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Concept of Beneficial Ownership

CONCEPT OF BENEFICIAL OWNERSHIP: DISCUSSION OF KEY ISSUES AND PROPOSALS FOR CHANGES TO THE UN MODEL COMMENTARY*

Summary

At its fifth annual session in 2009, the Committee of Experts on International Cooperation in Tax Matters mandated the Working Group on the Concept of Beneficial Ownership to follow up work undertaken on the beneficial ownership concept by the former Subcommittee on the Improper Use of Treaties, and to finalise a short addition to the Commentaries on some practical aspects of applying the concept.

This report addresses issues related to the beneficial ownership concept that would require thorough evaluation and consensus before extensive Commentary changes could be made. Nevertheless, the paper concludes that the Committee is potentially in a position to make a number of circumscribed changes to the Commentary for the next update. Those potential changes are described in the second section of the paper.

* This report should not be taken as necessarily representing the views of the United Nations.

CONCEPT OF BENEFICIAL OWNERSHIP: DISCUSSION OF KEY ISSUES AND PROPOSALS FOR CHANGES TO THE UN MODEL COMMENTARY

Introduction

1. At its fifth annual session in 2009 the United Nations Committee of Experts on International Cooperation in Tax Matters agreed to a number of mandates for work on various topics to be carried out by Subcommittees and Working Groups. Among these mandates is the following mandate for the Working Group on the Concept of Beneficial Ownership:

> (v) Concept of Beneficial Ownership: coordinated by Mr. Louie and mandated to follow up on the beneficial ownership concept, this work begun by the former Subcommittee on the Improper Use of Treaties, and to finalise a short addition to the Commentaries required on some practical aspects of applying the concept.

2. When the proposal to develop this concept was discussed at the fifth annual session, Mr. Louie cautioned that significant progress would not be likely, given that there little international agreement regarding the meaning of the term "beneficial ownership", found in Articles 10, 11 and 12 of the UN Model Double Tax Convention, and that many countries have had relatively little experience interpreting and applying beneficial ownership concepts in their domestic law. This paper attempts to briefly describe a few of the issues related to the beneficial ownership concept that would require thorough evaluation and consensus before extensive Commentary changes could be made. Nevertheless, the Committee is potentially in a position to make a number of circumscribed changes to the Commentary for the next update. Those potential changes are described in the second section of the paper.

Some Issues Related to the Interpretation of the Beneficial Ownership Concept

3. **Application of domestic law vs. contextual meaning** – Income tax treaties customarily do *not* contain a definition of "beneficial ownership". Paragraph 2 of Article 3 (General Definitions) provides a rule that undefined terms shall have the meaning prescribed under the domestic laws of the State applying the treaty (i.e., the State granting the treaty benefits), unless the context otherwise requires. This is the practice, for instance, of the United States, which has a fairly developed body of case law regarding the interpretation of the term "beneficial ownership". The following is an excerpt from the Technical Explanation to the 2006 U.S. Model Tax Convention:

> The term "beneficial owner" is not defined in the Convention, and is, therefore, defined as under the internal law of the State granting treaty benefits (*i.e.*, the source State). The beneficial owner of the dividend for purposes of Article 10 is the person to which the income is attributable under the laws of the source State. Thus, if a dividend paid by a corporation that is a resident of one of the States (as determined under Article 4 (Residence)) is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the dividend is not entitled to the benefits of this Article. However, a dividend received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 12 of the Commentary to Article 10 of the OECD Model. See also paragraph 24 of the Commentary to Article 1 of the OECD Model.

4. While some countries follow the practice of applying the beneficial ownership principles of the source State, there is no international consensus that this should be the standard application of income tax treaties. Paragraph 2 of Article 3 in this respect provides that if "the context otherwise requires" an undefined term may, depending on the circumstance as well as agreement by the competent authorities, have a meaning of a term that is independent of the domestic law of either country.

5. In reality, many countries do not have well-developed rules in their domestic laws to apply when those countries are the source State. These countries may favour the development and application of an internationally agreed definition of the term "beneficial owner." In the 2006 *Indofood* decision[1], the United Kingdom's Court of Appeal arrived at a similar conclusion, and referred in its decision to an "international fiscal meaning" of the term. The court decision expressly stated that "the term 'beneficial owner' is to be given an international fiscal meaning not derived from the domestic laws of the contracting states." Those adopting this approach in the UN Model context look to the limited elaboration of the term in the Commentaries – for example, paragraph 14 of the Commentary to Article 10 cites paragraph 12 of the 1995 OECD Commentary to OECD Article 10 which states: "Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State.

6. A third interpretation could be to apply a contextual meaning of the term in certain instances, such as when an application of the source State's definition would produce a result that is not consistent with the purpose of the treaty. This is the general approach of the revenue authority of the United Kingdom, as described in guidance released by Her Majesty's Revenue and Customs after the *Indofood* decision:

> Where there is no abuse of the DTC, there is no need, in practice, to apply the "international fiscal meaning" of beneficial ownership. The object of the treaty is likely to be met just as easily using the UK domestic law meaning of beneficial ownership. HMRC will also accept that there is no need to invoke the "international fiscal meaning" of beneficial ownership to deny treaty benefits where the lender receiving income directly from the SPV (the "true" beneficial owner of the interest) would, if they have been the direct recipient of the interest, have been entitled to treaty benefits as a resident of a state with which the UK has a DTC with zero withholding on interest.

Relevance of the domestic laws of the country of residence

7. An additional question that arises is the relevance, if any, of the domestic laws of the residence country to the beneficial ownership analysis. For instance, if priority is assigned to the beneficial ownership concepts under the laws of the source State, what bearing does the law of the residence country have?

8. A number of arguments can be made that the domestic law of the residence State has a role in the beneficial ownership analysis. For instance, one argument is that the domestic law of the residence State should be taken into account in determining whether a payee is a resident of the other Contracting State. According to this view, it is especially important to include this in a beneficial ownership

[1] [2006] EWCA Civ 158.

analysis, because with increasing frequency, situations arise in which an entity receiving a payment that could enjoy treaty benefits may be viewed differently by two treaty jurisdictions. For instance, an entity may be viewed as a body corporate by one country and as fiscally transparent by the other country. In these situations, the domestic laws of the residence State should be taken into account to avoided unintended treaty results, including the erroneous granting of benefits in undeserved instances as well as the denial of treaty benefits in situations where benefits should be given. A fuller explanation of the U.S. perspective on this topic is found in Annex 1. It is noted, however, that at this stage the UN Committee of Experts on International Cooperation in Tax Matters has not taken a view on the approach taken in the OECD Partnerships Report, or on these issues more generally.

Some Country Practices in the Area of Beneficial Ownership

9. Country practices to date regarding the application of beneficial ownership principles are varied. Some countries, such as the United States, rely on a body of case law regarding the interpretation of the term. An example is the *Aiken Industries* case of 1971[2] in which the U.S. Tax Court determined that a company resident in Honduras, to whom a promissory note had been assigned, was in substance an agent for a company in a third state with respect to interest that was being paid by a U.S. company, and thus not entitled to the benefits of the exemption for interest in the U.S.-Honduras income tax treaty.

10. Other countries have taken a more prescriptive approach by adopting, in their domestic laws, lists of criteria or factors that will be used in determining if a recipient of income should be considered the beneficial owner of the income. An example of this approach is Circular 601 that was released by China's State Administration of Taxation in 2009. The criteria set forth in the Circular examine a number of the attributes of the entity receiving the of the income, including the nature and extent of the entity's business activities, the extent to which the entity is subject to tax, and any contractual obligations of the entity to distribute its income to entities in a third country. See Annex 2 for a fuller description of China's Circular 601.

Proposals for UN Model Update

11. Given the numerous policy-level and technical-level issues related to the beneficial ownership concept, it appears that at this time the Committee is not in a position to entertain extensive revisions on the topic for the next update of the UN Model. Nevertheless, there are possibilities to make certain revisions to the Model Commentary in addition to the changes that have already been agreed to regarding improper use of the Convention that are found in the previously agreed changes to the Commentary to Article 1.

12. The proposed changes draw upon some of the language of the latest version of the OECD Model which it is believed assists the application of treaties following the UN Model, without entering into some of the controversies noted above. The proposals should not be taken as expressing a view on other aspects of the Commentary not addressed specifically, however. Language to be deleted is indicated with a ~~strike-through~~, and proposed new language is indicated with ***bold, italics and underline***. The proposals are as follows:

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[2] 56 T.C. 925 (1971).

(a) Revise paragraph 14 of the Commentary to Article 10 as follows:

14. The Commentary on the OECD Model Convention contains the following relevant passages:

“If a partnership is treated as a body corporate under the domestic laws applying to it, the two Contracting States may agree to modify subparagraph (a) of paragraph 2 in a way to give the benefits of the reduced rate provide for parent companies also to such partnership.” [para 11]

~~“Under paragraph 2, 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 … States which wish to make this more explicit are free to do so during bilateral negotiations…” [para 12]~~

“The requirement of beneficial ownership was introduced in paragraph 2 of Article 10 to clarify the meaning of the words “paid … to a resident” as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. 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.” [para 12]

“Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee, 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 received the benefits of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Conduit Companies”[3] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties].” [para 12.1]

“Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an

[3] Reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention, at page R(6)-1.

agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries). States which wish to make this more explicit are free to do so during bilateral negotiations. [para 12.2]"

"The tax rates fixed by the Article for the tax in the State of source are maximum rates. The States may agree, in bilateral negotiations, on lower rates or even on taxation exclusively in the State of the beneficiary's residence. The reduction of rates provided for in paragraph 2 refers solely to the taxation of dividends and not to the taxation of the profits of the company paying the dividends." [para 13]".

(b) Revise paragraph 19 of the Commentary to Article 11 as follows:

19. The Commentary on the OECD Model Convention contains the following relevant passages:

~~"Under paragraph 2, 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 … States which wish to make this more explicit are free to do so during bilateral negotiations." [para 8]~~

"The requirement of beneficial ownership was introduced in paragraph 2 of Article 11 to clarify the meaning of the words "paid … to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over interest income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is not used in a narrow technical 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." [para 9]

"Relief or exemption in respect of an item of income is granted by the State of source to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence. Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee, 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 received the benefits of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[4] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties]." [para 10]

"Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries). States which wish to make this more explicit are free to do so during bilateral negotiations. [para 11]"

Note that: if it is decided to adopt these changes to paragraph 19 with respect to beneficial ownership, the Committee will have to also decide how to address the rest of existing paragraph 19, which cites paragraphs of the OECD Model Commentaries that no longer exist. Given the inclusion of the new section on improper use of tax treaties in the Commentary to Article 1, the citation to prior paragraph 12 of the OECD Model Commentaries may no longer be needed. Then, the citations to prior paragraphs 13, 15, 16 and 17 could be converted into stand-alone UN Model Commentaries.

(c) Introduce a new paragraph 6 of the Commentary to Article 12 (with consequent re-numbering of the following paragraphs) as follows:

6. The Commentary on the OECD Model Convention contains the following relevant passages:

"[The requirement of beneficial ownership was introduced in paragraph1 of Article 12 to clarify how the Article applies in relation to payments made to intermediaries.] It makes plain that the State of source is not obliged to give up taxing rights over royalty income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is not used in a narrow technical 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." [para 4]

"Relief or exemption in respect of an item of income is granted by the State of source to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence.

[4] Reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention, at page R(6)-1.

Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee, 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 received the benefits of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[5] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties]." [para 4.1]

"Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee [located in a Contracting State or in a third State,] is interposed between the beneficiary and the payer, in those cases where the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries). States which wish to make this more explicit are free to do so during bilateral negotiations. [para 4.2]"

[5] Reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention, at page R(6)-1.

ANNEX 1

U.S. PERSPECTIVE REGARDING THE RELEVANCE OF THE DOMESTIC LAWS OF THE STATE OF RESIDENCE IN AN ANALYSIS OF BENEFICIAL OWNERSHIP

As a general matter, while in the U.S. view, the beneficial ownership principles of the source State should govern when applying a bilateral tax treaty, the domestic laws of the residence State should be taken into account when determining whether the payee is a resident of the residence State. If the payment is made to a resident of the other State, the source State concepts of beneficial ownership should then be applied to determine if that person beneficially owns that payment, or if that person is acting as an agent for another person. For example, if the payment is made to an entity that is treated as a company under the law of the residence State and as a partnership under the law of the source state, the conflict of qualification rules would dictate that the source country follow the rules of the residence State to determine to whom the income is allocated and thus to whom the payment is made. This is consistent with Example 5 of the OECD Partnership Report and paragraph 6.6 the Commentary to Article 1 of the OECD Model. The source State would then apply its beneficial ownership concepts to the person to whom the income is allocated under residence State principles to determine if that person is the beneficial owner of the payment.

The United States effectively addresses conflicts of qualification in regulations under section 894(c) of the Internal Revenue Code, by using the phrase “derived by” to take into account how an item of income is allocated by the residence country. An item of income may be derived by either the entity receiving the item of income or by the interest holders in the entity, depending on the taxation rules in the entity’s jurisdiction and the interest holder’s jurisdiction. Once the person who derives the item of income is determined to be a resident of a particular tax jurisdiction, the United States would apply its beneficial ownership principles to determine if that person beneficially owned that item of income.

Assume, for example, that an item of income is paid from Country A to LLC, an entity resident in Country B (or in a third country). Under the laws of Country B, LLC is treated as fiscally transparent (that is, the character and source of the income flow through LLC unchanged and the owners of the entity are required to take the income into account currently). LLC has two owners that have an equal share in LLC. Owner B is an individual resident in Country B, and Owner C is an individual resident in a third country. By applying Country B’s tax principles, Owner B and Owner C are determined to derive the income paid from Country A to LLC. Accordingly, only 50 percent (Owner B’s share) of the payment from Country A is derived by a resident of Country B and eligible for benefits of the Country A – Country B tax treaty.

Once the person that derives the item of income is identified, the next step would be to apply the source country’s principles of beneficial ownership to that person to determine, for instance, if that person is acting merely as an agent or nominee for another party which is not entitled to treaty benefits. Continuing with the above example, Country A would apply its principles of beneficial ownership to Owner B. If Owner B is deemed to be the beneficial owner of its share of the payment from Country A (and if he satisfies any additional requirements for entitlement to treaty benefits, such as satisfying a limitation on benefits), then Country A shall grant treaty benefits to Owner B’s share of the payment to LLC.

This example is intended to show the importance of appropriately distinguishing and coordinating the concepts of derivation of income and beneficial ownership when granting treaty benefits. Failing to do so could produce unintended and undesirable results. For example, if Country A viewed LLC as opaque, and did not regard Country B's domestic law in determining which person derived the income, the beneficial ownership analysis would have been applied to LLC. If LLC failed to meet Country A's beneficial ownership standards, Owner B would not receive treaty benefits to which he was entitled. Alternatively, if LLC did satisfy Country A's beneficial ownership requirements, Country A would then extend the benefits of the A-B treaty to Owner C, which is an equally unwelcome result.

ANNEX 2

GUIDANCE ON DEFINITION OF 'BENEFICIAL OWNER' FROM THE CHINESE STATE ADMINISTRATION OF TAXATION

Introduction

The following are excerpts from an article from Deloitte's China Tax Alert November 9, 2009, entitled "SAT Issues Guidance on Definition of 'Beneficial Owner'" by Leonard Khaw, Hong Ye and David McGuigan.

"The Chinese State Administration of Taxation (SAT) issued a circular (Circular 601) on 27 October 2009 that provides guidance for determining whether a resident of a contracting state is the "beneficial owner" of an item of income under China's tax treaties and tax arrangements.
Circular 601 is the latest development in China's focus on cross-border taxation and it supplements recent circulars aimed at strengthening the administration of non-resident enterprises claiming treaty benefits. (The International Taxation Division of the SAT recently issued circulars in relation to the implementation of the dividends article of tax treaties, non-residents claiming treaty benefits and implementation of the royalties article.)

Highlights of Circular 601

Beneficial owner: Circular 601 provides that the term beneficial owner refers to a person who has the right of ownership and control over the item of income, or the right or property from which that item of income is derived. It further notes that a beneficial owner, generally, must be engaged in substantive business activities and can be an individual, a corporation or any other group.

Agent or conduit companies: Circular 601 states that an agent or conduit company will not be regarded as a beneficial owner (and, therefore, will not qualify for treaty benefits) if the entity is considered a "conduit company," and the circular sets out guiding principles as to the type of entities the SAT would consider to be conduit companies.

Specifically, Circular 601 states that a conduit company normally refers to a company that is set up for the purpose of avoiding or reducing tax or transferring or accumulating profits. Additionally, conduit companies are generally those that are registered in their country of residence merely to satisfy the legal requirements of tax residence and are not companies that engage in substantive activities such as manufacturing, sales and management.

Specific factors to assist in determining the beneficial owner: According to Circular 601, the presence of the following would be considered factors that could negatively affect an applicant's status as the beneficial owner:

1) The applicant is obliged to distribute most of its income (e.g. more than 60%) to a resident of another country within a prescribed time period (e.g. within 12 months from the date of receipt);

2) The applicant has no or minimal business activities;

3) Where the applicant is an entity such as a corporation, its assets, scale of operations and personnel deployment are not commensurate with its income;

4) The applicant has no or minimal control and decision-making rights and does not bear any risks;

5) The income of the applicant is non-taxable or, if subject to tax, is subject to a low effective tax rate;

6) In the case of interest income, there is a loan or deposit contract between the applicant and a third party, the terms of which (i.e. the amount, interest rate, signing dates) are similar or close to those of the loan contract under which the interest income is received; and

7) In the case of royalty income, there is a license or transfer agreement between the applicant and a third party, the terms of which are similar to the terms under which the royalty income is received.

In addition, when a taxpayer applies for treaty benefits, it will need to provide documentation to the local tax authorities to support its claim as being the beneficial owner of the relevant income and that it does not fall within the scope of any of the above. The circular envisions the use of the exchange of information mechanism in tax treaties to obtain information relevant for the determination of the beneficial owner issue. Complex cases will be handed over to the International Tax Division of the SAT.

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