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Update of the UN Model Double Taxation Convention between Developed and Developing Countries -Beneficial Ownership

Summary
During the 17th Session of the United Nations Committee of Experts on International Cooperation in Tax Matters, the Subcommittee on the UN Model Update was directed to carry out further work on the issue of beneficial ownership.

This paper presents the issue at a high level to facilitate further discussion on the inclusion of a clarification project in the work programme of the Subcommittee. To achieve this purpose the paper focuses on the background to the OECD’s 2014 Model Update clarification project along with a brief description of the resulting changes. Comment will also be made on the possibility of incorporating the OECD’s clarifications into the UN Model to the extent the Committee agrees with the OECD’s interpretation. Doing so would achieve internal consistency within the UN Model Commentaries, as the current Commentaries to Articles 10-12 have not incorporated the 2014 OECD Model guidance on beneficial ownership, but the Commentary to new Article 12A (fees for technical services) does.

The present paper has been prepared with close reference to OECD paper CTPA/CFA/WP1/NOE2(2008)18/REV2/CONF on the meaning of beneficial ownership and the UN paper E/C.18/2008/CRP.2/Add.1 which introduced a paper by Phillip Baker QC titled “Possible Extension of the Beneficial Ownership Concept” for consideration at the 4th Session of the Committee.
The concept of beneficial ownership in tax treaties

Introduction into the OECD and UN models

1. The concept of beneficial ownership has been included in the passive income articles of the OECD Model since 1977 and the UN Model since 1980. Driven largely by the United Kingdom, the inclusion of the beneficial ownership concept prevented the granting of the benefit of the source tax limitation on passive income in a treaty where such income was paid to a nominee or agent with merely a legal right to the income. In the absence of general anti-treaty-shopping provisions, a plain reading of the text permitted treaty-shopping through use of a relatively simple structure.

2. Specifically, incorporation of the beneficial ownership concept was intended to clarify the words in the passive income articles “[income] paid...to a resident”. As first noted by the OECD in its 2003 Model Commentary at paragraph 12 “[the concept of beneficial ownership] makes plain that the State of source is not obliged to give up taxing rights...merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention.”

3. However, the incorporation of the beneficial ownership concept has not been straightforward. In particular, because it is not defined in the OECD or the UN Models, its meaning in a treaty context has been open to question. Over the years the application of the concept has been tested in domestic courts with inconsistent results, particularly on the issue of whether the interpretation of the term should be governed by domestic or international law. That problem has been compounded by the fact that the term beneficial ownership has no clear meaning in the domestic law of many countries and by the fact that the domestic law meaning of the term in the domestic law of some countries (in particular, those that distinguish beneficial and legal ownership under trust law) would produce unintended treaty results. An additional difficulty has been the very different meaning given to the concept of beneficial ownership in the context of instruments related to money laundering and exchange of information. Different interpretations by courts and tax administrations, and confusion as to how the concept should be applied to intermediaries that are not mere agents or nominees, risks double taxation and non-taxation.

Key cases

4. Meaning has been given to the concept of beneficial ownership either through the use of domestic law, giving it its own international fiscal meaning, or using a combination of both. Comparing judgments reveals divergence in the approach to determining the beneficial owner of income. Some courts have taken a legalistic and technical approach to the question which examines both the form of an arrangement and the existing contractual obligations. Such courts have primarily had regard to whether the recipient of income has the legal right to it without a contractual requirement to pass it on. Other courts have taken a broader, more holistic, approach which is directed toward the examination of the substance of an arrangement and what it achieves.

5. The case of Indofood International Finance Ltd. V. JP Morgan Chase Bank NA (2006)\(^1\), although not a tax case, represents the first extensive discussion of the beneficial ownership concept in a UK court. In Indofood, it was held a Dutch company interposed

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\(^1\) Indofood International Finance Ltd. V. JP Morgan Chase Bank NA [2006] EWCA Civ 158.
between an Indonesian parent guarantor and wholly owned issuer of loan notes incorporated in Mauritius would not be the beneficial owner of interest paid by the parent guarantor under a loan agreement because the interposed company could not enjoy the ‘full privilege’ of the interest paid.

6. In arriving at this conclusion, the UK Court of Appeal found that the concept of beneficial ownership has an “international fiscal meaning” not derived from domestic laws. In reaching its decision, the Court placed considerable reliance on both the OECD Commentary, and observations by Phillip Baker QC. The Court considered the legal obligations of the parties in relation to the interest income but noted that “the meaning to be given to the phrase ‘beneficial owner’ is plainly not to be limited by so technical and legal approach. Regard has to be had to the substance of the matter.” In other words, a substance over form approach.

7. By contrast, in the Canadian tax case of Prévost Car Inc. v. The Queen (2008) the Canadian Tax Court held that “beneficial ownership” in the Canada-Netherlands treaty took its meaning from domestic law. This was due to the wording of Article 3(2), which explicitly provides that domestic law is to guide the interpretation of terms not defined in the treaty, unless the context requires otherwise.

8. The Prévost judgment also is a good example of the difficulties which may arise when attempts are made to apply the concept of beneficial ownership to conduit companies. A technical and legal approach was taken to applying the concept of beneficial ownership to a company. The Court held that an interposed Dutch holding company with 100% shares in a Canadian company and no physical office or employees passing dividends under a Shareholders’ Agreement to its UK and Swedish shareholders was the beneficial owner of those dividends. To find otherwise would have required the holding company to have absolutely no discretion to use the income put through it as a conduit, or have agreed to act under instruction without any right to do otherwise. In this case, the Dutch holding company was under no obligation in law to pass the dividend on to the foreign shareholders, even though this was in practice what happened. On this basis the Court declined to pierce the corporate veil in order to treat the holding company as a mere conduit and the shareholders as beneficial owners.

9. In the 2006 French case, Ministre de l’Economie, des Finances et de Industrie v Société Bank of Scotland, the interpretation of beneficial ownership in the French-United Kingdom treaty came before the French Supreme Court. The facts of the case concerned whether a UK company interposed between a French and a US company was the beneficial owner of dividend income paid by the French company. The French Court of Appeal found in favour of the taxpayer, holding the UK company and not the US company was the beneficial owner because the right of the US company to receive the dividend payment was uncertain. The Supreme Court reversed this decision, finding instead that the manner in which the transaction was structured was artificial and motivated by a desire to treaty-shop. The Supreme Court reached

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2 at [42].
3 at [44].
5 Ibid, see para [100]-[105].
its decision by examining the substance of the arrangement and whether its purpose was consistent with the object and intention of the treaty. In contrast to Prévost, the Supreme Court found a company may be a conduit even in cases where it has some authority over the income received and no contractual obligation to pass it on.

10. Earlier cases also remain relevant and demonstrate the longstanding nature of the issues surrounding the concept’s interpretation. For example, the United States case *Aiken Industries v Commissioner of Internal Revenue (1971)*\(^7\) considered the general rule of interpretation in the United States-Honduras tax treaty required reference to domestic law. *Del Commercial Properties Inc v Commissioner of Internal Revenue (1999)*\(^8\) was decided for US tax authorities where a Dutch company was interposed between a US and a Canadian company because the only benefit of doing so was a reduction in US tax. In the Dutch case of *Royal Dutch Shell (1994)*\(^9\) the Court took a legalistic approach to determining beneficial ownership and considered whether there was an absolute right to the income, concluding that recipient was not the beneficial owner of income if it was required to pass the largest part of its income to a third party. This is not exhaustive and there are many other cases that could be discussed here to illustrate the different approaches courts have applied to determining beneficial ownership.

11. Despite the OECD’s 2014 work aimed at clarifying its interpretation, the concept of beneficial ownership can still present difficulties. This is particularly so where it runs into conflict with jurisdictional precedent, as the recent decision of *X Bank v Federal Tax Administration*\(^10\) illustrates. In that case, a British bank entered into a derivative arrangement with a client under which it would pay to the client any increase in the capital value of shares in a Swiss company and up to 80% of the gross value of the dividend the Bank received on the shares. In exchange, the client would pay to the Bank any decrease in the capital value of the shares. Although it was not obliged to, but in order to hedge the transaction, the Bank acquired shares in the Swiss company. Due to the onset of the 2008 financial crisis, the shares fell in value, and the Bank sought compensation from its client. The client ultimately failed to make payment as required. The Bank sold the shares at a loss, but not before it had received a dividend which it chose to retain.

12. In following the precedent set by the Swiss Federal Supreme Court in *Re Swiss Swaps Case*,\(^11\) the Swiss Federal Administrative Court held the Bank was not the beneficial owner of the dividend under the UK/Swiss treaty. The application of existing Swiss case law on the meaning beneficial ownership resulted in an unusual outcome where even though the Bank retained the dividend and made no corresponding payment to a third party, it was considered by the court not to be the beneficial owner.

**Response in 2014 OECD update**

13. Prior to 2014, decisions of the courts which consider the concept of beneficial ownership left two fundamental questions largely unanswered\(^12\):

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\(^7\) *Aiken Industries v Commissioner of Internal Revenue* 56 T.C. 925 (1971) – Case 292-69.

\(^8\) *Del Commercial Properties Inc v Commissioner of Internal Revenue* T.C. Memo 1999-411.

\(^9\) *Royal Dutch Shell* (6 April 1994) Case no 28 638, BNB 1994/217 (the Hoge Raad, the Netherlands).


\(^12\) These were identified in Baker’s 2008 paper presented at the 4th Session of the UN Committee.
1. Does the concept of term ‘beneficial owner’ take a domestic law meaning following the interpretive rules of Article 3(2), or does it rather have an international fiscal meaning / autonomous treaty meaning?

2. Is the concept intended to be a narrow and specific anti-abuse rule, or a general principle to counter treaty-shopping?

14. The 2014 OECD update answered these questions by providing, in summary, beneficial ownership in the Model and in tax treaties has an international fiscal meaning / autonomous treaty meaning and moreover, is intended to be a narrow specific anti-abuse rule with limited application.

15. The UN did not produce an update between 2011 and the current 2017 text. No project to address the concept of beneficial ownership and the outstanding questions as to its meaning and application was undertaken for the 2017 update.

16. The last detailed discussion on beneficial ownership by the UN Tax Committee was held its 4th Session in 2008 where discussion centred primarily on the possibility of extending its use to other Articles of the UN Model. The UN Tax Committee decided not to extend the use of the concept before its meaning had been refined further through reference to OECD developments. Instead, additional guidance was incorporated into the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries ("Manual"). The current version of the Manual includes a paragraph describing the interpretive issue and noting the work done by the OECD for its 2014 update and discussion in the Action 6 report. Although a view on the meaning and application of the concept is not given, the Manual states it should not automatically be assumed to take on the meaning afforded to it by domestic law. The Manual added that it would be useful for negotiators to discuss interpretation with their counterparts.

17. Despite the fact that the UN Committee did not formally discuss the meaning of the concept of beneficial owner since 2008, it is worth noting that the explanations of that concept that are provided in the Commentary on Article 12A (fees for technical services), which was adopted by the Committee in 2017, are largely based on the explanations included in the 2014 OECD Model. Ideally, the explanations of the concept of beneficial owner in the Commentaries on Articles 10, 11, 12 and 12A should be consistent.

Overview of the 2014 OECD changes

18. In clarifying the concept of beneficial ownership in 2014, the OECD did not amend the meaning of the term so much as affirm the original intention underlying its use in a treaty context. As a whole, the clarifications reflect the fact that the beneficial ownership was not intended to be a high threshold to meet.

19. The commentaries on Articles 10-12 now clarify that:

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13 The 2017 update was largely restricted to Base Erosion and Profit Shifting (BEPS) measures, the addition of a new fees for technical services article and updates to international transport provisions.


16 Ibid, page 92.

17 The appendix to this paper presents these changes in the context of the UN Model.
• The concept of beneficial ownership does not take its meaning from domestic law or other OECD instrument, but rather has an autonomous treaty meaning;

• The intention of the beneficial ownership concept was to clarify the use of the words “paid to…a resident” in the Model and so should be read in that context;

• Beneficial owners are those that have the right to use and enjoy the payment unconstrained by contractual or legal obligations to pass the payment on. Essentially meaning that persons acting as fiduciaries, agents and nominees are not beneficial owners;

• Use and enjoyment of property that derives the income is distinguished from the legal ownership of the property; and

• An obligation to pass payments on can be contractual or can be found to exist on the basis of facts and circumstances.

**The case for review**

20. One of the fundamental issues with the concept of beneficial ownership is what type of anti-abuse rule it is. That is, is it narrow and targeted, or general in nature intending to address any potential instances of treaty-shopping.

21. The adoption of the Base Erosion and Profit Shifting (BEPS) measures in the 2017 UN Model update may now mean this question can be settled. This is because:

• The anti-abuse rules found in the limitation on benefits (LOB) Article, and the principal purposes test (PPT), address treaty-shopping broadly; and

• A new preamble expressly stating that treaties are not concluded to provide opportunities to treaty-shop has also been included in the UN model.

Accordingly, it might now be expected that countries rely on these instead of tests such as beneficial ownership, particularly now that the new preamble (or equivalent text) and the PPT (or detailed LOB combined with an anti-conduit rule) are minimum standards for members of the OECD’s Inclusive Framework on BEPS. Further, the inclusion of these treaty-shopping protections in the UN Model may encourage developing countries outside the Inclusive Framework to adopt such measures.

22. For this reason, it could be a good time for the Committee to make the concept of beneficial ownership clearer in scope. Doing so may assist in focusing the resources of developing countries away from definitional arguments and towards applying the explicit new tools to combat treaty-shopping and avoidance arrangements incorporated as part of the BEPS project. Professor Baker’s 2008 paper similarly identified that continuing to use a concept which has a meaning so unclear that it continues to result in lengthy litigation in the highest courts points to the fact it is something worth clarifying, particularly for developing countries.

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18 As at January 2019 there were 127 country members of the Inclusive Framework on BEPS. These countries have committed to meet and be peer reviewed on the Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances minimum standard on treaty-shopping (http://www.oecd.org/tax/beps/beps-about.htm).

19 See Annex to E/c.18/2008/CRP.2/Add.1 at para 26.
23. As noted at the 17th Session\textsuperscript{20}, it is important at least for the UN Model to provide some guidance on the open questions relating to beneficial ownership to avoid unintended differences of interpretation between the two models and to address the problems created by conflicting court decisions. Undertaking a project will allow the Committee to identify areas in which it agrees or disagrees with the OECD on its guidance on the concept of beneficial ownership.

24. This work is relevant not only for articles 10-12 of the UN Model, but also 12A (fees for technical services). However, note the commentary on Article 12A already incorporates the key elements of the 2014 OECD clarification language. Adopting the same approach for 10-12 would promote consistency across all four Articles.

**Other changes to Articles 10-12**

25. The texts of Articles 10 and 11 in the OECD Model were also amended in 2014 to address an issue that was raised with how the provisions apply where the direct recipient of the income and the beneficial owner are in two different states.

26. Before the text was amended a literal interpretation of the words “such dividends and “such interest” in 10(2) and 11(2) respectively could lead to the conclusion that the dividend/interest income must be that paid direct to a resident of a Contracting state. This is problematic where the direct recipient and the beneficial owner are residents of two different States. This is already addressed in 12.2 of the Commentary but to remove any doubt the text of Articles 10 and 11 were amended to clarify that an intermediary (such as a custodian) located in a third State and interposed between the payer and the beneficial owner does not prevent the limitation of source taxation being provided to the beneficial owner.

27. The changes would also be relevant for Article 12 of the UN Model. Unlike the UN, the OECD Model does not provide for the source taxation of royalties and so does not use the same “such royalties” language in-text.

Appendix

Proposed modifications to the UN Model Convention

Proposed changes to Articles of the UN Model Convention

Article 10
2. However, such dividends paid by a company which is a resident of a Contracting State may also be taxed in that State the Contracting State of which the company paying the dividends 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) ___ per cent (the percentage is to be established through bilateral negotiations) 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 throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);

(b) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Article 11
2. However, such interest arising in a Contracting State may also be taxed in that State the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

Article 12
2. However, such royalties arising in a Contracting State may also be taxed in that State the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged
shall not exceed ____ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

Proposed changes to the Commentary on the Articles of the UN Model Convention

Commentary on Article 10

13. The Commentary on the 2010-2017 OECD Model Convention contains the following passages:

11. […]

Quoted OECD paragraph 11 is omitted as relates to the text in parenthesis “(other than a partnership)” in paragraph 10(2)(a). This may need to be considered by the Committee separately.

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 paid direct to a resident of a State with which the State of source had concluded a convention. [the rest of the paragraph has been moved to new paragraph 12.1]

12.1 Since the term “beneficial owner” was added to address potential difficulties arising from the use of the words “paid to … a resident” in paragraph 1, it 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). The term “beneficial owner” is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries1), rather, it should be understood in its context, in particular in relation to the words “paid … to a resident”, and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

1 For example, where the trustees of a discretionary trust do not distribute dividends earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognised as a separate taxpayer), could constitute the beneficial owners of such income for the purposes of Article 10 even if they are not the beneficial owners under the relevant trust law.

12.12 Where an item of income is received by paid to 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 direct recipient of the income as a resident of the other Contracting State. The immediate direct 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. [the rest of the paragraph has been moved to new paragraph 12.3]

12.3 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. For these reasons, the report from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Conduit Companies”\(^1\) 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.

\(^1\) Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R (6)-1.

12.4 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct 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 would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions, or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits under the principles of paragraphs 22 to 48 of the Commentary on Article 1. 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. It should also be noted that Article 10 refers to the beneficial owner of a dividend as opposed to the owner of the shares, which may be different in some cases.

12.5 The fact that the recipient of a dividend is considered to be the beneficial owner of that dividend does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse of this provision (see also paragraph 22 below). The provisions of Article 29 and the principles put forward in the section on “Improper use of the Convention” in the Commentary on Article 1 will apply to
prevent abuses, including treaty shopping situations where the recipient is the beneficiary owner of the dividends. Whilst the concept of “beneficial owner” deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of abuses, such as certain forms of treaty shopping, that are addressed by these provisions and principles and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

12.6 The above explanations concerning the meaning of “beneficial owner” make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments¹ that concern the determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of “beneficial owner” cannot be applied in the context of the Article. Indeed, that meaning, which refers to natural persons (i.e. individuals), cannot be reconciled with the express wording of subparagraph 2 a), which refers to the situation where a company is the beneficial owner of a dividend. In the context of Article 10, the term “beneficial owner” is intended to address difficulties arising from the use of the words “paid to” in relation to dividends rather than difficulties related to the ownership of the shares of the company paying these dividends. For that reason, it would be inappropriate, in the context of that Article, to consider a meaning developed in order to refer to the individuals who exercise “ultimate effective control over a legal person or arrangement.”²

¹ See, for example, Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation – The FATF Recommendations (OECD-FATF, Paris, 2012), which sets forth in detail the international anti-money laundering standard and which includes the following definition of beneficial owner (at page 110): “the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.” Similarly, the 2001 report of the OECD Steering Group on Corporate Governance, “Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes” (OECD, Paris, 2001), defines beneficial ownership as follows (at page 14):

In this Report, “beneficial ownership” refers to ultimate beneficial ownership or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial ownership refers to beneficiaries, which may also include the settlor or founder.
See the Financial Action Task Force’s definition quoted in the previous note.

12.27 Subject to other conditions imposed by the Article and the other provisions of the Convention, 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 and in 2014 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.

Commentary on Article 11

18. The Commentary on the 2010 2017 OECD Model Convention contains the following passages:

9. 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 paid direct to a resident of a State with which the State of source had concluded a convention. [the rest of the paragraph has been moved to new paragraph 9.1]

9.1 Since the term “beneficial owner” was added to address potential difficulties arising from the use of the words “paid to a resident” in paragraph 1, it 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). The term “beneficial owner” is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries1), rather, it should be understood in its context, in particular in relation to the words “paid to a resident”, and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

1 For example, where the trustees of a discretionary trust do not distribute interest earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognised as a separate taxpayer) could constitute the beneficial owners of such income for the purposes of Article 11 even if they are not the beneficial owners under the relevant trust law.

10. 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 direct recipient of the income as a resident of the other Contracting State. The immediate direct 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. [the rest of the paragraph has been moved to new paragraph 10.1]

10.1 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. For these reasons, the report from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Conduit Companies”\(^1\) 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 behalf of the interested parties.

\(^1\) Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(6)-1.

10.2 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the interest is not the “beneficial owner” because that recipient’s right to use and enjoy the interest 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 interest unconstrained by a contractual or legal obligation to pass on the payment received to another person. This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions, or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits under the principles of paragraphs 22 to 48 of the Commentary on Article 1. Where the recipient of interest does have the right to use and enjoy the interest unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the “beneficial owner” of that interest. It should also be noted that Article 11 refers to the beneficial owner of interest as opposed to the owner of the debt-claim with respect to which the interest is paid, which may be different in some cases.
10.3 The fact that the recipient of an interest payment is considered to be the beneficial owner of that interest does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse of this provision (see also paragraph 8 above). The provisions of Article 29 and the principles put forward in the section on “Improper use of the Convention” in the Commentary on Article 1 will apply to prevent abuses, including treaty shopping situations where the recipient is the beneficial owner of interest. Whilst the concept of “beneficial owner” deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on the interest to someone else), it does not deal with other cases of abuses, such as certain forms of treaty shopping, that are addressed by these provisions and principles and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

10.4 The above explanations concerning the meaning of “beneficial owner” make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments that concern the determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of “beneficial owner” cannot be applied in the context of the Convention. Indeed, that meaning, which refers to natural persons (i.e. individuals), cannot be reconciled with the express wording of subparagraph 2 a) of Article 10, which refers to the situation where a company is the beneficial owner of a dividend. In the context of Articles 10 and 11, the term “beneficial owner” is intended to address difficulties arising from the use of the words “paid to” in relation to dividends and interest rather than difficulties related to the ownership of the shares or debt-claims on which dividends or interest are paid. For that reason, it would be inappropriate, in the context of these articles, to consider a meaning developed in order to refer to the individuals who exercise “ultimate effective control over a legal person or arrangement”.2

1 See, for example, Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation – The FATF Recommendations (OECD-FATF, Paris, 2012), which sets forth in detail the international anti-money laundering standard and which includes the following definition of beneficial owner (at page 110): “the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.” Similarly, the 2001 report of the OECD Steering Group on Corporate Governance, “Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes” (OECD, Paris, 2001), defines beneficial ownership as follows (at page 14):

In this Report, “beneficial ownership” refers to ultimate beneficial ownership or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary
entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial ownership refers to beneficiaries, which may also include the settlor or founder.

2. See the Financial Action Task Force’s definition quoted in the previous note.

11. Subject to other conditions imposed by the Article and the other provisions of the Convention, 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 and in 2014 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.

Commentary on Article 12

4. Paragraph 1 omits the word “only” found in the corresponding provision of the OECD Model Convention, which provides that “royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State”. Paragraph 2 is an addition flowing logically from the premise underlying paragraph 1, which is that royalties may be taxable in the source country as well as the residence country. By providing for taxing rights in respect of royalties to be shared between the State of residence and the State of source, the United Nations Model Convention departs from the principle of exclusive residence State’s right to tax provided in the OECD Model Convention. In this context, it should be noted that several member States of OECD have recorded reservations to the exclusive residence State taxation of royalties provided by Article 12 of the OECD Model Convention.

5. The Commentary on the 2010 OECD Model Convention contains the following relevant passages:

4. The requirement of beneficial ownership was introduced in paragraph 1 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 paid direct to a resident of a State with which the State of source had concluded a convention. The term “beneficial owner” is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries), 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.

1 For example, where the trustees of a discretionary trust do not distribute royalties earned during a given period, these trustees, acting in
their capacity as such (or the trust, if recognised as a separate taxpayer) could constitute the beneficial owners of such income for the purposes of Article 12 even if they are not the beneficial owners under the relevant trust law.

4.1 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 paid to 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 direct recipient of the income as a resident of the other Contracting State. The immediate direct 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. [the rest of the paragraph has been moved to new paragraph 4.2]

4.2 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. For these reasons, the report from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Conduit Companies” 1 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.

1 Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(6)-1.

4.3 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the royalties is not the “beneficial owner” because that recipient’s right to use and enjoy the royalties 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 royalties unconstrained by a contractual or legal obligation to pass on the payment received to another person. This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions, or as a party to financial transactions or typical distribution obligations of pension schemes and of collective investment vehicles.
entitled to treaty benefits under the principles of paragraphs 22 to 48 of the Commentary on Article 1. Where the recipient of royalties does have the right to use and enjoy the royalties unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the “beneficial owner” of these royalties. It should also be noted that Article 12 refers to the beneficial owner of royalties as opposed to the owner of the right or property in respect of which the royalties are paid, which may be different in some cases.

4.4 The fact that the recipient of royalties is considered to be the beneficial owner of these royalties does not mean, however, that the provisions of paragraph 1 must automatically be applied. The benefit of these provisions should not be granted in cases of abuse (see also paragraph 7 below). The provisions of Article 29 and the principles put forward in the section on “Improper use of the Convention” in the Commentary on Article 1 will apply to prevent abuses, including treaty shopping situations where the recipient is the beneficial owner of royalties. Whilst the concept of “beneficial owner” deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on the royalties to someone else), it does not deal with other cases of abuses, such as certain forms of treaty shopping, that are addressed by these provisions and principles and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

4.5 The above explanations concerning the meaning of “beneficial owner” make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments that concern the determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of “beneficial owner” cannot be applied in the context of the Convention. Indeed, that meaning, which refers to natural persons (i.e. individuals), cannot be reconciled with the express wording of subparagraph 2 a) of Article 10, which refers to the situation where a company is the beneficial owner of a dividend. The term beneficial owner was intended to address difficulties arising from the use of the words “paid to”, which are found in paragraph 1 of Articles 10 and 11 and were similarly used in paragraph 1 of Article 12 of the 1977 Model Double Taxation Convention, in relation to dividends, interest and royalties rather than difficulties related to the ownership of the shares, debt-claims, property or rights with respect these dividends, interest or royalties are paid. For that reason, it would be inappropriate, in the context of these articles, to consider a meaning developed in order to refer to the individuals who exercise “ultimate effective control over a legal person or arrangement”.

1 See, for example, Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation – The FATF Recommendations (OECD-FATF, Paris, 2012), which sets forth in detail the international anti-money laundering standard and which includes the following definition of beneficial owner (at page 110): “the natural
person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.” Similarly, the 2001 report of the OECD Steering Group on Corporate Governance, “Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes” (OECD, Paris, 2001), defines beneficial ownership as follows (at page 14):

In this Report, “beneficial ownership” refers to ultimate beneficial ownership or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial ownership refers to beneficiaries, which may also include the settlor or founder.

2 See the Financial Action Task Force’s definition quoted in the previous note.

4.26 Subject to other conditions imposed by the Article and the other provisions of the Convention, the limitation of tax exemption from taxation 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 1995-1997 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.

The modification in paragraph 4.6 of the Commentary on Article 12 is inconsistent with the UN Model. The UN Model does provide for source taxation of royalties and so the Committee may want to include text in square brackets to reflect this e.g.

4.6 Subject to other conditions imposed by the Article and the other provisions of the Convention, 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,....