To: taxtreaties@oecd.org
Attn: Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA

Commentary on:

OECD Model tax convention: Revised proposals concerning the meaning of "Beneficial Owner" in articles 10, 11 and 12

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By:

M.L.L. van Bladel
Straatweg 185
3621 BM Breukelen
The Netherlands
Tel: (+31) 346 265 887
Mob: (+31) 624 204 502
e-mail: marco.van.bladel@planet.nl

Beneficial Ownership in the OECD model tax treaty

M.L.L. van Bladel

Preface

As managing director and global head of the structured tax transactions department ("Structured Funding and Investments") of (the old) ABN AMRO Bank N.V. (until July 2009), one of the worlds most internationally working financial institutions within one of the most facilitating international tax treaty environments (The Netherlands), I have seen many structures which have been set up to "create" beneficial ownership and circumvent (withholding) taxes. Although most of these aggressive structures have not been adopted by our financial institution, it has given me the time to formulate a policy on when beneficial ownership in a lot of situations can and should be assumed. It also gave me a clear view on the fact that, as long as there is no worldwide unified tax system, people may use the different tax systems of different countries to arbitrage on the definition beneficial ownership ("Beneficial Ownership").

I have, after discussing the issue of Beneficial Ownership with mr. Bas B. de Mik, a Dutch tax lawyer who has advised several times on (especially) international transfer pricing issues, written this short outline on Beneficial Ownership article 10, 11 and 12 of the OECD model treaty. I am available for any additional information you would like (if any). I have kept it as a sort outline to provide a readable respons.

Introduction

Beneficial Ownership has been introduced in the OECD-model treaty to try to eliminate the avoidance of (withholding) taxes in especially structured transactions. However, only in the domestic tax laws of just a few countries, the term Beneficial Ownership (or a similar local definition achieving the same) has been defined. In most countries the term Beneficial Ownership did not even exist in domestic (tax) legislation. In the countries which had a definition of Beneficial Ownership this definition stems from its local trust laws (mostly in common law countries). In later years the definition Beneficial Ownership was in some countries extensively interpreted in case law whereby the international meaning as intended in the OECD model treaty was not always followed. Other countries (and especially the developing countries which need the withholding taxes as income for their development) still do not have any concept of Beneficial Ownership which may protect them from any structures which decrease their (withholding)tax income. Therefore a workable definition of Beneficial Ownership should be introduced in the commentary to the OECD model treaty with objective reference points to establish the status of any ownership. This definition should not be exclusively interpreted from the definition or case law of one specific country, but should be logically determined after comprising the experience with the term Beneficial Ownership over the last 35 years. Therefore I haven't taken up any references to local legislation or local case law of any specific country.

To establish a workable definition of the term Beneficial Ownership in the OECD-model treaty, we first must analyse and define the term ownership.

Ownership can be divided in legal ownership and economic ownership. Full (100%) legal ownership and full (100%) economic ownership constitute full (100%) ownership.

Legal ownership
Legal ownership of an asset means that the legal person or individual ("Person") claiming legal ownership is regarded to be the legal owner under the (civil) laws of the country in which the Person and/or the asset is located. Under the civil laws of most countries, legal ownership will be assumed for a Person who has "possession" of the asset. "Possession" of the asset means either physical possession or official registration of the asset in the name of a Person. Initially, a legal owner also has full economic ownership of the asset.

To be "Beneficial Owner" of an asset, it is understood that one should <u>at least</u> be the legal owner of the asset. A legal owner can transfer (part of) the risk associated to the asset to another Person. This risk transfer is a transfer of (part of the) economic ownership. It is clear that being merely the legal owner ("agent" or "nominee") of an asset, after having transferred the full economic ownership of the asset, is not sufficient to be regarded as the the Beneficial Owner. It can be questioned whether the full economic risk can be transferred.

"Beneficial Ownership"
"Beneficial Ownership" is a term which originally stems from English trust law. It was introduced in the OECD-model tax treaty to codify that the sole owner of 100% legal ownership (and no economic ownership) would not benefit of certain treaty benefits. Beneficial Ownership has been introduced in the OECD model treaty after recognising that allocating treaty benefits to mere legal owners ("agent" or "nominee") who do not have any economic interest in an asset (which economic interest has been allocated to a non-treaty eligible person) would surpass the purpose of the treaty. Therefore, Beneficial Ownership requires 100% legal ownership and a certain degree of economic risk. Especially the term Beneficial Ownership has been introduced in the OECD-model treaty to try to eliminate the avoidance of (withholding) taxes through structured transactions.

What does Beneficial Ownership require of the legal owner of an asset? If a legal owner of an asset has transferred full economic ownership of the asset to another Person, this legal owner will not be regarded to be the beneficial owner of the asset. However what quality or quantity of economic ownership needs to reside with the legal owner to regard him also as the beneficial owner?

Quality of economic ownership will be determined by substitution of the risk in the asset which the legal owner has in its possession.

Example
A legal owner of a loan has received a guarantee from a bank which will guarantee (but not fund) a loan for its full amount. The legal owner has still a risk on its original debtor if the bank is not willing or able to pay the guaranteed amount when required to pay under the guarantee.

Quantity of economic ownership will be determined by the (objective) determination of remaining economic risk with the legal owner. Does (only) a percentage of the risk remain with the legal owner.

Example
A legal owner of a Loan has received a loan from a Person for 80% of the value of the Loan which only has to be repaid to the extend of and if the Loan is repaid. The legal owner has only for 20% risk on its debtor. This risk has been taken over for 80% by Person. Therefore this legal owner can not be regarded to be the Beneficial owner for 80% of the loan.

It is clear that when the full economic ownership has been transferred, the legal owner can not be regarded to be the beneficial owner.

In the commentary to article 10 of the OECD model treaty it is stated in 12.4:

12.4
"…the recipient of the dividend is not the "beneficial owner" because 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…."

It is clear that the "Beneficial Ownership" will be denied to legal owners who have "*a contractual or legal obligation to pass on the payment received to another person*". It is much more difficult to establish when "*in substance, the recipient clearly does not have the full right to use and enjoy the dividend*". This can be translated in the recipient (legal owner) not having any economic risk and solvency regarding the income producing asset.

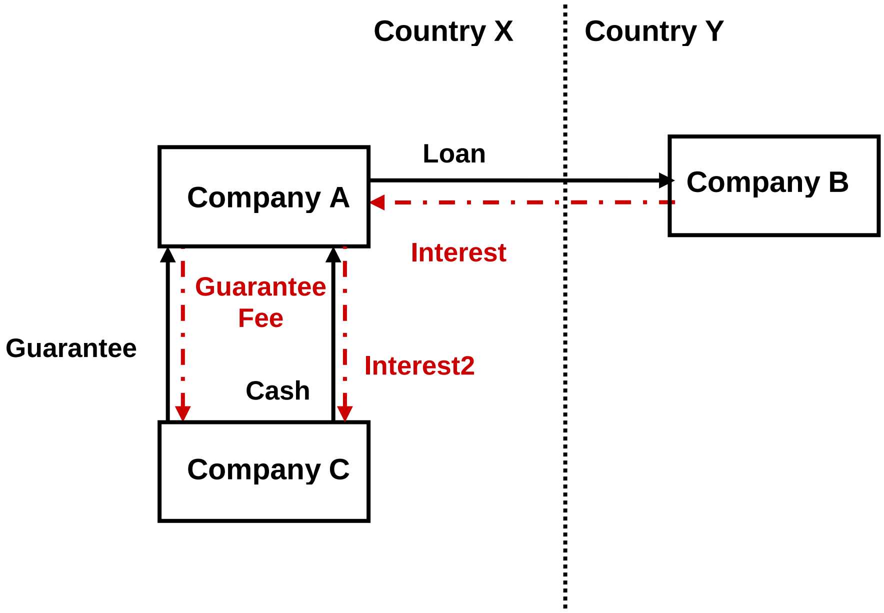
<u>Solvency (economic risk)</u>
In the financial world, it can easily be determined whether the owner of an asset runs any economic risk on this asset. Especially under the solvency rules as established by the Bank of International Settlements ("BIS"), the so called Basel II solvency rules ("Basel II"), it was very easy to determine. If the financial institution has an asset on which it runs an economic risk it has a solvency requirement and it needs to hold a percentage of capital against the value of the asset to cover the risk it runs on the asset.

The extend of the solvency required under Basel II (no solvency, 0%, 1.6%, 8%, 100%) reflects the economic risk that a recipient of income from an asset (which the recipient legally owns) runs on the asset. Simplified and in short the following can also be used under the solvency rules as changed by the BIS; the so called Basel III solvency rules ("Basel III"). Although there might be changes in the determination of the percentage of solvency under Basel III, no changes in the principles of solvency establishment are envisioned under Basel III which would change the relevance of this elucidation.

It is clear that in situations of 8% and 100% solvency requirements, the holder of the asset will be regarded to be the (full) economic owner of the asset and therefore runs sufficient economic risk to be perceived as the Beneficial Owner. Therefore, I will only discuss the situations which are of relevance: No solvency, 0% solvency and 1.6% solvency. I have made my simplified examples with loans and interest payments. However, this can also be used for Beneficial Ownership of dividends and royalties. Although the Basel II and Basel III solvency rules have been set up for regulated financial institutions, the establishment of economic risk on the asset under Basel II or Basel III can also be used in situations where the income producing asset is held by a corporate (non-financial institution) or individual.

No solvency (no economic risk)
No solvency is required if the legal owner of the asset does not run any economic risk on the asset; it is in effect merely an agent or nominee. The recipient should always be denied Beneficial Ownership irrespective whether there is or there is not a "*contractual or legal obligation to pass on the payment received to another person*" and therefore "*in substance, the recipient clearly does not have the full right to use and enjoy the dividend*", interest or royalty.

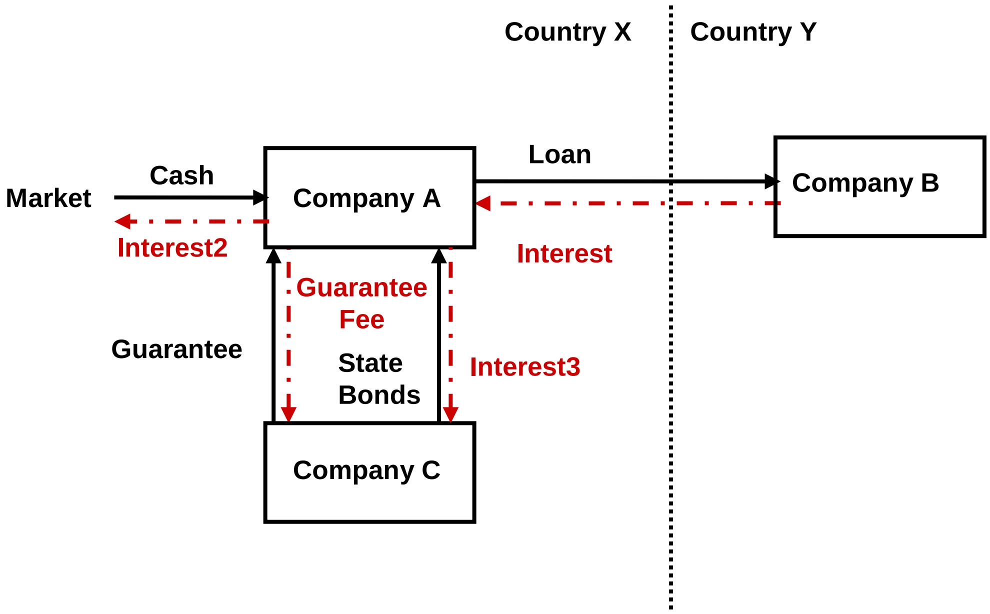
Example
Company A, a resident of Country X, has given a loan ("Loan") to company B, a resident of Country Y. Company C has provided Company A with a guarantee ("Guarantee") under which it will guarantee the repayment of Loan. Furthermore, Company C has provided a cash deposit to Company A ("Cash") which Cash is pledged ("Cash Collateral") to Company A for any obligations arising under the Guarantee. Company B will pay interest on the Loan to Company A ("Interest"). Company A will pay interest ("Interest2") and a guarantee fee ("Guarantee Fee") to company C.



Under this arrangement Company A can not be regarded to be the beneficial owner of the Interest paid by Company B under the Loan to Company A. Although there is no "*contractual or legal obligation to pass on the payment received to another person*", Company A will pay the Interest received from Company B on to Company C as Interest2 and Guarantee Fee. Therefore "*in substance, the recipient clearly does not have the full right to use and enjoy the*" Interest. The Cash Collateral provided to Company A through Cash will protect Company A from any economic risk on both the Loan and the Interest on the Loan. This is also reflected in the fact that there is no solvency obligation.

<u>0% solvency (very limited economic risk)</u>
0% solvency is required if the asset has been secured with a guarantee and a pledge and deposit of very high quality assets; in most instances state bonds ("State Bonds") issued by a reputable OECD country. In most cases overcollateralization of these State Bonds is necessary to arrive at the 0% on the full outstanding amount. The economic risk taken in this situation can be regarded to be insufficient to determine Beneficial Ownership. However, in my view the recipient can be regarded as the Beneficial Owner as there is an economic risk which is taken by the recipient. This economic risk is nevertheless regarded to be so small that no solvency is required.

Example
Company A, a resident of Country X, has given a loan ("Loan") to company B, a resident of Country Y. Company A has taken up a loan in the market ("Cash") to fund the Loan. Company C has provided Company A with a guarantee ("Guarantee") under which it will guarantee the repayment of the Loan. Furthermore, Company C has pledged state bonds ("State Bonds") to Company A which State Bonds are deposited with Company A for any obligations arising under the Guarantee. Company B will pay interest on the Loan to Company A ("Interest"). Company A will pay a guarantee fee ("Guarantee Fee") to company C. Company A will pay interest ("Interest2") to the Market on the Cash taken up. Company A will pay the interest received on the State Bonds on to Company C ("Interest3").

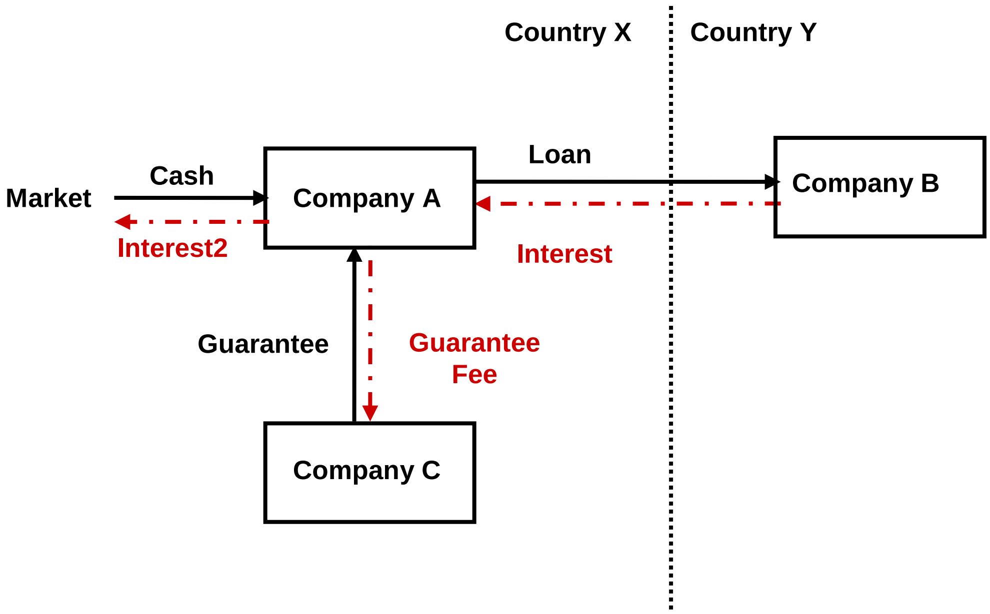


It is clear that Company A can not be regarded to be the Beneficial Owner of the interest on the State Bonds which is used to pay out as Interest3 to Company C.

However, under this arrangement Company A can (in my view) be regarded to be the beneficial owner of the Interest paid by Company B under the Loan to Company A. There is no "*contractual or legal obligation to pass on the payment received to another person*". Company A will pay the Interest received from Company B on to the Market as Interest2 and as a Guarantee Fee to Company C. If Company B does not perform under the Loan, Company A still has to pay Interest2 and Cash back to the Market. Company A first has to sell its collateral received (State Bonds) and it might be unclear whether this collateral has sufficient value to be able to repay Cash and Interest2 to the Market. It can be concluded that the 0% solvency requirement reflects the very limited risk of non-performance of the State Bonds. This limited risk should be used to argument that therefore "*in substance, the recipient clearly does…. have the full right to use and enjoy the..* " interest.

1.6% solvency (limited economic risk)
1.6% solvency is required if the asset has been secured with a guarantee of a Financial Institution located in a OECD country. The solvency would be 8% if guaranteed by a corporate (as corporates are non regulated entities, lower solvency is in most cases not available). In this case if the guarantee can not be effectuated, there is no cash deposit nor other collateral which would give any relief. Therefore in situations of 1.6% solvency the economic risk is sufficient to establish that the recipient of income from an asset is the Beneficial Owner.

Example
Company A, a resident of Country X, has given a loan ("Loan") to company B, a resident of Country Y. Company A has taken up a loan in the market ("Cash") to fund the Loan. Company C has provided Company A with a guarantee ("Guarantee") under which it will guarantee the repayment of the Loan. Company B will pay interest on the Loan to Company A ("Interest"). Company A will pay a guarantee fee ("Guarantee Fee") to company C. Company A will pay interest ("Interest2") to the Market on the Cash taken up.



It is clear that under this arrangement Company A can be regarded to be the beneficial owner of the Interest paid by Company B under the Loan to Company A. There is no "*contractual or legal obligation to pass on the payment received to another person*". Company A will pay the Interest received from Company B on to the Market as Interest2 and as a Guarantee Fee to Company C. If Company B does not perform under the Loan, Company A still has to pay Interest2 and Cash back to the Market. It can be concluded that the 1.6% solvency requirement reflects the limited risk of non-performance by an OECD country regulated bank. This limited risk should be used to argument that therefore "*in substance, the recipient clearly does…. have the full right to use and enjoy the..* " interest.

Conclusion

To be Beneficial Owner, the owner of an asset needs at least be the legal owner of the asset. Besides being the legal owner, a certain degree of economic ownership needs to reside with the legal owner. The level of economic ownership which has to reside with the legal owner has to be sufficient to reflect the possibility that this legal owner will not be able to fully recover (the value of) his asset. This is most clearly measured by the solvency rules which are established by the BIS under Basel II and Basel III whereby, if there is no solvency requirement, no Beneficial Ownership can be assumed. If there is a 1.6%, 8% or 100% solvency requirement it is clear that Beneficial Ownership can be assumed. If there is 0% solvency it will be debatable whether Beneficial Ownership can be established. In my view, Beneficial Ownership can be granted.

Although for a lot of professionals the Basel II and Basel III solvency rules as established by the BIS are unclear, these rules will give the possibility to establish the level of sufficient economic risk to be allocated to a structured transaction. Thereby an objective tool will be created to establish Beneficial Ownership which can be used in all tax systems around the world.