual residents of the residence state or companies in the residence state whose shares are publicly traded on a stock exchange in either contracting state, and (b) if less than 50 percent of the company's gross income is paid by the company, directly or indirectly, to third-state residents in the form of payments that are deductible in computing the company's taxable income in the residence state. Condition (b), which is often called the base erosion test, is regarded as a variation of the channel approach, and hence this test corresponds to a combination of the look-through approach, the channel approach, and the stock exchange provision in the OECD commentary.
- *Article 22(2).* A company is eligible for treaty benefits regarding an item of income derived from the source state (a) if the company is engaged in the residence state in the active conduct of a trade or business, and (b) if the income is derived in connection with, or is incidental to, that trade or business. This test corresponds to the activity provision in the OECD commentary.
- *Article 22(4).* A company is eligible for treaty benefits if the competent authority of the source state determines that the establishment, acquisition, or maintenance of the company and the conduct of its operations are considered as not having the obtaining of treaty benefits as one of its principal purposes. This test corresponds to the competent authority provision in the OECD commentary.

Among these four tests, the third and fourth tests correspond to bona fide provisions in the OECD commentary, which are introduced to avoid unreasonable results arising from a literal application of an LOB clause. Even if transactions might look like conduit transactions on their face, if either the third or fourth test is met, such transactions will be entitled to treaty benefits because they are considered legitimate transactions. However, the third and fourth tests are intended to entitle only some transactions to treaty benefits. This is apparent because if the OECD believed that only the transactions that met either the third or fourth test could be considered as legitimate, it would have proposed only these bona fide provisions as an LOB clause without proposing any other approaches. Therefore, failure to meet these tests does not mean that the transactions constitute tax avoidance.

In contrast, the first and second tests are intended to deny treaty benefits to certain types of transactions as tax avoidance, and failure to meet these tests means

[50] *Id.* at comment 19 on article 1, subpara. d).

[51] *Id.* at comment 19 on article 1, subpara. e).

[52] *Id.* at comment 19 on article 1.

[53] *Id.* at comment 20 on article 1.

that the transactions would be regarded as tax avoidance unless the third or fourth tests are met. Therefore, when examining the effectiveness of an LOB clause to deny treaty benefits to conduit transactions as tax avoidance, it is appropriate to examine the effectiveness of only the first and second tests, not the third and fourth tests. Note that both the first and second tests employ the look-through approach and require that at least 50 percent of the ultimate shareholders of the recipient be either individual residents or publicly traded companies in the residence state.[54] As later discussion will show, this has important implications.

B. Relationship With Beneficial Owner

To effectively examine the scope of beneficial owner in relation to an LOB clause, it is imperative to understand the relationship between the application of each provision — more specifically, which provision should be applied before the application of the other.

However, such relationship is less clear than one would expect. The LOB clause of the Japan-U.S. treaty, like LOB clauses in many other tax treaties, just stipulates that ''a resident of a Contracting State that derives income from the other Contracting State'' will satisfy the LOB clause, and does not specify who such ''a resident . . . that derives income'' is — the immediate recipient or the beneficial owner of the income.[55] Whereas the beneficial owner concept applies only to article 10 (dividends), article 11 (interest), and article 12 (royalties), the LOB clause in the Japan-U.S. treaty applies to all kinds of income under the treaty.[56] This suggests that since the LOB clause also applies to the recipient of those kinds of income to which the beneficial owner concept does not apply, ''a resident . . . that derives income'' to which the LOB clause applies should be interpreted as meaning the immediate recipient, rather than the beneficial owner for dividend, interest, and royalty income, as well.

That interpretation, however, is not reasonable if we consider its results. If the LOB clause applies to the immediate recipient, and therefore we do not examine whether the beneficial owner qualifies under the LOB clause, taxpayers will be able to easily avoid the application of the LOB clause by using two entities — an immediate recipient who satisfies the LOB clause, and a beneficial owner of the income to whom all the income is transferred from the immediate recipient. Under such interpretation, the latter entity, the beneficial owner, does not have to meet the LOB requirement, so the LOB clause will not serve its anti-tax-avoidance purpose.

The technical explanation of the Japan-U.S. treaty published by the U.S. Department of the Treasury (the U.S. technical explanation) clearly states that ''Article 22 . . . will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.''[57] In other words, before the application of an LOB clause, the issue of who is the beneficial owner of the income must be determined. In contrast, there seems to have been no discussion about this legal question in Japan, probably because not much attention had been paid to the concept of beneficial owner before, and in this sense, it is not clear whether the interpretation of the U.S. technical explanation will also be accepted in Japan. However, as noted above, the U.S. interpretation is reasonable, and for purposes of this article, I will assume the U.S. interpretation would be accepted in Japan as well.

III. Scope of Beneficial Owner

A. Typical Conduit Transactions

In this section, I will examine whether and to what extent an LOB clause can deal with typical conduit transactions, both direct conduits and steppingstone conduits. First, I will examine the LOB clause in the Japan-U.S. treaty and show that while it sufficiently handles direct conduits, it does not deal with steppingstone conduits. Then I will examine whether the example provision of the channel approach in the OECD commentary can sufficiently deal with steppingstone conduits. Although these examinations are based only on typical conduit transactions, we can make important deductions about the different functions to be performed by an LOB clause and the concept of beneficial owner from those examinations, as will be seen in Section III.A.3 of this article.

1. Typical Direct Conduits

Please refer to Figure 1 and the text above at Section I.B.2.a regarding typical direct conduits. In this case, because the wholly owning parent company of the recipient (the company resident of State A) is a third-state resident, the recipient would not satisfy the LOB clause in the Japan-U.S. treaty, which requires that at least 50 percent of the ultimate shareholders be

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[54]Like the LOB clause in the Japan-U.S. treaty, LOB clauses in many other tax treaties employ the look-through approach; therefore, in many cases, a certain percentage of the ultimate shareholders of the recipient must be either individual residents or publicly traded companies in the residence state.

[55]Japan-U.S. treaty, *supra* note 37, at article 22(1).

[56]*Id.* Unlike the LOB clause in the Japan-U.S. treaty, LOB clauses in many other tax treaties are only applicable to limited types of income. However, even under those treaties, LOB clauses often apply to more than the three types of income to which the concept of beneficial owner applies. Therefore, the same interpretation issue would equally apply to LOB clauses in other tax treaties.

[57]Department of the Treasury, Technical Explanation of the Convention Between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital Gains, at 80 (2004), *available at* http://www.irs.gov/pub/irs-trty/japante04.pdf.

individual residents or publicly traded companies in the residence state (State A). Therefore, the LOB clause in the Japan-U.S. treaty deals sufficiently with these typical direct conduits.

2. Typical Steppingstone Conduits

Please refer to Figure 2 and the text above at Section I.B.2.b regarding typical steppingstone conduits. The OECD commentary points out that the channel approach is the only effective way to deal with steppingstone conduits.[58] For example, the subject-to-tax approach would not work, because the recipient (the company resident of State A) is fully subject to tax in the residence state (State A).[59]

Also, the base erosion test in the Japan-U.S. treaty is regarded as employing the channel approach. Under the base erosion test, if the total amount of expenses paid by the recipient (the company resident of State A) to third-state residents accounts for 50 percent or more of its gross income in the residence state (State A), the recipient will fail to satisfy the test, and it might appear that this test effectively deals with steppingstone conduits. However, if such expense payment is less than 50 percent of the gross income of the recipient, the company can still pass the test. The problem with the test is that depending on the size of the gross income of the recipient (which includes any income that is relevant or irrelevant to the transaction between the recipient and third-state residents), 50 percent of the gross income can be a huge amount, which creates enough room for tax avoidance. In other words, the base erosion test permits tax avoidance to the extent that the deductible amount does not reach 50 percent of the gross income of the recipient.

Unlike the base erosion test in the Japan-U.S. treaty, the example provision regarding the channel approach in the OECD commentary looks at the percentage of the amount to be deducted from a certain item of income of the recipient, not the gross income of the recipient, as payment to a third-state resident having a substantial interest in, or the management of or control over, the recipient.[60] Although not completely clear from the language of the example provision, this provision calculates the percentage at issue without looking at the relationship between (a) the item of income of the recipient and (b) the payment made by the recipient to a third-state resident, and instead requires some interest or control over the recipient by the third-state resident. In other words, this provision calculates the percentage at issue by just allocating the entire cash outflow of the recipient to every item of income of the recipient on a pro rata basis. If true, the same criticism against the base erosion test in the Japan-U.S. treaty would also apply to this OECD example provision of the channel approach. If the overall cash outflow of the recipient is huge, it will decrease the percentage of the amount to be deducted from a certain item of income of the recipient as payment to a certain third-state resident and thereby create room for tax avoidance. Therefore, this OECD example provision of the channel approach would not work sufficiently, either.

3. Direct Conduits vs. Steppingstone Conduits

The above examination shows that, at least for typical direct conduits and steppingstone conduits, whereas an LOB clause cannot deal with steppingstone conduits sufficiently, it can handle direct conduits. If this is true for any direct conduits and steppingstone conduits, direct conduits could be excluded from the scope of beneficial owner and beneficial owner could focus on steppingstone conduits. To further examine this point, it is necessary to understand why an LOB clause can handle typical direct conduits while it cannot deal with typical steppingstone conduits.

When we look at the structures of both typical direct conduits and steppingstone conduits, the most notable difference is whether a third-state resident holds, vis-à-vis the recipient, shares in the recipient or debt claims. In my opinion, this difference determines whether an LOB clause successfully deals with those conduits.

Because of the 50 percent minimum shareholding requirement in an LOB clause, a third-state resident that is trying to abuse a tax treaty, regardless of whether through direct conduits or steppingstone conduits, must use a corporation in the residence state in which the third-state resident holds less than 50 percent of the shares. This means that in order to abuse a tax treaty, a third-state resident must pool its money with that of an arm's-length party, and such money would be subject to various risks related to using such arm's-length party, such as bankruptcy risk, mismanagement risk, the risk that its money is semi-permanently retained by the recipient without being paid to the third-state resident as dividends, and so forth. A third-state resident that would be interested in abusing a tax treaty would not engage in any conduit transactions unless it had some legal control over the payment, at least regarding the amount and timing of payment to it.

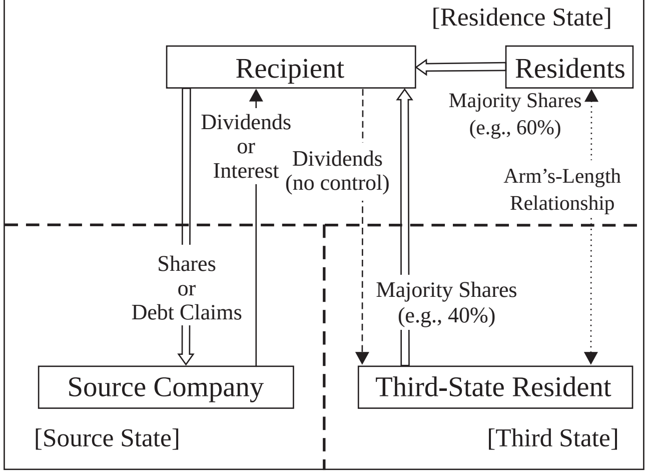
Regarding direct conduits, a third-state resident owns shares in the recipient and receives payment from the recipient in the form of dividends. Under ordinary corporate law systems, declaration of dividends generally must be made by a majority vote of shareholders; therefore, a third-state resident that holds less than 50 percent of the voting rights of the recipient cannot effectively determine when, and in what amount, a dividend payment should be made by the recipient to its shareholders, including the third-state resident. Therefore, for direct conduits, the risk is low that a third-state resident that holds less than 50 percent of the voting rights of the recipient will abuse a tax treaty. (See Figure 3.)

[58]*See supra* text accompanying note 44.

[59]OECD model, *supra* note 2, at R(6)-14; *see also supra* text accompanying note 42.

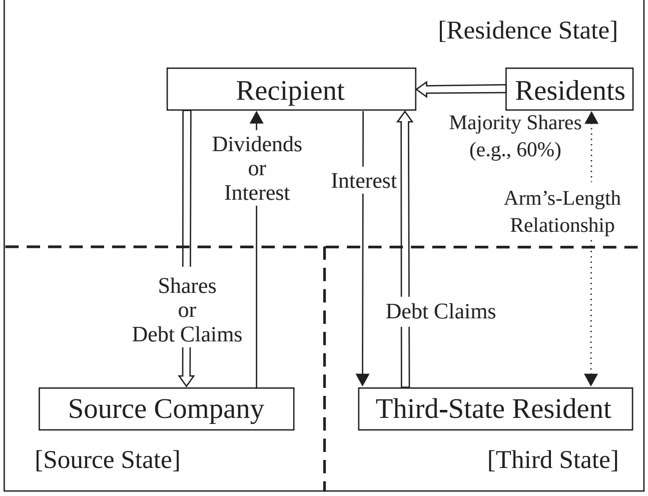
[60]OECD model, *supra* note 2, comment 17 on article 1.

Figure 3. 'Direct Conduits' With an LOB Clause



In contrast, for steppingstone conduits, a third-state resident that has a debt claim can claim a payment of a predetermined amount at a specified date against the recipient, regardless of the decisions or thoughts of the recipient, its shareholders, or other creditors. Therefore, the third-state resident can effectively have legal control over when, and in what amount, payment should be made by the recipient to it. Since there is no majority voting system like a shareholders' meeting involved, a mechanism similar to the minimum 50 percent shareholding requirement of an LOB clause for direct conduits does not work here. Although the look-through approach and the channel approach of an LOB clause might seem similar in that both use percentage threshold tests, this is why the channel approach cannot sufficiently deal with steppingstone conduits. (See Figure 4.)

Figure 4. 'Steppingstone Conduits' With an LOB Clause



Based on these analyses of typical direct conduits and steppingstone conduits, it becomes apparent that the factor that determines whether an LOB clause can sufficiently deal with those conduits is whether a third-state resident, despite the existence of an LOB clause, has legal control over the amount and timing of payment to it.

These examinations suggest two things. First, considering that a third-state resident would engage in conduit transactions only when it had legal control over the amount and timing of payment to be made by the recipient to it, one of the requirements for the beneficial owner should be that a third-state resident has legal control over the payment to be made by the recipient to the resident. Second, even for direct conduits in which a third-state resident owns less than 50 percent of shares in the recipient, if the third-state resident can have legal control over the amount and timing of payment to it, an LOB clause that relies simply on a majority voting system of shareholders would not be able to handle those direct conduits and such legal control is easily attainable by using various legal instruments.

B. Direct Conduits

1. Debtlike Hybrid Shares

A straightforward way for a third-state resident to try to abuse a tax treaty would be to have less than 50 percent of debtlike hybrid shares (typically, preferred stock), and thereby have legal control over payment to be made by the recipient while satisfying an LOB requirement.

However, as discussed in Section III.A of this article, the determinative factor that allows a third-state resident to abuse a tax treaty despite an LOB clause is whether it has legal control over payment to be made by the recipient. Hence, as long as a third-state resident has that legal control, it should be included in the scope of beneficial owner in the same way as a steppingstone conduit. Therefore, cases in which a third-state resident owns, vis-à-vis a recipient, debtlike hybrid stock that entitles the third-state resident to sufficient legal control over a dividend payment[61] should be included in the scope of beneficial owner.[62]

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[61]Since what matters is whether a third-state resident has legal control over the payment to be made by the recipient to it, and that there are various kinds of debtlike hybrid shares, we should not draw a conclusion by just looking at the name of such shares. Even if the shares are called preferred stock, if a vote of the board of directors to pay a dividend for such ''preferred stock'' is required, and if the third-state resident does not have any control over the vote by the board of directors, the third-state resident should not be regarded as having legal control over the payment.

[62]The LOB clause requires that at least 50 percent of each class of shares in the recipient will be owned by individual residents or publicly traded companies in the residence state. Japan-U.S. tax treaty, *supra* note 37, article 22(1)(c), (f). Therefore, if only a third-state resident owns the preferred stock vis-à-vis a recipient, the recipient will not satisfy the LOB clause. For the

(Footnote continued on next page.)

2. Shareholders' Agreements

Another way of giving a third-state resident sufficient legal control over a dividend payment is to execute a shareholders' agreement with individual residents or publicly traded companies who own 50 percent or more of stock in the recipient, which governs the timing and amount of dividend payment. By so doing, a third-state resident holding less than 50 percent of shares in the recipient, can, through the shareholders' agreement, legally control the dividend payment to be made by the recipient. Therefore, the cases in which a third-state resident can be considered as having legal control through shareholders' agreements should also be included in the scope of beneficial owner.

Taxpayers may try to disguise the existence of legal control in the relevant legal documents so that the tax authorities cannot easily find it. For example, if the shareholders' agreement states that the third-state resident can nominate the majority of the members of the board of directors of the recipient, and if under the domestic corporate law of the residence state majority voting at the board meetings can determine whether and how much dividends are to be paid to the shareholders of the corporation, the effect of that provision in the shareholders' agreement would be to give sufficient legal control over dividend payment to the third-state resident. Therefore, to determine whether legal control is given to a third-state resident, tax authorities would have to closely examine the relevant legal documents.[63]

When a third-state resident that owns a certain percentage of common stock is considered the beneficial owner of the payment to be made by the source company, to what extent should treaty benefits to the recipient be denied? Suppose that the third-state resident and an individual resident in the residence state own, respectively, 40 percent and 60 percent of the common stock in the recipient, which owns all shares in the source company. Suppose further that the third-state resident, though it only owns 40 percent of the common stock in the recipient, has legal control over payment to be made by the recipient through a shareholders' agreement. If we deny treaty benefits to only 40 percent of the dividends received by the recipient, this means that the recipient can enjoy treaty benefits for 60 percent of the dividends received. The treaty benefits will be distributed not only to the individual resident but also to the third-state resident, because under ordinary corporate law systems, all shareholders will be treated equally, so it would be impossible to distribute a different amount of dividends to shareholders who own the same common stock. In effect, the third-state resident is able to enjoy, though only in part, treaty benefits, which it is not supposed to receive, and the question whether this should be regarded as tax avoidance arises.

I believe that we would not have to consider this tax avoidance. The 60 percent of the dividends is paid out regarding the investment made by the individual resident, who is legitimately entitled to treaty benefits if he directly invests in the source company. From the perspective of the source state, to waive the right to tax for that amount is what is expected in the tax treaty, and there is no additional revenue loss as a result of this transaction. The only remaining issue is how to split such treaty benefits between the individual resident and the third state, an issue in which the source state should have no interest. As noted above, under ordinary corporate law systems, all common shareholders would receive the same amount of dividends per share. In the above example, the recipient receives treaty benefits for 60 percent of the dividends received from the source company; the 60 percent will then be allocated to the individual resident and the third-state resident under their shareholding percentage. Since the recipient enjoys only a limited percentage of the treaty benefits, even if the third-state resident in effect enjoys treaty benefits to some extent, there would still be incentives for the third state to enter a tax treaty with the

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recipient to satisfy the LOB clause, at least 50 percent of the preferred stock must be owned by individual residents or publicly traded companies in the residence state. However, this requirement is not so detrimental as to discourage such individual residents or publicly traded companies from helping a third-state resident engage in direct conduit transactions, because from the perspectives of individual residents or publicly traded companies who also own common shares in the recipient, this requirement only affects whether their dividends will be paid to them as dividends of common stock or preferred stock.

[63]Even when the shareholders' agreement does not give legal control over a dividend payment to a third-state resident, a third-state resident usually has legal control over when it sells its shares, and could effectively receive dividend equivalents as part of a capital gain from the sale.

In this regard, it would be logically possible to argue that since the receipt of consideration for the shares in part represents the receipt of dividends, that portion should be treated in the same way as dividends, and if the third-state resident has legal control over when it can sell the shares, it should be included in the scope of beneficial owner.

However, tax treaties handle dividends and gains derived from the alienation of shares separately, and the latter is in principle treated as tax exempt in the source state. *But see* public comment from Kim and Chang on the first discussion draft, at 4 (July 14, 2011), *available at* http://www.oecd.org/tax/treaties/48413696.pdf (stating that "tax authorities in several jurisdictions across Asia have been applying the concept of 'beneficial owner' to [capital gains]"). Given this separate treatment, it is inappropriate to regard as problematic the conversion from dividends to gains derived from the alienation of shares only in the context of beneficial owner. The relationship between gains derived from the alienation of shares appears to be a problem inherent to the current tax treaty structure, which should be remedied by fundamental reform.

(Footnote continued in next column.)

source state.[64] Further, in actual transactions, the individual resident would not be so willing to share his treaty benefits with the third-state resident and would instead propose an alternative transaction structure by which he would enjoy 100 percent of his treaty benefits while the third-state resident would enjoy nothing. For these reasons, we do not have to be worried about these kinds of transactions as being tax avoidance.

3. Dividend Payment Policy or Practice

Some companies have their own dividend policies or practices under which they pay all or a certain percentage of their profits to their shareholders every year. When a recipient has such a dividend payment policy or practice, as long as the recipient maintains the policy or practice, a third-state resident having less than 50 percent of the shares in the recipient can be considered as having legal control over payment to be made by the recipient.[65]

However, that policy or practice generally can be changed at the discretion of the recipient, and there is no legal guarantee that such change will not be made, unless the third-state resident has legal control regarding making any such change through other legal instruments, such as a shareholders' agreement with other shareholders that entitles the third-state resident to nominating powers of a majority of the members of the board of directors of the recipient, or that prohibits change of the policy or practice. Since the third-state resident and the recipient are in an arm's-length relationship, without such legal protection, the third-state resident would be hesitant to engage in conduit transactions with the recipient. Therefore, as long as the third-state resident does not have any legal control over such policy or practice, this case would not have to be included in the scope of beneficial owner.

4. A Shareholder Owning 50 Percent or More Shares

As noted above, typical direct conduits in which a third-state resident owns 50 percent or more of the shares in the recipient are within the scope of the LOB clause, and therefore it would not necessarily be essential to handle such typical direct conduit by way of the beneficial owner concept, although the third-state resident would have legal control over the payment to be made by the recipient. The question here is whether we should exclude all such cases from the scope of beneficial owner and leave them only to the LOB clause. I would say no.

Suppose that a third-state resident and an individual resident in the residence state own 60 percent and 40 percent of shares in the recipient, respectively. If a shareholder owning 50 percent or more shares in the recipient is excluded from the scope of beneficial owner, the recipient, not the third-state resident, would be considered to be the beneficial owner of the income paid by the source company to the recipient, and as a result of the application of the LOB clause to the recipient, treaty benefits would be denied since 60 percent of the shares in the recipient are owned by the third-state resident. In contrast, if a shareholder owning 50 percent or more shares in the recipient is included, the third-state resident would be considered to be the beneficial owner of 60 percent of the income received by the recipient, and denied treaty benefits because it is not a resident of the residence state.[66] Since the 40 percent individual resident shareholder owns only 40 percent of the shares in the recipient, and because of the lack of legal control over dividend payment, he would not be considered to be the beneficial owner; instead, the recipient would be regarded as the beneficial owner of the remaining 40 percent of the income received. However, because of the above-mentioned relationship between application of the LOB clause and the beneficial owner, under which the beneficial owner is determined before the application of the LOB clause, the LOB clause is applied to such recipient. Because 60 percent of the shares in the recipient are owned by the third-state resident, the recipient would be finally denied treaty benefits for the 40 percent of the income received as well.[67] Therefore, in this simple example, there would be no difference in results whether we exclude from the scope of beneficial owner direct conduit transactions in which a third-state resident owns 50 percent or more of the shares in the recipient.[68]

[64]*See supra* text accompanying note 44.

[65]*See* second discussion draft, *supra* note 7, at 8.

[66]*See supra* note 5.

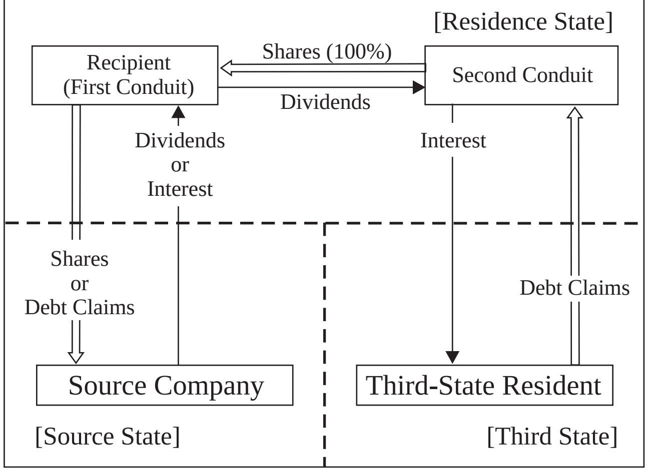
[67]In practice, I guess tax authorities would often deny treaty benefits to the recipient by applying an LOB clause to it without examining whether the third-state resident could be considered the beneficial owner.

[68]In the above analysis, I have implicitly assumed that because the individual resident owns 40 percent of the shares in the recipient, the individual resident does not have legal control over dividend payments. However, there might be a legal instrument, like a shareholders' agreement, in which the individual resident also has legal control over dividend payments. In that situation, there may be a difference in the outcome, depending on whether we exclude from the scope of beneficial owner direct conduit transactions in which a third-state resident owns 50 percent or more of the shares in the recipient.

However, as discussed in Section III.C.3 of this article, in order for a shareholder of the recipient to be the beneficial owner of the income received by the recipient, it must constrain the recipient's investment discretion by way of the relevant legal documents. Therefore, in the above example, in order for both the individual resident and the third-state resident to qualify as beneficial owner, they both must constrain the recipient's investment discretion in relevant legal documents. It is not apparent whether that transaction scheme would work in a practical sense. Further, even if it would work, an economically reasonable individual resident would not want to share his treaty benefits with the third-state resident, and would instead invest directly in the source company.

In contrast, the results may differ in a steppingstone conduit transaction in which two or more conduit companies are involved. Given the nature of a conduit, there does not necessarily have to be only one. Figure 5 illustrates an example of such a transaction, when a second conduit is interposed between the recipient (first conduit) and the third-state resident so that the third-state resident will receive payment from the second conduit, and not directly from the recipient.

Figure 5. 'Steppingstone Conduits' With Two Conduits



For this structure to work effectively for tax avoidance purposes, no additional tax burden should be incurred regarding the payment from the recipient to the second conduit. In the above case in which the second conduit owns shares vis-à-vis the recipient, under the domestic tax law of the residence state, dividends paid to the second conduit are commonly tax exempt or, if taxable, taxed at a very low rate.[69] Alternatively, if the second conduit or its parent company files a consolidated tax return that covers both the recipient and the second conduit, the payment by the recipient to the second conduit would be canceled for the purpose of income calculation of the consolidated group under the domestic tax law of the residence state; therefore, no additional tax burden would be incurred.[70] In this way, even when two or more conduit companies are involved, the tax avoidance purpose can be achieved in the same way.

In the above example, the second conduit owns all the shares in the recipient. If a shareholder owning 50 percent or more of shares in the recipient is excluded from the scope of beneficial owner, the recipient, and neither the second conduit nor the third-state resident, will be considered the beneficial owner of the income received; therefore, an LOB clause will be applied to the recipient. If this is the case, there is no possibility of the channel approach provision of an LOB clause being applied to the second conduit even when most of the dividends received by the second conduit are paid to the third-state resident as deductible expenses. Also, it would be very unreasonable if a third-state resident were able to circumvent the beneficial owner requirement just by interposing more than one conduit company that owns 50 percent or more shares in the recipient or another conduit company, between the source company and the third-state resident.

As shown above, while both interpretations can lead to the same result in conduit transactions if only one conduit is involved, exclusion of a shareholder owning 50 percent or more shares in the recipient from the scope of beneficial owner can cause undesirable results in conduit transactions in which two or more conduits are involved. Therefore, such shareholder should be included in the scope of beneficial owner.[71]

C. Relationship Between Two Transactions

1. Close Enough to Deny Treaty Benefits?

The next question is, given that the channel approach of an LOB clause does not sufficiently handle steppingstone conduits, and certain direct conduits in which a third-state resident has legal control over the amount and timing of payment to it, how can we deal with such transactions successfully? In this regard, considering the reason that the percentage threshold test of

[69]The same result can be achieved when the second conduit owns debt claims vis-à-vis the recipient as well, if no additional tax burden would be incurred from the transaction as a whole by the combination of expense deduction at the recipient and income inclusion at the second conduit.

[70]Although corporations would be treated as a quasi-single entity for purposes of the domestic tax law of the residence state, often such treatment in the residence state would not affect the treatment of the recipient and the second conduit as separate and distinct entities in the source state, and therefore the decision to give treaty benefits would be made based on such entity treatment in the source state, not the residence state.

[71]This conclusion might appear to make little sense since the concept of beneficial owner is to be applied before the application of the LOB clause, and the situations in which the recipient is denied treaty benefits because of its failure to satisfy the minimum shareholding percentage requirement of the LOB clause would decrease. As a result, this could minimize the significance of the requirement in the LOB clause.

However, as will be discussed in Section III.E of this article, ''beneficial owner'' is theoretically a more desirable measure than an LOB clause since it is based on the very nature of ''conduit'' transactions. Also, an LOB clause is necessary because the enforcement of ''beneficial owner,'' despite its theoretical superiority, can be costly and lead to tax avoidance. Therefore, in a situation where we can apply ''beneficial owner,'' we would not have to adhere to the application of the LOB clause. Further, this conclusion can be advantageous to a third-state resident, since if there is a tax treaty between the source state and the third state, it can enjoy treaty benefits under such tax treaty. See *infra* notes 83-84.

the channel approach cannot sufficiently handle steppingstone conduits, the only approach would be to look at the relationship between (a) investment by a third-state resident in the recipient and (b) investment by the recipient in the source company, and deny treaty benefits when the relationship is too close.

On the other hand, as is clear from the fact that a third-state resident often invests in corporate bonds issued by the company in the residence state having a subsidiary in the source state, it is also common in cases of legitimate investment, not only conduit transactions, that a third-state resident has legal control over the payment to be made by the recipient to it. Therefore, whether there is a sufficient nexus between the two transactions at issue determines whether the investment in the source company is legitimate investment entitled to treaty benefits. This issue is the most difficult issue and the main cause of uncertainty in the interpretation of beneficial owner. Because of this difficulty, the base erosion test in the Japan-U.S. treaty and the example provision of the channel approach in the OECD commentary presumably employed a mechanism to determine treaty eligibility based on the threshold percentage test, without looking at the relationship.

To this question, it would be reasonable to determine based on the nature and mechanism of conduit transactions whether (a) the recipient functions merely as a conduit for the investment by the third-state resident in the source company, or (b) the third-state resident invests in the recipient as its own investment, and the recipient invests in the source company as its own investment, both in form and in substance, and therefore, those are separate investments based on different decision making. That said, this is just a general idea, and has the potential of various interpretations, and hence it is unclear by itself and cannot provide enough foreseeability when applied to actual transactions. It then becomes important and necessary to incorporate this general idea into a more concrete and objective standard. In this regard, the Japan-U.S. treaty and the OECD commentary have information that is helpful.

Regarding a debt claim, the Japan-U.S. treaty has the following provision about the beneficial owner of interest:

> 11. A resident of a Contracting State shall not be considered the beneficial owner of interest in respect of a debt-claim if such debt-claim would not have been established unless a person:
>
> > (a) that is not entitled to benefits with respect to interest arising in the other Contracting State which are equivalent to, or more favorable than, those available under this Convention to a resident of the first-mentioned Contracting State; and
> >
> > (b) that is not a resident of either Contracting State
> >
> > held an equivalent debt claim against the first-mentioned resident.[72]

This is sometimes called a ''back-to-back'' arrangement provision, and the Japan-U.S. treaty has equivalent provisions for dividends and royalties.[73] This provision stipulates that (i) if the debt claim owned by the recipient would not have been established unless a third-state resident held a debt claim against the recipient, and (ii) if those two debt claims are equivalent, the recipient ''shall not be considered the beneficial owner of the interest in respect of'' such debt claim, and thereby focuses on the causal link between two debt claims and their equivalence. Although, according to the person in charge of the negotiation of the Japan-U.S. treaty on behalf of the Japanese government, this back-to-back arrangement provision was merely intended to show a typical example when the recipient will not be qualified as ''beneficial owner,''[74] the provision seems to correctly indicate possible factors that we should focus on when we try to distinguish conduit transactions from legitimate transactions.

In contrast, the commentary on article 1(6.14) regarding the role of a beneficial owner in a collective investment vehicle (CIV) states:

> 6.14 Some countries have questioned whether a CIV, even if it is a ''person'' and a ''resident'', can qualify as the *beneficial owner* of the income it receives. Because a ''CIV'' as defined in paragraph 6.8 above must be widely-held, hold a diversified portfolio of securities and be subject to investor-protection regulation in the country in which it is established, such a CIV, or its managers, often perform significant functions with respect to the investment and management of the assets of the CIV. Moreover, *the position of an investor in a CIV differs substantially, as a legal and economic matter, from the position of an investor who owns the underlying assets*, so that it would not be appropriate to treat the investor in such a CIV as the beneficial owner of the income received by the CIV. Accordingly, a vehicle that meets the definition of a widely-held CIV will also be treated as

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[72]Japan-U.S. treaty, *supra* note 37, at article 11(11).

[73]*Id.* at article 10(10), article 12(5). The scope of article 10(10) is limited to preferred stock, which is consistent with the position of this article.

[74]Masatsugu Asagawa, *Konmentāru kaitei nichi-bei sozei jōyaku* (Commentary on the Revised Japan-U.S. tax treaty) 136 (2005). Asagawa also says that under a ''back-to-back'' arrangement provision, the treaty benefits will be denied when a third-state resident substantially enjoys the treaty benefits given to the debt claim owned by the recipient. *Id.* at 135. However, not only that whether or not a third-state resident substantially enjoys the treaty benefits is a vague standard by itself, as shown in Section III.D of this article, to determine whether a third-state resident is regarded as substantially enjoying treaty benefits, tax authorities must understand the domestic tax law system of the residence state. I do not think that standard is desirable.

> the *beneficial owner* of the dividends and interest that it receives, *so long as the managers of the CIV have discretionary powers to manage the assets generating such income* (unless an individual who is a resident of that State who would have received the income in the same circumstances would not have been considered to be the beneficial owner thereof).[75] [Emphasis added.]

According to this paragraph, the main factor to determine whether a CIV (not an investor in the CIV) is considered the beneficial owner of the income would be whether ''the managers of the CIV have discretionary powers to manage the assets generating such income.''[76]

As seen above, the Japan-U.S. treaty and the OECD commentary appear to employ different standards for the determination of ''beneficial owner.'' However, I think these two standards embody the same general idea but just from different angles, and therefore they are both reasonable and do not conflict with each other. The standard of the Japan-U.S. treaty is based on the idea that when the investment by the third-state resident in the recipient and the investment by the recipient in the source company are equivalent, and there is a causal link between them, the recipient does not bear any risk attributable to its investment in the source company and does not enjoy any profit from it; therefore, it merely functions as a conduit for the investment by the third-state resident in the source company. The standard of the OECD commentary is based on the idea that when the manager of a CIV has discretion regarding its investment decisions, independently from its investors, the investors in the CIV are in form and substance investing in the CIV rather than its portfolio assets; therefore, the CIV should not be considered a conduit.

In this way, it is possible to understand that these two standards do not conflict with each other and that both are reasonable in distinguishing conduit transactions from legitimate transactions. Then we have to consider which standard is more appropriate, or whether both are equally appropriate. In this regard, it is necessary to determine what kinds of factors are necessary in order to be a desirable standard. Given that the object and purpose of ''beneficial owner'' is anti-tax avoidance, and that many from the business community are concerned about the foreseeability of its application, I believe we should employ a standard that can maintain foreseeability while not impairing the anti-tax-avoidance purpose. If we examine the Japan-U.S. treaty and the OECD commentary from that perspective, it becomes apparent that the transactions on which they are based are significantly different, which results in the difference in the two standards.

Specifically, for a transaction to fall within the scope of the Japan-U.S. treaty, the instruments of the investment by the third-state resident in the recipient and the investment by the recipient in the source company must be both preferred stock, both debt claims, or both royalty payments. The common nature of these instruments is that the amount of dividends, interest, or royalties is predetermined in the relevant legal documents, and it is possible to determine whether those investments are equivalent.

In contrast, the income to be received from a CIV by its investors depends, naturally from its character as a CIV, on the income earned by the CIV; as a result, equivalence between the investment made by the investors in the CIV and the investment made by the CIV in its portfolio assets is always maintained. However, this equivalence is an inevitable result of the mechanism of a CIV on which the tax system is based, and not the result of the intentions of the parties to the transaction. Therefore, it is not appropriate to determine the tax treatment of a CIV and its investors based on such inevitable equivalence. The reason that the OECD commentary employs a standard focusing on the discretion of a CIV rather than a standard focusing on the equivalence between investments like the Japan-U.S. treaty seems to derive from these elements.

The question of which standard is more appropriate or whether both are equally appropriate is best answered based on an analysis of the transactions at issue. It is possible to generalize an answer to some extent based on categories of transactions, such as a debt

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[75]OECD model, *supra* note 2, comment 6.14 on article 1.

[76]The above paragraph also mentions other factors, such as that a CIV be ''widely-held, hold a diversified portfolio of securities and be subject to investor-protection regulation in the country in which it is established,'' and these factors are apparently part of the assumption of the paragraph. However, for the purposes of analysis in this article, I don't think these factors are essential to determine whether a recipient is the beneficial owner. The requirements that CIVs be ''widely-held [and] hold a diversified portfolio of securities'' are set forth presumably to ensure that the investors are indeed investing in the CIVs, rather than their portfolio assets through the CIVs as conduits. The OECD may have taken into consideration the practical difficulty of applying the beneficial owner concept to CIVs as well, because they are not willing to provide information regarding their investors. The requirement that a CIV be ''subject to investor-protection regulation in the country in which it is established'' is stipulated presumably because the OECD has some skepticism towards the CIV industry, and thinks that it suffices to give treaty benefits only to CIVs doing business legitimately.

In contrast, this article assumes the existence of an LOB clause, which employs the look-through approach. CIVs are required to collect information regarding (at least 50 percent of) their investors, despite any practical difficulty. This would mitigate the concerns of tax authorities to some extent. Although the above-mentioned factors should be considered when determining whether a CIV is a beneficial owner when an LOB clause does not necessarily exist, they should not always be treated as necessary requirements for purposes of my analysis. Therefore, as long as CIVs have discretion over their investment decisions, it would not be unreasonable to regard them as a beneficial owner, although I do not object to the requirements that a CIV be a beneficial owner under the current OECD commentary, which does not assume the existence of an LOB clause.

claim, which is within the scope of the Japan-U.S. treaty, and common stock, which is similar to the beneficiary interest held in a CIV by its investors in the sense that the dividends to be paid to shareholders depend on the profits earned by the issuing corporation.

2. Debt-Claim/Debt-Claim Transaction

The first category I examine is a transaction in which both the investment made by the third-state resident in the recipient and the investment made by the recipient in the source company are debt claims (debt-claim/debt-claim transaction). Because the third-state resident and the recipient are in an arm's-length relationship, the amount of interest to be paid by the recipient to the third-state resident will be prescribed in the relevant legal documents. Therefore, determining the equivalence between those two investments based on the description in the relevant legal documents will be possible without significant difficulties, and that determination will be clear and based on objective facts. The causal link between the two transactions will not necessarily be prescribed in the relevant legal documents, but it can be reasonably presumed to exist, even without such prescription, if there is equivalence between the transactions and their time frames are essentially the same. Therefore, the standard based on the equivalence between two transactions and their causal link (the investment equivalence standard) used in the Japan-U.S. treaty is appropriate in these types of transactions.[77] Since the recipient and the third-state resident are in an arm's-length relationship, it would not be realistic to imagine that the recipient ''lends'' a part of its capital structure to the third-state resident for free; instead, it would generally request payment of some consideration from the treaty benefits that the third-state resident can enjoy from the conduit transactions. Therefore, those investments would rarely be completely equivalent and, instead, there would be some difference to the extent of such treaty benefits. When determining the equivalence of the investments, we must consider this difference.

Then the question is whether it is appropriate to apply the standard based on the recipient's discretion about its investment (the investment discretion standard) used in the OECD commentary. While it is possible to deny the recipient its status as beneficial owner when it clearly has no discretion about its investment, considering the nature of this type of transaction, that determination should be made with caution. In this type of transaction, the third-state resident would be satisfied only if the payment described in the relevant legal documents was made, and would not have a strong interest in stipulating in the documents where the money it invested in the recipient should be invested, since regardless of whether the recipient invested the money in the designated assets, the third state would be able to receive a predetermined amount of payment. Of course, if the recipient does not have sufficient assets to enable it to pay the predetermined amount to the third-state resident, the third-state resident will be concerned about whether the recipient invests in the assets it has designated. However, this is not always the case. For example, when the channel approach provision in the Japan-U.S. treaty applies, in order for the recipient to satisfy the LOB requirement, the payment made by the recipient to the third-state resident must be less than 50 percent of the gross income of the recipient. This means that the recipient must earn at least twice as much income as the payment to be made by the recipient to the third-state resident. Likewise, there will be many cases when the financial resources or solvency of the recipient are not a significant concern for the third-state resident. If we must apply the investment discretion standard in those cases, the third-state resident, to circumvent the standard, will not stipulate any obligation that would constrain the recipient's investment discretion after taking into consideration both the risk of being denied treaty benefits and the risks related to the recipient's financial resources. That the third-state resident could circumvent the investment discretion standard by its own initiative would not necessarily be beneficial to the third-state resident. It is possible that tax authorities that believe the third-state resident and the recipient are engaging in conduit transactions but cannot find any indication as to restrictions on the recipient's investment discretion from the relevant legal documents would try to challenge the transactions by arguing that they had found restrictions on the recipient's investment discretion from ''all relevant facts and circumstances.'' In this way, for debt-claim/debt-claim transactions, because of (a) the practical difficulty in applying the investment discretion standard, (b) the possible problems that would occur if this standard alone were applied, and (c) the sufficiency of mainly using the investment equivalence standard, it would not be appropriate to use the investment discretion standard as the main standard to determine whether the recipient is the beneficial owner, and such standard should be used only when it is reasonably apparent that the recipient's investment discretion is constrained by the relevant legal documents.

3. Common Stock Transactions

The second category I examine is a transaction in which the instrument of the investment made by the third-state resident in the recipient is common stock in the recipient (common stock transactions). It doesn't matter whether the instrument of the investment made by the recipient in the source company is common stock or debt claims. Similar to the beneficiary interest

[77]Incidentally, the U.S. anti-conduit rules use a similar standard regarding a conduit financing arrangement consisting of loans, leases, or licenses, or equity interests under which the holder owns some put or redemption rights, in which arrangement intermediate companies (the recipient, in the usage of this article) are not related entities. Reg. section 1.881-3(a)(4)(i)(C)(2) (as amended in 2012).

in a CIV held by its investor, the dividend income to be received from the recipient by the third-state resident, under ordinary corporate law systems, depends on the income earned by the recipient. As a result, equivalence between the investment made by the third-state resident in the recipient and the investment made by the recipient in the source company is almost always maintained. Since this is just a result of domestic corporate law in the residence state, which would occur regardless of whether the transaction was legitimate or a conduit, it is inappropriate to deny the recipient its status as beneficial owner just because of such equivalence.

At the same time, if a third-state resident intends to engage in conduit transactions in the manner of common stock transactions, unless the recipient appropriately invests in the assets the third-state resident has designated, the third-state resident will not be able to receive the profits it had expected from the investment. Therefore, in this type of transaction, the third-state resident, who enters into a conduit transaction with an arm's-length party (that is, the recipient), has a strong incentive to describe in the relevant legal documents which assets its money should be invested in by the recipient, and by so doing, constrains the recipient's investment discretion.[78] Therefore, objective fact-finding can be conducted based on the relevant legal documents, and the concern about allowing tax avoidance or inducing tax authorities to conduct arbitrary fact-finding can be fairly limited.[79]

4. Debt-Claim/Common Stock Transactions

The final category is a transaction in which the investment made by a third-state resident in the recipient is a debt claim and the investment made by the recipient in the source company is common stock. In this transaction, the interest payment to be made by the recipient to the third-state resident is a predetermined amount, regardless of the amount of dividends paid by the source company to the recipient. Therefore, there would basically be no equivalence between those two investments; therefore, the investment equivalence standard is not appropriate for this transaction. The investment discretion standard would not work sufficiently, either, since as noted above the third-state resident will be satisfied only if the payment described in the relevant legal documents is made. Therefore, neither standard seems to work for the debt-claim/common stock transactions.

However, I do not think this is problematic or indicative of a defect in my analysis. In the above debt-claim/common stock transactions, the interest payment to be made by the recipient to the third-state resident is a predetermined amount, regardless of how much dividends are paid by the source company to the recipient. Assuming that the interest amount is determined based on the creditworthiness of the recipient, it would be appropriate to regard the third-state resident as lending money to the recipient, not the source company, and therefore, not to regard the recipient as a conduit.

That said, there will be some exceptional situations when the third-state resident lends money to the recipient based on the creditworthiness of the source company rather than of the recipient. Those situations are equivalent to those in which the third-state resident lends money directly to the source company. Considering such equivalence, it would be necessary to deny the recipient the beneficial owner status in that case, because the third-state resident is substantially lending money to the source company and the recipient is a mere conduit. In that situation, if the recipient is a kind of special purpose company that has no other substantial assets, the third-state resident would require in the relevant legal documents that the recipient invest in the source company, because the third-state resident is relying on the creditworthiness of the source company rather than the recipient. Alternatively, if the recipient has other substantial assets, but the third-state resident still relies mainly on the creditworthiness of the source company, the third-state resident would require in the relevant legal documents that the recipient pledge the shares in the source company in order to secure the loan made by the third-state resident to the recipient, and such share pledge can be essentially equated with constraints on the recipient's investment discretion. Therefore, in either case, like the common stock transactions, the investment discretion standard is appropriate.

In sum, this article proposes to apply (a) the investment discretion standard to both debt-claim/debt-claim transaction, common stock transactions, and debt-claim/common stock transaction, but only when objective fact-finding regarding any restriction on the recipient's investment discretion can be conducted from the relevant legal documents, and (b) the investment equivalence standard[80] only to debt-claim/debt-claim transactions.[81]

[78]Such investment discretion includes the discretion as to when the recipient disposes of the investments it has made. *See* Public Comment from Avellum Partners on the Second Discussion Draft, *supra* note 27, at 2 (proposing to use the recipient's powers to dispose of the assets as a criterion).

[79]Taxpayers would try to obscure the existence of constraints on the recipient's investment discretion, and careful interpretation of the relevant legal documents is necessary, as has been discussed regarding the legal control by the third-state resident over payment in Section III.B.2 of this article.

[80]There is one significant difference between the investment discretion standard and the investment equivalence standard. Under the investment equivalence standard, the recipient is denied the status of beneficial owner if two investments are equivalent and there is a causal link between them. This is true even when the third-state resident does not know whether, or in what assets,

(Footnote continued on next page.)

D. Causes of Tax Avoidance

The main causes — on the part of domestic tax law systems of the residence state — that enable tax avoidance by way of conduit transactions are tax exemption of dividends, interest, royalties, or foreign earned income in general (in direct conduits); and expense deduction by the recipient (in steppingstone conduits).[82] Hence, it is possible to construct the scope of beneficial owner so that treaty benefits will be denied only when such domestic tax law treatment is available in the residence state. In contrast, under the approach of this article, the recipient will be denied its status as beneficial owner regardless of whether such domestic tax treatment is available in the residence state. Therefore, this approach potentially denies treaty benefits even when a third-state resident enjoys virtually no or limited treaty benefits because of the unavailability of such domestic tax law treatment.[83] Hence, the above approach to deny treaty benefits only when such domestic tax law treatment is available might seem to be appropriate considering the objects and purposes of the OECD model: ''the prevention of fiscal evasion and avoidance'' and ''avoiding double taxation.''

However, this approach could increase the enforcement costs to the tax authority in the source state. To determine the treaty benefits eligibility of the recipient, the tax authority must understand the domestic tax laws of the residence state. Increased enforcement costs can result in a situation in which tax authorities cannot effectively enforce the beneficial owner requirement, so tax avoidance becomes rampant. Rather than improve the object and purpose of the OECD model, this would instead impair it. Furthermore, from a perspective of the source state, even though a third-state resident enjoys virtually no or limited treaty benefits, through the transaction, the right to tax has in effect moved from the source state to the residence state. Considering that conduit transactions in which the recipient would be denied its status as beneficial owner under the approach of this article are just conduits, and they tend to have no substantially valid business reasons, I do not think we should impose such additional burdens on the tax authorities in the source states for the sake of such conduit transactions.

E. Reconsideration of the Relationship

This article has compared and examined the different functions to be performed by an LOB clause and beneficial owner to achieve clarification of the scope of beneficial owner, on the assumption that both measures are for the same purpose of preventing tax-avoidance by way of ''conduit'' transactions. As a result of such comparison and examination, it becomes apparent that (1) whereas an LOB clause handles, by establishing a clear standard, cases in which the probability and degree of tax abuse is high, such as where a majority of ultimate shareholders are third-state residents, or where

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the recipient is investing the money received from the third-state resident. Although this conclusion might appear odd at first glance, this is actually reasonable. For debt-claim/debt-claim transactions, since the amount of money the recipient must pay to the third-state resident is predetermined, the recipient can earn a margin in the form of treaty benefits by just putting the money received into equivalent investments in the source state. In other words, the recipient can abuse the tax treaty on its own initiative.

From the perspective of the third-state resident, even when the recipient will be denied the status of beneficial owner as a result of such transactions, it can receive the payment of a predetermined amount, and therefore there is no downside for it.

In contrast, since under the investment discretion standard there is a requirement for a restriction on the recipient's investment discretion through the relevant legal documents, the third-state resident should always know into what assets the recipient will put the money received. This is also reasonable because for common stock transactions, the recipient must pay all of the profits to its shareholders, and therefore, the recipient cannot earn a margin in the form of treaty benefits. For debt-claim/common stock transaction, since the recipient generally is not able to predict the amount of dividends it can receive in the future, the recipient is not able to earn a margin in the form of treaty benefits without bearing any additional risks.

[81] Some might raise the question of what standard should be used when a bona fide provision of an LOB clause applies, since in that case there does not necessarily exist an arm's-length relationship between the recipient and the third-state resident. Although this might be a question that should be answered from a theoretical and systematic perspective, there does not seem to be sufficient benefit in doing so, and tax authorities would not go into the details of the transactions either, because the transactions would be considered bona fide (that is, not tax avoidance). If I were challenged to answer such a theoretical and systematic question, I would suggest applying the same standards as those applicable to an arm's-length relationship.

[82] For conduit transactions in which two or more conduits are involved (*see* Section III.B.4 of this article), tax exemption or a lower tax rate on intercorporate dividends, or a consolidated tax return system would be additional main causes.

[83] The same might be true when a third-state resident would have been entitled to equivalent or more favorable treaty benefits under the tax treaty between such third state and the source state, if the transaction is structured directly between the source company and the third-state resident. Actually, the back-to-back arrangement provision in the Japan-U.S. treaty, cited in Section III.C of this article, excludes such cases from its scope. Japan-U.S. treaty, *supra* note 37, article 10(11)(a), article 11(11)(a), article 12(5)(a).

However, if the recipient is denied the status of beneficial owner, the third-state resident will be treated as the beneficial owner of the income; therefore, it can enjoy such equivalent or more favorable treaty benefits under the tax treaty between the third state and the source state. OECD model, *supra* note 2, comment 12.2 on article 10, comment 11 on article 11, comment 4.2 on article 12. *But see* public comment from Deloitte & Touche LLP on the first discussion draft, at 4-7 (July 13, 2011), *available at* http://www.oecd.org/tax/treaties/48445270.pdf (requesting further clarification in the OECD commentary in this regard). Therefore, in this case, there would be far less necessity to exclude such cases from the scope of beneficial owner than in the cases described above.

a majority of gross income flows to third-state residents as deductible expenses of the recipient, (2) beneficial owner deals with tax avoidance cases in which the probability or degree of tax abuse is not readily apparent, and that therefore are not handled by such an LOB clause, by more closely examining the relationship between two transactions.

Theoretically, the concept of beneficial owner is a more desirable measure since it is based on the very nature of conduit transactions, if perfect enforcement of it is guaranteed. However, perfect enforcement can hardly be achieved, and the cost to more closely examine the relationship between the two transactions can be high, especially for tax authorities. Therefore, an LOB clause, which can be judged based on more easily available facts, becomes necessary. This division of functions between an LOB clause and beneficial owner looks reasonable.

In this regard, the effect of an LOB clause and beneficial owner is also different. If a taxpayer does not satisfy an LOB clause, it cannot enjoy treaty benefits. In contrast, if a taxpayer is regarded as not being the beneficial owner regarding certain income or a certain percentage of such income, the taxpayer cannot enjoy treaty benefits only to the extent that it is not considered to be the beneficial owner. This difference also can be justified based on the fact that an LOB clause handles cases in which the probability and degree of tax avoidance is seemingly high.[84]

Considering these differences in function, it is clear that the criticism made by some practitioners against the term beneficial owner — that it should be narrowly interpreted since we now have a comprehensive LOB clause for antiavoidance purposes — is completely wrong, because the term has its own function that cannot be performed by an LOB clause.

[84]Another difference is the application to situations when the source state and the third state have a tax treaty between them that gives the third-state resident treaty benefits equivalent to, or more favorable than, the treaty benefits under the tax treaty between the source state and the residence state. If the recipient is denied the status of beneficial owner, the third-state resident will be able to enjoy the treaty benefits under the tax treaty between the source state and the third state. OECD model, *supra* note 2, comment 12.2 on article 10, comment 11 on article 11, comment 4.2 on article 12.

In contrast, under the LOB clause in the Japan-U.S. treaty, if the recipient does not satisfy the LOB requirement, neither the recipient nor the third-state resident will be able to enjoy treaty benefits under either tax treaty. However, this difference can be minimized if the Japan-U.S. treaty employs in the LOB clause an equivalent beneficiary clause, like article 22(7)(e) of the Japan-U.K. treaty. Convention Between Japan and 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 on Capital Gains, Japan-U.K., article 22(7)(e), Feb. 2, 2006, 2447 U.N.T.S. 81. Therefore, I do not believe this difference is so fundamental as to make the LOB clause and concept of beneficial owner significantly discrete.

IV. Second Discussion Draft

Finally, I will examine the definition proposed in the second discussion draft. Regarding the scope of beneficial owner, the second discussion draft states:

> 12.4 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), *the recipient of the dividend is not the "beneficial owner" because that recipient's right to use and enjoy the dividend is constrained by a contractual or legal obligation to pass on the payment received to another person*. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person. *This type of obligation must be related to the payment received*; it 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. . . . *Where the recipient of a dividend does have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the "beneficial owner" of that dividend.*[85] [Emphasis added.]

As shown in the above, the second discussion draft states that:

- "the recipient . . . is not the 'beneficial owner' when that recipient's right to use and enjoy the [income] is constrained by a contractual or legal obligation to pass on the payment received to another person"; and
- such contractual or legal "obligation must be related to the payment received."

To the extent that the second discussion draft requires a contractual or legal obligation for the recipient to make payment to the third-state resident and focuses on whether the recipient's discretion is constrained by a contractual or legal obligation, it is consistent with this article.

However, there are two significant differences between the positions of this article and the second discussion draft. First, while the second discussion draft focuses on whether the recipient's discretion to use and enjoy the income received is constrained, this article proposes to focus on whether the recipient's discretion to invest money received from the third-state resident is constrained (the investment discretion standard). Second, considering the practical difficulty of applying the investment discretion standard to debt-claim/debt-claim

[85]Second discussion draft, *supra* note 7, at 5-6.

transactions, this article proposes to also use the investment equivalence standard for such transactions, which the second discussion draft does not mention.

Regarding the first difference, the position taken by the second discussion draft might relate to the language used in the OECD model: ''the beneficial owner of dividends,'' ''the beneficial owner of interest,'' and ''royalties . . . beneficially owned.''[86] Since this language seems to focus on the income received, rather than the investment from which the income is derived, admittedly it would be natural to focus on whether the recipient's discretion to use and enjoy the income received is constrained. However, since money is fungible, it is not easy to determine whether the recipient's discretion to use and enjoy the income received is constrained. The reason that the second discussion draft emphasizes that the ''[contractual or legal] obligation must be related to the payment received'' would probably be to prevent tax authorities' arbitrary fact-finding that the recipient's discretion to use and enjoy the income received is constrained. However, even with this emphasis, concerns over the lack of foreseeability would remain, since I expect that what I have said about the application of the investment discretion standard to debt-claim/debt-claim transaction would likely occur. If the standard of the second discussion draft is employed, the third-state resident and the recipient will not describe in the relevant legal instruments the relationship between the legal or contractual obligation of the recipient to make payment to the third state and the income received by the recipient. Tax authorities would then become frustrated with this fact and begin to challenge the transactions that they believe to be conduit transactions based on their fact-finding from ''all relevant facts and circumstances.'' The language in the second discussion draft that the obligation ''may also be found to exist on the basis of facts and circumstances'' would encourage this tendency by the tax authorities.[87]

As discussed above, this article proposes:

- to focus on whether the recipient's discretion to invest money received from the third-state resident is constrained (the investment discretion standard) in debt-claim/debt-claim transaction, and common stock transactions and debt-claim/common stock transaction; and
- to apply the investment equivalence standard only to debt-claim/debt-claim transaction.

[86]OECD model, *supra* note 2, at article 10(2), article 11(2), article 12(1).

[87]Many public comments raise concerns in this regard. *See, e.g.*, public comment from BIAC on the second discussion draft, *supra* note 18, at 1; public comment from New Zealand Institute of Chartered Accountants on the second discussion draft, *supra* note 21, at 1; public comment from PwC on the second discussion draft, *supra* note 22, at 1.

This is based on the analysis of different categories of conduit transactions, and what kind of information will be written in the relevant legal documents between arm's-length parties involved in those conduit transactions. Since all necessary information will be available in the relevant legal documents, determining the beneficial owner can be made objectively, and the necessity for tax authorities to engage in arbitrary fact-finding from the somewhat vague term ''all relevant facts and circumstances'' will be limited. Although the second discussion draft may have some strength as a means of interpretation of the language in the OECD model, the OECD commentary itself focuses, regarding the term ''beneficial owner'' in the case of CIVs, on the recipient's discretion to invest money received from the third-state resident, as discussed above. Therefore, I believe the proposal in this article is more compelling than the second discussion draft.

V. Conclusion

Establishing a consensus among differing interests cannot be easily achieved. In particular, regarding a concept in international tax law like that of beneficial owner in tax treaties as discussed here, building a consensus becomes more difficult because of the variety of differing interests and the lack of supernational judicial authority for tax-related issues. To overcome such difficulties, this article has used two approaches. The first was by basing the analysis on the assumption of the necessity of tax avoidance by way of conduit transactions, which assumption presumably forms the basis of a consensus among many countries. The second approach was by using a functional analysis approach, which can be shared and understood in common among different jurisdictions, regardless of their domestic legal concepts.

Of course, the standard proposed by this article is not perfectly clear, and the need to interpret the language of the OECD model and the OECD commentary (as modified based on my proposal) will often arise. However, as I said above, any legal terminology necessitates the interpretation of language, and this itself is not problematic. Given such legal terminology written in a general manner, we must attempt to clarify its meaning by interpretation. The discussion drafts are perplexing for practitioners in the sense that they do not reveal any concrete rationale from which the definitions proposed in them come. For instance, though the discussion drafts require a contractual or legal obligation for the recipient to make payment to the third-state resident, in order for the recipient not to be considered the beneficial owner, there is no explanation as to why this is required. In contrast, this article has reached the same conclusion as to that requirement, but is based on an analysis of the functional difference between the concept of beneficial owner and an LOB clause, and thereby provides a rationale for such requirement. The same is true for the discussion drafts' focus on the recipient's discretion to use and enjoy the income received. Aside from the language of the OECD model noted above, there is no rationale provided as to why this is appropriate as a standard to determine whether the recipient is the beneficial owner. A dogmatic definitional approach with no rationale behind it confuses practitioners. In contrast, if the rationale behind a definition is provided, practitioners can develop their interpretation from there and sometimes formulate a better definition or rationale, if any. The current OECD approach deprives practitioners of those opportunities.[88]

Admittedly, this article is based on assumptions I have made, and I have examined only one tax treaty; therefore, this article is neither comprehensive nor conclusive about this topic. However, I believe all those assumptions are fairly reasonable. For instance, my assumptions regarding the context of beneficial owner and the object and purpose of the OECD model to be considered in the interpretation of beneficial owner would be acceptable to many people. Regarding the assumption of an LOB clause, the core part of the LOB clause in the Japan-U.S. treaty that I have used in my analysis is the minimum shareholding percentage requirement, which is 50 percent, based on the look-through approach, which is a common feature of most of the LOB clauses in effect in other tax treaties. Conversely, it also can be said that if countries employed in their tax treaties an LOB clause similar to that of the Japan-U.S. treaty, this would enable them to have a clearer understanding[89] of the scope of ''beneficial owner.''[90] Although I do not deny the necessity of further and comprehensive analysis, my analysis can be widely accepted. ◆

[88]Although I hope it doesn't, the OECD might not have come to agreement about the rationale behind the concept of beneficial owner, and therefore might sometimes have been unsure about where they should go further. For instance, the second discussion draft explicitly rejects the request made, in public comments on the first discussion draft, for the addition of examples in the OECD commentary, by stating that:

> the Working Party decided not to change the existing approach which focuses on general principles and concluded that the addition of obvious examples would not be very useful whilst the addition of examples dealing with more difficult cases would need to be extremely fact-specific and would raise additional questions concerning similar but not identical situations.

Second discussion draft, *supra* note 7, at 15. However, if there is a consensus at the OECD about the rationale behind the definition proposed in the second discussion draft, it should be able to provide examples without causing any unnecessary misleading effects by providing necessary and appropriate assumptions in each example. Though not comprehensive at all, sections III.B and III.C in this article are my slight attempt at such purposes. If such examples are provided in the OECD commentary, it will help people better understand the rationale and the scope of beneficial owner.

[89]Previous discussion met with difficulty in establishing a clear meaning of the term ''beneficial owner,'' presumably because those discussing it believed that a parent company should not be denied beneficial owner status just because of its status as a parent company. *See, e.g.*, public comment from John Avery Jones, Richard Vann, and Joanna Wheeler on the first discussion draft, *supra* note 26, at 3-5. The business community is of the same view. *See, e.g.*, second discussion draft, *supra* note 7, at 7; public comment from Kim and Chang on the first discussion draft, *supra* note 63, at 2-3; public comment from Federation of European Accountants on the first discussion draft, at 1 (June 27, 2011), *available at* http://www.oecd.org/tax/treaties/48330771.pdf; public comment from Japan Foreign Trade Council Inc. on the second discussion draft, *supra* note 18, at 2. In contrast, since this article assumes the existence of an LOB clause, which contains a minimum shareholding percentage requirement of 50 percent, I did not have to worry about that issue; therefore, I have presented a clearer scope of beneficial owner.

[90]Yoshihiro Masui suggests that it might be possible as a systematic interpretation to vary the interpretation of beneficial owner depending on whether the treaty at issue contains an LOB clause. Yoshihiro Masui, ''Dai-61-kai IFA taikai no hōkoku — Shotoku no jinteki kizoku no teishoku wo chūshin toshite'' (''Report of the 61st Congress of the International Fiscal Association: With a Central Focus on Conflicts in the Attribution of Income to a Person''), 700 *Sozei Kenkyū* 77, 89 (2008).