Clarification of the Meaning of “Beneficial Owner” in the OECD Model Tax Convention

Response from IBFD Research Staff

I  Introduction

The research staff of the IBFD welcomes this opportunity to engage in a discussion with the OECD about the meaning of the term “beneficial owner” as that term is used in the OECD Model Tax Convention (hereafter “OECD Model”). We hope that the following comments will provide a useful contribution to the work of the OECD in this respect and would be happy to provide further clarification of any of the points raised.

This response to the OECD’s discussion draft consists of three parts. Parts II and III are a direct response to the suggestions made by the OECD in the draft; Part II looks at the context of the current OECD Model in which the beneficial ownership concept is used and Part III considers the meaning of the term within that context. Part IV raises the wider issue of the attribution of income to a person in connection with treaties.

II  Beneficial ownership in the current OECD Model

(i) Autonomous treaty meaning or domestic law? The proposed changes to the Commentaries answer the long-standing debate as to whether the term “beneficial owner”, which is not defined in the text of the OECD Model, has an autonomous treaty meaning or whether it takes its definition from domestic law. The discussion draft invokes the exception to the general treaty interpretation rule of Art. 3(2), and states that the term should be interpreted in the treaty context because it was introduced to address potential difficulties arising from the words “paid to ... a resident” as used in Arts. 10(1) and 11(1) of the OECD Model. Given the mixed views on this issue, however, it is questionable whether the discussion draft provides enough evidence that the context in which the beneficial ownership concept is used in the OECD Model is sufficient to

1 The authors of this response were: Aleksandra van Boeijen-Ostaszewska, Jan de Goede, Luis Noel, Belema Obuoforibo, Joanna Wheeler and Wim Wijnen.
support the autonomous treaty meaning that the proposed Commentaries ascribe to the term.

(ii) Where should the definition be placed? The discussion paper proposes to expand on the definition of the beneficial ownership concept by making some additions to the Commentaries, but there are good arguments for adopting the broad lines of the definition in the Model itself, either in Art. 3 or in Arts. 10 – 12. One reason for doing so is the sheer importance of the beneficial ownership. Placing the definition in the Model itself would also emphasize that the concept has a definition that is specific to tax treaties.

An amendment to the Model would also provide a greater guarantee of a proper interpretation of the concept, at least in respect of future tax treaties based on the amended Model. The latter aspect may be particularly important for countries where the judiciary does not apply a dynamic interpretation of the Commentaries.

The definition proposed in the discussion paper is one which countries may have been reluctant to accept until now, as they may have wished to reserve the possibility of interpreting the term “beneficial owner” in a broader sense in the light of their anti-abuse doctrines. If, however, the OECD member countries are willing to agree to the proposed definition as described in the draft Commentaries, there is no obvious reason not to provide a basic definition in Model, particularly if the Commentaries state explicitly that the definition does not prevent the application of more general anti-abuse doctrines regarding treaty shopping as clarified in the Commentary on Art. 1.

III The meaning of the term “beneficial owner”

A - The substance of the definition

(i) General observations: The aim of the OECD to provide more clarity in respect of the beneficial ownership concept is a laudable one. Unfortunately the term has now acquired a large quantity of “definitional baggage”, which is far from consistent.\(^3\) It will be difficult to bring these sources into line with each other by changing only the Commentaries but, if it is the intention to set a new standard for the interpretation of the term, it would be useful to state this explicitly. In order to achieve this aim, it would also seem necessary for the Commentaries to address the issues that have arisen in the well-known case law that has developed in respect of beneficial ownership and indicate which elements are considered to be consistent or inconsistent with the proposed new text.

The proposed Commentaries state that the beneficial ownership concept was introduced to address potential difficulties arising from the words

“paid to ... a resident”. The use of one undefined term (beneficial ownership) to clarify another undefined term (paid to) invites confusion, however, particularly as the proposed amendments to all three Commentaries are essentially the same whereas Art. 12 no longer includes the “paid to” wording.

(ii) Ownership of the underlying assets: The proposed Commentaries state that the use and enjoyment of income should be distinguished from both the legal ownership and the use and enjoyment of the shares, debt claim or license in respect of which the income is paid. This statement accords with a well-known case decided in the Netherlands, but it does not accord with a common view that sees the beneficial ownership concept as an anti-avoidance measure. It would, therefore, be useful to provide some illustrations in this respect.

(iii) Technical meaning: The discussion paper states that beneficial ownership does not take a “technical” meaning from domestic law and gives trust law as an example of the source of such a meaning. It is far from clear, however, what is meant in the discussion paper by a “technical” meaning. In common-law countries the law relating to trusts is an integral and important part of the general body of property law. Is the discussion paper asserting that property law concepts should not be used in interpreting the beneficial ownership requirement? Does this assertion carry the implication that only tax law concepts may be used?

(iv) Trustees: The discussion draft describes a beneficial owner as a person who has “the full right to use and enjoy” income. This description presents severe problems in respect of trustees in receipt of trust income. One of the footnotes to all three proposed Commentaries states that trustees of a discretionary trust can be the beneficial owner where the dividends are not distributed to any beneficiary. The assumption seems to be that, by forbearing to distribute income, the trustees somehow acquire a "full right to use and enjoy" the income. But it is trite law that a trustee cannot have, qua trustee, full rights over the income, even if it is not distributed to a beneficiary. This example is completely inconsistent with the description of a beneficial owner in the main text of the suggested Commentaries.

(v) The full right to income: It is also possible that the right to use and enjoy income is divided in other situations. Case law in the Netherlands, for example has held that the economic ownership of income can be shared between two persons. In a case such as this, there is a danger that the description suggested in the discussion paper is too

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4 Hoge Raad 6 April 1994, nr. 28 638 (commonly known as the First Market Maker's case), BNB 1994/217 and IBFD Tax Treaty Case Law Database. The Hoge Raad decided that treaty benefits should be granted in respect of dividends paid on coupons, even though the company claiming the benefits was not the owner of the shares and even though it had paid a price to the original coupon holder which was, in effect, in lieu of the dividend.
5 Hoge Raad 22 November 2002, nr. 36 272 (commonly known as the Falcons case), BNB 2003/34, in which the Hoge Raad held that two persons were entitled to the participation exemption in respect of one payment of dividends as they shared the economic ownership of the dividends.
restrictive and that treaty protection would be lost altogether because neither person could claim to have the full right to use and enjoy the income.

**B - Treaty shopping and relationship with anti-avoidance measures**

One of the most important aspects of the proposed Commentaries is that they extend the concept of a nominee or agent beyond the strictly legal concept of such persons, to encompass also persons who are considered de facto to be in a comparable position. What the proposed Commentaries add in this respect to the broader view already taken in the existing Commentaries is, however, too simple and potentially goes further than intended.

Each Commentary states that the recipient of income is the beneficial owner where he “has the "full right to use and enjoy the [income] unconstrained by a contractual or legal obligation"” (emphasis supplied). This is a very wide form of words. There is a wide scale of obligations that can apply to a person in this respect, many of which should not prevent the person subject to the obligation from being the beneficial owner of the income he receives. Consider, for example, the following situations:

- a creditor obtains a court order which freezes the income of the debtor, so that the debtor is no longer able to dispose freely of his income;
- an individual is obliged to pay alimony to his former spouse. The individual's income consists of a limited salary and portfolio investment income, so that the obligation to pay alimony means, in effect, that he is no longer free to decide how to use part of that income.

It seems highly unlikely that the persons subject to the obligation in these examples are not the beneficial owner of the income received, yet the proposed Commentaries could be read as suggesting that these obligations do have this effect. Unfortunately the discussion paper does not draw out the crucial difference between obligations which should, and those which should not, change the beneficial ownership of income for treaty purposes. The important point is not the simple existence of an obligation that affects the income received, but rather the nature of that obligation. An obligation to apply, or spend, income, should not negate the beneficial ownership of the person receiving the income, but this situation should be distinguished from an obligation to pass the income received to another person.

The distinction between these two situations can be difficult to draw in respect of conduit structures. The current Commentaries, in a passage that is preserved in the texts suggested in the discussion paper, describes a company placed in a conduit structure as a “fiduciary”, but it is questionable whether a conduit structure really does have a fiduciary
character. Nevertheless, it is clear that a dividing line has to be drawn between a company that applies the payment it receives and a company that simply passes it through to another person.

It seems essential that some further illustrations are given of the situations in which the beneficial ownership concept would be appropriate to combat treaty shopping and situations in which other anti-abuse principles would be needed. The brevity of the proposed commentaries on this point is even more regrettable in the light of the mixed case law.

IV The wider treaty issue

The problems intended to be addressed by the beneficial ownership concept are only one set of issues raised by the attribution of income to a person. This topic has a much wider import than the beneficial ownership question alone and is of fundamental importance in the interpretation and application of treaties. Some of these wider questions, which are now starting to attract attention in the international forum, are explained briefly below.

(i) Conflicts of attribution to a person: It is far from clear how a treaty should be applied in the face of conflicting attributions of income to a person under the domestic law of states. The OECD’s Partnership Report deals with situations in which the conflict stems from differing determinations as to the person who is taxable in respect of income, but there is little authority on conflicts which stem from differing assessments of the qualitative connection between income and a person that leads to the taxation of the income in that person’s hands.

Such “qualitative” conflicts of attribution can arise for various reasons. One possibility is simply that two states have different basic principles for the attribution of income to a person in their domestic systems, with one state for example placing more emphasis on the legal entitlement to income and the other placing more emphasis on economic entitlement. A conflict can also arise due to the application of anti-avoidance legislation by one state. The matter is further complicated because attribution conflicts can arise in a wide range of constellations of source and residence states.

(ii) Ownership of income and tax liability in respect of income: Domestic anti-avoidance legislation sometimes taxes income in the hands of a person who is not the legal owner of income and who does not receive it, for example on the basis of a possibility that the person could receive the benefit of the income. A common example is legislation

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which attributes the income of a trust to the settlor for tax purposes if the settlor is able to revoke the trust.

A person who is subject to such a tax charge may be unable to claim treaty benefits in respect of the income, because the income is not “paid to” that person, as required by Arts. 10 and 11 OECD Model. The connection between the person and the income may also be too remote to be described as “ownership”, let alone “beneficial ownership”. Yet there is no obvious policy reason as to why a tax charge of this kind, imposed by the person’s residence state, should not give access to treaty benefits.

(iii) The role of the attribution of income to a person: Even more fundamentally, it is not clear what the role is of the attribution of income to a person for treaty purposes. For example, a state may have a personal service company regime which attributes the fees charged by a company directly to an individual who provides his services through the company. If a treaty partner state does not have a similar regime, there is clearly an attribution mismatch between the two states which has to be resolved for treaty purposes.

But what happens if the second state also adopts a personal service company regime which attributes the fees directly to the individual? Does the treaty issue simply disappear? Or does a treaty issue remain, because it is the company that is the legal owner of the fees, even though both states attribute them to the individual? In other words, is a treaty principle necessary only in order to resolve mismatches between the domestic law of states or are there autonomous attributions principles that apply for treaty purposes?